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The curious case of converts☆

Xiaoyang Li [a,*], Shannon Lin [b], Alan L. Tucker [c]

[a] Cheung Kong Graduate School of Business, 3/F, Tower 3E, Oriental Plaza, 1 East Chang An Avenue, Beijing, 100738, PR China
[b] Dalhousie University, Rowe School of Business, Room 4090, 6100 University Avenue, Halifax, Nova Scotia, B3H 4R2, Canada
[c] Shanghai, PR China

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ABSTRACT

We document negative abnormal returns and abnormally high short selling in the trading days immediately before the private placements of U.S. convertible bonds. Issues experiencing greater post-placement short selling have more intense pre-placement short selling. In contrast, there are no pre-placement negative abnormal returns and less pre-placement abnormal short selling for issuers who also engage in share repurchases. Pre-placement findings are related to specific terms of the converts and related buybacks. While other potential explanations exist, the overall weight of the evidence suggests that the most plausible explanation is front-running.
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1. Introduction

In June of 2007, four hedge funds and Deutsche Bank were fined $8.4 million by the Paris-based Autorite des Marches Financiers (AMF) after a trading probe involving the private placement of a 3-year, 8.25%-coupon, $1 billion face-value convertible bond issued by Vivendi Universal SA in November 2002. The hedge funds were blamed for using privileged information resulting from conversations with Deutsche Bank, and massively selling shares ahead of the placement ("front-running"). Vivendi shares fell 14% in the three trading days just prior to placement, and the company requested the AMF to investigate. While placement banks typically speak with potential investors to gauge demand before selling securities in the practice known as "wall crossing", the banks are required by the AMF to inform buyers that they cannot trade on any privileged information, and the banks must store the dates and times of the conversations. Deutsche Bank destroyed tapes of those discussions. Remarkably, some of the hedge funds did not purchase the Vivendi issue.[1]

Similar trading restrictions apply in the U.S. private placement market including Regulation Fair Disclosure ("Reg FD"), which makes potential buyers temporary insiders upon their execution of a non-disclosure agreement ("NDA"), thereby precluding them from licitly trading on material information provided by the institutional sales and trading desks of the placement banks. Over the last decade the Securities and Exchange Commission (SEC) has filed insider trading complaints against several hedge funds from their alleged trading on material information gleaned during the wall-crossing period in the U.S. private placement market. One example is a $15.8 million settlement reached with Langley Partners involving the shorting of stock prior to the issuance of

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* Corresponding author.
E-mail addresses: xyli@ckgsb.edu.cn (X. Li), Shannon.Lin@Dal.ca (S. Lin).

[1] See http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aCPasXEGQ8sw&refer=germany. While the Vivendi case is arguably the best known case of wall-crossing abuse, similar cases also have occurred in the United Kingdom, Japan, and the United States.

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several private placements of common stock.[2] Still, to our knowledge the SEC has never brought a complaint against any entity for wall-crossing (or other trading) abuse involving the private placement of a convertible bond ("converts" hereafter).

What is particularly interesting about convert issues – as opposed to other types of financing events, such as the private placement of common stock or the negotiation or renegotiation of a loan – is that the mere knowledge that the issuance of a convert is forthcoming is almost certainly sufficient information to safely profit. That is, the mere knowledge that a convert issue is in the pipeline may be regarded as "material information", albeit not necessarily in a legal sense, because large profits can be made, with high probability, by shorting the issuer's stock prior to convert placement — regardless of the health (or lack thereof) of the issuing firm. As described in the Appendix A, the principal form of convertible bond arbitrage ("convert arb" hereafter) occurs when a hedge fund purchases the convert and reverse-engineers its straight-debt component through the trading of swaps, thus leaving the fund an isolated long position in the equity call option embedded in the convert. The arbitrageur then sells a real or synthetic call, either of which occasions the short-selling (and downward price pressure) of the issuer's stock. In the U.S., it is estimated that convert arb hedge funds purchase about 75% of convert issues (Mitchell, Pedersen, & Pulvino, 2007). Thus, the vast majority of convert issuers are subject to having their stock sold short, often intensely. Therefore, the mere knowledge that a convert is forthcoming is very likely to occasion profits by shorting the stock prior to convert placement. Put another way, one does not need to know any traditionally-defined "material information" to profitably front-run; probably more so than any other security issuance marketplace, the knowledge of issuance per se in the convert market is almost certainly highly valuable information. In addition, and per the aforementioned Vivendi case, one does not have to purchase the convert issue in order to profit from shorting the issuer's stock prior to convert placement. Under the current rules (Reg FD), it appears that the following scenario can (and does) take place: an underwriter contacts a potential buyer, stating that a firm is coming to market with a convert, and asking if the buyer is interested, with perhaps an accompanying NDA; the buyer can merely reply "no thank you" and then proceed to short the firm's stock, and profit.[3]

