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Conflicts of Interest and Analyst Behavior: Evidence from Recent Changes in Regulation

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Regulation FD made analysts less dependent on insider information and diminished analysts' motives to inflate their forecasts. The Global Research Analyst Settlement had an even bigger impact on analyst behavior: The mean forecast bias declined significantly, whereas the median forecast bias essentially disappeared. These results are similar for all analysts.

Our investigation of the impact of recent changes in regulation on analysts' forecasting behavior follows a number of studies that argued that analysts were motivated to produce research reports that did not reflect their true opinions. Analysts tended to make excessive "buy" recommendations and inflated earnings forecasts for several reasons, two of which gained considerable attention from regulators in the United States. First, analysts may have felt compelled to favor managers in covered companies in order to gain privileged access to information flow (Lim 2001). Second, although analysts are supposed to provide investors with accurate and truthful research reports, conflicts of interest could occur because analysts' compensation was tied to profits generated from investment banking business and brokerage commissions (Lin and McNichols 1998; Carleton, Chen, and Steiner 1998).

In the early part of the first decade of this century, in an effort to restore public confidence in U.S. capital markets, U.S. regulators enacted several rules and regulations, prosecuted analysts whose research reports were tainted by conflicts of interest, and fined banks that failed to prevent research analysts' conflicts of interest. Two of the main regulatory developments during this period were (1) Regulation Fair Disclosure (Reg FD), which became effective on 23 October 2000, and (2) the Global Research Analyst Settlement (Global Settlement), which was announced on 20 December 2002.[1]

Although the primary goals of these two regulatory actions are different, they both have the potential to improve the quality of analyst forecasts. One of the stated goals of Reg FD is to prohibit private communication between companies and analysts, thereby helping to level the playing field so that market participants can have equal access to information and making analysts less dependent on such communication. In prohibiting companies from selectively disclosing private information to analysts, Reg FD may reduce analyst forecast bias by eliminating the incentive for analysts to inflate their earnings forecasts in order to gain access to insider information.

The Global Settlement is an important enforcement agreement between U.S. regulators and 12 large investment banks (the Big-12 banks) designed to eliminate research analysts' conflicts of interest. If successful, the Global Settlement should reduce optimistic bias in analyst forecasts.

Our study considered whether these two actions by U.S. regulators reduced the bias in analysts' earnings forecasts documented in previous studies. We focused on annual earnings forecast bias for several reasons. First, investors may use analyst forecasts to form expectations of earnings and cash flows, both of which are important inputs for stock valuation models. Inflated earnings forecasts can drive stock prices above their fair values if investors fail to adjust for the bias.[2]

Second, given the flurry of new regulations, regulators clearly consider analyst behavior an important factor in maintaining investor confidence in financial markets. Regulation is costly because of the significant expenses associated with analyzing problematic situations and developing remedies. Moreover, restrictions and reporting requirements imposed on various market participants result in ongoing compliance costs. These costs can be justified only if the new regulations help reduce analysts' conflicts of interest and thereby generate an important benefit for financial markets.

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Third, most studies that have examined the impact of Reg FD and the Global Settlement on analyst behavior focused on forecast accuracy and forecast dispersion (Bailey, Li, Mao, and Zhong 2003; Agrawal, Chadha, and Chen 2006).[3] These aspects of analyst behavior, however, are little affected by conflicts of interest, the focus of our study.

Other studies have examined forecast bias. Clarke, Khorana, Patel, and Rau (2006) found that the Global Settlement had no impact on relative bias in analyst forecasts. Focusing on the impact of Reg FD on bias in quarterly earnings forecasts between October 1999 and December 2001, Mohanram and Sunder (2006) found that these forecasts became more optimistic after Reg FD but attributed the increase to unexpectedly low realized earnings during the 2001 recession. Our longer study period (1996–2006) allowed us to control for macroeconomic conditions in our regression analysis. Furthermore, we examined longer-term (up to 24 months) earnings forecasts in which the forecast bias is more apparent (Richardson, Teoh, and Wysocki 2004). Although Herrmann, Hope, and Thomas (2008) found some evidence of decline in forecast bias following Reg FD, they focused on internationally diversified companies only; we examined all U.S. companies, and our primary focus was on changes in forecast bias after the Global Settlement.

Lastly, the ability of analysts to forecast earnings accurately can be easily and straightforwardly verified because actual earnings are observed at the end of the forecast period. Barber, Lehavy, McNichols, and Trueman (2006) studied the change in distribution of stock recommendations made from 1996 to 2003. They found that the percentage of buys decreased starting in mid-2000.[4] How unbiased the new distribution of stock recommendations is, however, remains uncertain. But we know that the bias should be zero at the aggregate level when analysts make their forecasts on the basis of their true opinions.

Institutional Background

Historically—and especially before recent regulations—analysts have tended to make unduly optimistic earnings forecasts. In this section, we discuss the possible reasons for this optimistic bias and the potential impacts of the recent regulations on such bias.

Why Do Analysts Make Overoptimistic Earnings Forecasts? A number of studies have documented that analysts regularly make overoptimistic earnings forecasts (Brown 1997; Chopra 1998; Beckers, Steliaros, and Thomson 2004). Optimistic bias tends to be larger for longer-term forecasts and smaller for forecasts made closer to the earnings announcement date. This phenomenon is usually referred to as the walk-down trend (Richardson, Teoh, and Wysocki 2004). Several explanations have been offered for analyst optimism.

