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Price behavior and insider trading around seasoned equity offerings: the case of majority-owned firms

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Abstract

Small public firms in the US and elsewhere are often managed by majority owners. This paper offers the hypothesis that majority insiders have an incentive to engage in insider trading around seasoned equity offerings (SEOs), primarily for the sake of preserving control. This hypothesis is tested side-by-side with traditional hypotheses regarding insider trading, such as signaling or growth opportunities that are often considered in the context of firms with dispersed ownership. The empirical analysis in this paper utilizes data of 76 SEOs announced by firms listed on the Tel Aviv Stock Exchange (TASE) between June 1989 and December 1997, whose inside ownership exceeds 50%. The results demonstrate the strong effect of expected post-announcement share price changes on insider trading, and a weaker effect of pre-announcement insider trading on price changes. Unlike minority insiders, who may have an incentive to trade on inside information in order to extract short-term capital gains, majority insiders appear to take the long-term view by buying shares before the offering in order to preserve or increase their control over the firm. This activity does not seem to be dependent upon the firm's growth opportunities. Rather, it seems to be market-dependent; that is, the ownership ratio of majority insiders is increased in a bear market and remains the same in a bull market.

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1. Introduction

This paper demonstrates that the insiders' trading activity in majority-owned firms is primarily motivated by their desire to maintain control over the firms; that is, to avoid dilution of their share in the firm's equity. It is hypothesized that in the case of the firms with majority ownership, the effects of signaling and the firm's growth opportunities are supplanted or joined by the effects of the insiders' actions that wish to avoid dilution. These joint effects lead to a unique causal relationship between majority insider trading and share price behavior.

Ever since the early 1960s, when the SEC has been moving after insider trading, and, subsequently, since the well-publicized 1987 debate between J. Grundfest and Henry Manne, Dean of the Law and Economics Center at George Mason University, regarding the involvement of the legislature in insider trading, this issue has attracted increasing academic attention in both the fields of finance and law. Demonstrating the harmful effects of insider trading seems to be the popular view among many academicians and practitioners.

The academic view that supports the abolishment of the prohibition on insider trading focuses on the notion that the market can sort this issue out by adequately pricing inside information. Carlton and Fischel (1983) argue that common forms of managerial compensation are left to private negotiation and that no one would seriously argue that these forms of compensation should be set by government regulations, irrespective of how improper these compensations are (see also Dye (1984)). Coase (1960) argues that the issue of insider trading as a form of compensation depends on whether the information property rights are more valuable to the firm's managers or to the firm's shareholders. Carlton and Fischel, adhering to the market mechanism, have theorized that an efficient allocation of information property rights to the highest-valuing user does not require actual negotiations between insiders and shareholders, since as long as shareholders are aware of the existence of insider trading, both share prices and insiders' compensation will be higher.

Bainbridge (in press), besides providing a list of the 261 papers that have discussed insider trading, succinctly summarizes the arguments for and against allowing insider trading. Stamp and Welsh (1996) surveyed the insider trading laws in a small subset of developed countries, while Bhattacharya and Daouk (2000) carried out a comprehensive survey of the existence and enforcement (as measured by legal prosecutions) of insider trading laws around the world. In fact, they raise a second question, as to whether the existence and enforcement of insider trading laws actually matter. The existence and enforcement of insider trading laws in stock markets are a phenomenon of the 1990s. Indeed, the empirically observed negative effect of the enforcement of insider trading laws survives after controlling the foreign exchange rate factor, the liquidity factor, and a variable measuring shareholder rights.

An independent, partially related group of studies analyzes the effect of seasoned equity offering (SEO) announcements on share prices, but the evidence is inconclusive. Some of the studies suggest that SEO announcements convey a negative signal to investors, while others believe that these announcements should have a positive effect.[1]

[1] Examples of a positive signal are found in Myers and Majluf (1984), Loughran and Ritter (1995), and Spiess and Affleck-Graves (1995); examples of a negative signal are found in Pilotte (1992) and Denis (1994).