VANDERBILT
Owen Graduate School of Management

FINANCIAL MARKETS

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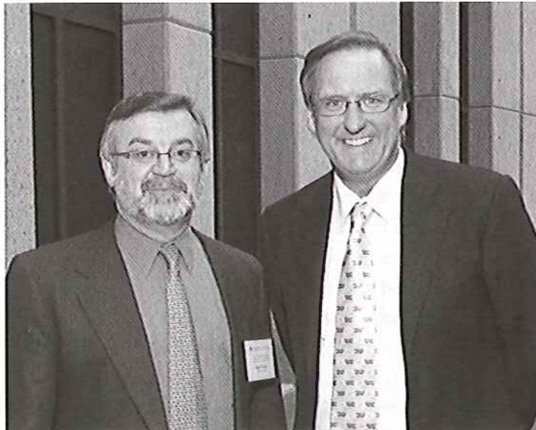
FINANCIAL MARKETS RESEARCH CENTER • 2005

Conference in *Honor of Hans R. Stoll's Contributions to the Field of Finance*

This year's Financial Markets Research Center conference, held May 19 – 20, 2005, honored **Hans R. Stoll** for his many contributions to the theory and practice of finance. The conference was organized by **Robert Whaley** and **Bill Christie** on the occasion of Hans's 65th birthday and 25th year at Vanderbilt.

This, the 18th annual conference of the Center, continued with its usual interface among academics, government regulators, and industry professionals, but its focus was broader and its participation wider than usual in recognition of Hans's research on such diverse topics as derivatives, market microstructure, and international finance. The program included people with whom Hans has interacted professionally during the past 40 years. From academia, there were classmates from the University of Chicago during his graduate school days, former colleagues from the Wharton School where Hans took his first academic position, collaborators from the times Hans was on leave and visiting the Federal Reserve, the Securities Exchange Commission, ESSEC, and Karlsruhe, and, finally, coauthors and colleagues from his 25 years at the Owen School. From industry, there were exchange officials, fund managers, consultants, and product strategists. The common thread running through the program is the influence that Hans has had on their careers and lives and vice versa.



Conference organizers Robert Whaley and Bill Christie

The conference was sponsored by the Financial Markets Research Center and by a special grant from the New York Stock Exchange. Additional support was provided by the Hull Family Foundation and by Sanborn Kilcollin Partners, LLC.

Jim Bradford, the newly appointed dean of the Owen School and **Bill Christie**, Professor of Finance at the Owen School and one of the conference organizers, welcomed participants. The first session of the day dealt with Derivatives and was chaired by **Duke Chapman**, former chairman of the Chicago Board Options Exchange and one of the first members of the Center. Chapman commented on the changes in options trading since the crash of 1987 when he had recently become chairman of the CBOE. Mr. Chapman introduced **Steve Figlewski**, Professor at NYU and currently on leave at Citibank, where he is analyzing credit derivatives. Professor Figlewski provided evidence on the correlation between credit default swap spreads and other measures of credit risk, such as yield spreads and implied volatilities from equity options. **Nick Bollen**, Associate Professor at the Owen School, discussed Figlewski's results and suggested that implied volatility of out-of-the-money puts might be a better indicator of credit risk than the implied volatilities of at-the-money puts.

Mr. Chapman next introduced **Markus Brunnermeier**, Assistant Professor of Economics at Princeton, who presented his paper, "Market Liquidity and Funding Liquidity," (with Lasse Pedersen). Brunnermeier's model provides an explanation of how liquidity suddenly dries up and what factors determine liquidity crises. **Bernard Dumas**, Professor at INSEAD, commented on the paper and noted that the dealer funding constraints in the model that produced the results may be artificial. He drew an analogy to the theory of forward exchange where artificial limits on arbitrage allowed forward rates to deviate from interest rate parity. The second commentator, **Glenn Satty**, Glenn Satty Ltd., provided a general commentary on derivatives and hedge funds. He noted that hedge funds can experience sudden liquidity crises, as in the Brunnermeier paper, because of high leverage. Lock-up restrictions by hedge funds spread the crisis as investors liquidate investments in those hedge funds not subject to lock-ups. The effect is likely to be that the liquidity crisis is transferred from the weak funds (with lock-up restrictions) to strong funds (without lock-up restrictions).

Alan Kraus introducing the panel.

After a short break, participants returned for a panel discussion on Recent Advances in Corporate Finance, chaired by **Alan Kraus**, Professor of Finance at the University of British Columbia. Professor Kraus introduced the first speaker, **Thomas Ho**, Thomas Ho Company, who presented his research paper, "Business Model: Capital Budgeting, Equity Valuation, and Returns Attribution." The model contrasts a naive "bottoms up" NPV approach to capital budgeting in which each project is considered independently to a more realistic "top down" approach in which projects are viewed as options that may be exercised contingent

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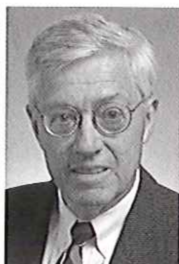
FROM THE DIRECTOR

A personal note of thanks to Bob Whaley and Bill Christie for organizing this year's Financial Markets Research Center conference. Thanks especially to Bob, who did it all from long distance at Duke. Pat Scott, administrator for the Center, deserves special plaudits for coordinating the conference details. Thanks also to my wife Margie, who helped plan the conference dinners and managed to reserve some surprises for me, not the least of which was the appearance of our children to present a "top ten things about dad" list. Margie, had her own list, but thankfully refrained from airing it. Thanks also for the kind comments from dinner speakers Bob Whaley, Tom Copeland, Rick Kilcollin, Roger Huang and Herb Grubel. I very much appreciate the efforts of so many colleagues and friends from the past 40 years to attend the conference, with several coming particularly long distances – Bernard Dumas from INSEAD, Hermann Goeppl from the University of Karlsruhe, and Christian Schlag from Goethe University. Others traveled from all parts of the US and Canada. It was a great conference and a great party! Many thanks.


Hans R. Stoll

As the Center enters its 19th year, it continues to pursue its principal goals – to maintain research data bases, to host conferences, to fund research, and to promote interaction among academics, regulators, and industry leaders. The 18 faculty associated with the Center come from the fields of finance, accounting, and economics and are listed elsewhere in this newsletter. Providing financial support are 12 Center members. They are also listed elsewhere in this newsletter. With regard to the administration of the Center, Paul Chaney, Professor of Accounting, has agreed to oversee the purchase of, and access to, the Center's various data bases. Christoph Schenzler continues as Research Associate and data base manager, responsible for maintaining major data bases and assisting faculty in accessing data.

In April of this year, William Spitz, Treasurer and Vice Chancellor for Investments at Vanderbilt, received the *2005 Award for Investment Leadership* from Hirtle, Callaghan and Company. The award recognizes investment practitioners who have consistently demonstrated over time exemplary investment management performance and unwavering professional ethics. The award is accompanied by a grant of $50,000. Bill Spitz directed the entire sum to the Financial Markets Research Center. Thank you Bill, and thank you Hirtle Callaghan. The funds will be used to provide two summer research scholar awards, to help fund a conference on conflicts of interest in finance and to fund Hirtle Callaghan's membership in the FMRC. I am also delighted to welcome Archipelago as a new lead member of the Center.

On behalf of the Center, its faculty and its supporting members, let me extend a hearty welcome to the new dean of the Owen School, Jim Bradford. Jim has been at Owen since 2002 teaching strategy, serving as associate dean for corporate relations, and most recently as acting dean for 9 months before assuming his duties as dean last March. Prior to joining Owen, Jim was CEO of two different international glass companies.

Other comings and goings during the past year include that of visiting assistant professor Nicole Branger, who ably taught the advanced derivatives course in the spring of 2005. Nicole received her PhD from Goethe University in Frankfurt, Germany where she also teaches derivatives. She again visits Owen in the fall of 2005 to teach a PhD course in asset pricing. Also visiting as a postdoctoral fellow during the past year was Ettore Croci. Ettore received his PhD degree from the University of Lugano in Switzerland and visited Owen to pursue research in mergers and acquisitions.

Related to the Center's mission of disseminating knowledge of financial markets is the Center's influence on curriculum at the Owen School. Based in part on input from Center members, the Owen School has established a Master of Science Program in Finance. The program is aimed at students with prior quantitative backgrounds who want to focus their further studies in finance. The nine month program is being led by Professor Cliff Ball. The curriculum consists of a number of required core courses along with a broad selection of electives. ■

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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J. Dewey Daane, Senior Advisor
Paul Chaney, Data Coordinator
Christoph Schenzler, Research Associate and Data Base Manager
Pat Scott, Administrator

FUNDING

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

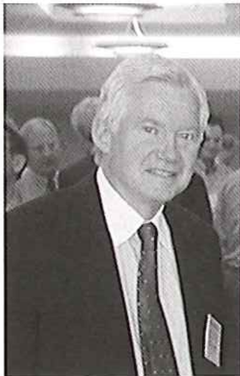
Current Center members are:

* Archipelago
Bear, Stearns & Company, Inc.
Caterpillar Financial Services
Chicago Board Options Exchange
Eclipse Capital Management, Inc.
* Hirtle, Callaghan & Co.
Hull Family Foundation
* Interactive Brokers Group
International Securities Exchange
* New York Stock Exchange, Inc.
Ronin Capital, LLC
* Thales Fund Management, LLC

*Indicates a lead member.

