

RESEARCH

Corporate Governance System Worked Well, Now Works Better



Matthew Gilson

Steven N. Kaplan

The collapse of Enron, Tyco, and other high-profile companies brought a storm of criticism of the U.S. corporate governance system. But research by **Steven N. Kaplan**, Neubauer Family Professor of Entrepreneurship and Finance, and Bengt Holmstrom of MIT argues that since the early 1980s, U.S. companies have performed well relative to the rest of the world in stock performance and in productivity improvements.

“We’re not saying it’s a perfect system, or the scandals didn’t happen. We’re saying this is not a disaster; there’s a lot to be positive about,” Kaplan said, describing his research to students in Hyde Park.

Since the early 1980s, public companies have changed substantially in three areas, Kaplan said. CEOs and top management receive substantially more equity-based compensation, driven largely by the increased use of stock options. More stock is owned by institutions and mutual funds whose managers are in a position to exert more pressure than individuals on CEOs and boards. And boards have changed in positive ways—they are smaller and directors own more equity (aligning their interest with that of shareholders), Kaplan said.

While the corporate governance system has changed for the better and appears to have performed well, the system has not been perfect, and some of those imperfections helped fuel the recent governance scandals. Corporate managers who own a lot of stock or options and are permitted to sell those options “have greater incentives to play earnings games,” Kaplan said. Also, boards have probably underestimated the value of options, and sometimes grant them to CEOs who already own substantial

portions of the firm’s stock. “Boards of these companies should be chastised for wasting shareholders’ money,” he said.

The new governance regulations resulting from scandals have likely had positive effects, Kaplan said. The Sarbanes-Oxley Act requires boards to hire an auditor who reports to the board’s audit committee, forcing management to be more accountable. “Furthermore, the act will result in CEOs and CFOs getting better information and, therefore, making better decisions,” he said. The New York Stock Exchange and NASDAQ strengthened the definition of conflict of interest for board members and mandated that boards meet without CEOs. The fact that it is mandated by law gives board members a way to change procedures without making the CEO uncomfortable, he added.

Negative effects include fixed costs and extra time, although those costs will decline over time. “Once you have put the system in place, the subsequent marginal costs will be lower,” he said.

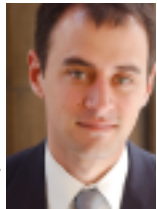
The changes are likely to make a good system better. “U.S. corporate governance has done very well in the last 20 to 25 years. Measure it by stock performance, by productivity growth, and by the changes in compensation, boards, and shareholders. Everything has appeared to go in the right direction.

“Those improvements uncovered some weaknesses, and the legal, regulatory, and market reactions have helped to respond to those weaknesses,” Kaplan said. “For the time being, we should be wary of making any more changes, and instead, see what happens going forward. I would expect good things rather than bad.” —P.H.

ON THE WEB To read Kaplan’s paper “The State of U.S. Corporate Governance: What’s Right and What’s Wrong?” or learn more about his research, visit gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html.

GSB Faculty Weigh In on Spending Habits, Teacher Pay Hikes, and Trips to Mars

Teacher Tests Get Failing Grade



Dan Dry

Guryan

Requiring public school teachers to pass state certification exams hasn't improved the quality of teachers, according to research by **Jonathan Guryan**, assistant professor of economics, and Joshua Angrist of MIT. Using nationwide survey data from 1987 to 2000, they found no improvement in the educational background of new teachers, but "they found that state-mandated exams did tend to raise teachers' salaries by some 3 to 5 percent," according to a *BusinessWeek* article on the research.

ON THE WEB To read the paper "Does Teacher Testing Raise Teacher Quality? Evidence from State Certification Requirements" or learn more about Guryan's research, visit gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html.

