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Double signals or single signal? An investigation of insider trading around share repurchases

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ABSTRACT

We examine directors' dealing activity around share repurchasing periods in Hong Kong. There are significant insider trading activities before the share repurchasing period. Consistent with the signaling hypothesis, the directors' purchase activities during the share repurchase period are significantly higher than the expected level while the directors' sale activities are significantly lower than the expected level. Double signals of share repurchase and directors' purchases create a stronger signal in conveying undervaluation, while insider sales around share repurchase reduces the undervaluation signal. We find some evidence that is consistent with the free cash flow and signaling arguments for share repurchases.

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1. Introduction

Signaling devices are used to reduce information asymmetry in financial markets. Two signaling devices we study in this paper are share repurchases by firms and directors' dealings in their firm's stocks. Specifically, we examine insider trading activity around the repurchasing period and use the simultaneous signal of share repurchase and insider trading to investigate whether the signaling hypothesis is a major factor driving share repurchases. The examination of the two trading signals, share repurchase and directors' dealings, provides evidence on their relative pricing effects (i.e., the magnitude of market reaction) and the credibility of the undervaluation message. We also examine other reasons for making repurchases.

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Previous studies mainly use US data. However, the recent implementation of regulations allowing share repurchases in other countries provides opportunities for research studies under different market settings such as Australia, the UK, and Canada (Harris and Ramsay, 1995; Ikenberry et al., 2000; Oswald and Young, 2004; McNally et al., 2006). In this study, we examine share repurchases and directors' dealings (insider trading) using data from Hong Kong. Hong Kong is an interesting setting for our research because of the unique disclosure regulations that make information on actual share repurchases and insider trading publicly available in a timely manner. Studies in the US examine the stock market's reaction to the announcement of a share repurchase program (the intention to make repurchases) but do not study the actual repurchases. Often the number of shares bought is far less than the number stated in the announcement. We use the actual repurchase transaction as the event date to measure the share price reaction to the share repurchase. Therefore, the possibility of a mismatch in the percentage of shares targeted in the repurchase announcements and that subsequently acquired in actual repurchases is eliminated.¹ In addition, the timing ability of the managers to buy undervalued shares can be evaluated only if the actual transaction date is precisely identified.

Directors frequently buy and sell shares in their companies and these trades need to be reported soon after the transaction is made. It is quite common for a director to buy and sell within the same week and so the signaling properties, if they exist, are complex. The frequency of repurchases and insider trading, combined with timely disclosures, enable us to make a detailed study of signaling in Hong Kong. Differences in the market setting and announcement and disclosure requirements, the high frequency of share repurchase and insider transactions, and the reversal of directors' trades may cause the market to behave in different ways to those documented in UK and US studies.

We examine the market reaction of the repurchasing firms with insider trading activity based on the methodology of Stephens and Weisbach (1998) and Dittmar (2000). In addition, we also use a Tobit model to determine the motives for share repurchase decisions in Hong Kong. We explicitly test three hypotheses, free cash flow, information signaling, and leverage. Various measures of insider trading activity are included in the models to examine the information signaling hypothesis of the "Buy" and "Sell" decisions of the directors.

Between 1993 and 2002, there are 10,076 share repurchase transactions in Hong Kong. Directors' trading activity is found before, during, and after the time when the firms conduct their share repurchase activity. The event study results show that share repurchases provide a signal of undervaluation. However, the presence of directors' trading signals around the repurchasing period complicates the market responses for share repurchases. The market appears to discount the undervaluation message of the repurchase signal when it is accompanied by directors' sales. The "Sell" signal conveys an overvaluation message. With the exception of firm size, the Tobit regression model fails to detect any dominant factor that motivates the share repurchase decision.

Section 2 describes the reporting requirements for share repurchases and insider trading in Hong Kong. In Section 3, we discuss salient studies from the U.S. and elsewhere. The sample and research design are described in Section 4. Section 5 presents the results, and Section 6 concludes.

2. Disclosure rules in Hong Kong

Repurchasing firms have to comply with the Code on Share Repurchase and Chapter 10 (Equity Securities: Restrictions on Purchase and Subscription) of the Exchange Listing Rules when they buy-back their shares. Rule 10.06 (1) (a) (iii) of the Listing Rules states that the shareholders of the repurchasing firms have to approve the repurchase decision (a general mandate) by way of an ordinary resolution at a General Meeting. Firms are required to report their repurchase transactions (the number of shares repurchased and the price at which the shares are repurchased) to the Hong Kong

¹ Stephens and Weisbach (1998) report that only about 74–82% of the shares targeted in the repurchase announcement are subsequently acquired in the three years after the repurchase announcement. Ikenberry et al. (2000) find 22.3% of firms making repurchase announcements do not repurchase any shares within 12 months and the average completion rate for Canadian repurchases is 28.6%.

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