VANDERBILT
Owen Graduate School of Management

FINANCIAL MARKETS

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FINANCIAL MARKETS RESEARCH CENTER • 2006

Conference on

Conflicts of Interest in Financial Markets

In many realms of financial markets, principals rely on agents to accomplish their goals. Because agents have their own interests at heart, conflicts arise between the goals of agents and the goals of principals. Examples of potential conflicts are many. Investors hire brokers to achieve best execution, while brokers have an incentive to trade where they receive payment for order flow. Investors hire money managers to trade their assets most efficiently, but money managers have an incentive to trade with

Dean Jim Bradford welcoming participants.

brokers that provide soft dollar credits that can be used to pay for research services. As Enron and other recent scandals have shown, street-side research analysts can neglect their obligation to their investor clienteles by writing reports favorable to the corporate clients of the brokerage firm rather than accurately depicting the state of the corporation. In corporations, managers have incentives to shirk their obligations to shareholders in favor of their own interests, perhaps leading to distortion of accounting numbers and to overly generous management compensation plans. What is the evidence on the presence and severity of these various conflicts? Should regulators limit activities that may lead to conflicts, or would transparency, full disclosure and competition be adequate to deal with conflicts?

These and related issues were discussed at the 19th annual conference of the Financial Markets Research Center, held on April 20-21, 2006 at Vanderbilt University. The conference was supported by a special grant from Hirtle, Callaghan & Co., Chief Investment Officers. Day one of the conference took place at the conference facilities of Caterpillar Financial Services, located next to the campus, and day two took place at the Owen School. **Ed Scott**, Chief Financial Officer of Caterpillar Financial, and **Jim Bradford**, Dean of the Owen School, welcomed the conference participants.

Hans Stoll, director of the Center introduced **Jon Hirtle**, co-founder of Hirtle Callaghan, who spoke on conflicts of interest in investment management, noting that his own firm was founded on the premise of eliminating conflicts inherent in multi-purpose money management organizations. The next speaker, **Chester Spatt**, Chief Economist of the Securities and Exchange Commission (on leave from Carnegie Mellon University), gave an overview of the regulatory approaches to different conflicts. These approaches included 1)requirement for board and auditor oversight, 2)self-policing by self-regulatory organizations, 3)specific policies and procedures that limit conflicts, 4)public disclosure of conflicts, 5)rules against certain abuses enforced by regulators, 6)Chinese walls, and 7)complete separation of functions (i.e. separation of auditor and consultant). He gave examples of some of these approaches and discussed some unintended consequences of certain approaches.

The next session, chaired by **Bob Whaley**, professor at the Owen School, examined three types of conflicts facing securities analysts. The first dealt with fairness opinions and was addressed in a paper by **Donna Hitscherich**, from Columbia University (written with Charles Calomiris), "Banker fee and acquisition premia for targets in cash tender offers: Challenges to the popular wisdom on banker conflicts." Hitscherich noted the narrow purpose of the fairness opinion – to give comfort to the board of the target company – and concluded that the fees charged were reasonably related to the cost of rendering the opinion. A second conflict was examined in a paper, "Information leakage and opportunistic behavior before analyst recommendations: An analysis of the quoting behavior of Nasdaq market makers," presented by **Xi Li**, from the University of Miami, (written with Hans Heidle). Heidle and Li find that market makers change their bid-ask quotes in anticipation of changes in stock recommendations by analysts from the same firm. They suggest that this may imply a break in the "Chinese Wall" between securities

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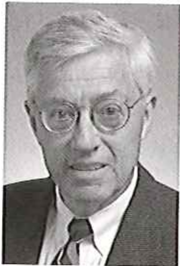
FROM THE DIRECTOR

It may be hard to believe but the Financial Markets Research Center is entering its 20th year. Our first annual conference in the spring of 1988 dealt with the stock market crash of 1987, and our latest annual conference, described elsewhere in this newsletter, examined conflicts of interest in financial markets. In-between, topics included a Conference on International Financial Policy honoring Dewey Daane in 1989, World Trading Markets in 1992, Reform of the Nasdaq Market in 1995, Coping with Global Volatility in 1999, Corporate Behavior and Financial Markets in 2003, and a variety of other topics.



Hans R. Stoll

Many thanks to the over 35 institutions that have supported the Center in the last 20 years. Center funding is used to support research at Vanderbilt that contributes to the understanding and appropriate oversight of financial markets. The Center purchases and maintains research data bases, helps fund summer research by Owen faculty, supports workshop presentation by outside speakers, and hosts conferences.

The faculty affiliated with the Center, listed elsewhere in this newsletter, have undergone some changes in the last year. First among these changes is the return of Bob Whaley to Vanderbilt as the Valere Blair Potter Professor of Management. Bob's first academic position was at Vanderbilt, and he had been here for two years when I joined the faculty in 1980. In 1986, he joined the Duke faculty where he was a major force in building up the finance group. Bob is an expert in derivatives and risk management and will contribute greatly to the Center's expertise on those areas. Bob has also agreed to be Co-director of the Financial Markets Research Center and to help in building the reputation of the Center and the Owen School We are really delighted to have him back. Also joining the Center-affiliated faculty is Richard Willis, associate professor of accounting. Richard has been on the faculty at Duke and Tulane. His research is in the area of financial accounting. Among the other coming and goings, two of our colleagues will be leaving Vanderbilt: Amar Gande has accepted a position at SMU and Anchada (Aida) Charoenrook has accepted a position at Washington University.

The finance PhD program, while small, continues to admit strong students and place them in academic positions. This year, Veronika Krepely Pool, who is completing a dissertation on the subject, "Essays in Liquidity and Trading Activity," will be joining the faculty of Indiana University, and Gemma Lee, who is completing a dissertation on equity offerings, will be going to the University of Alabama. Three students have been admitted for the fall of 2006.

Among other developments in the finance area is the establishment of a new Master of Science in Finance. The first year of the new program has been a great success. The one-year program caters to students with strong technical backgrounds who want to focus on finance. The school is planning to initiate a similar one-year program for accountants beginning in the fall of 2007. ■

GOALS OF THE CENTER

The Financial Markets Research Center at Vanderbilt University fosters scholarly research in financial markets, financial instruments, and financial institutions. Research of the Center examines participants in financial markets, such as brokers, exchanges, and financial intermediaries, businesses needing financing, and appropriate regulatory policy. The Center:

1 Provides a mechanism for interaction among industry practitioners, academic researchers, and regulators.
2 Identifies critical research issues in financial markets.
3 Supports research by faculty members and Ph.D. students at Vanderbilt.
4 Maintains data bases.
5 Funds research projects.
6 Disseminates research about financial markets. ■

VANDERBILT
Owen Graduate School of Management

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Christoph Schenzler, Research Associate and Data Base Manager
Pat Scott, Administrator

FUNDING

The Center is funded by its members and by outside research grants. Funds are used to maintain financial markets data bases and to support the Center's research projects. Members sit on the advisory board, participate in all activities of the Center, receive research reports, and give advice on the activities and research direction of the Center. Research grants for specific projects are sought from various research sponsors including foundations, government agencies, trade organizations, and corporations.

Current Center members are:

* Archipelago
Bear, Stearns & Company, Inc
Chicago Board Options Exchange
CTS Strategic Investments
Eclipse Capital Management, Inc.
* Hirtle Callaghan & Co.
* Interactive Brokers Group
International Securities Exchange, Inc.
* Ramsey Quantitative Systems, Inc.
* Thales Fund Management, LLC

*Indicates a lead member.

Conflicts of Interest in Financial Markets *(continued)*

Jon Hirtle making opening remarks.

analysts and market makers. The third paper considered the effects of the global settlement among the SEC, NYSE, NASD, the New York attorney general and 10 investment banking firms to separate securities analysis and investment banking, to make certain other changes, and to pay a penalty of $1.4 billion. The paper, "Conflicts of interest and stock recommendations: The effect of the global settlement and related regulations," presented by **Ohad Kadan** of Washington University (written with Leonardo Madureira, Rong Wong and Tzachi Zach) finds that analyst recommendations are now more balanced, and the over-optimism by analysts of securities firms managing a recent offering is reduced. **Craig Lewis**, from the Owen School, commented on the three papers. He suggested ways to more clearly distinguish the benign and jaundiced views of fairness opinions. With regard to the Heidle/Li paper, he argued that their results reflect information leakage rather than front-running by market makers. On the global settlement paper, he suggested tests to determine if the reduced optimism of analysts was due to the settlement or to changed market conditions.

After a luncheon break, the conference continued with a panel on Conflicts in Markets, chaired by **Richard Lindsey**, President of Bear Stearns Securities Corporation. Lindsey introduced the discussion by outlining categories of conflicts – conflicts in trading as between a broker and his customer, conflicts in competition as between an exchange and its users, conflicts in governance as between a board and the management, and conflicts in regulation as between an SRO and its members. **Dick DuFour**, Executive VP of the CBOE, discussed how multiple listing of options and increased competition led to payment for order flow as specialists in each option exchange tried to attract business. **Eric Noll**, Head of Strategic Relationships at Susquehanna International Group, noted that conflicts had some benefits. The practice of payment for order flow, for example, helped automate and improve the system for routing orders among exchanges. **Jim Overdahl**, Chief economist of the CFTC, discussed the conflicts inherent in exchange self-regulation. He noted that under CFTC regulation there are 18 core principals but no guide on SRO conflicts. **John Damgard**, President of the Futures Industry Association, spoke in favor of more truly independent directors on the boards of commodity exchanges and for greater competition in the futures industry.

Professor Stoll next introduced **Rick Kilcollin**, of Sanborn Kilcollin, who chaired a session on Conflicts in the IPO Market. The first speaker in this session was **Ron Masulis**, from the Owen School, who presented the results of a paper (written with Xi Li), "Venture capital investments by IPO underwriters: Certification, alignment of interest, or moral hazard?" Masulis and Li compare VC backed IPOs in which the underwriter was and was not a VC investor. They conclude that when the VC is also the underwriter, under-pricing is less and the offering is a greater success, results which they take as evidence of their certification hypothesis, namely that a VC position by the underwriter helps certify the quality of the IPO in the eyes of investors. **Jennifer Marietta-Westberg**, from Michigan State University, in a paper with William Johnson, "Universal banking, asset management, and stock underwriting," examines the conflict of interest when an underwriter is part of a universal bank that also has an asset management division. She finds that holdings of the IPOs by the asset management division are

Rick Cooper chairing hedge fund session.

greater when the firm acts as underwriter. Returns are also greater, however. She concludes that universal banks use their asset management division to improve an offering's success but that this "quid pro quo" policy has no adverse effect on returns in the asset management division. **Cindy Alexander**, Assistant Chief Economist at the SEC, commented on the two papers and made several suggestions.

The last session of Thursday, on Hedge Funds, was chaired by **Rick Cooper**, Chief Investment Officer of CTS Strategic Investments. The sole paper of the session, "Why is Santa so kind to hedge funds? The December return puzzle," (written with Vikas Agarwal and Narayan Naik) was presented by **Naveen Daniel**, of Purdue University. Based on a large sample of hedge funds for the period 1994 – 2002, the authors find a large positive return in December, which they ascribe to hedge funds managing their returns in order to earn incentive fees. Commentator, **Nick Bollen**, from the Owen School, noted that the pattern of returns observed for hedge funds is also observed for

Panelists Dick DuFour, Eric Noll, Jim Overdahl, and John Damgard in friendly debate.

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Conflicts of Interest in Financial Markets *(continued)*

Chester Spatt discussing the regulation of conflicts of interest.

