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FINANCIAL MARKETS RESEARCH CENTER • 2004

Conference on

*Exchange Governance and Securities Market Structure*

The New York Stock Exchange has joined corporate America in the spotlight of governance practices as a result of the controversial compensation package for Dick Grasso, former Chairman of the NYSE. The questions raised are many: How should an exchange be organized and regulated? Is an exchange a business or a public institution? Should exchanges demutualize? Can regulatory policy continue to be implemented through self regulatory organizations (SROs) or must alternative approaches be sought?

Independent of the Grasso affair, questions have arisen regarding the future of the specialist system. Is the specialist system outmoded? Should the function of the specialist be

sessions for the second day took place at the Owen School. **Hans Stoll**, director of the Center, **Ed Scott**, executive vice president of Caterpillar Financial, and **Bill Christie**, Dean of the Owen School, welcomed conference participants.

The Thursday morning session dealt with the issues of how exchanges should be governed and regulated and whether changes are needed in the national market system. **Richard Lindsey**, President of Bear Stearns Securities Corporation, introduced the topics by discussing progress toward the goals of a national market system as stated in the 1975 Securities Act Amendments. He then introduced **Richard Ketchum**, Chief Regulatory Officer of the New York Stock Exchange and former president of the Nasdaq

Stock Market. Ketchum's remarks focused on the changing governance structure of the NYSE and on the independence of the self-regulatory function in that structure. Ketchum advocated the SRO approach to regulation under an appropriate governance structure. Self regulation works because the self regulator is close to the market, is knowledgeable, and commits the industry to the task of regulation. At the same time the Securities and Exchange Commission (SEC) still maintains vigilant oversight.

Lindsey then introduced **Annette Nazareth**, Director of Market Regulation at the SEC. Lindsey noted



*Annette Nazareth, current director of the Division of Market Regulation at the SEC, flanked by two former directors, Rick Ketchum and Rich Lindsey.*

automated? Should the SEC change the rules under which the NYSE and its competitors operate? How should markets be linked? In addition to the NYSE, another respected institution – the mutual fund – has come under fire. How can the problems with mutual fund trading and valuation be solved? Are mutual fund expenses excessive?

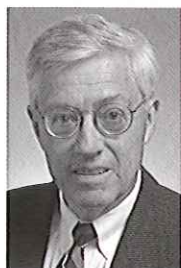
These issues and others were examined at a conference on Exchange Governance and Securities Market Structure held at Vanderbilt University on April 22<sup>nd</sup> and 23<sup>rd</sup>, 2004. The conference was the 17<sup>th</sup> annual conference of the Financial Markets Research Center and was sponsored by a special grant from the New York Stock Exchange.

The conference was attended by industry practitioners, academics, regulators, and students. The opening day's events were held at the facilities of Center member Caterpillar Financial Corporation located next to the campus, while the

that he had preceded Nazareth as the director of Market Regulation and that Ketchum had been Director of Market Regulation before him. Nazareth discussed the SEC agenda, noting that implementation of Sarbanes Oxley was near completion and that the Commission is now turning to the regulation of market structure and of exchanges. With regard to market structure, she discussed the SEC's recent Regulation NMS proposal which calls for modifications in the trade-through rules, fair access fees, and revisions in the way market data fees are distributed. With regard to exchange regulation, she discussed alternative approaches to the regulation of exchanges, ranging from a super SRO that oversees all exchanges to a variety of approaches for self regulation by each exchange. She noted the central importance of maintaining the independence of the regulatory function.

## FROM THE DIRECTOR

The FMRC, now entering its 18<sup>th</sup> year, continues to support research in financial markets and host conferences on current



*Hans R. Stoll*

issues in financial markets. Last year's conference focused on corporate governance and accounting issues arising from the Enron and WorldCom collapses. Just as the fallout from these collapses has subsided and new governance standards have been

established under Sarbanes Oxley and under NYSE listing standards, new controversies have arisen that call into question some of our nation's most hallowed financial institutions – the NYSE and the mutual fund industry. This year's conference, described elsewhere in this newsletter, focused on the current issues of exchange governance and regulation, mutual funds and the specialist system. At the NYSE, a new governance system has been implemented and a new independent self-regulatory responsibility established under Rick Ketchum, a speaker at this year's conference. While governance is critical for the future success of the NYSE, probably just as important, if not more so, is to compete effectively with new high tech markets and to deal with new SEC regulations (e.g. Regulation NMS) prescribing how markets should be linked. Conference participants heard much discussion of the needed reforms to mutual fund trading and mutual fund expenses, but no one recommended an independent chairman for each mutual fund, a rule just passed by the SEC. The specialist system was also examined at the conference with one presenter noting that trading in active stocks subsidizes liquidity in inactive stocks and another presenter noting that such cross-subsidization cannot continue in a competitive market. All in all, the conference gave much food for thought.

## 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:

Center faculty continue their research on a variety of finance topics, supported by the Center's data bases and assisted by research associate and data base manager, Christoph Schenzler. Titles of some of the current research projects include, "The World Price of Short Selling," "The Determinants of Issue Cycles for Initial Public Offerings," "Politically Connected Firms," "Socially Responsible Investors and Performance Sensitivity," "Choice of Financing Method in European Mergers and Acquisitions." More details on these and other working papers are elsewhere in this newsletter.

With regard to comings and goings, one major transition occurred this past year. On June 30, 2004, Bill Christie stepped down as dean of the Owen School to return to teaching and research as the Frances Hampton Currey Professor of Finance. Welcome back Bill! Also in the Spring of 2004, Owen welcomed back visiting professor Christian Schlag from Goethe University in Frankfurt, Germany, who taught Advanced Derivative Markets and participated in several research projects. Two Ph.D. students have completed their studies and have taken teaching positions. Vladimir Ivanov will be teaching at the University of Kansas and Raj Nahata has accepted a position at Baruch College in New York City.

The most important event for the Center in the past year, indeed since its inception, was the gift of an endowment valued at \$3 million. The gift was made by Thomas Peterffy, Chairman of Interactive Brokers Group, a founding supporter of the Center 17 years ago. The gift will provide stability for the Center and enable it to adhere to the long run objective of supporting fundamental research in financial markets. The gift will be used to expand and improve the data bases available to Center faculty, to provide research grants to faculty, to support seminars and conferences, and to host visiting scholars at Vanderbilt. ■

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



## VANDERBILT

Owen Graduate School of Management

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

- \*Bear, Stearns & Company, Inc.
- Caterpillar Financial Services
- Chicago Board Options Exchange
- Eclipse Capital Management, Inc.
- \*Interactive Brokers Group
- International Securities Exchange
- Lavery Consulting Group
- \*NASD Investor Education Foundation
- \*New York Stock Exchange, Inc.
- Ronin Capital, LLC
- \*Thales Fund Management, LLC

\*Indicates a lead member.

