Session 5. Corporate Governance and Regulation

Paper 7: Rethinking the Regulation of Share Repurchases in Korea

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Rethinking the Regulation of Share Repurchases in Korea

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Abstract

After Korea liberalized its share repurchase rules in 1994, Korean public companies (like public companies in the U.S. and elsewhere) have increasingly used open market repurchases, rather than dividends, to distribute cash to shareholders. This paper explains why Korean firms’ use of repurchases to distribute cash may well create perverse incentives for managers and distort managers’ payout decisions. The paper examines Korea’s current approach to regulating repurchases and explains how it might be modified to reduce the potential distortions associated with repurchases without interfering with any of their potential benefits for shareholders.

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I. INTRODUCTION

Korean public companies (like public companies in the U.S. and elsewhere) are increasingly using open market repurchases, rather than dividends, to distribute cash. This paper explains why firms' use of repurchases to distribute cash may well create perverse incentives for managers and distort their payout decisions. The paper also suggests how Korea's current approach to regulating repurchases could be modified to minimize these distortions without reducing any of the potential benefits of repurchases.

Corporate payout policy has a significant effect on shareholder value. Because capital markets are not perfect and borrowing is not costless, firms' payout decisions affect the economy-wide allocation of capital. When a firm distributes cash to shareholders, the firm has less capital to finance current and future projects, and shareholders have more capital to invest in other ventures. Payout policy can also affect shareholder value by increasing firm leverage. From shareholders' perspective, the optimal payout policy is the one that, taking into account all these effects, maximizes value for shareholders.

There are two methods for paying out cash to shareholders: dividends and share repurchases. Until the 1980s, most countries severely restricted the ability of public firms to repurchase their own shares. In the 1980s and 1990s, under pressure from the managers of publicly traded firms, European and Asian countries began liberalizing their share repurchase rules. Korea was part of this trend, lifting its prohibition against share repurchase in 1994. As in other countries that have removed legal barriers to repurchases, the use of repurchases by Korean firms to distribute cash has increased.
significantly. Most of these repurchases take the form of open market repurchases (AOMRs) in which the corporation uses a broker to buy its own stock on the market.1

Korea’s current approach to regulating share repurchases is based on a combination of limitations on daily repurchase activity and disclosure requirements. Korean firms must announce their intention to conduct a repurchase and specify the maximum number of shares to be repurchased. Any shares repurchased under the program must be repurchased within three months of the announcement date. The maximum number of shares that can be repurchased per day is the greater of 10% of the target amount and 25% of average daily trading volume for the month prior to the announcement. At the end of the three month period, the firm must report its repurchase activity since the announcement.

The liberalization of share repurchases around the world has generally been applauded by financial economists and legal academics.2 It

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1 See Jung, Lee, and Thornton (2003).
has been argued that repurchases can provide unique benefits to shareholders (benefits that dividends cannot). Among these potential benefits are repurchases' ability to (1) reduce shareholder-level taxes; (2) lower shareholder transaction costs; (3) provide the firm greater financial flexibility; and (4) serve as a mechanism for signaling information about the firm's value to shareholders.3


3 Repurchases can also be used to fend off a hostile takeover bid. For an explanation of how repurchases can be used to reduce the probability of success of a hostile tender offer, Jesse M. Fried, Insider Signaling and Insider Trading with Repurchase Tender Offers, 67 U. Chi. L. Rev. 421 (2000). Because protecting managers from a hostile takeover bid tends to benefit managers at the expense of the firm's
Few academics, however, have paid any attention to the potential economic costs of using repurchases to distribute cash. Drawing on some of this work, this paper explains that repurchases can give rise to costs as well as benefits. The paper also explains how requiring Korean firms to disclose their actual repurchases shortly before they conduct them – rather than at the end of the three month repurchase period – can reduce these costs without interfering with any of the potential benefits of repurchases.

As I have shown elsewhere, a share repurchase is economically equivalent to the following two-part transaction. First, the firm’s managers cause the “remaining shareholders” (those shareholders who remain after the repurchase) to buy shares directly from “selling shareholders” (those shareholders who sell their shares back to the firm) at the repurchase price. Second, the managers cause the firm to issue a dividend (to the remaining shareholders).

The first part of the transaction – that in which remaining shareholders buy shares from selling shareholders at the repurchase price – transfers value from selling to remaining shareholders whenever the shareholders, see Bebchuk, Empowering Shareholders (2003), I do not include the takeover-protection function in the list of the possible benefits share repurchases provide shareholders. Even if takeover protection were considered a benefit for shareholders, however, none of the analysis or recommendations of this paper would change.


6 Of course, shareholders may sell some but not all of their shares during a repurchase. For ease of exposition, however, I will assume throughout this paper that the shareholders who sell stock back to the corporation dispose of all of their shares in the transaction. This assumption does not affect any of the analysis.
repurchase price is below the stock’s actual value. Accordingly, managers with inside information indicating that the stock is underpriced can use a repurchase to transfer value from selling shareholders to themselves and other remaining shareholders. Essentially, a repurchase combines, in a single transaction, managerial insider trading and a dividend. In fact, there is considerable evidence from the U.S. and other markets that managers use repurchases for such insider trading.

From the perspective of shareholders as a group, the optimal payout policy is one that, taking into account its effects on capital allocation and firm leverage, maximizes their value. Tying corporate payouts to managers’ insider trading considerations – as repurchases do -- is likely to distort the corporation’s payout policy. The paper explains that when managers can use a repurchase for insider trading, they will sometimes have an incentive to pay out too much – to squander cash that, from the perspective of all shareholders should remain in the firm. At other times, managers will have an incentive to pay out too little – to hoard cash that should be distributed. In either case, whether the firm distributes too little cash or too much cash, shareholder wealth is destroyed.

In addition to distorting payout policy, the use of repurchases for insider trading gives managers an incentive to increase information asymmetry between themselves and public shareholders by, for example, delaying the disclosure of information to the market. Finally, managers intending to sell shares have an incentive to announce repurchases even when they have no intention of conducting them.

Because these distortions arise from managers’ use of repurchases for insider trading, they can be reduced by making it more difficult for managers to exploit their informational advantage with repurchases. As I

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7 See Fried 2003.
have argued elsewhere, requiring firms to disclose their repurchases shortly before effecting them would greatly diminish managers’ ability to use repurchases to indirectly trade on inside information and thereby reduce the resulting distortions in managers’ payout and disclosure decisions. Such a disclosure requirement would not adversely affect any of the benefits attributed to repurchases – lower tax and transaction cost for shareholders, greater financial flexibility for the firm, and signaling. The paper thus suggests that Korea consider moving from a post-repurchase disclosure requirement to a pre-repurchase disclosure requirement.

The remainder of the paper is organized as follows. Part II describes the importance of corporate payout policies and the use, potential benefits, and current regulation in Korea of repurchases. Part III explains why a repurchase is economically equivalent to a dividend payment coupled to managerial insider trading. It provides evidence from the U.S., Korean, and other stock markets that repurchases are used for insider trading and explains why insider trading, by itself, cannot increase the amount of value available to the firm’s shareholders. Part IV describes the costs to shareholders that arise when managerial insider trading and a dividend payment are linked together in a single transaction. Part V suggests how Korea might benefit from adopting an advance disclosure approach to regulating repurchases. Part VI concludes.

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8 See Fried (2003). In previous work I have shown that requiring individual insiders to disclose their intended trades in advance would substantially reduce insiders’ ability to trade profitably on inside information. See Jesse M. Fried, Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure, 71 S. Cal. L. Rev. 303 (1998).
II. SHARE REPURCHASES IN KOREA

Publicly traded Korean firms generate billions of dollars of earnings annually.9 Each year, the managers of these firms must decide how much of firms’ retained earnings should be distributed to shareholders. These payout decisions are important. Because capital markets are not perfect, a firm cannot always obtain outside financing for projects with positive net present value. Thus, payout decisions affect the firm’s ability to invest in both existing and potential new projects. The firm’s payout policy can also affect shareholders’ ability to invest in ventures outside of the firm. Finally, payout decisions also affect the firm’s leverage, which in turn might affect managers’ choice of projects. Thus, payout policy of Korean firms has a substantial effect on “shareholder value” – defined as the total amount of value available to all the firm’s shareholders.

Managers must decide not only the amount of cash that should be distributed to shareholders, but also how the money should be paid out: through dividends or through share repurchases. Historically, most publicly traded firms around the world – including Korean firms -- have used dividends exclusively because repurchases were prohibited or highly disfavored by the legal system. As the regulation of share repurchases has been liberalized over the last several decades, firms around the world have been increasingly using repurchases to distribute cash. Korea, which liberalized its share repurchase rules in 1994, has been part of this trend.

Section A of this Part describes the use and regulation of share repurchases in Korea. Section B describes the potential benefits of share repurchases for Korean firms and their shareholders.

9 JMF: Get Cite
A. The Use and Regulation of Share Repurchases in Korea

1. The Use of Repurchases in Korea

The Korean Securities Act of 1994 permitted Korean firms to begin repurchasing shares in that year. Since then, Korean firms have increasingly been using repurchases to distribute cash. These repurchases tend to take the form of an open market repurchase (OMR) in which the firm buys back its own stock on the open market, through a broker.\(^{10}\)

The average percentage of stock targeted for repurchase in Korea is 4%\(^{11}\) (compared to 7 percent in the U.S.).\(^{12}\) Unlike in the U.S., where a repurchase program can continue indefinitely, any shares repurchased under a Korean repurchase program must be repurchased within 3 months. On average, 89% of the targeted shares are repurchased during this three month period\(^{13}\) (compared to 70-80% in the U.S. within the three year period beginning with the OMR announcement).\(^{14}\)

As in the U.S, repurchase announcements are usually greeted favorably by the market. Korean repurchase announcements are associated with short-term “abnormal” (i.e., market-adjusted) share price increases averaging 2.8%,\(^{15}\) (similar to the increases of 3%-4% reported in the U.S.

\(^{10}\) See supra note x.
\(^{12}\) See Ikenberry, et. al., supra note, at 185 (reporting that the average percentage of outstanding shares sought in all of the open market repurchases announced between January 1980 and December 1990 by firms listed on the ASE, NYSE, and NASDAQ was 6.6 percent).
during the 1980s, and the 1-2% reported in the U.S. during the 1990s).

2. The Regulation of Share Repurchases in Korea

I will now sketch out the current regulatory framework that governs repurchases in Korea, briefly noting the most important differences with (and similarities to) U.S. law.