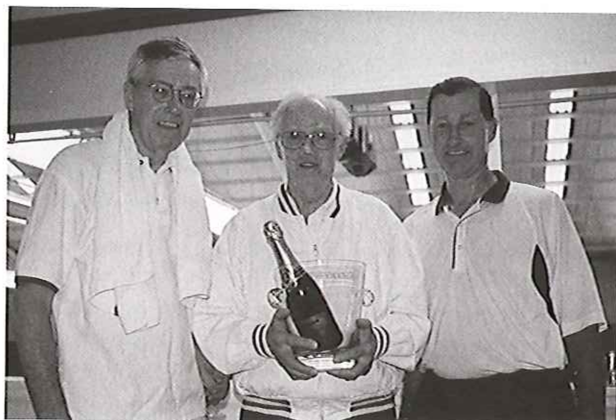
mutual funds. He concluded that additional work would be desirable to determine if the December return of hedge funds was truly an abnormal characteristic of hedge funds or a characteristic of the historical period covered by the data.

The first session on Friday produced a lively discussion on soft dollars. Soft dollars are that portion of the commission used to pay for research either to the executing broker or to a third party. **Bob Thompson**, Professor of Law at the Vanderbilt Law School, chaired the session and introduced the paper presenter, **Bruce Johnsen**, from the George Mason University School of Law. The paper, written with Stephen Horan, is entitled "Can third party payments benefit the principal? The case of soft dollar brokerage." Johnsen defended soft dollar payments as an incentive alignment tool in contrast to its many critics who view it as unjust enrichment for brokers. **David B. Jones**, Senior V.P. of Fidelity Management & Research Corporation, discussed the question of how research should be paid for without being too explicit about Fidelity's approach to this question. **George Sofianos**, Vice President at Goldman Sachs, discussed the issue from the sell side perspective. He noted that brokers were offering a portfolio of trading strategies ranging from highly automated and low cost to highly tailored and high cost. The result is that commissions vary considerably according to the services supplied.

The conference's session on conflicts in mutual funds was chaired by **Jim Klingler**, Senior Vice President of Eclipse Capital Management. While mutual funds have been criticized on a variety of grounds – high expenses, late trading, poor performance – the research presented in this session focused on corporate governance and the efficacy of alternative governance structures. The paper, entitled "Mutual fund governance: What works and what doesn't?" was presented by **Dragon Tang** of Kennesaw State University and was written with Sophie Kong. Tang and Kong examine the effect of three governance mechanisms on fees and other measures of performance. They conclude that unitary boards are associated with better performance, while board independence by itself has no association with performance. **Sean Collins**, Senior Economist at the Investment Company Institute, commented on the paper. He noted that the majority of mutual fund complexes have a unitary board. He also noted that competition among fund complexes works in that investors shop for low fee funds. ■

Dewey Daane Invitational Tennis Tournament

Inclement weather forced the combatants for the contents of the Daane Cup indoors, where **Jim Lodas** prevailed and **Hans Stoll** managed the runner-up position. Dewey Daane oversaw the event and awarded the prizes to the winners. ■



Dewey Daane flanked by runner-up, Hans Stoll, and winner, Jim Lodas.

Finance Student Activities

Owen School Finance Association

The goal of the Finance Association is to enhance Owen students' knowledge of current topics in finance as well as provide a link to the financial community. The Owen Finance Association hosts speakers from the finance industry and presents workshops on interviews and resumes. The Association also coordinates recruiting and informational trips to New York's Wall Street. The Association continues to provide career counseling and internship advice for Owen's first year class. Currently, total membership exceeds one hundred students. For more information, see http://www.owen.vanderbilt.edu/studentclubs/academic/finance. ■

Max Adler Student Investment Fund

The primary purpose of the Max Adler Student Investment Club is the active management of the fund created by the generous gift of Mrs. Mimi Adler in memory of her late husband, the founder of Spencer Gifts. The Fund invests in several sectors including energy, technology, healthcare, retail, and financial services and is one of the largest student-run investment funds in the country. Financial performance is measured against a benchmark of comparable risk and asset size. The Fund constantly strives to balance its primary goals of maintaining solid returns on investment and creating a learning environment for students of all experience levels. For more information, see http://www.owen.vanderbilt.edu/studentclubs/academic/maxadler. ■

Research Workshops

Workshops conducted at the Owen School throughout the year provide a forum for the exchange and testing of new ideas in areas of current research. During 2005-2006 the following researchers presented work on finance topics:

Gurdip Bakshi, *University of Maryland*: "The Distribution of Risk Aversion"

Ola Bengtsson, *University of Chicago*: "A Study of Repeated Relationships between Venture Capitalists and Entrepreneurs"

Zhi Da, *Northwestern University*: "Clientele Change, Liquidity Shock, and the Return on Financially Distressed Stocks"

Mark L. DeFond, *University of Southern California*: "Home Bias, Foreign Mutual Fund Holdings, and the Voluntary Adoption of International Accounting Standards"

Mara Faccio, *Vanderbilt University*: "Sudden Deaths: Taking Stock of Political Connections"

David B. Farber, *Michigan State University*: "Earnings Restatements, Changes in CEO Compensation, and Firm Performance"

Adlai Fisher, *University of British Columbia*: "SEOs, Real Options, and Risk Dynamics: Empirical Evidence"

Raymond Fisman, *Columbia University*: "Limits to Policy Reversal: Privatization in India"

Amar Gande, *Vanderbilt University*: "Are Banks Still Special When There Is a Secondary Market for Loans?"

Yaniv Grinstein, *Cornell University*: "Corporate Governance and Firm Value – the Impact of the 2002 Governance Rules"

Gustavo Grullon, *Rice University*: "Firm Age and Fluctuations in Idiosyncratic Risk"

Robert S. Hansen, *Tulane University*: "Investment Bank Governance: An Intraindustry Study of Corporate Governance"

Stanislav Ivanov and **Stephan Schoess**, *Options Clearing Corporation*: "Risk Management at the Options Clearing Corporation"

E. Han Kim, *University of Michigan*: "How Do Labor Laws and Investor Protection Affect Corporate Restructring"

Adam C. Kolasinski, *MIT*: "Subsidiary Debt, Capital Structure and Internal Capital Markets"

Camelia M. Kuhnen, *Stanford University*: "Social Networks, Corporate Governance and Contracting in the Mutual Fund Industry"

Mark T. Leary, *Duke University*: "Bank Loan Supply, Lender Choice, and Corporate Capital Structure"

Qin Lei, *University of Michigan*: "Cash Distributions and Returns"

Andrew Metrick, *University of Pennsylvania* and *NBER*: "Extreme Governance: An Analysis of Dual-Class Firms in the United States"

Gordon Phillips, *University of Maryland*: "The New Era? Real and Financial Industry Booms and Busts"

Lukasz Pomorski, *University of Chicago*: "Follow the Leader: Peer Effects in Mutual Fund Portfolio Decisions"

Allen M. Poteshman, *University of Illinois at Urbana-Champaign*: "Volatility Information Trading in the Option Market"

Roberto Rigobon, *MIT* and *NBER*: "Wealth Transfers and Portfolio Constraints"

Antoinette Schoar, *MIT*: "Mixing Family with Business: A Study of Thai Business Groups and the Families behind Them"

V.G. Sridharan, *University of Auckland*: "Knowledge Specificity in Management Controls: Science, Case Studies and Analytic Generalization"

Irina Stefanescu, *University of North Carolina*: "Capital Structure Decisions and Corporate Pension Plans"

Peter L. Swan, *University of New South Wales*: "Optimal Portfolio Balancing Under Conventional Preferences and Transaction Costs Explains the Equity Premium Puzzle"

Gregory F. Udell, *Indiana University*: "Are Trade Creditors Relationship Lenders?"

Xiaotong Wang, *Yale University*: "Stock Return Dynamics under Earnings Management"

Missaka Warusawitharana, *University of Pennsylvania*: "Corporate Asset Purchases and Sales: Theory and Evidence"

Ivo Welch, *Brown University* and *NBER*: "A Comprehensive Look at the Empirical Performance of Equity Premium Prediction"

Robert E. Whaley, *Duke University*: "Spurious Dichotomous Variable Regressions in Financial Economics"

Richard Willis, *Tulane University*: "Bold Security Analysts' Earnings Forecasts and Managers' Information Flow"

Lu Zhang, *University of Rochester* and *NBER*: "Anomalies" ■

Guest Speakers

An important aspect of the education of MBA students and the faculty at the Owen School is the opportunity to listen to and question senior executives from financial industries. Outside speakers are sponsored directly by the Financial Markets Research Center, the Owen Lecture Series, or the Finance Association, or are invited as an integral part of courses such as Monetary and Fiscal Policy and Financial Institutions. Guest speakers during the 2005-2006 academic year were:

John C. Bogle, Founder, *The Vanguard Group* and President, *Bogle Financial Markets Research Center*

Roger E. Brinner, Managing Director and Chief Economist, *The Parthenon Group*

G. William Hoagland, Director of Budget and Appropriations, *Office of the Majority Leader, U.S. Senate*

Douglas Holtz-Eakin, Director, *Congressional Budget Office*

Oliver Jakob, Managing Director, *Bear Stearns and Company*

Karen H. Johnson, Director, Division of International Finance, *Board of Governors of the Federal Reserve System*

David M. Jones, Chairman, *Investors' Security Trust Company*

Donald L. Kohn, Member, *Board of Governors of the Federal Reserve System*

Robert W. Kopprasch, Managing Director, The Yield Book, *Citigroup Global Markets, Inc.*

Catherine L. Mann, Senior Fellow, *Institute for International Economics*

Martin Mauro, Senior Economist, *Merrill Lynch*

Frank E. Nothaft, Vice President and Chief Economist, *Freddie Mac*

Mark W. Olson, Member, *Board of Governors of the Federal Reserve System*

Rudolph G. Penner, Senior Fellow, *The Urban Institute*, (former Managing Director, *Barents Group KPMG*, and former Director, *Congressional Budget Office*)

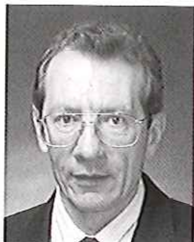
Deborah A. Perelmuter, Senior Vice President, *Federal Reserve Bank of New York*

Glenn J. Satty, Consultant

Richard Spillenkothan, Director, Division of Banking Supervision and Regulation, *Board of Governors of the Federal Reserve System*

Gary H. Stern, President, *Federal Reserve Bank of Minneapolis* ■

Current Activities of Center Faculty



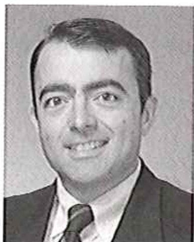
CLIFFORD A. BALL, Professor (finance and statistics); Director, PhD Program; Faculty Director, MS Finance Program. M.Sc., Nottingham 1975, Ph.D. (mathematics), New Mexico 1980.

Research interests include portfolio theory, interest rate dynamics, derivatives, volatility and correlation of asset returns, risk management, and equities. Current research includes: multivariate time series and nonlinear filtering methods applied to stochastic covariance estimation and prediction; value-at-risk methods using quantile auto-regression; financial contagion and stochastic interdependence of asset returns.

Professor Ball teaches statistical and econometric analysis and the intricacies of equities, bonds, options, and futures contracts. His classes also cover empirical testing of financial models; stochastic processes and statistical applications to finance. In Risk Management, Ball covers value-at-risk, credit derivatives, and capital requirements.

In the fall of 2005, the Owen School launched a new one-year Masters Degree in Finance. Professor Ball was heavily involved in the development and organization of this program and currently serves as the director.

Ball serves as associate editor for the *Journal of Empirical Finance* and acts as referee for numerous other finance and economics journals.



