SECURITIES $ EXCHANGE

# PUTTING THE SECURITIES LAWS TO THE TEST

*The long-standing approach to federal securities regulation is not working.*

BY ELISABETH DE FONTENAY

Of all the federal regulatory regimes, many would argue that the U.S. securities laws reign supreme, both in their design and function. They are widely touted as the country's first line of defense against a repeat of the Great Depression. (It is no coincidence that the federal government first began regulating securities immediately following the Depression.) While the recent financial crisis calls into question just how much protection the securities laws actually offer, the widespread view is that matters would only have been worse with unregulated, anything-goes capital markets. Indeed, the market for credit default swaps, perhaps the most notorious contributor to the financial crisis, was not subject to securities regulation at the time.

But what do we actually know about whether the securities laws work? Given the trillions of dollars at stake in the financial markets and the dramatic economic consequences of getting it wrong, figuring out whether the securities laws are actually doing their job is absolutely crucial. Surprisingly, we lack a definitive answer to this question, even after eight decades of federal securities regulation.

## MANDATORY DISCLOSURE IN FEDERAL SECURITIES REGULATION

There are many ways in which government could regulate securities offerings and trading. A common approach under pre-Depression state law was for a state agency to review each investment offered to citizens of that state and either approve or reject it according to its perceived level of risk. In contrast to this heavy-handed (and often arbitrary) approach in which the government acts as gatekeeper for corporate capital raising, the New Deal–era federal regulators opted simply to *mandate disclosure* by any company proposing to issue securities. In other words, issuers did not have to meet specific financial or accounting criteria or pay their way into the markets; they simply had to make public various information about the issuing company and the securities being issued. The thought was that requiring disclosure of the good, the bad, and the ugly would root out much of the fraud that permeated pre-Depression markets and provide investors with a clearer picture of the quality of firms competing for their investment money. That supposedly would lead to better investment decisions. As eventual Supreme Court justice Louis Brandeis noted, "[S]unlight is the best disinfectant."

What does mandatory disclosure actually entail for purposes of the securities laws? While the rules are complex and exceptions abound, the required disclosures fall into two broad categories:

- disclosures to be made at the time a security is issued (which are filed with the Securities and Exchange Commission in a securities registration statement or "prospectus")
- post-issuance disclosures that are to be made on an ongoing, periodic basis (captured in 10-K, 10-Q, and 8-K filings, for example)

The actual information to be disclosed is ever-increasing, but the broad categories include periodic financial disclosure (such as audited financial statements), particular risks that the issuer presents (such as major lawsuits, reliance on a small number of customers, regulatory changes, etc.), together with major devel-

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opments affecting the corporation in real-time (such as mergers, major financings, changes in senior executives, etc.).

The beauty of the mandatory disclosure approach, which goes a long way toward explaining its popularity, is that it appears minimally intrusive and preserves the freedom of individual choice that is thought to be the hallmark of a democratic, capitalist society. The federal government does not dictate what investors can or cannot invest in; it simply requires companies to reveal material information to investors and lets investors decide for themselves.

So far, so good. But do the securities laws actually work? Notwithstanding its minimalist intentions, mandatory disclosure imposes heavy costs on companies and other market participants such as underwriters and investors. The direct costs of compliance and enforcement are substantial. Firms issuing public securities must engage auditors and lawyers to assist with the securities registration process and government employees must review and approve the unending flow of disclosure. Management time is diverted from figuring out how to maximize firm value to worrying about what firms can and cannot say. The indirect costs of mandatory disclosure are impressive as well. For example, the prohibitive

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costs of compliance may well preclude many small issuers from issuing securities to the public, which inefficiently skews investment toward the largest issuers. Other indirect costs of mandatory disclosure include the additional delay it imposes on capital raising, the costs of defending against lawsuits alleging misstatements in disclosures, and the forced disclosure of sensitive or proprietary company information to competitors.