Hans R. Stoll's Contributions *(continued)*

on the company incurring a fixed cost to stay in business. Under this approach, projects must pay some of the cost of the option as well as the direct costs associated with the project. The next speaker, **Tom Copeland**, Head of the Monitor Corporate Finance Group, presented an option approach to corporate finance entitled, "A Theory of the Firm with Substitution between Real and Financial Options." He noted that corporate financial structure can be viewed as a three layer cake. The first layer is a primitive firm that operates with a given asset base and investment policy, where capital structure does not matter. The second layer is a firm that exploits real options – growth options or abandonment options. The third layer is a firm that retains options to adjust financial structure. He noted that real options and financial options interact to affect the optimal capital structure.



Tom Copeland describing the three layer capital structure cake.

The first part of the Thursday afternoon program was devoted to a session on market microstructure, chaired by **Thomas Peterffy**, Chairman of Interactive Brokers, and one of the founding supporters of the Financial Markets Research Center. Peterffy expressed concern about the anticompetitive effects of the recently announced mergers of the NYSE with Archipelago and of Nasdaq with Instinet. He then introduced the first speaker, **Maureen O'Hara**, Professor of Finance at Cornell, who presented her paper, "Down and Out in the Stock Market: The Law and Economics of the Delisting Process," (with Macey and Pompilio). The research examines the causes and effects of delisting and questions the NYSE process for delisting firms. **Erik Sirri**, Professor of Finance at Babson College, and **Paul Bennett**, Chief Economist of the NYSE, commented on the paper. Bennett challenged some of the statements in the paper and noted that the process and purpose of delisting are clearly stated in the NYSE rules and are clearly carried out by NYSE staff.

Blair Hull, Bill Brodsky, Phil DeFeo and Rich Lindsey preparing to respond to a question about financial innovation.

The second speaker in the microstructure session, **Larry Harris**, Professor of Finance at USC, presented his paper, "Corporate Bond Transparency and Transaction Costs," (with Edwards and Piwowar). Harris and his colleagues find that estimated bid-ask spreads narrow when trades are reported in the TRACE system, after controlling for other factors affecting spreads. **Paul Schultz**, Professor of Finance at Notre Dame, commenting on the paper, expressed surprise that the TRACE requirement that trades be reported within 45 minutes has an observable beneficial effect. He urged greater transparency in the market. **George Sofianos**, Vice President at Goldman Sachs, commented on the contrast between bond markets, where percentage transaction costs decline with trade size, and equity markets, where percentage transaction costs increase with trade size. TRACE reporting had little effect on this pattern, he observed.

After a break, the conference continued with a panel discussion on financial innovation chaired by **Rick Kilcollin**, cofounder of Sanborn Kilcollin Partners. Members of the panel included **William Brodsky**, Chairman and CEO of the Chicago Board Options Exchange, **Phil DeFeo**, Chairman and CEO of the Pacific Exchange, **Blair Hull**, Chairman and CEO of Matlock Capital, and **Richard Lindsey**, President of Bear Stearns Securities Corporation. The panel commented on the changes in the financial landscape as electronic markets, such as the ECNs in stocks and the International Securities Exchange in options, have taken market share away from traditional exchanges.

Traditional option markets, such as the CBOE, have had a difficult time in adjusting because members were reluctant to switch to new technologies that would jeopardize their future. The Pacific Exchange has met these challenges by (1) selling its equities business to Archipelago, (2) demutualizing, and most recently (3) agreeing to sell the rest of its business to Archipelago. Other issues discussed were the appropriate structure for governing and regulating exchanges and the competitive effects of the NYSE/Archipelago and Nasdaq/Instinet mergers. Most of the panelists were of the opinion that competition in trading services would continue to be effective in spite of the reduction in the number of players.

The Thursday evening reception and dinner was held at the Country Music Hall of Fame and Museum. **Bob Whaley** chaired the post dinner talks, welcomed the attendees, and said nice things about the honoree. Others commenting on their contact with Hans were Tom Copeland, Rick Kilcollin, Roger Huang, Herb Grubel, Jim Bradford, and Hans's wife and children (much to the honoree's surprise). Hans responded by thanking everyone for attending, and he denied all the allegations made by the previous speakers. He noted that success in the academic world can be assured by working with good co-authors. He thanked his co-authors – Alan Kraus, Tom Ho, Bob Whaley, Roger Huang, and Christian Schlag by presenting each of them with goblets inscribed with the references for their joint papers.

The conference resumed on Friday morning with a session on international finance chaired by **Tony Santomero**, President of the Federal Reserve Bank of Philadelphia. He introduced **Roger Huang**, Professor of Finance at Notre Dame University, who presented his paper, "Overseas Monitors and Emerging Financial Markets: Evidence from Foreign Investment Flows and Equity Ownership in Taiwan" (with Cheng-Yi Shiu). The research finds that stocks in emerging markets with high foreign ownership outperform other stocks, and this result is ascribed to the effective monitoring by foreign investors. **Amar Gande**, Assistant Professor of Finance at the Owen School, commented that perhaps factors other than monitoring, such as superior stock selection by foreigners, could explain the superior performance and suggested that it might be possible to measure the degree of monitoring directly.

Mr. Santomero next presided over a panel of three speakers on the topic, "Perspectives on International Finance." The first speaker, **Jack Lavery**, Chairman of Lavery Consulting Group, spoke on the fragility and the imbalances in the current U.S. economy. While growth has been strong, such other factors as the domestic deficit are not as encouraging. **Herbert Grubel**, Professor of Economics Emeritus at Simon Fraser University and a former member of the Canadian Parliament, spoke in favor of large

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Hans R. Stoll's Contributions *(continued)*

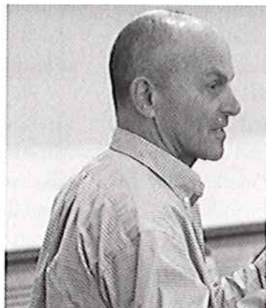
currency unions because, among other things, they result in better monetary policy and more efficient and liquid capital markets. He also commented on his recent trip to Shanghai and the dramatic developments he had observed there. **Jim Klingler**, Senior Vice President of Eclipse Capital Management, described his firm's approach to investing in the currency market. He noted that fundamental factors alone do not provide good trading signals; they must be supplemented by technical indicators that measure the market's sentiment.

The final session of the conference, on research directions in finance, was chaired by **Jim Cochrane**, former Senior Vice President at the NYSE and now affiliated with the Center for Corporate Governance at Vanderbilt. Cochrane did not introduce the panel members noting that these distinguished academics truly needed no introduction.

Marshall Blume, Professor of Finance at the Wharton School, discussed the paradigm shift that occurred in finance in the late 1950's and the 1960's when the Modigliani-Miller propositions, efficient capital markets and the CAPM were introduced, reviewed the subsequent attacks on these propositions, and left the audience wondering if there would be a new paradigm that would reconcile the two streams of work. **Gene Fama**, Professor of Finance at the University of Chicago, and personally responsible for much of the seminal research in finance in the last 40 years, gave an overview of finance in the past four decades, while recognizing he was violating the panel's charge to look toward future research directions.

Jim Cochrane not introducing the panelists.

He commented on the basic validity of the efficient markets hypothesis and remained unconvinced that behavioral finance provided a viable alternative explanation for the behavior of market prices. He expressed skepticism as to the contributions of corporate finance in explaining corporate behavior. **Michael Jensen**, Professor of Management, Emeritus, at Harvard, took a normative approach in his discussion of managerial incentives, managerial behavior, and management compensation. He gave a thoughtful review of his recent writings on appropriate managerial compensation, on the role of the stock market in diverting managers from their basic tasks, on the need to stop smoothing earnings, and on other issues. **Steve Ross**, Professor of Finance and Economics at MIT, commented on the debate between behavioral finance and efficient markets, coming down on the side of efficient markets. While noting the strengths of the classic finance propositions, he did reveal his concern about our inability to explain why prices changed in a particular way after the fact. He noted that it is understandable that stock price changes cannot be predicted, but it remains a puzzle that they cannot be explained.



Gene Fama speaking on the contributions of finance research.

Many conference participants stayed around for the post conference activities – the Dewey Daane Invitational Tennis Tournament, a hike around Radnor Lake led by Ron Masulis, and a pig roast dinner at the Stoll's. Some hardy souls retained sufficient energy to take a 30 mile bike trip down the Natchez Trace and back on Saturday morning. ■

Dewey Daane Invitational Tennis Tournament

On a warm and sunny Friday afternoon, a record turnout battled for the contents of the Daane Cup. Emerging victorious was **Jim Klingler** and taking second was **Christoph Schenzler.** Dewey Daane was unable to play because of a sore shoulder, but he had no trouble hoisting the contents of the cup and presenting them to the winner and runner-up. ■

Record turnout

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/. ■

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 2004-2005 the following researchers presented work on finance topics:

Andrew Ang, *Columbia University, USC* and *NBER*: "Risk, Return and Dividends"

Hendrik Bessembinder, *University of Utah*: "Optimal Market Transparency: Evidence from Corporate Bonds"

Nicolas P.B. Bollen, *Vanderbilt University*: "Fraud Detection in the Hedge Fund Industry"

Nicole Branger, *Goethe University*: "Optimal Portfolios when Volatility Can Jump"

Gregory W. Brown, *University of North Carolina*: "Estimating Systemic Risk in the International Financial System"

Anchada Charoenrook, *Vanderbilt University*: "Identifying Risk-Based Factors"

Tarun Chordia, *Emory University*: "Asset Pricing Models and Financial Market Anomalies" and "Liquidity and Autocorrelations in Individual Stock Returns"

Ettore Croci, *Vanderbilt University*: "Do Serial Acquirers Show Performance Persistence?"

