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Information content of directors' trading around acquisitions

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ABSTRACT

This paper investigates the patterns of directors' trades and returns around takeover announcements. We find that the pre-announcement net value (the difference between buy value and sell value) of directors' trading is positively related to acquirers' announcement period abnormal returns. This relation is stronger for private target acquisitions and for stock-financed acquisitions, when the information asymmetry between directors and outside investors is more pronounced. However, this relation does not hold for better governed and highly monitored acquirers. Our findings indicate opportunistic trading by directors prior to takeovers and highlight a significant role that corporate governance mechanism plays in restraining these opportunistic behaviors.

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1. Introduction

Information asymmetries exist between company insiders and outside investors. Because of preferential access to information, directors are subject to increased scrutiny, regulation, and restrictions regarding their trading activities (Cohen et al., 2012). Despite such strict regulations on directors' trading, several empirical studies have provided evidence that, on average, directors outperform other investors when trading their own stocks and the market perceives these trades are informative. Prior research also shows that there is a significant increase in insider trading in the acquiring firms prior to corporate acquisitions or merger announcements (Seyhun, 1990; Boehmer and Netter, 1997; Luo, 2005). As the acquisition can change the risk-return profile of the acquiring firm, directors may be more inclined to act opportunistically to time the market by investing more (less) of their personal resources in their firms prior to such announcements (Boehmer and Netter, 1997). More importantly, acquiring firms' directors have higher incentive to trade prior to corporate acquisitions due to the fact that directors of acquiring firms have relatively longer-term interest in their firms as compared to directors of targets. Therefore, it is important to examine the directors' trading in acquiring firms prior to corporate acquisitions.

In our paper, we attempt to critically address the specific issue of the information content of the directors' trade in conjecture with the motive of directors' trade on various acquisition characteristics. Specifically, we address the issues of (i) how acquirer directors' trading prior to acquisition of private targets differs from acquirer directors' trading of public targets; (ii) whether

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acquirer directors' trading conveys valuable information for stock-financed acquisitions; and (iii) how bidders' governance mechanisms affect the information content of acquirer directors' trading prior to acquisition announcements.

A considerable information asymmetry or uncertainty is likely to exist about the value of the private target's assets and opportunities compared to public targets (Officer et al., 2009; Madura and Susnjara, 2013). Private firms have few analysts following them and scant disclosure requirements, which makes it difficult for investors to acquire information about a private target. As information asymmetry is more prevalent in acquisitions of privately held firms, we expect that information content of directors' trading is more valuable to market participants when bidders acquire private targets. On the other hand, acquirer directors have the added advantage of knowing the private targets better as they are part of the discussions leading to acquisition decisions, which may induce them to trade heavily and opportunistically to time their trade to reap personal gain. Therefore, we investigate the effect of directors' trading on announcement period abnormal returns, distinguishing the bidders for public targets and bidders for private targets.

It is plausible that opportunistic directors might be especially sensitive to the probable whistle blowing and potential cost attached to such trading when better governance is in place (Fidrmuc et al., 2006; Cohen et al., 2012). Recent empirical studies suggest that strong corporate governance curtails insider-trading profits (Ravina and Sapienza, 2010). We, therefore, examine the moderating effects of the corporate governance characteristics of the bidding firms while examining the information content of directors' trading.

We investigate acquiring firm directors' trading prior to acquisition announcements which occurred between 2004 and 2012 for the Australian market. We start our analysis by examining whether directors' trades prior to acquisition announcements have any significant impact on announcement period abnormal returns. Our initial analysis shows that the announcement period abnormal return is higher for those acquiring firms where directors do trade comparing to bidding firms where directors do not trade one month, two months and three months prior to the acquisition announcement. This finding supports the conjecture that directors exploit their natural information advantage and their trades have significant information content for outsiders, especially when outsiders evaluate these trades in conjunction with acquisition announcements. The subsequent analysis shows that the level of directors' trading is more prevalent for private target acquisitions compared to public target acquisitions. Our results suggest that directors' trades convey more valuable information when bidders acquire small private targets compared to large public targets. As private firms have a high level of information asymmetry and are difficult to evaluate, the directors' trade prior to private target acquisitions reveals higher informational value compared to public targets. While examining the role of method of payment for acquisitions in directors' trading, our analysis of stock-only payment method shows that directors' trades have differential influence on stock-financed public targets versus stock-financed private targets. This finding supports the view that informational value of directors' trading is more pronounced for stock-financed private targets due to difficulty in valuing such targets. This finding is consistent with the view that stock-acquisition mitigates information asymmetry about the target (Hansen, 1987). On the other hand, directors' trading in stock-financed public targets indicate that their equity is overvalued (Myers and Majluf, 1984).

We find that the information content of directors' trading on acquisition announcement period returns is weaker in firms with higher blockholdings and/or firms with higher proportion of independent directors on the board. This implies that directors' trading contains less informational value when there are higher blockholders who monitor the firms, as well as when there is a higher proportion of independent directors on the board (Adams et al., 2008). Our results confirm that the market takes into account the firm's governance structure when reacting to acquisition announcements preceded by directors' trading. In better-governed companies directors are less likely to extract rent.

Our paper contributes to the current literature in the following ways. First, we show that directors' trading is positively related to acquirers' announcement period abnormal returns. This finding can be explained by the directors' opportunistic motive prior to acquisitions to reap private benefits which in turn convey information signals to the market participants about the target firms' value-relevant information. Our paper systematically reveals the rent-seeking behavior of acquiring firms' directors and informational value of such trades in relation to various acquisition characteristics. Second, we extend the prior literature by directly investigating the effect of pre-announcement period directors' trading on the announcement period abnormal returns after controlling various acquisition characteristics (Seyhun, 1990; Cumming and Li, 2011).[1] Our investigation is not only confined to directors' 'buy' trades, we have also examined directors' 'sell' trades, similar in spirit to Song (2007). Third, we find that pre-announcement period directors' trading is more valuable to market participants when private targets are acquired due to opacity and illiquid nature of private targets (Officer et al., 2009). We further document that directors significantly increase the dollar value of buy trades prior to private target acquisitions, implying that directors have superior private information. Finally, our paper takes into consideration the governance profile of the bidding firms while examining directors' trading prior to acquisitions. Fidrmuc et al. (2006) and Betzer and Theissen (2009) show that the ownership structure of firms has a significant impact on the informational value of directors' trading. Similarly, Fidrmuc et al. (2013) highlight that better shareholder protection might curb insider trading and result in smaller stock returns to insiders. We extend these studies by showing that opportunistic trading by directors prior to corporate announcements such as mergers and acquisitions can be mitigated by strong internal monitoring and the presence of external stakeholders. Overall, we add to the literature by empirically divulging the motive and informativeness of directors' trading prior to corporate acquisitions.[2]

[1] Seyhun (1990) examines the trading patterns of top corporate managers in bidder firms around the announcement of corporate takeovers. Cumming and Li (2011) show the relationship between the pre-announcement trading of acquirer stock and insider trading.

[2] See Balachandran et al. (2016) for the future direction of M&A research.

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