# Exchange Governance *(continued)*

**Jack Lavery**, the head of the Lavery Consulting Group and former head of corporate and policy research at Merrill Lynch, offered the conference participants a change of pace with an insightful analysis of election year economics. He reviewed the unemployment rate in the key election battleground states, noting that while the economy is improving, helped by household wealth increases, there are a few key states that are lagging. While the economic issues are important, he argued that in the end, Iraq will be the determining issue in the election.

After a break for lunch, the conference resumed with a panel on ownership, governance, and regulation of derivatives markets, chaired by **Duke Chapman**, Vice Chairman of ABN-AMRO Financial Services and former chairman of the Chicago Board Options Exchange. **Jim Overdahl**, Chief Economist of the Commodity Futures Trading Commission (CFTC), contrasted the regulatory structure in derivatives markets that is based on 18 core principles (since the Commodity Futures Modernization Act of 2000), with the structure in the stock markets that is based on detailed rules and regulations. Three core principles (14, 15, and 16) deal with governance and self regulation. Overdahl described the current review of self-regulation being conducted by the CFTC and noted that the next focus of the review would be on governance issues, including conflicts of interest, disciplinary committees and the overall role of the board of a futures organization. **James Falvey**, General Counsel of Eurex

US, which began operation as a U.S. futures exchange in February 2004, contrasted the structure of the Eurex US to that of “bricks and mortar” futures markets, such as the CME, and to pure “Dot Com” markets, such as the Intercontinental Exchange. **Richard DuFour**, Executive Vice President of the Chicago Board Options Exchange (CBOE) discussed developments at the CBOE, such as the new hybrid trading system that integrates electronic and traditional floor trading. He noted that the CBOE has made governance changes to increase the representation of independent directors.

**John Damgard**, President of the Futures Industry Association (FIA), commented on a variety of issues in the futures markets. In his view, dual regulation was adversely affecting single stock futures. On the governance side, he criticized the

board composition of certain futures exchanges and wondered why futures commission merchants (FCMs) were not more adequately represented. He lauded the competition introduced by the entry of the Eurex in U.S. markets. He questioned whether inspection of FCMs should be carried out by exchange SROs, since exchanges and FCMs are frequent competitors.

The day's final panel dealt with mutual fund issues, and was chaired by **Ron Masulis**, Professor at the Owen School. **Eric Zitzewitz**, Assistant Professor at the Stanford Graduate School of Business on leave to Columbia Business School, presented his paper, “How Widespread is Late Trading in Mutual Funds?” Zitzewitz distinguished the stale price problem (where 4 pm mutual fund

prices don't accurately reflect the value of the fund) and the late trading problem (where certain investors are able to buy or sell mutual funds at 4 pm prices but delay submission of trades until after 4 pm). He finds empirical evidence of late trading and concludes that late trading is

Index Funds.” Since the index funds in their study all held the same stocks, one can predict that index funds with low expense ratios will outperform those with high expense ratios. Yet Elton and his co-authors find that new funds do not flow to the lower cost funds to the degree one might expect, which suggests the fund investors are not entirely rational. **Gabe Butler**, of ITG Corp, presented methods for fair value pricing for funds, such as international funds, in which certain stocks have stale prices. The panel

concluded with a discussion by **David B. Jones**, Senior Vice President of Fidelity Management and Research Corporation, who commented on a number of issues. On stale prices, he favored some form of fair value pricing. On mutual fund fees,

he noted that fees are different to reflect the different services provided to different investors. He favored disclosure of soft dollar payments and quantification of what was received in return for soft dollars. On mutual fund governance, he questioned the need for an independent chairman for funds, noting that funds with independent chairmen don't necessarily have the lowest expenses.

On Friday morning the conference reconvened at the Owen School to hear from a panel on the specialist system and a panel on bond market microstructure. The chairman of the first panel, **Thomas Peterffy**, Chairman of Interactive Brokers Group, introduced the topic by questioning the need for a specialist and for the special rights given to specialists.

**Roger Huang**, Professor at Notre Dame, presented a paper written with Jerry Liu entitled “Do Individual Specialists Subsidize Illiquid Stocks?” They find evidence in support of cross-subsidization since the short run variability of illiquid stocks and the cost of trading such stocks are reduced if the specialist trading them also handles a very liquid stock. **Larry Harris**, Chief Economist of the Securities and Exchange Commission, reported the results of a study co-authored with Jay Coughenour titled “Specialist Profits and the Minimum Price



*Ron Masulis and Eric Zitzewitz discussing mutual fund issues.*



*Jim Overdahl, James Falvey and Dick DuFour reacting to a comment from the floor.*

widespread. To solve the late trading problem, he recommends tighter controls at the fund level and, in particular, a clear requirement that funds receive all orders before 4 pm.

**Ned Elton**, Professor at NYU, presented a study (co-authored with Jeff Busse and Martin Gruber), “Are Investors Rational?: Choices among

*continued on page 4*

# Exchange Governance *(continued)*

Increment.” Decimalization (completed January 29, 2001) has potentially offsetting effects on specialist profits. On the one hand, decimalization reduces spreads and thereby reduces specialist profits. On the other hand, decimalization makes it less costly for specialists to step in front of limit orders to compete for desirable order flow. Harris and Coughenour conclude that specialist profits increased in the low priced stocks where the reduced tick size had the greatest effect. In other stocks, measured profits have declined.

**Robert Jennings**, Professor at Indiana University, commented on changes in penny trading behavior on the NYSE. The frequency with which a trade occurs one penny better than the quote has not changed materially with the advent of decimal pricing, but the specialist’s involvement in penny trading has declined.

**George Sofianos**, Vice President at Goldman Sachs, discussed the challenges facing the NYSE and the specialist system. He noted that the NYSE hybrid system that combines electronic trading with a trading floor has the potential to serve the needs of both individual and institutional traders. What makes the NYSE different from

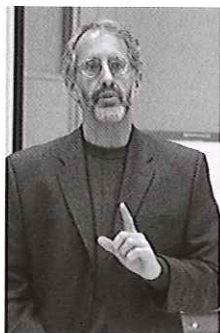
other markets is the presence of undisplayed liquidity that can be harnessed by floor brokers. He argued that the specialist should shift market making to provide liquidity for difficult trades

rather than to trade in small amounts at the inside quote.