Robert Dittmar, *University of Michigan*: "Long Run Risks and Equity Returns"

B. Espen Eckbo, *Dartmouth*: "Takeover Contests, Coercive Breakup Fees, and the Zero-Toehold Puzzle"

Mara Faccio, *Vanderbilt University*: "Political Connections and Government Bailouts"

Amar Gande, *Vanderbilt University*: "Shareholder Initiated Class Action Lawsuits: Shareholder Wealth Effects and Industry Feedback"

Ajay Khorana, *Georgia Institute of Technology*: "Board Structure, Mergers and Shareholder Wealth: A Study of the Mutual Fund Industry"

Jonathan Lewellen, *Massachusetts Institute of Technology* and *NBER*: "Taxes and Financing Decisions"

Michelle Lowry, *Penn State University*: "Institutional Investment in Newly Public Firms"

Vlad Mares, *Washington University*: "Bundling in Low Competition Environments"

Randall Morck, *University of Alberta*: "Patterns of Comovement: The Role of Information Technology Investment in the U.S. Economy"

Charu G. Raheja, *Vanderbilt University*: "The Determinants of Corporate Board Size and Composition: An Empirical Analysis"

Steve Ross, *MIT and Villanova University*: "Things I Don't Know About Finance"

Anjolein Schmeits, *Washington University*: "Credit Ratings as Coordination Mechanisms"

Anil Shivdasani, *University of North Carolina*: "Financial Fraud, Director Reputation, and Shareholder Wealth"

Michael Weisbach, *University of Illinois at Urbana Champaign* and *NBER*: "Why Are Buyouts Leveraged? The Financial Structure of Private Equity Funds"

Kent L. Womack, *Dartmouth University*: "Analysts, Industries, and Price Momentum"

Fei Xie, *Vanderbilt University*: "Corporate Governance and Acquirer Returns" and "Corporate Governance and the Value Creation by Mergers and Acquisitions"

David Yermack, *New York University*: "Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns" ■

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 2004-2005 academic year were:

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

Carole Brookins, Executive Director for the United States, *World Bank*

Jack Guynn, President, *Federal Reserve Bank of Atlanta*

Alan Hassenfeld, Chairman, *Hasbro*

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

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

Danny Huff, Chief Financial Officer, *Georgia Pacific Corporation*

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

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

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

Dino Kos, Executive Vice President, *Federal Reserve Bank of New York*

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

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

Martin Mauro, Senior Economist, *Merrill Lynch*

Laurence H. Meyer, Vice Chairman, *Macroeconomic Advisers* (former Member, *Board of Governors of the Federal Reserve System*)

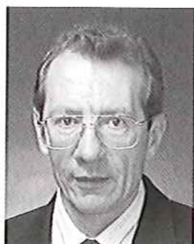
Rudolph G. Penner, Senior Fellow, *The Urban Institute*, (former Managing Director, *Barents Group KPMG*, and former Director, *Congressional Budget Office*)

Warren A. Stephens, President & CEO, *Stephens Inc.*

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

Marc Zenner, Global Head of Financial Strategy Group, *Citigroup* ■

Current Activities of Center Faculty



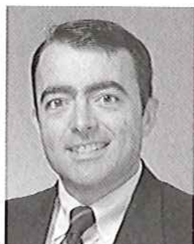
CLIFFORD A. BALL, Professor (finance and statistics); Director, PhD Program; Faculty Director, MS Finance Program. M.Sc., Nottingham 1975, Ph.D. (mathematics), New Mexico 1980.

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

Professor Ball teaches statistical and econometric analysis and the intricacies of equities, bonds, options, and futures contracts. His classes also cover empirical testing of financial models; stochastic processes and statistical applications to finance; the European monetary system; capital requirements, risk management and value-at-risk.

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

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



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

Research interests include financial markets, mutual funds, and investments. Current research includes: (1) the behavior of investors in socially responsible mutual funds; (2) the time-varying risks of hedge funds; and (3) the structure of the Pink Sheets market for low-priced stocks.

Professor Bollen's paper, "Short-term persistence in mutual fund performance," written with J.A. Busse, was recently published in the *Review of Financial Studies*. His paper, "Tick Size and Institutional Trading Costs: Evidence from Mutual Funds," also written with J.A. Busse, has been accepted for publication in the *Journal of Financial and Quantitative Analysis*. Bollen presented his paper, "Mutual Fund Attributes and Investor Behavior," written with Mark Cohen, at the April 2005 EFA Annual Meeting in Norfolk, VA. He also presented his paper "Screening for Fraud in the Hedge Fund Industry," written with Veronika Krepely, at LSU in March 2005 and at the Conference on Probability, Derivatives and Asset Pricing at the University of Virginia in July 2005. He was a discussant at the AFA Annual Meeting in Philadelphia in January 2005 and at the WFA Annual Meeting in Portland in June 2005.

In the Spring of 2005, Bollen was awarded tenure and was the recipient of the Owen School's Research Productivity Award, having had six research papers accepted for publication since 2001, including four in the top finance journals.

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

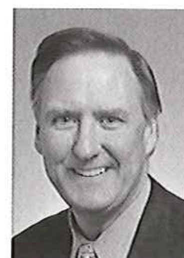
Research interests include auditor reputation, the quality of earnings, earnings management, and audit pricing.

Professor Chaney recently served as an associate editor for *Auditing: A Journal of Practice and Theory*. He also joined the editorial board of the *International Journal of Accounting*. At the American Accounting Association's annual meeting in San Francisco, Chaney served as a Senior Scholar. This is part of a new program implemented by the AAA in which senior faculty members are matched with new professors to help mentor them with their research. Also at the AAA meeting, Chaney presented his paper, "Self-Selection of Auditors and Size Nonlinearities in Audit Pricing," (co-authored with Debra Jeter and Lakshmanan Shivakumar).

ANCHADA CHAROENROOK, Assistant Professor (finance). M.S. (financial engineering), Ph.D (finance), Michigan 2000. M.S., Ph.D. (electrical engineering), U. of Washington 1995.

Research interests include theoretical and empirical tests of asset pricing models, derivative securities, risk management, the behavior of equity financial analyst, optimal capital structure and how it affects asset pricing, and, most recently, the physiology of brain function related to financial decisions. She teaches courses in investments and fixed-income markets.

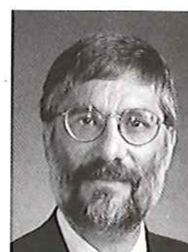
Professor Charoenrook's recent paper, "Identifying Risk-Based Factors," written with Jennifer Conrad, has been accepted to be presented at the AFA in January 2006. She presented a paper at the 2004 FMA and is chairing a session at the FMA in 2005. Her paper, "Conditional Skewness of Aggregate Market Returns," written with Hazem Daouk, received best paper award at the SWFA 2004 conference.



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

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

Professor Christie was named to a secondary appointment in the School of Law. He was also appointed to the Frances Hampton Currey chair after returning to the faculty from serving as Dean of the Owen School from July of 2000 through May of 2004. He served as session chair at the 2005 RFS/IU Conference on the Causes and Consequences of Recent Financial Market Bubbles, and he was a member of the program committee and discussant for the JFI Corporate Governance Conference at Washington University. Professor Christie stepped down as co-editor of the Journal of Financial Intermediation in August to assume the Editorship of Financial Management. He serves as faculty advisor to the Max Adler Student Investment Club, and will be teaching in both the EMBA and Law and Business programs this academic year.



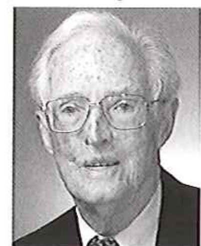
MARK A. COHEN, Justin Potter Professor of American Competitive Enterprise, Co-Director of the Vanderbilt Center for Environmental Management Studies. M.A., Ph.D., Carnegie-Mellon 1985.

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

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

In December 2004, Professor Cohen spoke on "Why Do Firms Comply (and sometimes 'Over-comply') with Environmental Regulations?" at the Conference on Economic Aspects of Environmental Compliance Assurance in Paris, France (sponsored by OECD Global Forum on Sustainable Development). He has recently served as a member of the U.S. EPA Science Advisory Board's Illegal Competitive Advantage Economic Benefit Advisory Panel and the General Accounting Office's Expert Panel on

Disclosure of Environmental Information in SEC filings. His book, The Costs of Crime and Justice, was published this past year.



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

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

In the fall of 2004, Dr. Daane attended the Bretton Woods Annual Meeting and the Group of Thirty International Banking Seminar in Washington, DC. In December, he participated in a Policy Forum, "Challenges and Opportunities in the Global Economy," at the Federal Reserve Bank of Philadelphia, and he attended a dinner for Alan Greenspan at the Federal Reserve Bank of Atlanta. In May 2005, he participated in the annual Financial Markets Research Center conference, and in June, he attended the Federal Reserve Bank of Boston's 50th Annual Economic Conference held in Chatham, MA.

