DETERMINANTS OF INVESTOR REACTION TO ANNOUNCEMENT OF SEC 10B-5 LAWSUIT

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Abstract

The Private Securities Litigation Reform Act (PSLRA) of 1995 requires SEC 10b-5 lawsuits to cite facts supporting a strong inference of fraud but there is little evidence of an association between the market's reaction to SEC 10b-5 lawsuit filing announcement and lawsuit filing attributes that give rise to an inference of fraud. Using a sample of 296 SEC 10b-5 lawsuits between 1996 and 2005, this study examines the relation between lawsuit attributes used to form fraud inferences and 3-day abnormal returns around SEC 10b-5 lawsuit announcement. We report a more adverse market reaction to SEC 10b-5 lawsuit announcement when the auditor of the firm is charged in the lawsuit. We also document the 'deep pocket effect' in the announcement returns with a more negative market reaction for larger firms as well as firms with lower leverage. Collectively, the results suggest that auditor liability is considered as a strong inference of fraud and investor anticipation of litigation costs

influence the market's reaction to securities lawsuits in the post-PSLRA period.

1. INTRODUCTION

The securities lawsuit filing announcement effect has been documented to contain new and additional information to the market beyond the misstatement revelation information. Amoah (2011), Ferris and Pritchard (2001) and Griffin, Grundfest and Perino (2004) report significantly negative 3-day abnormal returns around securities lawsuit filing announcements. Furthermore, Griffin, Grundfest and Perino (2004) find that the market reacts more negatively to SEC 10b-5 lawsuits compared to other types of lawsuits and they also report substantial variation in the abnormal returns. Although the literature provides evidence that the market considers SEC 10b-5 lawsuits as more adverse compared to other types of lawsuits, there is scant evidence of factors that explain the variability in SEC 10b-5 lawsuit announcement returns.[1]

Lawsuit filing characteristics that are cited to support an inference of fraud may be associated with the market's reaction to SEC 10b-5 lawsuit filing announcement following the Private Securities Litigation Reform Act (PSLRA) of 1995.[2] The PSLRA provisions affected SEC 10b-5 lawsuits to a greater extent compared to other types of lawsuits.[3] For example, the PSLRA requires SEC 10b-5 lawsuit filings to provide specific facts that support a strong inference of fraudulent intent otherwise the

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[1] Ferris and Pritchard (2001) examine the relation between fraud allegations in lawsuit filings and investor reaction to securities lawsuit but they do not use a SEC 10b-5 lawsuit sample and it is not clear whether their results apply to the post-PSLRA period.

[2] Securities lawsuits could also be brought under Sections 11, 12 and 15 of the Securities Act of 1933. Sections11, 12 and 15 lawsuits charge issuers, officers and directors and underwriters for issuing a registration statement and prospectus that contained material misrepresentations and/or omissions.

[3] For Section 11 lawsuits, the PSLRA amended the joint and several liability provisions to proportionate liability of defendants.

lawsuit will be dismissed. Moreover, SEC 10b-5 lawsuits must prove scienter under the PSLRA but this requirement does not apply to other categories of securities lawsuits.[4] Because of the greater impact of the PSLRA on the merit and outcome of SEC 10b-5 lawsuits, we expect that the observed variation in SEC 10b-5 lawsuit announcement returns will be associated with the lawsuit filing attributes that support an inference of fraud.

Using a sample of SEC 10b-5 lawsuits between 1996 and 2005, this study examines the relation between lawsuit characteristics that give rise to a fraud inference and investor reaction to SEC 10b-5 securities lawsuit. We focus on SEC 10b-5 lawsuits because they represent the most appropriate measure of ongoing litigation activity (Aganin, 2006) and we consider the roles of equity issue and abnormal insider trading, which are the lawsuit attributes that are commonly used to sustain fraud inferences. We also investigate whether auditor liability and the 'deep pocket effect' explain the variation in SEC 10b-5 lawsuit announcement returns.