The conference’s final session on the topic of bond market microstructure was chaired by **Bill Christie**, Professor and Dean of the Owen School. **Michael Piwowar**, Visiting Academic Scholar at the Securities



*Thomas Peterffy and Chancellor Gordon Gee.*



*Bob Jennings discussing the changes in penny trading.*

and Exchange Commission, presented a paper, “Municipal Bond Liquidity,” (written with Larry Harris). He described the lack of transparency in the bond market, the lack of publicly available quotes and timely trade reports, the large number of different securities, and the infrequency with which municipal bonds are traded. Despite these obstacles, Harris and Piwowar provide estimates of transaction costs inferred from transaction reports made by dealers to the Municipal Securities Rate Making Board. They estimate an effective spread averaging about 2% to trade a representative municipal bond. The session concluded with a very informative description of electronic bond trading systems by **Christopher Perry**, former Head of E-Commerce for the Americas at HSBC and a veteran of the fixed income markets. He discussed the issue of liquidity in these markets, noting that the lack of short selling is partly to blame. ■

## 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/>. ■

## Dewey Daane Invitational Tennis Tournament

For the first time in the tournament’s history Dewey Daane was unable to play, a result of a nagging shoulder injury. The others fought valiantly for the contents of the Daane Cup, which were won by **Hans Stoll** in tie-breaker playoff against **Hans Heidle**, who did not easily succumb to take the runner-up position. ■



*Combatants before the battle.*

# 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 2003-2004 the following researchers presented work on finance topics:

**Paul Bennett**, *New York Stock Exchange*: "Market Structure, Fragmentation and Market Quality – Evidence from Recent Listing Switches"

**Nicolas P.B. Bollen**, *Vanderbilt University*: "Socially Responsible Investors and Performance Sensitivity"

**Lawrence D. Brown**, *Georgia State University*: "A Temporal Analysis of Thresholds: Propensities and Valuation Consequences"

**Wolfgang Bühler**, *University of Mannheim*: "Valuation of Convertible Bonds with Sequential Conversion"

**Jennifer Conrad**, *University of North Carolina*: "Basis Assets"

**Amy K. Dittmar**, *University of Michigan*: "Stock Repurchase Waves: An Explanation of the Trends in Aggregate Corporate Payout Policy"

**Mike Edleson**, *NASDAQ Stock Market*: "A Look inside NASDAQ"

**Stephen Figlewski**, *New York University*: "Estimation Error in the Assessment of Financial Risk Exposure"

**Mark J. Flannery**, *University of Florida*: "Partial Adjustment toward Target Capital Structures"

**Amar Gande**, *Vanderbilt University*: "Informal Efficiency of Loans versus Bonds: Evidence from Secondary Market Prices" and "Sovereign Credit Ratings and Portfolio Flows"

**Karl Hackenbrack**, *University of Florida*: "Mandatory Disclosure and the Joint Sourcing of Audit and Management Advisory Services"

**Narasimhan Jegadeesh**, *Emory University*: "Value of Analyst Recommendations: International Evidence"

**Anthony W. Lynch**, *New York University and NBER*: "Explaining the Magnitude of Liquidity Premia: The Roles of Return Predictability, Wealth Shocks and State-Dependent Transaction Costs"

**Ganapathi Narayanamoorthy**, *Yale University*: "The Joint Determination of Audit Fees, Non-Audit Fees, and Abnormal Accruals"

**Thomas H. Noe**, *Tulane University*: "Tunnel-Proofing the Executive Suite: Transparency, Temptation, and the Design of Executive Compensation"

**Darius Palia**, *Rutgers University*: "Evidence of Jointness in the Terms of Relationship Lending"

**Robert Parrino**, *University of Texas at Austin*: "Horses and Rabbits? Optimal Dynamic Capital Structure from Shareholder and Manager Perspectives"

**David C. Parsley**, *Vanderbilt University*: "A Prism into the PPP Puzzles: The Micro-Foundations of Big Mac Real Exchange Rates"

**Luboš Pástor**, *University of Chicago*: "IPO Waves and Stock Prices"

**Nagpurnanand R. Prabhala**, *University of Maryland*: "Executive Stock Option Repricing: Creating a Mountain out of a Molehill"

**Lakshmanan Shivakumar**, *London Business School*: "Earnings, Business Cycle and Stock Returns"

**Hans R. Stoll**, *Vanderbilt University*: "Out-Trades: Reporting Delay, Trading Option, or Trade Size?"

**Anjan Thakor**, *University of Michigan*: "Disagreement and Flexibility: A Theory of Optimal Security Issuance and Capital Structure"

**Sunil Wahal**, *Emory University*: "Execution Risk and Liquidity"

**Zhenyu Wang**, *Columbia University*: "A Shrinkage Approach to Model Uncertainty and Asset Allocation"

**Guofu Zhou**, *Washington University*: "Modeling Non-Normality Using Multivariate t: Implications for Asset Pricing"

**Luigi Zingales**, *University of Chicago, NBER, and CEPR*: "Corporate Governance and Taxation" ■

# 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 2003-2004 academic year were:

**John Bogle**, Founder of *The Vanguard Group*

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

**J. Alfred Broaddus, Jr.**, President, *Federal Reserve Bank of Richmond*

**Robert A. Eisenbeis**, Senior Vice President and Director of Research, *Federal Reserve Bank of Atlanta*

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

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

**Charles O. Holiday**, Chairman & CEO, *DuPont*

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

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

**David M. Jones**, President and CEO, *DMJ Advisors*

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

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

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

**Martin Mauro**, Senior Economist, *Merrill Lynch*

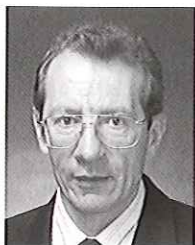
**Leon Metzger**, Vice Chairman, *Paloma Partners Management Company*

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

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

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

# Current Activities of Center Faculty

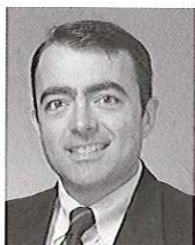


**CLIFFORD A. BALL,** Professor (finance and statistics). M.Sc., Nottingham 1975, Ph.D. (mathematics), New Mexico 1980.

Current research interests include equities, bonds, options, and

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

Professor Ball serves as associate editor for the *Journal of Empirical Finance* and acts as referee for numerous other finance and economics journals. In Minneapolis, Ball attended a week-long conference organized by the Institute of Mathematics and its Applications linking research in finance and mathematical sciences. His most recent research focuses on financial contagion and value-at-risk assessment.



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

Research interests include mutual fund performance, the valuation of derivative

securities, and empirical market microstructure. Current research includes: (1) a study of the behavior of investors in socially responsible mutual funds, (2) an examination of hedge fund performance, and (3) an analysis of the impact of decimal pricing for stocks on mutual fund trading costs. He teaches courses in equities markets, securities and portfolios, managerial finance, and asset pricing theory.

Professor Bollen has had two papers published in top journals in 2004. His paper, "Does net buying pressure affect the shape of implied volatility functions?" (with R.E. Whaley) was published in the *Journal of Finance*, and "Modeling the bid/ask spread: Measuring the inventory-holding premium" (with T. Smith and R.E. Whaley) was published in the *Journal of Financial Economics*. His paper, "Short-term persistence in mutual fund performance," (with J.A. Busse) is forthcoming in the *Review of Financial Studies*. In March, Bollen presented his paper, "Mutual fund attributes and

investor behavior," (with Mark Cohen) at Duke University.