NICOLAS P.B. BOLLEN, Associate Professor (finance). M.B.A., Ph.D., Duke 1997.

Research interests include financial markets, derivatives, mutual funds, and hedge funds.

Professor Bollen is currently collaborating with Professor Bill Christie on two projects involving the Pink Sheets market for low-priced stocks. The first studies an experiment designed by Bollen and Christie and conducted by the Pink Sheets market beginning in February 2006. The experiment centers on a new tick size schedule implemented by the Pink Sheets market on a subset of its stocks. The second studies suspicious trading activity in Pink Sheets stocks and estimates subsequent losses incurred by investors.

Professor Bollen presented his paper, "A Screen for Fraudulent Return Smoothing," co-authored with Veronika Krepely, at Sea Island, Georgia in May 2006 at a hedge fund conference organized by the Federal Reserve Bank of Atlanta. The paper studies whether a regulatory agency could use a statistical filter to successfully detect misreported returns in the hedge fund industry.

Professor Bollen presented his paper, "Mutual Fund Attributes and Investor Behavior," at the FMA Annual Meeting in Chicago in October 2005. The paper studies whether investors in socially responsible mutual funds behave differently than investors in other funds. The paper was cited in the *Wall Street Journal* in August 2005, and was accepted for publication by the *Journal of Financial and Quantitative Analysis* in March 2006.

PAUL K. CHANEY, Professor (accounting). M.B.A., Ph.D., Indiana 1983, C.P.A., C.M.A.

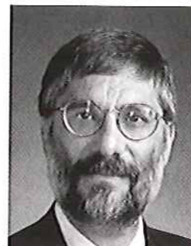
Research interests include auditor reputation, the quality of earnings, earnings management, and audit pricing.

Professor Chaney recently joined the editorial board of *Auditing: A Journal of Practice and Theory*. At the 2006 American Accounting Association's annual meeting in Washington DC, Chaney served as a Senior Scholar. This program implemented by the AAA matches a senior faculty member with a recently graduated accounting professor to help mentor them with their research. Professor Chaney has been asked to discuss a paper at the 2006 *Journal of Accounting, Auditing & Finance*/KPMG Conference to be held in New York in September. The conference is entitled, "Accounting Dynamism: Research on Recent Events, Corporate Governance, Regulation and Disclosure." His remarks will be published in the conference edition of the *Journal of Accounting, Auditing & Finance*.

WILLIAM G. CHRISTIE, The Frances Hampton Currey Professor of Management, Professor of Law. M.B.A., Ph.D., Chicago 1980, 1989.

Research interests include financial markets, market microstructure, and corporate finance.

Professor Christie serves as Editor of *Financial Management*, the flagship journal of the Financial Management Association. He served as a discussant and chairperson at the Financial Intermediation Research Society conference in Shanghai and also served on a panel in support of the Doctoral Symposium at the European meetings of the Financial Management Association, both in June 2006. His paper, "Wall Street Scandals: The Curative Effects of Law and Finance," co-authored with Professor Bob Thompson from the Law School, is forthcoming in the *Washington University Law Review*. He is undertaking research with Professor Nick Bollen on the microstructure of the Pink Sheets market. He serves as the Faculty Director of the Executive MBA program at Owen, and continues in his role as faculty advisor to the Max Adler Student Investment Club. Professor Christie will be teaching in the MBA, Executive MBA and Master of Science in Finance programs in the 2006-2007 academic year.

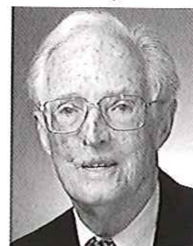


MARK A. COHEN, The Justin Potter Professor of American Competitive Enterprise, Co-Director of the Vanderbilt Center for Environmental Management Studies. M.A., Ph.D., Carnegie-Mellon 1985.

Research interests include law and economics, government regulation, white-collar and corporate crime, and environmental management and sustainability.

Professor Cohen is a member of the Stakeholder Council of the Global Reporting Initiative, Visiting Professor of Criminal Justice Economics at the University of York (UK), and Senior Fellow and Member of the Executive Committee of the Center for the Americas at Vanderbilt. He serves on the editorial boards of *Managerial and Decision Economics* and the *Journal of Forensic Economics*.

In November 2005, Professor Cohen spoke on "Imperfect Competition in Auto Lending: Subjective Markup, Racial Disparity, and Class Action Litigation" at Stanford Law School. In April 2006, he presented a paper, "Prevention, Crime Control or Cash? Public Preferences towards Criminal Justice Spending Priorities," at the University of Maryland. In June 2006, he presented an invited paper on "The Cost of Crime and Justice" at a conference held in Stockholm, Sweden.



J. DEWEY DAANE, The Frank K. Houston Professor of Finance, Emeritus; Senior Advisor, Financial Markets Research Center. M.P.A., D.P.A., Harvard 1949.

Research interests include monetary economics and international finance. During the spring semester, as part of his Seminar in Monetary and Fiscal Policy, Dr. Daane arranged for many of the guest speakers listed elsewhere in this newsletter.

In September of 2005, Professor Daane attended the Bretton Woods Annual Meeting and the Group of Thirty International Banking Seminar in Washington, DC. In October, he attended the Directors College at the Vanderbilt Law School, and in December, he attended the fifth annual Philadelphia Fed Policy Forum on "Fiscal Imbalance: Problems, Solutions, and Implications." In March 2006, he flew to Washington to meet with Chairman Bernanke and other members of the Board of Governors of the Federal Reserve System. In April, he participated in the annual Financial Markets Research Center conference, and in May he attended the 42nd Bank Structure & Competition Conference at the Federal Reserve

Bank of Chicago. In June, he attended the Federal Reserve Bank of Boston's 51st Annual Economic Conference, "Global Imbalances as Giants Evolve," held in Chatham, MA.

Professor Daane is a monthly contributor to the *Wall Street Journal's* economic forecast and this year earned a spot in their annual U.S. economic-forecasting rankings as one of the world's top prognosticators.

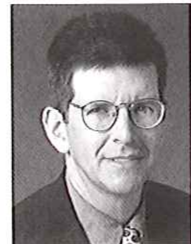
MARA FACCIO, Associate Professor (finance). M.Phil, City University Business School (London) 1997, Ph.D., Università Cattolica (Milan) 1999.

Research interests include corporate finance, international corporate governance, corporate ownership, and corporate monitoring. Professor Faccio teaches courses in International Corporate Finance and Corporate Financial Policy.

Professor Faccio presented her paper, "Sudden deaths: Taking stock of political connections," written with David Parsley, at the Hong Kong University of Science and Technology Finance Symposium, Cass Business School, London School of Economics, Tilburg University, Erasmus University, and the University of Amsterdam. She also presented her paper, "Reluctant Privatization," written with Bernardo Bortolotti, at the Corporate Finance Mini-Conference at University of Waterloo & Wilfrid Laurier University, at the American Finance Association meeting in Boston, the London Business School, Ohio State University, University of Michigan, University of Notre Dame, University of Texas at Austin, and Vanderbilt University. Finally, professor Faccio presented her paper, "Political Connections and Corporate Bailouts," written with Ronald W. Masulis and John J. McConnell, at the American Finance Association and at the American Economic Association meetings in Boston.

Her paper, "Expropriation vs. Proportional Sharing in Corporate Acquisitions," written with David Stolin, was published in the *Journal of Business* in May 2006; "Politically Connected Firms" was published in the *American Economic Review* in March 2006; "Returns to acquirers of listed and unlisted targets," written with John J. McConnell and David Stolin, was published in the *Journal of Financial and Quantitative Analysis* in March 2006; and "Political Connections and Corporate Bailouts," written with Ronald Masulis and John McConnell, is forthcoming in the *Journal of Finance*. She was the recipient of the 2006 Dean's Award for Research Productivity at Vanderbilt University.

Professor Faccio is a Research Affiliate of the Centre for Economic Policy Research and a Research Associate of the European Corporate Governance Institute.



LUKE M. FROEB, The William C. and Margaret M. Oehmig Associate Professor of Entrepreneurship and Free Enterprise. Ph.D., Wisconsin 1983.

Professor Froeb served as Chief Economist at the Federal Trade Commission from 2003-2005, where he managed over a hundred civil servants dedicated to tearing down barriers to competition, and enforcing the consumer protection and antitrust laws of the United States. He failed to accomplish his goal of getting fired from his job, although he came close, judging by the hostility his work provoked. In addition, he made it out of DC without having to buy a second suit.

After teaching management for over a decade, he discovered that there is a lot more to it than what he teaches in class. His mea culpa was sent out to all his former students. Also, after reading hundreds of poorly written documents submitted by merging companies to the FTC, Froeb wrote: "If Merger Is the Answer, What Is the Question?" berating CEO's for poorly documenting the reasons for merger.

For the second year in a row, Professor Froeb was named "Outstanding Professor" of the Vanderbilt Executive MBA program, an honor that he shared with his colleague and mentor, David Scheffman. Froeb's book, *Managerial Economics: A Problem Solving Approach*, will be published by Southwestern in 2007.

KARL E. HACKENBRACK, Associate Professor (accounting); Faculty Director, Master of Accountancy program; Co-Director, Law and Business Program. M.B.A., Shippensburg 1983; Ph.D., Ohio State 1988.

Research interests include audit service production, earnings management, corporate governance, and mandated corporate disclosure. Current research projects include: (1) mandatory disclosure of auditor-sourced non-audit services; (2) audit committee oversight of the financial reporting process when auditor independence is threatened; (3) auditor tenure and earnings management; and (4) auditor selection.

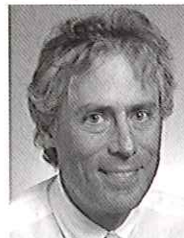
Professor Hackenbrack served as the Director of the 2006 American Accounting Association Audit Doctoral Consortium. He attended the PricewaterhouseCoopers Accounting and Auditing Symposium, PwC University for Faculty, KPMG's Audit Committee Roundtable, and the American Accounting Association Annual and Mid-year meetings where he presented his manuscript, "Mandatory Disclosure of Non-audit Services Is Not Benign," and served as a session chair. Karl serves on the editorial board of *Auditing: A Journal of Practice and Theory* and is a referee for numerous academic journals. He also serves as faculty advisor to the Owen Law and Business Society and teaches in the Law and Business program. He was Owen's faculty representative on the Vanderbilt Directors College Program Committee. The inaugural class of the new one-year Master of Accountancy program will matriculate Owen Fall 2007. Karl is the faculty director of this program, so will be heavily involved in developing and organizing this new program in the coming year.

DEBRA C. JETER, Associate Professor (accounting). M.B.A., Murray State 1981, Ph.D., Vanderbilt 1990, C.P.A.

Research interests include financial accounting and auditing, with specific interests in earnings and audit quality, earnings management, components of earnings, the market for audit services, audit pricing, and audit opinions.

Professor Jeter teaches financial accounting and accounting for mergers and acquisitions at Owen, and she taught in the summer Accelerator program in 2006. She is currently revising her textbook, Advanced Accounting, with coauthor Paul Chaney for its third edition (John Wiley & Sons Inc., publishers).

In the spring of 2006, Jeter presented her research in New Zealand at Auckland University, and she guest-lectured in a research seminar on financial accounting research. In January 2006, she presented her research at the Mid-Year Auditing Conference of the AAA, and also served as a discussant. She served as an associate editor for *Auditing: A Journal of Practice and Theory* in 2005 and 2006. Her paper, "Auditor Specialization: The Influence of Investment Opportunities" was presented at the AFANZ Conference in Wellington, New Zealand, in July 2006 and will be presented at the annual AAA meeting in August 2006 in Washington, DC.