The empirical results indicate that the naming of the firm's auditor as a defendant in the lawsuit is associated with a more negative investor reaction to SEC 10b-5 litigation announcement. Furthermore, investor reaction around the end of the class period date is positively associated with the market reaction to the SEC 10b-5 lawsuit.[5] Deep pocket effects are also documented in the market's reaction to SEC 10b-5 lawsuit announcement with the market's reaction being more negative for larger and lower leveraged sued firms. Taken together, the findings suggest that auditor liability supports a strong inference of fraud and investor anticipation of litigation and monitoring costs influence the market's reaction to securities lawsuits in the post-PSLRA period.

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[4] Scienter is the mental state that embraces intent to deceive, manipulate, or defraud.

[5] The class period is the time framework during which the alleged fraud occurred.

The remainder of this study is organized as follows. Section 2 presents the background and related research. Section 3 describes the hypotheses and model overview. Section 4 describes the empirical results and Section 5 presents the summary and conclusion.

2. BACKGROUND AND RELATED RESEARCH

SEC 10b-5 lawsuits allege that the defendants violated Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 by issuing a series of material misrepresentations to the market about the firm's financial condition thereby artificially inflating the stock price and causing losses to purchasers of the firm's stock during the class period.[6] Typically, SEC 10b-5 lawsuits are filed following the announcement of an accounting misstatement and there is evidence in the literature that the probability of a securities lawsuit is higher for more adverse accounting misstatements.

Palmrose, Richardson and Scholz (2004) and Griffin, Grundfest and Perino (2004) document a significantly negative reaction to the announcement of an accounting misstatement and Lev, Ryan and Wu (2008) find a negative relation between the 3-day restatement announcement abnormal returns and the probability of securities lawsuit. Palmrose and Scholz (2004), Hennes, Leone and Miller (2008) and Amoah and Tang (2010) document a positive association between accounting misstatements due to accounting irregularity and the probability of a securities lawsuit.

In addition to the accounting misstatement characteristics, lawsuit attributes typically cited as inferences of fraud have been reported in the literature as increasing the likelihood that an accounting misstatement will trigger a securities lawsuit. Evidence

[6]The defendants are usually the issuing firm and its officers and directors. In some instances the auditor, underwriter of any security issuance and analyst are also cited in the securities class action complaint.

from Ducharme, Malatesta and Sefcik (2004) suggests that a stock offer spurs aggressive earnings manipulation which in turn is positively associated with the likelihood of a securities lawsuit. Peng and Roell (2008) document abnormal insider trading during the class period of securities litigation firms compared to the non-class periods. Johnson, Kasznik and Nelson (2000) and Billings (2008) also find a positive relation between abnormal insider trading and the probability of securities lawsuit.

The PSLRA has increased the role of lawsuit characteristics (cited as inferences of fraud) in the filing and the resolution of securities lawsuits. The PSLRA raised the threshold for the strength of fraud inferences in securities class actions, particularly SEC 10b-5 lawsuits, and increased the likelihood that lawsuits that lack merit would be dismissed (Johnson, Kasznik, and Nelson, 2000; Johnson, Nelson and Pritchard, 2007; Choi and Thompson, 2006; Morris, 2009). Under the PSLRA, it is insufficient to allege that the defendants negligently made misrepresentations or negligently failed to disclose a material fact (Choi, 2007). Plaintiffs may recover monetary damages only when they provide proof that the defendant acted with scienter and they state the specific facts that support a strong inference that the defendants acted with scienter (Johnson, Nelson and Pritchard, 2007). The PSLRA further provides that the plaintiff has the burden of proving that the act or omission of the defendant caused the loss for which the plaintiff seeks to recover damages (Choi, Nelson and Pritchard, 2007).

