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Differences in the information environment prior to seasoned equity offerings under relaxed disclosure regulation ☆

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ABSTRACT

The SEC promulgated the Securities Offering Reform (SOR) in 2005 to ease disclosure restrictions prior to seasoned equity offerings (SEOs). The SEC argued that SOR would improve the information environment, but critics claimed it would allow firms to hype their stock. This paper is the first to examine the information environment at the time of capital formation under SOR. We find more frequent and accurate management earnings forecasts, more 8-K filings, greater absolute market-adjusted returns, and more positive stock returns leading up to the SEO issue date indicating a richer pre-SEO information environment with capital formation benefits after SOR.

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1. Introduction

It's a basic precept of American securities law that shareholders should be given the information they need to evaluate their companies.

Robert Jackson, professor of law, Columbia University (*New York Times*, April 24, 2013)

The information environment plays a critical role in capital market efficiency. However, the regulatory framework and the litigious climate within the U.S. often result in firms disclosing only information that is required (Cadwalader, Wickersham & Taft LLP, 2005; Rogers and Van Buskirk, 2009). Until recently, disclosure prior to seasoned equity offerings (SEOs) had been limited by the U.S. Securities and Exchange Commission (SEC) even though investor demand for information was high. Section 5(c) of the Securities Act restricted firm disclosure before an SEO to ban any attempts to "condition the market." The SEC promulgated the Securities Offering Reform (SOR) in 2005 to modernize the SEO process and eliminate restrictions that were no longer viewed as necessary to protect investors yet prevented the dissemination of accurate information.[1] This paper investigates whether SOR is associated with differences in disclosure and a richer information environment during the equity capital formation period (i.e., the period preceding an SEO issue when investors assess the SEO price and decide whether to invest).

SOR is a unique shift in the regulatory environment for SEOs. In addition to removing restrictions on factual and forward-looking disclosures prior to SEOs, SOR provides a safe harbor for disclosures and allows a novel disclosure venue: the free writing prospectus (FWP), which is any written communication that offers to sell securities that are or will be subject to a registration statement and can include factual and forward-looking information. Critics argued that eased restrictions under SOR would result in firms providing opportunistic disclosure to "hype" expectations before an SEO (e.g., Morrissey, 2007). However, the SEC argued that the primary benefit of SOR was to provide greater and timelier information flow when investors decide whether to invest in an SEO (SOR Final Rule, p. 44792). Despite the increased flexibility under SOR, greater disclosure during equity capital formation may not occur for several reasons. Firms may be concerned that greater disclosure could reveal proprietary information (Ali et al., 2014) or establish a disclosure precedent that is difficult to maintain or deviates from a long-standing policy (Graham et al., 2005). Firms may also continue the pre-SOR policy of limiting disclosure during the capital formation period due to liability concerns, such as shareholder litigation or SEC sanctions for conditioning the market (Cadwalader, Wickersham & Taft LLP, 2005). Thus, it is not clear that SOR automatically leads to greater disclosure or an improved information environment prior to the SEO issue date.

We analyze a sample of 360 SEOs issued by well-known seasoned issuers (WKSIs), a new class of issuers established by SOR, from 2002 to 2009. To provide the first evidence of whether disclosure is greater and the information environment is richer under SOR during the capital formation period, we conduct tests using multiple forms of factual and forward-looking disclosure. Specifically, we examine management earnings forecasts (MEFs), FWPs, 8-K filings, and earnings announcements. To capture the capital formation period, we focus on the month (i.e., 30 days) prior to the SEO issue date rather than the filing date, which is the focus in other studies. The role of disclosure before the issue date is important as a result of changes in the equity offering process, including a shift to shelf registrations and an increase in the distance between the SEO filing and issue dates under SOR (Table 1). In addition to our overall analysis, we separately examine firms with a policy of providing MEFs as well as other disclosures (forecasting sample) and firms with a policy of providing only disclosures other than MEFs (non-forecasting sample) to investigate whether firms behave differently under relaxed disclosure regulation based on prior disclosure practices.

We conduct three primary tests. First, we test whether SOR is associated with more factual and forward-looking disclosure. Second, we test whether MEF disclosure is indicative of a richer information environment under SOR for the forecasting sample. We examine MEFs to see if they are more accurate (i.e., informative), potentially reducing information asymmetry and litigation risk, or overly optimistic (i.e., opportunistic) as predicted by critics of SOR. Third, we analyze stock prices in two ways to further evaluate the information environment and investigate capital formation benefits. We examine absolute market-adjusted returns to measure the magnitude of information and signed raw returns to investigate whether disclosure is opportunistic or informative.

Overall, the results suggest that relaxed disclosure regulation under SOR is associated with greater disclosure prior to the SEO issue date, which is related to a richer information environment with capital formation benefits. Contrary to criticisms of SOR, we do not find evidence that these disclosures are opportunistic in nature. The use of FWPs in the full sample and a greater proportion of annual MEFs in the forecasting sample under SOR result in a 51% greater proportion of SEOs preceded by guidance disclosure during the capital formation period. The overall frequency of disclosure is 25% greater, and the amount of information provided in the 8-K immediately before the issue date more than doubles in size. Furthermore, the number of days between the last disclosure before an SEO and the issue date is lower under SOR. Also, MEFs immediately preceding the SEO issue date are 68% more accurate under SOR (i.e., have reduced error and bias) and tend to include more downward than upward revisions. In addition, the abnormal magnitude of information reflected in absolute market-adjusted returns is almost twice as large after SOR, and the difference is driven by SEOs with disclosure within one week before the issue date. Furthermore, stock returns during the capital formation period are greater after SOR for SEOs with disclosure within one week prior to the issue date with no reversal after the issue date,

[1] See the Securities Offering Reform Final Rule at http://www.sec.gov/rules/final/33-8591fr.pdf.