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Optimism bias in financial analysts' earnings forecasts: Do commissions sharing agreements reduce conflicts of interest?

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ABSTRACT

Implemented in May 2007, the French rules governing commission-sharing agreements (CSAs) consist of unbundling brokerage and investment research fees. The goal of this paper is to analyze the effect of these rules on analysts' forecasts. Based on a sample of one-year-ahead earnings per share forecasts for 58 French firms during the period from 1999 to 2011, we conduct panel data regressions. We show that the analysts' optimistic bias declined significantly after CSA rules, which suggests that these rules are effective at curbing the conflicts of interest between brokerage activities and financial research. Our results are robust to the impact of the Global Settlement and the Market Abuse Directive.

1. Introduction

Financial analysts provide information that is critical for financial markets to function properly. By issuing investment recommendations and forecasts of share values or earnings per share (EPS), financial analysts reduce information asymmetries between firms and investors or fund managers. Generally issued on behalf of brokers (in this case, analysts are referred to as “sell-side analysts”), forecasts and recommendations are widely used by fund managers for making portfolio allocation decisions.

However, sell-side analysts' forecasts and recommendations are excessively optimistic, which reduces the informational efficiency of financial markets.¹ One important source of optimism in sell-side analysts' forecasts is the presence of conflicts of interest between research and investment banking or brokerage activities (Devos, 2014; Arand and Kerl, 2015; Mathew and Yildirim, 2015).² First, when an analyst is linked to a financial institution that provides investment banking services to firms, issuing optimistic forecasts or recommendations for a firm allows the analyst to please his employer by helping him to develop or maintain a customer relationship with the firm manager (Lin and McNichols, 1998; Michaely and Womack, 1999; Dechow

et al., 2000; Lin et al., 2005; McKnight et al., 2010). Second, conflicts of interest may also emerge when sell-side analysts are employed by brokers, who provide not only investment research but also brokerage services (Carleton et al., 1998; Jackson, 2005; Mehran and Stulz, 2007; Agrawal and Chen, 2012). In this case, analysts produce optimistic forecasts or recommendations in the hope of generating buying orders and charging brokerage fees to customers.

Recent financial reforms have attempted to curb conflicts of interest in the financial research industry (Espahbodi et al., 2015). The most widely studied regulation is the Global Settlement (GS), which was announced in the US in December, 2002. The 12 large investment banks involved in this agreement are compelled to clearly separate their financial research and investment banking activities. A great deal of empirical literature shows that the GS was effective in reducing analysts' optimistic bias (Heflin et al., 2003; Mohanram and Sunder, 2006; Kadan et al., 2009; Clarke et al., 2011; Guan et al., 2012; Hovakimian and Saenyasiri, 2010, 2014).

Some financial reforms have also been implemented in Europe. In France, rules governing commission-sharing agreements (CSAs) were implemented by the *Autorité des Marchés Financiers* (AMF, the French Financial Markets Authority) in May 2007. In contrast to the

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¹ A persistent optimism bias has also been observed in management forecasts by Japanese firms (Kato et al., 2009; Cho et al., 2011).

² Optimism may also arise from the analysts' concern for satisfying firm management and ensuring their access to soft information released by managers (Francis and Philbrick, 1993; Matsumoto, 2002; Burgstahler and Eames, 2006; Green et al., 2014). By prohibiting any form of selective information release by large firms to analysts or investors, the Regulation Fair Disclosure Act, which was implemented in the US in October 2000, is intended to curb such behavior (Heflin et al., 2003; Mohanram and Sunder, 2006).

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GS, which addresses the conflicts of interest between financial research and investment banking, the aim of the rules governing CSAs is to eliminate conflicts of interest between financial research and brokerage activities. Indeed, whereas brokerage activities and financial research were previously provided as a single package and charges globally, the new regulation mandates unbundling the fees for these two types of services. Moreover, when an investor purchases brokerage services from an execution broker and financial research services from an independent analyst (i.e., an analyst who is not employed by a broker or an investment bank), the investor and the broker can enter into a CSA.³ Under such an arrangement, the broker must remit the financial research portion of the commission to the independent analyst. This regulation should reduce the optimistic bias in the financial research industry for two reasons. First, it promotes independent analysis, which is less subject to conflicts of interest and, consequently, to optimistic bias. Second, the rules governing CSAs clarify the actual cost of financial analysis. Therefore, mutual fund managers should be more careful about the way forecasts are produced, which should reduce sell-side analysts' incentive to intentionally bias forecasts to generate brokerage commissions.

To the best of our knowledge, whereas earlier empirical contributions have mainly focused on the separation between financial analysis and investment banking, no investigation has been conducted to assess whether financial reforms are also effective at curbing conflicts of interest between research and brokerage activities. The goal of this paper is precisely to fill this gap. Assessing the effect of the rules governing CSAs appears all the more interesting because the unbundling of research and execution fees is also a key element of the updated Markets in Financial Instruments Directive (MiFID2), which should take effect in 2017. Therefore, addressing the effectiveness of CSAs at curbing conflicts of interest between financial research and brokerage activities may be seen as a first step in evaluating the unbundling device that will soon be applied in Europe.