The PSLRA's elevation of the role of fraud-inference lawsuit attributes in the outcome of SEC 10b-5 lawsuits implies that auditor liability, equity issue and abnormal insider trading allegations could explain the variability in SEC 10b-5 lawsuit announcement abnormal returns. According to Ferris and Pritchard (2001), the market considers the filing of the lawsuit as a significant event and the market reaction to the lawsuit filing announcement is influenced by investor perception of the economic impact of the lawsuit on the sued firm. Ferris and

Pritchard (2001) and Griffin, Grundfest and Perino (2004) report an average 3-day excess return of -3.47 percent and -4.1 percent, respectively, around the announcement of a securities lawsuit filing. Furthermore, Griffin, Grundfest and Perino (2004) also report a correlation between investor reaction to securities lawsuit announcement and the litigation monetary penalty. Thus, if auditor liability and abnormal insider trading and equity issue allegations increase the merit of a SEC 10b-5 lawsuit, then we expect that the presence of these lawsuit attributes in a SEC 10b-5 lawsuit filing will result in a more negative SEC 10b-5 lawsuit announcement effect.

3. HYPOTHESES AND MODEL OVERVIEW

To investigate the determinants of investor reaction to SEC 10b-5 lawsuit abnormal returns, our model includes lawsuit filing and firm characteristics that we expect are associated with the market reaction to SEC 10b-5 lawsuit announcement. In our consideration of information conveyed by the SEC 10b-5 lawsuit filing announcement, we focus on attributes of the lawsuit typically cited to support an inference of fraud and also on whether the auditor is a defendant in the lawsuit.

Our first variable is whether or not there is abnormal selling of shares by insiders (AbTrad) during the accounting misstatement period, 0, otherwise. Generally, when abnormal insider trading is used to support an inference of fraud, the lawsuit filing contains information about alleged insider trading at a suspicious time or in an unusual amount.[7] AbTrad is included in the models based on the expectation that the presence of abnormal insider trading allegation within the SEC 10b-5 lawsuit filing increases the merit of the fraud allegations and the probability that the lawsuit will be settled.

[7] In securities lawsuit filings that allege abnormal insider trading, data on defendants' insider trading during class periods and non-class periods, insider stock ownership and changes in the defendants' equity holdings during the class period are provided to support the allegation.

Abnormal insider trading during the class period is also considered as an indication of greater losses to shareholders and lawsuit merit (Amoah, 2011). Consistent with this view, Billings (2008) reports a positive relation between abnormal insider trading prior to revelation of negative earnings-related news and lawsuit settlement. Accordingly, we expect that investors will react more negatively to SEC 10b-5 lawsuit announcements that include abnormal insider trading complaint.

The next fraud related lawsuit variable is whether or not the lawsuit filing contains an equity issue related fraud allegation (Equity Issue). Financial misreporting prior to a stock offer arguably inflates the stock price of a firm and increases the proceeds from the stock offer (Amoah, 2011). Rangan (1998), Teoh, Welch and Wong (1998a), Teoh, Welch and Wong (1998b) and Ducharme, Malatesta and Sefcik (2004), find that a stock offer motivates earnings manipulation to increase the proceeds from the stock issue. Disclosure of the true financial condition of the stock offering firm after the firm has received funds from the stock issue could therefore be perceived as a strong indication of the intent of the defendants to defraud purchasers of the stock of the issuing firm. Given that a stock offer during the class period could give rise to a strong inference of fraud and influence the outcome of SEC 10b-5 lawsuit, it is expected that investors will react more negatively to SEC 10b-5 lawsuit announcement that includes a stock-offer-related fraud allegation.

The next variable that is included in our model is whether or not the auditor is a defendant in the SEC 10b-5 lawsuit. According to Geiger, Raghunandan, Rama (2006), the PSLRA has significantly reduced the liability exposure of auditors in lawsuits involving client firms. Given that auditors are less likely to be cited in a frivolous lawsuit because auditor liability was reduced under the PSLRA, shareholders should cite the auditor as being complicit if there is strong evidence that the auditor committed fraud by knowingly issuing a more favorable audit report.

In addition to being less likely to be frivolously filed in the post-PSLRA period, auditor liability should support a strong inference of fraud because it suggests auditor and management complicity in the alleged fraud to produce substandard financial statements. Bonner, Palmrose and Young (1998) find that auditor litigation is more likely to occur when there are common cases of fraud or fraud arises from fictitious transactions. Thus, we expect that investors will perceive auditor litigation as a strong indication that the lawsuit has merit and will react more negatively to the SEC 10b-5 lawsuit announcement when the auditor is named as a defendant in the lawsuit.