CRAIG M. LEWIS, Professor (finance). M.S., Ph.D., Wisconsin 1986, C.P.A.

Research interests include equity analyst behavior, the security issue process, corporate financial policy, and the time series properties of the stock market volatility. Current research topics include herding by equity analysts, security issue cycles, and the specification of option pricing models when volatility is stochastic. Lewis has published papers on the topics of the behavior of equity research analysts, information content of implied volatilities, volatility forecasting, capital structure, debt maturity structure, the interaction between debt and lease financing, earnings management, and the design and use of convertible debt.

Professor Lewis primarily teaches corporate finance and will be offering courses in company valuation. He currently serves on the dissertation committees of Cong Wang and Shawn Mobbs.

During the past year, Lewis presented "Shareholder Initiated Class Action Lawsuits: Wealth Effects and Industry Feedback" to the Securities and Exchange Commission in Washington D.C. and at the Corporate Governance Conference at Washington University in St. Louis. He also served as a commentator on a panel that addressed the "Economics of Shareholder Litigation" at the Financial Management meetings in Chicago. Lewis attended the Financial Management

continued on page 8

Faculty Activities *(continued)*

Association meetings in Chicago and Stockholm, where he discussed several papers and served as a session chair, and he currently serves as Chairman of the Special Topics Session for this year's Financial Management Association conference to be held in Salt Lake City.

Lewis is an associate editor of the *Journal of Corporate Finance* and serves as referee for numerous academic journals. His paper entitled "Long-Run Investment Decisions, Operating Performance, and Shareholder Value Creation of Firms Adopting Compensation Plans Based on Economic Profits" was recently published in the *Journal of Financial and Quantitative Analysis.*

RONALD W. MASULIS, The Frank K. Houston Professor of Finance. M.B.A., Ph.D., Chicago 1978.

Research interests include corporate finance, corporate governance, executive compensation, investment banking, and international finance. Professor Masulis teaches courses in mergers and acquisitions, law and finance of mergers & acquisitions, venture capital, and corporate finance theory and evidence. Last Fall he taught a Ph.D. course in corporate governance at Emory University.

Last Summer and Fall, Professor Masulis presented "Corporate Governance and Acquirer Returns" at the Accounting and Finance Research Camp, Australian Graduate School of Management in Sydney; the Sloan Conference on International Markets and Corporate Governance at Georgetown Law School; and his co-author and Owen Ph.D., Fei Xie, presented the paper at the JFI/ CRES Conference on Corporate Governance at Washington University. Masulis also presented "Do Venture Investments by Financial Institutions Affect the IPO Underwriting Process?" and discussed a paper on IPOs at the Symposium in Corporate Finance at Hong Kong University of Science & Technology.

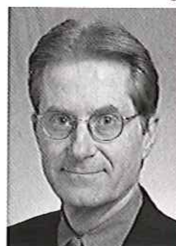
During the past Spring, Masulis presented "Analysis of Acquirer Returns When Targets Are VC-Backed" at the Eastern Finance Association in Philadelphia and "Do Venture Investments by Financial Institutions Affect the IPO Underwriting Process?" at the Financial Markets Research Center Conference on Conflicts of Interest in Financial Markets at Vanderbilt University. At the FIRS Conference on Banking, Corporate Finance & Intermediation in Shanghai, he presented "Corporate Governance and Acquirer Returns," chaired a session on "Going Public," and discussed a paper on venture capital. He was also a Keynote Speaker, at the Journal of Banking and Finance 30th Anniversary Conference, in Beijing.

During the summer of 2006, Masulis presented "Do Venture Investments by Financial Institutions Affect the IPO Underwriting Process?" at the University of Sydney and "Analysis of Acquirer Returns When Targets Are VC-Backed" at the University of New South Wales, also in Sydney. He presented "Seasoned Equity Offerings: Quality of Accounting Information and Expected Flotation Costs" at Auckland University and "Does Venture Capital Reputation Affect Subsequent IPO Performance" at Massey University also in Auckland. He also discussed a paper on Shareholder Activism at the NBER Corporate Governance Workshop in Boston.

His paper, "Political Connections and Corporate Bailouts" (with Mara Faccio and John McConnell), which studies corporate bailout activity around the globe and the degree of association between corporate directors and large shareholders to important government officials, is forthcoming in the *Journal of Finance.* His paper, "Corporate Governance and Acquirer Return" (with Cong Wang and Fie Xie), which studies the effects of various corporate governance mechanisms and especially takeover defenses, on the profitability of acquisitions is also forthcoming in the *Journal of Finance.*

He is currently Academic Director on the Board of the Financial Management Association. He serves as associate editor of the *Journal of Financial and Quantitative Analysis* and was recently appointed associate editor of *Pacific Basin Finance Journal* for a three year term, and he is a referee for numerous other finance journals.

Masulis is chair of the Finance Ph.D. Program at Owen and is currently serving as chairman of the dissertation committees of Gemma Lee, Cong Wang, and Shawn Mobbs.



DAVID C. PARSLEY, Associate Professor (economics). A.M., Indiana 1979, Ph.D., California, Berkeley 1990.

Research interests are in the fields of international finance and macroeconomics. His recent research studies links across countries, both in financial markets and in markets for goods and services. The role that exchange rates play in the market integration process is central to this research.

Professor Parsley recently served as visiting scholar at the International Monetary Fund in Washington D.C., the Bank of Japan in Tokyo, and at the Hong Kong Monetary Authority, where he made presentations on the findings of his recent research on capital flows, and on political connections around the world. He also made presentations at Carnegie-Mellon University, Trinity College-Dublin, and the European Central Bank.

Parsley's paper, "News Spillovers in the Sovereign Debt Market," written with Amar Gande, was published in the *Journal of Financial Economics,* and his paper, "Exchange Rate Pegs and Exchange Rate Exposure in East and South East Asia," written with Helen Popper, is forthcoming in the *Journal of International Money and Finance.* In addition, three papers have recently been accepted for publication: one on measuring capital market integration (joint with Professor Schlag) in the *Journal of Money, Credit, and Banking*; one on accounting for real exchange rate movements in the *Journal of International Money and Finance*; and another using Big Macs to study real exchange rate movements, in the *Economic Journal.*

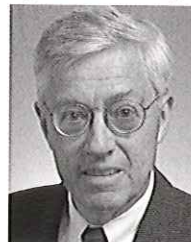
CHARU G. RAHEJA, Assistant Professor (finance). M. Phil, Ph.D., New York University, 2002.

Specific areas of expertise include theoretical and empirical issues in corporate finance, with particular focus on corporate governance, corporate boards of directors, management compensation, venture capital, founders, initial public offerings, and corporate distress.

Professor Raheja has examined how the size and composition of corporate boards affects board monitoring and CEO succession planning, as well as changes in the board structure as a firm moves in its life cycle and when firms under-perform. In addition, her work has explored how a combination of capital structure choices and management compensation can be used to align managers' incentives with other firm claim holders.

In the past year, Professor Raheja was a discussant at the 2005 Financial Management Association meeting and the 2006 Western Finance Association meeting. She was also on the Program Committees of the 2005 Financial Management Association and the 2006 European Finance Association meeting.

Professor Raheja's paper, "The Determinants of Corporate Board Size and Composition: An Empirical Analysis," is forthcoming in the *Journal of Financial Economics.* Her article, "Determinants of Board Size and Composition: A Theory of Corporate Boards," was the winner of the 2005 William F. Sharpe Award for Scholarship in Financial Research for the best paper published in *Journal of Financial and Quantitative Analysis.*



HANS R. STOLL, The Anne Marie and Thomas B. Walker Professor of Finance and Director of the Financial Markets Research Center. M.B.A., Ph.D., Chicago 1966.

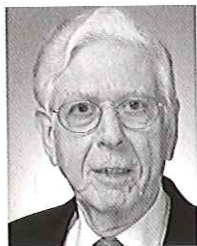
Research interests include stock market microstructure, derivatives, and other aspects of financial markets. Stoll teaches courses in derivatives and international finance.

In February 2006, Stoll lectured on the topic of market microstructure at the Donau University in Krems, Austria. In May of 2006, he participated in a conference on hedge funds organized by the Federal Reserve Bank of Atlanta and held at Sea Island, Georgia. In April, Stoll organized a conference on Conflicts

of interest in Financial Markets, held at Vanderbilt. In July 2006, Stoll participated in a meeting of the Financial Economists Roundtable held in Bretton Woods, New Hampshire.

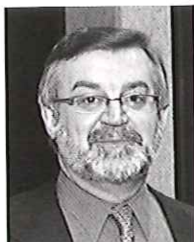
Stoll's paper, "Electronic Trading in Stock Markets," was published in the Winter 2006 issue of the *Journal of Economic Perspectives*. His paper, "Trades Outside the Quotes: Reporting Delay, Trading Option, or Trade Size," written with Christoph Schenzler, appeared in the March 2006 issue of the *Journal of Financial Economics*.

Stoll is a public director of the Options Clearing Corporation. He serves on the editorial boards of five academic finance journals.



H. MARTIN WEINGARTNER, The Brownlee O. Currey Professor of Finance, Emeritus. M.S., Ph.D., Carnegie Mellon 1962.

Before his retirement from Owen in January 1998, Professor Weingartner taught courses in negotiation, case studies in finance, financial decision making, and real estate finance. His research over the years focused on the premise that specialty is the financial strategy of organizations – particularly entrepreneurial ventures. He has written extensively on the uses of mathematical models in financial decision making and approaches to capital budgeting and has consulted for major financial institutions and other organizations. Professor Weingartner is a past president of The Institute of Management Sciences and associate editor of Management Science. He has authored *Mathematical Programming and the Analysis of Capital Budgeting Problems* as well as numerous articles.



ROBERT E. WHALEY, The Valere Blair Potter Professor of Management (finance) and Co-Director of the Financial Markets Research Center. Ph.D., University of Toronto 1978.

Research interests include derivatives, asset pricing, market microstructure, and market volatility.

Much of Professor Whaley's past work focused on investigations of the effects of program trading on stock prices, the expiration day effects of index futures and options, and the valuation of option and futures option contracts and the efficiency of the markets in which they trade. His research has been published in the top academic and practitioner journals, and he is a frequent presenter, chairman, and/or discussant at major conferences and seminars. His forthcoming papers include "The Persistent Presidential Dummy," coauthored with J.G. Powell, J. Shi, and T. Smith, to appear in *Journal of Portfolio Management* and "Ownership, Competition, and Financial Disclosure" with J.L. Birt, C.M. Bilson, and T. Smith, to appear in *Australian Journal of Management*. In January 2006, he discussed a research paper on stock market volatility trading at the American Finance Association meetings in Boston, MA. He has also published seven books, including a newly released textbook entitled *Derivatives: Markets, Valuation, and Risk Management*, John Wiley and Sons, Inc.

Whaley holds a number of editorial positions, serves as a referee for more than fifty journals and granting agencies, and is a former member of the Board of Directors of the Western Finance Association and the American Finance Association. He is currently a member of the International Advisory Board of the University Centre for Financial Engineering at the National University of Singapore.

RICHARD WILLIS, Associate Professor (accounting). B.S., University of South Alabama, 1983, M.A.S., Ohio State University, 1984, M.B.A. Duke University, 1992, Ph.D. University of Chicago, 1998, CPA (State of Illinois), 1996.

Research interests include security analysts and, in particular, their earnings forecasts, stock recommendations, and target prices.

