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How did Reg FD and the Global Settlement Affect US Capital Markets? A Review of the Evidence

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Overview

1. **Review of Reg FD and the Global Settlement**

2. **Research challenges**

3. **Effect of Reg FD**
   - Responses by management and analysts
   - Stock liquidity
   - Market efficiency
   - Analyst performance

4. **Effect of Global Settlement**
   - Punished bank responses
   - Value of independent research
   - Is buy side answer?

5. **Conclusions**

Reg FD

1. **Background**
   - Growth of closed conference calls
   - Private management meetings with key analysts and investors
   - Management review of assumptions in analyst models

2. **Key provisions: effective Oct. 23, 2000**
   - Banned selective management disclosure to favored analysts and investors
   - Required public disclosure within 24 hours of any unintentional selective disclosure of material new information

3. **SEC objectives**
   - Restore investor confidence in market's integrity
   - Limit management's power to restrict information to analysts with favorable reports
   - Recognize availability of new low cost forms of communication technology

Predicted impact: Advocates

Information effects

- Expanded public disclosure by management
- Reduce analysts' information advantage
- Increased private information search by analysts

→

Market effects: increased trust in markets

- More informed prices
- Increased stock liquidity
- Increased trading volume

Predicted impact: Opponents

Information effects

- Reduced management disclosure
- Less informed analysts

→

Market effects:

- Less informed prices
- Lower stock liquidity
- Lower trading volume

First research challenge: Confounding events

1. **Reg FD adopted on Oct. 23, 2000**
2. **Pre-adoption period coincided with:**
   - Internet stock boom
3. **Post-adoption period coincided with:**
   - 40% decline in Nasdaq (Aug 2000 to Mar 2001)
   - Corporate scandals (e.g. Enron Oct-Dec 2001, Worldcom mid-2002)
   - “Decimalization” of stock trading on NYSE & AMEX (Jan 2001) and NASDAQ (April 2001)
   - Terrorist attacks of Sept. 11 2001
4. **Problem: how to disentangle effects of Reg FD from pre- and post-adoption period events?**

Second research challenge: Identifying affected firms

1. **Assume Reg FD affects most firms**
   - Examine average effects
   - But what if no effects for most firms, or even conflicting effects across firms?

2. **Identify firms where effect magnified**
   - Firms with closed versus open conference calls
   - US firms versus non-US ADRs that were not subject to Reg FD

Research findings: Manager & analyst responses

1. **Conference calls**
   - Shift to open calls
   - 96.4% of firms with closed calls pre-FD hosted open calls post-FD (vs 98.2% for firms with open calls pre-FD)
   - Newsworthiness of calls by test firms unchanged post-FD

2. **Management earnings forecasts**
   - Increased use of management forecasts
   - 50%+ increase in frequency of forecasts in 3 post-FD quarters vs pre-FD quarter
   - But no benchmark to control for other events – 38% increase in 3 quarters pre-FD

3. **Analysts**
   - Increase in weighting of idiosyncratic information in earnings forecasts
   - Decline (increase) in coverage of firms that were closely- (less closely-) followed pre- FD
   - Decline in coverage of small companies, but unclear whether due to other events

Research findings: Stock liquidity and trading volume

1. **Stock Liquidity: Mixed results**
   - Post-FD, decline in total and adverse selection spreads before and after earnings announcements
   - No change in total or adverse selection spreads post-FD at time of conference calls

2. **Trading Volume: Also mixed results**
   - Increase in retail trading volume during conference calls for firms with closed calls pre-FD. No change for control firms
   - No change in total trading volume around earnings announcements after controls for decimalization or after benchmarking against non-US ADRs
   - Increase in retail trading volume after earnings announcements post-FD; but decline in institutional volume before and after earnings announcements post-FD

Research findings: Market efficiency and cost of capital

1. **Stock volatility before and at earnings announcements unchanged pre- and post-FD**
2. **138 basis point increase in cost of capital for small firms that lose analyst coverage post-FD, but much of this probably driven by other events**

Research findings: Analyst performance

1. **Decline in market reaction to forecast/recommendation updates**
   - 28% decline in stock reaction to updates of earnings forecasts/recommendations
   - Decline in reaction to downgrades by analysts at affiliated banks

2. **Mixed evidence on changes in earnings forecast accuracy**
   - Unchanged after controlling for confounding events
   - Declines using longer horizon and no controls
   - Increases for conference call firms versus firms with no calls

3. **Little changes in earnings forecast dispersion**
   - No change
   - Lower following earnings announcements and conference calls

Summary

1. **Management increase public disclosure post-FD**
   - Open conference calls
   - Earnings forecasts?

