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Pre-bid price run-ups and insider trading activity Evidence from Canadian acquisitions

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Abstract

A sample of 128 Canadian acquisitions from 1985 through 1995 is used to examine the relationship between pre-bid price run-ups in target shares and insider trading activity. We find that abnormal stock price performance at an early stage before the acquisition announcement is due to actual trading by corporate insiders. However, the run-up immediately preceding the takeover announcement appears due to market anticipation about an impending bid for the target. Furthermore, our results identify the stages in the acquisition process at which each effect occurs.

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1. Introduction

Significant stock price run-ups for target shares during the weeks preceding formal takeover announcements have been well documented in finance literature. For example, Keown and Pinkerton (1981), Masse, Hanrahan, and Kushner (1991), and Arshadi and Eyssell (1993) report cumulative abnormal returns ranging from 14.04 to 32.35% over the period up to and including the announcement date. More than half of this abnormal performance occurs before the actual takeover announcement.

Two explanations have been offered for the observed pre-bid price run-ups in target share prices. The first explanation is that price run-ups reflect investors' anticipation of an impending takeover bid. These expectations are based on information in press releases, mandated disclosures, comments by "shark watchers," and observations of activity by arbitragers. The other explanation is that price run-ups are driven by the

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trading activities of corporate insiders before the takeover announcement. The basic premise of the insider trading-information leakage hypothesis is that investors trade on this information when the insiders' activities are officially reported. In the meantime, however, the insiders have opportunity to earn excess returns over the period before the information becomes public knowledge.

Empirical studies have tested the validity of both the market anticipation hypothesis (Jarrell & Poulsen, 1989; Pound & Zeckhauser, 1990; Gupta & Misra 1989) and the insider trading-information leakage hypothesis (Keown & Pinkerton, 1981; Eyssell & Arshadi, 1993; Barclay & Warner, 1993) in explaining these pre-bid price run-ups. The results of these studies are mixed and provide no clear way to differentiate between the validity of the two competing hypotheses.

In this study, we examine the relationship between price run-ups in target shares preceding takeover announcements and the incidence of insider trading by analyzing insiders' daily transactions for a sample of Canadian acquisitions. While insider trading surrounding acquisition announcements has been extensively investigated in the United States, there is relatively little evidence with respect to Canadian corporations. In general, regulations governing insider trading are more lenient in Canada than in the United States. Furthermore, because the infrastructure of the securities system is less developed in Canada than in the United States, prosecutions for illegal insider trading in Canada are unusual. When successful prosecutions do occur, the punishments are generally less severe than those in the United States. The differences associated with the Canadian system, both in regulations dealing with insider trading and the enforcement of those regulations, may enable us to better differentiate between the two hypotheses.

While prosecutions for illegal insider trading are infrequent in Canada, the United States has had a number of highly publicized insider trading cases (Ivan Boesky and others). More recently, the U.S. Securities and Exchange Commission charged 25 people with trading on inside information related to the 1995 takeover of Lotus Development Corporation by International Business Machine Corporation (IBM). In terms of the number of defendants, this is one of the largest insider-trading cases ever filed by the Commission. To date, four defendants have agreed to settlements; seven other have pleaded guilty to criminal charges.[1] In contrast, a recent release from the Ontario Securities Commission reports a discussion about the settlement process for insider-trading cases.[2] An investigation of insider trading during the takeover of Morrison Petroleums Ltd. by West Central Capital Corporation concluded that illegal activity did occur, resulting in gains of $14 million to corporate insiders. The negotiated settlement agreed on deletion of the term "insider trading" from the original charges. In terms of penalties, one participant received a one-year trading ban; the other two received six-month bans. The defendants were required to cover $200,000 in court costs. No other financial penalty was imposed. This settlement is typical of penalties imposed for violation of Canadian insider trading regulations.

Moreover, it is especially timely to study this issue using Canadian data because the established system for dealing with insider trading activity is currently undergoing major revisions. By December 2000, the Canadian Securities Administrators (the