

Is a mandatory ‘Quiet Period’ appropriate in the new issues market?

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1. Background and aims

The U.S. currently has regulation which prevents news announcements following an IPO (known as quiet period). In fact the SEC extended the quiet period from 25 days to 40 on July 9, 2002. This regulation is designed to restrict IPO firms and their affiliated groups from publishing news concerning valuation and from making forward-looking statements relating to earnings, revenues and other similar items. The rationale behind the ‘quiet period’ is to give investors enough time to do their due diligence and allow market forces to establish a fair value without influence from the firm’s management or affiliated groups (Bradley, Jordan, Ritter & Wolf 2004) The purported benefit of the policy is to prevent price manipulation via news announcements.

The benefits from the policy to mandate a quiet period rely on the belief that firm’s management or affiliated groups may mislead investors by issuing positively biased recommendations to increase stock value around IPOs. In countries (such as U.S.) where a mandatory ‘quiet period’ is already in place, it is impossible to undertake an empirical evaluation of whether this policy is beneficial, as it is impossible to identify the consequences of not having (and therefore the benefits associated with implementing) this policy. Therefore, the basis for the policy is best informed by undertaking the analysis in an environment and at a time where the policy is not mandatory. Australia provides such an environment.

2. Significance and innovation

There is evidence in support of the ‘conflict of interest’ hypothesis that analysts affiliated with an IPO attempt to manipulate price through positively biased recommendations regarding IPOs (Michaely and Womack, 1999). News manipulation is an important tool to affect market reaction. Prior research has investigated the impact of news announcement at the end of a mandated quiet period on stock return (see Bradley, Jordan, Ritter & Wolf 2004; Bradley, Jordan and Ritter 2003) but findings are mixed and inconclusive (i.e. an explanation for the finding is that the researchers are unable to directly examine events in the period immediately after the IPO issue dates. The current study is the first to examine the impact of news announcements during the period immediately following an IPO (Quiet period).

Results from this study will inform international markets as to whether the policy of a mandatory quiet period is appropriate. Also, results will inform the Australian regulator as to whether the policy should be mandated in Australia.

3. Description of Approach

3.1 Data

We will collect news announcement from published information in the financial press for new public companies listed on the Australian Stock exchange (ASX) during the period 2000 to 2005. We select this sample period as the period of analysis is to mitigate the effects of the Internet Bubble during 1999-2000 period. The source for news announcements is the Factiva data base. Factiva provides access to full text coverage of all major Australian newspapers (including The Age, The Australian, The Australian Financial Review and BRW) as well as global newspapers and news wires. Relevant financial information will be

collected from the DatAnalysis, Connect 4, FinAnalysis, DataStream and SDC Platinum with which provide detailed reports of all current and formerly listed IPO companies on the Australian Stock Exchange (ASX). Finally, an econometric software package 'Eviews' will be the used to estimate the regression analysis in this study.

3.2. Research methodology

This study will investigate whether news announcements around IPO listing are being used as a tool for price manipulation. First we identify positive news announcements. Second we use three methods to measure the impact of these announcements in the new issues market. The measures are (i) the relationship between the news announcements and the stock price (ii) using news announcements to proxy firms engaged in market manipulation, we investigate if news announcements are associated with earning forecasting errors, (iii) long-run stock performance. Results from this study will therefore inform regulators whether the policy is appropriate for the Australian new issues markets

3.3 Measurement of news announcements

We identify news announcements associated with IPO performance, funding and strategy. Announcements will be classified as either good or bad news. Announcements will be further classified into 2 groups (1) Announcements made by management and affiliated groups such as the underwriter and financial analysts which we classified as potentially manipulative (2) Announcements made by un-affiliated financial analysts, business journalists etc which are more likely to be objective.

3.4 The effect of news announcements in the new issue market

We are currently considering three possible dependent variables to capture the effect of news manipulation in the new issue market.

i) Impact of news announcements on stock price. We first measure cumulative market-adjusted returns (CMAR) for all IPO firms for 40-day subsequent to each IPO listing date. We split the sample based on the above-mentioned classification and compare the CMAR for each group during the 40-day quiet period. We anticipate that IPOs with more good news announcements will exhibit higher CMAR.

ii) Association between News announcements and earning forecasting errors. Where IPOs provide earning forecasts in their prospectus (it is optional for Australian IPO firms to disclose earning forecasts), we identify variation between the earning forecasts and the reported earnings 1 year after listing (i.e. earning forecast errors). A significant negative variation between forecast and realized earnings may indicate an intention to mislead the investors (i.e. price manipulation).

We argue that firms with more positive news announcements are attempting to manipulate the market. Also we argue firms with negative forecast errors are similarly manipulative. Therefore, we expect a correlation between positive news announcements and negative forecast errors.

We derive the earning forecast errors as follows:

$$ForecastEr_i = \frac{PE_i - AE_i}{AE_i}$$

where: $ForecastEr_i$ = Rate of error in earnings forecasts for firm i

AE_i = Firm i 's actual earnings before taxes

PE_i = Firm i 's predicted earnings before taxes

We will measure the proposed association between earning forecast errors and news manipulation where the forecast error is the dependent variable controlling for other factors likely to impact the forecast error.

iii) *Impact of News announcements on long-run stock performance.* We argue that IPOs that engage in news manipulation are in the long run likely to experience negative share price performance as the market punishes unrealized outcomes. Again we proxy news manipulation using the number of positive announcements by related parties (i.e., management, underwriter) and we assess long-run stock performance using market adjusted return over a 2 year time horizon.

4. Deliverables and Expected Outcomes

Results from this study will inform national and international markets as to whether the policy of a mandatory 'quiet period' is appropriate. Results will therefore inform the Australian regulator as to whether the policy should be mandated in Australia.

References

Bradley, Daniel J., Jordan, B. D. & Ritter, J.R. (2003). *The quiet period goes out with a bang.* Journal of Finance, Vol. LVIII, no. 1.

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Michaely, Roni, & Womack, Kent (1999). *Conflict of interest and the credibility of underwriter analyst recommendations.* Review of Financial Studies 12, 653-686