Analyst preview ban: What were the costs and benefits of private communication with management?*

Kotaro Miwa[a] **Hidenori Takahashi**[b]

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Abstract

We identify which sell-side analysts privately communicate with management to obtain upcoming earnings figures ("previews") and examine the impact of the exogenous shock of the loss of private communication, known as the "preview ban." We find that, after the introduction of the preview ban, the forecast accuracy of preview analysts—analysts who rely on previews—deteriorates relative to nonpreview analysts; in addition, preview analysts' popularity, as measured by institutional investor votes on analyst rankings, declines. We also find that after the preview ban, preview firms—firms covered by preview analysts—experience a decrease in foreign institutional ownership and an increase in domestic institutional ownership; further, preview firms see some improvement in stock liquidity, and an increase in market valuation driven by a lower cost of capital. Overall, these results suggest that private communication was beneficial to analysts in several ways but came at a cost to firms.

Keywords: financial analysts, private communication, selective disclosure, earnings preview, disclosure regulation

JEL classification: G18, D82, G24

* This study is based on our work at the JSDA Capital Market Forum, conducted by the Japan Securities Dealers Association.

[a] Faculty of Economics, Kyushu University. Email: kotmiwa@econ.kyushu-u.ac.jp

[b] Corresponding author. Research Institute for Economics and Business Administration, Kobe University. Email: takahashi@rieb.kobe-u.ac.jp

Sell-side financial analysts gather information about the firms they follow and disseminate forecasts of financial statement items in the form of reports to capital market participants. Among the sources of information they use, analysts recognize private communications with management as one of the useful inputs to earnings forecasts (Soltes 2014; Brown et al. 2015). However, little research has been done to determine whether and how private communications cost and benefit analysts and firms. This gap stems from the inherent unobservability of private communications (Green et al. 2014b; Bushee et al. 2018; Bradley et al. 2020). To fill this gap, we shed new light on "observable" private communications between analysts and firms in the Japanese stock market.

Some analysts in Japan were accustomed to communicating privately with firm management to obtain upcoming earnings figures, commonly referred to as "earnings previews" or simply "previews," before the official release, and to write reports based on the earnings previews; these reports are known as "preview reports." This practice was legal and widespread, allowing (institutional) investors to find and consult preview reports (Bloomberg 2016).

The preview setting provides an excellent opportunity to address the identification challenges of studies examining the causal effects of disclosure regulation, as discussed by Leuz and Wysocki (2016), in two ways. First, because we can identify analysts who write preview reports and the firms they cover, we can generate nonpreview analysts and nonpreview firms as control groups. (We refer to analysts who have conducted previews as preview analysts and others as nonpreview analysts; we refer to firms that are the subject of preview reports as preview firms and others as nonpreview firms.) Although there have been extensive studies on Regulation Fair Disclosure (Reg FD) enacted in the United States in 2000 to prohibit selective disclosure and applied to all U.S. listed firms, confounding factors make it difficult to isolate the unique effect of the regulation (see Bailey et al. 2003). While several studies address this issue by using non-U.S. firms (Francis et al. 2006) or non-U.S. analysts (Bagnoli et al. 2008) who are exempt from Reg RD as a control group, we create control groups within a single country.

Second, we exploit the event when the preview practice suddenly became taboo, leading to the imposition of the preview ban, which can be viewed as an exogenous shock that disrupts private communication between analysts and management. In September 2016, the Japan Securities Dealers Association (JSDA) issued *Guidelines concerning Association Member Analysts' Interviews, etc. with Issuers and Communication of Information* (hereafter, guidelines). The primary purpose of the guidelines is to prohibit analysts from conducting preview interviews (i.e., interviews that require previews) with firms and selectively distributing previews to a subset of clients. Using the JSDA guidelines, we examine the causal effect of the loss of private communication. This is an important distinction from other studies that focus on private communication, which is now pervasive through investor conferences (Green et al. 2014a, b), analyst/investor (AI) days (Kirk and Morkov 2016), company site visits (Cheng et al. 2016), and

non-deal roadshows (NDRs) (Bradley et al. 2022).

We begin by identifying preview reports from a total of 90,334 analyst reports published between January 2013 and December 2016. To classify them into preview and nonpreview reports, we use a systematic approach: Two individuals with sufficient experience as institutional investors find keywords describing preview reports by each reading randomly selected analyst reports; then, we extract analyst reports that meet the combined condition of having the keywords. This process results in the identification of 1,316 preview reports (for 288 companies). Preview reports account for 2% of analyst reports, and preview firms account for 23% of the sample firms covered by analyst reports issued in 2013–2015. No preview reports have been observed since January 2016.

We first analyze the characteristics of preview reports and preview firms. We find that preview reports are more likely to be distributed approximately 40 days to 1 day before earnings announcements, and they are more often written by analysts affiliated with foreign brokerage firms. Moreover, preview firms are more prevalent in industries such as pharmaceuticals and transportation equipment and less prevalent in industries that are relatively easy to value (e.g., power and gas and wholesale trade). In multivariate regressions, we find that preview firms are more likely to have a higher ratio of research and development (R&D) expenditures; other firm characteristics (e.g., ratio of intangible assets, ownership structure, and number of segments) do not significantly affect the decision to preview.

