



Share repurchase regulations: Do firms play by the rules?

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ABSTRACT

Open market share repurchases are strictly regulated to prevent managers from taking advantage of selling shareholders. We examine compliance with these rules in France, where the mandatory disclosure of share repurchases provides detailed information on repurchases actually undertaken. Using a database containing 36,848 repurchases made by 352 French firms over the period 2000–2002, we show that very few firms fully comply with the regulations for all their buybacks. We document that illegal repurchases before earnings announcements are the most detrimental to selling shareholders.

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1. Introduction

Over the last decade, open market share repurchase has become a major corporate payout mechanism for public corporations all around the world (see for example Grullon & Michaely, 2004, for the U.S.; Ikenberry, Lakonishok and Vermaelen, 2000 for Canada; Rau & Vermaelen, 2002, for the UK). To implement these buybacks, managers act directly in the market as investors on behalf of the company. This action puts them in the position of insiders, and thus, their intervention can be costly for investors. To limit the risk of improper intervention, most countries have regulations for share repurchases to ensure that shareholder interests are protected, and that managers will not profit from their private information. The objective of this paper is to assess regulatory compliance and costs of non-compliance in France, where repurchase disclosure is mandatory. We find that most French firms violate the rules at least once over the 3-year period of our study. We document that non-compliance is costly for selling shareholders, due to insider trading profits and reduced liquidity.

Regulation of share repurchases is an element of a more general trend to eliminate illegal insider trading, when managers, directors, or major shareholders buy or sell shares and are the sole beneficiaries of the transactions. Most developed countries have introduced insider trading regulations (Bhattacharya & Daouk, 2002; Durnev & Nain, 2007) and there are studies that examine

their effectiveness.¹ In share repurchases, the decision is made by management, but on behalf of the company. However, if the firm repurchases stock at a low price by using private information, a value transfer occurs from selling shareholders to managers and other remaining shareholders.² As a result, the higher managers' ownership, the greater will be the incentive to repurchase underpriced shares. Raad and Wu (1995) report that managers of U.S. firms announcing repurchases own on average 11% of the firms' shares before the repurchase, and that they frequently buy shares for their own accounts before announcing repurchases. Li and McNally (2007) document that for Canada insiders have a significantly larger ownership share in firms that repurchase (27.7%) than in firms that do not (11.5%). As Fried (2005) points out, it may be easier for managers to buy stock indirectly through repurchases than to buy directly for their own accounts, due to liquidity constraints, short swings prohibitions (buy/sell transactions within a 6-month period when the purchase price is lower than the sale price) and restrictions on the trading of managers through the use of trading-windows (insiders are allowed to trade

¹ Bainbridge (2000) provides a comprehensive list of papers that discuss insider trading; one of the pioneer studies is by Seyhun (1986). Insider trading is widespread: according to Lakonishok and Lee (2001), there is at least some insider trading on more than 50% of stocks in a given year. The insiders generally make positive profits. Jeng, Metrick, and Zeckhauser (2003) find that insider purchases earn abnormal returns of more than 6% per year. Not all insider trading is illegal, and offences are not always easily detectable. Meulbroek (1992), in a study of 183 cases listed by the SEC, shows that the abnormal price movement on an illegal insider trading day is 40–50% of the subsequent price reaction to the public announcement of the inside information.

² In a theoretical model, Oded (2007) establishes that expected wealth transfers among shareholders increase with uncertainty about the firm value.

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only during certain prescribed periods). Further, Kahle (2001) finds that the decision to repurchase is positively related to the number of executive options outstanding. Managers about to exercise options and sell the received shares may use repurchases to boost the stock price. More generally, following Durnev and Nain (2007), firm trading as well as insider trading subject uninformed traders to an adverse selection problem, diminish investor confidence, increase transaction costs and hurt the integrity of capital markets.³

This body of evidence suggests that regulation of share repurchases is as important as regulation of illegal insider trading. In most countries, repurchases are not allowed when management has material information not disclosed to the market. There are also regulations to prevent manipulation of stock prices, which can arise when the company has contracts containing optional provisions that depend on share prices. This type of clause is common in mergers and acquisitions, LBOs and management remuneration packages. Restrictions on the quantity of shares repurchased during a given trading day reduce the impact of repurchases on the market price.