2. **Analysts**
   - Less private information
   - Even though increase private search

3. **But no evidence on impact on capital market**
   - Spreads, volume, reaction to earnings

4. **So …**
   - Advocates concern about lack of investor confidence from selective disclosures overblown
   - Critics concerns about overall drop in transparency over-stated

Global Settlement

1. April 23, 2003
2. Affected 12 large investment banks
3. Fines ($875m) and independent research funding ($432m)
4. Separate investment banking and research
5. Increased transparency on
   - Past performance
   - Conflicts of interest
6. Large banks provide research from independent third parties

Impact on sell-side analyst employment

Year	Punished Bank	Non-punished Bank	Non-bank
2002	1,840	1,681	940
2003	1,613	1,547	1,053
2004	1,478	1,485	928
2005	1,416	1,529	886
2006	1,374	1,456	902
2006 vs 2002	-25%	-13%	-4%

Anecdotal evidence on Global Settlement effects

1. **Funding effects**
   - Research budgets at punished banks cut 40%
   - Compensation for analysts cut 25%+
2. **Analyst migration**
   - Top analysts to buy side/hedge funds
   - Less talented to independents

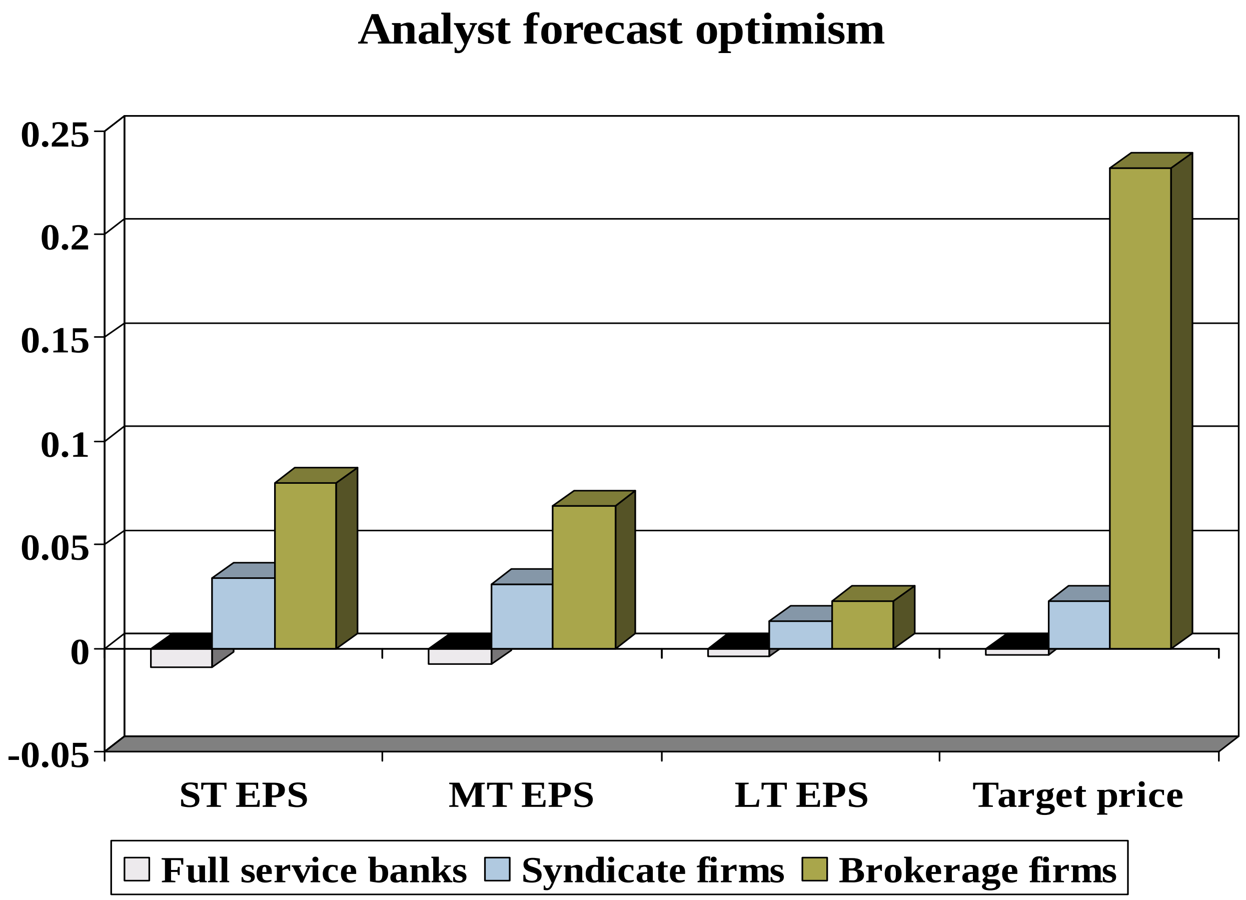
Questions generated by Global Settlement