Korea began the process of deregulating share repurchases in 1992, after sharp declines in share prices in the Korean stock market. That year, publicly traded Korean firms were permitted to participate in “Treasury Stock Trust Funds” for the purpose of “stabilizing” the price of their traded stock. Administered by one of three major Korean trust companies, each trust fund received contributions from several public companies and used the pooled funds to attempt to prop up the companies’ stock prices. 19

16 See Ikenberry et al., supra note __, at 190 (reporting that the average market reaction to OMR announcements in all of the OMRs announced between January 1980 and December 1990 by firms listed on the American Stock Exchange, New York Stock Exchange, and NASDAQ was 3.54%).

17 See Kathleen Kahle, When a Buyback Isn’t a Buyback: Open Market Repurchases and Employee Options, __ J. Fin. Econ. ____ (2002) (finding that the average abnormal return around the announcement of open market repurchases by firms in the Execucomp database between 1991 and 1996 was 1.6%)


19 Initially, a fund could not invest more than 20% of its assets in the stock of a single firm. In 1998, the limit was increased to 35%. At first, a firm could not contribute more than 5% of its market value to the fund. This limit was gradually increased and removed altogether in 1999. Firms contributing cash to a trust fund were permitted to demand repayment from the fund after a specified time. Initially, firms could not withdraw any money the first year. During the second year they could withdraw up to 10% of their original contribution per month. After two years they could withdraw the entire amount at any time. In 1998, the no-withdrawal period was reduced from one year to six months. See Sung-Chang Jung, Yong-Gyo Lee, John H. Thornton Jr., Stock Repurchases in a Developing Market: Evidence from Korea (working paper, 2003),
In 1994, Korean firms were for the first time permitted to directly repurchase their own shares in the open market. As in the case of U.S. repurchases, the shares are purchased through a broker. The acquired shares become treasury shares that can be either retired or reissued at a later date. As I noted in Section A.1, the repurchase program must be completed in three months. In the U.S., a repurchase program can continue indefinitely.

For my purposes, the two most important elements of repurchase regulation are (1) disclosure requirements and (2) restrictions aimed at reducing firm’s ability to manipulate their stock price. I address each in turn.

a. Disclosure Requirements

As in the U.S., Korean firms must announce the establishment of open market buyback programs. Unlike in the U.S., Korean firms announcing repurchases must provide the reason(s) for the stock repurchase and specify a targeted amount of shares. However, these announcements do

20 Also unlike in the U.S., a Korean firm cannot use borrowed funds to finance the repurchase. See Sung-Chang Jung, Yong-Gyo Lee, John H. Thornton Jr., Stock Repurchases in a Developing Market: Evidence from Korea (working paper, 2003), 5.
21 This requirement is imposed by the Korean Securities and Exchange Commission. In the U.S., however, the announcement requirement is imposed by the stock exchanges, not the Securities and Exchange Commission. See Matthew J. Gardella, Stock Buybacks: Legal Issues Under the Federal Securities Laws and Other Practical Considerations, 13 INSIGHTS 2 (1999).
22 According to a recent study, 83.4% of the firms list “stock stabilization” as the sole reason; 3.9% list “takeover defense” as the sole reason, and the remainder, 10.8%, list both “stock stabilization” and takeover defense. Given that the Korean government authorized stock repurchases at the bottom of the market for the purposes of takeover defense and stock price stabilization, one would expect managers – regardless of their actual motivation – to provide one or both of these reasons. Thus, it is not clear what inference can be drawn from these stated reasons.
23 When U.S. a firm announces an OMR, it will not always indicate the number of shares it intends to repurchase. See Maxwell and Stephens (reporting that 20% don’t announce), at 6; Jagannathan & Stephens, supra note x at 6 (reporting that 30% don’t announce). Some firms announce an intention to undertake open market repurchases without specifying a dollar amount or time limitation. See Grullon and
not commit the firm to repurchase a single share during the three month repurchase period.

After the announcement, Korean firms need not disclose any information about their actual repurchase activity until the three month period has ended. At that point, Korea firms must file a report stating the actual number of shares repurchased.

The disclosure requirements are thus more strict than in the U.S.. In the U.S., a repurchase announcement can cover an indefinite period of time. The repurchasing firm need not announce when it begins actually repurchasing shares, when it suspends repurchasing shares, or when it completes or abandons the repurchase 24

b. Anti-Manipulation Restrictions

Under Korean law, there are limits on the number of shares that can be repurchased each day. The original limit was 3% of the announced repurchase amount. This limit was raised in 1998 to the greater of 10% of the announced amount and 25% of average daily trading volume over the month prior to the announcement, but which cannot exceed 1% of outstanding shares.

In the U.S., there are no such restrictions. However, the securities laws give managers of U.S. firms have an incentive to limit daily repurchases. The anti-manipulation provisions of Section 9(a)(2) of the 1934 Act make it illegal to conduct a series of transactions creating actual or apparent active trading

Ikenberry, p. 33.

24 The SEC is currently considering increasing disclosure requirements for firms undertaking OMRs. In particular, the SEC is proposing that publicly traded firms report monthly share repurchases and related information in their quarterly disclosure statements filed with the SEC (Forms 10-Q and 10-K). For now, however, disclosure requirements are minimal.
in a security, for the purpose of inducing the purchase or sale of the security. Because buying one’s own shares might in some cases be considered manipulative, managers conducting a repurchase face some risk – however slight -- of liability under these laws.

Managers’ incentive to limit daily repurchases comes from SEC Rule 10b-18, which provides repurchasing firms a safe harbor from anti-manipulation liability under Section 9(a)(2) when they repurchase their shares in accordance with the rule’s “manner, timing, price, and volume” conditions. Among other things, Rule 10b-18 requires a firm seeking the safe harbor to (1) limit the number of shares it purchases on the open market each day to 25 percent of the average daily trading volume of the previous month and (2) not offer a price that is higher than the last sale price on the exchange or the current bid quote, whichever is higher. Although most firms fail to comply strictly with the requirements of the Rule 10b-18 safe harbor, managers in fact tend to sharply limit the number of shares repurchased per day in keeping with the “spirit” of the safe harbor.

B. The Potential Benefits of Repurchases for Korean Shareholders

The increase in the use of repurchases around the world has been widely viewed as good for shareholders by both academics and market.

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26 SEC Release No. 34-46980 (December 10, 2002). In releasing Rule 10b-18 the SEC made clear that it does not provide a safe harbor from Rule 10b-5 liability. Sec. Ex. Act. Rel. 19,244 26 SEC Dock. 868, 869 n.5 (1982). Thus the issuer is not permitted to repurchase while in possession of favorable, material, nonpublic information concerning its securities. See infra Part ___.
27 Other requirements are that open market purchases must be (a) made through only one broker (per day); (b) at a time other than the last half hour of trading and (c) after the opening transaction.
28 See Krigman, Cook,.
29 Id.
commentators. Repurchases are said to provide four main benefits to firms and their shareholders relative to dividends. Specifically, it has been argued that share repurchases (1) reduce tax costs for shareholders; (2) lower transaction costs; (3) offer greater financial flexibility; and (4) provide a mechanism for signaling that the stock is underpriced. I briefly describe each of these potential benefits below.

I wish to emphasize that I am not claiming that repurchases in fact provide all of these benefits. Indeed, I have argued elsewhere that there are much more efficient means of signaling stock underpricing than through a repurchase. Rather, my purpose here is simply to describe the benefits that other commentators have attributed to repurchases. In Part V I will show that, even if repurchases provide all these benefits to Korean shareholders, the advance disclosure requirement I suggest that Korea adopt would not impair any of them.

1. Shareholder Tax Efficiency

In most systems, taxable shareholders (those not exempt from the tax) pay tax either when they receive dividends or sell their shares for a profit. However, the proceeds from stock sales are almost always taxed less heavily than the receipt of dividends. Thus managers seeking to benefit shareholders may well wish to distribute cash through repurchases rather than through dividends.

30 Get cites.
31 In the U.S., repurchases also acquire shares needed for employee stock option plans.
When a firm issues dividends, all taxable shareholders are taxed on the entire amount of the dividend received. Any taxable shareholder who receives a $100 dividend must pay tax on $100.

Contrast this with the tax paid when $100 worth of shares are sold to the company. To begin, only those shareholders who sell their shares are taxed. This enables shareholders who would otherwise pay a high marginal tax to avoid any tax liability, while allowing shareholders who have purchased the shares at a higher price to realize a taxable loss that reduces their overall tax obligation.

In addition, those shareholders who are taxed on the sale of the shares in the stock are not taxed on the full amount of the sale proceeds, but rather only on the capital gains - the difference between the sale proceeds and the shareholders’ cost basis in the stock. Thus, a shareholder who sells $100 worth of shares that were purchased for (say) $60 pays tax on only $40.

Finally selling shareholders are taxed at the capital gains rate, which in many jurisdictions cases is less than the rate to which dividends are subject. [get info for Korea] Note that even if the capital gains rate is the same as the tax on dividends, share repurchases would still be more tax efficient than dividends because they enable individuals in the highest tax brackets to avoid an immediate tax and selling shareholders are taxed only on their capital gains, not the entire proceeds of the stock sale.

2. Transaction Cost Efficiency

It has been argued that repurchases might reduce shareholders’ transaction costs.33 At any given point in time, it is likely that some shareholders are seeking liquidity (that is, to convert shares into cash) and

33 See Elton and Gruber, supra note x.
others are not. Distributing cash through a repurchase rather than a dividend might affect the transaction costs borne collectively by these two groups of shareholders.

Suppose all shareholders receive a dividend. Those seeking liquidity will get what they want: cash. However, there may be many situations in which the dividend is not sufficient to meet the shareholders’ liquidity needs, in which case the liquidity-seeking shareholders must still sell shares to get the needed amount of cash. Those not seeking liquidity must also incur transaction costs reinvesting the dividend in the stock of the issuing (or another) firm. Accordingly, both groups of shareholders are likely to bear transaction costs.

