Tempting Trading Opportunities And Litigation Consequences

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Comments

1. Motivation

2. Contribution to literature

3. Research design and empirical issues
Research Question

• Do managers delay disclosure of bad news so as to trade profitably

• Does insider trading lead to greater costs for the firm in the form of high settlement costs

• Does this impose personal costs on managers in the form of management turnover
Contribution

• Potentially shed light on the debate over the relation between disclosure and litigation risk, with insider trading as an added dimension

• Potentially shed light on why many firms do not release bad news in a timely fashion
Sampling procedure

- Very careful data collection—painstaking hand collection of a variety of data fields (settlement data and insurance)

- Negative news sample: only those with extremely bad news (stock returns $<-35\%$) Does it limit generalizability?
Finding #1 Timeliness and insider trading

• Timeliness: defined relative to fiscal year end, not when managers are actually informed
  – Is there a better measure of timeliness?
  – Given the size of the news (35% price drop), it is hard to argue that managers were not aware of the news earlier. My guess is that both groups of firms, with or without insider trading, delayed the disclosure of bad news.

• The difference in timeliness between insider trading sample and control sample is small (mean dif =3 days, med dif=2 days).
  – Why do the insider trading firms delay the news just for a few days relative to the control firms? They should have had plenty of opportunities to trade earlier
Finding #1 Timeliness and insider trading

• Relation to previous literature
  – Noe (1999) finds that managers do not make insider transactions to profit from news about their firms before it becomes publicly available.
  
  – Kothari, Shu and Wysocki (2007) find that firms in general delay the release of bad news
Finding #2 Settlement and insider trading

- Lawsuits are costly
  - Settlement costs
  - Other costs to the firm

- Why not examine the relation between insider trading and the probability of being sued?
  - first order effect
  - Already have the sample
Finding #3 Insider trading and CEO Turnover

- Insider trading is measured in the year leading up to the bad news disclosure.
  - The window might not be a good proxy for the period over which the insiders actually concealed the news i.e., too much measurement error reduces the power of the test.
Additional Empirical Issues

• Definition of High Lit can be improved
  – The methodology mentioned in Fields et al (2005)
  – Rogers and Stocken (2005)

• Model 5: Timeliness regression (Table 6)
  – One of the explanatory variable, “Fall”, which measures the 3-day window disclosure return, is potentially endogenous. It is actually affected by timeliness.

• Model 6: Settlement equation (Table 7)
  – One of the explanatory variables, insurance, is expressed as a percentage of settlement, inducing a mechanical relationship
  – The second specification, settlement – insurance, yields weaker results on insider trading

• Model 7: Turnover equation (Table 8)
  – Need to control for firm performance