VANDERBILT
Owen Graduate School of Management

FINANCIAL MARKETS

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FINANCIAL MARKETS RESEARCH CENTER • 2003

Conference on

Corporate Behavior and Financial Markets

Investors have a strong interest in assessing the true value of companies. Yet the recent evidence indicates that many companies – particularly those in the technology sector – were overvalued in the 1998-2000 bubble. Can the overvaluation be ascribed to accounting misdeeds, to the failure of analysts to do their job, or just to irrational exuberance? Can financial markets provide more effective discipline of managers? Do institutional investors play a sufficiently aggressive role in monitoring companies and their management? Is disclosure by companies of their operations sufficient to the needs of investors? How important are accounting rules for proper valuation of companies? Does bad accounting lead to stock market mis-valuation? Does disclosure of bad accounting lead to stock price reactions? How important are key analysts in the valuation of companies? Do executive compensation arrangements provide perverse incentives? What is the relation between executive compensation and earnings reports and stock prices? Can financial markets discipline corporations or must more responsibility be put on the board of directors? Does poor corporate governance have a stock price effect? Can changes in regulation increase the effectiveness of market discipline – for example, would elimination of short sale restrictions help limit bubbles? Is the new issues market working properly or should changes be considered in the way companies raise equity capital?

Harvey Goldschmid, Susan Bies, and John Biggs

Many of these questions were addressed at the 16th annual conference of the Financial Markets Research Center, supported by a special grant from the New York Stock Exchange, and held on April 10-11, 2003 at Vanderbilt University. Day one of the conference took place at the conference facilities of Center member, Caterpillar Financial Services, located next to the campus, and day two took place at the Owen School. **James Beard**, President of Caterpillar Financial, and **Hans Stoll**, director of the Center, welcomed the conference participants.

The lead-off speaker, **Harvey Goldschmid**, Commissioner of the Securities and Exchange Commission, was introduced by **Randall Thomas**, Professor of Law at the Vanderbilt Law School. Commissioner Goldschmid noted that the corporate wrong-doings of the recent past were not an isolated problem or an example of one rotten apple, but rather the reflection of fundamental systemic problems. He called for greater independence and greater responsibility for corporate monitors – directors, auditors, analysts and lawyers. He discussed the role of the Sarbanes-Oxley Act in increasing independence of directors and auditors. He noted the importance of moving ahead with the Accounting Oversight Board, of providing better funding for the FASB, and of examining the role of rating agencies.

Richard Lindsey, President of Bear Stearns Securities Corporation, next chaired a session on Accounting and the Stock Market. Professor **Paul Chaney**, of the Owen School, presented the results of his paper (with Kirk Philipich), "Shredded Reputation: The Cost of Audit Failure." The research demonstrates the importance of auditor reputation for the value of companies. Chaney reported that Arthur Andersen's shredding of documents relating to its audit of Enron, resulted not only in a drop in the stock price of Enron, but also in a drop in the stock prices of all the companies audited by Andersen (relative to companies not

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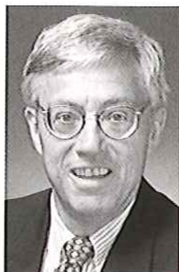
FROM THE DIRECTOR

"There is never a dull moment in financial markets." That thought is apt in the current environment of corporate accounting and governance scandals, a subject examined in this year's conference and described elsewhere in this newsletter. Yet it has always been the case, in the sixteen year history of the Financial Markets Research Center, that important and interesting issues arise, which deserve discussion at Center conferences and analysis by Center faculty. When the Center was founded in 1987, the most important issues related to index derivatives – the triple witching hour, portfolio insurance, and the role of derivatives in the Crash of 1987. Later, scandals such as the collapse of Barings Bank raised questions about risk management and risk controls. In the mid-nineties, high Nasdaq trading costs, which Center faculty helped identify, were at the forefront of investor and regulatory concern. The Center fostered discussion and analysis that helped produce important reforms in Nasdaq. The collapse of Long Term Capital in 1998 raised questions about hedge funds and hedge fund regulation, an issue that continues to linger. On-going is the question of how securities markets should be structured and regulated as technology and new competition alter the landscape.


Hans R. Stoll

The Center sponsors conferences to facilitate discussion and to encourage analysis of important topics in financial markets. This year, the conference, described elsewhere in this Newsletter, dealt with issues of corporate governance, accounting, the IPO market, and analysts' conflicts as well as the on-going issue of securities market structure and regulation. As is typical in the Center's conferences, participants heard from industry leaders, regulators, and academics – a mix of viewpoints intended to stimulate research and appropriate regulatory policy. The Center's objective is to provide continuity and stability in the study of financial markets. While current issues may change, the Center remains committed to fostering reasoned analysis of the markets.

Seventeen faculty members are affiliated with the Center. This year saw the departure of **Gordon Hanka**, who was visiting associate professor at the Owen School for the last two years. Arriving to join the Owen faculty and the Center is **Mara Faccio.** Mara received her PhD from the Catholic University of Milan in 1999. She taught at Notre Dame for two years before joining Owen. Her research is in the area of international corporate finance. One of her recent papers, "Politically Connected Firms," analyzes the role of politicians on corporate boards in 47 different countries.

Luke Froeb, William and Margaret Oehmig Associate Professor of Entrepreneurship and Free Enterprise, began an 18 month leave in August to serve as the Director of the FTC's Bureau of Competition. **David Parsley**, associate professor of economics, visited at the Goethe University in Frankfurt during the summer of 2003. Debra Jeter, associate professor of accounting, visited at the University of Auckland in the spring of 2003.

Center faculty continue to be active researchers. Current research is described elsewhere in this Newsletter, but two projects deserve to be highlighted. **Nick Bollen** recently completed an analysis of mutual fund trading costs before and after decimalization (with Jeff Busse). He concludes that institutional trading costs increased. His work was cited in the *New York Times* and the *Financial Times* and other news media. **Paul Chaney**'s paper (with Philipich), "Shredded Reputation: the Cost of Audit Failure," published in the *Journal of Accounting Research* in September 2002, received extensive media coverage. The paper was also presented at this year's FMRC conference.

Dewey Daane, steadfast senior advisor to the Financial Markets Research Center, turned 85 in July of this year. Dewey is active in the affairs of the Center and Owen School. He continues to run the Seminar on Monetary and Fiscal Policy. And he is a regular on the tennis court. Congratulations Dewey! Many thanks to **Pat Scott**, administrative assistant, for her indefatigable care in organizing the conference and the other affairs of the Center. ■

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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Hans R. Stoll, Director
J. Dewey Daane, Senior Advisor

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:

Aeltus Investment Management, Inc.
Bear, Stearns & Company, Inc.
Caterpillar Financial Services
Chicago Board Options Exchange
Eclipse Capital Management, Inc.
*Interactive Brokers Group
International Securities Exchange
Lavery Consulting Group
*The NASDAQ Educational Foundation
*New York Stock Exchange, Inc.
Ronin Capital, LLC
Susquehanna International Group, LLP
*Thales Fund Management, LLC

*Indicates a lead member.

Corporate Behavior *(continued)*

audited by Andersen). The stock price effect of the shredding averaged more than $30 million per Andersen client. **Robert Fisher**, Economist at the Securities and Exchange Commission, discussed alternative approaches to more effective auditing. On the one hand, one can strengthen and extend auditing rules. On the other hand, one can rely on broader auditing principles and hold auditors to those principals. He noted that an SEC study of these issues was due in July, 2003.

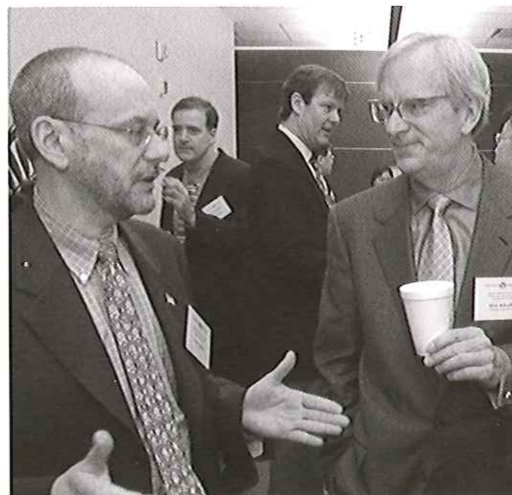
After a short break, conference participants returned for a talk by **Susan Bies**, Governor of the Federal Reserve Board, on the topic of corporate governance. Governor Bies noted that the Federal Reserve Board has been concerned with the governance of banks and the proper attention to risk management of banks. Banks are required to provide a management report on internal controls that includes an assessment of risks, internal controls, auditor quality and the like. Auditors are required to determine if the management report is a fair representation of the facts. Bank regulators have the authority to de-bar auditors that do not meet their responsibilities.

The first session of the afternoon dealt with the topic of investment banking, the new issues market and the role of analysts. **Paul Bennett**, Chief Economist of the New York Stock Exchange, chaired the session. Professor **Jay Ritter**, of the University of Florida, provided a comprehensive overview of the new issues market and the tendency for new issues to appreciate in the immediate aftermarket. He recommended actions to control practices such as spinning, laddering, and high commissions. Professor **Ron Masulis**, of the Owen School, presented his paper (with Xi Li), "Venture Capital Investments by IPO Underwriters: Certification or Conflict of Interest." The authors find that IPOs in which the underwriter provides venture financing are underpriced to a lesser degree than IPOs in which the underwriter has no venture financing role. The authors conclude that venture financing has a beneficial certification role. Professor **Leslie Boni**, of the University of New Mexico, summarized academic work on conflicts of interest facing securities analysts and reported on joint research with Kent Womack that examines the quality of analysts' recommendations. They find that analysts' upgrades and downgrades predict returns of stocks, which implies that analysts' recommendations have value.

