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Did Regulation Fair Disclosure affect credit markets?

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ABSTRACT

This study assesses whether the implementation of Regulation Fair Disclosure (Reg FD) has affected the quantity and quality of information in credit markets. We find that, after Reg FD, borrowing from new lenders was associated with a higher loan spread. We also document that, after Reg FD, (1) borrowers became more dependent on relationship lending; (2) lead lenders retained a higher loan share; and (3) a typical loan syndicate involved a smaller number of participating lenders. We interpret these results as evidence of an increased level of information asymmetry in credit markets after Reg FD.

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1. Introduction

The Securities and Exchange Commission's (SEC) Regulation Fair Disclosure (Reg FD) took effect on October 23, 2000. Reg FD imposed new restrictions on selective disclosures of material non-public information to equity market professionals, such as institutional investors and financial analysts.[2] The intention of Reg FD was to level the playing field for investors, by requiring public disclosure of material private information to all market participants. However, both academics and practitioners have expressed concerns about a potential "chilling effect", on the amount of information actually disseminated to the market following the adoption of this regulation.[3]

While most of the existing literature focuses on the effect of Reg FD on the equity market and its participants, little is known about how this regulation influenced the credit market and its participants, such as bank lenders and borrowers.[4] This gap in the literature should not be neglected given the wide reliance of public firms on loan financing as part of their capital structure. Moreover, prior empirical research investigating the impact of Reg FD on the

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[2] SEC's (2000) final ruling on Reg FD states that "four categories of persons to whom selective disclosure may not be made absent a specified exclusion. The first three are securities market professionals – (1) broker-dealers and their associated persons, (2) investment advisers, certain institutional investment managers and their associated persons, and (3) investment companies, hedge funds, and affiliated persons. These categories will include sell-side analysts, many buy-side analysts, large institutional investment managers, and other market professionals who may be likely to trade on the basis of selectively disclosed information. The fourth category of person included in Rule 100(b) (1) is any holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that such person would purchase or sell securities on the basis of the information".

[3] For example, the association for Investment Management and Research (now the CFA Institute) argues, "Corporations will almost certainly curtail the information flow to the market to avoid having to decide on the spot whether certain information will be deemed to be material..." (AIMR, 2001).

[4] Firms' disclosure of private information to credit rating agencies was exempted from Reg FD until the introduction of Dodd Frank Act in 2010. Jorion et al. (2005) examine stock price reactions to the announcements of credit rating upgrades (downgrades) and found that stock price responded to such announcements more significantly in the post Reg FD period, implying that changes in credit rating carried more information content after Reg FD.

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"quantity and quality" of information has produced mixed results.[5] The lack of consensus about the ultimate impact of Reg FD on the information environment of the capital market is partially attributable to the challenge of measuring the "quantity and quality" of information itself. Syndicated loans that involve a group of lenders with a typical agent-participant syndicate structure actually provide a unique venue to measure the informational frictions in the capital market. Therefore, the main focus of this paper is to examine how Reg FD affected the quantity and quality of information production among different loan market participants in the post-Reg FD period.

Indeed, the loan market is different from the public equity market in that information disclosure is not governed by the SEC. In particular, Reg FD provided an exemption regarding the communication of private information by borrowers to creditors as long as the disclosed information is kept confidential by lenders (SEC, 2000).[6] As a standard practice, borrowers required creditors to adhere to confidentiality agreements during the loan syndication process both before and after the passage of Reg FD.

However, Reg FD could have imposed an additional cost on borrowers if the lender directly or indirectly breached confidentiality agreements after Reg FD. Prior literature has shown that lenders in a loan syndicate may not adhere to the confidentiality agreement. For instance, Ivashina and Sun (2011) show that institutional lenders use sensitive private information obtained from their participation in loan syndicate to generate trading profits for their equity holdings.[7] Ivashina et al. (2009) show that lenders release private information to "strong" corporate customers to better enable them to takeover "weak" corporate borrowers so as to reduce the risk of loan defaults.[8] After Reg FD, this leakage of information, i.e., breach of confidentiality agreements could force borrowers to make any private information disclosed to loan syndicate participants public if the private information is misused.[9] In addition, Reg FD can affect the information flow in the credit market if the quantity of information released by firms was reduced after Reg FD. This effect is particularly relevant for the syndicated loan market because loan syndication involves non-agent participating lenders that do not have direct access to borrowers' private information and mainly rely on publicly available information or an information memo stripped of sensitive private information provided by agent lenders (Standard & Poor's, 2011).