Mars Trip Boosts Engineer Paychecks, Not Economy



Kevin Weinstein

Goolsbee

President Bush may back the idea of sending a man to Mars, saying the resulting technological breakthroughs will filter down to the average American, but professor of economics **Austan D. Goolsbee** says it only means big raises for engineers. His study, "Does Government R & D Policy Mainly Benefit Scientists and Engineers?" was quoted in a *New Yorker*

column on finance last winter. "New spending doesn't boost 'inventive activity' as much as people think. Instead, it results in 'windfall gains'—basically, engineers get big raises. And since the private sector tends to be more productive than the government, it's unlikely that shifting the engineers from private enterprise to Starship Enterprise is really going to help the economy—unless by 'the economy' you mean Boeing and Lockheed Martin," according to the magazine.

ON THE WEB To read Goolsbee's paper or learn more about his research, visit gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html.

Banner Advertising Clicks with Current Customers



Lynn Saville

Manchanda

It may seem easy to overlook the banner ads on a Web page, but in fact they have real appeal for customers who have purchased an advertiser's products or services through the Web before, according to research by **Puneet Manchanda**, associate professor of marketing; **Jean-Pierre Dubé**, assistant professor of marketing; **Pradeep K. Chintagunta**, Robert Law Professor of Marketing; and current student **Khim Yong Goh**. Manchanda told the *Investor's Business Daily* that banners provide a steady stream of reminders about a product or service and "reinforce the relationship with people who have already bought from a Web site."

Additionally, he noted, consumers find banner ads less irritating than pop-up ads and spam.

ON THE WEB To read the paper "Banner Advertising as a Customer Retention Tool in Customer Relationship Management" or find other research by Manchanda, Dubé, or Chintagunta, visit gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html.

Lower Mortgage Rates Don't Fuel Consumer Spending



Dan Dry

Hurst

While consumers are sensitive to interest rates, homeowners who refinance and spend the resulting equity are more likely to do so because unemployment has caused financial strain, not because they are simply reacting to the lower rates, according to a study by **Erik Hurst**, associate professor of economics, and Frank Stafford of the University of Michigan. A story on the study in the *Financial Times* last fall noted that the research offers an answer to the question of why some homeowners refinance mortgages even when interest rates are stable or rising.—P.H.

ON THE WEB To read the paper "Home Is Where the Equity Is: Liquidity Constraints, Refinancing, and Consumption" or learn more about Hurst's research, visit gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html.

BOOKSHELF

Crazy Horse, Custer, and C++: What Faculty Are Reading

GSB faculty read more than research in their areas of expertise. Here's a look at what two professors had on their bookshelves recently.



Darrin Dry

Per Strömberg
Associate professor
of finance

The Corrections, Jonathan Franzen (Farrar Straus & Giroux, 2001) “One of the best novels I have read recently. The story features a rich set of characters and is full of dark humor. It is great in capturing the atmosphere and the values of the ‘roaring’ late 1990s, similar to what *The Great Gatsby* did for the 1920s. And on top of that, the author (1) is of Swedish heritage and (2) refused to participate in Oprah’s Book Club. A must-read!”

Crazy Horse and Custer: The Parallel Lives of Two American Warriors, Stephen E. Ambrose (Doubleday, 1975) “I bought this book when I traveled in South Dakota last summer and got to experience the dismal state of the Native American communities there. I also am a big fan of Ambrose’s World War II books, and he did a great job in this one as well. Using the lives of Crazy Horse and Custer as a theme, he provides the reader with a very balanced view of the Indian Wars of the late 1800s. Ambrose is great at conveying this very tragic but seemingly inevitable clash between two cultures, without pointing fingers in any direction. Highly recommended.”

Lies and the Lying Liars Who Tell Them: A Fair and Balanced Look at the Right, Al Franken (EP Dutton, 2003) “Given that I am Swedish and hence a closet left-winger, this book was a must-read for me. You may not agree with everything (anything?) that he says, but one thing is clear: the guy is totally hilarious!”



Matthew Gilson

Peter E. Rossi,
M.B.A. '80, Ph.D. '84
Joseph T. Lewis Pro-
fessor of Marketing
and Statistics

Accelerated C++: Practical Programming by Example, Andrew Koenig and Barbara E. Moo (Addison-Wesley, 2000) “All right, I am a geek! Simply the best book on C++ available, this is a marvel of clarity and conciseness. Most programming books blather on for hundreds of pages, using a ‘learn by example’ method. Just as in the classroom at the GSB, we learn by application of a few powerful principles. Even if you are not interested in learning C++, this book is a wonderful example of how to set forth useful concepts and ideas in the most direct possible way.”