First, analysts may be influenced by conflicts of interest if their compensation is tied to investment banking fees and brokerage commissions. Lin and McNichols (1998) found that analysts affiliated with underwriters make more favorable stock recommendations and long-term earnings growth forecasts than analysts not so affiliated. Agrawal and Chen (2005) discovered that optimism in long-term earnings growth forecasts is high when analysts work for financial institutions whose revenues come mainly from brokerage business. Carleton, Chen, and Steiner (1998) found that stock recommendations made by brokerage firms are more optimistic than those of nonbrokerage firms. Using Australian data, Jackson (2005) noted that optimistic analysts generate more trades for their brokerage firms than do less optimistic analysts. Chan, Karceski, and Lakonishok (2007) showed that analysts' earnings forecasts are influenced by their desire to win investment banking clients. Doukas, Kim, and Pantzalis (2005) reported that stocks with excess analyst coverage yield lower future returns, consistent with the conflict-of-interest hypothesis. Hong and Kubik (2003) found that brokerage houses reward optimistic analysts; optimistic analysts at low-status brokerage houses are more likely to move up to higher-status brokerage houses than are less optimistic analysts.

Second, analysts may feel compelled to maintain good relations with company management in order to gain access to insider information that can help improve the accuracy of their forecasts (Lim 2001). Third, analysts may tend to cover stocks for which they have positive views and drop or avoid stocks for which they have negative views, which can induce a self-selection bias (McNichols and O'Brien 1997). Fourth, analysts may have a cognitive bias that leads them to overreact to good earnings information and underreact to bad earnings information (Easterwood and Nutt 1999; Nutt, Easterwood, and Easterwood 1999). Finally, the walk-down trend may be driven by the "earnings guidance game," in which analysts issue optimistic forecasts at the start of the fiscal year and then revise their estimates until the company can beat the forecast at the earnings announcement date (Richardson, Teoh, and Wysocki 2004).

Recent Regulations. Before Reg FD, analysts and institutional investors often had an informational advantage over small investors through private communications with management and conference calls in which company managers discussed past performance and provided guidance on future prospects. Such timely information gave these investment professionals an unfair advantage that allowed them to trade stocks profitably at the expense of uninformed investors.

To gain access to this information flow, analysts may have had to maintain good relations with insiders by making optimistic forecasts and buy recommendations in their research reports. Analysts' excessively optimistic views of the stocks were misleading and contributed to the deterioration of investor confidence in capital market integrity. Through Reg FD, which was introduced in October 2000, the U.S. SEC intended to improve fairness and restore public confidence in the markets by requiring U.S. public companies to disclose material information simultaneously to all market participants.

Other sources of conflicts of interest, however, remained unaddressed by Reg FD. For instance, analysts could be pressured to make optimistic forecasts and buy recommendations in order to favor investment banking clients and generate trading volume. The SEC and such self-regulatory organizations (SROs) as the National Association of Securities Dealers (NASD; now the Financial Industry Regulatory Authority [FINRA]) and the NYSE paid significant attention to this issue and introduced a number of new rules and regulations to curb the negative consequences of these conflicts of interest.

The Sarbanes–Oxley Act of 2002 (SOA), also known as the Public Company Accounting Reform and Investor Protection Act of 2002, became law on 30 July 2002. The SOA is a broad piece of legislation that covers various business practices, including auditor independence, corporate responsibility, enhanced financial disclosure, analysts' conflicts of interest, and corporate and criminal fraud accountability. The SOA amended the Securities Exchange Act of 1934 by creating Section 15D, which requires FINRA and the NYSE to adopt rules reasonably designed to address research analysts' conflicts of interest.

To comply with the SOA, the NASD released Rule 2711 (Research Analysts and Research Reports) and the NYSE amended its Rule 351 (Reporting Requirements) and Rule 472 (Communications with the Public). Most provisions of these rules went into effect on 9 July 2002. These rules mitigate analysts' conflicts of interest by separating research analysts from the influence of the investment banking and brokerage businesses. Research analysts' compensation can no longer be tied to the performance of these businesses. In addition, analysts are restricted from personal trading in the stocks they cover.

On 6 February 2003, the SEC adopted Regulation Analyst Certification (Reg AC).[5] Reg AC provides guidelines for proper disclosure of potential conflicts of interest of sell-side analysts, including their association with investment banking clients and the structure of their compensation.

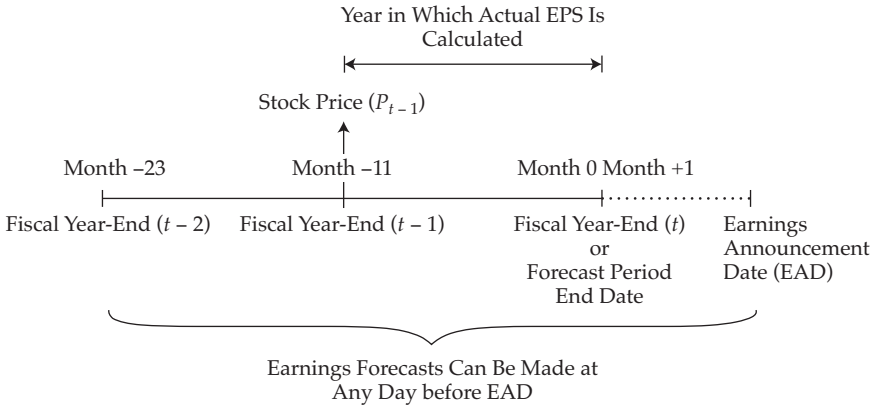
Regulatory objectives have also received support from rigorous enforcement actions. Following a joint investigation by the SEC, NASD, NYSE, and New York State Attorney General, 10 large U.S. and multinational investment banks agreed to pay a fine of $1.435 billion in the Global Research Analyst Settlement for their failure to adequately address research analysts' conflicts of interest. Announced on 20 December 2002, the terms of the Global Settlement initially covered 10 banks.[6] The final agreement was announced on 28 April 2003. Two more banks reached settlements on 26 August 2004.[7] The Global Settlement and the SRO rules share the same spirit in that their mutual objective is to eliminate analysts' conflicts of interest.