If the firm repurchases shares rather than issues a dividend, those not seeking liquidity do not receive unwanted cash. As a result, they are not forced to incur any transaction costs reinvesting the funds. Those who need cash can sell stock, which, the argument goes, they may well have needed to do even if the firm had issued a dividend. Thus, a repurchase eliminates transaction costs for one set of shareholders - non-liquidity seeking shareholders - while only marginally increasing transaction costs for the other - liquidity-seeking share repurchases.34

3. Financial Flexibility

Repurchases are also said to provide more financial flexibility than share repurchases. Paying a dividend, the argument goes, implies to the

34 I am very skeptical of this transaction cost benefit, especially in the U.S., where shareholders can reinvest dividends costlessly through dividend reinvestment programs. In addition, the analysis ignores the large extra transaction costs -- in the form of bid-ask spreads and trading fees -- incurred by the firm and its shareholders when cash is distributed through market trading rather than electronically. See Fried (2003).
market a commitment by the firm to make future distributions.\textsuperscript{35} Thus, managers faced with a one-time need to distribute cash will be reluctant to issue dividends because distributing cash in that form would falsely raise investors’ expectations about the firm’s expected future cash flows.\textsuperscript{36}

4. Financial Signaling

Economists have long argued that managers can use repurchases to signal that the stock is underpriced. Specifically, managers who have private information indicating that the stock is underpriced and wish to signal credibly that the stock is underpriced can do so by having the firm conduct a repurchase while committing not to sell their shares.\textsuperscript{37}

In theory, repurchases can be used to credibly signal that the stock is worth more than the repurchase price. As the Introduction explained, any share repurchase is economically equivalent to a transaction in which remaining shareholders collectively buy shares directly from the selling shareholders at the repurchase price. Accordingly, managers who make a double commitment -- to (1) have the firm repurchase shares and (2) not sell their own shares until the underlying good news emerges --- effectively commit to buy their pro rata share of the repurchased shares at the repurchase price. If firm value is in fact less than the repurchase price, the

\textsuperscript{35} There is a considerable literature explaining how firms that initiate or increase dividends send a signal to the market that long-term cash flows have increased. See, e.g., John and Williams (1985); Bernheim (1991); DeAngelo, DeAngelo, and Skinner (2000). But see Gustavo Grullon, Roni Michaely, Shlomo Benartzi, and Richard H. Thaler, Dividend Changes Do Not Signal Changes in Future Profitability (working paper, 2003).

\textsuperscript{36} I am skeptical about this benefit of repurchases because for many years firms have distributed cash through so-called “special dividends.” These are one-time (or infrequent) dividends that are issued by the firm with an indication that the firm has no current plans to make any such payouts in the future. See Fried (2003).

\textsuperscript{37} See, e.g., Buckley, supra note, at 539.
repurchase makes managers worse off by causing them to overpay for the shares.\textsuperscript{38} Thus, by committing to repurchase shares and to not sell their own shares, managers send a credible signal that firm value exceeds the repurchase price.\textsuperscript{39}

\textsuperscript{38} By distributing cash, the repurchase also increases risk to the firm, imposing an additional risk-bearing cost on managers. See McNally, supra note, at 56.

\textsuperscript{39} See William J. McNally, Open Market Stock Repurchase Signaling, [finish citation]. For a critique of the signaling theory see Fried (2001).
III. SHARE REPURCHASES: INSIDER TRADING AGAINST THE FIRM’S OWN SHAREHOLDERS

We saw in Part II that in theory managers can use repurchases to benefit shareholders by reducing shareholders’ tax burden and transaction costs, by giving firms greater financial flexibility, and by enabling managers to communicate information about the stock’s value to shareholders.

This Part explains how managers can and do use repurchases for insider trading. It begins in Section A by explaining that a repurchase is economically equivalent to a transaction in which managers (and other remaining shareholders) first buy selling shareholders’ stock at the repurchase price and then receive a dividend from the corporation. A repurchase thus integrates in a single transaction managerial insider trading and a dividend.

Section B describes the considerable amount of evidence collected in the U.S. and elsewhere indicating that managers in fact use at least some repurchases to engage in insider trading with selling shareholders. It also shows how the available Korean data on share repurchases is consistent with the use of at least some repurchases for insider trading.

Section C explains why the insider trading effect of a repurchase, assuming it has no influence on managers’ payout decisions, does not increase shareholder value. In the next Part, I will explain how linking a firm’s payout policy to insider trading considerations can distort the firm’s payout policy in a way that reduces further total shareholder value.
A. The Insider-Trading Effect of a Repurchase

As I have shown elsewhere, a share repurchase can be reconceptualized in a way that helps illuminate the economic effect of using repurchases to distribute cash to shareholders. In particular, a share repurchase can be decomposed into three transactions: shareholder-level trading between departing and remaining shareholders, a dividend payment by the firm, and a reverse stock split. In particular, a repurchase is equivalent to the following three transactions: (1) managers purchase for themselves and other remaining shareholders, at the repurchase price, the shares of selling shareholders; (2) managers issue a dividend equal to the dollar amount of the repurchase; and (3) managers effect a reverse stock split.

A diagram can be used to illustrate the equivalence between a share repurchase and these three transactions.

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40 See Fried (200); (2003).
41 By “selling shareholders,” I mean those selling shareholders whose shares are purchased by the repurchasing firm.
42 I ignore transaction costs, which would be lower under a repurchase than under the three step transaction described here.
Suppose that XYZ Corp. has 2 shareholders, A and B, each of whom owns one share. The figure to the left of the “=” shows a stock repurchase in which XYZ repurchases B’s share for $100. The effect of the repurchase is that (1) B has sold his share for $100; (2) XYZ has distributed $100 in cash; and (3) A owns XYZ’s single share (100% of XYZ’s equity).

The figures to the right of the “=” show three transactions: First, A buys B’s share for $100. Second, XYZ distributes a dividend of $100 to A (to reimburse A for his purchase of B’s share). Third, XYZ effects a reverse stock split by converting A’s 2 existing shares into 1 new share.

It is easy to see that the results of these three transactions are identical to those of the repurchase on the right: (1) B ends up with $100 and no shares in XYZ; (2) XYZ has distributed $100 in cash; and (3) A owns XYZ’s single share (100% of XYZ’s equity).

Because the reverse stock split is merely a nominal change with no economic significance, for purposes of the analysis we need to focus only on the first two of the three transactions: (1) the shareholder-level trading
transaction, in which the managers and other remaining shareholders buy
the stock of selling shareholders, and (2) the payout transaction.

Let us consider the inter-shareholder distributional effects of these
two transactions. The second transaction – the dividend payout to
remaining shareholders – has no distributional effects among shareholders as
it affects all (remaining) shareholders equally. However, the first transaction
– the shareholder-level trading transaction – can redistribute value among
shareholders. In particular, if the purchase price is less than the stock’s
actual value, the shareholder-level trading redistributes value from selling
shareholders to remaining shareholders.

Because a repurchase is equivalent economically to these two
transactions – shareholder-level trading and a dividend payment -- it must
have the same economic effects as these two transactions. Accordingly,
when the repurchase price is less than the stock’s actual value, the
repurchase transfers value from selling shareholders to the managers and
other remaining shareholders. In effect, a repurchase at a low price allows
the managers and other remaining shareholders buy the shares of departing
stockholders at a bargain price.

For example, suppose that the pre-distribution value of XYZ is $300. Each of the two shares is thus worth $150.
The figures to the left of the “=” show a stock repurchase in which XYZ repurchases B’s share for $100. The effect of the repurchase is that (1) B has sold his share for $100; (2) XYZ has distributed $100 in cash; and (3) A owns XYZ’s single share (100% of XYZ’s equity), which is worth $200 ($300 pre-distribution value less $100 paid to B).

The figures to the right of the “=” show a two-step transaction: First, A buys B’s share for $100. Second, XYZ distributes a dividend of $100 to A (to reimburse A for his purchase of B’s share). The exchange element of the transaction redistributes value between A and B because A is buying B’s share for $100, even though it is actually worth only $150. A and B each started with stock worth $150. The $50 transfer from B to A means that B ends up with $100 and A ends up with $200.

In general, the amount of the transfer to A – the remaining
shareholders -- equals the difference between the actual value of the stock and the repurchase price (in this example, $50), multiplied by the number of shares repurchased (in this example, one). The greater the difference between the price and the value of the stock, and the more shares repurchased, the larger is the transfer to the remaining shareholder. If A were thought of as a group of shareholders -- managers and remaining shareholders -- rather than a single shareholder -- the remaining shareholders would enjoy the transfer pro rata. Thus, the larger is managers' proportional ownership, the greater is their share of the transfer. As we will see shortly, there is evidence from both the U.S. and Korean markets suggesting that managers with larger equity stakes are more likely to use repurchases for insider trading.

**B. MANAGERS’ USE OF REPURCHASES FOR INSIDER TRADING**

Having seen how a repurchase can be used for insider trading, this Section explains that managers have the ability and incentive to use the repurchase redistributional effect for the benefit of themselves and other remaining shareholders, and presents evidence from the U.S., Korea, and other countries that they indeed do so.

**1. Managers’ Ability and Incentive to Use Repurchases for Insider Trading**

There is considerable evidence that corporate managers have important private information relating to firm value by virtue of their positions within their firms. Most of this evidence comes from the U.S., where researchers have access to the trading data high-level managers must
report to the SEC.

The most persuasive evidence is that U.S. managers are able to exploit private information about firm value to increase their personal trading profits. Managers increase their selling before releasing “bad news” and increase their buying before releasing “good news.” For example, corporate insiders sell heavily in the five-month period preceding a bankruptcy announcement. Corporate insiders also tend to frequently exercise options shortly before stock price declines. Finally, corporate insiders as a group consistently earn excess returns in their personal trading. One study found that in their personal trading between 1984 and 1989, which includes, presumably, trades not based on inside information (e.g., liquidity-driven sales), managers annually earned excess returns averaging 7%.47

To the extent managers have inside information and can use it to increase their personal trading profits, they can also use this information to benefit themselves and other remaining shareholders by having the firm repurchase stock at a bargain price. Indeed, there are a number of factors that may make it easier for managers to buy indirectly through repurchases than to buy directly for their own accounts when the stock is underpriced.

For example, managers facing liquidity constraints might find it difficult to buy shares for their own accounts, or at least to buy as many shares as they would like. Such liquidity-constrained managers might purchase directly in the market as many shares as they can, given their

43 See Fried, supra note x, at 317-20 (collecting and summarizing studies).
45 See Steven Huddart & Mark Lang, Information Distribution Within Firms: Evidence from Stock Option Exercises (working paper, 2001).
46 See Fried, supra note x, at 321-23 (collecting and summarizing studies).
liquidity constraints and, after they have reached those constraints, conduct a repurchase. In fact, in the U.S. managers frequently buy shares for their own accounts before announcing repurchases.\textsuperscript{48}

As Section A explained, a repurchase at a low price transfers value from selling shareholders to managers and other remaining shareholders. The value transferred is shared rata bly among the managers and remaining shareholders. The benefit to the managers is thus increasing both in the total amount transferred and managers' proportional interest in the post-repurchase firm. As a result, the higher managers' proportional ownership, the greater the incentive to repurchase shares when the stock is underpriced.

