

## **Discussion of**

# **Watching the Watchdogs: The Information Content of SEC Interactions**

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# Motivation

- Existing literature on SEC oversight uses data from SEC to study **official investigations** and/or **enforcement actions**
- Necessarily ignores **~ 50%** of **Matters Under Inquiry (MUI)** that *“conclude without escalation to a formal investigation and **leave no public record**”*
- Observing when MUIs begin *would allow us to learn more about extent of SEC oversight...*
- *... determine how much bad news is impounded into stock prices during informal investigations...*
- *... and extent to which insiders sell shares during MUIs*

# This (Very Cool) Paper

- **How can we observe that which leaves no public record?**
- Use smartphone geolocation data to identify SEC visits to Firms **and** Firm visits to SEC → **“SEC-Firm interaction”**
- SEC-Firm interactions predict both formal investigations and enforcement actions
- SEC-Firm interactions predict negative returns over next 3 months... which is before most formal investigations begin
- SEC-Firm interactions reduce likelihood of insider sales...
- ... but those who sell avoid 3 month abnormal returns between -3.2% and -6.3% → **“fortune favors the bold”**

# 1. Signal Strength?

- 17.0% of firms visited by SEC (398 of 2,342 firms)
- 22.1% of firms interact w/ SEC (524 of 2,367 firms)

		<b>During</b>	<b>Post</b>
SEC Formal Investigation	Visited by SEC	<b>11%</b>	<b>9%</b>
	Interact w SEC	<b>13%</b>	<b>11%</b>
	Neither	<b>9%</b>	<b>8%</b>

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- How many MUI does authors' algorithm miss? Don't know. Most investigations begin without measurable interaction
  - **8% \* 1,843 = ~ 147** while **11% \* 524 = ~ 58**
- Visits to SEC less common, but less prone to false positives?

# 1. Signal Strength? *(cont.)*

- Enforcement Actions are rare!

		<b>During</b>	<b>Post</b>
SEC Enforcement Action	Visited by SEC	<b>2%</b>	<b>6%</b>
	Interact w SEC	<b>2%</b>	<b>6%</b>
	Neither	<b>1%</b>	<b>3%</b>

- Even during Post sample period, only ~ 31 of 525 SEC-Firm interactions result in enforcement action
- Would be interesting to distinguish Visited by SEC from Visit to SEC... but lack of decimal places makes it difficult for me to calculate meaningful conditional probabilities

