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Statement

of The Bond Market Association before the United States House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Hearing on Fair Disclosure or Flawed Disclosure: Is Regulation FD Helping or Hurting Investors?

May 17, 2001

Submitted for the Record

The Bond Market Association is pleased to submit this statement on the effect of Securities and Exchange Commission's Regulation FD on the market for high-yield corporate bonds. The Association represents securities firms and banks that underwrite, trade and sell bonds in the international and domestic markets. Our membership represents the top underwriters and dealers of high-yield bonds and collectively accounts for more than 95 percent of nation's overall bond underwriting activity. We commend Chairman Baker for holding this hearing and appreciate the opportunity to present our views.

Regulation FD was designed to encourage issuers to make full and fair disclosure of material information on a non-selective basis. The Association supports this goal and opposes the practices Regulation FD was designed to address. In earlier comments to the SEC on a draft version of Regulation FD, the Association agreed with the need to end selective dissemination of material, non-public information that is intended to confer a benefit or preference.¹ At the same time, we expressed concern that the requirements of Regulation FD could hurt the flow of information in the market for high-yield bonds. This would, in turn, create difficulties for businesses seeking to raise capital through offerings of high-yield bonds.

Our members' initial experience with Regulation FD suggests the new disclosure requirement, while beneficial in some respects, has had generally negative consequences for the high-yield bond market that merit continued monitoring. During the six months following the implementation of Regulation FD, the Association has observed the following:

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- The volume and quality of the information made available by issuers in the high-yield marketplace has declined, and effective analysis of matters with particular relevance for investors in high-yield bonds has become more difficult as a result;
- The price volatility of certain segments of the market, especially the high-yield bonds of smaller businesses, may have increased, and the liquidity of certain bond

- issues may have decreased, as a result of changes in the flow of information to the marketplace; and
- Private placements of high-yield bonds have required increased time and expense, particularly in light of the difficulty in obtaining written confidentiality agreements as part of the offering process.

I. Overview of the High-Yield Debt Market

High-yield securities are a critical method of raising capital for businesses that do not possess an investment grade rating from a rating agency and might not otherwise be able to access the bond markets.² Typically, a company will fail to win an investment-grade rating because of the firm's high level of debt, or financial leverage, or because of uncertainty regarding the company's future revenue. The market for high-yield securities in the United States has tripled over the last ten years, increasing from \$200 billion in principal amount of securities outstanding in 1990 to approximately \$600 billion in 2000.³ Companies have issued over 5,000 high-yield bonds in the last ten years. This growth reflects the significant capital needs of high-yield issuers, as well as growing investor demand for the securities.⁴

High-yield securities share several characteristics that distinguish them from both equities and investment grade bonds and raise particular issues of concern under Regulation FD. First, high-yield securities are more sensitive to real or perceived changes in a firm's capacity to service its obligations. Companies that raise money with high-yield bonds often have high levels of financial leverage. They are, therefore, more vulnerable to increases in interest rates or a deterioration in the economic environment in their respective markets. Either could affect their ability to repay principal and interest.

Research analysts suggest these credit concerns have contributed to the decline in the volume of new issues of high-yield bonds over the last two years. The volume of new issues of high-yield securities amounted to \$47.5 billion in the year 2000, compared to \$143.9 billion in 1998.⁵ Sensitivity to such external factors underscores the importance of maintaining an adequate and consistent stream of high quality information about issuers in the high-yield sector. It is essential to the vitality of the high-yield market that analysts have access to the information necessary to identify credit issues on a timely basis and place their significance in the proper context.⁶

Second, companies that use high-yield securities are generally smaller, in financial terms, than companies in the investment grade bond market. These companies often have considerable competing demands on available financial resources and may not have adequate resources to communicate with the public on a regular basis. The quality and quantity of information companies provide is consequently limited by their ability to make the legal and business determinations and stage the broad, public dissemination of information required by Regulation FD.

