Merger Announcements and Insider Trading Activity in India: An Empirical Investigation

REFEREE REPORT 1

This paper proposes to analyze the incidence of insider trading by looking at cumulative abnormal returns prior to a sample of mergers in India. It is proposed that if the CARs portray a drift prior to the merger, there is evidence that insiders are capturing gains in advance of the impending acquisition.

I believe that the issue of whether there is evidence of insider trading in India is an important one. But I am not sure the methodology adopted by the authors is suited towards addressing this issue. For example, the authors themselves point out that Jarrell and Poulsen (1989) suggest that legitimate sources such as media speculation and bidders' purchase of shares in the target contribute to the share price runup. However, the authors do not indicate how they would control for these factors that contaminate attempts to attribute CARs to insider profits. Similarly Seyhun (1986) is cited as finding that insider profits are generally small. Also, Givoly and Penman (1985) suggest that uninformed piggybacking on insider trades contributes to the appearance that insiders are making money. The authors also need to look at recent literature on insider trading (for example, Bhattacharya, et al., JFE Jan 2000; Chakravarty/McConnell, JFQA, June 1999; Eckbo/Smith, JF, April 1998) to see how these studies fit in with he authors' hypothesis and investigation. For example, Bhattacharya et al present strong evidence of insider trading around mergers. Chakravarty/McConnell however indicate that insider trading profits are small. Also, the authors should attempt to procure a copy of a working paper by Arturo Bris at Yale who is looking at insider trading around mergers for a variety of countries around the world (including India).

The authors also do not indicate whether the parameters (alpha and beta) of the market model would be estimated in-sample or out of sample. I believe it is standard practice to estimate them out of sample to avoid problems of shifting beta risk due to the event itself. I also suggest the authors read up the Brown and Warner papers in the JFE (1980, 1985) to incorporate the discussion of the event study methodology.

In sum, I have three main suggestions for the authors (1) More convincing evidence must be provided that the CARs are actually associated with insider profits (2) A more recent literature review must be provided, and issues raised by this literature must be explicitly discussed in the proposal

Any important issues raised by this literature must also be incorporated into the study (3) The methodological issues must be more carefully examined (how to estimate alpha and beta, e.g., over what horizon, what do with heteroskedasticity of the error terms).