Thomas Peterffy and Hans Stoll

In the next session, **John Biggs**, retired Chairman and CEO of TIAA-CREF, spoke on how corporations can be more effectively monitored. He noted that the current governance structure can be described as "strong management, weak boards, and passive investors." He favored strengthening the board, particularly the audit committee, while retaining a strong CEO. He recommended that major institutional investors develop research programs to monitor governance of their portfolio companies and that they act via proxy votes and direct negotiation with companies to improve corporate governance.

Thursday's last session on the subject of corporate governance was chaired by **Craig Lewis**, of the Owen School. **Anup Agrawal** presented a paper, Corporate Governance and Accounting Scandals (with Sahiba Chadha) in which he analyzed the frequency of earnings restatements as a function of corporate governance characteristics, such as degree of board independence, auditor independence, and financial sophistication of the board. He concluded that restatements are not related to most governance characteristics except that the financial sophistication of the board is associated with fewer restatements. **Robert Thompson**, Professor of Law at Vanderbilt, commented on the Agrawal paper and discussed the nature and source of the regulation of corporate governance. He noted that state law has changed little with regard to corporate governance. Instead, Federal law – the Sarbanes-Oxley Act – and exchange listing standards have been the source of changes in corporate governance regulations.



Larry Harris and Rick Kilcolllin

On Friday morning, attendees assembled at the Owen Graduate School of Management to hear from two panels. The first panel, chaired by **Thomas Peterffy**, Chairman of Interactive Brokers, dealt primarily with equities markets. **Paul Bennett**, Chief Economist of the New York Stock Exchange, discussed several trends in equities markets – the increased use of a VWAP (value weighted average price) standard for evaluating a broker, the growth in program trading, and the increase in the frequency of quote changes. **Adena Friedman**, Executive Vice President of the Nasdaq Stock Market, reviewed recent developments in Nasdaq, such as Supermontage, Viewsuite (which provides information on depth), and a new opening procedure. She expressed concern that market fragmentation in the trading of Nasdaq stocks has weakened Nasdaq's ability to provide regulatory oversight. **David Krell**, Chief Executive Officer of the three year old International Securities Exchange, reported on the continued growth in his exchange's share of option volume. In March 2003, the ISE accounted for 24.7% of option volume, second only to the CBOE. He ascribed the ISE success to its technology, to its internal competition, and to the ease with which the exchange can be accessed. **William Rainer**,

continued on page 4

Corporate Behavior *(continued)*

Chief Executive Officer of OneChicago and former chairman of the Commodity Futures Trading Commission, traced the genesis of single stock futures, noted their benefits, and commented on the still slow development of that market. **Larry Harris**, Chief Economist of the Securities and Exchange Commission, departed from his prepared remarks to summarize and comment on the remarks of the other panelists. On the question of market data fees, he suggested alternative ways to allocate fees, including that they be allocated on the basis of the quality of a market as measured by the frequency with which the market is at the inside. On the question of market linkage, he noted the difficulties of linking markets when different markets proceed at different speeds. With regard to single stock futures, he noted the benefits of easier short selling made possible by such a market.

Richard DuFour discussing options markets.

The second panel, chaired by **James Klingler**, Senior Vice President of Eclipse Capital, dealt primarily with developments in futures and options markets. **John Damgard**, President of the Futures Industry Association, argued forcefully for a single futures clearing organization as opposed to the separate clearing houses that now exist for each of the principal futures markets. **Sharon Brown-Hruska**, Commissioner of the Commodity Futures Trading Commission, noted the purpose of the Commodity Futures Modernization Act of 2000 to lessen or simplify regulation, and she discussed several issues coming before the Commission. **Richard DuFour**, Executive Vice President of the Chicago Board Options Exchange, commented on the earlier discussion of option markets by David Krell. He noted that the ISE has multiple quoters which narrows the ISE's posted quote in comparison to the CBOE which disseminates the quote of the single specialist. He also described the development at the CBOE of an integrated screen and floor based trading system. **Jack Gaine**, President of the Managed Funds Association, discussed the growing interest of regulators in the operation of hedge funds. He noted that the Securities and Exchange Commission is conducting a study of hedge funds which would, among other things, consider valuation practices, retailization of hedge funds, and the role of the prime broker. ■

Dewey Daane Invitational Tennis Tournament

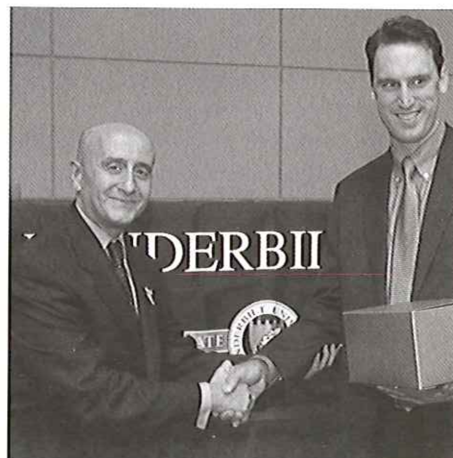
As has been the case since 1992, the Daane round-robin tennis tournament took place Friday afternoon after the conference. After much battle, **Dewey Daane** emerged victor of his own tournament and was presented the contents of the Daane Cup. He graciously thanked his partners in the effort. The runner-up award went to **Craig Lewis**. ■

Daane and Lewis receiving contents of the Daane Cup.

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://mba.vanderbilt.edu/owenclubs/finance/.



Chris Saponari, President of the Owen Finance Club, presenting the Financial Executive of the Year Award to Dick Grasso, Chairman of the New York Stock Exchange.

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://mba.vanderbilt.edu/owenclubs/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 2002-2003 the following researchers presented work on finance topics:

Nicolas P.B. Bollen, *Vanderbilt University*: "Common Cents? Tick Size, Trading Costs, and Mutual Fund Performance"

Oleg Bondarenko, *University of Illinois at Chicago*: "Statistical Arbitrage and Securities Prices"

Alon Brav, *Duke University*: "Expected Return and Asset Pricing"

Lawrence D. Brown, *Georgia State University*: "A Temporal Analysis of Earnings Management Thresholds"

Jeffrey A. Busse, *Emory University*: "Bayesian Alphas and Mutual Fund Persistence"

Peter Carr, *Courant Institute, New York University*: "Static Hedging of Standard Options"

Gia M. Chevis, *Texas A&M University*: "Market Perceptions of Efficiency and News in Analyst Forecast Errors"

Joel S. Demski, *University of Florida*: "Endogenous Reporting Discretion and Auditing"

Ronald M. Harstad, *Rutgers University*: "Private Information Revelation in Common-Value Auctions"

Thomas S.Y. Ho, *Thomas Ho Company, Ltd*: "Valuing a High Yield Bond: A Structural Model with Fixed Costs"

Toshiaki Iizuka, *Vanderbilt University*: "The Effects of Direct-to-Consumer Advertising in the Prescription Drug Market"

Robert Jennings, *Indiana University*: "Determinants of Order Choice on the New York Stock Exchange"

Kose John, *New York University*: "Institutions, Markets and Growth: A Theory of Comparative Corporate Governance"

Gautam Kaul, *University of Michigan*: "Value versus Glamour"

Simi Kedia, *Harvard Business School*: "Performance Impact of Employee Stock Options"

Yrjö Koskinen, *Stockholm School of Economics*: "The Euro Is Good After All: Corporate Evidence"

Owen A. Lamont, *University of Chicago*: "Evaluating Value Weighting: Corporate Events and Market Timing"

Michael L. Lemmon, *University of Utah*: "Structural Models and Endogeneity in Corporate Finance"

Craig M. Lewis, *Vanderbilt University*: "The Determinants of Issue Cycles for Initial Public Offerings"

Erik Lie, *College of William & Mary*: "Stock Prices and Information Releases around CEO Stock Option Awards"

Ananth Madhavan, *ITG Inc.*: "Resiliency in an Automated Auction"

Ronald W. Masulis, *Vanderbilt University*: "Why Is Cash the Preferred Method for Financing European M&A?"

Vassil T. Mihov, *Texas Christian University*: "Off-Balance Sheet Financing: How Much Debt Lurks in the Leases?"

Todd T. Milbourn, *Washington University*: "Do Stock Prices Incorporate the Potential Dilution of Employee Stock Options?"