## 2. False Positives?

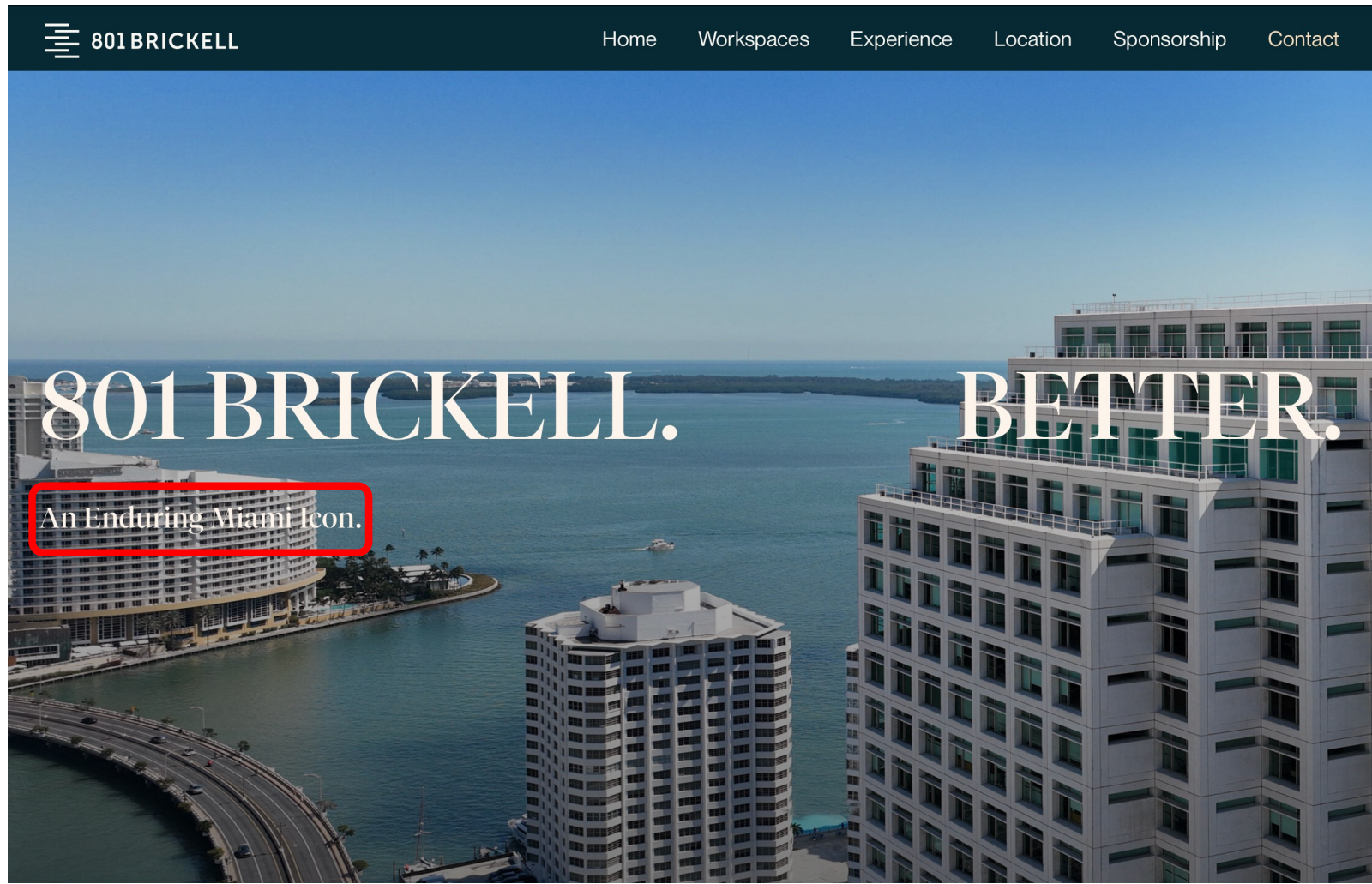
- Authors focus on smartphones appearing inside buildings containing SEC regional offices... **but most office buildings contain LOTS of other tenants**