Third, secondary market liquidity for high-yield bonds--liquidity refers to the ability to trade a security without substantially affecting its price--is not maintained as readily as in

the market for investment grade securities. A lack of current information in the market, therefore, is more likely to have an effect on the pricing of high-yield bonds. In addition, many businesses that issue high-yield bonds are relatively small and not monitored by a broad group of analysts. As a result, the amount of information produced by analysts covering issuers of high-yield bonds has fewer points of origin and may be less extensive than is the case for companies that issue investment-grade bonds.⁷

II. Initial Experience with Regulation FD

A. Regulation FD Inhibits Disclosure in the High-Yield Marketplace

Based on our members' experience to date, Regulation FD has had an adverse impact on the volume and quality of information issuers provide to the public. The Regulation has improved access to material information in some respects, but it has also imposed constraints on communication between issuers and analysts. The Regulation limits the venues in which discussions tend to occur and narrows the range of information made available to the public--*e.g.*, issues of concern to the high-yield debt market. To avoid the cost of making the difficult materiality assessments required by Regulation FD, a number of companies have reduced the amount of information they provide and the frequency with which they disseminate information. This is particularly true for smaller firms that maintain a less extensive investor relations staff. The ability of high-yield bond analysts to collect information and disseminate it has been impaired as a result.

Companies and Analysts

The adoption of Regulation FD has markedly altered the quality of information available to analysts by limiting opportunities for in-depth dialogue with issuers--particularly on matters that are relevant to the high-yield market.

Many companies try to limit materiality assessments under Regulation FD--as well as to avoid the appearance of providing selective disclosure to analysts--by conducting the vast majority of communications with analysts and investors in public venues such as websites, teleconferences, or through regulatory filings. These formats have improved investor and market professional access to material information from companies. For example, since the implementation of Regulation FD, the amount of statistical and other relevant information provided by companies on their websites has improved significantly. In this way, Regulation FD has leveled the playing field for high-yield analysts and other market professionals who were previously excluded from conference calls with a company's favored equity analysts.

The Association favors the use of public venues and innovative technologies to communicate with investors and other market participants, but these venues suffer from numerous limitations and therefore cannot serve as an effective substitute for ongoing dialogue between companies and analysts. Publicly conducted webcasts and conference calls do not afford the same opportunities to acquire information essential to effective analysis of fixed income instruments. Large public settings render it more difficult to draw out the depth and nuance that can be elicited by the third, fourth or fifth follow-up question--questions that can only be asked in the one-on-one context. Moreover, issuers

may find it easier in a public meeting to avoid insightful questions or to resist elaborating on specific issues--particularly where the questions do not relate directly to financial forecasts. The situation is analogous to the difference between a press conference and a one-on-one interview. A one-on-one interview is more likely to elicit detailed information while individuals can often deflect unfavorable questions in press conference settings.

Regulation FD has created particular problems for analysts that focus on issues of relevance to a specific market segment--such as high-yield bonds. Analysts in the high-yield market focus on issues that generally are not of interest to shareholders and equity analysts, such as covenant packages and related features of specific securities or financing. Because Regulation FD has channeled most disclosure into the above-mentioned venues, high-yield bond analysts must now compete with equity analysts and others for the limited time allotted for company conference calls and webcasts. In this context, high-yield and other bond analysts generally have had less opportunity to explore issues of concern to bondholders in detail. Likewise, asking multiple follow-up questions and probing assertions made by management on issues uniquely important to the bond market has also been difficult.

To overcome these obstacles to company-to-analyst communication under Regulation FD, the SEC should provide guidance on what information would be considered material under Regulation FD. Guidance of this nature would counteract the conservative reflex among certain firms and legal counsel to adopt silence as a way of steering clear of problems under Regulation FD. In addition, this guidance could provide companies with a level of assurance concerning the basis on which the SEC's Enforcement Division would or would not pursue enforcement proceedings under Regulation FD.

Investors and Analysts

Regulation FD has reduced the frequency of companies' communication with investors and analysts and the amount of information made available when disclosures are made. The impact has varied from firm to firm and reflects a range of factors.