Bollen was presented the Dean's Award for Excellence in Research in the fall of 2003.

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

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

Professor Chaney recently joined the editorial board of the American Accounting Association's premier research journal, *The Accounting Review*. His paper, "The Impact on the Market for Audit Services of Aggressive Competition by Auditors" (with Debra C. Jeter and Pamela Erickson Shaw), was published in the November/December 2003 issue of the *Journal of Accounting and Public Policy*. In 2003, Professor Chaney won the Dean's Award for Excellence in Research. In August of 2004 at the AAA annual conference, Professor Chaney was asked to discuss three papers that examine the impact of Arthur Andersen's demise on their client firms' stock prices and the impact on the audit market in general.



**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 empirical asset pricing, derivative securities, risk management, corporate finance theory as applied to security pricing, and problems in economic modeling.

Professor Charoenrook teaches courses in securities and portfolios and fixed-income markets. In the fall of 2003, Charoenrook chaired a session at the FMA Annual Conference in Denver. In June 2004, she served as a discussant of Anna Scherbina's paper, "Analyst Disagreement, Forecast Bias and Stock Returns," presented at the Western Finance Association Annual Meeting in Vancouver.



**WILLIAM G. CHRISTIE,** Frances Hampton Currey Professor of Finance. B. Comm., Queens University, 1978, M.B.A., Ph.D., Chicago, 1980, 1989.

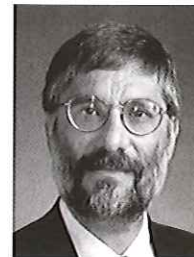
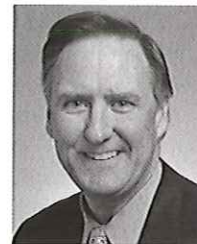
Professor Christie served as the Dean of the Owen Graduate School of Management for four years, and returned to the faculty on June 1, 2004 where he holds the Frances Hampton Currey chair in finance. He recently served on the Business Accreditation Committee of the Association to Advance Collegiate Schools of Business (AACSB) and was a member of the re-accreditation teams that visited Case Western Reserve University, Tulane, Wilfred Laurier and the University of Notre Dame. He served on the Board of Directors of the Graduate Management Admissions Council (GMAC), where he was also chair of the Finance and Investments Committee. He was an invited panelist in the session, "A Discussion with Deans," at the 2003 meetings of the *Financial Management Association*. He continues in his role as co-editor of the *Journal of Financial Intermediation* and serves on the program committee for the Corporate Governance Conference to be held at Washington University in November, 2004.

Christie's paper, "Do Firms Time Equity Offerings? Evidence from the 1930s and 1940s," (with Timothy Birch and Vikram Nanda) appeared as the lead article in the spring 2004 issue of *Financial Management*. He was also the recipient of the Executive MBA Outstanding Professor Award in 2003.

**MARK A. COHEN,** Senior Associate Dean of the Owen Graduate School of Management, Justin Potter Professor of American Competitive Business, Co-Director of the Vanderbilt Center for Environmental Management Studies.

M.A., Ph.D., Carnegie-Mellon 1985. Research interests include government regulation, law and economics, white-collar and corporate crime, and environmental management.

Professor Cohen was recently appointed as a member of the "Expert Panel on Disclosure of Environmental Information in SEC Filings." In

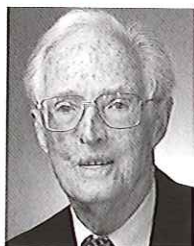


July 2004, the GAO issued its report on environmental information disclosure taking into account the panel's recommendations. He was also recently appointed as a member of the U.S. EPA's Science Advisory Board's, Illegal Competitive Advantage Economic Benefit Advisory Panel. That group will advise EPA on appropriate penalties for firms that violate environmental laws.

Professor Cohen was recently invited to present papers at several workshops and conferences, including: "Empirical Research on Environmental Enforcement, Monitoring and Compliance," at the University of Kansas' Institute of Public Policy Studies. He also traveled to China to present a paper on "Oil Pollution Prevention and Enforcement Measures and their Effectiveness: a Survey of Empirical Research from the U.S." at the International Conference on Marine (Oil) Pollution Prevention and Legal Remedies, sponsored by Shanghai Maritime University, Maastrichts University and Catholic University of Leuven. In the Spring, he traveled to Helsinki to present "The Cost of Crime: Methods and Findings from Past & Recent Research" at the European Seminar on Costs and the Distribution of Costs of Crime and Disorder and Crime Prevention, sponsored by Finnish National Council for Crime Prevention, Swedish Council for Crime Prevention, and European Commission.

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

In November 2003 Dr. Daane participated in a Policy Forum at the Federal Reserve Bank of Philadelphia, and in April he participated in the annual Financial Markets Research Center conference. In May, Dr. Daane attended the Federal Reserve Bank of Chicago's 40th Annual Conference on Bank Structure and Competition, which focused on "How Do Banks Compete? Strategy, Regulation, and Technology." In June, he attended a dinner sponsored by the Bretton Woods Committee honoring Paul Volcker, and he participated in the Federal Reserve Bank of Boston's 49th Annual Economic Conference held in Chatham, MA. This year's conference focused on "The Macroeconomics of Fiscal Policy."



**MARA FACCIO,**

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

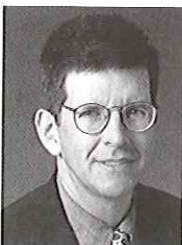
Research interests

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

Professor Faccio presented her paper, "Politically Connected Firms," at the International Monetary Fund, Stockholm School of Economics, Università Cattolica (Milan) and Università di Lugano. She also presented "Political Connections and Government Bailouts" (with Ronald W. Masulis and John McConnell) at the 9th Mitsui Life Symposium on Global Financial Markets at the University of Michigan. Two of her papers have been accepted for publication: "The Choice of Payment Method in European Mergers & Acquisitions" (with Ronald W. Masulis) in the *Journal of Finance* and "Expropriation vs. Proportional Sharing in Corporate Acquisitions" (with David Stolin) in the *Journal of Business*.

**LUKE M. FROEB,**

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



Research interests include industrial organization, econometrics, mergers, and antitrust policy. Current 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 now divides his time between teaching executive MBA's on weekends at Vanderbilt and searching for barriers to competition so he can destroy them. (If you find any, especially those erected by well-intentioned bureaucrats, please notify him at once, [lfroeb@ftc.gov](mailto:lfroeb@ftc.gov).)

At the FTC, Froeb manages 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 is also responsible for enforcing the antitrust laws of the United States. After teaching management for ten years, he is testing the hypothesis that "those who cannot do, teach."