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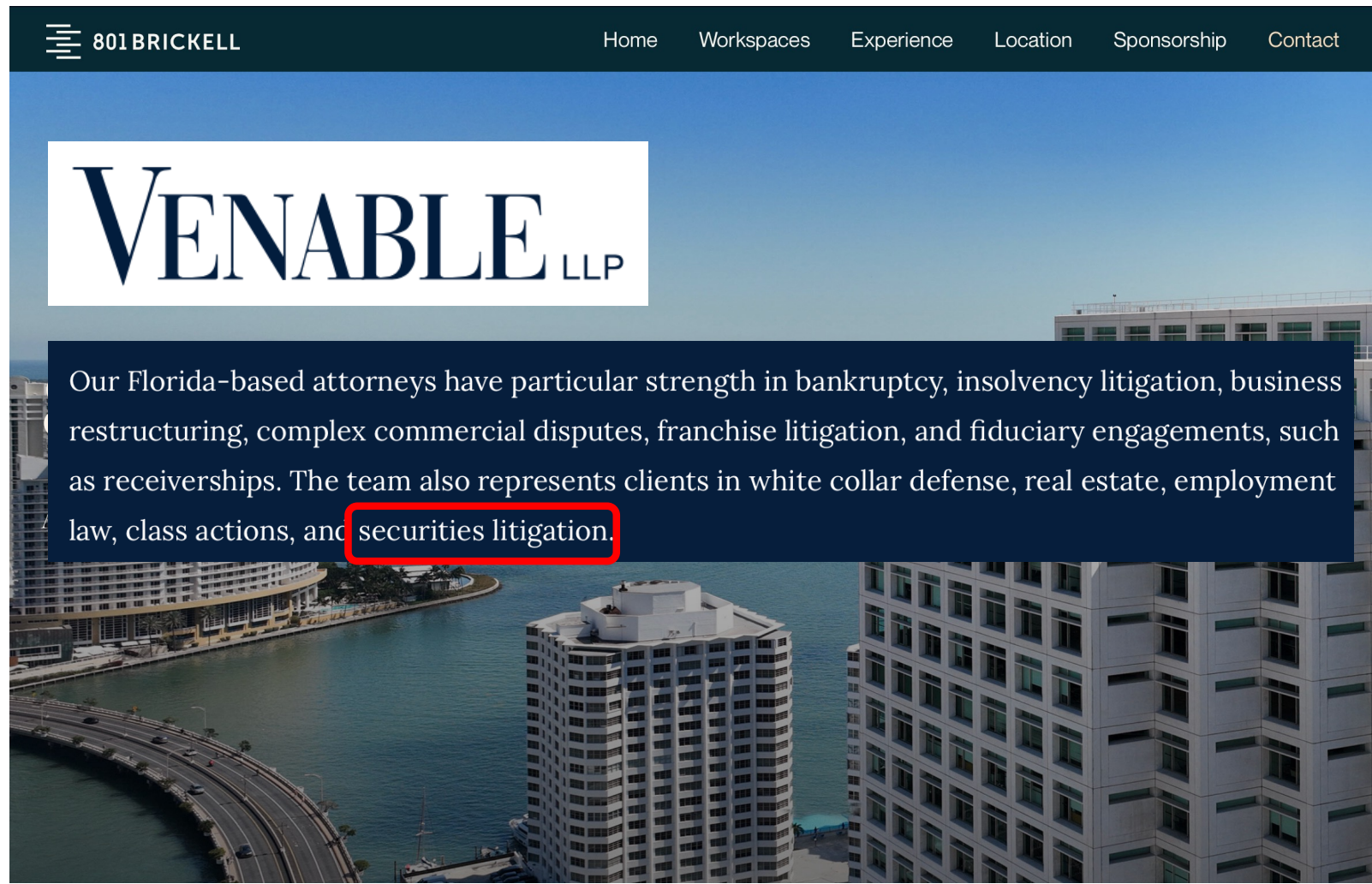
## 2. False Positives?

- Authors focus on smartphones appearing inside buildings containing SEC regional offices... but most of the buildings contain law firms, etc.
- **1961 Stout Street in Denver** is Byron G. Rogers Federal Building & U.S. Courthouse, which houses 11 federal agencies → **few/no false positives**
- **801 Brickell Avenue in Miami** is prestige address with at least one major law firm → **potential for false positives**
- **33 Arch Street in Boston** contains *law firms and other firms that companies might hire when experiencing crises* → **greater potential for false positives**

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# Miami Regional Office?



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If Iron Mountain trucks show up at my office, I might decide to sell some shares and there might never be an SEC investigation, informal or otherwise