The introduction of these rules and regulations allows us to differentiate among the alternative explanations for analyst forecast bias proposed in the literature. First, a reduction in forecast bias after Reg FD would support the argument that analysts were overoptimistic owing to their need for insider information, especially if such a reduction were stronger for informationally more opaque companies. Second, a reduction in bias after the Global Settlement and Rule 2711 would be consistent with the hypothesis that analyst behavior was unduly influenced by conflicts of interest.[8] In contrast, self-selection and cognitive biases may exist even in a world without conflicts of interest. Therefore, if these biases are the main reasons for analysts' overoptimistic forecasts, then these regulatory changes should have no effect on forecast bias.[9]

Sample and Variables

We downloaded sell-side analysts' earnings forecasts for fiscal year-end dates between 1996 and 2006 from the Detail file of the I/B/E/S database. We used forecasts for current- and subsequent-year earnings per share (EPS), which are made for the upcoming and following years' earnings announcement dates.[10] **Figure 1** illustrates the timeline of analyst forecasts. The earliest analyst forecasts for a specific fiscal year-end EPS are made 24 months before the forecast fiscal year-end (in forecast month –23). For each EPS, analysts can

Figure 1. Timeline of Analyst Forecasts



make multiple forecasts over the course of the next 24 months. Some analysts may continue to make forecasts after the forecast fiscal year ends because companies announce their annual earnings after a delay of several months. Because the length of the EPS announcement delay could be affected by how high or low the realized EPS is relative to the consensus, we retained only those forecasts made no more than one month after the forecast fiscal year-end (in forecast month +1), which left us with a total of 2,297,792 forecasts.

For each forecast, I/B/E/S provides actual earnings, forecast date, forecast period (fiscal year) end, earnings announcement date, analyst code identity, broker code identity, and number of analysts used for consensus calculation.[11] We used the I/B/E/S Broker Translation file to convert broker codes into brokers' names, which we used to identify analysts who worked for the Big-12 banks. Stock prices are from the I/B/E/S Summary file.[12] We downloaded real GDP growth rates from the website of the U.S. Bureau of Economic Analysis. We downloaded SIC codes from the CRSP monthly file.

We defined analyst forecast bias, the focus of our analysis, as the average analyst forecast error and calculated it as follows:

$$Bias_{j,t,m} = 100\left(F_{j,t,m} - A_{j,t}\right)/P_{j,t-1}, \quad (1)$$

$$F_{j,t,m} = \frac{1}{I_{j,t,m}} \sum_{i=1}^{I} F_{j,t,m,i}, \quad (2)$$

and

$$F_{j,t,m,i} = \frac{1}{K_{j,t,m,i}} \sum_{k=1}^{K} F_{j,t,m,i,k}, \quad (3)$$

where

$A_{j,t}$ = the actual earnings per share for company j in fiscal year t

$F_{j,t,m,i}$ = the average of annual earnings forecasts for fiscal year-end t of company j, made in month m by analyst i

$K_{j,t,m,i}$ = the number of forecasts made in month m by the same analyst i for the same company j and fiscal year t

$I_{j,t,m}$ = the number of analysts making forecasts in month m for company j and fiscal year t

$P_{j,t-1}$ = the stock price of company j one year before the fiscal year-end t[13]

Note that all EPS forecasts made for the same company and the same fiscal year are normalized by the same stock price. Using the same stock price as the denominator guarantees that any changes in forecast bias across forecast months (m) are the result of changes in analyst forecasts, not of changes in the stock price. In our calculations according to Equations 1–3, we used only new forecasts made in month m. Stale forecasts from earlier months (m – 1, etc.) were not carried over into month m. In other words, each forecast participated in the calculation of the forecast bias only once, in the month in which the forecast was made. In our sample, an average analyst made 4.5 forecasts for each annual EPS. Because for each annual EPS we tracked 25-month forecasts (from month –23 to month +1), the implication is that an average analyst in our sample made a forecast for each covered company about once every six months.

To minimize the influence of outliers and misreported data in our analysis, we replaced with missing values any extreme observations of forecast bias, company size, market-to-book ratio, the number of stocks, and the number of industry analysts following.[14] We dropped from the sample all forecasts made in October 2000 and December 2002 (1.5 percent of our sample) and observations with missing values of any relevant variable. We were

left with 1,586,000 individual analyst forecasts, which we used to calculate 434,268 average forecast errors. For each fiscal year and for each of our 7,315 sample companies, our sample contained up to 25 monthly observations of forecast bias ($Bias_{j,t,m}$).

Table 1 reports the summary statistics for the overall sample of 434,268 observations and for each of the three subperiods. The period before Reg FD represents 53 percent of our sample observations, with the period between Reg FD and the Global Settlement and the period after the Global Settlement representing 18 percent and 29 percent of the sample observations, respectively. The mean forecast bias across all sample observations is 1.39 percent of stock price. This result is consistent with prior evidence that analysts' forecasts are optimistically biased (Brown 1997; Chopra 1998). No significant difference exists between the mean forecast bias before Reg FD (1.72) and the mean forecast bias between Reg FD and the Global Settlement (1.97). The mean forecast bias is more than four times smaller after the Global Settlement (0.41), with the difference statistically significant at the 1 percent level.

The average market capitalization of companies in our sample was $4.5 billion, and the average market-to-book ratio was 3.57. On average, 8.41 analysts covered a company in any particular month. The analysts in our sample worked for brokers that, on average, each employed 65.7 analysts. A typical analyst followed 16.30 stocks from 4.78 industries and, at the time of the forecast, had been in the I/B/E/S database for 6.24 years and making forecasts for the covered stock for 2.5 years. Around 17 percent of forecasts were made for companies with negative earnings, and 36 percent of forecasts were made for companies whose earnings were declining relative to earnings in the prior fiscal year.