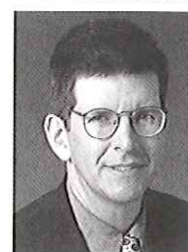
MARA FACCIO, Assistant Professor (finance). M.Phil, City University Business School (London) 1997, Ph.D., Università Cattolica (Milan) 1999.

Research interests include corporate finance, international corporate governance, corporate ownership, pension fund investments (UK), and corporate monitoring.

Professor Faccio teaches courses in International Corporate Finance and Corporate Financial Policy.

Professor Faccio presented her paper, "Political Connections and Corporate Bailouts," written with Ronald W. Masulis and John J. McConnell, at the University of Pennsylvania, University of North Carolina, Vanderbilt University, the World Bank, the 2005 Vanderbilt Law and Business Conference, and the 2005 CIFRA International Conference on "Financial Development and Governance" in Moscow. She also presented her paper, "Reluctant Privatization," written with Bernardo Bortolotti, at Emory University, Vanderbilt University, and the 2005 European Finance Association meeting in Moscow. Her paper, "The Choice of Payment Method in European Mergers & Acquisitions," written with Ronald W. Masulis, was published in the *Journal of Finance* in June 2005, and four of her papers have been accepted for publication: "Expropriation vs. Proportional Sharing in Corporate Acquisitions," written with David Stolin, in the *Journal of Business*; "Politically Connected Firms," in the *American Economic Review*; "Returns to acquirers of listed and unlisted targets," written with John J. McConnell, and David Stolin, in the *Journal of Financial and Quantitative Analysis*; and "Political Connections and Corporate Bailouts," written with Ronald Masulis and John McConnell, in the *Journal of Finance*. She was the recipient of the 2005 Hirtle Callaghan Research Scholar award.

Professor Faccio was appointed as Research Affiliate of the Centre for Economic Policy Research in January 2005, and as Research Associate of the European Corporate Governance Institute in July 2004.



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

Research is focused on the economics of competition policy.

Appointed Director of the Bureau of Economics at the Federal Trade Commission in 2003, Professor Froeb divided his time for two years between teaching executive MBAs on weekends in Nashville and searching for barriers to competition so he could destroy them in Washington. At the FTC, Froeb managed over a hundred civil servants dedicated to tearing down barriers to competition, protecting consumers against weight loss schemes without diet or exercise, credit-repair fraud, unwanted phone calls, and work-at-home scams. He was also responsible for enforcing the antitrust laws of the United States. Froeb has written numerous articles and given numerous talks on various subjects during the past year such as: "Economics and Antitrust: Enforcement R&D," keynote address at the annual meeting of the European Association in Industrial Economics in Berlin; "Use of Economics in Competition Law," keynote speech at the IBC Conference in Brussels; "Regulatory Risk" at a Legg-Mason Conference in Nashville; and "International Regulatory Risk" at Pioneer Investments in New Hampshire.

During the summer of 2005, Froeb returned to Vanderbilt full time, where he co-teaches an undergraduate class in Mathematical Models in Economics in the Math Department and teaches managerial economics to both MBAs and executive MBAs at the Owen School. He was named Outstanding Professor of the Vanderbilt Executive MBA program for 2004-05, and he recently joined the editorial board of *Competition Policy International*.

AMAR GANDE, Assistant Professor (finance). B.Tech, IIT Madras (India) 1986, M.B.A., IIM Calcutta (India) 1988, Ph.D., NYU 1997.

Research interests include investment banking, commercial banking, international finance, and corporate finance. 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.

Professor Gande's paper, "News Spillovers in the Sovereign Debt Market," (co-authored with David Parsley) was published in the March 2005 issue of the *Journal of Financial Economics*. His survey paper on "Commercial Banks in Investment Banking: A Survey" is scheduled to be published in the North Holland/Elsevier's *Handbook of Financial Intermediation* edited by Anjan Thakor and Arnoud Boot. In June 2005, Gande attended the Western Finance Association annual meeting in Portland, Oregon where he presented a paper, "Informational Efficiency of Loans versus Bonds: Evidence from Secondary Market Prices," (co-authored with Edward Altman and Anthony Saunders). In January 2005, he attended the American Economic Association annual meeting in Philadelphia where he presented a paper, "Does Global Diversification Destroy Value?" (co-authored with Christoph Schenzler). In October 2004, he presented the same paper at the Financial Management Association annual meeting in New Orleans. Gande also presented papers at several university seminars. For instance, he presented "Shareholder initiated class action lawsuits: shareholder wealth effects and industry spillovers" (co-authored with Craig Lewis) at Vanderbilt University and the University of Alabama at Tuscaloosa in September 2004, and at the University of Oklahoma in May 2005. In addition, he presented a paper, "Sovereign Credit Ratings, Transparency and Portfolio Flows," (co-authored with David Parsley) at the Darden School, University of Virginia's Emerging Markets Conference, and at Vanderbilt University's Law & Business Conference both in March 2005. Finally, he discussed numerous papers at professional meetings and conferences, such as at the Maryland University Finance Symposium and the Georgia-Tech International Finance Conference in April 2005, the FMRC Conference in honor of Hans Stoll in May 2005, and the McGill University Finance Symposium in June 2005.

KARL HACKENBRACK, Associate Professor (accounting), Co-Director of the Law and Business Program. M.B.A., Shippensburg 1983, PhD., Ohio State 1988.

Research interests include audit service production, earnings management, corporate governance, and mandated corporate disclosure.

Professor Hackenbrack joined the Owen faculty in 2004 from the Fisher School of Accounting at the University of Florida. His writings and teachings address corporate

continued on page 8

Faculty Activities *(continued)*

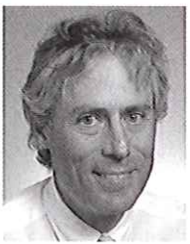
governance issues associated with external financial reporting, including fraudulent financial reporting, the structure of accounting standards, the public accounting industry, corporate valuation, and the regulation of professional services. He is currently working on papers that examine audit client retention and engagement-level pricing pressures, mandatory disclosure and the joint sourcing of audit and management advisory services, as well as the trade-offs among corporate governance mechanisms. Hackenbrack was invited to speak on "Issues in Publishing, An Authors Perspective," at the American Accounting Association Audit Mid-year Meeting in January of 2005.

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, and she taught an accelerated course in the Vlerick School of Management in Ghent, Belgium in the International Executive MBA program in October 2004.

In the spring of 2005, Jeter presented her research in New Zealand at Massey University, and she co-taught a research seminar at the University of Auckland on financial accounting research. In August 2005, she moderated a financial reporting session on Auditing and Corporate Governance at the annual AAA conference in San Francisco and also served as a Senior Scholar for the AAA New Scholar Sessions. Her paper, "The Impact on the Market for Audit Services of Aggressive Competition by Auditors," written with Paul Chaney and Pam Shaw, has received extensive media attention.



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

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

Professor Lewis primarily teaches corporate finance and will be offering courses in company valuation and econometric methods. He currently serves on the dissertation committees of Veronika Krepely and Gemma Lee.

Lewis lectured on security pricing at the Donau University in Vancouver, British Columbia in June 2005. During the summer of 2005, Lewis presented his paper, "The Determinants of Issue Cycles for Initial Public Offerings," (with Vladimir Ivanov) at the Financial Management Association meetings in Sienna, Italy. In May he presented "Shareholder Initiated Class Action Lawsuits: Wealth Effects and Industry Feedback" to the Securities and Exchange Commission in Washington D.C., and in June presented it at the Summer Finance Conference hosted by the University of British Columbia at Tofino on Vancouver Island.

He attended the Corporate Governance Conference at Washington University in St. Louis and the Financial Management Association meetings in New Orleans and Sienna, where he discussed several papers and served as a session chair. He currently serves as Chairman of the Best Paper Award Committee for this year's Financial Management Association conference to be held in Chicago, Illinois.

Lewis currently is an associate editor of the *Journal of Corporate Finance* and the *Journal of Financial Research*, and he serves as referee for numerous academic journals.

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

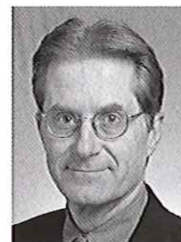
Research interests include corporate finance, corporate governance, investment banking, and international finance.

Professor Masulis teaches courses in mergers and acquisitions, law and finance of mergers & acquisitions, venture capital, corporate finance theory and evidence, and corporate value management. In April of 2005, he was a visiting professor at the Hong Kong University of Science and Technology. During the summer of 2005, he was a visiting professor at the Australian Graduate School of Management in Sydney and the School of Banking and Finance at the University of New South Wales, also in Sydney.

During the past year, Masulis has presented his research at the Hong Kong University of Science and Technology, the Chinese University of Hong Kong, Korea University in Seoul, the University of New South Wales, and the University of Queensland. His paper, "Political Connections and Corporate Bailouts," (with Mara Faccio and John McConnell) which studies corporate bailout activity around the globe and the degree of association between corporate directors and large shareholders to important government officials, is forthcoming in the *Journal of Finance*.

