Cheap-Stock Tunneling in US Rights Offerings: Empirical Evidence and Policy Implications

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Introduction

- **Rights offering** = method to issue new shares by distributing “rights” to existing shareholders, which allows them to subscribe to their pro rata part of the share issuance (= pre-emptive share issuance)
- **Cheap-stock tunneling** = value extraction by insiders from minority shareholders by issuing shares too cheaply to themselves
- **Traditional view:** minority shareholders are protected against cheap-stock tunneling in rights offerings because they have an equal opportunity to participate
- ⇔ **Fried & Spamann (2020) model:** information asymmetries
 - Minority shareholders do not know whether issue price is too high or too low; insiders do
 - Insiders are not legally required to disclose participation
 - ➤ They propose that insiders should **disclose** whether they will participate; minority shareholders can mimic what insiders do, eliminating the information asymmetry problem

Summary of the empirical findings

- **Voluntary disclosure of insider participation** already occurs in a majority of transactions, but not in all
- This does **not always facilitate mimicking** by minority shareholders
 - Commitments by insiders to backstop or participate still lead to increases in insider ownership, indicating minority shareholders do not fully exercise their rights
- **Transferable rights** seem to facilitate mimicking, as the number of insider ownership increases diminishes
- **Private benefits** for insiders in transactions seems to prevent mimicking, as they more often lead to insider ownership increases
- **Positive abnormal stock returns** occur when insider ownership increases are announced after rights offerings, which suggests that the market interprets the transaction as market timing by insiders

Data and methodology – sample

- Sample of 260 rights offerings between July 1996 and July 2019 via Capital IQ
- The final sample excludes several transactions:
 - 19 transactions with missing prospectus
 - 6 transactions with missing ownership data
 - 20 transactions that could not be found in SEC Edgar
 - 21 transactions that were not a pure rights offering, but a more complicated transaction (restructuring, reincorporation, tracking stock proposal, conversion, ...)
 - 123 transactions that were conducted by funds or investment companies
- Not all transactions have stock price data or industry codes ➤ some studies have fewer observations

Data and methodology – data collection

- Transaction data collected from Capital IQ and hand-collected from prospectuses
- Insider ownership data hand-collected from proxy statements, form 4, form 13-D and form 13-G (tracked on an individual level)
- Insider is defined as:
 - Officers & directors (& affiliated persons) > 5%
 - All other shareholders > 15%
- Stock price data collected from CRSP and OTC Markets

Transaction structure of rights offerings

	Frequency	Percentage
Binding Insider Commitment	44	16.92%
Non-binding Insider Commitment	79	30.38%
Insider Standby	60	23.08%
Any Disclosure of Insider Participation	150	57.69%
Insider Commitment to Not Participate	37	14.23%
Transferable Rights	53	20.38%
Special Committee	66	25.38%
Fairness Opinion	17	6.45%
Effective Shareholder Approval	26	10.00%
Private Benefits	34	13.08%
<i>Because fees are paid to insiders</i>	11	32.35%
<i>Because proceeds are used to repay a debt to insiders</i>	25	73.53%

Characteristics of transaction and issuer

	Mean	Median	Standard deviation
Transaction Size (% of outstanding shares)	92.49%	35.72%	213.75%
Market Capitalization	188,141,550\$	32,101,603\$	656,589,066\$
Announcement Discount*	13.86%	16.67%	53.25%
Expiration Discount*	7.58%	5.28%	23.77%
Percentage Subscribed	82.53%	100%	31.42%
Total Insider Ownership	41.70%	38.63%	25.02%
Insider Ownership Changes	3.74%	0.75%	10.16%

