FIN 542 MMBR - Syllabus

Session 1 (February 22, 2018): Capital Structure

Instructor: Ernst Maug

The first session will start with the classic topic of capital structure. We will begin with a generalized version of the Modigliani-Miller theorem and then address the two main contenders for capital structure explanations: arguments based on adverse selection ("pecking order theory") and arguments based on the trade-off between tax savings and costs of financial distress ("trade-off theory"). They key theoretical concepts will focus on signaling and adverse-selection.

Given the large and long literature on capital structure, the state of research on important questions is still surprisingly inconclusive. One difficulty is that the foundational theories are formulated in a static, one-period context and covered dynamic aspects more recently. Empirically, dynamic aspects are difficult to track and we will discuss dynamic panel data models and their pitfalls and how they can address dynamic predictions. Another empirical question relates to the power of tests, since standard empirical tests often have little power to distinguish between alternative hypotheses.

Student Presentations:

Chang, X. I. N., and Sudipto Dasgupta, 2009, Target Behavior and Financing: How Conclusive Is the Evidence?, *Journal of Finance* 64, 1767-1796. Chang and Dasgupta address the often surprisingly lower power of tests of capital structure theories and shows that some results that were thought to be conclusive proofs for the trade-off theory could just as well occur if firms' capital-structure choices are driven by other considerations.

Danis, András, Daniel A. Rettl, and Toni M. Whited, 2014, Refinancing, profitability, and capital structure, Journal of Financial Economics 114:3, 442-443. Danis, Rettl, and Whited discuss evidence for the trade-off theory by separating situations in which firms are close to their optimal capital structure from other situations, in which they are not so close. They claim they can resolve the puzzle of a negative correlation between profitability and leverage, which is usually held against the trade-off theory.

Required Readings:

Flannery, Mark J., and Kasturi P. Rangan, 2006, Partial adjustment toward target capital structures, Journal of Financial Economics 79:3, 469-506. Flannery and Rangan provide tests of the trade-off theory based on the notion that firms close a part of the gap between their actual and their target capital structure each year. They estimate the speed of adjustment.

Kraus, Alan, and Robert H. Litzenberger, 1973, A State-Preference Model of Optimal Financial Leverage, Journal of Finance 28:4, 911-922 Kraus and Litzenberger's paper is the classic statement of the trade-off theory of capital structure and the theoretical foundation for the APV approach discussed in almost any textbook of corporate finance.

Myers, Steward C., and Nicholas S. Majluf, 1984, *Corporate Financing and Investment Decisions when Firms Have Information that Investors do not Have*, Journal of Financial Economics 13, no. 2 (June), pp. 187-224 Myers and Majluf's article is a classic in capital structure theory and provides some key claims and intuitions for the pecking-order argument. Unfortunately, the argument is not very rigorous, an issue addressed by Noe (1988). Noe's paper requires more advanced game theory and we will discuss it only briefly in class. Students with a background equivalent to E603 are encouraged to read his paper.

Further readings:

Flannery, M. J., and K. W. Hankins, 2013, Estimating dynamic panel models in corporate finance, Journal of Corporate Finance 19:1-19. Flannery and Hankins discuss the econometric problems with estimating dynamic panel data models with fixed effects.

Frank, Murray Z., and Vidhan K. Goyal, 2015, The Profits–Leverage Puzzle Revisited, Review of Finance 19:4, 1415-1453

Giroud, Xavier, Holger M. Mueller, Alex Stomper, and Arne Westerkamp, 2012, Snow and Leverage, Review of Financial Studies 25:3, 680-710

Graham, John R., and Mark T. Leary, 2011, A Review of Empirical Capital Structure Research and Directions for the Future, Annual Review of Financial Economics 3:1, 309-345

Heider, Florian, and Alexander Ljungqvist, 2015, As certain as debt and taxes: Estimating the tax sensitivity of leverage from state tax changes, Journal of Financial Economics 118:3, 684–712.