Masulis joined the Financial Economists Roundtable in 2005. He is currently on the Board of Directors/Executive Committee of the Financial Management Association and will serve as a program chair at the 2005 FMA Doctoral Symposium. He is an associate editor of the *Journal of Financial and Quantitative Analysis* and a referee for numerous other finance journals.

Masulis is chair of the Finance Ph.D. Program at Owen and serves on the dissertation committees of Veronika Krepely and Gemma Lee.



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

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

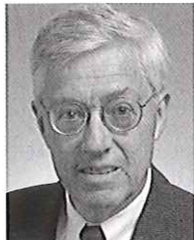
Professor Parsley has recently served as visiting scholar at the International Monetary Fund in Washington D.C., the Hong Kong Monetary Authority, and the Bank of France, where he made research presentations on the subject of declining passthrough of exchange rates to prices around the world. He is scheduled to visit the Bank of Japan where he will present the findings of his recent research with Amar Gande on transparency and portfolio capital flows.

During the past year, Parsley's paper, "News Spillovers in the Sovereign Debt Market," written with Amar Gande, was published in the *Journal of Financial Economics*; his paper, "Pricing in International Markets: A 'Small Country' Benchmark" was published in the Review of International Economics; his paper, "Aggregate Price Changes and Dispersion: A Comparison of the Equity and Goods and Services Markets" was published in Contributions to Macroeconomics. Parsley's paper, "A prism into the PPP Puzzles: The Micro-foundations of Big Mac Real Exchange Rates," written with Shang-Jin Wei, was featured in the Economist Magazine in June 2005, and his paper, "Exchange Rate Pegs and Exchange Rate Exposure in East and South East Asia," written with Helen Popper, has been accepted for publication in the *Journal of International Money and Finance*.

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 particular focus on corporate governance, management compensation, venture capital, initial public offerings, and corporate distress. Professor Raheja teaches courses in corporate financial policy and introduction to financial management.

Professor Raheja chaired a session on management compensation and presented her empirical paper on corporate boards at the Financial Management Association meeting in October 2004. She presented her paper, "The Determinants of Board Size and Composition: An Empirical Analysis," written with Audra Boone, Laura Field, and Jonathan Karpoff, at the American Finance Association Annual Meeting in January and at the University of Massachusetts Amherst in the spring of 2005. Her paper, "Determinants of Board Size and Composition: A Theory of Corporate Boards," was published in the June 2005 edition of the *Journal of Financial and Quantitative Analysis.*

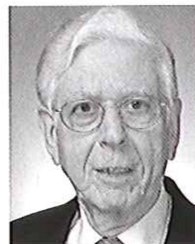


HANS R. STOLL, The Anne Marie and Thomas B. Walker Professor of Finance and Director of the Financial Markets Research Center. MBA, PhD Chicago, 1966.

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

In August 2004, Stoll chaired a session at the UBC Summer Conference in honor of Alan Kraus, held in Tofino, Vancouver Island. In January 2005, he spoke at the WHU Conference on "Options and Futures: How Derivatives Shape Corporate Risk Management," held in Vallendar, Germany. In July 2005 he spoke on the topic "Finance: Fact and Friction," at a conference in Karlsruhe, Germany honoring Hermann Goeppl.

Stoll's paper, "Revenues of Immediacy Suppliers versus Execution Costs of Investors: Evidence from the NYSE," written with Roger Huang, appeared in the book, *The Legacy of Fischer Black*, edited by Bruce Lehmann and published in 2004. "Price Impacts of Options Volume," written with Christian Schlag, was published in the *Journal of Financial Markets* in February of 2005. "Trades Outside the Quotes: Reporting Delay, Trading Option, or Trade Size," written with Christoph Schenzler, is forthcoming in the *Journal of Financial Economics*. Stoll was elected to a three year term as a public director of the Options Clearing Corporation, effective July 1, 2005. He continues to serve on the editorial boards of seven academic finance journals.



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

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

Faculty Research Papers

Current working papers, completed or revised since January 1, 2004, are listed below. Many of the papers are available on the Center's web site. Hard copies may be obtained by writing Pat Scott, Owen Graduate School of Management, Vanderbilt University, Nashville, TN 37203, calling 615-322-3671, or emailing 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.

99-08 "Long-Run Investment Decisions, Operating Performance and Shareholder Value Creation of Firms Adopting Compensation Plans Based on Economic Profits," by Chris Hogan and ***Craig Lewis****. (forthcoming in Journal of Financial and Quantitative Analysis)*

Proponents of compensation plans based on economic profits, defined as net operating profits after tax less the cost of all capital used to generate those profits, argue that these plans control for deficiencies in stock-based or earnings-based bonus plans and thereby better align managers' and shareholders' interests. We examine whether compensation plans based on economic profits do in fact produce better investment decisions. We use a sample of 65 firms adopting economic profit plans between 1983 and 1995 to examine compensation, ownership, and governance structures, and long-run operating and stock price performance. While we document significant improvements in operating performance subsequent to adoption of the compensation plans, a sample of nonadopting matched firms shows similar significant improvements. There is no significant difference in the stock price performance of the two groups in the four-year period following an adoption. We conclude that economic profit plans are no better than traditional plans that provide a blend of earnings-based bonuses and stock-based compensation in terms of their ability to create shareholder wealth.

99-26 "Enhancing Security Value by Ownership Restrictions: Evidence from a Natural Experiment," by ***Amar Gande*** *and Manju Puri. (September 2005)*

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 at approximately 150 basis points below comparable benchmarks leading to a bottom line savings of over a billion dollars. This is an intriguing issue because it raises the question, how can an emerging market issuer with junk bond ratings obtain such low yields?

We argue that ownership restrictions can lead to value enhancement and value transfer (from holders of other securities). Ownership restrictions enhance value since they enable an issuer to precommit to renegotiate efficiently in the potential default states, thereby 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. Ownership restrictions can result in a transfer of value from holders of unrestricted bonds to holders of restricted bonds since restricting the ownership to a favored clientele results in an implicit seniority of restricted bonds vis-a-vis unrestricted bonds. We empirically test and find support for both value enhancement and value transfer. Our results are robust to alternative explanations such as a higher perceived credit rating, different measures of credit rating, market segmentation, taxes, and commissions. Our evidence suggests that firms 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 Daley, ***Debra Jeter****, and* ***Paul Chaney****. (February 2005)*

This paper investigates whether firms' adoption strategies for SFAS No. 106 and SFAS No. 109 were linked, in an effort to gain insight into interactive choices and other strategies made in the adoption of newly mandated accounting standards in general. The evidence shows that most firms adopted the two standards in the same year. We find that firms for whom the deferred tax effect (SFAS No. 109) was relatively high, considered in conjunction with the impact of SFAS No. 106, were particularly likely to use an offsetting strategy and take the immediate approach for their adoption of the standard on postretirement benefits.

We also find that firms with a positive effect from adopting SFAS No. 109 (DTAX) were more likely to choose the current, rather than retroactive, approach for adoption of that standard. However, even among those firms with a negative DTAX effect, the predominant choice was the current approach. This finding suggests that firms viewed the added costs imposed by the restatement of prior periods under the retroactive method as outweighing the advantage of bypassing the income statement. Thus, we suggest that the recent FASB proposal to require the retroactive method for all mandatory changes, while serving to level the playing field, may not be optimal. Finally, in weighing the tradeoffs between a large, one-time (income decreasing) charge against the smaller, but longer lasting effects of amortization, most non-regulated firms opted for the one-time, "below the line" charge despite the more immediate impact on the balance sheet; while most regulated firms opted for the more gradual (albeit "above the line") effects of amortization.

00-10 "Bank Incentives, Economic Specialization, and Financial Crises in Emerging Economies," by ***Amar Gande****, Kose John, and Lemma W. Senbet. (August 2005)*

We model the vulnerability of an economy to a financial crisis as arising from the interaction of the degree of economic specialization and the intermediated financing of the investment opportunities. The probability of a financial crisis is shown to increase in the degree of economic specialization. Bank debt financing (the most common source of intermediated financing in emerging economies) has the beneficial effect of lowering the degree of economic specialization by increasing access to financing of investment opportunities that would not have been financed due to wealth constraints of entrepreneurs (financial access effect). However, bank debt financing induces risk-shifting incentives (leverage effect). The net effect on the probability of a financial crisis depends on which of these two effects dominates. We show that commonly employed mechanisms in managing financial crises, particularly bailouts, induce an additional agency cost on the part of banks. Since the bailout is focused only on the financial crisis state, it distorts bank incentives to concentrate its loans in specific sectors (bank debt concentration effect). We propose a solution mechanism that consists of two tax structures: (1) a corporate tax that changes the ex ante incentives of the residual claimants in the right direction by concavifying the pay-off structure of the after-tax cash flows, and (2) a tax on bank cash flows that eliminates the bank debt concentration effect. Our proposed solution mechanism is targeted towards prevention rather than an ex post resolution of a financial crisis. The foundation for our main results linking financial crisis with the degree of economic specialization is supported by the available date (presented in the form of a couple of empirical tests) – a full-fledged empirical analysis of the predictions of this theory paper is left for future research. Implementation issues and empirical/policy implications are also discussed.

00-18 "Preferences of the Rich and Famous: Conspicuous Consumption in Competitive Markets," by ***Anchada Charoenrook*** *and Anjan V. Thakor. (January 2004)*

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.