We include Class Period in our model consistent with Ferris and Pritchard (2001) who find that the Class Period is negatively associated with the 3-day abnormal returns around the securities litigation announcement. Class Period is the number of days between the date the accounting misstatement is first misreported and the date the accounting misstatement is revealed.

The next variable in our model is the 3-day investor reaction around the end of the class period, $ECP_{(-1,1)}$. $ECP_{(-1,1)}$ is the cumulative abnormal return measured over the three-day interval beginning on the day prior to the date the misreporting is revealed. Following Griffin, Grundfest and Perino (2004), we include $ECP_{(-1,1)}$ in the regression model because it is a measure of the seriousness of the misstatement and the expected monetary penalty. Griffin, Grundfest and Perino (2004) document a positive relation between 3-day cumulative abnormal returns around litigation and misstatement disclosure announcements.

Based on the deep pockets hypothesis, firm size and leverage are included in the model. According to the deep pocket hypothesis, firms that have a greater ability to bear litigation costs are more vulnerable to lawsuits and should incur greater monetary and market penalty (Harper and Adams, 1996). Consistent with the deep pockets hypothesis, we expect that the market will react more negatively to SEC 10b-5 lawsuit announcement when the sued firm is larger in size or lower leveraged because larger firms and lower

leveraged firms should have a greater capacity to cover litigation costs. Similar to Gande and Lewis (2009) and Billings (2008), our firm size measure is the log of market value of equity (LnMV). Leverage is the ratio of total liabilities to total assets. Accordingly, the regression model is presented in the following equation:

$$\text{Litig}_{(-1,\,1)} = \alpha + \beta_1 \text{AbTrad} + \beta_2 \text{Equity Issue} + \beta_3 \text{Auditor} + \beta_4 \text{Class Period} + \beta_5 \text{ECP}_{(-1,\,1)} + \beta_6 \text{Size} + \beta_7 \text{Lev} + \varepsilon$$

Sample Selection

Table 1 shows the sample selection procedure. Beginning with 2,551 securities class actions identified from the Stanford Securities Class Action Clearinghouse database between 1996 and 2005, we search through the CRSP and Compustat databases, respectively, for event studies and firm characteristics data. Application of the CRSP and Compustat data criteria results in the deletion of 1,665 lawsuits from the sample. We read each lawsuit filing to verify that it is a SEC 10b-5 lawsuit and we also obtain the lawsuit filing date, end of class period date and fraud allegations data. Lawsuit filing data from the Stanford database is verified using the Lexis Nexis database and SEC filings. Exclusion of lawsuits with incomplete data and non-SEC 10b-5 lawsuits further reduces the sample by 590 lawsuits and results in a final sample of 296 SEC 10b-5 lawsuits.

Table 1

Description	Number
Securities Lawsuits from the Stanford Database (1996-2005)	2551
Lawsuit firms without CRSP and Compustat data	1665
Missing lawsuit filing data and non-SEC 10b-5 lawsuits	590
Litigation sample	296

4. EMPIRICAL RESULTS

Table 2, Panel A presents descriptive statistics of the continuous variables for 296 SEC 10b-5 lawsuit firms. The mean (median) Class Period of 411 (299) days in this study is comparable to the 411 (296), respectively, reported by Griffin, Grundfest and Perino (2004). Mean (median) of the ratio of total liabilities to total assets (Lev) is 0.5566 (0.5615) and the mean (median) log of market value of equity (LnMV) is 4.9493 (4.5018).