1. How serious were investment banking conflicts of interest?
2. How independent are analysts at firms with no investment banking?
3. Is research better funded on buy-side?

Research on conflicts of interest

1. **Paper:** Groysberg, Healy and Cowen
2. **Conflicts of interest**
   - Investment banking
   - Brokerage
3. **Compare analysts by source of funding**
   - Full service investment banks
   - Syndicate firms
   - Brokerage firms
4. **Performance**
   - EPS forecast optimism
   - Recommendation optimism
5. **Sample period**
   - Jan. 1996 to Dec. 2002

Research optimism by firm-type



Recommendation optimism

1. **Highest for syndicate firms**
   - 24.2% likelihood of strong buy
2. **Comparable for full service banks and brokerage firms**
   - 22.6% likelihood of strong buy

Other findings

1. **Brokerage analysts forecasts also less accurate**
2. **Bulge analysts least optimistic forecasts**
3. **Analysts more optimistic at**
   - Retail/institutional brokerage than
   - Pure institutional brokerage
4. **Brokerage analysts more likely to drop coverage on poor performing stocks**
5. **Brokerage optimism unaffected by stock market crash**

Is buy-side research the answer?

1. **Money management firms can profit directly from private equity research**

2. **Buy-side analysts face fewer conflicts of interest**

   - Not funded from investment banking
   - Not funded from trading
   - Private reports, so no concern about alienating managers of companies covered

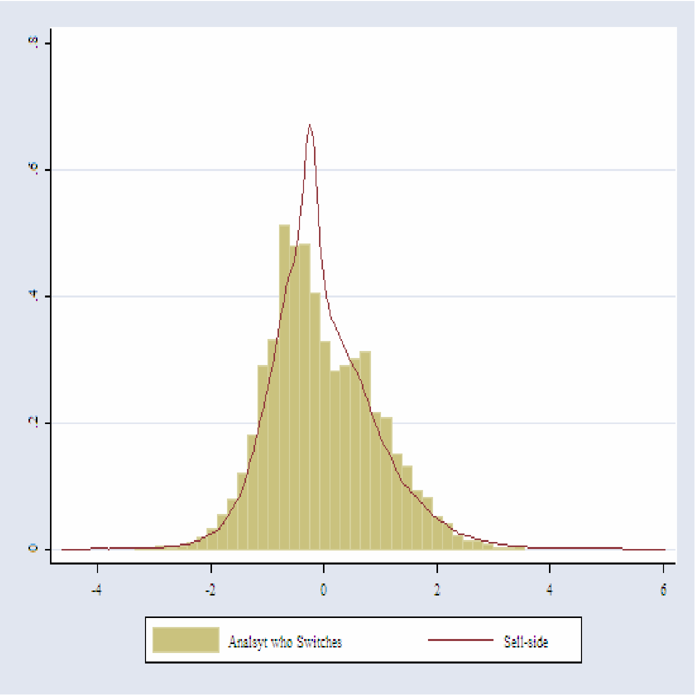
Research on buy-side research

1. **Co-authors:** Groysberg, Healy, Chapman (2008) and Groysberg, Healy, Shanthikumar & Gui (2008)
2. **Compare performance of**
   - Analysts at a top 10 buy-side firm that values research
   - All sell-side analysts
3. **Performance metrics**
   - EPS forecast bias/accuracy
   - Recommendation optimism
   - Recommendation performance
4. **Time period**
   - July 1997 to Dec. 2004