If managers owned only a small percentage of their firms' shares, they would have little incentive to engage in repurchase insider trading. But in the U.S. managers of firms announcing repurchases tend to own a substantial fraction of the firms' shares before the repurchase: an average of 15-20\%.\textsuperscript{49} As a result, managers capture an average of one out of every five or six dollars of value transferred from selling shareholders to remaining shareholders, providing them with significant incentive to conduct repurchases when the stock is underpriced.

Korean managers have an even greater incentive to use repurchases for insider trading. As of the end of October 1997, the major shareholders of Korea's listed firms had average shareholdings of 33.31\%.\textsuperscript{50} Hence, these shareholders capture an average of one out of every three dollars of value.


\textsuperscript{49} See McNally, supra note , at 59; Vafeas, supra note , at 112-13.

transferred from selling shareholders to remaining shareholders.

To be sure, managers do not have an unlimited ability to use repurchases for insider trading. A firm might face cash constraints. That is, it might not have enough cash readily available to fully exploit a temporary gap between the actual value of the stock and the share price.51 These cash constraints will limit managers' ability to exploit mispricing.52

Even absent cash constraints, U.S. managers might be reluctant (to buy a large number of shares during the period before the nonpublic information on which they are trading emerges. Large purchases and increases in trading volume might signal clearly that the stock is underpriced, boosting the price of the stock and significantly reducing the amount of value transferred to managers and remaining shareholders.53 In Korea, where there are limits on daily repurchase activity, managers will be unable to repurchase more than a certain number of shares per day. However, within these cash and volume constraints, managers of public firms still have the ability to use repurchases for insider trading.

2. The Effect of Insider Trading Law on Managers' Repurchase Insider Trading

In principle, insider trading law could prevent managers from engaging in repurchase trading. However, even in the U.S., where insider

51 For example, the firm might have the cash, but prefer to use it for other (real) investments that are likely to earn for remaining shareholders an even higher return. The firm might also fear credit downgrades that will increase its cost of borrowing.

52 The firm might also be able to raise funds by issuing debt, but there is likely to be a time lag during which the stock might become fairly priced (or even overpriced). In addition, the costs of issuing additional debt (e.g., excessive leverage) might exceed the expected benefit from buying the stock at a low price.

53 The firm might also fear that the purchases will force the price up quickly through price pressure. See Fried (2003).
trading is taken seriously and effort is made to enforce the insider trading laws, insider trading laws cannot prevent U.S. managers from engaging in repurchase insider trading. It is thus unlikely that Korean insider trading law, which is less developed and less enforced than in the U.S., can prevent Korean managers from using repurchases for insider trading.

In the U.S., corporations trading their own shares are subject to the insider trading laws. The most important legal restriction on insider trading is Rule 10b-5, which was promulgated by the SEC under section 10 of the Securities Exchange Act of 1934. Rule 10b-5 requires insiders – including the firm and its officers and directors – to refrain from trading in the firm’s shares while in possession of “material” nonpublic information regarding their value.

Although Rule 10b-5 prohibits a firm from repurchasing shares when managers have material inside information indicating the stock is underpriced, there are likely to be many cases in which Rule 10b-5 cannot prevent managers from having the firm trade profitably on nonpublic information. First, Rule 10b-5 prohibits trading on inside information only when that information is legally “material.” However, internal projections and other forms of “soft” information are not considered legally material, even if the information is important and would be of great interest to investors. Thus, managers are free to have the firm trade and to conduct

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54 17 C.F.R. § 240.10b5 (2000).
55 *McCormick v. Fund Am. Cos., Inc.*, 26 F.3d 869, 876 (9th Cir. 1994) (“The corporate issuer in possession of material nonpublic information, must, like other insiders in the same situation, disclose that information to its shareholders or refrain from trading with them.”); See Fried, supra note x, at 330. By Anside information, I mean nonpublic information relating to the value of the firm’s shares that is available to managers by virtue of their positions within the corporation, whether or not that information would be considered legally material. See *United States v. O’Hagan*, 521 U.S. 642, 643 (1997).
56 See also John Coates, *A Fair Value as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions*, 147 U.PA. L. REV. 1251, 1315 (1999); Mitu
share repurchases without disclosing a wide range of valuable but inside information.58 Moreover, courts have been reluctant to find even non-soft information “material” unless it concerns a “bombshell event”—such as the definite existence of a takeover offer—whose announcement dramatically changes the stock price.59 Thus, the threshold of materiality is such that insiders can easily profit by trading directly or indirectly through repurchases on information that, while price-sensitive, is not legally material.60 These gaps in the insider trading laws explains why, as I noted above, there is so much evidence that U.S. managers trade profitably on inside information for their own account. And it explains why, as I will show shortly, there is so much evidence that managers in the U.S. and in other markets engage in repurchase insider trading.

3. Evidence Managers Use Repurchases to Transfer Value

Having seen that managers have the incentive and ability to use a repurchase’s insider trading effect to benefit themselves and remaining shareholders, we now turn to the considerable evidence that managers in fact use at least some repurchases for this purpose. The evidence can be divided into two categories: (1); managers’ behavior before and after the repurchase announcement and (2) price movements before, around the time

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58 See Fried, supra note, at 310; Donald Langevoort, Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation, 99 COLUM. L. REV. 1319, 1335 (1999) (observing that insiders at almost all times have the advantage of superior insight and a sense of which way things are going even if they do not possess a fact that a court would call material and nonpublic).
59 See Fried at 336.
60 See Dennis W. Carlton & Daniel Fischel, The Regulation of Insider Trading, 35
Managers’ behavior before and after the repurchase announcement are consistent with the use of at least some repurchase insider trading. The higher the managers’ percentage ownership, the greater the incentive to conduct a repurchase for insider trading. This would suggest that the more shares managers own, the more likely they are to conduct a repurchase. Consistent in this prediction, there is evidence that in the U.S. managers owning more options are more likely to conduct a repurchase. Similar evidence comes from Canada. One study found that Canadian firms conducting repurchases between 1989-1992 had an average inside ownership of 29.4%, while a sample of similar firms not conducting repurchases have an average inside ownership of 9.8%.

The relationship between managers’ equity stake and their incentive to conduct insider trading repurchases suggests that managers with large stakes are not only more likely to have their firms’ repurchase shares but also more likely to repurchase stock when the price is low. Indeed, in the U.S.
there is a positive relationship between pre-repurchase managerial ownership and post-repurchase stock appreciation, indicating that managers with larger stakes are more likely than managers with smaller stakes to conduct a repurchase when the stock is underpriced. Similarly, in Korea the market response to a repurchase announcement increases in the size of managers' holdings, which suggests that the market believes that repurchases by firms with large managerial holdings are more likely to be driven by insider trading considerations.

In addition, there is some evidence that U.S. managers buy more shares for their personal accounts before repurchases that are followed by significant stock price appreciation, indicating that managers are aware, at the time of the announcement, whether the stock is underpriced. This is consistent with survey data. When asked in anonymous surveys what

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64 See Jung, Lee, and Thornton (2003), p. 21


66 Insider trading would predict that the greater are the CEO's holdings, the more likely they are to repurchase shares. See Kathleen M. Kahle, When a Buyback isn't a Buyback: Open Market Repurchases and Employee Options, J. Fin. Econ. (2002)(finding that the decision to repurchase shares is affected by the number of managerial options outstanding); Fenn and Lang, supra note x; Jolls, supra note x.

Of course, an alternative explanation is that managers holding equity will generally prefer repurchases over dividends even in the absence of insider trading. See supra note x.
would motivate managers to conduct a repurchase, 66% responded that the stock being undervalued would cause them to initiate a repurchase.67

Managers’ behavior post-announcement is also consistent with the use of at least some repurchases for insider trading. There is also considerable evidence suggesting that post-announcement managerial behavior is driven, at least in part, by insider trading consideration. U.S. managers are more likely to follow up a repurchase announcement with actual repurchases if the stock subsequently performs poorly.68 A recent study of repurchases on the Hong Kong Stock Exchange (SEHK), where repurchasing firms must report the date, volume, and prices of every share repurchased on the morning of the next business day, concluded that managers were using inside information to make their repurchase decisions.69

b. Stock Price Movements

Stock price movements before, during, and after repurchase announcements are also consistent with the use of at least some repurchases for insider trading.

Consider first stock price movements before repurchase announcement. If repurchases are conducted when the stock is underpriced, one would expect many repurchases to follow periods in which the stock

69 Paul Brockman and Dennis Y. Chung, Managerial Timing and Corporate
experienced negative abnormal returns. In fact, in both Korea and the U.S., the stock prices of Korean firms announcing repurchases on average exhibit negative abnormal returns in the 30-day period prior to the announcements\textsuperscript{70}, which is consistent with the shares having become underpriced at the time of the repurchase.

Stock price movements around the time of the repurchase announcement are also consistent with the use of repurchases for insider trading. If managers were to sometimes use repurchases for insider trading, then an announcement would signal that the expected value of the stock is higher than the current market price. Indeed, when a repurchase is announced, the market reacts to the announcement by bidding up the price of the stock. In Korea, for example, the average abnormal return during the three-day period beginning with the announcement date is 2.78\%.\textsuperscript{71} This reaction is consistent with the announcement sending a signal that the stock is underpriced.

It is useful to compare the stock price movements of firms announcing repurchases to those of firms announcing the creation of stock stabilization funds. Stock stabilization funds allow for insider trading because they enable the firm to buy its own shares through the fund. However, stock stabilization funds are poor vehicles for insider trading relative to

\textsuperscript{70} See Jung, Lee, and Thornton (2003), p. 14 (reporting that firms announcing repurchases in Korea experience large abnormal negative returns in the 30-day period prior to the announcement). In the U.S, Jagannathan and Stephens, supra note x report that for infrequent or occasional repurchasers (firms which conducted only 1 or 2 repurchases respectively in the previous 5-year period) average returns in the year before the announcement are 11\% and 5\%, respectively, below those of peer firms. U.S. firms announcing first time repurchases also have high book to market ratios, which is consistent with their being underpriced. See Grullon and Ikenberry, supra note x.

repurchases. First, stock stabilization funds take the stock purchase decision out of the hands of managers and put it the hand of the trustee, who has less inside information. Second, any profits from buying the shares of a particular company at a low price must be divided pro rata among all the firms contributing to the stabilization fund. Thus, one would expect stock price movements around the announcement of the creation of stock stabilization funds prior to 1994, before repurchases were allowed, to be similar to those around the announcement of share repurchases after 1994, only smaller in magnitude.

