Available online at www.sciencedirect.com
SCIENCE DIRECT
ELSEVIER
Pacific-Basin Finance Journal 14 (2006) 91–117
PACIFIC-BASIN FINANCE JOURNAL
www.elsevier.com/locate/pacfin

# The information content of insider trading around seasoned equity offerings

Ken M.L. Ching [a], Michael Firth [b,*], Oliver M. Rui [c]

[a] *CEIC Data Company Limited, Hong Kong*
[b] *School of Accounting and Finance, The Hong Kong Polytechnic University, Hung Hom, Kowloon, Hong Kong*
[c] *Chinese University of Hong Kong, Hong Kong*

Received 23 April 2002; accepted 1 July 2005
Available online 10 October 2005

**Abstract**

This paper examines insider trading around seasoned equity offering (SEO) announcements in Hong Kong. The announcements of private placings (rights offerings) are associated with positive (negative) abnormal stock returns. However, longer-term stock returns are negative for both private placings and rights offerings. In general, insiders are net purchasers in placing firms in the 6 months prior to and 6 months subsequent to the SEO, whereas insiders are net sellers in rights issue firms in the 6 months prior to and 6 months subsequent to the issue. The net purchases made by the insiders of firms making placements help them maintain their control rights, which are otherwise diluted by the placements. Insider trading does not explain longer-term investment returns.


*JEL classification:* G14; G32
*Keywords:* Insider trading; Placings; Rights offerings

## 1. Introduction

Insider trading is the subject of a large and growing body of research (for a review, see Lakonishok and Lee, 2001). These research studies include the development of theoretical models and the empirical testing of hypotheses that emanate from the theories. Most of the empirical research uses data from the U.S. One particular strand of empirical research examines

* Corresponding author. Tel.: +852 2766 7062; fax: +852 2330 9845.
*E-mail address:* afmaf@inet.polyu.edu.hk (M. Firth).

0927-538X/$ - see front matter 
doi:10.1016/j.pacfin.2005.07.002

insider transactions around firm-related events such as takeovers (Seyhun, 1990; Eyssell and Arshadi, 1993), CEO turnover (Niehaus and Roth, 1999), equity issues (Gombola et al., 1999; Niehaus and Roth, 1999), dissemination of firms' forecast information (Penman, 1982, 1985), dividend announcements (John and Lang, 1991), and exchange listing (Webb, 1999). These studies conclude that insiders trade on future firm-specific events. For example, Penman (1982) finds that insiders frequently trade profitably on their private information before corporate earnings announcements. Similarly, Elliott et al. (1984) find evidence of increased insider buying (selling) before very favorable (unfavorable) earnings announcements. Seyhun (1988) finds that the trading patterns of insiders even anticipate shifts in the overall direction of the stock market. Thus, analysts can develop a better stock-picking strategy by knowing the patterns of insider trading.

Regulators examine insider trades in order to set, revise, and implement rules governing the practice of insider dealing. Restricting insider trading may reduce perceptions of unfair practices and thus level the playing field for investors; this attracts more capital and lowers the cost of capital. However, severe restrictions on insider trading can have motivational problems that interfere with efficient contracting between the managers and owners of the firms (Demsetz, 1986). Cornell and Sirri (1992), among others, argue that insider trading aids the process of price discovery and therefore the practice should be encouraged rather than restricted. Karpoff and Lee (1991) and Gombola et al. (1999) document increased insider selling before the announcement of SEOs in the U.S. This insider selling activity can lead to higher investment returns (or reduced losses) for insiders as empirical evidence shows SEO announcements are associated with reductions in stock prices (Asquith and Mullins, 1986; Masulis and Korwar, 1986; Smith, 1986; Jung et al., 1996).[1]

In this study, we examine insider trading behavior around seasoned equity offering announcements using data from Hong Kong. The Hong Kong stock market is the ninth largest in the world by market capitalization at the end of 2004 and it is a major fund raising center for firms in China. We choose Hong Kong as the venue for our research because it has a number of unique characteristics that have a strong influence on the motivations of insiders to trade. These motivations lead to different patterns of insider trading than observed in the U.S. and they result in different stock market reactions. Two important characteristics that impact insider trading in Hong Kong are the ownership structure of firms and the rules and regulations governing insider dealing. A major characteristic of listed firms in Hong Kong is that many are majority owned by an individual or a family, and the individual or family take senior management positions and dominate the board of directors. One consequence of this ownership characteristic is that the maintenance of control is a major consideration in the investment decisions of insiders. In Hong Kong, the rules and regulations on insider trading differ from those in other markets. For example, there are no restrictions on short swing sales and, consequently, insiders can buy on one day and sell the next (in fact, they can buy and sell on the same day). Leung (1993) states that it is common practice for insiders in Hong Kong to trade on inside information and he argues that the rules encompassed in the Securities (Insider Dealing) Ordinance have not been aggressively enforced. As a consequence of these factors, we argue that CEOs and directors in Hong Kong feel less constrained in dealing in their own firm's shares.

[1] Negative stock returns are consistent with the prediction from Myers and Majluf (1984) who argue that managers have an incentive to issue *SEO*s when their firm is overvalued.