Ultimately our view of the merits of securities regulation should depend on the answer to a simple empirical question: do the benefits of mandatory disclosure outweigh its costs? While stating the question is easy enough, answering it is anything but. Testing the effectiveness of mandatory disclosure is astonishingly difficult, mainly for two reasons. First, it is virtually impossible to measure (or even identify) the true costs and benefits of mandatory disclosure—more on that below. Second, the real-world statistical models used to test the securities laws' effects are messy, plagued by both conceptual and technical difficulties. To illustrate: we can easily show that stocks became less volatile following the Great Depression, but was that because of the salutary effects of mandatory disclosure or simply because the Great Depression wiped out so many risky issuers? A separate failing of existing attempts to gauge securities regulation's effectiveness is that they have focused almost entirely on the stock market rather than on the corporate debt markets. This is an unfortunate and surprising omission because corporate debt issuances are so much larger than corporate equity issuances, and the economy suffers so much more when things go south in the corporate debt markets.

## NATURAL EXPERIMENT

In a forthcoming article in the *Journal of Corporation Law*, I argue that recent developments in the corporate debt markets create a natural experiment testing whether mandatory disclosure is effective—one that avoids the major pitfalls of prior empirical tests. The natural experiment is provided by the dramatic convergence of certain risky corporate bonds ("high-yield" or "junk" bonds) and corporate loans ("leveraged loans") into functionally the same asset class. This surprising development is invaluable for testing the securities laws' effectiveness because corporate bonds are treated as securities under the U.S. securities laws (and thus subject to the full weight of mandatory disclosure), while corporate loans are not. Notwithstanding that high-yield bonds and leveraged loans are regulated so differently, they have recently become virtually identical as a functional matter. As argued below, this convergence strongly suggests that the securities laws are not doing the work they were intended to do.

***Changing paradigms of loans and bonds*** / Why, historically, have loans and bonds been treated differently under the securities laws? This difference began when the laws were first enacted. It is the product of the widely accepted view that securities regulation should remain hands-off with respect to sophisticated parties in bilateral commercial transactions, while carefully protecting unsophisticated parties making passive investments.

Historically, the functional reality of corporate loans and bonds meshed well with this regulatory framework. Traditional corporate loans were made by a single bank to a single company. As the sole lender, the bank had significant incentives and ability to monitor the borrowing company closely and to negotiate loan provisions that minimized credit risk. As such, loans have always been viewed as commercial transactions (rather than investments) made by sophisticated parties (banks) that do not require the additional protection of the securities laws.

In contrast, bonds have always been viewed as passive investments. Bonds were traditionally sold widely to the general public, including unsophisticated retail investors with little experience in assessing credit risk and little ability to bear losses. Not only are bonds sold to large numbers of passive investors, but post-issuance they can be freely traded, making the connection between the borrowing company and the ultimate investor even more attenuated. Such investments, it was thought, clearly demanded the protection of the securities laws. The regulatory framework has been set by this dichotomy between loans and bonds ever since.

But sweeping changes in the corporate debt markets, primarily over the last 15 years, have turned the regulatory logic on its head. More and more, corporate loans resemble bonds. Large corporate loans are no longer funded and held to maturity by a single bank. Instead, they are underwritten like bonds; they are funded by many creditors (a process referred to as syndication), consisting primarily of non-bank institutional investors. Post-funding, they are rapidly traded in a liquid market and are often securitized to reach still more creditors. The syndication and trading of loans fundamentally changed the nature of corporate loans into their traditional opposite—public bonds.

Two major developments drove this dramatic transformation. On the supply side, the increased competition and overlap between commercial banking and investment banking (following the repeal of the Glass-Steagall Act) and the Basel II rules on bank capital requirements both prompted banks to get out of the business of originating illiquid loans. Instead, they were incentivized to underwrite loans and sell them off to other creditors, thereby allowing them to earn lucrative underwriting fees while significantly diversifying their loan portfolios. On the demand side, the rise of leveraged buyouts since the 1980s has fueled an ever-increasing need for massive, tradable corporate debt.