Noe, Thomas H., 1988, Capital Structure and Signaling Game Equilibria, Review of Financial Studies 1, no. 4 , pp. 331-355

Session 2 (March 8, 2018): Shareholder voting and ownership

Instructor: Ernst Maug

This session will look at two different aspects of corporate voting. In the US and some other market, shareholders can tender their shares to (hostile) bidders who then change management and restructure the firm. Grossman and Hart were the first to advance an argument for when the separation of voting rights from cash flow rights may be optimal to provide incentives for takeover bidders and generate additional returns for founding shareholders. This strand of the literature argues that voting rights are important to facilitate transfers of control. A second literature sees shareholder voting more in the context of a direct-democracy model in which shareholders decide on important issues. We will address both arguments and explore the benefits of regression discontinuity design to make causal inferences about the impact of shareholder voting on corporate decisions and valuation.

Student Presentations:

Agrawal, Ashwini K., 2012, Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting, Review of Financial Studies 25:1, 187-226.

Becht, Marco, Andrea Polo, and Stefano Rossi, 2016, Does Mandatory Shareholder Voting Prevent Bad Acquisitions?, Review of Financial Studies 29:11, 3035-3067. Becht, Polo and Rossi explore the impact of mandatory shareholder voting on acquisitions in the UK using a refinement of regression discontinuity design.

Required Readings:

Aghion, Philippe, and Patrick Bolton, 1989, The Financial Structure of the Firm and the Problem of Control, European Economic Review 33, pp. 286-293. Aghion and Bolton's seminal paper was one of the first to use incomplete-contract theory to analyze how ownership is relevant to corporations and explore the ownership aspect of capital strucure decisions. The EER-paper is a short summary of the longer version, which appeared later (see further readings, Aghion and Bolton (1991)).

Cunat, Vicente, Mireia Gine, and Maria Guadalupe, 2012, The Vote Is Cast: The Effect of Corporate Governance on Shareholder Value, Journal of Finance 67:5, 1943-1977.

Cunat, Gine and Guadalupe investigate the value impact of the adoption of shareholder proposals at shareholders' annual general meetings. The paper uses regression discontinuity design to support causal inference on the impact of voting proposals.

Grossman, Sanford J., and Oliver D. Hart, 1988, One Share-One Vote and the Market for Corporate Control, Journal of Financial Economics 20, pp. 175-202.

This paper is the foundational paper on the one-share one-vote debate and discusses conditions under which the separation of voting rights from cash flow rights would be optimal.

Maug, Ernst, and Kristian Rydqvist, 2009, Do Shareholders Vote Strategically? Voting Behavior, Proposal Screening, and Majority Rules, Review of Finance 13:1, 47-79.

This paper analyzes strategic voting on proposals at annual general meetings and uses a very simple form of structural estimation.

Further Readings:

Davis, Gerald F., and E. Han Kim, 2007, Business Ties and Proxy Voting by Mutual Funds, Journal of Financial Economics 85:2, 552-570.

Hu, Henry T. C., and Bernard Black, 2007, Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership, Journal of Corporate Finance 13:3443-367.

Aghion, Philippe, and Patrick Bolton, 1992, An "Incomplete Contract" Approach to Financial Contracting, Review of Economic Studies 59:200, 473-494. This is the long version of the EER article with complete proofs and further extensions.

Session 3 (March 22, 2018): Board Structure

Instructor: Ernst Maug

Boards have received tremendous interest by research in the area of corporate governance. While all firms are legally required to form a board, their composition (e.g. in terms of board size, the fraction of outside directors, employee representation) varies widely across firms and countries. The debate about boards focuses on two questions: (1) how is board structure determined? (2) how does board structure affect board actions and in particular firm performance?

Whereas there is a huge amount of empirical studies dealing with boards, theoretical work on boards is *comparatively sparse. A notable exception, which we will discuss, is the paper by Hermalin and Weisbach (1998). Their paper shows that CEO power, board composition (in particular board independence relative to the CEO) and board actions (e.g. CEO turnover) are closely intertwined. We will also discuss the model by Adams and Ferreira (2007). This model is useful to discuss distinctions between one-tier and two-tier board systems.*

Empirical research about boards has to cope with the joint endogeneity of board composition and board actions. Following the discussion of theoretical models, we review the empirical evidence regarding the link between board structure, board actions and firm performance. In particular, we will discuss natural experiments (e.g. Ahern and Dittmar, 2012) and dynamic panel data estimators (Wintoki, Linck, and Netter, 2012) as two remedies for the endogeneity problem.