By conducting panel regressions on a data set that includes I/B/E/S analysts' EPS forecasts for 58 French firms from the *Euronext 100* index from January 1999 to December 2011 on a monthly basis, we show that the policy on CSAs has mitigated the conflicts of interest faced by financial analysts and reduced their optimistic bias. This result is robust to the impact of the GS and the Market Abuse Directive (MAD).

The paper is organized as follows. Section 2 provides the theoretical and empirical background for our research. Our methodology is presented in Section 3. Section 4 presents our results. Section 5 proposes some extensions to our work. Section 6 concludes the paper.

2. Literature

In this section, we present the framework of our study. We first focus on the sources of conflicts of interest. We then present the impact of regulations on conflicts of interest.

Optimism in financial analysts' forecasts can result from two types of conflicts of interest.

On the one hand, conflicts of interest and over-optimism may arise when the analyst is linked to (employed by) a financial institution that provides investment banking services to firms. By encouraging investors to buy newly issued securities of a firm, issuing optimistic forecasts or recommendations for a firm allows the analyst to please his employer by helping him to win or to preserve a potentially lucrative customer relationship with the firm.

First, this increases the investment bank's likelihood to be selected by the firm as a lead or a co-underwriter for equity offerings. Second, once the investment bank is selected, it is able to secure the firm's underwriting activity. Relying on an I/B/E/S dataset over the period

1989–1994, Lin and McNichols (1998) find that affiliated analysts, i.e., analysts employed by an investment bank that intervenes as a leader or co-underwriter of a firm, issue more optimistic forecasts about this firm than do non-affiliated analysts. This finding is corroborated by McKnight et al. (2010) on a large dataset covering 13 countries (Austria, Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland and the United Kingdom). Finally, using a sample covering the 1981–1990 period, Dechow et al. (2000) show that analysts who are employed by an investment bank that manages an IPO produce more optimistic forecasts than do others. This result also holds in the case of analysts' recommendations, as Michaely and Womack (1999) demonstrate.

On the other hand, conflicts of interest may exist when sell-side analysts are employed by brokers that provide not only financial research but also brokerage services (Jackson, 2005; Mehran and Stulz, 2007). Indeed, issuing optimistic forecasts encourages customers to buy stocks, thus allowing brokers to charge brokerage fees. It is true that pessimistic forecasts or recommendations also generate (selling) transaction fees. However in contrast to selling transactions, buying orders do not face short-selling constraints. Moreover, because buying transactions usually induce selling transactions in the future, optimism provides a double opportunity to charge brokerage commissions. Based on a sample of 2300 analysts employed by more than 200 brokerage and non-brokerage firms in December 1994, Carleton et al. (1998) show that brokerage firms produce more optimistic recommendations than do non-brokerage firms. Similarly, using I/B/E/S data for the US between 1994 and 2003, Agrawal and Chen (2012) reveal that optimism increases with the intensity of conflicts of interest, measured by the share of the brokers' profit resulting from brokerage activity.

Some recent financial reforms have attempted to curb the conflicts of interest described above. Announced in December 2002 and officially published on April 28, 2003,⁴ the GS is an agreement among the US Government, the SEC, the NYSE, the NASD and 12 large investment banks (Citigroup, Bear Stearns, Credit Suisse, JP Morgan, Goldman Sachs, Morgan Stanley, Merrill Lynch, UBS, Lehman Brothers and U.S. Bancorp Piper Jaffray).⁵ The 12 banks involved in this agreement (“the 12 big banks” or “the sanctioned banks”) are compelled to implement a clear separation between financial research departments and investment banking activities and to disclose information about their financial research process and historical ratings.⁶ Kadan et al. (2009) show that analysts' recommendations are less likely to be optimistic (i.e., “buy” or “strong buy”) over the post-GS period (between September 2002 and December 2004) compared to the pre-GS period (from November 2000 to August 2002). Clarke et al. (2011) find that the reduction in the optimistic bias consecutively to the GS is particularly strong for affiliated analysts. Moreover, based on a sample of 40 countries over the 1991–2010 period, Hovakimian and Saenyasiri (2014) show that the GS reduced analyst forecast bias more strongly in those countries where the 12 big banks are strongly present and those with low investor protection. In the same vein, Guan et al. (2012) reveal that recommendations issued by sanctioned banks' analysts are significantly more optimistic in the pre-reform period than in the post-reform period. Taken together, these findings suggest some effectiveness of the GS in neutralizing analysts' conflicts of interest.

The MAD, enacted in the European Community in 2003 and

⁴ A first set of GS rules (New York Stock Exchange (NYSE) rule 472 and National Association of Security Dealers (NASD) rule 2711) intended to limit the links between investment banking and research activities within banks were enacted in September 2002. For a more specific investigation of the effect of NASD rule 2711 on analysts' recommendations, see Barber et al. (2007).

⁵ Deutsche Bank and Thomas Weisel Partners entered into the agreement on August 26, 2004.

⁶ For example, the GS regulation forbids the analysts employed by these financial institutions from following bankers in roadshows organized by a firm that is preparing a public offering. Moreover, the IPO “quiet period” was increased from 25 days to 40 days.

³ *Commission de Courtage à Facturation Partagée (CCP)* in French.

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