To assess whether the quality and quantity of information were reduced in the syndicated loan market after the introduction of Reg FD, we utilize stylized facts regarding asymmetric or imperfect information flows among borrowers and lenders. In particular, the level of information asymmetry could be different among borrowers and different types of lenders. Relationship lenders, having invested time and resources in collecting and generating "reusable" proprietary information about borrowers through multiple interactions in the past (Boot, 2000; Bharath et al., 2011), faceless information asymmetries than "non-relationship lenders", lenders never lending to the borrower. The implementation of Reg FD could have exacerbated these non-relationship lenders' information disadvantage either because non-relationship lenders no longer have access to selectively disclosed private information outside of the loan syndication process or because borrowers reduced their information disclosure to the general investing public after Reg FD (e.g., Wang, 2007). As a result, non-relationship lenders needed to incur higher information production costs (such as the increased costs of collecting soft information) in assessing the creditworthiness of a new borrower, which can be passed, at least in part, to borrowers in the form of a higher loan spreads and fees. Thus, we test whether it became more costly for borrowers to switch to new (non-relationship) lenders. Furthermore, facing an additional disclosure risk and a higher cost of switching to new lenders,[10] borrowers could have become more reliant on relationship lenders or switched less to new lenders after Reg FD. Accordingly, we test whether there was an increase in relationship banking intensity in the syndicated loan market after the introduction of Reg FD.

In addition, information asymmetries also exist between lead lenders and participating lenders in loan syndications because lead lenders have direct access to borrowers' private information, while participating lenders only have access to an information memo prepared by lead lenders with all sensitive private information removed. Consequently, to resolve any adverse selection and syndicate moral hazard problems, lead lenders may have needed to retain a larger proportion of a syndicated loan and/or involve fewer participating lenders (Dennis et al., 2000; Sufi, 2007). Accordingly, we test whether lead lenders retained a greater percentage of a loan and/or whether loan syndicates involved a smaller percentage of participating lenders as a result of a widened informational gap between lead lenders and participating lenders after Reg FD.

To test the above hypotheses, we analyze syndicated loans originated before and after the Reg FD implementation year (i.e. using 2000 as the event year) in terms of the cost of switching lenders, relationship intensity, and the loan syndicate structure. Overall, we find that, after the introduction of Reg FD, borrowers needed to pay 31 basis points more in all-in-spread drawn (AISD), representing $465,000 additional annual interest and fees on a median sized loan in our sample, in order to borrow from new (non-rela-

[5] For instance, Heflin et al. (2003) show that management earnings forecasts increased right after the implementation of Reg FD. Bushee et al. (2004) suggest that firms did not reduce their disclosure through open conference calls following the adoption of Reg FD. However, Wang (2007) and Gomes et al. (2007) show that some firms reduce their public disclosure after Reg FD. Sidhu et al. (2008) extract an adverse selection component from stock bid-ask spreads and show that the level of information asymmetry increased after Reg FD, consistent with a decline in the quantity and quality of information being disclosed to the investing population. Duarte et al. (2008) document that the cost of equity for firms traded on NASDAQ increased in the post-Reg FD period. Both the Sidhu et al. (2008) and Duarte et al. (2008) papers suggest that information quantity and quality in the equity market declined following the introduction of Reg FD.

[6] Motivated by this exemption, Petacchi (2014) examines whether the implementation of Reg FD caused a significant change in firms' capital structure. She finds a significantly increased average leverage ratio among public firms in the post-Reg FD period and attributes this finding to firms' increased reliance on debt financing to avoid public disclosures.

[7] As a real world example, in March 2006, a large movie rental chain (Movie Gallery) held a private conference call with about 200 lenders. The company announced its poor financial condition to these potential lenders before making it publicly available information. During the next two days, Movie Gallery's shares were heavily traded and its stock plummeted 25%, triggering an SEC investigation (see, Jenny Anderson, *As Lenders, Hedge Funds Draw Insider Scrutiny*, N.Y. TIMES, October 16, 2006).

[8] The breach of confidentiality agreement could lead to lawsuits between borrowers and their financial advisors. For example, in June 2012, CF partners brought a legal action for about $164 Euros against Barclays Capital, who was accused of using confidential information received in its role as a lender.

[9] More specifically, the SEC, in its final ruling, puts forth that "We believe that reporting companies making unregistered offerings should either publicly disclose the material information they disclose non-publicly or protect against misuse of that information by having those who receive it agree to maintain it in confidence. If a reporting issuer releases material information non-publicly during an unregistered offering with no such understanding about confidentiality, we believe that *disclosure under Regulation FD* is appropriate". SEC further states that "Public companies undertaking unregistered offerings will need to consider the impact their selective disclosure could have on any exemption they use. Before an exempt offering begins, issuer's counsel should advise the client of the potential complications that selective disclosure of material non-public information could raise." (see, SEC Final Rule: Selective Disclosure and Insider Trading", 2000)

[10] A strand of research highlights how disclosure risk could impact firms' financing decisions. For example, Yosha (1995) predicts that good quality firms choose to borrow from a single lender because the proprietary information they disclose to lenders could be leaked to product market competitors through multilateral lending agreement. Asker and Ljungqvist (2010) document that, to avoid information leakage, industry competitors would not select the same equity/debt underwriters. These studies suggest that disclosure risk does affect firms' selection of lenders.

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