Smaller firms--with fewer resources and less extensive investor relations and legal staffs--have experienced greater difficulty in arranging for frequent discussions with analysts under Regulation FD. All companies, in considering whether to release information, must balance the benefits of disclosure against the legal expense associated with difficult materiality decisions. Other factors include the cost of making disclosure in a public setting or filing and the demand for scarce management time. In the case of smaller companies, this assessment has led to less frequent and extensive disclosure.

The incentives for disclosure of information important to holders of high-yield bonds often will not outweigh the additional compliance burdens resulting from Regulation FD. Company management, whose principal fiduciary duty is to shareholders, has a greater interest in ensuring marketplace disclosure on issues affecting an issuer's equity securities than on those affecting solely its debt securities. Companies are less likely to create opportunities to permit high-yield analysts to obtain the specialized information they

seek. In some situations, companies may have selectively invoked Regulation FD itself as a shield to avoid discussions with high-yield analysts. This problem is particularly acute, moreover, in cases where a company's only publicly traded securities are debt and not equity. In that case, high-yield analysts cannot benefit from information that might otherwise be provided for the equity security holders.

Regulation FD has a disproportionate impact on smaller firms that do not have the resources to make the assessments required by Regulation FD. The Association, therefore, recommends the SEC create an exemption from the rule for smaller firms.⁸ In addition, we recommend a separate exemption for companies with public debt outstanding but no public equity. This would permit disclosures to be made to fixed income analysts in a context where the potential does not exist for the abuses against which Regulation FD is directed.

B. High-Yield Volatility has Increased and Liquidity has Decreased

Although a definitive assessment cannot yet be offered, our experience to date suggests the changes in the flow of information resulting from Regulation FD may have had a negative effect on the price volatility of high-yield bonds, as well as on the liquidity of smaller issues of high-yield bonds. In the Association's view, it is essential for the SEC to carefully assess the potential for longer-term, adverse effects on the efficiency of the high-yield bond market.

Increased price volatility is particularly problematic in the high-yield market, which does not enjoy the depth of liquidity of the government or even the investment-grade corporate securities markets. In the case of less liquid securities (particularly those issued by smaller firms), the lack of access to regular information can decrease investor interest in trading between periodic disclosures. This reduces liquidity further, which, in turn, heightens the risk of greater volatility. While empirical data have not yet emerged, these risks could result in wider spreads or a reduction in the number of market makers for the bonds of a particular company. The cost of raising capital through high-yield bonds would increase as a result.

C. Regulation FD Places Added Burdens on the Private Placement Process

Regulation FD has increased the burdens on firms conducting Rule 144A private placements, particularly for small-cap companies. The regulation has heightened the importance to companies of avoiding disclosure of nonpublic information in the context of a private placement that might, in hindsight, be regarded as material. Because issuers have generally found it difficult to obtain confidentiality agreements from prospective investors, companies have deemed it necessary to adopt more stringent procedures for "sanitizing" private placement memoranda to ensure prospective purchasers receive no material information that is not simultaneously disclosed to the public.⁹

These additional procedures are costly and have introduced considerable delays in the private placement process without appreciably improving the information made available to the public.¹⁰ For example, counsel must review private offering documents and assess the materiality of the disclosures, while question-and-answer sessions and other meetings

with prospective investors must be carefully structured to avoid inadvertent disclosure of material information that will not have been simultaneously published.¹¹ Companies and their counsel must also make certain that all public disclosures (e.g., on Form 8-K) are drafted in a manner that does not violate the prohibition against general solicitations under Section 5 of the Securities Act of 1933.¹² These additional steps, moreover, address a policy issue of only marginal concern, since issuers refrained from disclosing material, nonpublic information to investors in the context of private placements before Regulation FD was adopted.