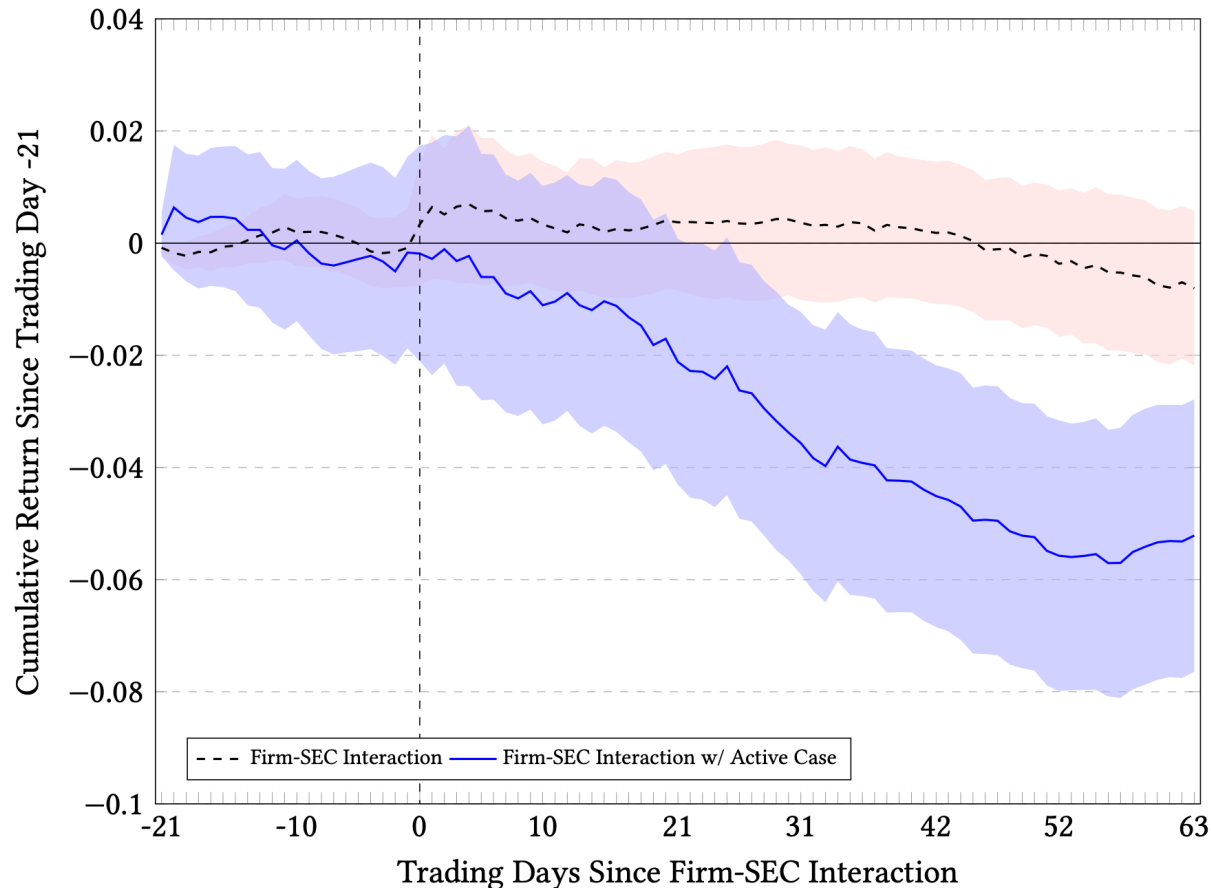
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# 3. Abnormal Returns for Whom?

- SEC-Firm interactions predict negative returns over next 3 months... which is before most formal investigations begin



But most of the abnormal returns are experienced by firms that SEC chose to formally investigate... at least in the full sample (*Figure 4*)

## 4. Returns to Insider Trading?

- Consistent with increased oversight, SEC-Firm interactions reduce likelihood of insider sales
  - Exception: Non-officer sales in “Reporting Companies Sample”... possibly in response to Iron Mountain trucks
- Nevertheless, insider sales around SEC-Firm interactions predict negative 3-month returns of between **-3.2%** (Full Sample) and **-6.3%** (Reporting Companies Sample)
- If we presume these are illegal sales based on inside info, it begs the question: **How many dollars are being “earned” by these insider sales? Enough to justify the risk?**

## 4. Returns to Insider Trading? *(cont.)*

- **Martha Stewart** sold 230,000 shares of ImClone (IMCL) on Thursday, December 27, 2001 at \$58.30
- IMCL closed at \$55.25 on Friday, December 28, before its failure to obtain FDA approval was announced
- IMCL closed at \$46.46 on Monday, December 31, the first trading day after the announcement
- IMCL closed around \$19.00 by the end of January 2002
- So, Martha “saved” **\$2.7 million** from insider sales over 3 trading days and **\$9.0 million** over about 1 month
- **What are ballpark savings of insiders in this paper?**

# 5. Other Questions

- **What more can we learn about the likelihood an informal investigation is escalated?**
  - *Do larger negative returns during MUI predict formal investigations/enforcement?*
  - *Do more or more profitable insider sales during MUI predict formal investigations/enforcements?*
  - *Do political contributions from firms prevent MUI from becoming formal investigations/enforcements?*
- **Next application of geolocation data? Determine which firms Iron Mountain shredders visit in the dead of night!**

# Conclusion

- Clever idea to use smartphone geolocation data to infer beginnings of informal SEC investigations
  - Going to miss the (many?) MUI that begin without office visits... which may be more common in some industries than others
  - Going to end up with some interesting false positives... where the likelihood of a false positive is likely to vary across regional offices
  - I'd like more statistics on Visited by SEC only versus Visits SEC only versus Visited by SEC and Visits SEC
- **Good luck with the paper... on the river!**