Front-running alarms regulators and other market participants because it erodes public trust in capital markets which in turn can raise the cost of capital, increase trading costs, and decrease economic growth (Bhattacharya & Daouk, 2002).[4] This study provides the results of a systematic investigation of potential trading abuse in the U.S. convertible bond marketplace for the period 1997–2010. Our results are consistent with market participants actively trading prior to the placements of U.S. converts that are likely to have been sold to hedge funds.[5] We document that the stocks of convert-issuing companies have significantly negative abnormal stock returns prior to the placements of their converts, provided that these companies do not engage in a related stock buyback. For our focal sample period of 2005 and 2006, a period for which we have reliable short selling data, and for the event window −5 trading days to −1 trading day immediately before placement, the cumulative abnormal stock return associated with convert issues (when the issuing company does not engage in a related stock repurchase) is −1.60% (significant at the 1% critical level). Furthermore, these issuers' stocks experience significantly high levels of short selling (at the 0.1% critical level) for the same event period. On a daily average, the excess shares (relative to normal trading days) being shorted exceeds 0.25% of the total number of shares outstanding. These findings are more pronounced for the event window [−2,−1]. When we expand the sample period to 1997 through 2010, abnormal return results remain qualitatively similar.

We also document that pre-placement abnormally negative returns and short selling are more pronounced for the convert issues subject to a more intense level of post-placement convert arb. If there is front-running, the pre-announcement CAR (pre-announcement short selling) should be more negative (intense) the larger the issue size relative to shares outstanding; however, because only a small tranche of an issue may have been sold to arbitrageurs, post-issuance shorting intensity better captures convert arb activity than does issue size. Post-issuance shorting intensity also reflects the issue's Delta; an issue subject to arbitrage may have little value to pre-placement traders if Delta is low. Specifically, we show that for convert issues where post-issue stock shorting is particularly intense (top quintile sample of post-placement abnormal shorting), the average pre-placement abnormal stock return is −2% for event window [−5, −1] and the level of pre-placement abnormal stock short selling is more than three times that of other convert issues. As discussed more within, this evidence helps to refute alternative explanations for the pre-placement findings, including the potential capability of hedge funds to predict forthcoming convert issues.[6] For these findings to be explained by hedge fund's ability to predict convertible issuance, not only would the funds have to be able to predict which firms are more likely to issue converts and *when* a convert issue is going to occur, the funds also would have to be skilled at predicting which issuers are going to be subject to more intense stock shorting. It is extremely difficult to envision how hedge funds could predict shorting intensity; that would require the ability to

[2] See http://www.sec.gov/litigation/litreleases/lr19607.htm. In the Langley settlement the defendant neither admitted nor denied wrongdoing. Indeed, it is not settled presently in the courts whether short selling based upon private knowledge of an upcoming "PIPE" (private investment in public equity) is illegal (cf. *SEC v. Cuban* and *SEC v. Mangan*). None of the SEC wall-crossing actions to date have included accompanying criminal charges brought by the U.S. Department of Justice (DOJ).

[3] According to the investment bankers that we spoke with, private placements (which are also commonly known as Rule 144-A offerings and private labels) of converts, including happy meals, are almost surely purchased (at least in part) by convert arb hedge funds. Converts are often sold in tranches, with some tranches bought by arbitrageurs and others by more traditional creditors. Like in the syndicated loan marketplace (Sufi, 2009), it is probably the case that the introduction of ratings on converts allowed nonbank institutional investors, such as hedge funds and other predating lenders, to participate in the convert marketplace. See Brophy, Ouimet, and Sialm (2009).

[4] Whether or not front-running in the convert marketplace is economically important cannot be measured by the mere examination of pre-placement abnormal returns. After all, front-running is a zero-sum game when focusing exclusively on those who profit from it and their trade counterparties. The economic importance instead lies in the social costs described by Bhattacharya and Daouk (2002).

[5] While we focus on the prospect of hedge funds trading prior to convert placement, it is also possible that other parties are trading, including insiders of the issuing firms as well as the proprietary trading desks of the investment banks managing the convert placements.

[6] Consistent with Desai, Krishnamurthy, and Venkataraman (2006), it is important to distinguish between short selling motivated by valuation based on publicly available information and short selling motivated by access to potentially privileged information (which, in the case of converts, may be merely the knowledge of a forthcoming offering). Engelberg, Reed, and Ringgenberg (2012) provide evidence that short sellers are particularly good processers of public information.

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