To address this concern, we recommend the SEC create an exemption under Regulation FD for information conveyed by issuers in the course of completing an offering of securities under the private placement/Rule 144A provisions of the federal securities laws. Regulation FD currently contains an exemption for disclosures made in the course of a registered offering under the Securities Act of 1933. We believe a parallel exemption for disclosures made during a Rule 144A offering or other private placement transaction should similarly be established under Regulation FD. Offerees in Rule 144A/private placement transactions would benefit from the opportunity to engage in the more flexible give-and-take that is permitted to occur in the context of road shows in public transactions. Moreover, there has been no suggestion that issuers or placement agents have used these transactions as a means of providing inappropriate selective disclosure or otherwise to engage in the abuses against which Regulation FD is directed.

Conclusion

Regulation FD was designed to encourage issuers to make full and fair disclosure of material information, but it appears the rule may have caused a decrease in the volume and quality of information that companies make available to the public. In particular, analysts have encountered significant difficulties in eliciting information--especially regarding issues of concern to the high-yield debt market--from companies that have come to rely on the use of public venues for the dissemination of material information to avoid making the materiality assessments required by Regulation FD.

In light of these developments, it is essential the SEC continue to assess the progress of companies and the analyst community in implementing Regulation FD and vigilantly monitor the impact of the regulation on the market for high-yield and other fixed income securities.

In particular, we recommend that the SEC consider approaches to alleviating the legal and administrative burdens of complying with Regulation FD as follows:

- Providing guidance on the difficult materiality assessments firms must make when engaging in discussions with analysts or other market professionals--particularly with respect to issues that concern only a limited segment of the market;

- Create an exemption from Regulation FD for firms below a certain capitalization threshold or that have outstanding high-yield debt but no publicly held equity; and
- Create an exemption for Regulation FD for disclosures made in connection with Rule 144A private placements.

We appreciate the Subcommittee's initiative in seeking views on Regulation FD from the bond underwriter and dealer community along with companies and investors. The Association's members look forward to working with the Subcommittee and the SEC to find ways to continue to ensure fair disclosure to all investors while improving the quality and efficiency of the fixed income markets.

Footnotes

1. Letter from Irshad Karim, Chair, Corporate Bond Legal Advisory Committee, The Bond Market Association to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Apr. 28, 2000).
2. For purposes of this statement, a high-yield security is one that is rated by at least one nationally recognized statistical rating organization and that does not possess at least one investment grade rating (*i.e.*, a rating of BBB-/Baa3 or higher).
3. The Bond Market Association estimate.
4. According to the Investment Company Institute, the net assets of high-yield bond mutual funds increased from \$45.1 billion in 1994 to \$116.9 billion in 1999.
5. The Bond Market Association Research Quarterly, Feb. 2001, page 5.
6. Unlike bond rating agencies, which evaluate solely the ability of an issuer to meet its obligations when and as they become due, high-yield analysts additionally provide "relative value" analysis of high-yield issues--*i.e.*, using established relationships based on criteria such as maturity, seniority, and industry prospects to identify situations in which certain issues may offer a better yield to investors vis-à-vis similarly situated issues.
7. This factor may be exacerbated in the case of high-yield issuers that have not issued publicly traded equity and are therefore followed only by fixed income analysts.
8. "Smaller firms" could be defined as companies with a capitalization under a threshold amount.

9. Prospective purchasers, typically large institutions, have almost uniformly been unwilling to agree to any confidentiality undertakings that might restrict their right to trade securities. This has proven especially true in the context of Rule 144A offerings, which play a central role in the high-yield securities markets, because of purchasers' desire to preserve complete flexibility to engage in resales.

10. The Association understands that similar problems have been experienced in other fixed income market sectors, including mortgage-backed and asset-backed securities offerings conducted pursuant to Rule 144A.

11. Material information that may be disseminated during roadshows for many registered offerings, by contrast, is not covered by Regulation FD. *See* Rule 100(b)(2)(iv) of Regulation FD.

12. In the Regulation FD adopting release, the SEC acknowledged that Regulation FD requires public disclosure of material information provided to an investor in an unregistered offering "even if, as a result of such disclosure, the availability of the Securities Act registration exemption may be in question." Securities Act Release No. 7881 (Aug. 15, 2000), 65 Fed. Reg. 51,716, 51,725 (Aug. 24, 2000).