Student Presentations:

Ahern, Kenneth, R., and Amy K. Dittmar, 2012, The Changing of the Boards: The Impact on Firm Valuation of Mandated Female Board Representation, Quarterly Journal of Economics, 127, no. 1, pp. 137-197. Ahern and Dittmar investigate value implications of the mandated gender quota in Norway. They exploit the unprecedented exogenous change to board structure to avoid endogeneity issues that are a major challenge in this area.

Wintoki, M. Babajide; James S. Linck, and Jeffry M. Netter, 2012, Endogeneity and the dynamics of internal corporate governance, Journal of Financial Economics 105, no. 3, pp. 581-606. This paper uses dynamic panel data models in the context of the effect of board structure on firm performance and the determinants of board structure.

Required Readings:

Adams, Renée B., and Daniel Ferreira, 2007, A Theory of Friendly Boards, Journal of Finance 62, no. 1, pp. 217-250. This paper highlights the dual role of the board as monitor and advisor of the CEO. Adams and Ferreira analyze the trade-off a CEO faces in providing information to the board.

Adams, Renée B.; Benjamin E. Hermalin, and Michael S. Weisbach, 2010, The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey, Journal of Economic Literature 48, no. 1, pp. 58-107. This is a comprehensive survey about the major contributions in the field of board structure.

Hermalin, Benjamin E., and Michael S. Weisbach, 1998, Endogenously Chosen Boards of Directors and Their Monitoring of the CEO, American Economic Review 88, no. 1, pp. 96-118. This paper is a key theoretical contribution to the field and uses a model to understand the interrelations between CEO power, board independence, and board actions.

Further Readings:

Adams, Renée B., and Daniel Ferreira, 2009, Women in the boardroom and their impact on governance and performance, Journal of Financial Economics 94, no. 2, pp. 291-309. This paper investigates the differences of male and female directors in terms of board outcomes.

Belot, François; Edith Ginglinger, Myron B. Slovin, Marie E. Sushka, 2014, Freedom of choice between unitary and two-tier boards: An empirical analysis, Journal of Financial Economics 112, no. 3, pp. 364-385. The authors analyze the determinants of board structure choice in France – a country that has allowed the choice between a one- and a two-tier board system since 1966.

Coles, Jeffrey L.; Naveen D. Daniel, and Lalitha Naveen, 2008, Boards: Does one size fit all? Journal of Financial Economics 87, no. 2, pp. 329-356.

Dittmann, Ingolf; Ernst Maug, and Christoph Schneider, 2010, Bankers on the Boards of German Firms: What They Do, What They Are Worth, and Why They Are (Still) There, Review of Finance 14, no. 1, pp. 35-71.

Fahlenbrach, Rüdiger; Bernadette A. Minton, and Carrie H. Pan, 2011, Former CEO Directors: Lingering CEOs or Valuable Resources? Review of Financial Studies 24, no. 10, pp. 3486-3518.

Fich, Elizier M., and Anil Shivdasani, 2006, Are Busy Boards Effective Monitors? Journal of Finance 61, no. 2, pp. 689-724.

Harris, Milton, and Artur Raviv, 2008, A Theory of Board Control and Size, Review of Financial Studies 21, no. 4, pp. 1797-1832.

Nguyen, Bang Dang, and Kasper Meisner Nielsen, 2010, The value of independent directors: Evidence from sudden deaths, Journal of Financial Economics 98, no. 3, pp. 550-567. Nguyen and Nielsen draw on the sudden death of directors to mitigate endogeneity concerns in analyzing the value implications of independent directors.