Indeed, the stock price movements of firms announcing stabilization funds after between 1992 and 1994, when direct repurchases were not permitted, followed the pattern of the stock prices of Korean firms announcing repurchases after 1994. As in the case of repurchasing firms, there were abnormal negative returns prior to the announcement of the creation of stock stabilization funds and positive abnormal returns around the announcement date, although the magnitudes.

Because share repurchases are a superior mechanism for insider trading, one would also expect that after the legalization of repurchases the announcement of the creation of a stock stabilization fund would be less likely to be associated with negative abnormal returns before and positive abnormal returns after the announcement date. Indeed, after 1994, shares announcing the creation of stock stabilization funds did not exhibit statistically significant negative abnormal returns prior to the announcement or positive abnormal returns during the period beginning with the announcement. 72

If managers use repurchases for insider trading, one would predict that firms announcing repurchases tend to outperform firms not announcing repurchases in the period subsequent to the announcement. Although apparently there are no data on the stock performance of Korean firms after they announce repurchases, there are a considerable amount of data on repurchasing firms in other markets, including the U.S. And these data indicate that the shares of repurchasing firms tend to outperform. In the U.S., for example, one study reports there are abnormal price increases averaging 12% over the forty-eight months following repurchase announcements.73 These post-repurchase returns provide extremely strong evidence that as a group, firms announcing OMRs are underpriced at the time the repurchase is announced.

To be sure, the stock price movements described above are also consistent with the use of repurchases for purposes other than insider trading. The negative abnormal returns prior to the repurchase announcement cannot not prove that the stock was underpriced at the time of the announcement. It is possible that the stocks were overpriced prior to the negative abnormal returns and that those negative abnormal returns simply corrected the overpricing, bringing the stock to its fair value. If managers use repurchases as a tax-advantaged method of distributing cash, they might have waited until the stock returned to its fair value before distributing cash. This story would be consistent with abnormal returns prior to the repurchase announcement.

73 See Ikenberry, Lakonishok, and Vermaelen, supra note, at 190 (reporting large price increases following OMRs undertaken between 1980 and 1990). See also Chan, Ikenberry and Lee, Do Managers Knowingly Repurchase Stock on the Open Market (examining long-horizon returns for a sample of over 4000 open market programs announced by US firms from 1980 to 1996 and finding long-term abnormal returns of 5.73% [RA: over what period?] (working paper, 2000).
Similarly, the positive stock market reaction to the repurchase announcement could result from factors other than the signaling. Firms announcing repurchases might have excess cash that the market had previously believed the managers would continue to wastefully hoard. In such a case, an announcement of a repurchase would increase the stock price by revealing that managers intended to distribute cash that is sitting idly in the corporation.

Finally, the subsequent abnormal price increases do not prove that the stock is underpriced at the time of the repurchase announcement. There could be another explanation for the post-announcement price increases: that firms conducting repurchases boost the price of their shares by buying back shares from their lowest-valuing shareholders.74

Thus, each of these types of stock price movements, by themselves, cannot prove that at least some repurchases are driven by insider trading considerations. But the pattern of stock price movements is highly suggestive that managers use at least some repurchases for insider trading. And these stock price studies, combined with the studies of managers behavior around repurchases and managers own statements as to why they repurchase shares, together provide strong evidence that managers in fact use at least some repurchases for insider trading.

4. Why the Currently Required Repurchase Announcement Does Not Fully Eliminate Underpricing

As I noted earlier, a Korean firm must announce the initiation of the program before repurchasing any shares. As we saw, the announcement will, on average, boost the stock price. When the stock is underpriced, the

74 See Fried (2003).
price increase will narrow the gap between the share price and the stock’s actual value, making it more difficult for the managers to profit by indirectly buying shares from selling shareholders.75

However, any price boost is unlikely to completely close the gap because the repurchase announcement has less informational content than it might appear. There are a number of reasons why firm might announce a repurchase other than to exploit underpricing. For example, the firm might distributing excess cash in a tax efficient manner or giving itself the option to repurchase shares should the stock become underpriced during the three month repurchase window.7677 Or, as I will explain shortly, the managers might be announcing the program simply to boost the stock price before selling their own shares.78 It is worth noting that a number of Korean firms announcing open market repurchase did not repurchase a single share. Knowing that these are a number of possible reasons for the announcement, many of which are not associated with current under-pricing, the market’s reaction will be muted -- even if the market is perfectly efficient. This, I believe explains why the reaction to open market share repurchase announcements is only 2-4% on average.

If the market is not efficient at processing the information conveyed by the repurchase announcement, the market’s response to the announcement will be even more muted. Interestingly, the shares of U.S. firms announcing repurchases exhibit large abnormal returns in the months and years following the announcement. This indicates that even the world’s most developed stock market on average underreacts to the information conveyed by the announcement.

75 In Fried (2003) I consider the possibility that stock repurchases might boost the stock price by taking stock out of the hands of the lowest-valuing shareholders. To the extent repurchases exert such price pressure, the gap will be narrowed further.
76 See Ikenberry and Vermaelen, supra note x.
signaled by the repurchase announcement (that is, the stock price does not adjust to reflect all of the information available about its value). Because the market underreacts to the repurchase announcement, it is even easier for managers to benefit themselves and remaining shareholders by buying shares through the firm when the stock is underpriced. If even the relatively sophisticated U.S. market does not properly interpret the signal sent by repurchase announcements, it is at least possible that the Korean market suffers from the same underreaction.

C. The (at-best) Zero-Sum Nature of Insider Trading

We have seen in Section A that using repurchases for insider trading benefits managers and other remaining shareholders. In Section B we saw evidence that managers in fact use repurchases for insider trading. In this Section, I explain why repurchase insider trading, even if it does not affect managers' payout decisions, does not increase the value available to shareholders as a group.

While buying stock at a low price from selling shareholders makes remaining shareholders better off, it makes selling shareholders worse off. Selling shareholders bear the cost of insider trading through larger bid-ask spreads that reduce the price at which they are able to sell their shares. When managers use repurchases for insider trading, market makers must widen their bid-ask spread to compensate themselves for the expected loss associated with dealing with informed traders - namely the corporation itself. This lowers the bid price, and thus imposes a cost on selling shareholders. A study of repurchases in Hong Kong (where daily repurchase transactions must be reported) finds that the bid-ask spread widens by an average of 10%

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78 See infra Part IV.C.
on the days that firms repurchase shares. Trading depth (the number of
shares offered or sought at the ask and bid prices, respectively) also drops
significantly on the day of the repurchase.80

If shareholders’ liquidity shocks are random (each shareholder is as
likely, ex ante, to be selling shares in the future as any other shareholder),
then ex ante the distinction between selling and remaining shareholders
dissolves. For every shareholder, the expected gain from insider trading
repurchase qua remaining shareholder is offset by the expected loss from
insider trading repurchases qua selling shareholder.81

One might have the intuition that selling shareholders are better off ex
post by a repurchase because the repurchase announcement boosts the stock
price, allowing them to sell their shares at a higher price. But this intuition
is incorrect.

To begin, the intuition is based on the implicit assumption that the
managers could not have otherwise communicated information about the
stock’s undervaluation. As I will explain in the next Part, the use of
repurchases for insider trading depends on the maintenance of information
asymmetry between public shareholders and the managers. Thus managers
will have an incentive to withhold information from the market and use that
information to make insider trading profits. Were managers unable to use
the information indicating that the stock is undervalued, they might release
the information directly, causing the stock price to rise. Indeed, release of
the information would likely cause a larger price increase because that
information would be less ambiguous than a share repurchase

79 See infra Part IV.B.3.
80 Thus, the authors conclude that repurchases on the Hong Kong stock
exchange reduce firm liquidity. Paul Brockman and Dennis Y. Chung, Managerial
Econ. 417, 441 (2001).
81 I am putting aside the fact that insiders systematically gain from insider
announcement, because managers might announce a repurchase for reasons other than underpricing.

To be sure, it might be argued that the managers will not or cannot release the information indicating that the stock is underpriced. The only way to know whether the stock is underpriced or overpriced is through a share repurchase announcement (or lack thereof). In such a case, it would seem, the selling shareholders are better off if the firm makes a repurchase announcement. But even in such a case, the repurchase announcement does not make selling shareholders better off ex ante. The intuition misleadingly focuses on the ex post sale price in the event of a repurchase announcement rather than on the seller’s expected sale price ex ante before the market knows whether or not there will be a repurchase announcement.

Suppose, for simplicity, that a firm will announce a repurchase if the stock is underpriced but also under other conditions. And suppose that the market does not know whether the firm will in fact make such an announcement. If the firm in fact makes such an announcement, the market will infer that the stock is (in expected value) underpriced and bid the price up. Liquidity sellers will therefore be able to sell their shares at a higher price. But if the firm does not make such an announcement, the market will interpret the lack of a repurchase announcement to indicate that the stock is (in expected value) overpriced, and bid down the stock price. As a result, liquidity sellers will be forced to sell their shares at a lower price. The intuition that share repurchases benefit selling shareholders because they boost the stock price focuses on only one of these two ex post outcomes—that in which the firm actually makes a repurchase announcement. Understanding the welfare of the selling shareholders requires looking at their ex ante expected sale price, which takes into account both ex post trading, which means that public shareholders systematically lose.
outcomes.

And that ex ante sale price will be lower than in a world in which managers could not use repurchases for insider trading. In a world in which managers cannot use repurchases for insider trading, the ex ante market price will reflect the expected value of the shares, which I will call V. In a world in which managers use repurchases for insider trading, the ex ante price will be V less a discount for the expected loss to selling shareholders from insider trading.