Vikram Nanda, *University of Michigan*: "Hot Markets, Investor Sentiment, and IPO Pricing"

Charu G. Raheja, *Vanderbilt University*: "The Interaction of Insiders and Outsiders in Monitoring: A Theory of Corporate Boards"

Eduardo S. Schwartz, *University of California, Los Angeles*: "R&D Investments with Competitive Interactions"

Charles Shi, *University of California, Irvine*: "Accounting Choice for Software Development Costs and the Cost of Capital: Evidence from Underpricing of Initial Public Offerings in the Software Industry"

Shang-Jin Wei, *International Monetary Fund*: "Transparency and International Investor Behavior"

Russ Wermers, *University of Maryland*: "Is Money Really 'Smart'? New Evidence on the Relation Between Mutual Fund Flows, Manager Behavior, and Performance Persistence"

James P. Weston, *Rice University*: "Does Stock Market Liquidity Matter? Evidence from Seasoned Equity Offerings"

Robert E. Whaley, *Duke University*: "Modeling the Bid/Ask Spread: Measuring the Inventory-Holding Premium" ■

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 2002-2003 academic year were:

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

Dan Creedon, Senior Manager, *KPMG,LLP*

Roger W. Ferguson, Jr., Vice Chairman, *Board of Governors of the Federal Reserve System*

Edward M. Gramlich, Member, *Board of Governors of the Federal Reserve System*

Dick Grasso, Chairman and CEO, *New York Stock Exchange*

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

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

David Jones, Chairman, *Aubrey Lanston & Co.*

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

David A. Lereah, Senior Vice President and Chief Economist, *National Association of Realtors*

John Lipsky, Chief Economist, *JP Morgan Chase*

R. Brad Martin, Chairman and CEO, *Saks, Inc.*

Martin Mauro, Senior Economist, *Merrill Lynch*

Cathy Minehan, President, *Federal Reserve Bank of Boston*

Paul H. O'Neill, Secretary of the Treasury of the *United States*

Rudolph G. Penner, *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*

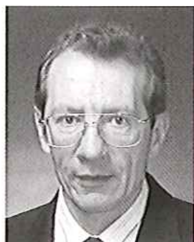
Alan Reynolds, Senior Fellow, *Cato Institute*

Anthony M. Santomero, President, *Federal Reserve Bank of Philadelphia*

Tony Torchia, Partner, *KPMG, LLP*

Richard Wallman, Senior Vice President and CFO, *Honeywell International, Inc.* ■

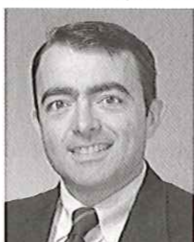
Current Activities of Center Faculty



CLIFFORD BALL, Professor (finance and statistics). M.Sc., Nottingham 1975, Ph.D. (mathematics), New Mexico 1980.

Current research interests include equities, bonds, options, and futures contracts; empirical testing of financial models; stochastic processes and statistical applications to finance; the European monetary system; capital requirements, risk management and value-at-risk.

Professor Ball's paper, "True Spreads and Equilibrium Prices" (with Tarun Chordia), was published in the *Journal of Finance*. He recently participated as a discussant in the Western Finance Association annual meetings in Los Cabos, Mexico. Ball serves as referee for numerous research journals and is an associate editor of the *Journal of Empirical Finance*.



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

Research interests include mutual fund performance, the valuation of derivative securities, and empirical market microstructure. He has recently found evidence that mutual fund managers possess short-term ability, which suggests that a strategy of actively investing in prior period top performers may be profitable. Two current projects are (1) the efficiency of the S&P 500 index option market, and (2) the impact of decimalization on mutual fund trading costs. He teaches courses in equities markets, securities and portfolios, managerial finance, and asset pricing theory.

Professor Bollen presented his paper, "Does Net Buying Pressure Affect the Shape of Implied Volatility Functions?" (with Robert E. Whaley), at the American Finance Association's annual meeting in Washington, D.C. in January 2003. The paper has since been accepted for publication in the *Journal of Finance*. Bollen presented his paper, "Common Cents? Tick Size, Trading Costs, and Mutual Fund Performance" (with Jeffrey A. Busse), at the University of Colorado in April and at the Western Finance Association's annual meeting in Cabo, Mexico, in June. This paper, which estimates that mutual fund trading costs increased significantly following the switch in the U.S. to decimal pricing of stocks, has received extensive coverage in the popular press, including citations in the *New York Times*, *Barron's* and *The Financial Times*. Bollen's paper, "The Performance of Alternative Valuation Models in the OTC Currency Option Market" (with Emma Raisel), was recently published in the *Journal of International Money and Finance*.

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

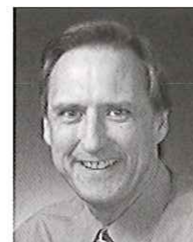
Research interests include auditor reputation, the quality of earnings, earnings management, and audit pricing.

Professor Chaney presented his paper, "The Price-Earnings Relation in Troubled Times" at Yale University in February 2003. His paper "Shredded Reputation: The Cost of Audit Failure", was cited in newspapers with total circulations of over 1.6 million subscribers. His paper, "Self-Selection of Auditors and Audit Pricing in Private Firms" (with L. Shivakumar and Debra Jeter), was accepted for publication by the *Accounting Review*.

ANCHADA CHAROENROOK, Assistant Professor (finance). M.S. (financial engineering), Ph.D (finance), Michigan 2000. M.S., Ph.D. (electrical engineering), Washington.

Current research interests include empirical testing of asset pricing models, theoretical asset pricing, risk management, corporate finance theory as applied to security pricing, and problems in economic modeling. Professor Charoenrook teaches courses in securities and portfolios and fixed-income markets.

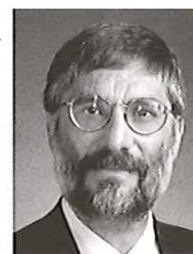
In October 2002, Professor Charoenrook presented her paper, "Change in Consumer Sentiment and Aggregate Stock Market Return," at a research seminar at Lehman Brothers in New York.



WILLIAM G. CHRISTIE, Dean of the Owen Graduate School of Management, Ralph Owen Professor of Management. M.B.A., Ph.D., Chicago, 1980, 1989.

Dean Christie serves on the Board of Directors of the Graduate Management Admissions Council, and will begin his term as Chairman of the Finance and Investments Committee at GMAC this fall. He is also a member of the newly formed Maintenance Accreditation Committee of the AACSB for a one-year term, also beginning in the fall. He participated in the team that reaccredited Case Western Reserve University's Weatherhead School in 2003, and he will be visiting both Tulane University and Wilfred Laurier University on their accreditation teams.

Christie was the recipient of the Executive MBA Program Outstanding Professor Award in 2003. This award "recognizes the outstanding professors into perpetuity for their excellence and contribution to Executive MBA education." He continues to teach the course, Law and Finance of Equity Markets, in the Law and Business Program, and he recently returned from a fact-finding trip to São Paulo and Rio de Janerio, Brazil to explore partnerships with leading business schools and host alumni receptions in both cities. He will travel to London, England in the fall to meet with alums and corporations, he and will be the keynote speaker at the "Equity Markets Microstructure Seminar: Teaching Microstructure and Using Trading Floors in MBA Programs" seminar that will be hosted by Baruch College's Subotnick Financial Services Center on November 13-14, 2003.



MARK A. COHEN, Senior Associate Dean of the Owen Graduate School of Management, Justin Potter Professor of American Competitive Business, Director of the Vanderbilt Center for Environmental Management Studies. M.A., Ph.D., Carnegie-Mellon 1985.

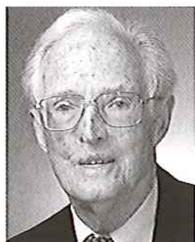
Research interests include government regulation, law and economics, white-collar and corporate crime, and environmental management.

Professor Cohen presented two papers at the University of Warsaw: "An Economic Approach to Crime: Balancing the Costs and Benefits," and "Corporate Criminal Liability and Punishment: An Economic Approach." The conference was co-sponsored by the U.S., British and Dutch Embassies, and proceedings will be published in the Polish journal, *Ius et Lux*. Cohen was appointed to the International Board of that journal and the Advisory Board of Benchmark Survey of Global Environmental & Social Reporting.

Cohen's paper, Determinants of Environmental Innovation in U.S. Manufacturing Industries" (with Smita Brunnermeier), was published in the *Journal of Environmental Economics and Management* in March. He presented a paper entitled "Corporate Sustainability Reporting" at the International Petroleum Industry Environmental Conservation/American Petroleum Institute Workshop on CRS/Sustainability Reporting in San Francisco on April 3, 2003.

At Commencement in May, Cohen was the recipient of the Owen Research Productivity Award. He was appointed to the Justin Potter Professorship in American Competitive Business for a renewable five-year term beginning July 1, at which time he also assumed the position of Senior Associate Dean of the Owen School.

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 on Monetary and Fiscal Policy, Daane arranged for many of the guest speakers listed elsewhere in this newsletter.

In September 2002, Dr. Daane attended the annual meeting of the International Monetary Fund (Group of Thirty) in Washington, DC. In November he participated in a Policy Forum at the Federal Reserve Bank of Philadelphia. Dr. Daane attended the Baseball Economics Conference at the Vanderbilt Law School in February 2003, and in April, he participated in the annual Financial Markets Research Center conference. In May, Dr. Daane attended the Federal Reserve Bank of Chicago's 39th Annual Conference on Bank Structure and Competition, which focused on "Corporate Governance: Implications for Financial Services Firms," and in June he participated in the Federal Reserve Bank of Boston's 48th Annual Economic Conference held in Chatham, MA. This year's conference focused on "How Humans Behave: Implications for Economics and Economic Policy."

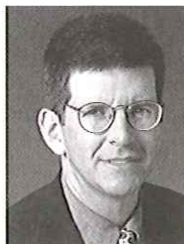
MARA FACCIO,

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

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

Professor Faccio presented her paper, "Politically Connected Firms," at the American Finance Association meeting in Washington D.C. in January 2003, at the METU International Conference in Economics in Ankara in September 2002, at Indiana University, Syracuse University, University of Michigan and the University of Notre Dame. She presented the paper, "Benefits of Control? Evidence from Western European Acquisitions" (with John J. McConnell and David Stolin), at the Western Finance Association meeting in Park City, and at the University of Notre Dame. Finally, she presented the paper, "The Choice of Financing Method in European Mergers & Acquisitions" (with Ronald W. Masulis), at the University of Notre Dame.