Session 4 (April 12, 2018): CEO Labor Markets

Instructor: Marc Gabarro

CEOs are the most powerful decision-makers in the firm. Conventional wisdom associates the success and failure of firms to particular CEOs. Which incentives do CEOs have to perform well on their job, how can CEOs be disciplined and how do CEOs matter? These questions have attracted the attention of researchers in corporate finance and labor economics. We will cover a model about career concerns of managers by Holmström (1999) – the most recent Nobel Prize Winner. One of the most important disciplining devices is the firing of bad performing CEOs. Inference about the effectiveness of CEO turnover as disciplining device requires the distinction between forced and unforced CEO and leads inevitably to some misclassifications. We will discuss a new method for categorizing CEO turnover by Jenter and Lewellen (2014).

Replacing the CEO has no impact on firm performance if (1) managers are perfect substitutes or if (2) the governance arrangements of firms restrict individual CEOs in leaving their mark on firm policies. We will discuss several empirical papers that challenge this view and acknowledge that CEOs matter for firm policies and performance due to differences in terms of their personal characteristics (e.g. overconfidence (Malmendier, Tate, and Yan, 2011), financial experience (Custodio and Metzger, 2014) or ability (Graham, Liu, Qi (2012)). We will discuss an assignment model of CEOs and firms by Tervio (2008), which explains how differences in ability translate into different pay levels.

Student Presentations:

Graham, John R.; Si Li, Jiaping Qiu, 2012, Managerial Attributes and Executive Compensation, Review of Financial Studies 25, no. 1, pp. 144-186. This paper introduces the AKM method into finance. Their method allows to capture differences in CEO ability empirically and to disentangle unobserved firm-specific and manager-specific heterogeneities.

Jenter, Dirk, and Katharina Lewellen, 2014, Performance-induced CEO turnover,Working Paper, Stanford University & Tuck School at Dartmouth. The concept of performance-induced CEO turnover drop the distinction between forced and voluntary turnovers. This approach may avoid misclassifications that obscure the turnover-performance sensitivity.

Required Readings:

Fee, C. Edward; Charles J. Hadlock, and Joshua R. Pierce, 2013, Managers with and without Style: Evidence Using Exogenous Variation, Review of Financial Studies 26, no. 3, pp. 567-601.

This paper challenges the view that managerial style play a causal role in corporate policies or performance.

Holmström, Bengt, 1999, Managerial Incentive Problems: A Dynamic Perspective, Review of Economic Studies 66, no. 1, pp. 169-182. Holmström derives an important model about managerial career concerns.

Malmendier, Ulrike; Geoffrey Tate, and Jon Yan, 2011, Overconfidence and Early-Life Experiences: The Effect of Managerial Traits on Corporate Financial Policies, Journal of Finance 66, no. 5, pp. 1687-1733. In this paper, Malmendier et al. find empirical support for a relation between managerial characteristics such as overconfidence and experience and corporate financing decisions

Tervio, Marko, 2008, The Difference That CEOs Make: An Assignment Model Approach, American Economic Review 98, no. 3, pp. 642-668. The paper is based on an assignment model and the underlying matching between CEOs and firms. Tervio derives implications for differences in ability for CEO pay and firm value.

Further Readings:

Adams, Renée B.; Heitor Almeida, and Daniel Ferreira, 2005, Powerful CEOs and Their Impact on Corporate Performance, Review of Financial Studies 18, no. 4, pp. 1403-1432. In this paper, Adams et al. derive and test the hypothesis, that the link between CEO characteristics and firm performance depends on the organizational power that the CEO has in the firm.

Almazan, Andres and Javier Suarez, 2003, Entrenchment and Severance Pay in Optimal Governance Structures, Journal of Finance 58, no. 2, pp. 519-547.

Bertrand, Marianne, and Antoinette Schoar, 2003, Managing with Style: The Effect of Managers on Firm Policies, Quarterly Journal of Economics 118, no. 4, pp. 1169-1208. In their seminal paper, Bertrand and Schoar show that individual managers matter for firm policies and firm performance.

Custódio, Cláudia, and Daniel Metzger, 2014, Financial expert CEOs: CEO′s work experience and firm′s financial policies, Journal of Financial Economics 114, no. 1, pp. 125-154.