**AMAR GANDE,**

Assistant Professor  
(finance). M.B.A., IIMC  
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," (with David Parsley) was accepted in November 2003 for publication in the *Journal of Financial Economics*. In April 2004, he presented a paper, "Sovereign Credit Ratings, Transparency and Portfolio Flows," (with David Parsley) at Vanderbilt University. In May, he presented a paper, "Informational Efficiency of Loans versus Bonds: Evidence from Secondary Market Prices," (with Edward Altman and Anthony Saunders) at the annual Bank Structure Conference of the Federal Reserve Bank of Chicago. In June, Gande attended the Western Finance Association annual meeting in Vancouver where he presented a paper, "The Role of Incentives in the Prevention of Financial Crises in Emerging Economies," (with Kose John and Lemma Senbet).

**DEBRA C. JETER,**

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

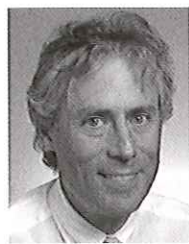


Research interests include financial accounting and auditing, with specific interests in earnings management, components of earnings, the market for audit services, audit pricing, and audit opinions.

Professor Jeter teaches financial accounting and accounting for mergers and acquisitions and has agreed to teach 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 2004, Jeter presented her research in New Zealand at the University of Auckland, and she presented two papers at the Western Regional Meeting of the American Accounting Association. In August she moderated an auditing session at the annual AAA conference. Her paper, "The Impact on the Market for Audit Services of Aggressive Competition by Auditors," (with Paul Chaney and Pam Shaw) has received extensive media attention.

## Faculty Activities (continued)



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

Research interests include equity analyst behavior, the security issue process, and corporate financial policy. Current research topics include herding by equity analysts, the relation between executive compensation and firm performance, and security issue cycles. Lewis has published papers on the topics of the behavior of equity research analysts, information content of implied volatilities, volatility forecasting, capital structure, debt maturity structure, the interaction between debt and lease financing, earnings management, and the design and use of convertible debt.

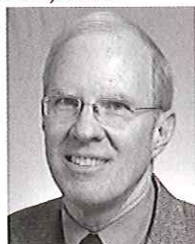
Professor Lewis primarily teaches corporate finance and will be offering an independent study on Investor Behavior. He currently serves on the dissertation committees of Fei Xie, Veronika Krepley, and Rajarishi Nahata, and he serves as chairman of Vladimir Ivanov's committee.

Lewis lectured on security pricing at the Donau University in Krems, Austria in January 2004. In February, he attended the Winter Finance Conference at the University of Utah. During the winter of 2004, Lewis presented his paper, "The Determinants of Issue Cycles for Initial Public Offerings," (with Vladimir Ivanov) at the University of New Orleans and the University of Oklahoma, and in the spring he presented it at Tübingen University and Freiberg University in Germany. In June he attended the Western Finance Association Annual Meeting in Vancouver and the FMA European Conference in Zurich, where he served as session chair and discussant for two papers.

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

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

Research interests include investment banking, optimal financing decisions, market microstructure, and international finance. Current research projects center on corporate governance, management



compensation, merger financing, underwriting of IPOs and seasonal equity offerings, global equity offerings, and venture capital.

Professor Masulis teaches mergers and acquisitions, venture capital, corporate finance theory and empirical evidence, and the law and finance of mergers & acquisitions, a joint offering with the Vanderbilt Law School. This past year he also co-taught a seminar course on corporate Governance and management compensation as a joint offering with the Law School. During the summer of 2004, he was a visiting professor at the School of Banking and Finance of the University of New South Wales in Sydney.

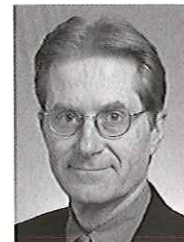
In August of 2003, Masulis presented "Venture Capital Investments by IPO Underwriters: Certification or Conflict of Interest," (with Xi Li, a former Owen PhD student) at the European Finance Association Annual Meetings in Glasgow Scotland. In October, he presented this paper at the University of South Carolina and served on the program committee of the American Finance Association Annual Meetings. In December of 2003, Masulis presented "The Choice of Financing Method in European Mergers and Acquisitions" (with Mara Faccio) at the Australasian Finance and Banking Conference in Sydney Australia.

In January of 2004, Masulis chaired a session on "Impacts of Seasoned Equity Issues" at the American Finance Association's Annual Meetings in San Diego. In March, he presented his paper, "Venture Capital Investments by IPO Underwriters: Certification or Conflict of Interest," at the Venture Capital and Private Equity Conference in Kansas City. In April, he presented the same paper at the University of Southern California and the New York Federal Reserve Bank. In May, he presented that paper, discussed a paper on IPOs, and chaired a session on Corporate Financial Policy at the FIRS Conference on Banking, Insurance and Intermediation in Capri, Italy, and in June he presented the "Venture Capital Investments" paper at the Annual Accounting and Finance Research Camp of the Australian Graduate School of Management in Sydney.

His most recent research (with Mara Faccio and John McConnell) is "Political Connections and Government Bailouts," which studies corporate bailout activity around the globe and the degree of association between corporate directors and large shareholders to important government officials. Masulis currently serves as associate

editor of the *Journal of Financial and Quantitative Analysis* and is a referee for numerous other finance journals.

**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. He has concentrated on the macroeconomics of exchange rates, prices, and the relationship between the two. His current research is directed in four main areas: (1) quantifying globalization using prices, including the factors affecting the integration of the goods market, (2) the importance of deviations from the law of one price in determining real exchange rate movements, (3) the relation between aggregate inflation and the variability of relative prices, and (4) how exchange rates affect cross-border pricing.

Professor Parsley has recently been an invited Research Fellow at the Hong Kong Institute for Monetary Research, the International Monetary Fund, and Goethe University in Germany. As an invited fellow, he conducts research quantifying the level of firm's exposure to exchange rate variation, the progress towards global goods market integration, and the factors affecting real exchange rate variation among regional economies.

Last year Parsley's paper, "News Spillovers in the Sovereign Debt Market," (with Amar Gande) was accepted for publication in the *Journal of Financial Economics*. In 2004, he has had three additional papers accepted for publication: "Exchange Rate Pegs and Foreign Exchange Rate Exposure in East and South East Asia" (with Helen Popper) in the *Journal of International Money and Finance*; "Pricing in International Markets: A Small Country Benchmark" in the *Review of International Economics*; and "Aggregator Price Changes and Dispersion: A Comparison of the Equity and Goods and Services Markets" (with Helen Popper) in *Contributions to Macroeconomics*.



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

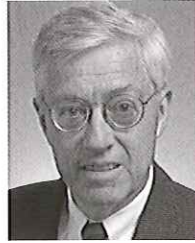
Research interests include theoretical and empirical issues in corporate finance, with specific interests in corporate governance, management compensation, venture capital,



and initial public offerings. Her paper, "The Determinants of Board Size and Composition: A Theory of Corporate Boards," was recently accepted for publication in the *Journal of Financial and Quantitative Analysis*.