LUKE M. FROEB,



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

Research interests include industrial organization, econometrics, mergers, and antitrust policy. Professor Froeb's experience as an antitrust "cop" has many business applications that he teaches to his introductory management classes. He is also the editor of the award winning web site, Antitrust Policy at www.antitrust.org.

Professor Froeb and Dr. Gregory Werden, Senior Economic Counsel at the Antitrust Division of the U.S. Department of Justice, put on a two-day course for the competition authorities of the United Kingdom and Canada. In late April, their host was the UK Office of Fair Trading, and in mid May their host was the Canadian Competition Bureau. The course applies quantitative economic models to competition issues, especially those arising with mergers of competitors. Much of the material Froeb presented is based on joint research with Professors Steven Tschantz and Philip Crooke of the Math Department at Vanderbilt.

In July, Froeb moved to Washington DC to replace David Scheffman as Director of the Bureau of Economics at the Federal Trade Commission, effective August 4. He will return to Nashville every other weekend to teach Managerial Economics in the Executive MBA program at the Owen School.

AMAR GANDE,

Assistant Professor (finance). M.B.A., IIMC 1988, Ph.D., NYU 1997.

Research interests include international finance, corporate finance, and investment banking. Professor Gande teaches courses in International Financial Markets & Instruments, International Corporate Finance, Corporate Value Management for MBA students, and Managing Global Enterprise for Executive MBA students.

In October 2002, Professor Gande presented a paper, "News Spillovers in the Sovereign Debt Market" (with David Parsley), at the Financial Management Association (FMA) Annual Meetings in San Antonio, Texas. This paper won the FMA Competitive Paper Award in the area of Fixed Income. In November 2002, he discussed a paper, "Optimal contracts for teams of money managers," at the Fifth Maryland Finance Symposium at University of Maryland. In January 2003, he presented two papers, "News Spillovers in the Sovereign Debt Market" (with David Parsley) and "Can Ownership Restrictions enhance Security Value? Evidence from a Natural Experiment" (with Manju Puri), at the American Finance Association Annual Meetings in Washington, D.C. Gande presented "The Role of Incentives in the Prevention of Financial Crises in Emerging Economies" (with Kose John and Lemma Senbet) at the Ninth Annual International Finance Conference at Georgia-Tech University in Atlanta in April 2003 and at the Conference on Challenges & Opportunities in Global Asset Management at McGill University, Canada, in June 2003. During the summer of 2003, Gande worked on five different projects (some with coauthors, at Owen and at other Universities) that examine the underwriting costs of global stock offerings, the valuation effects of geographic diversification, impact of sovereign rating agencies on portfolio flows, whether securities

continued on page 8

Faculty Activities *(continued)*

class action law suits improve managerial incentives, and the valuation effects of securities class action lawsuits.

In May 2003, the graduating class of MBA 2003 honored Professor Gande with the James A. Webb Award for Excellence in Teaching at Owen graduation.

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 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. She broadened her experience by teaching internationally during 2002-2003, first in the Vlerick School of Management in Ghent, Belgium in the International Executive MBA program and later at the University of Auckland, New Zealand. She attended the Contemporary Accounting Research conference in Canada in 2002 and served as moderator of the audit pricing session at the mid-year Auditing Sectional meeting of the AAA in January 2003.

Jeter presented her research in New Zealand in the spring of 2003 at both the University of Auckland and at UNITEC Institute of Technology. She served as moderator of a financial reporting session on Stock Market Anomalies at the annual AAA meeting in August 2003. New editions of two textbooks Jeter co-authored, an advanced accounting textbook and a textbook on managerial cost accounting, are both scheduled in 2003-2004.

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

Research interests include equity analyst behavior, the security issue process, and corporate financial policy. Current research topics include herding by equity analysts, the relation between executive compensation and firm performance, and security issue cycles. 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. He is co-director of the Law and Business program where he jointly teaches a class titled "Life Cycle of the Firm" with Professor Randall Thomas of the Vanderbilt Law School. He currently serves on the dissertation committees of Vladimir Ivanov and Raj Nahata. Lewis is a past winner of the best teacher awards voted by the regular MBA and Executive MBA programs and the Dean's Award for teaching excellence.

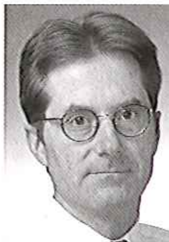
Lewis currently serves as associate editor of the *Journal of Corporate Finance* and the *Journal of Financial Research*, and he serves as referee for numerous academic journals. He recently presented research papers at the University of Kentucky and Babson College.

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

Research interests include investment banking, optimal firm financial decisions, corporate finance, financial institutions, market microstructure, and international finance. His research on capital structure changes and the security issuance process is widely referenced. Current research projects center on European merger activity, underwriting of seasonal stock offerings, IPOs, global equity offerings, and venture capital. Masulis teaches mergers and acquisitions, venture capital, corporate finance theory and empirical evidence, and the law and finance of M&A, a joint offering with the Vanderbilt Law School.

Professor Masulis presented "Venture Capital Investments by IPO Underwriters: Certification or Conflict of Interest?" coauthored with Xi Li in November 2002 at Notre Dame and in April 2003 at Tulane University, the University of New Orleans, Vanderbilt Law School, and the FMRC Annual Conference. In April, he also presented "Dilution of Corporate Control and Cash Financing of European M&A" coauthored with Mara Faccio at the University of Miami, the University of Pittsburgh, and at the Owen School. In July, he presented the latter paper at Melbourne University and the University of New South Wales. In May, his paper, "Trading Activity and Stock Price Volatility: Evidence from the London Stock Exchange," coauthored with Roger Huang was published as the lead article of the *Journal of Empirical Finance.*

Masulis was the recipient of the Dean's Research Impact Award in the Spring of 2003. He is currently organizing a session on "Equity Offerings" for the American Finance Association's Annual Meetings in San Diego next January.



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

Professor Parsley's research interests are in the fields of international finance and macroeconomics. He has concentrated on the macroeconomics of exchange rates, prices, and the relationship between the two. His current projects focus on quantifying global goods and financial market integration, and explaining variability in real exchange rates.

Parsley has recently been an invited fellow/scholar at the Hong Kong Institute of Monetary Research, the International Monetary Fund, and Goethe University in Germany. His paper, "Exchange Rate Pass-Through in a Small Open Economy: Panel Evidence from Hong Kong," was recently published in the *Journal of Finance and Economics*, and "Pricing in Export Markets" was published in the *Review of International Economics.* Another paper, "News Spillovers in the Sovereign Debt Market," co-authored with Owen colleague, Amar Gande, won the 2002 Best Paper Award (fixed income category) from the Financial Management Association.

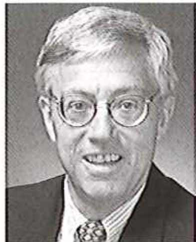
CHARU G. RAHEJA, Assistant Professor (finance). M. Phil, Ph.D., New York University, 2002.

Research interests include theoretical and empirical issues in corporate finance, with specific interests in corporate board of directors, management compensation, venture capital, and initial public offerings.

Professor Raheja participated in the 2002 American Finance Association meeting where she presented her paper, "The Interaction of

Insiders and Outsiders in Monitoring: A Theory of Corporate Boards." During the summer of 2003, Raheja worked on two different projects relating to the effectiveness of corporate governance structure in firms. One of the projects studied the life cycle of corporate boards by following corporate boards from the initial public offering for a period of 10 years. The second project examined the disciplinary measures that take place on the board and on the managers of firms experiencing a large decline in operating performance.

Professor Raheja teaches courses in corporate financial policy and financial management. She was the moderator in the Boards and Corporate Governance session of the C-200 Spring Outreach seminar organized by the Owen Graduate School of Management.

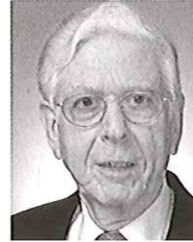


HANS R. STOLL, The Anne Marie and Thomas B. Walker Professor of Finance, Director of the Financial Markets Research Center. M.B.A., Ph.D., Chicago 1966.

Research interests include stock market structure, derivatives, and other aspects of financial markets.

Professor Stoll's current research includes "Price Impact of Option Volume," (with Christian Schlag), and "Out-Trades: Trading Option, Reporting Delay, or Trade Size?" (with Christoph Schenzler). His survey paper, "Market Microstructure," is forthcoming in the *Handbook of the Economics of Finance*. His "Comment" on Benn Steil, "Changes in the Ownership and Governance of Securities Exchanges: Causes and Consequences," recently appeared in Brookings-Wharton *Papers on Financial Services*.

In March, Stoll lectured on market microstructure at the University of Krems, Austria, and in July he attended the Financial Economists Roundtable in Vancouver. Stoll serves on the editorial boards of nine academic finance journals. He continues to serve as a public governor of the Pacific Exchange.



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 is associate editor of *Management Science*. He has authored *Mathematical Programming and the Analysis of Capital Budgeting Problems* as well as numerous articles. ■

Faculty Research Papers

Current working papers, completed or revised since January 1, 2002, are listed below. Individual copies may be obtained by writing Pat Scott, Owen Graduate School of Management, Vanderbilt University, Nashville, TN 37203 or calling 615-322-3671, or email pat.scott@owen.vanderbilt.edu. There is a charge of $10.00 per paper for non-members of the Center. Academics may request up to five papers free of charge. Many of the papers are available on the Center's web site.

