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Share repurchase tender offers and bid–ask spreads

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Abstract

This paper examines the impact of share repurchase tender offers on the market microstructure. We find that there is a temporary reduction in the bid–ask spread, and a temporary increase in volume and quotation depth during the offer period. Our evidence suggests that the bid–ask spread is asymmetric during the offer period with the bid-side spread smaller than the ask-side spread. The temporary reduction in the spread around offers is consistent with the competing-market-maker hypothesis which predicts that the intensified competition for the market maker raises bid prices and narrows the spread asymmetrically during the offer period. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

An extensive body of literature has been written on the impact of corporate share repurchases on stock prices. However, few studies investigate the

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behavior of the market microstructure around share repurchase programs. Barclay and Smith (1988), Cook et al. (1995), Miller and McConnell (1995), and Wiggins (1994) study the bid–ask spread around open-market repurchases. Barclay and Smith suggest two different but not mutually exclusive hypotheses about the direction of spread changes around open-market repurchases: (1) increased information asymmetry caused by firms' expected buy-back activities widens the spread (the information asymmetry hypothesis); (2) competition between the firm and the specialist for the sell order flow narrows the spread (the competing-market-maker hypothesis).¹ Empirical evidence on the two hypotheses, however, is mixed at best. Based on yearly data, Barclay and Smith document a significant increase in the bid–ask spread following the repurchase announcement. More recently, using intraday data, Miller and McConnell as well as Wiggins find no evidence of a significant change in spreads. Cook, Krigman, and Leach report that the spread on a corporate purchase day is wider than the pre-announcement period but narrower than the adjacent trading days. Cook et al. interpret this result as evidence that open-market repurchases increase both information asymmetry and competition for the specialist.

Though they occur less frequently than open-market repurchases, repurchase tender offers, which include both fixed-price and Dutch-auction offers, have a much greater impact on the market because of the substantial offer volume and premium involved.² For example, Comment and Jarrell (1991), in measuring returns over the three days around the announcement day, report the average net-of-market returns of 8.3% for fixed-price offers and 7.5% for Dutch-auction offers, compared with 2.3% for open-market repurchases. However, we know very little about the empirical patterns of the market microstructure surrounding repurchase tender offers. The extensive literature on open-market repurchases does not provide useful clues in analyzing market microstructure around repurchase tender offers, because the two types of repurchases can have different impacts on market microstructure. For example, as illustrated by Barclay and Smith (1988) and Cook et al. (1995), the announcement of an open-market repurchase can aggravate the information asymmetry problem facing the specialist because of the expected share pur-

¹ According to the information asymmetry hypothesis, open-market buy-backs increase the probability that the specialist is trading with an informed trader, thus aggravating the information asymmetry problem facing the specialist. In response, the specialist protects himself from the potential loss to the informed by raising the bid–ask spread, which leads to a rise in the company's cost of capital. The competing-market-maker hypothesis claims that the limit buy orders submitted by the firm establish a lower bound for the specialist's bid price, thus narrowing the spread that the specialist quotes.

² For details, see Bagwell and Shoven (1989), Barclay and Smith (1988), and Comment and Jarrell (1991).

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