Table 2

Panel A: Continuous Variables (N=296)

Variable	Mean	Median	Min	Max	Std. dev.
Class Period	411	299	0	1814	362
Lev (TL/TA)	0.5566	0.5615	0.0441	1.5058	0.2506
Size (LnMV)	4.9493	4.5018	-3.1010	12.6421	3.6289

Panel B: Binary Variables (N=296)

	Number of firms	Percentage	Sample Size N
Auditor	31	10.47	296
Equity Issue	94	31.76	296
AbTrad	135	45.61	296

Panel A presents descriptive statistics of the continuous variables and **Panel B** reports descriptive statistics of the binary variables. **Class Period** equals the number of days between the initial misstatement date and the revelation date. **Leverage (Lev)** is the ratio of total liabilities to total assets. **Size (LnMV)** equals log of market value of equity. **Auditor** equals 1 if the auditor of the firm during the class period is sued, 0, otherwise. **Equity Issue** equals 1 if the lawsuit is equity issue related, 0, otherwise. **AbTrad** equals 1 if the lawsuit filing includes an allegation of abnormal insider trading during the class period, 0, otherwise.

Table 2, Panel B reports the frequency of the binary variables. Out of a total of 296 SEC 10b-5 lawsuits, 31 (10.47%) cited the auditor as defendant, 94 (31.76%) included equity issue related fraud allegation and 135 (45.61%) filings alleged abnormal insider trading.

Panel A, Table 3 presents the distribution of the SEC 10b-5 lawsuit firms across the sample period (1996-2005). Distribution of the lawsuit firms across the sample period is not significantly different from the distribution of SEC 10b-5 lawsuits reported in the Stanford database. Similar to the Stanford database, the number of lawsuits is increasing between 1996 and 2002 except for a few drops during the period. Drops in SEC10b-5 lawsuits in 1998 and 2000 may be due partly to the overall health of the stock market. When there is an overall rise in the stock market, there are fewer incidences of sudden drops in stock prices and shareholders losses, therefore, it is expected that fewer class actions will be filed (Morris, 2009). The highest number of SEC 10b-5 lawsuits (40) was recorded in 2002. Thereafter, the number of SEC 10b-5 lawsuits steadily declined to 18 lawsuits in 2005. The lowest number of lawsuits (15) during the sample period was recorded in 1996.

Table 3
Panel A. Distribution of shareholder litigation by fiscal year (N=296)

Litigation Firms	Number of Firms
1996	15
1997	38
1998	33
1999	40
2000	29
2001	30
2002	41
2003	28
2004	24
2005	18
Total	296

Panel B: Industry Classification of Lawsuit Sample (N=296)

Industry	Two-Digit SIC Code	Number of Firms	Percentage
Metal Mining	10	3	1.01
Oil and Gas Extraction	13	4	1.35
Bldg Cnstr-Gen Contr,Op Bldr	15	1	0.34
Heavy Construction, Except Building	16	1	0.34
Construction-Special Trade	17	1	0.34
Food Products	20	5	1.69
Textile Mill Products	22	1	0.34
Apparel and other Textile Products	23	4	1.35
Lumber and Wood Pds, Ex Furn	24	2	0.68
Printing, Publishing & Allied	27	1	0.34
Chemical and Allied Products	28	31	10.47
Petroleum and Coal Products	29	1	0.34
Rubber and Miscellaneous Plastics Products	30	3	1.01
Stone, Clay, and Glass Products	32	1	0.34
Primary Metal	33	2	0.68
Fabricated Metal Products, Machinery and Equipment	34	1	0.34
Industrial, Communication, Machinery and Computer Equipment	35	25	8.45
Electronic and Other Electric Equipment	36	25	8.45
Transportation Equipment	37	6	2.03
Instruments and Related Products	38	18	6.08
Miscellaneous Manufacturing	39	1	0.34
Railroad Transportation	40	2	0.68
Trucking Freight and Warehousing	42	1	0.34
Water Transportation	44	1	0.34
Transportation by Air	45	1	0.34
Transportation Services	47	1	0.34
Communications	48	10	3.38
Electric, Gas and Sanitary	49	22	7.43

