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Speed of issuance and the adequacy of disclosure in the 144A high-yield debt market☆

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Abstract

I document the shift of high-yield issuance from the public to the Rule 144A private placement market and exploit data on credit spreads to investigate whether investors regard disclosure in the two markets as comparable. The key implications of the inadequate-disclosure hypothesis are that investors require premiums on 144A securities and that such premiums are largest for first-time bond issuers and privately owned firms about whom less information is publicly available. I find that 144A premiums, though positive initially, have vanished over time, and I find no evidence of larger 144A premiums for first-time issuers or private firms. Investors do, however, require premiums of first-time issuers, and to a lesser extent of privately owned firms, regardless of whether securities are issued in the 144A or public market. These findings imply that sophisticated investors do not value the incremental information provided by securities registration, but do value ongoing disclosure. © 2000 Elsevier Science S.A. All rights reserved.

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1. Introduction

Rule 144A, adopted by the SEC in April 1990, establishes conditions under which private placements can be freely traded among 'qualified institutional buyers' (QIBs). By creating a more liquid class of private placement, the SEC hoped to attract issuers – especially foreign issuers – dissuaded by the illiquidity premiums commanded in the traditional private placement market and the registration requirements of the public market (Carey et al., 1993). Since 1990, foreign bond issuance in the U.S. has increased sharply; foreign issuance has been robust in both the public and Rule 144A markets, however, and it is not clear that Rule 144A was needed to trigger this growth.

This paper focuses on a very different use of Rule 144A than the one anticipated by the SEC. Rule 144A has been widely adopted by domestic, below-investment-grade firms as a means of quickly issuing securities that are subsequently registered. By issuing high-yield debt as 144A private placements, issuers are able to raise funds as soon as their securities can be marketed to investors. When the bonds are subsequently registered, investors enjoy the benefit of public-market liquidity.

The ability to issue debt quickly through the Rule 144A market has revolutionized issuance procedures for junk-rated firms in the same way that Rule 415 shelf registrations did for investment-grade firms. With a shelf registration statement, firms are able to pre-register securities that are issued up to two years in the future. The purpose of pre-registration is to permit rapid issuance as financing needs arise without the delay of waiting for the SEC to approve a registration statement. Yet many junk-rated firms do not meet the SEC's requirements for shelf registration, and even if they do shelf registration is not efficient for firms that cannot accurately predict their future financing requirements (Johnson, 1991, p. 417). The majority of junk-rated firms, therefore, register bonds at issuance, which, until the adoption or Rule 144A, led to potentially costly delays.

The use of Rule 144A by junk issuers has increased steadily over time: in 1993, less than 15% of junk-rated issues were issued through Rule 144A; in 1997, in conjunction with record issuance, more than 80% of below-investment-grade issues were issued in the 144A market. That trend continued in 1998, and market analysts have suggested that eventually all high-yield debt will be issued in the 144A market (Investment Dealers' Digest, 1997).

While using the 144A market to issue bonds rapidly is extremely useful to issuers, it is unclear how this practice is viewed by investors. Lack of registration may imply less disclosure, and more rapid issuance may allow less time for due diligence by investors. Press accounts suggest that investors are divided about how significant the disclosure and due diligence issues are (Investment Dealers' Digest, 1997). The reaction of investors to the 144A market is the focus of this paper.