01-13 "Currency Arrangements and Goods Market Integration: A Price Based Approach," by ***David C. Parsley*** *and Shang-Jin Wei. (2005)*

A rapidly expanding literature studies the effect of currency union and other exchange rate arrangements on goods market integration. All existing studies employ a methodology based on observed volumes of trade. However, from a theoretical point of view the connection between market integration and the volume of trade is loose. In this paper, we propose a different metric of market integration, based on the dispersion of prices of identical products in different countries. This metric is motivated by the theory of arbitrage in the presence of transaction costs. We apply the methodology to a unique 3-dimensional data set that includes prices of 95 very disaggregated goods (e.g., light bulbs and toothpaste with fluoride) in 83 cities around the world from 1990 to 2000. We find that a currency board or a currency union generally provides a stimulus to goods market integration that goes far beyond merely reducing exchange rate volatility to zero. However, there are important exceptions. Long-term currency unions exhibit greater integration than more recent currency boards. All existing arrangements can improve their integration further relative to a U.S. benchmark.

02-02 "Trades outside the quotes: Reporting delay, trading option, or trade size?" by ***Hans R. Stoll*** *and* ***Christoph Schenzler****. (forthcoming in Journal of Financial Economics)*

In the period 1993 through 2002 examined in this study, quoted and effective spreads declined substantially on Nasdaq and to a lesser degree on the NYSE. At the same time, however, trades outside the quotes increased dramatically on Nasdaq. Because investors would prefer to trade at the quotes rather than outside the quotes, we examine why trades outside the quotes are observed. We focus on how the continuous market mechanism itself influences the outcome of orders and the reporting of trades, and we conclude that slippage exists in the market mechanism. Outside-trades occur on Nasdaq, first, because of delays in reporting trades, second, because the ability of dealers to delay execution of trades creates a look-back option, which when exercised results in outside-trades, and third, because large trades can take place at prices outside the quotes. Outside-trades are rarely observed on the NYSE because the market is more centralized. While the pattern of trading on the NYSE is not inconsistent with the presence of a look-back option, our tests provide no direct evidence that specialists are exercising such an option.

02-04 "Pre-IPO Investments by Financial Intermediaries: Certification or Moral Hazard?" by Xi Li and ***Ronald W. Masulis****. (September 27, 2005)*

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

02-06 "Does Sentiment Matter?" by ***Anchada Charoenrook****. (June 2005)*

Whether investor sentiment has any bearing on asset returns has long been a topic of interest in finance. I examine a sentiment measure based on the University of Michigan Consumer Sentiment Index. I find that changes in consumer sentiment are positively related to contemporaneous excess market returns. They are negatively related to future excess market returns at one-month horizon and one-year horizon over 1979-2003 and 1955-2003 periods. Change in consumer sentiment is a strong economic and statistical predictor of returns compared to other known market return predictors. Change in consumer sentiment performs better than an AR(1) benchmark model in out-of-sample forecasting tests. Change in consumer sentiment may predict returns because it measures time-varying rational beliefs that cause time-varying expected returns or is related economic cycles. To test this proposition, I include a myriad of well-known predictors of time-varying expected returns and contemporaneous measures of economic cycles in the analysis. Test results suggest that the predictive power of change in consumer sentiment is unrelated to time-varying expected returns or economic cycles.

02-18 "Exchange Rate Pegs and Exchange Rate Exposure in East and South East Asia," by ***David Parsley*** *and Helen Popper. (forthcoming in Journal of International Money and Finance)*

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

02-23 "Tick Size and Institutional Trading Costs: Evidence from Mutual Funds," by ***Nicolas P.B. Bollen*** *and Jeffrey A. Busse. (forthcoming in Journal of Financial and Quantittative Analysis)*

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

02-25 "Informational Efficiency of Loans versus Bonds: Evidence from Secondary Market Prices," by Edward Altman, ***Amar Gande****, and Anthony Saunders. (June 2005)*

This paper examines the informational efficiency of loans relative to bonds using a unique dataset of daily secondary market prices of loans. We find that the loan market is informationally more efficient than the bond market prior to and surrounding information intensive events, such as corporate (loan and bond) defaults, and bankruptcies. Specifically, we find that loan prices fall more than bond prices prior to an event, and less than bond prices of the same borrower during a short time period surrounding an event. This evidence is consistent with a monitoring advantage of loans over bonds. Our results are robust to a different empirical methodology (Vector Auto Regression based Granger causality), and to alternative explanations which control for securityspecific characteristics, such as seniority, collateral, recovery rates, liquidity, covenants, and for multiple measures of cumulative abnormal returns.

03-06 "Politically Connected Firms," by ***Mara Faccio****. (forthcoming in American Economic Review)*

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 2005)*

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. (forthcoming in the Journal of Business)*

An important and growing literature in finance points to existence of considerable 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 Market-Wide Issue Cycles for Initial Public Offerings," by Vladimir Ivanov and ***Craig M. Lewis****. (September 2005)*

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

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03-11 "A Prism into the PPP Puzzles: The Micro-Foundations of Big Mac Real Exchange Rates," by ***David C. Parsley*** *and Shang-Jin Wei. (October 2004)*

The real exchange rate has been called the single most important price in an economy, yet its behavior exhibits several puzzles. In this project, we use Big Mac prices as a unique prism to study the movement of real exchange rates. Part of our innovation is to match these prices to the prices of individual ingredients. 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 know (almost) 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 several biases inherent in examinations of aggregate CPI based real exchange rates. These biases -- the product-aggregation bias (Imbs, Mumtaz, Ravn, and Rey, 2002), the temporal aggregation bias (Taylor, 2001), and the bias generated by non-compatible consumption baskets across countries – are candidate explanations for the puzzlingly slow mean reversion alluded to by Rogoff (1996). Finally, 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. We offer some evidence that departure from the Engel effect can be systematically linked to economic factors.

03-13 "A Study of Market-Wide Short-Selling Restrictions," by ***Anchada Charoenrook*** *and Hazem Daouk. (January 2005)*

This paper contributes empirical evidence to the on-going debate on short sales. Our examination of how market-wide short-sale restrictions affect aggregate market returns focuses on two main questions: What is the effect of short-sale restrictions on skewness, volatility, the probability of market crashes, and liquidity? What is the effect on the market expected return or cost of capital? We report new data on the history of short-selling and put option trading regulations and practices from the 111 countries that have a stock exchange, and create a short-selling feasibility indicator for the analysis of stock market indices around the world. We find that when short-selling is possible, aggregate stock returns are less volatile and there is greater liquidity. When countries start to permit short-selling, aggregate stock price increases, implying a lower cost of capital. There is no evidence that short-sale restrictions affect either the level of skewness of returns or the probability of a market crash. Collectively, our empirical evidence suggests that allowing short-selling enhances market quality.

04-01 "Returns to acquirers of listed and unlisted targets," by ***Mara Faccio,*** *John J. McConnell, and David Stolin. (forthcoming in Journal of Financial and Quantitative Analysis)*

We examine announcement period excess returns to acquirers of listed and unlisted targets in 17 Western European countries over the interval 1996 through 2001. Acquirers of listed targets earn an insignificant average excess return of 0.38%, while acquirers of unlisted targets earn a significant average excess return of +1.48%. This "listing effect" in acquirers' returns persists through time and across countries and remains after controlling for the method of payment for the target, the acquirer's size and Tobin's Q, pre-announcement leakage of information about the transaction, whether the acquisition created a blockholder in the acquirer's ownership structure, whether the acquisition was a cross-border deal, and other variables. The fundamental factors that give rise to the listing effect, which has also been documented in U.S. acquisitions, remain elusive.

04-02 "Mutual Fund Attributes and Investor Behavior," by ***Nicolas P.B. Bollen*** *and* ***Mark A. Cohen.*** *(April 2005)*

Do non-financial investment attributes affect investor behavior? To answer this question, we study the dynamics of investor cash flows in socially responsible mutual funds. Consistent with anecdotal evidence, we find that the monthly volatility of investor cash flows is lower in socially responsible funds than conventional funds. In addition, annual flows in socially responsible funds are less sensitive to lagged negative returns than flows in conventional funds, but more sensitive to lagged positive returns. We argue that these results can be explained by a non-financial component of the utility functions of socially responsible investors.

04-03 "The Determinants of Corporate Board Size and Composition: An Empirical Analysis," by Audra Boone, Laura C. Field, Jonathan M. Karpoff and ***Charu G. Raheja.*** *(August 2005)*

Several theories have been proposed to explain how corporate boards are structured. This paper groups these theories into four hypotheses and tests them empirically. We utilize a unique panel dataset that tracks corporate board development from the time of a firm's IPO through 10 years later. The data support three distinct but mutually compatible hypotheses of board development: (i) board size and independence increase as firms grow in size and diversify over time; (ii) board independence is negatively related to the manager's influence and positively related to constraints on such influence; and (iii) board size reflects a trade-off between the firm-specific benefits of monitoring and the costs of such monitoring. The data do not support the view that boards are structured inefficiently or to facilitate managers' consumption of value-decreasing private benefits. These results are consistent with the view that economic considerations – in particular, the specific nature of the firm's competitive environment and managerial team – drive corporate board size and composition.

