Research Opportunities in the Bond Market

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Securities legislation and accounting regulations can have long-lasting and far-reaching impacts on businesses; changing corporate performance and investor behavior. A large number of studies examine economic consequences of securities legislation and accounting regulations in the stock market, leaving the debt market less explored. A recent review in accounting literature calls for more research in the debt market since shareholders and debtholders likely have different information needs. Moreover, debt represents a significant source of financing. As of December 2009, there were $4.1 trillion in face value of corporate bonds outstanding in the U.S. non-financial sector and $5.8 trillion in the financial sector. The recent development of debt-related data sources (e.g., Mergent FISD, DealScan), newly-emerging phenomena in the debt market (e.g., enforcement of bondholder rights), and changes in regulation in bond markets (e.g., initiation of TRACE) provide ample opportunities to test existing accounting and economic theories.

Economic Consequences of Securities Legislation in the Bond Markets

Congress passed the Sarbanes-Oxley Act (SOX) in July 2002, in response to a number of high-profile scandals starting in late 2001. The Act has been widely considered the most far-reaching securities legislation since the Securities Acts of 1933 and 1934. It not only imposes additional disclosure requirements, but more importantly, proposes substantive corporate governance mandates, a practice that is unprecedented in the history of federal securities legislation.

Since SOX has different implications to bondholders than to shareholders, we cannot assess the impact of SOX on firms’ debt financing behavior from the extant research in the equity market. Besides, the impact of SOX may reverberate around the world via country characteristics, there is marginal evidence that firms from countries requiring more disclosure are more likely to choose the U.S. bond market after SOX. [1,2]. Changes in regulation in bond markets (e.g., initiation of TRACE) provide ample opportunities to test existing accounting and economic theories.

Regulation and Bondholder Rights

While the US corporate bond market dwarfs the equity market, with $865 billion newly issued corporate bonds versus $206 billion equity issuance in year 2008 (Federal Reserve Board of Governors, Release June 2009), characteristics and motivations of the players in the corporate bond market are less researched [3]. In particular, it is not well understood how bondholders monitor borrowers on an ongoing basis and how their rights are enforced upon covenant violations. In contrast to the renegotiation process in the private debt market [4-6], renegotiation is relatively uncommon in the bond market with dispersed bondholders. Banks are shown to influence violating firms’ investment and financing behavior, which leads to better performance and increased CEO turnover.

Impact of Increase in Bond Market Transparency on the Information Environment

In July 2002, the Financial Industry Regulatory Authority (FINRA) launched Trade Reporting and Compliance Engine (TRACE), which captures and disseminates consolidated information on secondary market transactions in publicly traded TRACE-eligible securities. TRACE brings transparency to the corporate bond market since traditionally bond trades were reported only to the parties involved, so investors could not compare their own execution price to other transactions. TRACE creates a level playing field for all market participants by providing comprehensive, real-time access to public corporate bond trading information. The implementation of TRACE provides an excellent opportunity to study the impact of providing trading information on a market’s overall information environment. Recent research has shown that increased transparency through TRACE introduced in 2002 leads to lower transaction costs, higher liquidity and improved quality of bond ratings [7-10].

References


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Received June 23, 2013; Accepted June 25, 2013; Published June 30, 2013


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