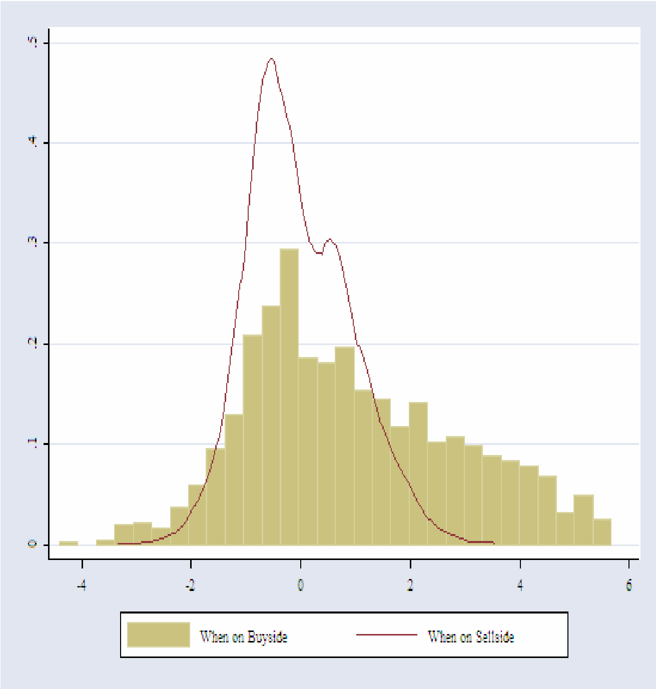
Impact of moving to buy-side firm

Forecast accuracy for analysts hired from sell-side:

Before hiring



After hiring



Other information on buy-side firm analysts

1. **Increased earnings forecast optimism for switching analysts**
   - Comparable to sell-side prior to switch
   - More optimistic after switch
2. **Higher returns from buy recommendations for switching analysts**
   - Slightly higher returns than sells-de pre-switch
   - Lower returns post-switch
3. **Performance of all buy-side firm analysts inferior to sell-side**
   - More optimistic earnings forecasts
   - Less accurate forecasts
   - Less optimistic recommendations
   - But, less profitable buy recommendations (3.5% per year market-adj. return vs 6.5% for sell-side)

Reasons for weak performance of buy-side firm switchers

1. **Less competitive environment**
   - Transparency of sell-side performance (ratings vs peers)
   - Buy-side firm more likely to retain weak analysts
2. **Performance measurement system**
   - Based on market-adjusted returns for Buys and portfolio manager ratings
   - No comparison to sell-side
   - But … new service to provide sell-side benchmarks
3. **Less buy-side access to management?**
   - Temporary decline in sell-side performance post-Reg FD
4. **Less opportunity to stress test ideas**

Not due to …

1. **Poor management firm performance**
   - Large cap stocks beat index by 2.7% per year
   - Funds highly rated

2. **Wider stock coverage by buy-side**
   - Findings similar using sell-side benchmarks with comparable #analysts and breadth of coverage

3. **Buy-side dropping coverage of poor-performing stocks**

Future of sell-side research

1. **Continued funding challenges**
   - Electronic trading
   - Unbundling
   - Restricted role of investment banking
2. **Increased competition**
   - Buy-side, hedge funds, private equity
   - Research substitutes, e.g. expert networks
3. **New funding models**
   - Hard dollars
   - Proprietary trading
   - Issuer funding, e.g. Independent Research Network
   - Auction research to highest bidders
4. **Likely Outcome**
   - Continued steady decline in sell-side research