Professor Willis joined the Owen faculty in 2006 from the Freeman School of Business at Tulane University. Prior to Tulane he was an Associate Professor at the Fuqua School of Business at Duke University. His teaching interests are in managerial accounting and financial statement analysis, courses for which he has won several teaching awards. He is on the editorial board of *The Accounting Review* and serves as a referee for numerous accounting and finance journals. ■

Faculty Research Papers

Current working papers, completed or revised since January 1, 2005, are listed below. Many of the papers are available on the Center's web site. www.owen.vanderbilt.edu/fmrc/

"Mutual Fund Attributes and Investor Behavior," by **Nicolas P.B. Bollen** (forthcoming in *Journal of Financial and Quantitative Analysis*)

I study the dynamics of investor cash flows in socially responsible mutual funds. Consistent with anecdotal evidence of loyalty, the monthly volatility of investor cash flows is lower in socially responsible funds than conventional funds. I find strong evidence that cash flows into socially responsible funds are more sensitive to lagged positive returns than cash flows into conventional funds, and weaker evidence that cash outflows from socially responsible funds are less sensitive to lagged negative returns. These results indicate that investors derive utility from the socially responsible attribute, especially when returns are positive.

"Tick Size and Institutional Trading Costs: Evidence from Mutual Funds," by **Nicolas P.B. Bollen** and Jeffrey A. Busse (forthcoming in *Journal of Financial and Quantitative Analysis*)

This paper measures changes in mutual fund trading costs following two reductions in the tick size of U.S. equity markets: the switch from eighths to sixteenths and the subsequent switch to decimals. We estimate trading costs by comparing a mutual fund's daily returns to the daily returns of a synthetic benchmark portfolio that matches the fund's holdings but has zero trading costs by construction. We find that the average change in trading costs of actively managed funds was positive following both reductions in tick size, with a larger and statistically significant increase following decimalization. In contrast, index fund trading costs were unaffected.

"Wall Street Scandals: The Curative Effects of Law and Finance," by **William Christie** and Robert Thompson (forthcoming in *Washington University Law Review*)

This paper studies three scandals that embroiled U.S. financial markets during the past decade, including the Nasdaq market-maker antitrust case, the abuse of specialist power on the NYSE, and the mutual fund scandal. We attempt to attribute the resolution of these situations to the curative effects of markets versus regulation. We argue that the intervention of the legal system through regulation and/or litigation is often necessary to help resolve the misalignment of incentives needed for markets to accomplish their goal of maximizing value. The paper suggests that there exists an important synergy between financial markets and the bar that is often overlooked.

"Prevention, Crime Control or Cash? Public Preferences towards Criminal Justice Spending Priorities," by **Mark A. Cohen**, Roland T. Rust, and Sara Steen (forthcoming in *Justice Quarterly*)

We propose and test a new survey methodology to assess the public's criminal justice spending priorities. Respondents are explicitly forced to trade-off one type of crime prevention or control policy for another and to consider the fact that any money spent on crime prevention or control policies is money they could otherwise have in their pockets. Thus,

respondents are asked to allocate a fixed budget into five categories - more prisons, police, youth prevention programs, drug treatment for nonviolent offenders, and a tax rebate to citizens. In a nationally representative sample, we found overwhelming public support for more money being devoted to youth prevention, drug treatment for nonviolent offenders, and more police. However, the median respondent would not allocate any new money to building more prisons and would not avail him or herself of a tax rebate if the money were spent on youth prevention, drug treatment and police. At the margin, we estimate the public would receive $3.07 in perceived value by spending $1.00 of their tax dollars on youth prevention; $1.86 in value for every dollar spent on drug treatment; and $1.76 in value for a dollar spent on police. However, the public would clearly not spend more on prisons at the margin, deriving only 71 cents in value for every dollar spent.

"Political Connections and Corporate Bailouts," by **Mara Faccio, Ronald W. Masulis**, and John J. McConnell (forthcoming in *Journal of Finance*)

We analyze the likelihood of government bailouts of a sample of 450 politically-connected (but publicly-traded) firms from 35 countries over the period 1997 through 2002. We find that politically-connected firms are significantly more likely to be bailed out than similar non-connected firms. Additionally, politically-connected firms are disproportionately more likely to be bailed out when the IMF or World Bank provide financial assistance to the firm's home country. Further, among firms that are bailed out, those that are politically-connected exhibit significantly worse financial performance than their non-connected peers at the time of the bailout and over the following two years. This evidence suggests that, at least in some countries, political connections influence the allocation of capital through the mechanism of financial assistance when connected companies confront economic distress. It may also explain prior findings that politically-connected firms borrow more than their non-connected peers.

"Corporate Governance and Acquirer Returns," by **Ronald W. Masulis**, Cong Wang, and Fei Xie (forthcoming in *Journal of Finance*)

We examine whether a firm's anti-takeover provisions affect the profitability of its acquisitions. We find that acquirers with more anti-takeover provisions experience significantly lower announcement-period abnormal stock returns than acquirers with fewer anti-takeover provisions. This supports the hypothesis that managers at firms protected by more anti-takeover provisions are less subject to discipline from the market for corporate control and thus, are more likely to indulge in empire-building acquisitions that destroy shareholder value. Our evidence provides a partial explanation for why anti-takeover provision indices developed by Gompers, Ishii, and Metrick (2003) and others are negatively correlated with shareholder value. We also find that acquiring firms operating in more competitive industries experience higher abnormal announcement returns, as do acquirers that separate the positions of CEO and chairman of the board.

"Accounting for Real Exchange Rate Changes in East Asia," by **David C. Parsley** (forthcoming in *Journal of International Money and Finance*)

This study measures the proportion of real exchange rate movements that can be accounted for by movements in the relative price of non-traded goods using the framework employed by Engel (1999). Among the twenty-one bilateral Asian-Pacific real exchange rates considered here, that proportion is found to be trivially small for all possible horizons that the data allow – from one month up to 25 years. This pattern appears unaffected by the cross-sectional variation in either income level, or the degree of openness present among these Pacific-Rim economies. The only qualifications occur when considering fixed (or semi-fixed) exchange rate regimes.

"Exchange Rate Pegs and Foreign Exchange Exposure in East and Southeast Asia," by **David C. Parsley** and Helen Popper (forthcoming in *Journal of International Money and Finance*)

This paper shows that many Asia-Pacific firms are significantly exposed to foreign exchange risk. Their exposure appears to be much more widespread than is typical for the large, western industrialized economies. The paper also shows that exchange rate pegs appear to do little to alleviate this widespread exposure against currencies other than the peg. The firms studied here are most exposed to fluctuations in the U.S. dollar; the yen and euro are important in a few countries. The extent of their exchange rate exposure has varied but not diminished over the last decade. The most widespread exchange rate sensitivity (not just the most exchange rate fluctuation) occurred during the Asian Crisis period; this is evident even after accounting for the local macroeconomic conditions that affect aggregate local returns.

"Measuring Financial Integration via Idiosyncratic Risk: What Effects Are We Really Picking Up?" by **David C. Parsley** and Christian Schlag (forthcoming in *Journal of Money, Credit, and Banking*)

We study the method proposed by Flood and Rose (FR, 2004, 2005) for checking for financial integration by estimating the risk-free rate using the idiosyncratic component of individual stock returns. Performing simulations with data with a known return generation process, we find that the FR methodology produces poor estimates of the risk-free rate, and hence the FR method fails to accept integration when true. We then show analytically that the FR method actually provides an estimate of the market return, and conclude the FR methodology would also falsely accept integration as long as the market returns in the two markets do not differ widely.

"A Prism into the PPP Puzzles: The Micro-foundations of Big Mac Real Exchange Rates," by **David C. Parsley** and Shang-Jin Wei (forthcoming in *The Economic Journal*)

We match Big Mac prices with prices of its ingredients as a unique prism to study real exchange rates (RERs). This approach has several advantages. First, the *levels of the* Big Mac RER *can be measured* meaningfully. Second, as the exact composition of a Big Mac is known, the contributions of its tradable and non-tradable components can be estimated relatively precisely. Third, the dynamics of the RER can be studied in a setting free of several biases inherent in CPI-based RERs. Finally, a large cross-country dimension allows us to overturn the Engel result on what drives RERs.

"The Determinants of Corporate Board Size and Composition: An Empirical Analysis," by Audra L. Boone, Laura Casares Field, Jonathan M. Karpoff, and **Charu G. Raheja** (forthcoming in *Journal of Financial Economics*)

Many theories have been proposed to explain how corporate boards are structured. This paper groups these theories into three hypotheses and tests them empirically. We utilize a unique panel dataset that tracks corporate board development from the time of a firm's IPO through 10 years later. The data indicate that: (i) board size and independence increase as firms grow in size and diversify over time; (ii) board size – but not board independence – reflects a trade-off between the firm-specific benefits of monitoring and the costs of such monitoring; and (iii) board independence is negatively related to the manager's influence and positively related to constraints on such influence. These results are consistent with the view that economic considerations – in particular, the specific nature of the firm's competitive environment and managerial team – help explain cross-sectional variation in corporate board size and composition. Nonetheless, much of the variation in board structures remains unexplained even when all three hypotheses are combined, suggesting that idiosyncratic factors affect many individual boards' characteristics.

"Do Underwriters or Venture Capitalists Restrain Earnings Management by IPO Issuers?" by Gemma Lee and **Ronald Masulis** (September 3, 2006)

This study examines evidence of earnings management by companies going public, and investigates whether financial intermediaries participating in the IPO process appear to play a significant role in restraining earnings management activity. More specifically, we examine whether earnings management around an IPO is negatively related to the reputation of underwriters and venture capital (VC) investors. We find strong evidence that more reputable investment banks are associated with significantly lower earnings management, which is consistent with them implicitly certifying the quality of issuers' financial reporting. This conclusion is invariant to controlling for potential endogeneity of underwriter reputation. After controlling for the potential endogeniety of VC-backing, neither VC investment nor reputation significantly restrains apparent earnings management by IPO issuers. This result holds both for more reputable and less reputable VCs.

"Hedge Fund Risk Dynamics: Implications for Performance Appraisal," by **Nicolas P.B. Bollen** and **Robert E. Whaley** (September 2006)

Accurate appraisal of hedge fund performance must recognize the freedom with which managers shift asset classes, strategies, and leverage in response to changing market conditions and arbitrage opportunities. The standard measure of performance is the abnormal return defined by a hedge fund's exposure to risk factors. If exposures are assumed constant when in fact they vary through time, then estimated abnormal returns may be incorrect. We employ an optimal changepoint regression that allows risk exposures to shift, and illustrate the impact on performance appraisal using a sample of live and dead funds during the period January 1994 through December 2004.

"Analysts and Audit Quality: Analysts' Forecasts During the Meltdown of Andersen," by Steven F. Cahan, **Paul K. Chaney**, **Debra C. Jeter**, and Wei Zhang (September 2006)

The collapse of Enron, and the admission by its auditor, Arthur Andersen, of having shredded related documents, had significant consequences for the financial community. The long-held belief that auditors were inhibited from ignoring or overlooking serious accounting problems because of the possible loss of their reputation capital was called into dispute. In this study, we examine how the Andersen-Enron affair affected the activity and forecasts of financial analysts. We find evidence of an increase in revision frequency for the Andersen clients. Our results are strongest for annual forecast revisions and for quarterly forecast revisions around October 16, 2001, which is when Enron first announced a $1.01 billion pre-tax charge for accounting irregularities. While we find evidence of a change in revision frequency, we find little evidence of changes in either forecast errors or forecast dispersion. Our interpretation is that while the Andersen-Enron events led analysts to make more frequent revisions, they were able to incorporate the new information about Andersen's audit quality in a meaningful way so that their forecast accuracy and dispersion did not change. Further, we find some evidence that the revisions were informative, particularly around October 16, suggesting that Enron's massive write-down for accounting irregularities ($1.01 billion pre-tax) led to immediate concerns about Andersen's audit quality.