During the summer of 2004, Professor Raheja worked on two different projects relating to the effectiveness of corporate governance structure in firms. One of the projects studied the life cycle of corporate boards by following corporate boards from the initial public offering for a period of 10 years. The second project examined the disciplinary measures that take place on the board and on the managers of firms experiencing a large decline in operating performance. Her paper, "Determinants of Board Size and Composition: A Theory of Corporate Boards," was accepted for publication in the *Journal of Financial and Quantitative Analysis*. In June, Raheja attended the Western Finance Association meeting. She plans on chairing a session on management compensation and presenting her empirical paper on corporate boards at the Financial Management Association meeting in October.

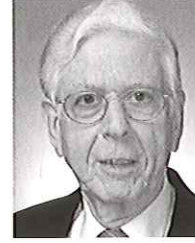
Professor Raheja teaches courses in corporate financial policy and financial management. She was the 2003 recipient of the Dean's Award for Excellence in Teaching.



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

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

Professor Stoll's survey paper, "Market Microstructure," appeared in the *Handbook of the Economics of Finance*, edited by Constantinides, Harris and Stulz, published in 2003. His paper, "Price Impacts of Options Volume," (with Christian Schlag) is forthcoming in the *Journal of Financial Markets*. In the spring of 2004 Stoll presented his working paper, "Trades Outside the Quotes: Reporting Delay, Trading Option, or Trade Size," (with Christoph Schenzler) at Notre Dame, NYU, and Vanderbilt seminars. In March, Stoll lectured on market microstructure at the Donau University in Krems, Austria. In July, he participated in the Financial Economists Roundtable deliberations on issues surrounding corporate pension plans. In June, Stoll stepped down as a public governor of the Pacific Exchange. He had been a governor for 4 years. Stoll 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 is associate editor of *Management Science*. He has authored *Mathematical Programming and the Analysis of Capital Budgeting Problems* as well as numerous articles. ■

## Faculty Research Papers

Current working papers, completed or revised since January 1, 2003, 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.

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

The per share revenue of immediacy suppliers is estimated by a measure we term the "realized half-spread." The estimate,

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

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

This paper examines the role of ownership restrictions in raising capital from niche clienteles. Extant literature suggests that limiting availability of securities to only certain classes of investors constricts demand, and hence decreases prices. We argue that ownership restrictions can have positive implications for prices when viewed in the overall context of security design. We provide empirical evidence through an in-depth analysis of a natural experiment: multiple events of capital raising by an emerging market company with ownership restrictions, namely \$4.2 billion and \$5.5 billion of bonds offered by India's largest bank, State Bank of India exclusively to Indians living abroad at approximately 150 basis points below comparable benchmarks leading to a bottom line savings of \$1.08 billion. This is an intriguing issue because it raises the question, how can an emerging market issuer with junk bond ratings obtain such yields? We argue that ownership restrictions can lead to value enhancement as well as value transfer (from holders of other securities). Ownership restrictions can enhance value by circumventing the deadweight costs of prolonged negotiations, particularly when a security is restricted to a homogenous clientele that values the underlying collateral higher than other investors. Restricting the ownership further ensures that investment is limited to a homogenous class of investors that the issuer cares about. It thus serves as a precommitment to ensuring an efficient ex-post renegotiation in the potential default states, resulting in a lower ex-ante offering yield (and a higher offer price). This can result in an implicit seniority of holders of these restricted bonds vis-a-vis holders of unrestricted bonds. We empirically test and find support for both value enhancement as well as for value transfer from ownership restrictions. Overall, our results suggest that firms with niche clienteles can

benefit from designing securities with ownership restrictions, by offering new securities exclusively to investors who value them the most.

00-05 "Joint Accounting Choices: An Examination of Firms' Adoption Strategies for SFAS No. 106 and SFAS No. 109," by **Michele Daly**, **Debra Jeter**, and **Paul Chaney**. (May 2004)

This paper investigates interactive choices made in the adoption of newly mandated accounting standards. Specifically, we consider whether firms' adoption strategies for SFAS No. 106 and SFAS No. 109 were linked, in addition to considering the interaction between choices related to adoption method and timing for each standard separately. The evidence presented is consistent with adoption strategies being associated with incentives to smooth income and to reduce political costs, and with adoption strategies for the two standards being chosen jointly. The paper also provides some insight into how firms view recurring versus non-recurring charges, and how they weigh the tradeoff between a large one-time (income decreasing) charge against the smaller but longer lasting effects of amortization.

00-10 "Bank Incentives, Economic Specialization, and Financial Crises in Emerging Economies," by **Amar Gande**, **Kose John** and **Lemma W. Senbet**. (August 2004)

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 as a solution mechanism two tax structures designed: (1) to

eliminate the bank debt concentration effect, and (2) to change the ex ante incentives of the residual claimants in the corporate sector in the right direction by concavifying the pay-off structure of the after-tax cash flows. Our proposed solution mechanism is targeted towards prevention rather than an ex post resolution of a financial crisis. 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 constrained 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.

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

This study measures the proportion of real exchange rate movements that can be accounted for by movements in the relative price of non-traded goods among twenty-one bilateral Asian-Pacific real exchange rates. Following Engel (1999), the decomposition is done at all possible horizons that the data allow – from one month up to 25 years. For the most part, evidence presented here is consistent with that from his sample of (predominantly) G7 countries. In particular, relative prices of non-traded goods appear to

account for virtually none of the movements in Pacific Rim real exchange rates. This pattern appears unaffected by the cross-sectional variation in either income level, or the degree of openness present among these Pacific-Rim economies. The exceptions to these results occur when we examined the drift in real exchange rates, and more generally, for fixed (or semi-fixed) exchange rate regimes.

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

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

01-11 "Price Impacts of Options Volume," by **Christian Schlag and Hans Stoll**. (forthcoming in *Journal of Financial Markets*)

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

01-13 "How Big and Heterogeneous Are the Effects of Currency Arrangements on Market Integration? A Price Based Approach," by **David C. Parsley and Shang-Jin Wei**. (September 2003)

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.

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

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

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

01-20 "Short-term Persistence in Mutual Fund Performance," by **Nicolas P.B. Bollen and Jeffrey A. Busse**. (forthcoming in *Review of Financial Studies*)

We estimate parameters of standard stock selection and market timing models using daily mutual fund returns and quarterly measurement periods. We then rank funds quarterly by abnormal return, and measure the performance of each decile the following quarter. The average abnormal return of the top decile in the post-ranking quarter is 39 basis points. The post-ranking abnormal return disappears when funds are evaluated over longer periods. These results suggest that superior performance is a short-lived phenomenon that is observable only when funds are evaluated several times a year.

