Optimal Disclosure and Litigation Rules around IPOs and SEOs

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In recent years, there have been a number of reforms to the legal and regulatory framework governing disclosures and litigation around initial public offerings (IPOs) and seasoned equity offerings (SEOs). The most prominent of these are the JOBS Act of 2012 and the Securities Offering Reform of 2005. In a recent paper, we develop a theoretical analysis of the optimality of allowing firms to disclose various kinds of information prior to IPOs and SEOs, and of alternative rules to govern private securities litigation. In our model, firm insiders, with private information about variables affecting their firm’s future performance, may make disclosures (claims) about their firm’s future economic outcomes prior to selling new equity to outsiders. The issue price of firms’ equity is affected by their disclosures; by the demand for equity from institutional investors, which may conduct costly (and noisy) verifications of firm disclosures; and by the demand from retail investors, who do not have access to such an informative verification technology. There may also exist both an agency with the power to regulate firm disclosures and shareholders willing to file private securities litigation, as a result of which the courts are able to penalize firms ex post for making optimistic disclosures without a strong basis in fact.

The first implication of our model relates to the self-regulatory incentives of firms to make conservative disclosures in the absence of any regulatory agency or ex post litigation. Our results imply that such incentives exist only in markets where a large proportion of the demand for new equity issues arises from institutional (sophisticated) investors, which may conduct costly (and noisy) verifications of firm disclosures; and by the demand from retail investors, who do not have access to such an informative verification technology. There may also exist both an agency with the power to regulate firm disclosures and shareholders willing to file private securities litigation, as a result of which the courts are able to penalize firms ex post for making optimistic disclosures without a strong basis in fact.

When there is an agency regulating disclosures, our theory has implications for the kinds of disclosures that may be beneficial prior to new equity issues. If the proportion of institutional investors in the equity market is relatively large, and if the claims made by the firm can be verified by institutions with sufficient precision at a relatively low cost at the time of the offering, then it is beneficial (from the point of view of minimizing information risk faced by uninformed investors) to allow the information to be disclosed. However, even when the proportion of institutional investors is large, disclosures that are very costly to verify should be restricted. Further, such restrictions need to be more stringent in equity market settings where the participation rate of retail investors is greater.

Our paper shows that when it is easy for investors to file lawsuits against firms for making inaccurate forward-looking statements and to win or settle for large amounts, and the litigation regime is rather uninformative, firms issuing new equity will be deterred from making disclosures. However, when penalties are moderate, and the litigation regime is such that court verdicts are informative (i.e., insiders with better grounds for making a particular forward-looking statement are found liable and penalized less often), private securities litigation will not have a stifling effect on disclosure. In such a litigation regime, the potential for private securities litigation makes disclosures more credible to investors, thus promoting disclosure.

This post comes to us from Professor Onur Bayar at the University of Texas at San Antonio, Professor Thomas Chemmanur at Boston College’s Carroll School of Management, and Professor Paolo Fulghieri at the University of North Carolina’s Kenan-Flagler Business School. It is based on their recent article, “Optimal Disclosure and Litigation Rules Around IPOs and SEOs,” available here.