"Information, Selective Disclosure, and Analyst Behavior," by Anchada Charoenrook and **Craig M. Lewis** (September 2006)

This paper examines whether the prohibition of selective disclosures to equity research analysts mandated by Regulation FD alters the amount of information and the manner in which it is revealed to the market. We find that, following Reg FD, more information is communicated through public disclosure channels. We also document that firms use earnings guidance as a substitute for selective disclosure rather than increasing their reliance on press releases. We conclude that Reg FD has been successful in encouraging firms to disclose information through public information channels. Moreover, we demonstrate the importance of controlling for all potential disclosure channels. Prior studies that only observe one channel in isolation, such as company-issued earnings guidance, are likely to draw misleading conclusions about the overall impact of Reg FD.

"Acquirer Returns When Targets Are Venture Capital Backed," by **Ronald Masulis** and Rajarishi Nahata (August 31, 2006)

We study the profitability of acquisitions of privately held firms and the relationship to venture capital (VC) backing. Five competing hypotheses for explaining acquirer announcement returns and target purchase price-to-book value ratios are evaluated. Acquisitions of VC-backed private targets are compared to a matched sample of non VC backed private targets using propensity score matching. Acquisitions of VC-backed targets lead to significantly higher acquirer announcement returns, which are substantially larger than those in equity financed acquisitions. We find evidence that higher acquirer returns are in part caused by liquidity pressures on VC funds nearing their termination dates, which increase VC incentives to exit from their target investments. We also observe that acquisitions of targets backed by VCs with acquirer financial relationships lead to significantly higher acquirer announcement returns and lower target purchase price-to-book value ratios. This evidence is consistent with a VC moral hazard problem where VC incentives to obtain higher acquisition prices for target firms are compromised because of their dual financial relationships. Finally, acquisitions of firms backed by corporate venture capitalists (CVC) lead to higher acquirer stock returns. We conclude that CVC pursuit of strategic objectives and VC inexperience lead to higher wealth gains for acquiring firms. In summary, we document a number of causes for higher acquirer announcement returns when targets are VC-backed.

"Does Venture Capital Reputation Affect Subsequent IPO Performance?" by C.N.V. Krishnan, **Ronald W. Masulis**, and Ajai K. Singh (August 29, 2006)

A venture capitalist's (VC) reputation is based on its expertise and especially on its past performance. We investigate the relation between measures of VC reputation and VC-backed IPO issuer's long-term performance. A VC's reputation is, in large part, determined by successful exits from its past venture investments, where IPOs are generally the most profitable. We consider several alternative VC reputation measures including market share of VC-backed IPOs, VC age, proportion of a VC's portfolio companies that successfully go public and the proportion that go public or are acquired, VC capital under management, and total investment in all portfolio companies. We examine well-known measures of long-run performance including the match-adjusted rate of return on assets, market to book ratio, long-run survival (frequency of remaining listed on a major exchange) and long-run abnormal stock returns. We find that of all the VC reputation measures examined, past market share of the VC-backed IPO market is consistently a significant predictor of the long-run performance of firms a VC subsequently brings to the IPO market.

"Regulatory Commitment to Auditing and Pay-Performance Sensitivity," by Hui Chen, **Debra Jeter**, and Ya-Wen Yang (August 27, 2006)

The purpose of this paper is to investigate the impact on pay-performance sensitivity of a commitment by regulatory bodies to monitor the auditing of managers' financial reporting. We approach our investigation first by modeling the effect of an imposed mandatory audit of the auditor. We then test our model in an empirical setting by comparing managers' pay-performance sensitivity before and after the passage of the Sarbanes-Oxley (SOX) Act of 2002. Our model reveals that, in a laissez-faire economy with random audits and inspections, the pay-performance sensitivity remains the same as that of the classic moral hazard problem. However, when required audits or inspections are introduced, the change in pay-performance sensitivity is shown to vary depending on the state of nature. We draw on the predictions of the model to investigate in an empirical setting the impact on managerial incentive schemes of the regulatory commitment initiated by SOX. Using an economic indicator consistent with a generally "good" state of nature in the post-SOX era, we conclude that pay-performance sensitivity should, and does, increase.

"A Classification of Firms Based on Earnings Attributes," by **Paul K. Chaney**, Bruce Cooil, and **Debra C. Jeter** (August 24, 2006)

Using a two-level latent class cluster analysis, we present evidence of the existence of six clusters or categories of firms, across forty-four industries, with respect to the quality of reported earnings. Francis, LaFond, Olsson and Schipper (2004) examine the relation between the cost of capital and seven earnings attributes, including four accounting-based attributes and three market-based attributes. We draw upon their analysis to probe more deeply into the attributes that best capture earnings quality and to link that construct to audit-related variables. We perform a latent class analysis first to identify those attributes with the greatest explanatory power in classifying firms into categories of varying levels of earnings quality, and then to find the best possible model based on those attributes that is also supported by the residual diagnostics.

In the second stage of our paper, we relate our quality clusters to several audit-related variables. For example, we present evidence that those categories that have the best overall quality of earnings attributes use Big 5 (4) auditors with the greatest frequency, consistent with arguments that have been widely accepted in the past (i.e., that Big 5 auditors provide superior quality audits or that clients with higher quality earnings tend to hire Big 5 auditors), but which have come into dispute in the face of recent accounting scandals. We also find that the highest quality clusters are generally associated with longer auditor tenure, inconsistent with the arguments that auditors become complacent or "cozy" with management over time.

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"CEOs vs. Directors: Who Calls the shots?" by John C. Easterwood and **Charu G. Raheja** (August 24, 2006)

We study the evolution of the board in response to a sudden negative performance shock and highlight the importance of the balance of power between the board and the CEO in determining the changes that occur in response to underperformance. We find that board size increases following poor performance, and boards become more independent. Overall, there is a high turnover of directors of underperforming firms and director ownership decreases. After firms underperform, the proportion of directors that work as consultants and directors who are executives in other firms increase, while the proportion of directors in the financial industry, the proportion of directors that hold multiple board seats, and directors representing large shareholders, decrease. CEO influence is an important factor on the observed board changes. Influential CEOs are associated with lower increases in board independence and less turnover of directors. Changes in the percentage of directors who are executives in other firms and directors who are representatives of large shareholders are also negatively related to CEO influence. Together, these results suggest that influential CEOs are able to maintain their influence in firms following an underperformance event.

The CEO influence and the board changes associated with influential CEOs are not related to subsequent changes in firm performance and the likelihood that firms will experience a bankruptcy related event. These results indicate that boards adjust to each firm's specific managerial and firm requirements.

"Post-Merger Product Repositioning," by Amit Gandhi, **Luke Froeb**, Steven Tschantz, and Gregory J. Werden (August 16, 2006)

This paper analyzes the effects of mergers between firms competing by simultaneously choosing price and location. Products combined by a merger are repositioned away from each other to reduce cannibalization, and non-merging substitutes are, in response, repositioned between the merged products. This repositioning greatly reduces the merged firm's incentive to raise prices and thus substantially mitigates the anticompetitive effects of the merger. Computation of, and selection among, equilibria is done with a novel technique known as the *stochastic response dynamic*, which does not require the computation of first order conditions.

"Information Disclosure as Environmental Regulation: A Theoretical Analysis," by **Mark A. Cohen** and V. Santhakumar (August 2006)

Governments around the world are beginning to embrace a new form of environmental regulation - mandatory disclosure of information. While information disclosure programs appear to have an impact on subsequent firm behavior - often resulting in lower levels of pollution - little is known about the costs and benefits of these programs and whether or not they enhance social welfare. This paper presents a simple bargaining model where mandatory information disclosure is used to overcome a lack of information on the part of the public. We characterize the conditions under which information disclosure will lead to a reduction in emissions, and ultimately, the conditions under which it will enhance social welfare. Several extensions of the model are briefly explored, including the effect of two sources of pollution - only one of which is subject to information disclosure.

"Enabling Auditor-Sourced Management Advisory Services," by George Drymiotes and **Karl Hackenbrack** (August 2006)

We study how companies manage the risk of compromised auditor independence when the incumbent auditor provides management advisory services. The setting for this study is circa 1980, a time period when both the SEC mandated disclosure of auditor-sourced management advisory services and companies were allowed to choose whether to assign outside directors to the audit committee. We find that companies dealt with the risk of compromised auditor independence by assigning outside directors to the audit committee. Our results help explain why 25 years of research on the effects of auditor-sourced management advisory services rarely report any detrimental effects, and provide evidence the independent audit committees we see today are not simply the result of recent stock exchange and SEC rules.

"Understanding Real Exchange Rate Movements with Trade in Intermediate Products," by **David C. Parsley** and Helen Popper (August 2006)

This paper reexamines decompositions of the real exchange rate that apportion its movements into a part that reflects international deviations from the law of one price and a part that reflects the relative prices of traded and nontraded goods within countries. Using Japanese and U.S. data, we first show that in such decompositions the traded/nontraded distinction is irrelevant at the consumer level. Next, motivated by a model of trade in intermediate products, we use implied import weights and find that relative traded/nontraded price changes, appropriately defined, can account for much of the real exchange rate's variation. These findings contrast sharply with earlier results that attribute real exchange rate movements to deviations in the law of one price; and, they provide fresh support for traditional real exchange rate models which rely on the distinction between the open and closed sectors of the economy.

"When Security Analysts Talk, Who Listens?" by Michael B. Mikhail, Beverly R. Walther, and **Richard H. Willis** (August 2006)

Regulators' interest in analyst reports stems from the belief that small investors are unaware of the conflicts sell-side analysts face and may, as a consequence, be misled into making suboptimal investment decisions. We examine who trades on security analyst stock recommendations by extending prior research to focus on investor-specific responses to revisions. We find that both large and small traders react to analyst reports; however, large investors appear to trade more than small traders in response to the amount of information contained in the analyst's recommendation and earnings forecast revision (proxied by the magnitudes of the recommendation change and the earnings forecast revision, respectively). We also find that small investors do not fully account for the effects of analysts' incentives on the credibility of analyst reports, as captured by the type of recommendation (i.e., upgrade versus downgrade or buy versus sell). In particular, small investors not only trade more than large investors following upgrade and buy recommendations, but also trade more following upgrade and buy recommendations than they do following downgrade and hold/sell recommendations. Furthermore, we observe that, on average, small traders are net purchasers following recommendation revisions regardless of the type of the recommendation; large traders tend to be net sellers following downgrades and sells. Consequently, following both good and bad news recommendation revisions, large traders generate statistically positive returns from their trading, while small traders generate statistically negative returns from their trading. These findings are consistent with large investors being more sophisticated processors of information, and provide direct support for regulators' concerns that analysts may more easily mislead small investors.

"Political Regimes, Business Cycles, Seasonalities, and Returns," by John G. Powell, Jing Shi, Tom Smith, and **Robert E. Whaley** (July 31, 2006)

This paper provides a method for testing for regime differences when regimes are long-lasting. Standard testing procedures are generally inappropriate because regime persistence causes a spurious regression problem—a problem that has led to incorrect inference in a broad range of studies involving regimes representing political, business, and seasonal cycles. The paper outlines analytically how standard estimators can be adjusted for regime dummy variable persistence. While the adjustments are helpful asymptotically, spurious regression remains a problem in small samples and must be addressed using simulation or bootstrap procedures. We provide a simulation procedure for testing hypotheses in situations where an independent variable in a time-series regression is a persistent regime dummy variable. We also develop a procedure for testing hypotheses in situations where the dependent variable has similar properties.