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

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

01-25 "Determinants of Board Size and Composition: A Theory of Corporate Boards," by **Charu G. Raheja**. (forthcoming in *Journal of Financial and Quantitative Analysis*)

This paper models the interaction of firm insiders and outsiders on a corporate board and addresses the question of the ideal size and composition of the board. In the model, the board is responsible for monitoring projects and making CEO succession decisions. Inside directors are better informed regarding the quality of firm investment projects, but outsiders can use CEO succession to motivate insiders to reveal their superior information and help the board in implementing higher value projects. The optimal board structure is determined by the tradeoff between maximizing the incentive for insiders to reveal their private information, minimizing the cost

to outsiders to verify projects, and maximizing outsiders' ability to reject inferior projects. I show that optimal board size and composition are a function of the directors' and firm's characteristics. I also develop testable implications for the cross-sectional variations in the optimal board structure across firms.

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

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

01-28 "News Spillovers in the Sovereign Debt Market," by **Amar Gande** and **David Parsley**. (forthcoming in the *Journal of Financial Economics*)

We study the effect of a sovereign credit rating change of one country on the sovereign credit spreads of other countries from 1991 to 2000. We find evidence of spillover effects, that is, a ratings change in one country has a significant effect on sovereign credit spreads of other countries. This effect is asymmetric: positive ratings events abroad have no discernable impact on sovereign spreads, whereas negative ratings events are associated with an increase in spreads. On average, a one-notch downgrade of a sovereign bond is associated with a 12 basis point increase in spreads of sovereign bonds of other countries. Interestingly, the magnitude of the spillover effect following a negative ratings change is amplified by recent ratings changes in other countries. We distinguish between common information and differential components of spillovers. While common information spillovers imply that sovereign spreads move in tandem, differential spillovers are expected to result in opposite effects of ratings events across countries. Despite the predominance of common information spillovers, we also find evidence of differential spillovers among countries with highly negatively correlated capital flows or trade flows vis-à-vis the United States. That is, spreads in these countries generally fall in response to a downgrade of a country with

highly negatively correlated capital or trade flows. Variables proxying for cultural or institutional linkages (e.g., common language, formal trade blocs, common-law legal systems), physical proximity, or rule of law traditions across countries do not seem to affect estimated spillover effects.

01-29 "Pricing of Initial Audit Engagements for Listed and Unlisted Clients," by **Paul K. Chaney**, **Debra C. Jeter**, and **L. Shivakumar**. (July 2003)

Because of concerns that price cutting might lead to impaired audit quality, the discounting of initial audit engagements, sometimes referred to as low-balling, has long been of concern to accounting theorists and researchers, as well as to standard setters and various users of accounting data. Results of prior studies investigating the issue, however, are inconsistent in several respects. Our study offers certain advantages over the existing literature. Our sample includes unlisted as well as listed firms, and it is larger and more comprehensive than that used in any of the prior studies. Our firms cover a wide range of SIC codes, and we examine all four types of auditor switches, non-Big to non-Big, Big to Big, Big to non-Big, and non-Big to Big. We find no evidence of discounting for upgrades, but some evidence of discounting for most other categories of switches. Further, we show that the evidence is consistent with our theoretical framework.

02-02 "Trades Outside the Quotes: Reporting Delay, Trading Option, or Trade Size?" by **Hans R. Stoll** and **Christoph Schenzler**. (July 6, 2004)

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. Since traders 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 there is "slippage" in the market mechanism. Outside-trades occur in Nasdaq because of delays in reporting trades, because the ability of dealers to delay execution of trades creates a look-back option which when exercised results in outside-trades, and 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. Nevertheless the pattern of trading on the NYSE is not inconsistent with the specialist benefiting from a look-back trading option.

02-04 "Venture Capital Investments by IPO Underwriters: Certification, Alignment of Interest or Moral Hazard?" by **Ronald W. Masulis** and **Xi Li**. (June 21, 2004)

We study IPO pricing when underwriters are venture capital investors in issuers and test three hypotheses concerning the effects of underwriter share ownership on the IPO underwriting and pricing processes. We find that venture investments by underwriters significantly reduce IPO underpricing and the result is stronger for lead underwriters. This evidence is consistent with both underwriter certification and improved underwriter alignment of interests with issuers. The fall in underpricing is substantially greater when there is greater uncertainty about IPO valuation, which supports the underwriter certification effect. Controlling for endogeneity effects does not change our conclusions. Lead underwriter venture investment in IPO issuers also reduces underwriter gross spreads. Overall, the evidence is consistent with both an underwriter certification effect and a greater alignment of interests with IPO issuers.

02-06 "Does Sentiment Matter?" by **Anchada Charoenrook**. (December 2003)

Whether investor sentiment has any bearing on asset returns has long been a topic of interest in finance. In this paper I examine whether sentiment, as measured by yearly change in the University of Michigan Consumer Sentiment Index, affects stock returns. I find that changes in consumer sentiment reliably predict excess stock market returns at one-month and one-year horizons over 1979-2000 and 1955-2000 periods. Its univariate prediction is stronger than other popular stock return predictors. Change in consumer sentiment performs better than an ARI benchmark model in out-of-sample forecasting tests. Changes in consumer sentiment predict future excess stock returns after controlling for dividend yield, the book-to-market ratio of the Dow Jones Industrial Average, the slope of the term structure, the yield spread between Baa and Aaa bonds, the short rate yield, lagged excess market returns, and the consumption-wealth ratio. The predictability of change in consumer sentiment is mostly unrelated to economic cycles as measured by real GDP growth or consumption growth.

02-18 "Exchange Rate Pegs and Foreign Exchange 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, Trading Costs, and Mutual Fund Performance," by **Nicolas P.B. Bollen** and **Jeffrey A. Busse**. (April 2004)

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**. (April 2004)

This paper examines the informational efficiency of loans relative to bonds surrounding loan default dates and bond default dates. We examine this issue using a unique dataset of daily secondary market prices of loans over the 11/1999-06/2002 period. We find evidence consistent with a monitoring role of loans. Specifically, consistent with a view that the monitoring role of loans should be reflected in more precise expectations embedded in loan prices, we find that the price decline of loans is less adverse than that of bonds of the same borrower around loan and bond default dates. Additionally, we find evidence that the difference in price decline of loans versus bonds is amplified around loan default dates that are not preceded by a bond default date of the same company. Our results are robust to several alternative explanations, and to

controlling for security-specific characteristics, such as seniority, collateral, covenants, and for multiple measures of cumulative abnormal returns. Overall, we find that the loan market is informationally more efficient than the bond market around loan default dates and bond default dates.

