PERKS OR PEANUTS

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OVERVIEW OF THE PAPER

- What does the paper show?
  - The *dollar* profits to the typical insider is small
  - The likelihood of a round-trip trade just longer than six months are much more likely than those just short of it
    - The former are also more profitable on average
  - Effect of governance / SEC enforcement on insider trading not consistent across returns and dollar profits to insiders
- Why do we care?
  - Does corporate insider trading represent a meaningful source of private benefits?
  - Magnitude of costs imposed on other market participants

WHAT I LIKE ABOUT THE PAPER

- First paper to look at the comprehensive insider trading sample from a *dollar profits* perspective
  - Most of the previous literature has focussed on abnormal returns, but not dollar profits

- Lots of interesting empirical patterns documented

COMMENT 1: WHAT DO WE LEARN FROM THE PAPER

- Is this the right analysis for magnitude of costs imposed on market participants?
- Probably not, since one needs to account for the size of the insider trades in relation to the overall trading in the market for a particular stock
- Jeng. et. al. (2003) already do this exact analysis

- **Suggestion:** Don't try to sell the paper on this angle and stick to looking from the perspective of insiders in terms of dollar profits

COMMENT 2: ARE DOLLAR PROFITS SURPRISINGLY SMALL?

- Average yearly abnormal dollar profit to insider = \$12,000
  - Profit here = trade size x 21-day abnormal returns after trade
- Average abnormal returns = 0.9%
  - Can't be the surprising part, since enormous prior literature on insider trading has looked at abnormal returns
- Average yearly value traded = \$1.68 Mn
- Quick calculation: 1.68 Mn x 0.9% = \$15,120
- Is \$12,000 of yearly profit surprisingly small?
  - Is the gap between \$15K and \$12K *surprisingly* large?
  - Or is the yearly value traded *surprisingly* small?

MEDIAN VS MEAN

- Is median the right thing to look at?
  - If yes, you need to explain better why this is the case
- Let’s say 20% of the trades are informed and 80% are not.
  - Assume average returns of 80% of the trades is 0%. Assume 20% of the trades make high profits.
- Then the median of the whole distribution captures the 75th percentile of the profits of the non-informed trades
  - While the mean captures: probability of informed trade x profit conditional on trade being informed
- Even then, median trade size x median abnormal return = $1,338 (v.s. median abnormal return of $464)

COMMENT 2: ARE DOLLAR PROFITS SURPRISINGLY SMALL?

- Is the mean yearly value traded of \$1.68 Mn surprisingly small?
  - Ahern (2017) finds that average dollar value invested per tip in the SEC prosecuted insider trading cases (not just corporate insiders) is \$1.69 Mn
- If an insider did have information that would be revealed within 21 days, how much would he invest?
- **Thought:** Have a (simple) model on what the trade size and dollar profits should be to benchmark against
  - Merton portfolio choice type model?
  - Wouldn't account for deterrence of having to reveal his trade publicly

COMMENT 3: INSIDERS CAN GAIN EVEN FROM NON-TRADING

- Both measures of insider profits miss out a source of gain to the corporate insider
- Consider the following:
  - A past stock grant just vested
  - Insider knows stock price is going to go up this year, so holds on
  - At the end of the year, insider knows stock price will increase more and continues to hold
  - After two years, stock price has gone up and seems fair. Insider sells for diversification reasons. No abnormal returns following sale.
- In this case neither of the two measures would capture the gain to the insider from his insider knowledge

COMMENT 3: INSIDERS CAN GAIN EVEN FROM NON-TRADING

- Even if the insider knows that stock prices will go up, he may not buy stock because he may already have (vested and non-vested) equity exposure
  - His trade sizes might seem "too small" for purchases
- **Suggestion:** Create another measure of insider gain that takes into account the change in inventory value
  - Form 4 also have "inventory" information
  - Round trip trade profit measure: If an insider buys 100K shares and prices go up 20% over the next two years, during which he is still filing forms, but no sale. If you do not observe any sale at all (perhaps because the sale is after he is no longer required to file Form 4) what is a better assumption for expected profits?: zero or 20% x initial investment?

COMMENT 4: DISCONTINUITY AROUND 6-MONTH ROUND TRIP TRADES

- Paper finds: Rounds trip trades of slightly longer than 6 months is much more likely than slightly shorter.
  - Short-swing rules require insiders to disgorge any profits on trades in opposite direction within a six month period
  - **Proposed interpretation:** this shows insiders trade with an intention to make profits
- Consider the following: I purchase shares because I have am below holding requirements of 3 x salary. Stock price goes up 20% after five months, so the constraint is relaxed and I am free to sell some of the shares. My decision: sell now and pay "20% tax" or sell one month later and pay no tax.
  - Discontinuity pattern around 6-month threshold can arise even trades are not motivated by turning a profit

FINAL THOUGHTS

- The third section of the paper, which examines effect of stronger enforcement on abnormal returns vs. dollar profits is quite interesting
  - Would benefit from motivating empirical tests after thinking through some hypotheses

- Overall, I think this is very promising work
- In spite of a large insider trading literature, the authors have a come up with novel way of looking at the data - dollar profits and not abnormal returns
- Lots of interesting empirical patterns documented

THANK YOU!

FIRST MEASURE

- Basically what the paper is saying is insiders do not make profits over the next 21 days after the trade
- Note that trade is revealed to the public. So very obvious, large, and explicit timing is difficult
- Ke, Huddart, and Petroni (2003) show insiders can trade upon information disclosures for as long as two years in advance
- Nevertheless, I think there is value to showing that despite the abnormal returns in the month following insider trades shown in the literature, the dollar gains are small

SECOND MEASURE

- For majority of the cases, you do not see the reversing trade
- Trades with buy but not sell
- What fraction of the shares are being captured

- Consider an insider who is granted shares. Knows stock is undervalued and doesn't sell for two years. When stock reaches fair value, he sells. You only capture the sell transaction and no abnormal returns following it, but miss out on the *hold* decision based on information.
- Benchmark is not zero