Test Results

In this section, we present the results of the univariate tests and of the regression analysis of the effects of Reg FD and the Global Settlement on bias in analyst forecasts.

Univariate Results by Forecast Month. **Table 2** presents the median forecasts by the month in which the forecasts were made and by the fiscal year for which they were made. The numbers in the leftmost column represent the month (relative to the fiscal year-end) of the forecast. The numbers in the top row represent the fiscal years for which the

Table 1. Summary Statistics

				Number of Observations			Mean		
Description	Variable	Number of Observations	Mean	Before Reg FD	Between Reg FD and GS	After GS	Before Reg FD	Between Reg FD and GS	After GS
Forecast bias	Bias	434,268	1.39	231,096	77,305	125,867	1.72	1.97	0.41
Reg FD indicator	RegFD	434,268	0.18	231,096	77,305	125,867	0.00	1.00	0.00
Global Settlement indicator	Glob	434,268	0.29	231,096	77,305	125,867	0.00	0.00	1.00
Company characteristics									
Analyst coverage	NumA	434,268	8.41	231,096	77,305	125,867	8.21	8.23	8.88
Market cap ($ millions)	CompanySize	434,268	4,470.00	231,096	77,305	125,867	3,480.00	5,250.00	5,800.00
Market-to-book ratio	MB	434,268	3.57	231,096	77,305	125,867	3.78	3.47	3.23
Negative EPS	EPSLoss	434,268	0.17	231,096	77,305	125,867	0.16	0.26	0.14
Declining EPS	EPSDecline	434,268	0.36	231,096	77,305	125,867	0.37	0.45	0.27
Litigation	Litigation	434,268	0.27	231,096	77,305	125,867	0.25	0.30	0.27
Labor intensive	Labor	434,268	0.61	231,096	77,305	125,867	0.60	0.63	0.63
Analyst characteristics									
Company-specific experience	YearStk	434,268	2.50	231,096	77,305	125,867	2.55	2.43	2.46
General experience	YearIBES	434,268	6.24	231,096	77,305	125,867	6.45	6.19	5.87
No. of stocks covered	NumStk	434,268	16.30	231,096	77,305	125,867	18.18	14.31	14.06
No. of industries covered	NumInd	434,268	4.78	231,096	77,305	125,867	5.46	4.15	3.93
Broker size	BrokerSize	434,268	65.70	231,096	77,305	125,867	54.98	89.03	71.06

Note: This table presents the summary statistics for the overall sample and for the three subperiods.

Table 2. Forecast Bias by Fiscal Year and Forecast Month

	Forecast Period End Year										
Month	96	97	98	99	00	01	02	03	04	05	06
–23	0.1	0.4	1.4	1.6	–0.3	1.9	2.3	1.2	–0.2	–0.3	–0.3
–22	0.3	0.5	0.9	1.3	0.5	2.2	2.7	1.3	0.0	–0.1	0.0
–21	0.3	0.5	1.1	1.6	0.5	2.1	2.6	1.3	0.0	0.0	0.2
–20	0.4	0.5	1.1	1.3	0.6	2.2	2.2	1.4	–0.1	0.0	0.0
–19	0.5	0.7	1.1	1.6	0.5	2.1	2.1	1.3	–0.1	0.0	0.1
–18	0.5	0.4	1.2	1.4	0.6	2.1	1.8	1.1	–0.2	0.0	0.1
–17	0.4	0.4	1.2	1.1	0.5	2.1	1.4	1.0	–0.2	0.0	0.1
–16	0.4	0.5	1.3	1.3	0.6	2.0	1.5	1.1	–0.1	0.0	0.2
–15	0.4	0.4	1.1	0.8	0.4	1.7	0.9	0.8	–0.3	0.0	0.2
–14	0.4	0.3	0.9	0.6	0.4	**FD**	0.6	0.4	–0.2	0.0	0.1
–13	0.4	0.3	1.0	0.6	0.4	1.5	0.5	0.3	–0.2	0.1	0.2
–12	0.3	0.2	0.8	0.4	0.3	1.6	0.4	**GS**	–0.2	–0.1	0.1
–11	0.3	0.3	0.8	0.3	0.1	1.3	0.3	0.1	–0.1	0.0	0.1
–10	0.2	0.2	0.5	0.1	0.2	1.1	0.2	0.0	–0.1	–0.1	–0.1
–9	0.2	0.2	0.6	0.1	0.1	1.1	0.2	0.0	–0.1	0.0	–0.1
–8	0.1	0.1	0.5	0.1	0.1	0.7	0.2	–0.1	–0.1	–0.1	–0.1
–7	0.1	0.0	0.5	0.1	0.1	0.6	0.2	–0.1	0.0	0.0	0.0
–6	0.1	0.1	0.4	0.0	0.1	0.5	0.2	–0.1	–0.1	–0.1	0.0
–5	0.0	0.0	0.2	0.0	0.0	0.2	0.1	–0.1	0.0	–0.1	0.0
–4	0.0	0.0	0.1	0.0	0.0	0.2	0.1	–0.1	0.0	0.0	0.0
–3	0.0	0.0	0.1	0.0	0.0	0.1	0.0	–0.1	–0.1	0.0	0.0
–2	0.0	0.0	0.0	0.0	**FD**	0.0	0.0	–0.1	–0.1	0.0	0.0
–1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	–0.1	0.0	0.0	–0.1
0	0.0	0.0	0.0	–0.1	0.0	0.0	**GS**	–0.1	0.0	0.0	–0.1
1	0.0	–0.1	0.0	–0.1	–0.1	0.0	0.0	–0.1	–0.1	–0.1	–0.3
Median bias	0.2	0.2	0.8	0.3	0.1	1.2	0.4	0.0	–0.1	0.0	0.0
Mean bias	1.2	1.1	1.8	2.2	1.4	3.0	2.1	1.6	0.1	0.5	0.3
Mean forecast	6.2	5.3	4.6	5.1	5.3	3.7	3.0	4.0	4.4	4.2	5.0
Mean actual earnings	5.0	4.1	2.8	2.9	3.9	0.7	0.9	2.4	4.2	3.7	4.7
Mean stock return (%)	0.2	0.2	0.0	0.2	0.0	0.0	–0.2	0.6	0.2	0.1	0.2
GDP (%)	3.7	4.5	4.2	4.5	3.7	0.8	1.6	2.5	3.9	3.2	3.3