A more useful intuition is that for a purely redistributive activity to make all current shareholders – both selling shareholders and remaining shareholders – better off, somebody must be made worse off. Because buying shareholders are the only parties transacting with the current shareholders, for current shareholders to be better off as a group, buying shareholders must be worse off. But unlike liquidity sellers, who have no choice but to sell, buyers will not buy shares at a price greater than their expected value. In other words, buyers cannot be made worse off, on average, from repurchase insider trading. Thus, the gains to managers and remaining shareholders must be offset by the selling shareholders’ losses.82

In short, while using share repurchases for insider trading might create the illusion that all shareholders are better off, there is no free lunch. The benefits to managers and remaining shareholders come at the expense of selling shareholders, who, on average, sell their shares for less than they would have sold those shares absent insider trading repurchases. On average, shareholders cannot be made better off.

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82 The analysis assumes a horizontal sloped demand curve for shares. The analysis gets more complex if there is a downward sloping demand curve for shares. In such a case, a repurchase can be used use to transfer value from buying shareholders. See Fried (2003).
IV. The Costs to Shareholders

In Part III, we saw that managers can and do use repurchases for insider trading and that, if there are no efficiency costs, insider trading repurchases simply transfer value from selling shareholders to managers and remaining shareholders. This Part shows that the use of repurchases for insider trading does in fact impose efficiency costs on the firm and its shareholders, which have the effect of reducing total shareholder value. Section A describes the distortions to payout policy that can result from managers’ use of repurchases for this purpose. Section B briefly describes the other perverse incentives repurchases create for managers. Section C explains who bears the cost of these distortions.

A. Distortions to Payout Policy

This Section describes the potential distortions to payout policy that can result from managers’ use of repurchases to transfer value from selling shareholders. If first describes what I call the “cash-squandering” distortion: when the stock is sufficiently underpriced, managers may have an incentive to conduct a repurchase even when from the perspective of shareholders as a group, the cash is better invested in the firm. I then describe the second distortion likely to arise from the use of repurchases for insider trading: that managers are likely to maintain large cash reserves (“the cash-hoarding distortion”) when shareholders as a group would be better off if the money is either invested in the firm or distributed to shareholders.
1. Cash-squandering

Suppose a payout policy of $X maximizes value for shareholders as a group. Paying out less than $X hurts shareholders by tying up cash that is better invested by shareholders outside of the firm.

The first problem with linking payout policy to insider trading considerations is that it might sometimes encourage managers to “squander cash” – that is, to pay out too much.

Suppose the managers have private information about the value of the stock, indicating the stock is underpriced. The managers know that, if they repurchase shares, the insider trading effect of the repurchase is going to make themselves and the other remaining shareholders better off at the expense of selling shareholders. Everything else equal, managers have an incentive to repurchase shares by distributing cash to shareholders.

In addition to the insider trading effect, the repurchase reduces the capital available to the firm and increases the capital available to shareholders to invest in other ventures. Accordingly, the repurchase not only transfers value from selling shareholders to managers and remaining shareholders, but also affects the total amount of value to shareholders as a group. If increasing the firm’s payouts increases total value available to shareholders as a group, the managers would have a stronger incentive to conduct a repurchase because it can boost the value of their shares both by creating value and by transferring value from selling shareholders.

Unfortunately, the managers may also have an incentive to repurchase shares even when the payout reduces total value available to shareholders. Specifically, they may have an incentive to repurchase shares when the value transferred from selling shareholders exceeds the reduction in total value from the repurchase born by remaining shareholders.
Suppose that A and B each own 50% of XYZ Corporation. The market values XYZ at $200, or $100 per share. However, the manager (A) knows that XYZ is actually worth $300. In the absence of a repurchase, A’s 50% interest is worth $150 (1/2 x $300). But A contemplates having XYZ Corporation repurchase B’s share for $100, $50 less than it is actually worth. In the absence of an efficiency effects, such a repurchase would transfer $50 to A (by leaving him with 100% of a firm worth $200).

However, suppose there would be some costs to such a repurchase. Specifically, suppose that such a repurchase would reduce XYZ’s value by an extra $25 (beyond the $100 paid out to B) because XYZ would need to forego certain high value projects in order to “finance” the repurchase. Nevertheless, A decides to go forward with the repurchase, because at the end of the repurchase he will own 100% of a firm worth $175, while in the absence of a repurchase he would own 50% of a firm worth $300.

There is some evidence consistent with repurchases reducing firm value. A recent study comparing repurchasing firms in the U.S. to
nonrepurchasing firms found that the nonrepurchasing firms’ stock outperformed that of repurchasing firms. The authors reported that the higher investments by nonrepurchasing firms in working capital and capital projects were largely responsible for the performance gap.\(^83\)

To be sure, under some regimes a firm might be able to borrow money to fund the repurchase, which would reduce the problem of distributing cash better invested in the corporation. But in Korea, such borrowing is not permitted.

Even if borrowing were permitted, the managers might practically be unable to borrow, either because bond covenants prohibit it or because it takes too much time, during which the underpricing might disappear. And even if borrowing were possible, managers might personally prefer not to increase the firm’s debt burden and the likelihood of financial distress.\(^84\)

2. The Cash-Hoarding Distortion (Underpayout)

The use of repurchases for insider trading can also lead to the opposite problem of cash-squandering – cash-hoarding. Knowing that they are likely to be able to use repurchases for insider trading, managers have an incentive to maintain cash reserves that are too large. By “too large,” I mean that from the perspective of shareholders as a group, it would be better

\(^{83}\) See John Evans and James Gentry, “Do Strategic Share Repurchase Programs Create Long-Run Firm Value” p. 24 (working paper, 2000). See also Robert O’Brien, “Stock Buybacks Gain Popularity, But Price Pops Aren’t Guaranteed”, Wall St. Journal p. 17 Column 3 (3/6/00) (citing research report by chief investment strategist of Credit Suisse First Boston as saying that "heavy repurchases are counterintuitively associated with poor share performance"). Of course, it is not clear in which direction causality runs. It is possible that poorly performing companies without attractive investment possibilities are more likely to distribute (excess) cash than companies with better opportunities.

\(^{84}\) JMF: Get cite that AT provisions lead to reduced leverage.
either to distribute the cash to shareholders or to invest it in the firm’s projects. There are two scenarios in which this cash-hoarding distortion can arise: (1) when managers believe the stock might become underpriced; and (2) when the stock is overpriced.

a. Stock Might Become Underpriced

When managers think it likely that the stock price will fall below its actual value (by, for example, over-reacting to bad news) or that there will be good news that will not immediately be reflected in the stock price, they have an incentive to keep cash in the firm rather than distribute it or invest it. For example, a firm that has $1 billion in excess cash might decide to distribute the $1 billion through repurchases over the next several years, buying when the stock becomes underpriced, rather than distributing it immediately so that it can be invested outside the firm.

Consider the following example.

Suppose that ABC Co, with 10 shares outstanding has $V in operating assets and $10 in cash. It has already announced that from time to time it will repurchase shares. Suppose that $V = either $180 or $0 with equal likelihood. Managers will learn the actual value at the beginning of next period, before the public. The stock currently has an expected value of $10 and (let us assume) is trading for $10.85 The $10 in cash sitting in the firm will generate $0 during the current period. If it is distributed, the $10 in cash will generate $1 of profit. (For simplicity, assume that if the $10 is invested in the firm’s operations it generates no return).

85 Because of the possibility that the managers will decide to purchase the stock when it is underpriced, the bid price will be below $10 and the ask price will be above $10. But I ignore this complication because it does not affect the analysis.
If the $10 in cash is distributed now (through a repurchase or a dividend), that cash will generate $1 of profit, creating a total of $11. The actual value of ABC will be either $180 or $0 with equal likelihood. Thus, the expected value flowing to ABC’s shareholders, as of the time the cash is distributed is 101 ($90 + $11).

If the $10 is not distributed now, there are two possibilities: if $V = $180, it will be distributed (in the form of a repurchase of one share for $10); if $V= $0, the $10 will not be distributed. Each is equally likely. Thus, the expected value of ABC’s shares, is (.5)($180 + $10) + (.5)($10) = $100, which is less than the value of the shares if the funds are distributed currently.

From the point of view of all shareholders, the $10 should be distributed.

Consider now the interests of managers and remaining shareholders. If the $10 in cash is used now to issue a pro rata dividend, the remaining shareholders will receive, through the dividend, the profit on the invested dividend, and the liquidation of their shares, a total of $1.10 + $9 (or $10.10) per share.

If, instead, the $10 is retained by the firm in order to facilitate insider trading, then the remaining shareholders have the option of buying a share for around $10 if V turns out to be $180. In that case, the expected value of their shares will be (.5)($180/9) + (.5)($10/10) = $10.50. Thus it is not in the interest of remaining shareholders to distribute the excess cash but rather to retain it in order to have the option of engaging in insider trading with selling shareholders.
b. **Stock is Overpriced**

Now consider the case in which the managers have private information indicating that the stock is overpriced. And suppose the only method available for ABC’s managers to distribute cash is a share repurchase. (I will justify this assumption shortly).

In that case, the managers know that the insider trading effect of a repurchase is going to make the managers and remaining shareholders worse off. In essence, a repurchase would cause managers and remaining shareholders to buy the shares of selling shareholders at an inflated price. The managers will therefore have an incentive not to repurchase shares, everything else being equal.

Of course, everything is not equal. The managers will also consider the value that can be created for shareholders through the payout associated with the repurchase. For example, the repurchase might be used to distribute excess cash.

But managers will not have an incentive to repurchase shares unless the value created by the repurchase for remaining shareholders exceeds the value transferred to selling shareholders. If the stock is very overpriced, the managers will not have an incentive to conduct a repurchase even when a significant amount of value can be generated for shareholders as a group by distributing cash. Instead, they will wait until the stock’s price/value ratio falls sufficiently to make the repurchase worthwhile and then distribute the cash. During this interim period, when the repurchase is delayed, the excess cash sitting in the corporation is not optimally invested, and the value available to shareholders as a group falls.

I was assuming in this subsection that the only way to distribute cash is through a repurchase. If the firm could both repurchase shares and issue dividends, when the stock is overpriced, the firm could simply issue a
dividend that has no redistributational element. Accordingly, the managers and remaining shareholders could distribute cash without buying the shares of selling shareholders at a high price. This would solve the problem of the delayed cash distribution.86

However, the managers’ decision to issue a dividend, when the firm frequently repurchases shares, would signal that the stock is overpriced and cause the price to fall, making it difficult for managers, who frequently sell shares received upon exercise of employee stock options, to sell their own shares at as high a price. Thus managers might not issue a dividend even if it would be efficient to do so. In fact, managers only rarely issue large one time dividends.