To examine the costs and benefits of private communication, our subsequent analyses use the implementation of the guidelines as an exogenous shock to the loss of private communication. We assess the impact of the guidelines on analysts' output by comparing the earnings forecast accuracy of preview and nonpreview analysts for the same firms. We find that the forecast accuracy of preview analysts deteriorates relative to that of nonpreview analysts after the guidelines. The deterioration in the forecast accuracy of preview analysts is unlikely to be driven by a change in the disclosure behavior of their covering firms (i.e., a chilling effect), because any corporate behavior should have the same effect on both preview and nonpreview analysts; rather, it is more likely driven by the loss of private communications. Our results suggest that private communications with management are a useful input to analysts' earnings forecasts, which is consistent with Soltes (2014) and Brown et al. (2015).

Next, we examine the impact of the guidelines on analyst rankings, which are the outcome of competition among analysts (Bagnoli et al. 2018). Using institutional investor votes on analyst rankings as a measure of popularity, we find that the popularity of preview analysts decreases by 0.38 standard deviations, while the popularity of nonpreview analysts does not change significantly after the guidelines. These results suggest that previews are a means of gaining popularity (i.e., votes in analyst rankings).

Finally, we examine the impact of the guidelines on firms. Comparing the ownership

structure of preview and nonpreview firms before and after the guidelines, we find that the ownership share of foreign institutional investors decreases by 1.5 percentage points in preview firms relative to nonpreview firms after the guidelines. Conversely, the ownership shares of domestic institutional investors and individual investors, who do not benefit from previews, increase in preview firms. These results suggest that previews are instrumental in gaining the recognition of foreign investors who are likely to play financial results.

We find that after the guidelines, preview firms have better stock liquidity, as measured by trading volume, Roll's (1984) measure, and Amihud's (2002) measure (ILLIQ), than nonpreview firms. We also find that, after the guidelines, preview firms experience a higher increase in firm value, as measured by Q (market-to-book ratio), than nonpreview firms; this effect is more pronounced for preview firms with high idiosyncratic risk. These results suggest that providing the opportunity for a preview interview comes at a cost in terms of illiquidity and lower valuation.

Furthermore, we find a positive relationship between stock liquidity and firm value. To identify the mechanism of this relationship, following Fang et al. (2009), we decompose Q into three components: price-to-operating income, financial leverage, and operating profitability. We then regress the change in these components on the change in liquidity measures. We find a significant positive relationship between liquidity improvement and the price-to-operating income ratio but not between the other two components, suggesting that increased firm value is primarily driven by a lower cost of capital (Amihud and Mendelson 1986).

Overall, we show that the preview ban has negative effects on preview analysts in terms of deteriorating forecast accuracy and losing popularity, and positive effects on preview firms in terms of increased stock liquidity and firm valuation. In other words, private communication between analysts and firms has a variety of benefits for analysts who engage in it. However, private communication can be costly for firms in terms of stock (il)liquidity and firm (under)valuation.

The contributions of this study are threefold. First, we contribute to the literature on disclosure channels through private communication. Previous studies in this area have shown the upside of private communication for firms, analysts, and institutional investors (e.g., Green et al. 2014a, b; Bushee et al. 2018; Bradley et al. 2022). We are the first study to show the downside of private communication for firms. In addition, previous studies have focused on investor conferences, AI days, and NDRs. We add a new disclosure channel—previews—to this list. Previews are "more private" meetings than investor conferences and AI days and are similar to NDRs in that the dates, locations, and participants of the events are not disclosed, and there are no transcripts or webcasts (Bradley et al. 2022). In this sense, our study is closely related to Bushee et al. (2018) and Bradley et al. (2022), who focus on private meetings between

institutional investors and management via NDRs but differ from them in that the previews are private meetings between analysts and management. Our study is also related to Soltes (2014) and Brown et al. (2015), who show the usefulness of private meetings using data from a single firm and surveys of analysts, respectively. We complement some of their evidence with a larger sample size.

Second, we contribute to the literature on disclosure regulation. Disclosure regulations play an important role in ensuring market transparency and fairness; one prominent example is Reg FD. Although Reg FD has been extensively studied and found to be somewhat effective—that is, it has leveled the playing field among investors without creating a "chilling effect" on the flow of information (see, e.g., Koch et al. 2013), there is evidence that selective disclosure through private meetings continues even after the Reg FD era (Green et al. 2014b; Soltes 2014; Solomon and Soltes 2015; Bushee et al. 2017; Bradley et al. 2020; Campbell et al. 2021). We isolate the unique effects of regulation (i.e., JSDA guidelines) in an environment that, unlike in the United States, is not affected by confounding factors such as decimalization (see Bailey et al. 2003; Francis et al. 2006; Leuz and Wysocki 2016).

Third, we clarify the incentives of information buyers and sellers to engage in selective disclosure. Although understanding the incentives for selective disclosure is important for an appropriate institutional design, there is little research in this direction. As a few exceptions, Bagnoli et al. (2008) find that Institutional Investor (II) All-America rankings, which are determined by institutional investor votes, fluctuate significantly around Reg FD, suggesting that analysts who are rewarded for providing information obtained through selective disclosure are replaced. Although Bagnoli et al. (2008) do not observe private communication between top-ranked analysts and management, we do so through the content of analyst reports, and our findings strengthen those of Bagnoli et al. (2008).

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