Gabaix, Xavier, and Augustin Landier, 2008, Why Has CEO Pay Increased So Much?, Quarterly Journal of Economics 123, no. 1, pp. 49-100.

Jenter, Dirk, and Fadi Kanaan, 2015, CEO Turnover and Relative Performance Evaluation, Journal of Finance 70, no. 5, pp. 2155-2184. This paper shows a link between forced CEO turnover and bad industry or bad market performance.

Kaplan, Steven N.; Mark M. Klebanov, and M. Sorensen, 2012, Which CEO Characteristics and Abilities Matter? Journal of Finance 67, no. 3, pp. 973–1007.

Stein, Jeremy, 1989, Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior, Quarterly Journal of Economics 104, no. 4, pp. 655-669.

Session 5 (April 26, 2018): Insider Trading

Instructor: Marc Gabarro

Insiders are investors who possess private information on the value of a financial asset. When they exploit this information they earn profits at the expense of other, uninformed traders. In most countries insider trading is prohibited. Board members and beneficial owners of a firm are likely to possess superior information on the future prospects of their firm and may therefore qualify as insiders. In many countries they are obliged to report trades they make in the shares of their firm ("directors' dealings"). This data is available for empirical analyses.

In this section we will start with a discussion of insider trading in general. In this context we will also briefly discuss theoretical models from the market microstructure literature which analyze how the presence of insiders affects market quality. We will then turn to theoretical models and empirical studies of directors' dealings.

Student Presentations:

Betzer. A., J. Gider, D. Metzger and E. Theissen (2015): Stealth Trading and Trade Reporting by Corporate Insiders. Review of Finance 19, 865-905. Prior to the Sarbanes-Oxley Act insiders in the U.S. had up to 42 days to report their trades. This paper shows that they used these lenient requirements to execute a string of trades before reporting any of the trades. The paper also argues that this behavior adversely affects the informativeness of prices.

Brochet, F. (2010): Information content of insider trades before and after the Sarbanes–Oxley Act. Accounting Review 85, 419-446. This paper analyzes how the stricter reporting requirements imposed by the Sarbanes-Oxley-Act affect insider trading and the market reaction to the publication of the trades,

Required Readings:

Bhattacharya, U. (2014): Insider Trading Controversies: A Literature Review. Annual Review of Financial Economics 6, 385-403. A survey, cast in the form of a trial, of insider trading.

Fidrmuc, J. P., M. Goergen and L. Renneboog (2006): Insider trading, news releases and ownership concentration. Journal of Finance 61, 2931-2973. This paper analyzes the market reaction to the publication of insider trades in the UK as well as the determinants of the market reaction.

Lakonishok, J. and I. Lee (2001) Are insider trades informative? Review of Financial Studies 14, 79-111. This is an extensive empirical study of trading by corporate insiders in the U.S. equity markets.

Further Readings:

Huddart, S., J. S. Hughes and C. Levine (2001): Public disclosure and dissimulation of insider trades. Econometrica 69, 665-681. Building on Kyle (1985), this model explains how an obligation for insiders to report their trades affects the insider's trading strategy and the market outcome.

Kyle, A. (1985): Continuous Auctions and Insider Trading. Econometrica . A fundamental microstructure paper that derives the optimal trading strategy of a profit-maximizing insider.

Lenkey, S. (2014): Advance Disclosure of Insider Trading. Review of Financial Studies 27, 2504-2537. This paper explores the welfare implications when an insider is forced to disclose her trades in advance.

Session 6 (May 17, 2018): Ownership and Performance

Instructor: Marc Gabarro

This session will explore the (causal) relationship between ownership and performance, focussing on the impact of family ownership/succession and the role of passive investors. Does the presence of block holders improve firm performance? Do family owned firms perform better? What ware the reasons behind this differential performance?

Morck et al. (1988) first documented a non-monotonic relationship between block ownership and firm performance. Since then, researchers have focused on distangling the correlation effects from the causal relationship using panel data (Himmelberg et al. 1999), differences in differences (Tsoutsoura, 2015), instrumental variables (Bennedsen et al. 2007 and Appel et al. 2016) and RDD.