The convergence between loans and bonds is the most striking at the high-risk, high-return end of the spectrum. "Leveraged loans" and "high-yield bonds" are, respectively, loans and bonds issued by companies that are below investment grade (i.e., that have "junk" status). Investors in those markets now view the two as functionally identical: they are issued with virtually the same economic terms, the same covenants, and the same number and

types of creditors. If banks are no longer the principal creditors for leveraged loans, and the creditors act as passive investors in the loans rather than as active monitors of the borrowing company, and if leveraged loans have loose terms and are traded like bonds, why aren't they regulated like bonds? Why aren't leveraged loans treated as securities and subject to mandatory disclosure? Why do they continue to escape the lengthy SEC registration process when they are issued, and the onerous subsequent disclosures?

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None of this makes sense if one believes that "like cases should be treated alike" under the law. How we got here is a fascinating story of innovation in the financial markets and regulatory path-dependence and inertia.

### IMPLICATIONS OF THE LOAN-BOND CONVERGENCE

What does the existence of two identical markets that are regulated entirely differently tell us? How can it help us evaluate the effectiveness of mandatory disclosure where past empirical assessments have failed? For starters, focusing the inquiry on the debt markets has a major advantage over prior studies of the equity markets: it allows us to simplify the question enough to finally answer it. In order to determine whether mandatory disclosure works, we need a clear picture of the benefits it aims to provide. Then we can decide whether those benefits exceed the costs. The two most commonly proposed benefits of mandatory disclosure are protecting unsophisticated investors and correcting inefficiencies in the market for company information. The second goal requires elaboration—but more on that later.

The problem for prior studies of the securities laws is that these two goals are in tension with each other, sometimes demanding opposing courses of action. This tension makes it almost impossible to determine whether mandatory disclosure is achieving its stated goals, even before we get to the question of whether the benefits outweigh their costs. The benefit of zeroing in on the debt markets is that this allows us to completely ignore the first goal, protecting unsophisticated investors. This is because, unlike the publicly traded stock markets, for example, today's debt markets have essentially no direct retail investors, which are the prototypical unsophisticated investor. (Direct retail investors are individuals who purchase and hold their investments directly, rather than through an intermediary such as a mutual fund or retirement plan manager.)

So we are left with only the second goal of mandatory disclosure: correcting inefficiencies in the production of company information. What is this all about? Even absent a legal mandate, companies seeking investors have substantial incentives to disclose information to the public in order to attract and retain investment. In addition, investors have incentives to seek out and even produce their own information about companies. But many scholars argue that, in the absence of regulation, the market will not produce enough information to attract the optimal level of investment. Information is a public good, the argument goes, and so the free market under-produces accurate, material investment information. For example, because of collective action and free-riding problems, investors as a whole will not spend enough to obtain the amount of accurate information that they actually want. Similarly, the companies seeking investors do not have the right incentives to coordinate to produce information that is easily comparable to other companies' information, or to reveal information that makes management look bad or that may be viewed as proprietary. If that is the case, mandatory disclosure can easily correct this inefficiency by simply requiring companies to disclose material investment information to everyone, at the same time, and in the same format. The argument is plausible so far as it goes—it is simply an empirical question as to whether such inefficiencies exist and whether mandatory disclosure is actually mitigating them.

So mandatory disclosure need only satisfy one goal in the debt markets: getting companies to produce the "right" amount of information. How can we tell whether it is achieving that goal? If mandatory disclosure is indeed correcting some inefficiency in a given market, then mandatory disclosure should lead to an *increase* in investment in that market. If the "public good" story about investment information is correct, then mandatory disclosure is better for *both* investors and companies, and brings us closer to the optimal equilibrium of supply and demand for investment that would exist under perfect market conditions. In other words, mandatory disclosure means more investment.

Looking at it in a slightly different way, if markets for two identical financial instruments existed side-by-side, with the only difference being that just one was subject to mandatory disclosure, then all investors would prefer the regulated market. Companies looking to attract investment would thus only issue in the regulated market—mandatory disclosure makes everyone better off!