04-05 "Do Government Agencies Respond to Market Pressures? Evidence from Private Prisons," by ***Mark A. Cohen*** *and James F. Blumstein. (2004)*

This paper examines the role of privatization on the cost of government provided services. We examine data on the cost of housing public and private prisoners from all 50 states over the time period 1999-2001, and find that the existence of private prisons in a state reduces the growth in per prisoner expenditures by public prisons by a statistically significant amount. In 2001, the average Department of Corrections expenditures in states without private prisoners was approximately $455 million. Our findings suggest that if the "average" state in that group were to introduce the use of private prisons, the potential savings for one year in Department of Corrections expenditures for public prisons could be approximately $20 million. These savings on public prisons would be in addition to any direct savings from the use of private prisons by itself.

04-06 "Conditional Skewness of Aggregate Market Returns," by ***Anchada Charoenrook*** *and Hazem Daouk. (January 2005)*

This paper examines whether conditional skewness of daily aggregate market returns is predictable and investigates the economic mechanisms underlying this predictability. In both developed and emerging markets, there is strong evidence that lagged returns predict skewness; returns are more negatively skewed following an increase in stock prices and returns are more positively skewed following a decrease in stock prices. The empirical evidence shows that the traditional explanations such as the leverage effect, the volatility feedback effect, the stock bubble model (Blanchard and Watson, 1982), and the fluctuating uncertainty theory (Veronesi, 1999) are not driving the predictability of conditional skewness at the market level. The relation between skewness and lagged returns is more consistent with the Cao, Coval, and Hirshleifer (2002) model. Our findings have implications for future theoretical and empirical models of time-varying market return distributions, optimal asset allocation, and risk management.

04-07 "Reluctant Privatization," by Bernardo Bortolotti and ***Mara Faccio.*** *(August 2005)*

We study the evolution of the control structure of 141 privatized firms from OECD countries over the period from 1996 through 2000. We find that governments do not relinquish control after "privatization." As of 2000, governments are the largest shareholder or use special control powers to retain voting control of 62.4 percent of privatized firms. However, contrary to accepted theory, greater government control over privatized firms does not negatively affect market valuation. In fact, large government stakes are positively and significantly related to peer-adjusted market-to-book ratios. Results are not driven by reverse causality or by the agency costs associated with diffuse ownership.

04-10 "Political Connections and Corporate Bailouts," by ***Mara Faccio, Ronald Masulis,*** *and John McConnell. (forthcoming in Journal of Finance)*

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

04-11 "Slow Passthrough Around the World: A New Import for Developing Countries?" by Jeffrey Frankel, ***David Parsley,*** *and Shang-Jin Wei. (March 2005)*

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

04-12 "Contagion in the Presence of Stochastic Interdependence," by ***Clifford A. Ball.*** *(March 9, 2004)*

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

04-13 "Sovereign Credit Ratings, Transparency and Portfolio Flows," by ***Amar Gande*** *and* ***David Parsley.*** *(July 2005)*

We examine the response of equity mutual fund flows to sovereign rating changes in 85 countries from 1996-2002. We find that the response is asymmetric: Sovereign downgrades are strongly associated with outflows of capital from the downgraded country while improvements in a country's sovereign rating are not associated with discernable changes in equity flows. Greater transparency moderates the response, i.e., highly transparent countries experience smaller outflows around downgrades. Moreover, flows around downgrades are consistent with a flight to quality phenomenon. That is, highly transparent non-event countries are net recipients of capital inflows, and these inflows increase with the severity of the cumulative downgrade abroad. The results remain after controlling for country size, legal traditions, market liquidity, crisis versus non-crisis periods, and are invariant to different assumptions regarding the within-month distribution of equity flows, monthly predicted benchmark flows, and persistence of equity flows. Taken together, the results suggest that improving transparency could mitigate some of the perceived negative effects associated with global capital flows.

04-14 "Information and Selective Disclosure," by ***Anchada Charoenrook*** *and* ***Craig Lewis.*** *(October 2004)*

This paper examines whether the prohibition of selective disclosures to equity research analysts mandated by Regulation FD alters the manner in which information is revealed to the market. We use the aggregate behavior of equity research analysts to construct a sample of all material information events. We find that the same amount of firm-specific information is incorporated into stock prices before and after the adoption of Reg FD. More firm-specific information is communicated using public disclosure channels after Reg FD. We find that firms use earnings guidance as a substitute for selective disclosure. Surprisingly, companies do not increase their use of press releases to communicate information other than earnings guidance. We conclude that the passage of Reg FD has successfully encouraged firms to disclose the same amount of information as before while achieving its objective of "leveling the playing field" for all investors.

04-17 "Mandatory Disclosure and the Joint Sourcing of Audit and Management Advisory Services," by ***Karl Hackenbrack.*** *(July 2004)*

This paper contributes to the ongoing debate about the consequences of mandatory disclosure. The question considered is whether mandating the disclosure of auditor-sourced management advisory services advances the government's interest in ensuring appropriate consideration is given to the influence of joint sourcing on auditor independence. The evidence is consistent with disclosure substantively altering managements' joint-sourcing decisions in a manner consistent with investors' expressed preferences. An implication of the reported result is that mandatory disclosure might achieve the policy objective of ensuring auditor independence without resorting to the one-size-fits-all solution of denying all companies access to potentially valuable, auditor-sourced services.

04-18 "Does Global Diversification Destroy Value?" by ***Amar Gande*** *and* ***Christoph Schenzler.*** *(October 2004)*

This paper examines the effect of global diversification on firm value using a dataset of U.S. firms from 1994-2002. We document that global diversification enhances firm value, as measured by Tobin's Q. Specifically, we find that Tobin's q increases with foreign sales, measured as a fraction of a firm's total sales. Interestingly, we find no such evidence for industrial diversification. We find that the valuation benefit from global diversification is higher if a firm diversifies into countries with stronger creditor rights, or common-law legal systems, or higher GDP per capita. Our results are robust to controlling for a firm's endogenous choice to diversify across countries or across industries, to multiple measures of diversification, to industry and calendar time fixed-effects, and to several different econometric specifications.

05-01 "Self-Selection of Auditors and Size Nonlinearities in Audit Pricing," by ***Paul Chaney, Debra Jeter,*** *and Lakshmanan Shivakumar. (February 4, 2005)*

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

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size nonlinearities in any audit fee study using standard OLS regressions to control for client size or auditor size (or quality).

05-02 "Identifying Risk-Based Factors," by ***Anchada Charoenrook*** *and Jennifer Conrad. (August 2005)*

Existing studies find that size, book-to-market, and momentum explain the cross-section of average returns. Some studies also report evidence that suggests that liquidity risk is priced. There is an ongoing debate about whether these factors are related to fundamental risks. We propose a new test that examines whether a candidate variable meets a necessary condition to be considered a risk-based factor, by demonstrating that there must be a relationship between the conditional mean and conditional variance of the return on any factor-mimicking portfolio if the factor is a priced risk. In addition, the sign of the relation between the conditional mean and variance is given by the sign of the risk premium of the factor-mimicking portfolio. Our results suggest that factors based on size and liquidity pass this 'necessary condition' to be considered a priced risk; a factor based on book-to-market passes the hurdle only during the latter part of the sample period (1963-2003). We find strong evidence that the variance of a momentum factor varies through time, but the relation between conditional variance and conditional mean is of the wrong sign. Thus, the evidence for momentum is not consistent with a risk-based explanation in the mean-variance setting.

05-03 "Vertical Antitrust Policy as a Problem of Inference," by James Cooper, ***Luke Froeb****, Daniel O'Brien, and Michael Vita. (forthcoming in International Journal of Industrial Organization)*

The legality of nonprice vertical practices in the U.S. is determined by their likely competitive effects. An optimal enforcement rule combines evidence with theory to update prior beliefs, and specifies a decision that minimizes the expected loss. Because the welfare effects of vertical practices are theoretically ambiguous, optimal decisions depend heavily on prior beliefs, which should be guided by empirical evidence. Empirically, vertical restraints appear to reduce price and/or increase output. Thus, absent a good natural experiment to evaluate a particular restraint's effect, an optimal policy places a heavy burden on plaintiffs to show that a restraint is anticompetitive.

05-04 "Electronic Trading," by ***Hans R. Stoll****. (May 12, 2005)*

Stock markets are central to modern capitalistic economies. They provide signals about the economic viability of firms. They facilitate the allocation of resources among firms. They provide liquidity to investors that wish to save or consume. In this article, I examine how electronic trading has altered stock markets. How have markets changed? What is the role of dealers, such as the specialist, in electronic markets? How has electronic trading affected trading costs? Will computer programs replace human judgment? What is the role of regulation in electronic markets? Can a wholly electronic market serve the needs of all investors? What is the effect of electronic trading on the number and types of securities markets?

05-05 "Screening for fraud in the hedge fund industry," by ***Nicolas P.B. Bollen*** *and* ***Veronika Krepely****. (April 2005)*

This paper constructs a test for fraudulent managerial reporting in the hedge fund industry. We develop a model in which a manager reports satisfactory returns more readily than losses. This asymmetric smoothing generates conditional serial correlation and provides a red flag for fraud. Simulation evidence indicates that the statistical power of the test may be sufficient to deter fraudulent reporting. Empirical evidence shows that the probability of triggering a red flag is significantly related to the volatility and magnitude of investor cash flows, consistent with managerial smoothing in response to the risk of capital flight.