94-05 "Revenues of Immediacy Suppliers versus Execution Costs of Investors: Evidence from the NYSE," by Roger D. Huang and ***Hans R. Stoll****. (forthcoming in Bruce Lehmann (ed.) The Legacy of Fischer Black, Oxford University Press)*

The per share revenue of immediacy suppliers is estimated by a measure we term the "realized half-spread." The estimate, based on the complete record of all transactions for 343 New York Stock Exchange stocks that are continuously listed n the S&P 500 in the period 1987 to 1991, is about two to three cents per share. The realized half-spread is compared with per share trading gains of securities firms as calculated from financial reports filed with the SEC. Inferences about the revenues of public limit orders as compared with the revenues of securities firms are made, and they suggest that limit orders are "picked off." The realized half-spread is reconciled with frequently used measures of investor execution costs – the quoted and effective half-spreads. Also examined are the Roll implied spread and a measure termed the perfect foresight half-spread.

96-20 "Margin Adequacy and Standards: An Analysis of the Crude Oil Futures Market," by Theodore E. Day and ***Craig M. Lewis****. (forthcoming in Journal of Business)*

This paper proposes two value-based standards for setting initial margin requirements on futures positions. Our approach recognizes that the distributions of the payoffs to futures traders and the potential losses to the futures clearinghouse can be described in terms of the payoffs to barrier options with appropriately defined strike prices and knockout boundaries. Based on this observation, we argue that initial margin requirements are adequate if the initial margin that must be posted is either (1) equal to the ex ante value of the payoffs to the futures position or (2) sufficient to reduce the value of the potential losses absorbed by the futures clearinghouse to zero. Using a numerical valuation approach that incorporates the stochastic volatility of the futures market, we examine the adequacy of margin requirements in the crude oil futures market. Our results suggest that on average the initial margin requirements set by the New York Mercantile Exchange have been in excess of the minimum margins required under our option-based standards for adequacy.

97-08 "The Impact on the Market for Audit Services of Direct Solicitation by Auditors," by ***Paul K. Chaney, Debra C. Jeter****, and Pamela Erickson Shaw. (March 1, 2003)*

Supporters of direct uninvited solicitation activities argue that clients can make more informed choices of auditors when auditors are allowed to solicit prospective clients. In banned markets, auditors are allowed to submit bids to provide audit services only when invited by the client. This study provides theoretical models that examine the efficiency of client-auditor alignments in the banned and allowed market. We identify conditions under which realignment differences between the two markets occur and derive client losses in the banned market as compared to the allowed

market. We also identify conditions under which independence may be impaired in the allowed market, consistent with the claims of solicitation opponents. However, we believe that, in view of the potential positive effects related to audit pricing and client-auditor alignment, restrictions on advertising or direct uninvited solicitation are not necessarily indicated. Instead, regulators or market mechanisms should insure that the independence (truth telling) condition is so readily satisfied as to be virtually irrelevant. This can happen in one of two ways: (a) increased scrutiny, leading to an increased likelihood of discovery, or (b) increased penalties when an audit failure is discovered, leading to increased costs of an audit failure, or both.

98-15 "Raising International Capital through ADRs: Evidence from Emerging Markets," by ***Amar Gande****. (July 2003)*

Since the last decade, significant amounts of international capital were raised through ADRs by foreign firms, many of whom were first-time issuers from emerging markets. However, little is understood about the extent of underpricing of ADRs and its evolution over time. Based on an extensive data set of emerging market ADRs listed on NYSE, AMEX and NASDAQ between 1991 and 1998, I find that first-time ADR issues are underpriced relative to the after-market traded price, and that later ADR issues from a country are less underpriced relative to earlier issues from the same country. In fact, such a decrease in underpricing is not offset by a similar increase in the underwriter spreads as more ADR issues from the same country are brought to the market. I rationalize this finding in a theoretical framework where investors in the ADR market learn about the country-specific component of the after-market price through sequential issues of ADRs from the same country. Implications for the price impact of new ADR listings on the seasoned ADR issues from the same country are also discussed.

99-26 "Can Ownership Restrictions Enhance Security Value? Evidence from a Natural Experiment," by ***Amar Gande*** *and Manju Puri. (July 2003)*

This paper examines the role of ownership restrictions in raising capital from niche clienteles. Extant literature suggests that limiting availability of securities to only certain classes of investors constricts demand, and hence decreases prices. We argue that ownership restrictions can have positive implications for prices when viewed in the overall context of security design. We provide empirical evidence through an in-depth analysis of a natural experiment: multiple events of capital raising by an emerging market company with ownership restrictions, namely $4.2 billion and $5.5 billion of bonds offered by India's largest bank, State Bank of India exclusively to Indians living abroad at approximately 150 basis points below comparable benchmarks leading to a bottom line savings of $1.08 billion. This is an intriguing issue because it raises the question, how can an emerging market issuer with junk bond ratings obtain such yields?

We argue that ownership restrictions can lead to value enhancement as well as value transfer from holders of other securities. Ownership restrictions can enhance value by circumventing the deadweight costs of prolonged negotiations, particularly when a security is restricted to a homogenous clientele that values the underlying collateral higher than other investors. Restricting the ownership further ensures that investment is limited to a homogenous class of investors that the issuer cares about. It thus serves as a precommitment to ensuring an efficient ex-post renegotiation in the potential default states, resulting in a lower ex-ante offering yield (and a higher offer price). This can result in an implicit seniority of holders of these restricted bonds vis-a-vis holders of unrestricted bonds. We empirically test and find support for both value enhancement as well as for value transfer from ownership restrictions. In particular, we find evidence of a transfer of wealth from existing holders of foreign currency denominated bonds of other Indian firms. However, the implicit seniority accounts for some but not all the difference in yields suggesting that ownership restrictions also enhance value through other avenues such as higher collateral valuation and lower renegotiation costs. Overall, our results suggest that firms with niche clienteles can benefit from designing securities with ownership restrictions, by offering new securities exclusively to investors who value them the most.

00-05 "Joint Accounting Choices: An Examination of Firms' Adoption Strategies for SFAS No. 106 and SFAS No. 109," by Michele Daly, ***Debra Jeter****, and* ***Paul Chaney****. (December 2002)*

This paper investigates interactive choices made in the adoption of newly mandated accounting standards. Specifically, we consider whether firms' adoption strategies for SFAS No. 106 and SFAS No. 109 were linked, in addition to considering the interaction between choices related to adoption method and timing for each standard separately. The evidence presented is consistent with adoption strategies being associated with incentives to smooth income and to reduce political costs, and with adoption strategies for the two standards being chosen jointly. The paper also provides some 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.

00-10 "The Role of Incentives in the Prevention of Financial Crises in Emerging Economies," by ***Amar Gande****, Kose John and Lemma W. Senbet. (July 2003)*

We examine the role of the incentives of the decision-makers in corporations and banks in financial crises. We propose incentive-based mechanisms toward the prevention rather than an ex post resolution of these crises. We show that private incentives for risk shifting in the local economy in the corporate and banking sectors could ultimately produce distorted economic performance and financial instability leading to an increased probability of a financial crisis. However, this effect depends on how diverse the economy is in terms of the investment opportunities – the less diverse an economy is, the more vulnerable is it to a financial crisis. We also show that currency risk associated with foreign-currency denominated debt leads to aggravated risk-shifting, which when undertaken in coordination by many firms can magnify into a "contagion". The channel for our solution mechanisms to prevent a financial crisis is predicated on their role to mitigate distorted incentives arising from explicit or implicit bailouts, which in turn mitigates a country's vulnerability to a financial crisis. These mechanisms alter the structure of the after-tax cash flows to residual claimants in the corporate and banking sectors and change the incentives in the right direction. We also consider the interaction between the incentives of banks and the incentives of corporations. In a model in which banks monitor corporate investments in addition to making the loan decisions, we design a tax structure for banks which provides monitoring incentives to the bank which, in turn, induces optimal investment by the corporate sector. Issues of implementation of the proposed mechanisms are also discussed.

00-12 "Self-Selection of Auditors and Audit Pricing in Private Firms," by ***Paul Chaney, Debra Jeter****, and L. Shivakumar. (forthcoming in Accounting Review)*

Prior research has examined audit pricing for publicly held firms and provided some evidence of a Big 8 premium in pricing. We investigate audit pricing among private firms, and provide evidence that private firms do not pay such a premium on average. The relatively greater degree of dispersion in auditor choice (between Big 5 and non-Big 5 auditors) in our large sample of privately held audit clients allows us to predict the auditor choice for each firm and to control for potential self-selection. We reject the null hypothesis that clients are randomly allocated across Big 5 and non-Big 5 auditors. Using standard OLS regressions, we document a Big 5 premium; however this premium vanishes once we control for self-selection bias. Moreover,

we find that 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 private firms being segmented along cost-effective lines. Further, our results suggest that auditees in our setting do not, on average, view Big 5 auditors as superior in terms of the perceived quality of the services provided to a degree significant enough to warrant a fee premium.

