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The consequences to analyst involvement in the IPO process: Evidence surrounding the JOBS Act☆

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ABSTRACT

The JOBS Act allows certain analysts to be more involved in the IPO process, but does not relax restrictions on analyst compensation structure. We find that these analysts initiate coverage that is more optimistically biased, less accurate, and generates smaller stock market reactions. Investors purchasing shares following these initiations lose over 3% of their investment by the firm's subsequent earnings release. By contrast, issuers, analysts, and investment banks appear to benefit from this increased bias, as optimism is more positively associated with proxies for firm visibility and investment banking revenues when analysts are involved in the IPO process.

1. Introduction

Analysts face conflicting incentives regarding the precision of their research because they benefit from both accurate and optimistically biased reports. Accurate earnings forecasts can improve analysts' reputations and facilitate more favorable labor market outcomes,[1] but optimistic research can increase future investment banking business and generate higher trading volume.[2] To the extent that analyst reports affect stock prices, investors' understanding of how analysts manage this tradeoff will determine whether they benefit from or are harmed by the content of analyst reports. One way that regulators have

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[1] See Mikhail et al. (1999), Hong and Kubik (2003), Jackson (2005), and Ke and Yu (2006).
[2] See Jackson (2005), Degeorge et al. (2007), Ljungqvist et al. (2009), and Niehaus and Zhang (2010).

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sought to influence how analysts manage this tradeoff is by controlling the extent to which analysts are permitted to participate in the securities issuance process. However, there is no direct academic evidence on how such participation actually affects analyst behavior. On the one hand, such involvement may endow analysts with private information and industry knowledge to produce more accurate reports.[3] On the other hand, increased interactions with bankers and investors may increase analysts' incentives or ability to influence trading and issue prices through their optimism.

The purpose of this paper is twofold. We first exploit a policy experiment to identify how analysts' participation in the securities issuance process affects their research output. Next, we use this policy experiment as a legislative shock to analyst behavior to provide new evidence on the value and implications of analyst research.

Empirical evidence on the effect of analysts' participation in the securities issuance process on their research is limited, in large part because such participation is unobservable. Evidence that does exist is indirect, inferred from a series of regulations passed in the early 2000s. A limitation to this identification strategy is that these regulations simultaneously introduced several other changes beyond constraining analysts' participation in securities offerings, such as restrictions on analyst report content and compensation structure (Kadan et al., 2009). Bradshaw (2009), Koch et al. (2013), and Leuz and Wysocki (2016) discuss how the large number of simultaneous regulatory changes in this period, such as the Global Settlement, Regulation FD, and stock market decimalization, make it difficult to isolate the consequences of any one particular regulatory shock.[4] Some literature overcomes this challenge by using the fact that the Global Settlement targets only a subset of banks to identify the consequences of the punitive and reputational costs associated with the Global Settlement.[5] Corwin et al. (2017) find that these costs resulted in analysts employed by sanctioned banks becoming less optimistic, but they provide little evidence that concurrent analyst rule changes, including limiting analysts' involvement in the IPO process, significantly affected analyst research. Indeed, the large number of simultaneous changes in the regulatory and economic environments at that time prevents any direct takeaways regarding the empirical question of whether or how analyst involvement in the underwriting process affects the quality of their research.

We use the April 5, 2012 passage of the Jumpstart Our Business Startups Act (JOBS, or the "Act") as a less fettered setting to identify the effect of analysts' participation in the securities issuance process on their research. The JOBS Act was designed to reduce the regulatory burdens of going public for issuers of initial public offerings (IPOs) with less than $1 billion in pre-IPO annual revenue, referred to as emerging growth companies (EGCs).[6] An important component of the Act is a set of provisions that allow analysts employed by members of the EGC issuer's IPO underwriting syndicate ("EGC affiliated analysts") to be more extensively involved in the IPO process. To this end, the JOBS Act allows EGC affiliated analysts to attend pitch meetings and due diligence sessions with investment bankers and to interact with potential investors at the request of investment bankers, even before the IPO.

Two important features of the JOBS Act allow us to plausibly identify the effect of IPO participation on analyst behavior. First, the JOBS Act applies only to EGC affiliated analysts. Thus, analysts covering EGCs that are not affiliated with any of the issuer's underwriters ("EGC unaffiliated analysts") and all analysts covering non-EGCs represent natural control groups whose permissible activities are unaffected by JOBS. Second, unlike previous legislative changes affecting IPO participation, the JOBS Act does not relax restrictions on analyst compensation or report content because these restrictions were viewed as necessary for investor protection (IPO Task Force, 2011). Thus, we interpret the differential change in the behavior of EGC affiliated analysts (i.e., treated analysts) relative to untreated analysts following JOBS as the effect of IPO participation on analyst behavior.

To evaluate the consequences of analyst participation in the IPO process, we begin by investigating how this involvement affects analysts' initial earnings forecasts after the IPO. We find that following JOBS, EGC affiliated analysts become significantly less accurate and more optimistic: after JOBS, the relative accuracy of affiliated analysts (compared to their unaffiliated counterparts) declines by 0.42% of price, or 0.5 standard deviations, more for EGCs than it does for non-EGCs. The post-JOBS increase in the relative optimistic bias of EGC affiliated analysts is of similar magnitude. To the extent that we have identified the JOBS Act treatment effect of greater analyst participation in the offering process, our results suggest that participation results in more optimistic and less accurate analyst research.

We next examine the economic consequences of this post-JOBS increase in EGC affiliated optimism. We begin by investigating the three-day cumulative abnormal returns surrounding analyst coverage initiations to determine whether the reports initiated by post-JOBS EGC affiliated analysts produce less value-relevant information for investors consuming the reports at the time of their release. We find that the reports initiated by analysts affiliated with the underwriters of post-JOBS EGCs garner a more muted stock market reaction. This finding is robust to removing confounding events (Altınkılıç et al., 2013), restricting the sample to optimistic analysts, and using two-hour intraday CARs. This muted market reaction suggests that allowing analysts to participate in the IPO process results in less value-relevant information at the time their reports are

[3] See Boni and Womack (2003), Jacob et al. (2008), Chen and Marquez (2009), Green et al. (2014a), Soltes (2014), Brown et al. (2015), and Bradley et al. (2017).

[4] Consequently, existing research provides contradictory evidence on the source of the change in analyst behavior in the early 2000s (e.g., Francis et al., 2006; Arping and Sautner, 2013; Chen et al., 2017).

[5] See, for example, Kadan et al. (2009) and Guan et al. (2012).

[6] Throughout the paper, we refer to issuers with less (greater) than $1 billion in pre-IPO annual revenue as EGCs (non-EGCs) whether their IPO occurs before or after the JOBS Act.

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