While detailed regulations have also been established for share repurchases, there are few studies that have analyzed actual compliance with the rules.⁴ Companies' disclosures of their total buybacks provide the only basis for verification of compliance, and disclosure requirements vary widely between countries and periods.⁵ Until 2004, the country with the most lenient regulations was the United States. Firms could repurchase shares without prior announcement and announce buyback programs without fulfilling them. The only disclosure requirement for repurchases was the reporting of the number of shares outstanding at quarter-end. The only guide for executing open market repurchases was SEC safe harbor Rule 10b-18 under the Exchange Act of 1934. Rule 10b-18 provides issuers with a "safe harbor" from liability for manipulation when they repurchase their common stock in the market in accordance with the rule's manner, timing, price, and volume conditions. Prior to December 2003, when the SEC adopted amendments to Rule 10b-18, requiring companies to disclose all repurchases, the SEC had no means of investigating 10b-18 compliance for U.S. firms. Given the absence of regulatory based data, Cook, Krigman and Leach (2003) investigate 10b-18 compliance by using voluntarily disclosed data for 54 firms' repurchase programs during 1993 and 1994. They document that only 2 of the 54 firms were verifiably in compliance with the safe harbor guidelines for all reported repurchases. Since their sample contains only voluntarily supplied information, their results imply that few U.S. public firms complied totally with Rule 10b-18, prior to the enactment of the disclosure amendments.

In Europe, open market share repurchases are a recent practice that has been accompanied from the outset by regulations requiring actual repurchases to be reported at the time of the event. Under a European Union (EU) directive that took effect in 2004, national repurchase regulations are now tending to con-

³ For the Hong Kong Stock Exchange, Brockman and Chung (2001) find that managers exhibit timing ability and that liquidity deteriorates during repurchase periods. Zhang (2005) finds that firms repurchase shares after a 20-day period of negative share price performance, and that subsequent 20-day period share price performance is positive but only weakly significant.

⁴ McNally and Smith (2003) report that approximately 50% of Canadian firms engaging in repurchases do not disclose their trades to the Ontario Securities Commission, as required. They also find that the volume of repurchases is much higher than expected before material news announcements. See also Bhattacharya and Daouk (2005), who argue for insider trading that it is sometimes better not to have a law than to have a law but not enforce it.

⁵ Kim, Varaiya, and Schremper (2005) propose a comparison of open market share repurchase regulations in the 10 largest stock markets around the world: the U.S., Canada, Japan, Hong Kong and several European countries.

verge. French regulations are similar to U.S. Rule 10b-18 in many respects, but firms listed on Paris Stock Exchange are required to disclose repurchases made during a given month at the beginning of the following month.⁶ The information disclosed to the regulators states only the number of repurchased shares for the whole month, but we also obtained a previously unused database of repurchases from the *Autorité des Marchés Financiers* (AMF), an organization that has the same role as the SEC in the U.S. This database includes the trading dates, the number of shares acquired and the price paid per share. Thus it is possible to analyze the level of compliance with current repurchase regulations for all repurchases, avoiding the self-selection bias inherent to voluntarily disclosed survey data. Given the similarities of French repurchase regulations to U.S. regulations and empirical results, our data have implications for projecting the effects of the 2004 amendments in the U.S. French regulators have also initiated several investigations and lawsuits against companies and their management. A well-known case concerned the massive stock repurchases by Vivendi just after 11 September 2001.⁷ These buybacks did not comply with the volume restriction specified in French repurchase regulations, and also took place during the 15 days prior to publication of the company's half-yearly results, a prohibited period. These activities resulted in a legal inquiry that led to executives being placed under investigation, an indication that non-compliance with share repurchase regulations is a risky strategy for management.

In this paper, we analyze French businesses' compliance with the main share repurchase rules. Using data from Euronext Paris (the Paris Stock Exchange), we study repurchase regulation compliance on the Paris Stock Exchange for 806 repurchase programs and 36,848 repurchase trading days over the period 2000–2002. First, we examine whether the companies comply with the maximum repurchase price and the maximum percentage of capital for repurchase, as established by shareholders at the annual meeting. We show that most firms comply with these constraints. We also observe that most firms set limits that are greater than the requirements for their share repurchase programs. The few violations we find relate to companies that set limits that are stricter than the average.

We then study two of the main features of French share repurchase regulations, a limit on volume (repurchases must not exceed 25% of the reference volume for each trading day), and a rule prohibiting repurchases during the 15 days preceding publication of earnings results. We find that 79% of firms violate the volume rule in at least one repurchase day over the period 2000–2002, and 69% violate the rule for more than 5% of repurchase days. This finding primarily applies to the smallest and least liquid firms. Only 13.89% of CAC40 companies violate the rule for more than 5% of repurchase days. 70% of repurchasing companies bought back stock at least once during a non-trading window, just before announcing their results, and this non-compliance covers a total of 5.64% of repurchase trading days. We conclude that French publicly traded companies do not always comply with share repurchase regulations, and that violations are particularly frequent for companies listed on the cash-only market.

We then examine the negative consequences of rule violations for selling shareholders. First, we document an average positive abnormal return of 1.92% during the 2-week period following

⁶ As of 2004, the disclosure of information concerning repurchases by U.S. companies is basically similar to French pre-2004 practices. Since the end of 2004, French firms must disclose their repurchases within 7 days of the transactions.

⁷ The AMF took a firmer stand on this matter than the SEC, which temporarily suspended all regulations on share repurchases after 11 September 2001.

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