00-18 "Preferences of the Rich and Famous: Conspicuous Consumption in Competitive Markets," by ***Anchada Charoenrook*** *and Anjan V. Thakor. (2002)*

This paper explains why consumers are willing to purchase luxury goods at prices significantly above producer's marginal costs. It also explains the choice of goods that qualify for such 'conspicuous consumption' status. These results are obtained by modeling conspicuous consumption as a signaling game in which wealthy individuals signal their wealth to society in order to obtain higher social status. Conspicuous consumption is constraint by discrete cost of display. This cost can be interpreted as arising from limited physical space, limited social opportunities for display, or both. It is shown that signaling by consuming a higher-priced good can arise under general single crossing-property conditions. The conditions under which consumers signal using price rather than quantity are derived. Results show that the higher the cost of display, the more likely is the consumer to signal by purchasing high-price conspicuous goods; the lower the free display space and time available, and the higher equilibrium price. Finally, it is shown that goods with higher upper bound in the variability of innate consumption utility in the cross-section of consumers are accepted as conspicuous goods at higher prices than those with lower variability.

01-04 "Inflation and Price Dispersion in Equity Markets and in Goods and Services Markets," by ***David C. Parsley*** *and Helen A. Popper. (June 2002)*

We reexamine the empirical link between inflation and relative price dispersion, and we reconsider its standard interpretations. The most prominent studies interpret the link in terms either of menu costs models, such as Sheshinski and Weiss (1977), or of imperfect information models, such as Lucas (1973). While these models both imply that the inflation-dispersion link should exist in markets for goods and services, they imply no such link in the stock market. Thus, the stock market provides a natural benchmark for reassessing these interpretations. We find that an inflation-dispersion link – comparable to that found in other markets – does exist in the stock market. We also examine whether we can attribute the results to small sample biases. We find an important but generally overlooked bias that is present in many existing studies. However, the bias alone cannot explain the strength of our own findings in either the stock market or the markets for goods and services.

01-05 "Accounting for Real Exchange Rate Changes in East Asia," by ***David C. Parsley****. (February 2003)*

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 among twenty-one bilateral Asian-Pacific real exchange rates. Following Engel (1999), the decomposition is done at all possible horizons that the data allow – from one month up to 25 years. For the most part, evidence presented here is consistent with that from his sample of (predominantly) G7 countries. In particular, relative prices of non-traded goods appear to account for virtually none of the movements in Pacific Rim real exchange rates. 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 exceptions to these results occur when we examined the drift in real exchange rates, and more generally, for fixed (or semi-fixed) exchange rate regimes.

01-07 "The Role of Capital Structure in Cross-Sectional Tests of Equity Returns," by ***Anchada Charoenrook****. (February 2003)*

This paper examines the impact of time varying capital structure in cross-sectional tests of equity returns (the capital structure effect). Theoretical analysis yields very different empirical implications and interpretations than is common in the asset pricing literature. The analysis shows that the capital structure effect biases regression coefficients in the Fama and MacBeth (1973) estimation, and can induce the relation between size or book-to-market and equity returns. A new empirical test that distinguishes this explanation from other explanations in the literature reveals that in a cross section of equity returns the capital structure effect accounts for at least 50\% of the explanatory power of size and 70\% of the explanatory power of book-to-market.

01-11 "Price Impacts of Option Volume," by Christian Schlag and ***Hans Stoll****. (July 9, 2003)*

The price impacts of signed option volume are investigated with transactions data for options and futures on the DAX index. We find that signed option and futures trading have a significant contemporaneous price effect and we investigate the source of the effect. We find that the price effect of option volume has a temporary component, which implies the presence of a liquidity effect. On the other hand, the price impact of futures volume is largely permanent, which implies an information effect. We conclude that futures traders possess private information about the index and that they, not the option traders, are the informed traders in the DAX. We also investigate the relation of options and futures volume and find that signed futures volume leads signed option volume, which suggests that the options traders are the followers not the leaders in price discovery. We investigate whether options or futures volume predict price changes and conclude that they do not.

01-13 "Currency Arrangements and Goods Market Integration: A Price Based Approach," by ***David C. Parsley*** *and Shang-Jin Wei. (August 2002)*

Recent studies of the effect of currency arrangements on goods market integration (starting with Rose, 2000) employ a methodology based on volumes of trade. However, the connection between market integration and trade flows can be loose. In this paper, we adopt a different methodology that uses a 3-dimensional panel of prices of 95 very disaggregated goods (e.g., light bulbs) in 83 cities around the world from 1900 to 2000. We find that the impact of an institutionalized stabilization of the exchange rate, i.e., a currency board or a currency union, generally provides a stimulus to goods market integration that goes far beyond reducing exchange rate volatility to zero. However, there are important exceptions. Among the institutional arrangements, long-term currency unions demonstrate greater integration than more recent currency boards. All of them can improve their integration further relative to a U.S. benchmark.

01-16 "Market Microstructure," by ***Hans R. Stoll****. (forthcoming in Handbook of the Economics of Finance)*

Market microstructure deals with the purest form of financial intermediation – the trading of a financial asset, such as a stock or a bond. In a trading market, assets are not transformed but are simply transferred from one investor to another. The field of market microstructure studies the cost of trading securities and the impact of trading costs on the short-run behavior of securities prices. Costs are reflected in the bid-ask spread (and related measures) and in commissions. The focus of this chapter is on the determinants of the spread rather than on commissions. After an introduction to markets, traders and the trading process, I review the theory of the bid-ask spread in section II and examine the implications of the

continued on page 12

spread for the short run behavior of prices in section III. In section IV, the empirical evidence on the magnitude and nature of trading costs is summarized, and inferences are drawn about the importance of various sources of the spread. Price impacts of trading from block trades, from herding or from other sources, are considered in section V. Issues in the design of a trading market, such as the functioning of call versus continuous markets and of dealer versus auction markets, are examined in section VI. Even casual observers of markets have undoubtedly noted the surprising pace at which new trading markets are being established even as others merge. Section VII briefly surveys recent developments in U.S securities markets and considers the forces leading to centralization of trading in a single market versus the forces leading to multiple markets. Most of this chapter deals with the microstructure of equities markets. In section VIII, the microstructure of other markets is considered. Section IX provides a brief discussion of the implications of microstructure for asset pricing. Section X concludes.

01-18 "Pricing in International Markets: A 'Small Country' Benchmark," by ***David C. Parsley****. (forthcoming in Review of International Economics)*

This study examines export pricing to market (PTM) in a 'small-country' context using a panel of disaggregated exports from Hong Kong to its major flexible exchange rate destinations since 1992. Conventional wisdom on PTM is taken from G7 countries, where PTM is commonplace. In contrast it is often found that U.S. exporters apparently do not mitigate export prices in response to exchange rates. This study provides a benchmark by which to interpret the puzzling behavior of U.S. export prices.

Empirically, Hong Kong's export price behavior is comparable to that from the U.S. Indeed, there is very little evidence of PTM by Hong Kong exporters. This similarity reinforces the idea that PTM behavior is also a function of home market conditions and the ability to price discriminate across markets. In line with existing research, we find little evidence of differences in PTM across export destinations.

01-20 "Short-term Persistence in Mutual Fund Performance," by ***Nicolas P.B. Bollen*** *and Jeffrey A. Busse. (October 2002)*

Using daily data, we find evidence of short-term persistence in mutual fund performance. We estimate parameters of standard stock selection and market timing models every quarter, rank funds by abnormal return, and then measure the performance of each decile the following quarter. In contrast to Carhart (1997), we find that superior performance persists after controlling for momentum. The annualized average post-ranking abnormal return of the top decile is 1.5 percent. The post-ranking abnormal return disappears when funds are evaluated over longer periods. These results suggest that superior performance is a short-lived phenomenon that is observable only when funds are evaluated several times a year.

01-22 "Optimal Contract Design: For Whom?" by ***Nicolas P.B. Bollen****, Tom Smith, and Robert E. Whaley. (forthcoming in Journal of Futures Markets)*

In designing a derivative contract, an exchange carefully considers how its attributes affect the expected profits of its members. On November 3, 1997, the Chicago Mercantile Exchange doubled its tick size of its S&P 500 futures contract and halved the denomination, providing a rare opportunity to examine empirically the search for an optimal contract design. This paper measures changes in the trading environment that occurred in the days surrounding the contract redesign. We find a discernible change in the incidence of price clustering, an increase in the bid/ask spread, a reduction in trading volume, and no meaningful change in dollar trade size. These results suggest that the contract redesign did not increase accessibility but did increase market maker revenue. Despite the increase, however, the bid/ask spread of the S&P 500 futures contract remains low relative to the costs of market making and the spreads in markets for competing instruments.

01-24 "Compensation and Capital Structure Incentives for Risk-Averse Managers," by Murillo Campello, Farzad Mashayekhi, and ***Charu G. Raheja****. (February 2003)*

This paper studies managerial incentive contracts and capital structure choices that maximize the value of the firm when the CEO is risk averse. We examine in detail the management project choices when the external claims in the firm are (1) all equity, and (2) equity and risky debt. We do this by proposing a theory which demonstrates that increasing pay-for-performance sensitivity of the manager's compensation contract does not always increase the incentives of the managers to increase project risk. This result is contrary to previous belief that higher levels of equity compensation would cause the manager to risk-shift. We test our model using a large data set of industrial firms over the 1992-1998 period and confirm the main implication of our theory.