03-01 "The Choice of Payment Method in European Mergers & Acquisitions," by **Mara Faccio**, and **Ronald W. Masulis**. (forthcoming in *Journal of Finance*)

We study merger and acquisition (M&A) payment choices of European bidders for publicly and privately held targets in the 1997-2000 period. Europe is an ideal venue for studying the importance of corporate governance in making M&A payment choices, given the large number of closely held firms, and the wide range of capital markets, institutional settings, laws and regulations. The tradeoff between corporate governance concerns and debt financing constraints is found to have a large bearing on the bidder's payment choice. Consistent with earlier evidence, we find that several deal and target characteristics significantly affect the method of payment choice.

03-06 "Politically Connected Firms," by **Mara Faccio**. (July 2004)

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**. (September 2003)

Whereas debt constrains the expropriation of dispersed shareholders by professional managers of US corporations, in European and Asian corporate pyramids debt can facilitate the expropriation of minority shareholders by the controlling shareholder. European capital market institutions appear sufficiently effective that competition for external capital from informed suppliers restricts the leverage of corporations that appear more vulnerable to expropriation through being lower down a pyramid. Asian institutions appear ineffective,

allowing the controlling shareholders of corporations lower down a pyramid to increase leverage to acquire more resources to expropriate. These contrasting outcomes are reflected in regional differences in access to related-party loans.

03-08 "Expropriation vs. Proportional Sharing in Corporate Acquisitions," by **Mara Faccio** and **David Stolin**. (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 Issue Cycles for Initial Public Offerings," by **Vladimir Ivanov** and **Craig M. Lewis**. (June 2004)

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

03-11 "A Prism into the PPP Puzzles: The Micro-Foundations of Big Mac Real Exchange Rates," by **David C. Parsley** and **Shang-Jin Wei**. (February 18, 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 (to a first approximation) 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 "The World Price of Short Selling," by *Anchada Charoenrook and Hazem Daouk*. (July 2004)

This paper provides empirical evidence relevant to the ongoing debate about how short-sale constraints affect aggregate market returns and whether short sales should be allowed. The study focuses on two main questions. What is the effect of short-sale constraints on skewness, coskewness, volatility, the intensity and severity of market crashes, and liquidity? What is the effect on the cost of capital? We collect new data on the history of short-sale and put option trading regulations and practices from the 111 countries that have a stock exchange. We find that there is no difference in the level of skewness and coskewness of returns, probability of a crash occurring, or the frequency of crashes, between countries where short-selling is possible and where it is not. In countries where short-selling is possible, volatility of aggregate stock returns is lower and liquidity is higher. Lastly, we find that countries where short-selling is possible have lower cost of capital. Collectively, the empirical evidence suggests that short-sale constraints reduce market quality.

04-01 "When do bidders gain? The difference in returns to acquirers of listed and unlisted targets," by *Mara Faccio, John J. McConnell, and David Stolin*. (February 9, 2004)

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*. (May 2004)

Do mutual fund 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. Surprisingly, annual flows in socially responsible funds are more strongly related to prior annual performance than flows in conventional funds. We argue that both empirical results can be explained by a non-financial dimension in the utility functions of socially responsible investors.

04-03 "Determinants of Corporate Board Size and Composition: An Empirical Analysis," by *Audra Boone, Laura C. Field, Jonathan Karpoff and Charu G. Rabeja*. (2004)

Several theories have been proposed to explain how corporate boards are structured. In this paper we group these theories into four hypotheses and test them empirically. Our data consist of firms going public from 1988-1992, which we track for 10 years after the IPO and which provide a unique panel dataset of corporate board development during the early years of a firm's public existence.

Consistent with the hypothesis that boards are shaped by the scope and complexity of the firm's activities, we find that board size and the fraction of independent outsiders are positively related to firm size, age, and diversification. The fraction of independent outsiders is negatively related to measures of the quasi-rents the CEO generates for the firm, indicating that board composition is affected by the CEO's influence with outside board members. We also find that board size is influenced by the opportunities for private benefits to insiders and the monitoring costs afforded by the firm's unique business environment. The data do not support the view that boards are structured

inefficiently or to facilitate managers' consumption of value-decreasing private benefits. These results indicate that corporate boards adjust to the firm's specific advising and monitoring requirements, and undermine notions that one-size-fits-all remedies can improve board and firm performance.

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*. (July 2004)

The characteristics of the distribution of security returns, such as skewness, play a significant role in financial theory and practice. 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. Hong and Stein (2003) model predict a relation between turnover and skewness. We find some weak evidence that in developed countries, high trend-adjusted turnover predicts more negative skewness in returns. Our findings have implications for future theoretical and empirical models of time-varying market returns.

04-07 "Reluctant Privatization," by *Bernardo Bertolotti and Mara Faccio*. (April 27, 2004)

We study the evolution of the control structure of a large sample of privatized firms from OECD countries. We document that governments do not relinquish control after privatization. Governments in fact still control (through ownership or golden shares) 62.4 percent of privatized firms as of the end of 2000. We then analyze the effects of government's reluctance to privatize on firm value. We first show that the market-to-book ratios of privatized firms converge through time to those of a control sample. However, we find that this convergence does not depend on the relinquishment of control rights by the governments. On the contrary, when we take into account possible endogeneity of government's stakes, we find that privatized firms where the government is a large shareholder outperform companies more fully privatized. Under some circumstances, the agency costs of private ownership may more than offset the costs of political interference in firms.

04-10 "Political Connections and Government Bailouts," by *Mara Faccio, Ronald Masulis, and John McConnell*. (May 24, 2004)

We analyze the likelihood of a government bailout for a sample of 357 politically-connected firms from 35 countries and their matching peers over the period 1997 to 2001. We find that political connections result in a higher likelihood of a company bailout, but this occurs only when the involved government receives a loan from the IMF or World Bank. Further, we report that "stronger" connections (e.g., connections through the owner rather than through a director, or connections with the Prime Minister rather than a MP) result in a higher probability of a bailout. In comparison with peers, CEO turnover is lower for bailed out companies. Excess stock returns around announcements of bailouts are not significantly different from zero.

04-11 "Slow Passthrough Around the World: A New Import for Developing Countries?" by *Jeffrey Frankel, David Parsley, and Shang-jin Wei*. (July 8, 2004)

Developing countries traditionally experience passthrough of exchange rate changes that is greater and more rapid than high-income countries experience. This is true equally of the determination of prices of imported goods, prices of local competitors' products, and the general CPI. But developing countries in the 1990's experienced a rapid downward trend in the degree of passthrough

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

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*. (August 2004)

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 are associated with 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. Overall, improving transparency appears to be beneficial to a sovereign in terms of smaller outflows around negative news (such as downgrades) domestically, and larger inflows around negative news abroad.

04-14 "Information and Selective Disclosure," by *Anchada Charoenrook and Craig Lewis*. (July 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 that are not earnings guidance. We conclude that the passage of Reg FD has indeed achieved its objective of "leveling the playing field" for all investors and yet encourage firms to disclose the same amount of information. ■

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