Notes: *Forecast bias* is the difference between the mean of all forecasts made in a particular month for a particular company and a particular fiscal year and the realized EPS, scaled by the stock price and multiplied by 100. *Forecast period end year* is the fiscal year for which the forecast was made. *Month* is the month of the forecast relative to the fiscal year-end. *FD* is the month in which Reg FD became effective (October 2000). *GS* is the month in which the Global Settlement was announced (December 2002). Stock returns were calculated from our samples.

forecasts were made. For example, forecasts made in September 2000 for the fiscal year ended December 2000 (i.e., three months before the fiscal year-end) are in row –3 and column 00. The two solid lines separate the forecasts made before and after Reg FD and the forecasts made before and after the Global Settlement. The six bottom rows present forecast bias for each fiscal year averaged across all forecast months, along with the realized earnings per share, average forecasts, annual stock returns, and real GDP growth rates.[15] To align fiscal year-end dates with annual variables, such as real GDP growth rates, we used only forecasts for companies with December fiscal year-ends.

For each year before the Global Settlement, the median forecast errors are significantly positive. Furthermore, for each year before the Global Settlement, we observe the walk-down trend with forecast bias steadily declining as forecasts are made closer to the fiscal year-end. After the Global Settlement, we observe a significant drop in the forecast bias. The results show a total absence of bias in the median forecast errors for 2004–2006 (–0.1 percent, 0.0 percent, and 0.0 percent, respectively). The walk-down trend in median forecast errors is also practically nonexistent for fiscal years 2004–2006.

These results suggest that analysts' conflicts of interest indeed led to excess optimism in earnings forecasts before the Global Settlement and that the Global Settlement has been effective in neutralizing analysts' conflicts of interest. Alternative interpretations of the forecast bias, such as self-selection, cognitive bias, and need for insider information, cannot explain these findings because the Global Settlement should have no effect on these factors.

Unusually high stock valuations and/or realized earnings, rather than less optimistic forecasts, could be responsible for the decline in the average forecast errors after the Global Settlement. A quick look at the actual and forecasted EPS, stock returns, and real GDP growth rates before and after the Global Settlement, however, does not seem to support this idea. Neither aggregate economic performance nor stock valuations seem to be out of the ordinary in the post-settlement years. The actual earnings, stock returns, and GDP growth rates seem to be unusually low in the period between Reg FD and the Global Settlement. We controlled for the effects of these and other potentially relevant factors by examining the effects of Reg FD and the Global Settlement in a regression framework.

Regression Analysis. To examine how Reg FD and the Global Settlement affect bias in analyst forecasts while controlling for the confounding effects of company and analyst characteristics, as well as economic conditions, we estimated the following regression model:

$$\begin{aligned} Bias_{j,t,m} &= \alpha_0 + \alpha_1 RegFD_{t,m} + \alpha_2 Glob_{t,m} + \alpha_3 NumA_{j,t,m} \\ &+ \alpha_4 CompanySize_{j,t,m-1} + \alpha_5 MB_{j,t,m-1} \\ &+ \alpha_6 YearStk_{j,t,m} + \alpha_7 YearIBES_{j,t,m} \\ &+ \alpha_8 NumStk_{j,t,m} + \alpha_9 NumInd_{j,t,m} \\ &+ \alpha_{10} BrokerSize_{j,t,m} + \alpha_{11} EPSLoss_{j,t} \\ &+ \alpha_{12} EPSDecline_{j,t} + \alpha_{13} Litigation_j \\ &+ \alpha_{14} Labor_{j,t,m-1} + \alpha_{15} ActualGDP_t \\ &+ \alpha_{16} UnexpectedGDP_{t,m} + \beta Month_m + \gamma Year_t \\ &+ \delta_j \sum DCompany_j + \varepsilon_{j,t,m}. \end{aligned} \quad (4)$$

In Equation 4, $Bias_{j,t,m}$ is the mean forecast error for all forecasts for company j made in month m relative to the end of fiscal year t, calculated according to Equations 1–3. $RegFD_{t,m}$ equals 1 for forecasts made between 23 October 2000 and 20 December 2002. $Glob_{t,m}$ equals 1 for forecasts made after 20 December 2002. A negative sign for the coefficient of $RegFD_{t,m}$ or $Glob_{t,m}$ would indicate a decline in the bias following, respectively, Reg FD and the Global Settlement.

Lim (2001) argued that the forecast bias is higher when a company's information environment is less transparent—for example, when the company is small and has less analyst coverage. Beckers, Steliaros, and Thomson (2004) showed that the number of analysts following a stock affects the accuracy of the consensus earnings forecast. Hence, we used analyst coverage and company size as proxies for the degree of information transparency. Analyst coverage, $NumA_{j,t,m}$, is defined as the number of outstanding forecasts used in I/B/E/S's monthly consensus calculation. Analyst coverage represents the number of analysts following company j in month m for fiscal year t. $CompanySize_{j,t,m-1}$ is defined as the natural log of the company's market capitalization at the end of the previous month.