01-25 "The Interaction of Insiders and Outsiders in Monitoring: A Theory of Corporate Boards," by ***Charu G. Raheja****. (June 2003)*

This paper presents a theoretical model of the interaction of inside and outside members of a corporate board by examining the board's monitoring of firm projects and its involvement in CEO succession decisions. I show that board structure affects the flow of information and the effectiveness of the corporate board, and I endogenously derive the optimal board size and composition. Inside directors are better informed than outsiders regarding firm investment projects. Outside directors use their CEO succession votes to create a competition among insiders and incite insiders to reveal their superior information to the board. The structure of the optimal board and the ability of the board to generate information and monitor projects vary with firm characteristics. For example, firms where it is very costly for outsiders to verify projects can find it optimal to select a small board with a high proportion of insiders. Optimal boards of firms with costly verification are less effective in generating information and monitoring management

01-27 "Does Net Buying Pressure Affect the Shape of Implied Volatility Functions?" by ***Nicolas P.B. Bollen*** *and Robert E. Whaley. (forthcoming in Journal of Finance)*

This paper examines the relation between net buying pressure and the shape of the implied volatility function (IVF) for index and individual stock options. We find that changes in implied volatility are directly related to net buying pressure from public order flow. We also find that changes in implied volatility of S&P 500 options are most strongly affected by buying pressure for index puts, while changes in implied volatility of stock options are dominated by call option demand. Simulated delta-neutral option-writing trading strategies generate abnormal returns that match the deviations of the IVFs above realized historical return volatilities.

01-28 "News Spillovers in the Sovereign Debt Market," by ***Amar Gande*** *and* ***David Parsley****. (July 2003)*

We study the effect of a sovereign credit rating change of one country on the sovereign credit spreads of other countries for 155 ratings change events from 1991 to 2000. We find evidence of spillover effects, that is, a ratings change in one country has a significant effect on sovereign credit spreads of other countries. This effect is asymmetric: positive ratings events abroad have no discernable impact on sovereign spreads, whereas negative ratings events are associated with an increase in spreads. On average, a one-notch downgrade of a sovereign bond is associated with a 12 basis

point increase in spreads of sovereign bonds of other countries. Interestingly, the magnitude of the spillover effect following a negative ratings change is amplified by recent ratings changes in other countries. Conceptually, we distinguish between common information and competitive components of spillovers. While common information spillovers imply that sovereign spreads move in tandem, competitive spillovers are expected to result in a differential effect of ratings events across countries. Despite the predominance of common information spillovers, we also find evidence of competitive spillovers among countries with highly negatively correlated capital flows or trade flows vis-à-vis the United States. That is, spreads in these countries generally fall relative to other countries in response to a downgrade of a country with highly negatively correlated capital or trade flows. Variables proxying for cultural or institutional linkages (e.g., common language, formal trade blocs, common-law legal systems), physical proximity, or rule of law traditions across countries do not seem to affect estimated spillover effects.

01-31 "Do Firms Time Equity Offerings? Evidence from rights and firm commitment offers during the 1930s and 1940s," by Timothy Burch, ***William G. Christie,*** *and Vikram Nanda. (July 10, 2003)*

We investigate whether the timing of equity sales to exploit market overvaluation may account for the reported poor post-offer stock performance of firms issuing equity. We posit that rights offers, targeted at the firm's existing shareholders, are less likely to be timed to exploit overvaluation. Our study compares firm commitment and rights offerings during 1933-1949 when rights were prevalent. We find that abnormal returns for firms electing the firm commitment method were significantly negative over the year following the offer, while those for firms using rights were not. This suggests that firm commitments were timed while rights were not.

02-02 "Out-Trades: Trading Option, Reporting Delay, or Trade Size?" by ***Hans R. Stoll*** *and* ***Christoph Schenzler.*** *(July 3, 2003)*

By almost any measure, market quality improved greatly in the period 1993 through 1999 initially examined in this study. Quoted and effective spreads declined greatly on Nasdaq and to a lesser degree on the NYSE. At the same time, however, out-trades – trades occurring outside of quotes – increased dramatically on Nasdaq. Perhaps this is not surprising in view of the greatly narrowed spreads; nevertheless, one wonders why investors choose not to trade against superior posted quotes and why a similar tendency for out-trades is not observed on the NYSE. We investigate the source of out-trades in order to better understand how the Nasdaq dealer market functions in comparison to the NYSE auction market. We conclude that out-trades occur in Nasdaq because of delays in reporting trades, because the ability of dealers to delay execution of trades creates a look-back option which when exercised results in an out-trade, and because large trades can take place at prices outside the quotes. Out-trades are rarely observed on the NYSE because the market is more centralized. Nevertheless the pattern of trading on the NYSE is not inconsistent with the specialist benefiting from a look-back trading option.

02-03 "The Effects of Accounting Choice on Analysts' Forecast Errors and Market Response in the Oil and Gas Industry," by ***Paul K. Chaney*** *and* ***Debra C. Jeter.*** *(January 2002)*

A long-standing controversy exists over whether the two acceptable methods of accounting for certain assets in extractive industries (primarily oil and gas) should continue to be allowed. This paper considers how the choice between full costing (FC) and successful efforts (SE) in extractive industries affects the degree of accuracy and bias in analysts' forecasts of earnings. When such characteristics as firm size, diversification and leverage are controlled for, multivariate findings reveal that the choice of the FC method leads to smaller absolute errors and less upward bias in forecasts. By allowing full costing as an alternative, the standards enable a set of firms electing that method to increase the predictability of reported earnings through accounting choice, thereby accomplishing to a degree what other (generally larger) firms may accomplish through more frequent disclosures, diversification, or other means.

02-04 "Venture Capital Investments by IPO Underwriters: Certification or Conflict of Interest?" by ***Ronald W. Masulis*** *and Xi Li. (July 2003)*

We study IPO pricing when underwriters are venture capital investors in issuers and evaluate whether this creates a serious conflict of interest with IPO investors or reduces the conflict of interest with IPO issuers. Theoretically, prior underwriter venture investment has several effects. First, it can increase alignment of underwriter interests with issuers, which decreases the credibility of underwriter due diligence investigations with IPO investors, lowering investor demand and IPO offer prices, if prices are set competitively. Second, it can improve underwriter access to IPO issuer information, thereby enhancing the credibility of its due diligence investigations and raising investor demand and IPO offer prices. Third, it improves the alignment of interest of underwriters and IPO issuers, which results in higher IPO offer prices, if underwriters have pricing power in an oligopolistic market and capture rents from allocating underpriced issues.

Empirically, venture capital investments by *lead* underwriters significantly reduce IPO underpricing, while venture investments by other syndicate underwriters have no effect. This lead underwriter certification effect is stronger when investors have greater uncertainty about IPO valuation. The certification effect weakens as lead underwriter shareholdings rise to 10% or above, which is consistent with a more serious moral hazard problem for IPO investors under these circumstances. Controlling for endogeneity effects does not change our conclusions. Lead underwriter venture investment in IPO issuers also reduces underwriting fees. This evidence is consistent with greater alignment of interests between lead underwriters and IPO issuers, which lead to higher offer prices and lower underwriter spreads.

02-06 "Change in the Consumer Sentiment Index and Aggregate Stock Returns," by ***Anchada Charoenrook.*** *(January 2002)*

This study finds yearly changes in the consumer sentiment index to be negatively related to future aggregate excess stock market returns. Changes in consumer sentiment reliably predict excess stock market returns at one-month and one-year horizons over 1979-2000 and 1955-2000 periods. Changes in consumer sentiment predict future excess stock returns after controlling for dividend yield, the ratio of the Dow Jones Industrial Average, the slope of the term structure, the yield spread between Baa and Aaa bonds, the short rate yield, and lagged excess market returns. The primary result is robust with respect to small-sample bias.

02-10 "Information Disclosure as Environmental Regulation: A Theoretical Analysis," by ***Mark A. Cohen*** *and V. Santhakumar. (January 2002)*

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.

continued on page 14

02-11 "Vertical Restraints and the Effects of Upstream Horizontal Mergers," by ***Luke Froeb****, Steven Tschantz, and Gregory Werden. (March 27, 2002)*

This paper investigates how monopoly retail sector "filters" the price effects of mergers among upstream Bertrand competitors. Three alternative game-theoretic treatments of the relationship between the retailer and manufacturers are considered . In one the retail sector is "transparent"—the price effects of a merger of competing manufacturers are exactly those that would occur if the manufacturers sold directly to consumers. In a second, the retail sector is "opaque"—consumer prices do not change following a merger, which merely shifts rents from the retailer to the merged firm. In the third, the price effects of a manufacturer merger are affected in various ways by the retail sector, and the retail prices of competing products sold by non-merging firms may decrease as a result of the merger.

02-12 "Modeling the Bid/Ask Spread: Measuring the Inventory-Holding Premium," by ***Nicolas P.B. Bollen****, Tom Smith, and Robert E. Whaley. (forthcoming in Journal of Financial Economics)*

The need to understand and measure the determinants of market maker bid/ask spreads is crucial in evaluating the merits of competing market structures and the fairness of market maker rents. After providing a brief review of past work, this study develops a simple, parsimonious model for the market maker's spread that accounts for the effects of price discreteness induced by minimum tick size, order-processing costs, inventory-holding costs, adverse selection, and competition. The inventory-holding and adverse selection cost components of spread are modeled as an option with a stochastic time to expiration. This inventory-holding premium embedded in the spread represents compensation for the price risk borne by the market maker while the security is held in inventory. The premium is partitioned in such a way that the inventory holding and adverse selection cost components, as well as the probability of an informed trade, are identified. The model is tested empirically using NASDAQ stocks in three distinct minimum tick size regimes and is shown to perform well both in an absolute sense and relative to competing specifications.