Student Presentations:

Tsoutsoura, M., 2015, The Effect of Succession Taxes on Family Firm Investment: Evidence from a Natural Experiment, Journal of Finance 70, 649–688. Tsoutsoura uses a triple-difference-in-difference methodology to examine the decision to retain the firm within the family and the impact of succession taxes on the investment decisions around successions.

Appel, Ian R., Todd A. Gormley, Donald B. Keim, 2016, Passive Investors, Not Passive Owners, Journal of Financial Economics 121, 111-141. Appel, Gormley, and Keim use the inclusion of firms in the Russell 1000 and Russell 2000 as an instrument to explore the impact of passive mutual funds on firm performance.

Required Readings:

Morck, Randall, Andrei Shleifer, Robert W. Vishny, 1988, Management Ownership and Market Valuation, *Journal of Financial Economics* 20, 293-315. Morck, Shleifer and Vishny document the (non-linear) relationship between ownership and performance. Please focus on the general idea rather than the piecewise linear specification.

Himmelberg, Charles P., R. Glenn Hubbard, and Darius Palia, 1999, Understanding the Determinants of Managerial Ownership and the Link Between Ownership and Performance, *Journal of Financial Economics* 53, 353-384. Himmelberg Hubbard, and Palia use panel data to explore the relationship between ownership and performance. Zhou (2001) wrote an interesting comment [Zhou, Xianming, 2001 Understanding the Determinants of Managerial Ownership and the Link Between Ownership and Performance: Comment, *Journal of Financial Economics* 62, 559-571.]

Bennedsen, Morten, Kasper Meisner Nielsen, Francisco Perez-Gonzalez, and Daniel Wolfenzon, 2007, Inside the Family Firm: The Role of Families in Succession Decisions and Performance, *Quarterly Journal of Economics* 122, 647-691. Bennedsen et al. use the gender of the first child as an instrument for family succession.

Further Readings:

McConnell, John J., Henri Servaes, Karl V. Lins, 2008, Changes in Insider Ownership and Changes in the Market Value of the Firm, *Journal of Corporate Finance* 14, 92-106.

Anderson, R. C. and Reeb, D. M. (2003), Founding-Family Ownership and Firm Performance: Evidence from the S&P 500, *Journal of Finance*, 58: 1301–1328. Anderson and Reeb show the importance of a selection in family ownership.

Lins, Karl V., Paolo Volpin, Hannes F. Wagner, 2013, Does Family Control Matter? International Evidence from the 2008–2009 Financial Crisis, *Review Financial Studies* 26, 2583-2619. Lins, Volpin and Wagner use the recent crisis as an exogenous shock to performance.

Lilienfeld-Toal, Ulf V. and Stefan Ruenzi, 2014, CEO Ownership, Stock Market Performance, and Managerial Discretion, Journal of Finance 69, 1013–1050.

Student Presentation Schedule

Note: The ordering of presentations in each session is normally in the order of publication, i. e., older publications come first.

Please take note of the presentations guidelines with some dos and don'ts for good presentations.

	Date	Title	Paper	Presenter
1	February 22, 2018	Capital Structure	Chang & Dasgupta (2009)	
1	February 22, 2018	Capital Structure	Danis, Rettl, Whited (2014)	
2	March 8, 2018	Shareholder voting	Agrawal (2012)	
2	March 8, 2018	Shareholder voting	Becht, Polo, Rossi (2016)	
3	March 22, 2018	Board Structure	Ahern and Jacob (2012)	
3	March 22, 2018	Board Structure	Wintoki et al. (2012)	
4	April 12, 2018	CEO Labor Markets	Graham, Li, Qiu (2012)	
4	April 12, 2018	CEO Labor Markets	Jenter and Lewellen (2014)	
5	April 26, 2018	Insider Trading	Betzer et al. (2015)	
5	April 26, 2018	Insider Trading	Brochet (2010)	
6	May 17, 2018	Ownership and Performance	Tsoutsoura (2015)	
6	May 17, 2018	Ownership and Performance	Appel et al. (2016)	