3. Do Repurchases Induce Managers to Distribute Excess Cash?

It is well known that managers generally have an incentive to retain too much “free” cash and not to distribute it.87 Managers benefit from retaining excessive cash in two ways. First, the cash enables them to expand the corporate empire and thereby increase their perks and prestige. Second, the cash provides a cushion in the event of a downturn, reducing managers’ cost of performing badly.

Repurchases might appear useful in counteracting managers’ tendency to retain too much cash. In particular, the insider trading profits generated by insider trading repurchases might encourage managers to distribute cash that from shareholders’ perspective should be paid out but managers might not otherwise distribute. The distribution of such cash

86 See Bhagwan Chowdhry and Vikram Nanda, Repurchase Premia as a Reason for Dividends: A Dynamic Model of Corporate Payout Policies, 7 REV FIN STUD 321 (1994)(arguing that dividends allow corporations to distribute cash more cheaply when the stock is overvalued).
87 See Jensen 1986.
would reduce managers’ ability to build empires and to cushion themselves from poor performance. However, in some cases managers’ profits from repurchase insider trading might be sufficiently high to offset and thereby motivate managers to distribute the cash.

While one cannot rule out the possibility that insider trading repurchases mitigate the problem of managers’ retaining too much cash, both theory and the available empirical data suggest that this effect is not likely to be substantial.

Even if firms in aggregate tend to hoard too much cash, this does not mean that, at every point in time, every firm is distributing too little cash. Rather, it is likely that at any given time there are both firms with excess cash as well as firms with valuable projects that should not be distributing cash. While the use of insider trading repurchases by managers of the former set of firms will make shareholders better off, the use of insider trading repurchases will make shareholders worse off as a group. And there is no a priori reason to believe that the underpricing of the stock, and hence the incentive to engage in repurchase insider trading, is correlated with the amount of the firm’s excess cash.

Moreover, as Section A2 explained, tying payout policy to insider trading can lead not only to cash squandering – the problem of overpayment – and cash hoarding – but also to the problem of underpayment when the stock is overpriced or fairly priced. To the extent that the use of repurchases for insider trading leads to reduced payout, the repurchases will only exacerbate the problem of managers hoarding free cash.

Empirically, there is little evidence that the increasing use of repurchases in the U.S. has led to a reduction in firm’s free cash. If the use of repurchases caused managers to distribute more free cash, one would expect cash payout rates to increase as managers substituted repurchases for
dividends. However, aggregate payout data from the U.S. suggest that the use of share repurchases is not reducing the problem of excess cash.\textsuperscript{88} During 1974 -- 1998, the average repurchase-payout/earnings ratio (the amount of cash distributed through share repurchases, divided by earnings) increased from 3.7\% to 13.6\%, and the average dividend-payout/earnings ratio declined from 22.3\% to 13.8\%.\textsuperscript{89} As a result, the average payout/earnings ratio for publicly traded U.S. firms has remained fairly constant during the period 1974-1998, at around 26-28\%.\textsuperscript{90}

In any event, because there is unlikely to be no correlation between underpricing and a firm's excess cash position, and because repurchase insider trading can cause firms not to distribute excess cash, repurchase insider trading would be an odd way for policy makers to try to mitigate the problem of excessive cash retention. A more straightforward way to address the problem of excessive cash retention would be to shift some of the decision-making over cash distribution to shareholders, as a number of commentators have proposed.\textsuperscript{91}

\textsuperscript{88} See, e.g., Gustavo Grullen and Roni Michaely, Dividends, Share Repurchases, and the Substitution Hypothesis (working paper, 2001); Amy K. Dittmar and Robert F. Dittmar, Stock Repurchase Waves: An Explanation of Trends in Aggregate Corporate Policy (working paper, 2002)(finding that repurchases and dividends are seen by firms as substitutes for distributing permanent earnings).

\textsuperscript{89} See Grullon and Ikenberry, What do we Know about Stock Repurchases?, J. OF APPLIED CORP. FIN. (2000), at 41.

\textsuperscript{90} See Grullon and Ikenberry, What do we Know about Stock Repurchases?, J. APPLIED CORP. FIN. (2000), at 41. To be sure, managers' investment opportunities might have increased over this time period, so that by 1988 the excess cash portion of the non-paid out earnings might have shrunk. If that is so, the use of repurchases might have led to a reduction in excess cash. But it is also possible that managers investment opportunities have declined over the period, in which repurchases would be associated with an increase in excess cash.

\textsuperscript{91} See Bebchuk, Empowering Shareholders (2003); Zohar Goshen; Merrit Fox (1987).
B. MANAGERS’ OTHER PERVERSE INCENTIVES

In Part IV.A we saw that the use of share repurchases for insider trading can affect the level of investment (both inside and outside the firm) both before and after the repurchase. Such use of share repurchases can also adversely affect other managerial decisions. First, managers who have the option of using share repurchases for insider trading have an incentive to delay disclosure of inside information. Second, the use of repurchases for insider trading gives managers intending to sell shares an incentive to announce a repurchase, even when they have no intention of effecting it, in order to boost the stock price before selling their shares.92

1. Reduced and Delayed Disclosure

The use of share repurchases for insider trading can cause managers to distort or withhold information, or to mislead the public, especially around the time of the share repurchase, in order to maximize the information asymmetry between the managers and public shareholders.93

Insiders cannot profit from their access to nonpublic information unless the stock price does not reflect that information. As soon as the information becomes public and incorporated in the stock price, insiders’

92 See Fried (2001); (2003), supra note x, at ___. Finally, the use of share repurchases for insider trading encourages managers to invest in projects that are difficult for outsiders to assess, whether or not these projects are value-maximizing for shareholders as a group, in order to increase the information asymmetry between themselves and public shareholders so they can make insider trading. See Fried (2003)

93 In this way, using the share repurchases for insider trading may have the same adverse effects on price efficiency as personal insider trading, which gives managers an incentive to delay disclosing information to the market or to deliberately provide the market with misleading information. See Fried, supra note
ability to profit from their access to private information vanishes. Thus, it is 
well understood that managers who can engage in insider trading have an 
incentive to delay disclosure of nonpublic information to the market, or even 
misreport such information (e.g., through fictitious earnings) in order to 
profit from their access to inside information. Managers who use share 
repurchases for insider trading have the same incentives.

2. Misleading Repurchase Announcements

We have seen that managers can -- and do -- use the insider trading 
effect of repurchases to transfer value to remaining shareholders when the 
actual value of the stock exceeds the stock price. Market participants are not 
unaware of this fact. Thus, market participants are likely to infer from a 
repurchase announcement that the stock may be underpriced, and bid up the 
price of the stock upon hearing the announcement. 94

Of course, not all repurchases are driven by insider trading 
considerations. There are likely to be repurchases that have other 
motivations. For example, managers in the U.S. may repurchase shares in 
order to distribute excess cash in a tax efficient manner or to “fund” option 
programs. Thus investors cannot be certain that any given particular 
repurchase is motivated by managers’ desire to purchase stock for 
themselves and remaining shareholders at a low price.95

x, at n.54 and surrounding text.

94 There are other reasons that market participants might react favorably to a 
repurchase announcement besides the signal it sends about the actual value of the 
stock. For example, investors might bid the price up because they believe the firm 
will distribute excess cash that it had been holding and that was earning relatively 
poor returns inside the firm.

95 Interestingly, there is evidence that the reaction is lower when the market 
believes that the repurchase is intended to fund option plans. In particular, the 
reaction is lower when there are a large number of employee options outstanding.
However, even if many repurchases are motivated by other reasons a repurchase announcement signals that the expected value of the stock is likely to be higher than the pre-announcement market price. This, in turn, suggests that managers intending to sell shares might announce a repurchase in order to boost the price of the stock before selling the shares, even if they have no immediate intention of repurchasing any shares.

To be sure, average stock price reactions to repurchase announcements are fairly modest in the U.S. and Korea, 2-4%. However, in the U.S. there are abnormal returns averaging 7-8% when smaller firms announce repurchases and when the announcement has not been preceded by another in the last five years. In any event, for managers selling millions of dollars worth of shares, as well as managers exercising options whose strike price is close to the pre-announcement market price, the ability to sell shares at even a slightly higher price may well be significant.

Thus, managers have an incentive to announce repurchases even when they don't intend to execute them. Essentially, managers who wish to sell shares attempt, by announcing a repurchase, to "mimic" or "pool" with managers of underpriced firms who are using a repurchase to buy stock at a low price. To the extent that the market cannot distinguish between the different types of firms, the repurchase announcement boosts the stock price, enabling the mimicking managers to sell their shares at a higher price.97 The

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See _____ Kahle, supra note x, at 6. See infra Part __ for a discussion of the need for repurchases to fund option plans. See also Jagannathan and Stephens, Motives for Multiple Open-Market Repurchase Programs (working paper, 2001)(reporting that the stock market reaction to first time repurchases is higher than that to multiple repurchases by the same firm in a 5 year period, presumably because the firm conducting multiple repurchases has different motives for repurchasing – such as distribution of excess cash and acquisition of shares to fund option programs).
96 See supra note.
97 Cf. Bhattacharya & Dittmar, supra note, at 27 (reporting that there is no difference in market reaction between OMR announcements followed by repurchases and OMR announcements not followed by repurchases).
presence of overpriced firms in the pool of firms announcing repurchases dampens the price reaction to repurchase announcements. This price-dampening inures to the benefit of managers of underpriced firms, by enabling them to buy shares for themselves and other remaining shareholders at a lower price. Thus, mimicking by selling managers of indirectly buying managers benefits all managers announcing repurchases.

There is evidence from the U.S. consistent with the use of repurchase announcements to boost the stock price before managers sell shares: at least one study reports that mean and median insider percentage ownership fall around the time of repurchase announcements.\(^98\) In addition, Jagannathan and Stephens find that although the average post-announcement returns of infrequent and occasional repurchasers are positive, the median is significantly negative relative to the market, which is consistent with many firms having been overpriced at the time of the announcement.\(^99\) Because it is unlikely that in all of these overpriced firms managers were planning to repurchase shares, and given managers’ tendency to sell when they know the stock is overpriced, it is likely that at least some of these repurchase announcements were made by managers solely with the intent of boosting the stock price before selling their shares.