02-14 "Real Options for Real Firms: Valuing a Heterogeneous Set of Call Options with Suboptimal Exercise Decisions," by ***Gordon Hanka****. (March 2002)*

If the fixed parameters of the Black-Scholes model are replaced with prior distributions, the result is a closed formula for the value of a draw from a heterogeneous set of European calls. This option pricing approach easily accommodates quantity risk, uncertain strike price, and suboptimal exercise decisions. This represents a parsimonious analytical solution to a common but heretofore unsolved problem: translating abstract measures of forecast accuracy (e.g., standard error, R2, and bias) into concrete measures of expected wealth creation when choosing from a large and diverse set of investment opportunities. A natural application is to quantify the firm-wide expected costs of common frictions such as cash flow forecast noise, capital rationing, hubris, empire building, ratio fixation, and overreaction. The pricing equation is demonstrated by deriving some rough rules of thumb for when managerial overinvestment and overreaction are costly enough to be worrisome.

02-15 "Simple Limits on Liquidity Hedging with Futures," by ***Gordon Hanka****. (April 2002)*

Here it is shown that, if the motive for hedging is to protect liquidity reserves against long-term income shocks that can have either positive or negative sign, then an ideal static futures hedge can deliver, at most, the same protection that would be obtained by doubling the firm's liquid reserve. To obtain greater protection, the firm must adopt a dynamic strategy of chasing past returns, reducing futures positions that lose money and increasing positions that make money.

02-16 "Does Insider Trading Impair Market Liquidity? Evidence from IPO Lockup Expirations," by Charles Cao, Laura Casares Field, and ***Gordon Hanka****. (April 3, 2002)*

We test the hypothesis that insider trading impairs market liquidity, by analyzing intraday trades and quotes around 1,497 IPO lockup expirations in the period 1995-1999. We find that, while lockup expirations are associated with considerable insider trading for some IPO firms, they have little effect on effective spreads. By contrast, two other liquidity measures, quote depth and trading activity, improve substantially. In the 23 percent of lockup expirations where insiders disclose share sales, spreads actually decline. These findings indicate that a large body of well-informed, blockholding insider traders can enter a market from which they had previously been absent, and substantially change trading volume and share price, without impairing market liquidity.

02-18 "Exchange Rate Pegs and Foreign Exchange Exposure in East Asia," by ***David Parsley*** *and Helen Popper. (October 2002)*

This paper shows that many East Asian 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 East Asian firms studied here are most exposed to fluctuations in the U.S. dollar, and the mark and yen 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.

02-23 "Common Cents? Tick Size, Trading Costs, and Mutual Fund Performance," by ***Nicolas P.B. Bollen*** *and Jeffrey A. Busse. (May 2003)*

This paper measures changes in equity mutual fund trading costs following two changes in tick size on Nasdaq and the NYSE: the switch from eighths to sixteenths and the switch from sixteenths to pennies. 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 index fund performance is unaffected by the switch to pennies. In contrast, actively managed funds under perform their benchmark by an additional one percent of fund assets per year after decimalization.

02-25 "Informational Efficiency of Loans versus Bonds: Evidence from Secondary Market Prices," by Edward Altman, ***Amar Gande****, and Anthony Saunders. (July 2003)*

This paper examines the informational efficiency of loans relative to bonds surrounding bond default dates and loan default dates. We examine this issue using a unique dataset of secondary market prices during the period 11/99-06/02. We find that return correlations between loans and bonds are relatively low for the entire sample period but are considerably higher during a 21-day event window surrounding the default dates. We also find that price reaction of loans is less adverse than that of bonds around the default dates, and this differential price reaction is directly related to the differences in expected recovery rates in default. Overall, our evidence is consistent with a monitoring role of loans, and suggests that the loan market is informationally more efficient than the bond market around default dates.

03-01 "The Choice of Financing Method in European Mergers & Acquisitions," by ***Mara Faccio****, and* ***Ronald W. Masulis****. (June 2003)*

We study the financing choices in a broad sample of 3864 mergers and acquisitions (M&A) by European bidders of publicly and privately held targets and over the period 1997-2000. Europe is an ideal venue for studying the importance of corporate governance in making M&A financing choices, given the large number of closely held firms. Furthermore, our dataset allows for a wide range of institutional settings and legal and regulatory rules which can impact M&A activity. A model of the M&A financing choice is developed and tested with panel data. The trade off between corporate governance concerns and debt financing constraints is found to have a large bearing on the bidder's financing choice. Consistent with earlier evidence, we find that other bid attributes such as deal and target characteristics significantly affect the choice of M&A payment method.

03-02 "Accounting for Real Exchange Rate Changes with Individual Goods," by ***David Parsley*** *and Helen Popper. (December 2002)*

In this paper, we examine the role of individual goods' prices in explaining real exchange rate fluctuations. We show that deviations from the law of one price in even a single good, such as a haircut, can account for virtually all of the real exchange rate movements. We compare this finding with that of Engel (1999), who shows that virtually all of the fluctuation can be accounted for by aggregate deviations from the law of one price in traded goods.

03-06 "Politically Connected Firms," by ***Mara Faccio****. (February 2003)*

For a sample of 42 countries, I examine firms with controlling shareholders and top managers who are members of national parliaments or governments. I find this overlap to be quite widespread. Connected companies enjoy easy access to debt financing, low taxation, and higher market share. These benefits are particularly pronounced when companies are connected through their owner, a seasoned politician, or a minister. Benefits are generally greater when connected firms operate in countries with higher degrees of corruption, resulting in a significant increase in value.

03-07 "Debt and Expropriation," by ***Mara Faccio****, Larry H.P. Lang, and Leslie Young. (July 2003)*

Whereas debt constrains the expropriation of dispersed shareholders by professional managers of US corporations, in European and Asian corporate pyramids debt can facilitate the expropriation of minority shareholders by the controlling shareholder. European capital market institutions appear sufficiently effective that competition for external capital from informed suppliers restricts the leverage of corporations that appear more vulnerable to expropriation through being lower down a pyramid. Asian institutions appear ineffective, allowing the controlling shareholders of corporations lower down a pyramid to increase leverage to acquire more resources to expropriate. These contrasting outcomes are reflected in regional differences in access to related-party loans.

03-08 "Expropriation vs. Proportional Sharing in Corporate Acquisitions," by ***Mara Faccio*** *and David Stolin. (July 15, 2003)*

An important and growing literature in finance points to existence of substantial benefits to being a controlling shareholder, especially when legal protection of minority shareholders is weak, and when separation of ownership from control is high. At the same time, the substantial and well established literature on mergers often finds these key corporate events to be subject to agency costs. Relying on these two arguments, we employ a novel application of the Bertrand et al (2002) insight to study the hypothesis that controlling shareholders use acquisitions to expropriate resources to their benefit. The findings do not allow us to reject the null hypothesis of proportional sharing of acquisition gains in favor of the alternative hypothesis of expropriation of bidder's minority shareholders.

03-10 "The Determinants of Issue Cycles for Initial Public Offerings," by Vladimir Ivanov and ***Craig M. Lewis****. (July 2003)*

The paper identifies the determinants of security issues cycles using an autoregressive conditional duration model. We examine the business conditions, investor sentiment, and time-varying asymmetric information hypotheses, and find support for the business conditions hypothesis.

03-11 "The Micro-Foundations of Big Mac Real Exchange Rates," by ***David C. Parsley*** *and Shang-Jin Wei. (June 30, 2003)*

The real exchange rate is said to be the single most important price in an economy. While we used to think that we knew what explained its movements (e.g., the Balassa-Samuelson effect), the recent much-cited result by Engel (1999) proposes a serious reinterpretation; specifically, nearly 100% of the movements in the U.S. real exchange rate are explained by deviations from the law of one price. Engel's finding holds even in the medium run – when cross-country movements in the relative price of non-tradables were thought to be of paramount importance.

In this project, we study the movement of real exchange rates based on the prices of Big Macs (which we show are highly correlated with the CPI-based real exchange rates). Our main innovation is to match these prices to the prices of individual ingredients (ground beef, bread, lettuce, labor cost, rent, etc.) in 34 countries during 1990-2002. There are a number of advantages associated with our approach. First, unlike the CPI real exchange rate, we can measure the Big Mac real exchange rate in levels in an economically meaningful way. Second, unlike the CPI real exchange rate, for which the attribution to tradable and non-tradable components involves assumptions on the weights and the functional form, we (almost) know the exact composition of a Big Mac, and can estimate the tradable and non-tradable components relatively precisely. Third, we can study the dynamics of the real exchange rate in a setting free of: the product-aggregation bias (argued by Imbs, Mumtaz, Ravn, and Rey, 2002, to be important in studies on CPI real exchange rates); the temporal aggregation bias (argued to be important by Taylor, 2001); and the bias generated by non-compatible consumption baskets across countries. Fourth, we show that Engel's result that deviations from the law of one price are sole explanation for real exchange rate movements does not hold generally. Finally, we offer some evidence on the importance of economic and institutional factors underlying Engel's result.

03-13 "Short Sale Restrictions, Stock Returns, and the Cost of Equity: Evidence from World Markets," by ***Anchada Charoenrook*** *and Hazem Daouk. (March 2003)*

This paper reports regulations and practice of short sales and put option trading of 111 countries that have a stock exchange. We use this dataset to study the effects of short sale constraints on the distribution of equity returns, liquidity of the stock markets, frequency of crashes, and the cost of capital. Overall, countries that allow short sales have lower market return volatility, higher liquidity, and more negative skewness. The probability of crashes and the cost of capital are indifferent between countries with and with out short sale constraints. When short sales are constrained, skewness is negatively related to (1) increase in trading volume relative to recent past, and (2) positive returns over the recent past. ■

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