Insider Ownership Changes

Insider ownership changes by insider commitments

Probit regressions of increases in insider ownership

	Model 1 > 3%	Model 2 > 5%	Model 3 > 3%	Model 4 > 3%	Model 5 > 3%
Transferable Rights	-0.897*** (0.298)	-0.929*** (0.318)	-0.785*** (0.281)	-0.199 (0.400)	-0.347 (0.531)
Private Benefits	1.273*** (0.342)	1.137*** (0.315)	1.130*** (0.292)	1.109*** (0.406)	1.127** (0.522)
Log Market Cap				-0.369*** (0.115)	-0.282 (0.184)
Expiration Discount				-2.196*** (0.830)	-3.218*** (1.169)
Fairness Opinion					-1.533* (0.907)
Extra Controls	No	No	No	No	Yes
Industry Dummies	No	No	No	No	Yes
Constant	0.0276 (0.152)	-0.259* (0.153)	-0.0638 (0.134)	6.609*** (2.043)	5.856* (3.201)
N	113	113	139	92	88
Pseudo R ²	0.148	0.137	0.120	0.301	0.354

Stock price reaction to announcement of insider participation

	Model 1 VW (-1, 1)	Model 2 VW (-1, 1)	Model 3 EW (-1, 1)	Model 4 VW (-3, 3)
Binding Insider Commitment	-0.0417 (0.0267)	-0.0562* (0.0292)	-0.0561* (0.0288)	-0.0164 (0.0321)
Non-binding Insider Commitment	0.00663 (0.0228)	0.000860 (0.0251)	0.000499 (0.0248)	0.0404 (0.0257)
Insider Standby	0.0301 (0.0252)	0.0251 (0.0307)	0.0262 (0.0305)	0.0196 (0.0354)
Insider Commitment to Not Participate	0.0788* (0.0407)			
Insider Commitment to Not Participate (Narrow Definition)		0.0746 (0.0492)	0.0712 (0.0495)	0.0694 (0.0665)
Preceded by a Private Placement	0.00423 (0.0320)	0.0397 (0.0307)	0.0414 (0.0302)	0.0432 (0.0359)
Transaction Size (%)		0.0150** (0.00668)	0.0150** (0.00673)	0.0196*** (0.00415)
Extra Controls	No	Yes	Yes	Yes
Industry Dummies	No	Yes	Yes	Yes
Constant	-0.0141 (0.0147)	0.0257 (0.186)	0.0312 (0.186)	0.113 (0.210)
N	207	204	204	204
R ²	0.053	0.156	0.161	0.123
Adjusted R ²	0.029	0.032	0.038	-0.006

Stock price reaction to actual insider participation

	Model 1 VW (-1, 1)	Model 2 VW (-1, 1)	Model 3 VW (-1, 1)	Model 4 VW (-1, 1)
Insider Ownership Changes	0.459* (0.257)	0.230** (0.106)	0.0337 (0.123)	0.00107 (0.140)
Transaction Size (%)			0.0529** (0.0261)	0.0544** (0.0254)
Major Exchange			0.134*** (0.0490)	0.146*** (0.0414)
Extra Controls	No	No	No	Yes
Industry Dummies	No	No	No	Yes
Constant	-0.00998 (0.0148)	-0.0111 (0.0145)	-0.156*** (0.0537)	-0.242 (0.165)
<i>N</i>	100	99	99	99
<i>R</i> ²	0.048	0.029	0.289	0.450
Adjusted <i>R</i> ²	0.039	0.019	0.266	0.291

Legal framework and policy suggestions

- **Current legal framework** for rights offerings is lenient in the US
 - Typically no shareholder approval under listing rules for RPTs
 - Typically business judgment rule will be applied by courts
- **Disclosure rule** would combat cheap-stock tunneling (Fried & Spamann)
 - A majority of transactions already contain some disclosure ➤ not too costly
- BUT: shareholders do **not completely mimick insiders**
 - Transferable rights seem to facilitate mimicking
 - Private benefits seem to hinder mimicking
- ➤ make **business judgment rule conditional** on disclosure, transferable rights, and absence of private benefits
 - Some support for this exists in current case law
- Otherwise, **entire fairness review** applies to insiders buying shares, unless:
 - Procedural safeguards from MFW are used (approval by special committee + majority of the minority shareholders)
 - Insiders commit to buy no more than their pro rata part of the issuance

Thank you for your
attention!