Managers have themselves acknowledged announcing repurchases without having any intention to repurchase the number of shares indicated in the announcement. Following the 1987 stock market crash in the U.S., for example, many firms announced repurchases in order to show confidence in

\(^98\) See Vafeas, supra note. In addition, Chan, Ikenberry, and Lee find that repurchase announcements occur around time executive options are exercised.

their stock and support the price. However, the number of outstanding shares declined for only 41% of the NYSE and AMEX firms announcing repurchases, and for only 33% of the OTC firms announcing repurchases. After Arkansas Best announced an intention to repurchase 2 million shares, one manager was later quoted in the New York Times as saying “I don’t think we ever intended to repurchase two million shares. We did it to build confidence.” A problem with repurchase announcements is that companies have informed S&P that they have little intention of implementing the authorizations. In fact, many firms made big repurchase announcements after the crash, and then ran over to S&P in an effort to protect their credit rating. 

C. WHO BEARS THE COST OF INSIDER TRADING DRIVEN PAYOUT POLICY?

We now turn to examine how the potential costs associated with the use of repurchase insider trading are borne by the corporation’s shareholders. I first explain that these costs are borne by all shareholders. I then explain why the existence of such costs cannot be determined by observing the market price’s reaction to the announcement of a repurchase. Specifically, I

100 RA: Can you find news stories reporting that insiders sold shares in 1987/ early 1988 after making these announcements? If not, please get the names of 15 firms announcing repurchases from the cited article, then try to get info on subsequent insider trades from SEC archives.


103 I. Picker, “Are Those Buyback Programs For Real,” Institutional Investor
show that the market price might increase in response to an announcement of a share repurchase even when everyone knows the repurchase reduces shareholder value.

1. The Effect of Value-Reducing Repurchase Insider Trading on Shareholders

As we saw in Part III, when insider trading repurchases have no effect on total shareholder value, they simply transfer value from selling shareholder to remaining shareholders. The selling shareholders’ loss is precisely offset by the remaining shareholders’ gain. When managers undertake value-reducing repurchases in order to engage in insider trading, however, total shareholder value is, by definition, reduced. Thus, repurchases no longer lead to a zero-sum transfer. Rather, the selling shareholders’ loss will exceed the gain to managers and remaining shareholders. [TO BE COMPLETED]

2. Understanding the Market’s Reaction to Share Repurchase Announcements

At least in the past, the stock market has reacted favorably to share repurchase announcements. As noted in the introduction, share repurchase announcements in Korea are associated with short-term “abnormal” (i.e., market-adjusted) share price increases averaging 2-3%. In the U.S., share repurchase announcements were associated with abnormal share price increases averaging 3%-4% in the 1980s,104 and 1-2% in the 1990s.105 [TO BE COMPLETED]


104 See Ikenberry et al., supra note __, at 190 (reporting that the average market reaction to OMR announcements in all of the OMRs announced between January 1980 and December 1990 by firms listed on the American Stock Exchange, New
V. IMPROVING KOREAN DISCLOSURE REQUIREMENTS

This Part suggests how Korea's regulation of repurchases might be improved to reduce the costs associated with the use of repurchases for insider trading: require firms to provide specific information about their repurchase plans shortly before effecting them. Before proceeding, it should be emphasized that the proposed change would not in any way reduce or undermine the potential benefits of share repurchases for Korean shareholders: tax efficiency, transaction-cost efficiency, financial flexibility, and signaling. Section A describes the approach. Section B explains its benefits. Section C considers its possible costs.

A. The Proposed Approach: Pre-Repurchase Disclosure

Under Korea's current approach to regulating repurchases, managers must announce their repurchase program only when they initiate the program and after the three-month repurchase period has expired.

In earlier work, I have shown that requiring insiders to disclose their intended trades in advance would substantially reduce insiders' ability to engage in insider trading.¹⁰⁶ This paper has explained that a repurchase is distributionally equivalent to managers and remaining shareholders purchasing the shares of departing shareholders. Accordingly, requiring

¹⁰⁵ See Kathleen Kahle, When a Buyback Isn't a Buyback: Open Market Repurchases and Employee Options,  __ J. Fin. Econ. ___ (2002) (finding that the average abnormal return around the announcement of open market repurchases by firms in the Execucomp database between 1991 and 1996 was 1.6%).

firms disclose in advance every intended trade would also reduce managers' ability to use repurchases to indirectly trade on inside information. 107

Under the advance disclosure rule, a firm could not submit an order to its broker to buy its own shares without first giving notice to the market of the order at least several hours (and perhaps as much as one business day) in advance. So for example, if the order to the broker is “buy 1000 shares at $10 or below,” the corporation would need to disclose that it was submitting an order to the broker to buy 1000 shares at $10 or below. In the disclosure, the firm could include any other information that it wishes to communicate to the market. So, for example, if the firm knew that it would not be buying more than 5000 shares over the next month, it could choose to disclose that information as well. As under Korea’s current approach to regulating repurchases, the firm would be required to report the details of the repurchase after it is effected.

Following the disclosure of an intended repurchase, market participants could adjust the price at which they are willing to trade to reflect

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107 An alternative to pre-purchase disclosure would be to require firms repurchasing shares to adhere to guidelines similar to those set out in the U.S. S.E.C.'s Rule 10b5-1 that are designed to give insiders (and firms) an affirmative defense to insider trading liability under Rule 10b-5.

In 2000, the SEC issued Rule 10b5-1, which creates a safe harbor from Rule 10b-5 liability for a repurchasing firm that delegates purchase decisions to a third party that does not have access to material inside information regarding the firm. The safe harbor also extends to trades conducted according to a pre-arranged plan, a binding contract, or irrevocable instructions that were not created at a time when the firm's management had material nonpublic information. Thus, a firm that delegates repurchase decisions to an uninformed third party or repurchases its own shares under a pre-arranged plan, contract, or irrevocable instructions would be insulated from Rule 10b-5 liability, even if the repurchase takes place at a time when the managers know material nonpublic information indicating that the stock price will increase. See Steven E. Bochner and Leslie A. Hakala, Implementing Rule 10b5-1 Stock Trading Plans, 15 INSIGHTS 2 (2001)
the heightened possibility of an abnormal price change that is signaled by the firm's order. To see how the rule might work, consider the following example. Suppose that on Monday, when ABC stock is trading for $10, the firm announces that, on Tuesday, it will submit an order to buy 20,000 shares at a price of $11 or lower. Knowing that there is a possibility that the firm is buying now because the managers believe, based on inside information, that the stock is underpriced, market participants who had been considering trading ABC stock on Tuesday and Wednesday might choose to modify or abandon their planned trades. Market participants who were considering selling shares of ABC stock might not go forward with these sales, or might increase the price at which they are willing to sell the stock. Market participants who were considering buying ABC stock might increase the price at which they are willing to buy it. Market participants who, prior to the firm's announcement, were not considering buying the stock might decide to buy shares. The combined effect of these adjustments would be, everything else being equal, to increase the price at which those making a market in the stock are willing to buy and sell the stock. When the firm's repurchases are executed on Wednesday, it is likely to be executed at a higher price than if the firm had not disclosed the order in advance—to the extent that market participants believe that the managers are trading on inside information.

The prerepurchase disclosure requirement would not be difficult to enforce. The KSEC could easily maintain a record of the prerepurchase announcements that it receives. Reported repurchases and announcements could be matched to determine whether any trades had not been preceded by an announcement.

To prevent managers from using advance repurchase announcements to boost the price of the stock as they (secretly) sold their own shares, the
advance disclosure requirement would be extended to managers as well. Such advance disclosure would reveal to the market the net direction of managers' direct and indirect trades, allowing the market to draw the appropriate conclusion about the actual value of the stock.

It is worth noting that the Stock Exchange of Hong Kong (SEHK) does require firms to report to the SEHK completed repurchases (including price and volume) at least 30 minutes before the start of trading the following business day. The information is then disseminated to data vendors at or around the start of trading, along with number and percentage of shares repurchased since the shareholder resolution approving the repurchase.

Such a requirement makes it more difficult for managers to indirectly transfer value from selling shareholders, because any information contained in the repurchase should become reflected in the price the following day. However, from time to time firms can still repurchase secretly a significant number of shares when the stock is underpriced. If advance disclosure were not considered feasible, contemporaneous disclosure would be second best, and the SEHK approach would be third best.

B. The Benefits and Costs of Advance Disclosure

Pre-repurchase disclosure would make it more difficult for managers to decide to acquire shares at a high price, but they would need to sell very few of their own shares to give them a net gain. Suppose that the firm buys back 1000 shares at an inflated price and managers own 5% of the company. This is equivalent to the managers buying 50 high price shares. As long as the managers sell more than 50 shares at that same price, they will profit from the transaction. This problem could be overcome by requiring managers themselves to announce their trades in advance.

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108 To be sure, the managers would then be forced to indirectly acquire shares at a high price, but they would need to sell very few of their own shares to give them a net gain. Suppose that the firm buys back 1000 shares at an inflated price and managers own 5% of the company. This is equivalent to the managers buying 50 high price shares. As long as the managers sell more than 50 shares at that same price, they will profit from the transaction. This problem could be overcome by requiring managers themselves to announce their trades in advance.

109 Paul Brockman and Dennis Y. Chung, Managerial Timing and Corporate Liquidity: Evidence from Actual Share Repurchases, 61 J. Fin. Econ. 417, 418 (2001). The repurchasing firm's annual report must include repurchase prices and volumes aggregated on a monthly basis. Id.
to use share repurchases to transfer value from selling shareholders. To the extent that investors believed that the announced repurchase was intended to buy stock for remaining shareholders at a low price, the announcement would cause them to bid up the price of the stock, reducing the value that is transferred to remaining shareholders. This in turn would reduce managers’ incentives to use repurchases to transfer value in the first instance, which would also reduce the accompanying distortions - underinvestment, cash-hoarding, and reduced disclosure.

C. The Costs of Pre-Repurchase Disclosure

Advance disclosure is simple. There are almost no transaction costs of publicizing a firm’s communications with the broker who will carry out a firm’s repurchase. Pre-purchase disclosure would not reduce any tax benefit of repurchases; would not impair the potential transaction-cost benefits of repurchase; would not reduce firm’s financial flexibility; and would not make it more difficult for firms to get shares for option plans.

Indeed, any signaling benefit of open market repurchases would be enhanced by a requirement that the firm announce its specific repurchase plans rather than merely issue a vague statement regarding its intent to possibly buy shares in the future. The detailed information conveyed by the proposed rule would indicate clearly to shareholders the prices at which managers believe a repurchase will make themselves and other remaining shareholders better off.

VI. Conclusion

[TO BE ADDED]