Analysts tend to forecast more accurately when they have more experience and resources (Clement 1999; Lim 2001). We measured company-specific experience as the number of years analyst i has been following company j ($YearStk_{j,t,m}$). We measured general experience as the number of years since analyst i first appeared in the I/B/E/S database ($YearIBES_{j,t,m}$). $BrokerSize_{j,t,m}$ is the number of analysts who work for the same employer during the same forecast year as the analyst who makes the forecast. Analysts who work for larger firms tend to have more resources at their disposal.

Clement (1999) found that analysts' forecasts are less accurate the more stocks and the more industries they follow. $NumStk_{j,t,m}$ is the number of stocks for which analyst i supplies at least one forecast within the calendar year. $NumInd_{j,t,m}$ is the number of two-digit SIC industries for which analyst i supplies at least one forecast within the calendar year.

Previous studies have found that forecasting is more difficult when companies report a loss or a decline in earnings (Brown 2001). The $EPSLoss_{j,t}$ indicator equals 1 when the corresponding actual earnings of company j are negative. The $EPSDecline_{j,t}$ indicator equals 1 when actual earnings in fiscal year t are lower than actual earnings in the previous year.

Matsumoto (2002) argued that companies in industries with a higher risk of shareholder lawsuits and/or greater reliance on implicit claims with stakeholders are more likely to avoid missing analyst forecasts. The $Litigation_j$ indicator equals 1 for companies in high-litigation-risk industries: SIC codes 2833–2836 (biotechnology), 3570–3577 and 7370–7374 (computers), 3600–3674 (electronics), and 5200–5961 (retailing).

Matsumoto (2002) also argued that labor-intensive companies try to avoid missing analyst forecasts because their stakeholders are concerned about company credit risk. Labor intensity, $Labor_{j,t,m-1}$, is defined as 1 minus the ratio of gross plant, property, and equipment (PPE) to total gross assets, where gross PPE is the quarterly Compustat item 118 and total gross assets is item 44 plus item 41. $Labor_{j,t,m-1}$ is measured at the end of the last quarter preceding forecast month m.

Richardson, Teoh, and Wysocki (2004) found lower forecast bias for companies with high growth opportunities. We used the market-to-book ratio ($MB_{j,t,m-1}$) at the end of the last quarter preceding the forecast month as a proxy for growth opportunities. The ratio is calculated as the market value of equity divided by the book value of common equity (Compustat quarterly data item 14 multiplied by item 61 and divided by item 59).

We used both the real GDP growth rate and the unexpected change in the real GDP growth rate to capture analysts' inability to forecast earnings accurately if the state of the economy changes substantially. $ActualGDP_t$ is the actual real GDP growth rate in fiscal year t. $UnexpectedGDP_{t,m}$ is defined as the difference between the expected real GDP growth rate and the actual real GDP growth rate in fiscal year t. For earnings forecasts made more than nine months before the fiscal year-end date, the expected real GDP growth rate in fiscal year t is defined as the real GDP growth rate in the quarter for which analysts made earnings forecasts. For forecasts made in Q2 (seven to nine months before the fiscal year-end date), we calculated the expected real GDP growth rate as (Growth in Q1 + 3 × Growth in Q2)/4. For forecasts made in Q3 (four to six months before the fiscal year-end date), we calculated the expected real GDP growth rate as (Growth in Q1 + Growth in Q2 + 2 × Growth in Q3)/4. For forecasts made within the three months before the fiscal year-end date, $UnexpectedGDP_{t,m}$ is set to zero.

Prior research and our results in Table 2 show that forecasts made earlier in the fiscal year are less accurate (Richardson, Teoh, and Wysocki 2004). To control for forecast horizon, we used $Month_m$, defined as the number of months until the fiscal year-end date. For example, for an analyst forecast made in October 1999 for the fiscal year ended December 1999, $Month_m$ equals 2. Richardson, Teoh, and Wysocki (2004) found that forecast bias has been declining gradually since the early 1990s. To address the concern that our results may be driven by this trend, we included a calendar year variable, $Year_t$, in the regression model (Equation 4). To control for unobserved company effects, we estimated the regressions with fixed company effects ($DCompany_j$).

The first set of estimation results in **Table 3** is for the regression model (Equation 4). The results imply that forecast bias declined by 0.24 percent of the stock price after the introduction of Reg FD. This finding confirms our earlier conjecture that the increase in forecast bias following Reg FD (observed in our univariate results) was driven by unexpectedly poor macroeconomic conditions. The decline in forecast bias following Reg FD is consistent with Lim's prediction (2001) that analysts become less optimistic when they rely less on insider information.

After the Global Settlement, the forecast bias is lower by 0.96 percent of the stock price compared with the forecast bias before Reg FD. This result is consistent with our univariate findings and implies that the Global Settlement and related regulations successfully neutralized analysts' conflicts of interest. The positive coefficient on *Month* suggests the presence of the walk-down trend. Forecast bias is high for earlier forecasts and becomes lower over time. On average, forecast bias increases by 0.14 percent of the stock price per month with the length of the forecast horizon.

Because the Global Settlement is an enforcement agreement between U.S. regulators and the Big-12 banks, we next examined whether the impact of the Global Settlement is limited to the Big-12 banks or whether there are spillover effects on other analysts.[16] In a recent study, Barber, Lehavy, McNichols, and Trueman (2006) reported that the proportion of buy recommendations declined significantly among all analysts after the implementation of NASD Rule 2711. They also documented that the decline was stronger for the sanctioned banks. Whether the Global Settlement has had a differential impact on analyst forecast bias, however, remains an open question.