Per our natural experiment described above, we have two real-world markets for identical products, only one of which is subject to mandatory disclosure. Leveraged loans and high-yield

bonds are functionally identical, yet—contrary to the orthodoxy of mandatory disclosure—more and more companies are choosing to issue leveraged loans over high-yield bonds. The market not subject to mandatory disclosure is not only thriving, it is surging past its regulated counterpart. The implication is plain: in the corporate debt markets, mandatory disclosure is simply not achieving its only plausible goal.

How can this be? The answer to that question determines how we should think about securities regulation.

## EXPLAINING THE STATUS QUO

The first possibility is that the premise behind mandatory disclosure—that regulation provides investors with better information than the market can—is simply false. Although dispersed, passive investors are clearly subject to free-riding and collective action problems; in today's markets they appear to obtain the investment information that they need regardless. Particularly in the debt markets, virtually all information that is relevant to investors can be (and is) simply obtained through contract: the loan agreement or bond indenture requires the borrowing company to produce annual audited financials, to report on material developments and events, and so forth. Contract is doing the work that regulations purport to do. In addition, more and more private services are popping up that compile and present relevant market information, filling niches not yet satisfied by the rating agencies (which have recently begun rating loans in addition to their longstanding practice of rating bonds).

*Maintaining the regulatory status quo allows regulators and market participants to go their merry ways while turning a blind eye to the fact that the regulatory scheme no longer passes the laugh test.*

The other possibility is that information inefficiencies are indeed real in investment markets, but that the costs of mandatory disclosure are too high in comparison. Perhaps the SEC is asking companies to disclose all the wrong things or asking them to disclose far too much, or perhaps the compliance costs are crowding out too many worthy companies. Any of these could explain the dramatic rise and success of the leveraged loan market, notwithstanding its unregulated status under the securities laws.

But now we have another puzzle posed by our natural experiment: if mandatory disclosure is not effective or its costs are excessive, why would any company issue in the regulated market if given the choice? Why is anyone still issuing high-yield bonds and going through the time and expense of registering them with the SEC when they could simply issue leveraged loans instead? The likely explanation is that—for reasons that may themselves no longer be valid—many institutional investors are required to hold all or some minimum portion of their investments as registered securities. Mutual funds, for example, are often required to invest in registered securities: as between leveraged loans and high-yield bonds, they are compelled to pick high-yield bonds, and thus some companies will continue to issue high-yield bonds in order to access that liquidity. Similarly, whether for regulatory or political reasons, pension funds may choose to invest at least some portion of their assets in registered securities. If the general public believes that registered securities are somehow less risky (even if they are mistaken), then pension funds would be wise to invest in registered securities in order to avoid the public ire when a downturn occurs.

So where do we go from here? Treating leveraged loans and high-yield bonds differently under the securities laws no longer makes any sense at all from a functional standpoint. Yet, perhaps surprisingly, I come down on the side of maintaining the regulatory status quo for the time being, for three reasons. First, letting our natural experiment continue for a significant period of time should provide invaluable information about what works and what does not work with the mandatory disclosure rules. Comparing the disclosure practices in the leveraged loan and high-yield bond markets over time, and tracking which of the two markets is attracting the most investment, will provide a rare opportunity to observe regulatory success or failure in practice. Second, since some investors are still restricted to purchasing registered securities (as noted above), there is some justification for continuing to treat high-yield bonds as securities in order to avoid shutting those investors out of the high-yield space entirely. Finally, maintaining the current state of play is unlikely to do much harm given that, if issuers want to avoid the burdens of mandatory disclosure, they can simply issue leveraged loans instead. And if mandatory disclosure is not doing any real work, there is no cause for imposing it on leveraged loans. Regulators and market participants can go their merry ways while turning a blind eye to the fact that the regulatory scheme no longer passes the laugh test.

None of this is to say that the debt markets and debt-market participants should be left entirely unregulated. Market bubbles fueled by excessive leverage are damaging to the wider economy, and the right regulatory approach could conceivably limit their frequency and severity without excessively hampering corporate financing. Unfortunately, our current securities laws simply are not fulfilling that role. *R*