"Seasoned Equity Offerings: Quality of Accounting Information and Expected Flotation Costs," by Gemma Lee and **Ronald W. Masulis** (July 30, 2006)

As accounting information becomes less reliable, it becomes more difficult for equity investors to evaluate a firm's true performance. This increased asymmetry information between issuers and outside investors is likely to heighten investor concerns following major firm decisions, especially when a firm plans to sell new equity securities. Thus, poor accounting information by increasing investor uncertainty also lowers their demand for a firm's equity, thereby raising both the expected cost and risk associated with underwriting a seasoned equity offering (SEO). To measure quality of accounting earnings, we use an approach developed by Dechow and Dechev (2002) that uses the estimation error from a standard earnings accruals model to assess reliability. Using a large sample of SEOs, we find that poor accounting quality is associated with larger expected flotation costs measured by (1) larger underwriting fees, (2) a larger negative SEO announcement effect, and (3) a higher probability of SEO withdrawals. These results are robust to adjustments for a potential sample selection bias.

"Regulation Fair Disclosure and the Cost of Adverse Selection," by Baljit K. Sidhu, Tom Smith, and **Robert E. Whaley** (July 17, 2006)

Regulation FD, imposed by the Securities and Exchange Commission in October 2000, was designed to create a level playing field by prohibiting disclosure of material private information to selective recipients such as financial analysts. Exactly what informational advantage these recipients gain is unclear. If multiple "insiders" receive identical information, the information is immediately incorporated in price and the expected profit of each insider is zero. If, on the other hand, Regulation FD has curtailed the flow of information from firms to the investment public, private information becomes long-lived and, hence, more valuable. And, with increased risk in providing immediacy to potentially informed traders, market makers will demand increased compensation by widening the adverse selection component of the bid/ask spread. To test this proposition, we identify the cost components of the bid/ask spread for a sample of NASDAQ stocks in the period just before and just after the implementation of Regulation FD. The evidence indicates that, after controlling for other factors affecting the market maker's spread, Regulation FD has led to an increase in adverse selection costs.

"Do Venture Investments by Financial Institutions Affect the IPO Underwriting Process?" by Xi Li and **Ronald W. Masulis** (July 4, 2006)

We study debt and equity venture investments in IPO issuers by investment banks, commercial banks and insurance companies and examine their marginal effects on underpricing, offer price revisions and issue long run performance. We also assess whether underwriters with venture investments in issuers have incremental effects. Our major findings are that debt as well as equity investments by major classes of financial institutions (FIs) all have significant positive certification effects on the IPO underwriting process and these individual effects are stronger when multiple classes of FIs are venture investors. When an FI venture investor is also an IPO underwriter, there is an added certification effect. This evidence is consistent with separate certification effects by major classes of FIs that are positive functions of the size of issuer venture investments. These results are robust to adjustments for endogeneity.

"Reluctant Privatization," by Bernardo Bortolotti and **Mara Faccio** (July 2006)

We study the evolution of the control structure for a large sample of privatized firms in OECD countries and find evidence broadly consistent with the concept of "reluctant privatization", defined as the transfer of ownership rights in State-owned enterprises without a corresponding transfer of control rights. Indeed, as of 2000, governments are the largest shareholder or use special control powers to retain voting control of 62.4% of privatized firms. However, contrary to accepted theory, greater government control over privatized firms does not negatively affect market valuation. In fact, government stakes are positively and significantly related to peer-adjusted market-to-book ratios. Results are not driven by the choice of the benchmark, reverse causality or by agency costs associated with private ownership. Rather, it appears that the relationship documented reflects more frequent financial aid (bailouts) accruing to privatized firms that remain under government control.

"The Characteristics of Politically Connected Firms," by **Mara Faccio** (July 2006)

Examination of firms in 47 countries shows that companies connected with officials have higher leverage, lower taxation, and higher market shares, but they underperform non-connected companies on an accounting basis. Differences between connected and unconnected firms become particularly pronounced when political links are stronger, and when connected firms operate in countries with higher levels of corruption.

"Corporate Response to Distress: Evidence from the Asian Financial Crisis," by **Mara Faccio** and Rajdeep Sengupta (July 2006)

This paper provides a comprehensive examination of the ways in which companies respond to a country-wide crisis through the restructuring of their assets (through asset sales, mergers or liquidations) or liabilities. We find the restructuring of liabilities to be the most common type of response. On the other hand, we argue that firms may be reluctant to engage in major asset sales due to substantial price discounts that need to be applied to these transactions during the crisis. In fact, we document that transaction multiples dropped by 40% during the crisis, compared to a pre-crisis period. We contrast financial and corporate governance considerations and find strong support for the notion that, during a crisis, financial constraints have a large impact on the restructuring choice. However, we find corporate governance (e.g., control) considerations to matter only marginally both in statistical and economic terms.

"The Persistent Presidential Dummy," by John G. Powell, Jing Shi, Tom Smith, and **Robert E. Whaley** (June 15, 2006)

Despite the general presumption that dichotomous explanatory variables are well-behaved in time-series regression analysis, dummy variables can be highly persistent, and, if they are, spurious regression results can arise. This paper uses a simulation procedure to deal with persistent dichotomous explanatory variables and assesses the extent to which the spurious regression problem combined with data mining can affect inference in a dummy variable regression model. The simulations indicate that the coefficient estimates obtained in a recent study of presidential regime stock market return differences are less than would be expected by chance. The conclusion that presidential regime differences are insignificant is further reinforced by extending the data back in time to include all Republican/Democratic administrations.

"Security Offerings," by B. Espen Eckbo, **Ronald W. Masulis**, and Oyvind Norli (June 2006)

This essay surveys the extant literature and adds to the empirical evidence on issuance activity, flotation costs, and valuation effects of security offerings. We focus primarily on public offerings of equity for cash, although we also review and present new evidence on debt offerings and private placements. The essay has four major parts: (1) We review aggregate issue activity in exchange listed securities from 1980 through 2004. Following the IPO, only about one-half of the publicly traded firms undertake a public security offering of any type, and only about one-quarter undertake a SEO. Thus, SEOs are relatively rare, which is consistent with adverse selection costs being an important consideration when raising cash externally. (2) We review the evidence on direct issue costs across security types and flotation methods, including the more recent SEO underpricing phenomenon. A large number of studies provide evidence on the determinants of underwriter compensation, and confirm the importance of variables capturing information asymmetries and underwriter competition. (3) We survey and interpret the valuation effects of security issue announcements. In the period since the Eckbo and Masulis (1995) survey, many studies examining announcement-period stock returns have focused on the effects of flotation method choice and foreign offerings. The well-known negative average announcement effect observed for U.S. SEOs appears to be a somewhat U.S.-specific phenomenon. (4) We review and extend evidence on the performance of issuing firms in the five year post-issue period. The literature proposes either a risk based-explanation or a behavioral explanation for the phenomenon of low average realized returns following IPOs and SEOs. Standard factor model regressions fail to reject the null that the low average returns are commensurate with issuers' risk exposures. Recent theoretical developments suggest that lower risk levels following equity issues may be linked to issuers' investment activity, a promising direction for future research.

"Auditor Specialization: The Influence of Investment Opportunities," by Steven F. Cahan, Jayne M. Godfrey, Jane Hamilton, and **Debra C. Jeter** (May 2006)

A report issued by the U.S. General Accounting Office (GAO) in 2003 identified industry specialization as a key driver of consolidation among audit firms and highlighted the extreme levels of auditor concentration in some industries. Like the GAO, we view auditor concentration as a measure of industry specialization, and we examine one feasible explanation for why auditor specialization differs across industries. We posit that the investment opportunity set (IOS) plays an important role in determining whether an industry is an attractive target for auditor specialization and in creating barriers to auditor entry. We argue that when industry-specific IOS is high, auditors will make costly industry-specific investments that allow them to offer a differentiated product and to create entry barriers for other audit firms. However, when a large component of IOS is specific to individual firms within an industry so that IOS is highly variable within the industry, the auditors' knowledge requirements are highly specific to those firms and it is more difficult to transfer knowledge and spread costs across clients in that industry. Using two different measures of IOS and three alternative industry classification schemes, we present evidence that auditor specialization is increasing in industry IOS levels and decreasing in within-industry IOS variability.

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"Strategic Investing and Financial Contracting in Start-ups: Evidence from Corporate Venture Capital," by **Ronald W. Masulis** and Rajarishi Nahata (April 5, 2006)

This paper provides an empirical analysis of venture investments by strategically inclined corporate venture capitalists (CVCs). A strategic investor's quest for synergies can be economically damaging to the start-up because the wealth gains for the strategic investor are not always aligned with the economic benefit to the start-up. Consistent with this argument, we find that the start-ups are more likely to involve complementary firms as venture investors. Second, the founders/entrepreneurs of the start-ups are likely to limit CVC influence by awarding them lower board power if the CVC parent corporations are potential competitors. Furthermore, we find that insiders in start-ups have greater board power when faced with competitive strategic investments. Third, we find that the lead CVCs have lower board representation relative to lead traditional venture capitalists and this is consistent with entrepreneurs' wanting to limit the influence of these CVCs, particularly at the earliest stages of the start-ups' lifecycle. Finally, insiders in start-ups are able to extract higher valuations from CVC investors when the CVC parents are potential competitors of the start-up firms, which is consistent with the predictions of standard bargaining models.

"Ownership, Competition, and Financial Disclosure," by Jacqueline L Birt, Chris M. Bilson, Tom Smith, and **Robert E. Whaley** (March 9, 2006)

A firm's incentive to disclose has been linked empirically to a range of variables including information asymmetry, agency costs, political costs, and proprietary costs. While the intuition underlying each of the variables seems plausible, Verrecchia (2001) argues that disclosure models can be characterized as an eclectic mingling of highly idiosyncratic economic-based models and challenges researchers to take the first steps to unification. First, we investigate the role of ownership and competition variables in explaining voluntary segment disclosures in Australian firms and find support for both these variables. Second, drawing on theory supported by the corporate governance, strategic management and industrial organization literatures we introduce a new economic variable that unifies both ownership and competition variables. We find that the unifying variable performs better than our model focusing on ownership and competition variables alone. We conduct a series of robustness tests on the model and find that its significance is not affected by the inclusion of disclosure control variables identified in prior literature, the change in standard, and acquisitions and disposals of physical assets.

"Contagion in the Presence of Stochastic Interdependence," by **Clifford A. Ball** and Walter N. Torous (March 2006)

Contagion represents a significant change in cross-market linkages precipitated by a crisis and is properly measured only after taking into account the interdependence or extant linkages prevailing between markets. Since it is well known that stock return volatilities and correlations are stochastic in the absence of a crisis, interdependence between markets should reflect the time varying nature of these covariances. We measure contagion in the presence of stochastic interdependence using data on stock indices from South East Asian countries around the July 1997 crisis. Since stock return covariances are observed with error, this suggests casting our model in a state space framework which is estimated using a multivariate Kalman filter. In the presence of stochastic interdependence, we find reliable evidence of contagion between Thailand and Indonesia, Malaysia, and the Philippines but not between Thailand and Hong Kong or Singapore.

"Sudden Deaths: Taking Stock of Political Connections," by **Mara Faccio** and **David C. Parsley** (March 2006)

Many firms voluntarily incur the costs of attempting to influence politicians. However, estimates of the value of political connections have been made in only a few cases. We propose a new approach to valuing political ties that builds on these previous studies. We consider connected to a politician all companies headquartered in the politician's home town, and use an event study approach to value these ties at their unexpected termination. Analysis of a large number of sudden deaths from around the world since 1973 reveals a market adjusted 2% decline in the value of connected companies. Our results suggest connections matter in many countries, and that they are more important for family firms, firms with high growth prospects, and firms headquartered in highly corrupt countries.