To identify the differential impacts of Reg FD and the Global Settlement on Big-12 analysts, we compared the bias in the forecasts of Big-12 analysts with the bias in the forecasts of other analysts. In a univariate comparison, we found that, on average, the forecasts of analysts working for the Big-12 banks are statistically significantly less biased than the forecasts of their counterparts in each of the three periods. The differences, however, are economically trivial. For example, the difference between the mean forecast bias of Big-12 analysts and that of other analysts is –0.04 percent of the share price in the pre–Reg FD period, –0.09 percent after Reg FD, and –0.05 percent after the Global Settlement.

Table 3. The Impact of Reg FD and the Global Settlement on Forecast Bias

	(1)		(2)	
	Coefficient	*t*-Statistic	Coefficient	*t*-Statistic
RegFD	–0.24**	–3.29	–0.16*	–2.05
Glob	–0.96**	–10.68	–0.86**	–9.51
CompanySize	0.65**	16.89	0.67**	17.52
NumA	0.02**	3.39	0.01**	2.68
MB	–0.03**	–5.97	–0.03**	–5.59
YearStk	0.01	1.58	0.01**	2.59
YearIBES	0.00	1.54	0.00	0.78
NumStk	0.00*	–2.38	0.00*	–2.05
NumInd	–0.01	–1.18	–0.01	–1.40
BrokerSize	0.00	–1.64	0.00	–0.41
EPSLoss	5.40**	43.20	5.23**	40.53
EPSDecline	2.40**	62.82	2.38**	60.63
Litigation	–0.03	–0.24	–0.08	–0.66
Labor	0.52	2.12	0.47	1.89
ActualGDP	–0.04*	–2.05	–0.03	–1.23
UnexpectedGDP	–0.03**	–6.26	–0.04**	–6.61
Big12			–0.06**	–3.05
Big12 × RegFD			–0.07*	–2.04
Big12 × Glob			0.03	1.34
Month	0.14**	51.70	0.13**	47.76
Year	0.03*	2.16	0.02	1.09
Adjusted R^2	0.46		0.45	
No. of observations	434,268		434,268	
No. of companies	7,315		7,315	

Notes: This table presents the coefficients obtained from Equation 4. The dependent variable is earnings forecast bias, defined as the difference between the mean of all forecasts made in a particular month for a particular company and a particular fiscal year and the realized EPS, scaled by the stock price and multiplied by 100. The RegFD indicator equals 1 for forecasts made between 23 October 2000 and 20 December 2002. The Glob indicator equals 1 for forecasts made after 20 December 2002. Analyst coverage, NumA, is the number of outstanding forecasts used by I/B/E/S to calculate monthly consensus. CompanySize is the natural log of a company's market capitalization. Market-to-book ratio, MB, is the market value of equity divided by the book value of common equity. Company-specific experience, YearStk, is the number of years since the analyst made her first forecast for a particular stock. General experience, YearIBES, is the number of years since the first day the analyst appeared in I/B/E/S. NumStk and NumInd are the number of stocks and the number of industries covered by the analyst, respectively. The EPSLoss indicator equals 1 when the corresponding actual earnings of company *j* are negative. The EPSDecline indicator equals 1 when the realized earnings in fiscal year *t* are lower than the realized earnings in the previous year. BrokerSize is the number of analysts working for the employer of the analyst who makes the forecast. The litigation risk indicator, Litigation, equals 1 for companies in high-litigation-risk industries. Labor intensity, Labor, is (1 – Gross PPE/Total gross assets). The regressions are estimated with fixed company effects. The reported *t*-statistics reflect robust standard errors adjusted for heteroscedasticity and clustering by company.

*Significant at the 5 percent level.
**Significant at the 1 percent level.

To see whether the differential impacts of Reg FD and the Global Settlement on Big-12 and other analysts change when we control for company and analyst characteristics, as well as economic conditions, we re-estimated the regression model (Equation 4) with the Big-12 indicator and its interactions with the Reg FD and Global Settlement indicators included as additional independent variables.[17] The second set of results in Table 3 is for this regression. Consistent with our univariate results, the Big-12 indicator and its interaction with Reg FD are significant in statistical but not in economic terms. More importantly, the interaction of the Big-12 indicator with the Glob indicator is insignificant, both statistically and economically.

These results imply that both Big-12 and other analyst forecasts were biased before Reg FD, which is consistent with Lin and McNichols (1998), who found no difference between the earnings forecasts of analysts affiliated with banks involved in underwriting deals with the covered companies and the forecasts of unaffiliated analysts. These results also imply that the impact of the Global Settlement and related regulations is the same among Big-12 and other analysts. This finding may reflect the fear of non-Big-12 firms that they may become targets of similar investigations. In addition, because Big-12 banks no longer reward optimism, the incentive for lower-tier analysts to make optimistic forecasts as a means of moving up to the bigger banks has also been reduced. Finally, the rules and regulations introduced by the SEC, NYSE, and NASD around the time of the Global Settlement covered all analysts.

We checked the robustness of our main conclusion—that forecast bias declined after both Reg FD and the Global Settlement—in a number of ways. First, we used an alternative definition of the forecast bias by normalizing it by the book value of equity per share.[18] Second, we changed the cutoff dates for each period by using the effective date of Rule 2711 instead of the announcement date of the Global Settlement. Third, to ensure that our conclusions were unaffected by changes in the sample composition across the three subperiods, we required at least one forecast by the same analyst for the same company in all three periods. Fourth, we dropped observations with stock prices under $5 to avoid any potential biases induced when the scaling factor is a small number. Fifth, we extended our sample period to include an earlier period (January 1984–December 1995). In all these cases, the results (not reported here) remain qualitatively the same as those reported in Table 3, confirming that forecast bias declined after Reg FD and especially after the Global Settlement.