Services			
Wholesale – Durable Goods	50	3	1.01
Wholesale – Nondurable Goods	51	5	1.69
General Merchandise Stores	53	3	1.01
Food Stores	54	4	1.35
Apparel and Accessory Stores	56	2	0.68
Furniture and Home Furnishings Stores	57	3	1.01
Eating and Drinking Places	58	2	0.68
Miscellaneous Retail	59	10	3.38
Depository Institutions	60	8	2.70
Nondepository Credit Institution	61	6	2.03
Security and Commodity Brokers	62	1	0.34
Insurance Carriers	63	12	4.05
Insurance Agents, Brokers and Service	64	4	1.35
Holding, Other Invest Offices	67	2	0.68
Hotels, Other Lodging Places	70	1	0.34
Personal Services	72	2	0.68
Business Services	73	35	11.82
Motion Pictures	78	1	0.34
Amusement and Recreation Services	79	3	1.01
Health Services	80	8	2.70
Educational Services	82	2	0.68
Engr,Acc,Resh,Mgmt,Related Services	87	2	0.68
Nonclassifiable Establishment	99	2	0.68
Total		296	100

Panel A presents the distribution of the lawsuit firms across the sample period (1996-2005). The distribution of lawsuit firms across the sample period is not significantly different from the distribution of SEC 10b-5 lawsuits reported in the Stanford Securities Class Action database over the same period. **Panel B** presents the industry distribution of the litigation sample and shows a fair distribution of sample firms across all industries.

Table 3, Panel B presents the industry distribution of the SEC 10b-5 litigation sample. There is a fair distribution of sample

firms across all industries. Business Services (2-digit SIC=73) industry has 35 (11.82%) lawsuits, which represents the highest number of lawsuits in the sample. Chemical and Allied Products (2-digit SIC=28) industry has 31 lawsuits (10.47%), which is the next highest number of lawsuits in the sample. With the exception of Chemical and Allied Products (2-digit SIC=28) and Business Services (2-digit SIC=73) industries, the percentage of sample firms in each industry is less than 10 percent.

Event Study

Table 4 presents the 3-day cumulative abnormal returns around the end of the class period, $ECP_{(-1,1)}$, and litigation filing announcement date, $Litig_{(-1,1)}$, respectively.

Table 4

Cumulative Abnormal Returns (N=296)

	Mean	Median	Std. Dev.
$Litig_{(-1,1)}$	-0.0464[a] (<0.0001)	-0.0162[a] (0.0020)	0.1455
$ECP_{(-1,1)}$	-0.2299[a] (<0.0001)	-0.2000 [a] (<0.0001)	0.2125

Table 4 shows cumulative abnormal returns for the shareholder litigation sample over the three-day (-1, 1) interval relative to the class action lawsuit, **$Litig_{(-1,1)}$,** and misstatement disclosure, **$ECP_{(-1,1)}$**, announcement dates, respectively (day, 0). Abnormal returns are calculated following Brown and Warner (1985) using a single-factor market model, the CRSP equally-weighted market index, and a 255 day estimation period ending 45 days prior to the announcement. The first column presents the mean abnormal return, the second the median abnormal return and third column the standard deviation. Statistical significance at the 1 % level is denoted by [a].

Event study methodology is used to estimate the 3-day cumulative abnormal returns. Announcement dates with

confounding events within the three-day window (-1, +1) are excluded from the analysis. Following Brown and Warner (1985), the 3-day cumulative abnormal return is calculated using a single-factor market model, the CRSP equally-weighted market index, and a 255-day estimation period which ends 45 days prior to the respective event dates, day=0.

In the first column of the results in Table 4, we report the mean abnormal return and p-value for the t-test of statistical significance of the mean return, the second column presents the median abnormal return and the p-value for the Wilcoxon test, and the third column shows the standard deviation. $Litig_{(-1,\ 1)}$ has a mean (median) of -4.64% (-1.62%) which is significant at the 1% level and a standard deviation of 14.55%. We report mean (median) of $ECP_{(-1,1)}$ as -22.99% (-20.0%) and it is significant at the 1% level. The standard deviation of $ECP_{(-1,1)}$ is 21.25 percent.

Regression Results

Table 5 reports the result of the regression of the investor reaction to SEC 10b-5 litigation on the lawsuit measures and other variables. The coefficient of $ECP_{(-1,\ 1)}$ and Leverage (Lev) are positive while the coefficient of auditor litigation (Auditor), firm size (LnMV) and Class Period are negative. The coefficient on $ECP_{(-1,1)}$ and leverage (Lev) are positive as expected and indicate that investor reaction to litigation announcement is less negative when a firm is highly leveraged or the market reaction to the revelation of a misstatement is less negative.

