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The effect of the European Markets in Financial Instruments Directive on affiliated analysts' earnings forecast optimism

Jörg Prokop*, Benno Kammann

Carl von Ossietzky University of Oldenburg, Finance & Banking, D-26111 Oldenburg, Germany

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ABSTRACT

We investigate the effects of the European Markets in Financial Instruments Directive (MiFID) on optimism in financial analysts' earnings forecasts for Euro Area firms. We find that before MiFID came into force affiliated analysts – that is, analysts with closer business ties to the firms they follow – issued more optimistic longer-term earnings forecasts than their more independent peers. At the same time their short-run forecasts were significantly less optimistic which is consistent with the notion of downward management of their earnings forecasts to avoid negative earnings surprises. Since the adoption of MiFID, these differences in short-term and longer-term forecasts by affiliated and non-affiliated analysts have been eliminated indicating that with respect to affiliated financial analysts' earnings estimates MiFID has been successful in mitigating conflicts of interest.

1. Introduction

In this study we examine the impact of the Markets in Financial Instruments Directive (MiFID) on financial analysts' earnings forecasts. In particular, with a focus on the Euro Area, we investigate whether MiFID has been successful in mitigating the biases in financial analysts' forecasts identified in earlier research.

In this context, potential sources of conflicts of interest leading to bias may be, for instance, current or prospective investment banking ties between the analyst's employer and the target company, or an analyst's relationship to the target company's management. This study focuses on conflicts of interest arising from investment banking ties of the analyst's employer and the mitigating effects of recent regulatory changes. Any analyst who issues an earnings forecast on a firm for which his or her employer has acted as an underwriter (in seasoned equity offerings, initial public offerings, or debt issuances) or as an M&A advisor over the last 12 months is considered affiliated (Dubois, Fresard and Dumontier, 2014).

As prior studies show, affiliated analysts are prone to being influenced by conflicts of interest, and tend to issue more optimistic signals than non-affiliated analysts (Lin & McNichols, 1998; Michaely & Womack, 1999). The empirical evidence on biases in equity research combined with the malfunctioning of "Chinese Walls" revealed in investment banks has led US regulators to adopt several changes in order to reduce financial analysts' tendency toward overoptimism. In 2000, Reg-

* Corresponding author.
E-mail address: joerg.prokop@uni-oldenburg.de (J. Prokop).

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ulation Fair Disclosure (RegFD) was adopted, banning firms from selectively disclosing information to market participants. In 2002, NYSE and NASD passed rules concerning the separation of research and investment banking, banning banks from offering favorable analyst reports in order to attract investment banking business and from linking analyst compensation to specific investment banking deals. In addition analysts were required to publish information on the distribution of their recommendations, on the accuracy of investment recommendations for companies covered, as well as on private stock trades (NASD Rule 2711, NYSE Rule 472). Later in 2002, the Global Analyst Research Settlement was reached between the largest US investment banks and the Securities and Exchange Commission, NASD, NYSE and other domestic regulators. The settlement led to enforcement actions aimed at further mitigating conflicts of interest in investment research.

After these regulatory changes, several studies examined the effects on analysts' recommendations and earnings forecasts. According to the empirical evidence gathered, respective measures successfully mitigated biases in financial analysts' output (Cornett, Tehranian, & Yalcin, 2007; Chen & Chen, 2009; Ertimur, Sunder, & Sunder, 2007; Guan, Lu and Wong, 2012; Kadan et al., 2009).

Following the US example to some degree, European regulators have also recently taken steps to increase the quality of analyst signals and to foster investor protection within the EU. In 2003, the European Commission enacted the Market Abuse Directive, or MAD (Directive 2003/125/EC) which was adopted by EU member states between 2004 and 2006. The directive "is intended to guarantee the integrity of European financial markets and increase investor confidence . . . to create a level playing field for all economic operators in the Member States as part of the effort to combat market abuse".[1] In particular MAD requires financial analysts to disclose all material assumptions underlying their recommendations as well as any potential conflict of interest.[2]

Then, in November 2007 MiFID came into effect in EU member states (Directive 2004/39/EC along with implementing measures contained in Directive 2006/73/EC and Regulation (EC) No 1287/2006). "Its aim is to improve the competitiveness of EU financial markets by creating a single market for investment services and activities, and ensuring a high degree of harmonized protection for investors in financial instruments".[3] In order to mitigate potential conflicts of interest faced by financial analysts MiFID requires financial services firms to maintain remuneration schemes and internal controls that ensure analysts' independence, and to separate investment research from all activities that might impair analysts' objectivity. Thus, while MAD focuses more on improving disclosure of analysts' conflicts of interest, MiFID substantially raises the regulatory bar by setting stricter rules regarding the internal governance structure of financial service firms.

Our study contributes to the literature in two ways. First, we provide new empirical evidence on the effectiveness of the first European directive that aims to mitigate affiliated analysts' conflicts of interest by encroaching on investment research firms' internal control systems. Second, while previous research concerning the impact of European financial market regulation on financial analysts' behavior focuses on analyst recommendations we investigate the impact of MiFID specifically on earnings forecasts. Unlike analyst recommendations earnings forecasts can be benchmarked against firms' actual earnings which involves another potential conflict of interest: When a firm's actual earnings are announced, it may experience a positive or negative earnings surprise relative to analysts' earnings forecasts. Thus, compared to recommendations these forecasts represent a much more prominent threshold between positive and negative signals – actual earnings falling short of forecasted earnings may have negative effects both on the respective firm (as investors will revise their cash flow forecasts) and on the analyst's reputation (as the forecast has been identified as overly optimistic). In line with this argument, Burgstahler and Eames (2006) show that US firms are likely to manage earnings to avoid negative earnings surprises. In addition, they find that financial analysts tend to cater to management by skewing their earnings forecasts downwards to enable firms to avoid negative earnings surprises. Our empirical design allows us to explore whether affiliated analysts' earnings forecast optimism is conditional on the time horizon of their earnings forecasts for European firms, and whether respective findings differ before and after the implementation of MiFID.

Based on a multiple regression model controlling for firm, year, industry and country-specific effects we show that before MiFID is implemented affiliated analysts are significantly more optimistic than non-affiliated analysts when forecasting earnings over a time horizon of six to nine months, but they are less optimistic than their non-affiliated peers when issuing forecasts of earnings that will materialize within the next three months. This finding is consistent with the idea that analysts downward manage their earnings forecasts to allow target firms to achieve zero or small positive earnings surprises (Burgstahler & Eames, 2006). In this regard, our study highlights similarities between EU and US financial markets with respect to differences in analyst behavior for long and short earnings forecast horizons. Moreover, our results indicate that MiFID successfully reduced the aforementioned biases in both short-term and long-term earnings forecasts issued by affiliated analysts. Our results are relevant to equity investors, financial services firms, and regulators alike in that they constitute an assessment of the impact of MiFID on financial intermediaries' behavior, and of the extent to which financial analysts' earnings forecasts might be biased by conflicts of interest.

The remainder of the paper is organized as follows: In section two we develop our research hypotheses. Section three contains a description of the data as well as the methodology used. In section four we discuss the empirical results, and in section five we summarize our main conclusions.

[1] http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_transactions_in_securities/l24035_en.htm

[2] For a detailed analysis of the differences between MAD and respective US regulation see Dubois, Fresard and Dumontier (2014).

[3] http://ec.europa.eu/internal_market/securities/isd/mifid/index_en.htm