We also examined the breadth of these effects by estimating forecast bias regressions (Equation 4) separately for 12 business sectors and for subsamples formed on the basis of annual quintile sorts by company size and analyst coverage.[19] The results (not reported here) show that the effects of the Global Settlement are negative for 11 of 12 sectors and are statistically significant for 9 sectors. The effects of Reg FD are negative for 8 of 12 sectors, but significantly so for only 6 sectors. Our results also show that the effect of Reg FD is concentrated among smaller companies and companies with low analyst coverage, whereas the effect of the Global Settlement is more widespread, with no clear cross-sectional pattern.

Conclusion

Analysts' conflicts of interest were evident before the Global Research Analyst Settlement and were not limited to the 12 banks covered by it. Reg FD made analysts less dependent on insider information and thus diminished analysts' motives to favor company managers by inflating their earnings forecasts. The impact of Reg FD is more significant for companies with a less transparent information environment in which insider information has the most value.

Introduced in 2002, the Global Settlement and related regulations had an even bigger impact than Reg FD on analyst behavior. After the Global Settlement, the mean forecast bias declined significantly, whereas the median forecast bias essentially disappeared. Although disentangling the impact of the Global Settlement from that of related rules and regulations aimed at mitigating analysts' conflicts of interest is impossible, forecast bias clearly declined around the time the Global Settlement was announced. These results suggest that the recent efforts of regulators have helped neutralize analysts' conflicts of interest.

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This article qualifies for 1 CE credit, inclusive of 1 SER credit.

Notes

1. Several rules and regulations were enacted around the Global Research Analyst Settlement—for example, NASD Rule 2711, NYSE Rule 472, and Regulation Analyst Certification. Because they were introduced over a relatively short period, determining the separate impact of each one of these regulatory actions is impossible. Nevertheless, all these rules and regulations share the same goal of reducing analysts' conflicts of interest. Therefore, we use the term Global Settlement to represent all the rules and regulations enacted around the Global Research Analyst Settlement to address analysts' conflicts of interest.
2. Scherbina (2004) found a negative relationship between the estimated bias that arises from self-selection in coverage and subsequent stock returns. Her results suggest that retail

investors fail to adjust for the bias. Malmendier and Shanthikumar (2007) found that retail investors react to stock recommendations literally. Institutional investors buy stocks that have "strong buy" ratings and sell stocks that have "buy" ratings, whereas retail investors buy in both cases. Kwag and Shrieves (2006) found that persistence in forecast errors can lead to potentially profitable trading strategies.

3. Overall, these studies found either no change (Bailey, Li, Mao, and Zhong 2003) or a decrease in forecast accuracy (Agrawal, Chadha, and Chen 2006; Mohanram and Sunder 2006) and forecast dispersion (Agrawal, Chadha, and Chen 2006) following Reg FD.
4. Kadan, Madureira, Wang, and Zach (2009) documented that stock recommendations have become less optimistic since the Global Settlement. Furthermore, they found that the likelihood of an optimistic recommendation is no longer associated with analyst affiliation. Ferreira and Smith (2006) found that investors have not changed the way they respond to analysts' changes in recommendations since Reg FD. Examining bid–ask spreads and trading activity following Reg FD, Lee, Rosenthal, and Gleason (2004) found no significant increase in volatility or in the adverse-selection component of bid–ask spreads.
5. Reg AC took effect on 14 April 2003. See the joint report by the NASD and NYSE (2005) for the effectiveness of the new rules.
6. The 10 investment banks are Bear Stearns, Citigroup, Credit Suisse First Boston, Goldman Sachs, J.P. Morgan, Lehman Brothers, Morgan Stanley, Merrill Lynch, UBS, and U.S. Bancorp Piper Jaffray. In 2008, Bear Stearns and Merrill Lynch were taken over because of their deteriorating financial positions, whereas Lehman Brothers ended up in bankruptcy. Because our sample period ends in 2006, these events did not affect our results.
7. These two investment banks are Deutsche Bank and Thomas Weisel Partners.
8. Because prior studies (e.g., Lin and McNichols 1998) found no cross-sectional differences in forecast bias between affiliated and unaffiliated analysts, one would not reasonably expect cross-sectional differences in the impact of the Global Settlement on these two analyst types.
9. Therefore, one would not reasonably expect cross-sectional differences in the impact of the Global Settlement on self-selection bias.
10. Forecasts for current-year EPS are the forecasts in I/B/E/S with code FPI 1. Forecasts for subsequent-year EPS are the forecasts in I/B/E/S with code FPI 2.
11. We excluded forecasts in the I/B/E/S Excluded Estimates file and forecasts for which actual earnings figures were missing.
12. The I/B/E/S Summary file contains monthly snapshots of consensus-level data and corresponding stock prices. The snapshots are as of the Thursday before the third Friday of every month. The reported stock prices in this file are the last available prices before the Thursday. I/B/E/S's earnings-related data and stock prices are split adjusted.
13. Using stock price to normalize forecast bias is common (see, e.g., Richardson, Teoh, and Wysocki 2004). Later in the article, we discuss the robustness of our findings to alternative scaling of analyst forecast errors.
14. We defined extreme values as those in 1 percent of both tails of the distribution. Variables that took only positive (negative) values were trimmed only on the right (left) tail of the distribution.
15. Realized earnings and forecasts are scaled by the stock price, consistent with the scaling of the bias measure.
16. Other regulations, such as NASD Rule 2711, affect all analysts.
17. In this analysis, for each forecast month of each sample company-year, the mean forecast bias is calculated separately for Big-12 and other analysts.
18. This step also ruled out the possibility that such events as the decimalization of stock prices in August 2000–April 2001 affected our findings.
19. The sector classification for each company is from the I/B/E/S Identifier file.

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