The negative coefficient for size (LnMV) is as expected and implies that the market reacts more negatively to announcement of a class action against larger firms. The reported negative relation between firm size and investor reaction to litigation announcement is contrary to Gande and Lewis (2009) and Ferris and Pritchard (2001) who do not report any significant relation.

Table 5

Regression of Investor Reaction to SEC 10b-5 Lawsuit Announcement

Variable	Coefficient (p-value)
Intercept	0.0033
	(0.9091)
$ECP_{(-1,1)}$	0.1863[a]
	(<.0001)
Class Period	-0.0001[b]
	(0.0258)
AbTrad	0.0131
	(0.4670)
Auditor	-0.0692[b]
	(0.0206)
Equity Issue	-0.0220
	(0.2327)
Lev	0.0972[b]
	(0.0100)
LnMV	-0.0055[b]
	(0.0317)
Adj. R-Sq	0.1152
F-Value	6.49[a]
(P-value)	(<.0001)

Table 5 presents the result of the regression of investor reaction to SEC 10b-5 litigation announcement**, $Litig_{(-1,1)}$,** using 296 lawsuit firms over the period 1996-2005. **$ECP_{(-1,1)}$** is the cumulative abnormal returns over the three-day interval beginning on the day prior to the end of class period date. **Class Period** equals the number of days between the initial misstatement date and the misstatement revelation date. **AbTrad** equals 1 if the lawsuit filing includes an allegation of abnormal insider trading during the class period, 0, otherwise. **Auditor** equals 1 if the auditor of the firm during the class period is sued, 0, otherwise. **Equity Issue** equals 1 if lawsuit is equity issue related, 0, otherwise. **Leverage (Lev)** is the ratio of total liabilities to total assets. **Size (LnMV)** equals log of market value of equity. P-values are shown below the parameter estimates in parentheses. Statistical significance at the 1 and 5% level is, respectively, denoted by [a] and [b]. Variance Inflation Factor for the regression is 1.2512 indicating that multicollinearity is not a problem.

5. SUMMARY AND CONCLUSION

There is evidence in the literature that the market considers the announcement of a SEC 10b-5 lawsuit filing as more adverse compared to other categories of securities lawsuits but we know little about factors that explain the variation in the abnormal returns around SEC 10b-5 lawsuit announcement. This study investigates the determinants of investor reaction to SEC 10b-5 lawsuit using a sample of 296 SEC 10b-5 lawsuits between 1996 and 2005. We hypothesize that the lawsuit filing attributes used to form inferences of fraud are an indication of the merit of the lawsuit and should be associated with the SEC 10b-5 lawsuit announcement effect.

The empirical results indicate a positive relation between investor reaction to SEC 10b-5 lawsuit filing and the market reaction around the end of the class period. The 'deep pocket effect' is also documented in the SEC 10b-5 lawsuit announcement effect with the investor reaction being more negative for larger and lower leveraged firms because the market expects that they are more capable of bearing litigation costs and monetary penalty. Contrary to our hypothesis, we do not find a significant relation between investor reaction to SEC 10b-5 lawsuit announcement and equity issue and abnormal insider trading. The insignificant relation may be due to the market's expectation of equity issue and abnormal insider trading allegations because they are often cited in lawsuit filings. Consistent with our hypothesis, we report a more adverse market reaction to SEC 10b-5 lawsuit announcement when the auditor of the firm is charged in the lawsuit. The negative relation between investor reaction to SEC 10b-5 lawsuit and auditor liability suggests that inclusion of the auditor as a defendant in the lawsuit is perceived by the market as a strong inference of fraud and an indication of greater litigation costs.

Finally, the primary limitation of this study is that the reported results may not be generalizable to the period after the credit crisis which was characterized by severe erosion of investor confidence and many lawsuits against financial services industry

firms. Because our data covers the period prior to the credit crisis, future studies may replicate the present study using more recent data to determine whether the reported relations exist after the credit crisis.

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