Session 23

Information Trading: Following the Insiders

Test

1. In publicly traded firms in the US, which of the following are classified as insiders by the Securities Exchange Commission (SEC)?
    a. Directors in the company
    b. Managers and executives in the company
    c. Owners who own more than 5% of the outstanding shares in the company.
    d. Investment banks/Consultants to the company
    e. All of the above
2. Looking at studies on insider buying/selling, which of the following conclusions would you draw from them?
    a. Stock prices are unaffected by insider buying (selling).
    b. Stock prices go up after insider buying and down after insider selling.
    c. Stock prices go down after insider buying and up after insider selling.
    d. Stock prices go up more at companies where there is insider buying than they do at companies where there is insider selling.
3. If you decide to track insider trading, which of the following measures of insider activity would you use?
    a. Total shares bought by all insiders
    b. Total shares bought by top executives and directors.
    c. Net shares traded (shares bought – shares sold) by all insiders
    d. Net shares traded (shares bought – shares sold) by executives and directors.
4. In which of the following types of companies will tracking insider trading yield the biggest payoff?
    a. Small, lightly followed companies in risky, changing businesses
    b. Large, heavily followed companies in risky, changing businesses
    c. Small, lightly followed companies in stable, predictable businesses
    d. Large, heavily followed companies in stable, predictable businesses
5. Assume that you want to track illegal insider trading, rather than legal insider trading. Which of the following would you use as an indication of illegal insider activity?
    a. A sudden increase in trading volume on the stock
    b. An unexplained large increase/drop in the stock price
    c. Increased activity in the options listed on the stock
    d. A surge in institutional buying or selling on the stock
    e. All of the above

Solution

1. In publicly traded firms in the US, which of the following are classified as insiders by the Securities Exchange Commission (SEC)?
    a. Directors in the company
    b. Managers and executives in the company
    c. Owners who own more than 5% of the outstanding shares in the company.
    d. Investment banks/Consultants to the company
    e. All of the above

Explanation: The definition of insider is broad and essentially covers anyone who has access to non-public information about a company (while having a fiduciary relationship with the company).

2. Looking at studies on insider buying/selling, which of the following conclusions would you draw from them?
    a. Stock prices are unaffected by insider buying (selling).
    b. Stock prices go up after insider buying and down after insider selling.
    c. Stock prices go down after insider buying and up after insider selling.
    d. Stock prices go up more at companies where there is insider buying than they do at companies where there is insider selling.

Explanation: The average returns are positive for both the insider buying and insider selling groups, but they tend to be more positive for the former.

3. If you decide to track insider trading, which of the following measures of insider activity would you use?
    a. Total shares bought by all insiders
    b. Total shares bought by top executives and directors.
    c. Net shares traded (shares bought – shares sold) by all insiders
    d. Net shares traded (shares bought – shares sold) by executives and directors.

    Explanation: Insider trading by top managers is more informative than trading by lesser employees and it is the net trading that matter.

4. In which of the following types of companies will tracking insider trading yield the biggest payoff?
    a. Small, lightly followed companies in risky, changing businesses
    b. Large, heavily followed companies in risky, changing businesses
    c. Small, lightly followed companies in stable, predictable businesses
    d. Large, heavily followed companies in stable, predictable businesses

Explanation: The payoff to tracking insider activity seems to be highest at companies where there is less external information (from analysts) about the company and where there is more uncertainty about future prospects.

5. Assume that you want to track illegal insider trading, rather than legal insider trading. Which of the following would you use as an indication of illegal insider activity?
    a. A sudden increase in trading volume on the stock
    b. An unexplained large increase/drop in the stock price
    c. Increased activity in the options listed on the stock
    d. A surge in institutional buying or selling on the stock
    e. **All of the above**

   Explanation: When insiders trade in large quantities, you should see it reflected in volume and price. Since institutions sometimes have better mechanisms for tracking insiders, their trading may also give you a leading indicator.