"Shareholder Initiated Class Action Lawsuits: Shareholder Wealth Effects and Industry Spillovers," by Amar Gande and **Craig M. Lewis** (March 2006)

This paper documents significantly negative stock price reactions to shareholder initiated class action lawsuits. We find that shareholders partially anticipate these lawsuits based on lawsuit filings against other firms in the same industry and capitalize part of these losses prior to a lawsuit filing date. Consequently, we show that filing date effects understate the magnitude of shareholder losses on average by approximately a third. We demonstrate that prior expectations about the likelihood of being sued are important determinants of the losses anticipated prior to the filing of an actual lawsuit, and on the lawsuit filing date.

"The Determinants of Market-Wide Issue Cycles for Initial Public Offerings," by Vladimir Ivanov and **Craig M. Lewis** (March 2006)

This paper identifies the determinants of market-wide issue cycles for initial public offerings (IPOs) using an autoregressive conditional count model. We extend the extant literature by examining high frequency (daily) issue activity. Count models are a natural way to address the additional econometric problems associated with relatively high frequency data because they explicitly recognize that the number of IPOs are nonnegative, integer-valued random variables. We examine a number of hypotheses related to business conditions, time-varying information quality, and investor sentiment. Using a unified framework that allows us to examine which explanations have empirical content, the evidence indicates that time variation in the cost of capital due to changing business conditions and investor sentiment are the most important determinants of issue activity.

"Mandatory Disclosure of Non-Audit Services Is Not Benign," by **Karl Hackenbrack** (February 2006)

This study advances the auditor independence debate by compiling and analyzing a new dataset that is uniquely suited to answer the question: Does mandatory disclosure of auditor supplied non-audit services help align managements' purchase decisions with investors' references? I find that the mandatory disclosure of joint sourcing activities mediates the relationship between current and future purchases of non-audit services in a manner that reflects investors' expressed preferences. The result is important in assessing the effectiveness and necessity of the disclosure regulations that exist today as well as the need for additional regulations like outright bans on certain services legislated by Sarbanes Oxley.

"A Screen for Fraudulent Return Smoothing in the Hedge Fund Industry," by **Nicolas P.B. Bollen** and Veronika Krepely Pool (January 2006)

This paper constructs a statistical screen for fraudulent return smoothing in the hedge fund industry. We show that if true returns are independently distributed, and a manager fully reports gains but delays reporting losses, then reported hedge fund returns will feature conditional serial correlation. Simulation evidence indicates that the power of the screen is restricted by the limited histories of some funds, but may still be sufficient to deter fraudulent return smoothing. Empirical evidence shows that the probability of observing conditional serial correlation is related to the volatility and magnitude of investor cash flows, consistent with managerial smoothing in response to the risk of capital flight.

"Microstructure of the Pink Sheets Market," by **Nicolas P.B. Bollen** and **William Christie** (December 2005)

Using all quotes and trades recorded by the Pink Sheets electronic quotation service and Pink Link electronic execution service in the 2004 calendar year, we examine whether regularities that exist in highly regulated markets arise for stocks traded through the Pink Sheets, a relatively unstructured trading venue that is virtually free of corporate reporting requirements. We find that the market appears quite capable of creating organized rather than chaotic quotation and trading activity in an environment without a tick size, even among penny stocks. Clustering of quotes and trade prices occurs at different scales for different price levels, and varies cross-sectionally with proxies for the availability of public information. Cross-sectional variation in bid-ask spreads can be largely explained by standard models of market maker costs.

"Joint Accounting Choices: An Examination of Firms' Adoption Strategies for SFAS No. 106 and SFAS No. 109," by **Debra Jeter**, **Paul Chaney**, and Michele Daley (December 2005)

We provide insight into an argument that firms minimize the costs imposed by new accounting standards through their adoption choices. Focusing on two standards with potentially large impacts on both balance sheet and income statement accounts for many firms, we present evidence that firms chose their strategies for SFAS No. 106 (OPEB) and 109 (DTAX) jointly rather than separately. We also

provide insight into how firms view recurring versus non-recurring charges, and how they weigh the tradeoff between a large one-time (income decreasing) charge against the smaller, but longer lasting effects of amortization.

"Determinants of Persistence in Security Analysts' Stock Picking Ability," by Michael B. Mikhail, Beverly R. Walther, Xin Wang, and **Richard H. Willis** (December 2005)

We examine a number of factors that might account for our finding in prior research that stock picking ability persists: industry expertise, task diffusion, a propensity to deviate from the herd in issuing recommendations, timeliness of recommendation releases, and the use of fundamental analysis in recommended securities. Our preliminary findings uncover a number of salient differences in these attributes between superior and inferior analysts. In addition to having economically meaningful implications for investors who choose to follow security analysts' advice, these findings identify features of successful analysts that might be useful in educating future analysts.

"Incentive Contracts as Merger Remedies," by Gregory J. Werden, **Luke Froeb**, and Steven Tschantz (October 2005)

Contrary to the suggestion of Williamson (1968), a merger enhancing total social welfare through the creation of substantial efficiencies nevertheless may violate current antitrust law in the United States, which considers only the effects of mergers on consumers. To avoid violating antitrust laws, merging firms could contract with a third party in a manner that offsets the incentive created by a merger to raise price or restrict output.

"Intra-Industry Spillover of the Benefits of Analyst Coverage," by Jennifer Francis, **Richard H. Willis**, and Ling Zhou (October 2005)

We investigate whether analyst activities, measured based on their forecasting revision activity for a given firm, improve the synchronicity of stock returns for non-analyst followed ("unfollowed") firms in the same industry. Return synchronicity refers to the proportion of a firm's stock return variability, in a given year, that is explained by the firm's stock price co-movement with current and lagged market returns and current and lagged industry returns. In particular, if investors of unfollowed firms in a given industry know that analysts' activities improve the incorporation of industry level information in the stock prices of followed firms, then we expect investors to extract this information from followed firms' prices and to incorporate it into their investment decisions for unfollowed firms. We refer to the portion of returns synchronicity of unfollowed firms that is attributable to the existence of analyst activities for followed firms in their industry as "analyst spillover." We expect that, on average, analyst spillover has positive consequences. That is, we expect to observe higher returns synchronicity for unfollowed firms than we would in the absence of analyst spillover. However, it is also possible that some firms experience negative consequences from analyst spillover, which might occur, for example, if investors of unfollowed firms incorrectly use the information in followed firms' stock prices, resulting in less informative prices for unfollowed firms. Our interest in this study is in documenting whether analyst spillover exists, and whether it generates net benefits or net costs for unfollowed firms. We will also examine firm-, industry-, analyst-, and investor-specific factors that are likely to lead to more spillover benefits.

"The Determinants of Market-Wide Issue Cycles for Initial Public Offerings," by Vladimir Ivanov and **Craig M. Lewis** (September 2005)

This paper identifies the determinants of market-wide issue cycles for initial public offerings (IPOs) using an autoregressive conditional count model. We extend the extant literature by examining high frequency (daily) issue activity. Count models are a natural way to address the additional econometric problems associated with relatively high frequency data because they explicitly recognize that the number of IPOs are nonnegative, integer-valued random variables. We examine a number of hypotheses related to business conditions, time-varying information quality, and investor sentiment. Using a unified framework that allows us to examine which explanations have empirical content, the evidence indicates that time variation in the cost of capital due to changing business conditions and investor sentiment are the most important determinants of issue activity.

"Venture Capital Investments by IPO Underwriters: Certification, Alignment of Interest or Moral Hazard?" by Xi Li and **Ronald W. Masulis** (September 2005)

We study IPO pricing when financial intermediaries are pre-IPO investors in these issuers and tests whether these investments create a certification or conflicts of interest effect which alters the IPO underwriting and pricing processes. We find that prior debt and equity investments significantly reduce IPO underpricing; and the result is stronger when commercial banks and investment banks are also underwriters in these IPOs. This evidence is consistent with certification of IPO issues by these financial intermediaries. The fall in underpricing is substantially greater when there is greater uncertainty about IPO valuation, which further supports the underwriter certification effect. Controlling for endogeneity effects does not change our conclusions. We find that prior equity investment also significantly reduces offer price revisions from the filing range midpoints. Finally, financial intermediaries investments in IPO issuers are also associated with higher 5 year rates of return on assets. This body of evidence is consistent with an underwriter certification hypothesis and inconsistent with an underwriter conflict of interest hypothesis.

"Bold Security Analysts' Earnings Forecasts and Managers' Information Flow," by Allen H. Huang, **Richard H. Willis**, and Amy Y. Zang (August 2005)

We examine the relation between security analysts' annual earnings forecast boldness ("bold analysts") and changes in the inferred flow of earnings-related information from managers of the forecasted firm to bold analysts. We find that unfavorably bold analysts experience an improvement in their subsequent relative forecast accuracy. Favorable forecasters, however, experience a decrease in subsequent relative forecast accuracy. Our forecast revisions tests suggest that the market recognizes the improvement in subsequent relative forecast accuracy for unfavorably bold analysts and places no additional weight on forecast revisions from favorably bold analysts.

"Self-Selection of Auditors and Size Nonlinearities in Audit Pricing," by **Paul K. Chaney**, **Debra Jeter**, and Lakshamanan Shivakumar (February 4, 2005)

Prior research has examined audit pricing for publicly held firms and provided some evidence of a Big 8 premium in pricing. More recent research provides evidence that private firms do not pay such a premium on average; i.e. a premium is observed using standard OLS regressions, but it vanishes once self-selection bias is controlled for. This paper returns to the setting of listed U.S. firms and provides evidence that, on average, the firms in the sample examined also do not pay a Big 5 premium (once self-selection bias and nonlinearities in client size are taken into account). Consistent with the findings of Chaney, Jeter, and Shivakumar (2004), we find that publicly traded client firms choosing Big 5 auditors generally would have faced higher fees had they chosen non-Big 5 auditors, given their firm-specific characteristics. Our results are consistent with audit markets for listed firms, as well as for private firms, being segmented along cost-effective lines. Our findings emphasize the importance of controlling for self selection and size nonlinearities in any audit fee study using standard OLS regressions to control for client size or auditor size (or quality).

"Slow Passthrough Around the World: A New Import for Developing Countries?" by Jeffrey A. Frankel, **David C. Parsley**, and Shang-Jin Wei (February 2005)

Developing countries traditionally experience passthrough of exchange rate changes that is greater and more rapid than high-income countries experience. This is true equally of the determination of prices of imported goods, prices of local competitors' products, and the general CPI. But developing countries in the 1990s experienced a rapid downward trend in the degree of passthrough and speed of adjustment, more so than did high-income countries. As a consequence, slow and incomplete passthrough is no longer exclusively a luxury of industrial countries. Using a new data set - prices of eight narrowly defined brand commodities, observed in 76 countries - we find empirical support for some of the factors that have been hypothesized in the literature, but not for others. Significant determinants of the passthrough coefficient include per capita incomes, bilateral distance, tariffs, country size, wages, long-term inflation, and long-term exchange rate variability. Some of these factors changed during the 1990s. Part (and only part) of the downward trend in passthrough to imported goods prices, and in turn to competitors' prices and the CPI, can be explained by changes in the monetary environment - including a fall in long-term inflation. Real wages work to reduce passthrough to competitors' prices and the CPI, confirming the hypothesized role of distribution and retail costs in pricing to market. Rising distribution costs, due perhaps to the Balassa-Samuelson-Baumol effect, could contribute to the decline in the passthrough coefficient in some developing countries. ■

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