05-06 "Shareholder initiated class action lawsuits: Shareholder wealth effects and industry spillovers," by ***Amar Gande*** *and* ***Craig M. Lewis****. (August 2005)*

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

05-07 "The Investment Opportunity Set and Industry Specialization by Auditors," by Steven F. Cahan, Jayne M. Godfrey, Jane Hamilton, and ***Debra C. Jeter****. (July 2005)*

While auditor industry specialization has attracted widespread interest in the academic literature, one of the most fundamental questions remains unanswered: Why do some industries lend themselves to more intensive auditor specialization than others? In this study, we posit that IOS plays an important role in determining whether an industry is an attractive target for auditor specialization. We argue that when industry-specific IOS is high, auditors must make costly industry-specific investments that allow them to offer a differentiated product and create entry barriers for other audit firms. However, when a large component of IOS is unique to specific firms within an industry (i.e. IOS is highly variable within the industry), it is more difficult to transfer knowledge (and spread costs) across clients in that industry because each firm faces a unique set of investment opportunities and this creates unique knowledge requirements for the firm's auditor. Relying upon two measures of IOS derived from factor analyses of variables used by Gaver and Gaver (1993) and variables used by Baber et al. (1996), we present strong evidence that auditor specialization is increasing in industry IOS levels and weaker evidence that auditor specialization is decreasing in within-industry IOS variability.

05-08 "Post-Merger Product Repositioning," by Amit Gandhi, ***Luke Froeb****, Steven Tschantz, and Gregory Werden. (September 1, 2005)*

We study mergers among firms that compete by simultaneously choosing price and location. The merged firm moves its two products away from each other to reduce cannibalization, and the non-merging firms move their products in between the merging firm's products. Post-merger repositioning increases product variety, which benefits consumers, but repositioning also affects post-merger prices in two ways: There is upward pressure on price as products spread out, but the merged firm's incentive to raise prices is reduced as its products are moved away from each other. Either effect can dominate, although the latter is likely to be the more important. We use a novel technique known as the stochastic response dynamic to find equilibria, which does not require the computation of first-order conditions.

05-09 "A Variance Screen for Collusion," by Rosa Abrantes, ***Luke Froeb****, John Geweke, and Christopher Taylor. (forthcoming in International Journal of Industrial Organization)*

In this paper, we examine price movements over time around the collapse of a bid-rigging conspiracy. While the mean decreased by sixteen percent, the standard deviation increased by over two hundred percent. We hypothesize that conspiracies in other industries would exhibit similar characteristics and search for "pockets" of low price variation as indicators of collusion in the retail gasoline industry in Louisville. We observe no such areas around Louisville in 1996-2002.

05-10 "Economics at the FTC: Cases and Research, with a Focus on Petroleum," by ***Luke Froeb****, James Cooper, Mark Frankena, and Louis Silvia. (August 2005)*

Economics at the Federal Trade commission (FTC) covers both the antitrust and consumer protection missions. In this year's essay, we focus mainly on the competition-side of the agency. Drawing on a wealth of recent research, we provide descriptive and analytical information about the petroleum industry. Mergers, as always, were a major preoccupation of the FTC, and we discuss a few oil industry mergers as well as one leading litigated case – Arch Coal's acquisition of Triton Coal. Finally, we review the empirical literature on the effects of vertical restraints, noting that the literature supporting an animus toward such restraints is surprisingly weak.

05-11 "Prevention, Crime Control or Cash? Public Preferences towards Criminal Justice Spending Priorities," by ***Mark A. Cohen****, Roland T. Rust, and Sara Steen. (2005)*

We propose and test a new survey methodology to assess the public's criminal justice spending priorities. Respondents are explicitly forced to trade-off one type of crime prevention or control policy for another and to consider the fact that any money spent on crime prevention or control policies is money they could otherwise have in their pockets. Thus, respondents are asked to allocate a fixed budget into five categories – more prisons, police, youth prevention programs, drug treatment for nonviolent offenders, and a tax rebate to citizens.

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

05-12 "Gradually Truncated Log-normal in Publicly Traded Firm Size Distribution," by Hari M. Gupta, José R. Campanha, Daniela Gabriel, and ***Charu G. Raheja****. (August 2005)*

We study the statistical distribution of firm size for U.S. and Brazilian publicly traded firms through the Zipf plot technique. Sale size is used to measure firm size. The Brazilian firm size distribution is given by a log-normal distribution without any adjustable parameter. However, the log-normal distribution has to be gradually truncated after a certain critical value for US firms. Therefore, the original hypothesis of proportional effect proposed by Gibrat is valid with some modification for very large firms. We also consider the possible mechanisms behind this distribution.

05-13 "Wall Street Scandals: The Curative Effects of Law and Finance," by ***William Christie*** *and Robert Thompson. (2005)*

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

05-14 "Microstructure of the Pink Sheets Market," by ***Nicolas P.B. Bollen*** *and* ***William Christie****. (2005)*

This paper studies the trading and quotation patterns for stocks that reside in the Pink Sheets. Using all quotes and trades reported through the Pink Sheets Electronic Quotation and Trading System in the 2004 calendar year, we examine whether regularities that exist in highly regulated markets arise naturally in a market with few affirmative obligations or reporting requirements. We find that the market appears quite capable of creating organized rather than chaotic quotation and trading activity in an environment without a tick size, even among penny stocks. Our results suggest that although trading costs are high in this market relative to the listed exchanges or Nasdaq, the market makers respond to a similar set of economic forces when establishing bid-ask spreads.

05-15 "Are banks still special when there is a secondary market for loans?" by ***Amar Gande*** *and Anthony Saunders. (September 2005)*

This paper utilizes a unique dataset of secondary market loan prices to examine whether a secondary market for bank loans enhances or erodes the specialness of banks. We argue that a secondary market for loans results in two potentially adverse influences on the specialness of banks: it can reduce the incentives of banks to monitor, and the secondary market loan prices provides an alternative source of information regarding a borrower's perceived creditworthiness. Despite these potential effects, we find that new loan announcements are associated with a positive stock price announcement effect even when a borrower's loans trade on the secondary market. This result also holds true for distressed borrowers who are ex ante expected to be most adversely affected by a potential reduction in bank incentives to monitor, as a result of a secondary market for loans. Moreover, when a borrower's existing loans trade for the first time in the secondary loan market, it elicits a positive stock price announcement effect. Overall, our results suggest that banks continue to be special even in the presence of a secondary market for bank loans, and that the bank monitoring function and the secondary market for bank loans are complementary sources of information about borrowers, which implies that banks and markets can co-exist as information producers.

05-16 "Commercial Banks in Investment Banking: A Survey," by ***Amar Gande****. (forthcoming in Handbook on Financial Intermediation)*

In many countries, commercial banks routinely conduct investment banking activities such as helping their customers in bringing new debt and equity issues to the market. However, in the United States, since the Glass-Steagall Act was passed in 1933, commercial banks have not been allowed to underwrite securities for almost six decades. In 1989, Congress allowed commercial banks to underwrite corporate securities in a limited manner through Section 20 subsidiaries. Recently, all restrictions for underwriting securities were removed in November 1999 with the repeal of the Glass-Steagall provisions through the Financial Modernization Act of 1999.

This paper starts with a brief description of the main benefits (information advantages and scope economies) and the main costs of combining lending with underwriting (conflicts of interest and information monopoly rents). It summarizes the underlying theory for these benefits and costs, and presents empirical evidence. In examining the commingling of lending and underwriting, this paper attempts to provide specific answers to the following questions that have pre-occupied researchers in recent times: (1) Should commercial banks be allowed to underwrite securities? (2) If commercial banks were to be allowed to underwrite securities, in what organizational form should they underwrite securities?, and (3) Whether commercial banks, with prior access and superior information about firms to whom they lend (from loan monitoring activities), have an unfair advantage in underwriting that can result in their monopolizing the market, and drive investment houses out of underwriting securities, especially in the longer-term? We end this paper with a summary of the main results from the literature, and a few suggestions for future research.

05-17 "Corporate Governance and Acquirer Returns," by ***Ronald W. Masulis****, Cong Wang, and Fei Xie. (August 22, 2005)*

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

05-18 "Security Offerings: A Survey," by Espen Eckbo, ***Ronald W. Masulis****, and Øyvind Norli. (September 2005)*

05-19 "Seasoned Equity Offerings: Quality of Accounting Information and Expected Flotation Costs," by ***Gemma Lee*** *and* ***Ronald W. Masulis****. (September 27, 2005)*

As accounting information becomes less reliable, it becomes more difficult for equity investors to evaluate a firm's true performance. This increases the asymmetry information between issuers and outside investors, which heightens investor concerns following major firm decisions, especially when a firm raises new equity capital. Since poor accounting information increases investor uncertainty, raises the underwriting risk associated with seasoned equity offerings (SEOs), causing flotation costs to rise. To examine this question, we measure accounting quality using the estimation errors from an earnings accruals model, based on the Dechow and Dechev (2002). We examine whether poor accruals quality is associated with larger expected flotation costs of equity offerings. Using a large sample of SEOs, we find that poor accruals quality is associated with (1) larger underwriting fees, (2) a larger negative SEO announcement effect, and (3) a higher probability of SEO withdrawals. These results are robust after controlling for a potential sample selection bias. ■

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