Sex, Death, and Fly-fishing, John Gierach (Fireside, 1990) “The title of the book touches on three of the most important aspects of life. However, you might be surprised to learn that ‘sex’ refers not to what a fly fisher might be doing, but to what mayflies do. Some of the most exciting fly-fishing occurs when mayflies mate and fall dying to the surface of the water. These ‘spinner falls’ are central to Gierach’s experiences in western rivers. Delightfully written, this collection of essays is hugely entertaining.”



Faculty Efforts Bring Honors

Daniel Bens, M. H. Franco Wong

Bens, associate professor of accounting, and Wong, assistant professor of accounting, were named joint recipients of the annual Ernest R. Wish Accounting Research Award in January. A committee of senior accounting faculty selected them for their paper “Employee Stock Options, EPS Dilution, and Stock Repurchases.” The prize is funded by **Ernest Wish, '71 (XP-29)**, chairman of Wish Enterprises and former managing partner of PricewaterhouseCoopers, through a gift he made in conjunction with his former firm.—P.H.

ON THE WEB To read the complete paper or to learn more about Bens's or Wong's research, visit gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html.

Tanya Menon

The German Marshall Fund of the United States named Menon, assistant professor of behavioral science, one of 55 American Marshall Memorial Fellows. The fellowship aims to provide American leaders with an intimate understanding of European political, social, and economic institutions through visits to Europe and briefings on topics including the European Union, NATO, and transatlantic issues.—A.R.

ON THE WEB To read an article about Menon's research, see page 26. To learn more, visit gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html.

Luigi Zingales

Zingales, Robert C. McCormack Professor of Entrepreneurship and Finance, was awarded the Germán Bernácer Prize in January by the *Observatorio del Banco Central Europeo* (Observatory of the European Central Bank) “for his research analyzing the circumstances under which healthy and competitive financial markets provide a very useful tool in spreading opportunity and fighting poverty,” according to the organization's prize selection committee. Zingales received EUR 20,000 with the award.—P.H.

ON THE WEB To read an article about Zingales's research, see page 20. To learn more, visit gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html.

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READINGS

Faculty Publish on Cliometrics, Post-Enron Policy, and Derivatives

Robert W. Fogel,
Charles R. Walgreen Distinguished Service
Professor of American Institutions
The Slavery Debates, 1952–1990:
A Retrospective, Louisiana State
University Press, 2003



With his groundbreaking 1974 book, *Time on the Cross*, Nobel laureate **Robert W. Fogel** challenged the prevailing notion that American slavery had been an economically weak labor system. Fogel and coauthor Stanley Engerman used cliometrics—the use of statistics and other social science techniques to analyze historical problems—to show that slavery had been viable, efficient, and even profitable. Widely praised and fiercely disputed by historians, economists, and sociologists, the book catapulted cliometrics into the forefront of academic consciousness and had a seismic impact on the debate on American slavery that had been building since World War II.

In *The Slavery Debates, 1952–1990: A Retrospective*, Fogel mixes memoir and history to offer his unique perspective on the debates and the role that cliometric analysis played in the study of slavery. He also discusses the difficulty of developing a precise, emotionally detached analysis of such a morally sensitive subject. Based on his 2001 Walter

Lynwood Fleming Lectures in Southern History at Louisiana State University, the book recounts Fogel's own participation in the debates and summarizes the contributions of other economists and historians.

Christopher L. Culp, Ph.D. '97,
adjunct professor of finance
Corporate Aftershock: The Public Policy
Lessons from the Collapse of Enron and
Other Major Corporations, Wiley, 2003



In the preface to his book *Corporate Aftershock*, **Christopher L. Culp** writes that policy makers should treat Enron like a ravaged building after an earthquake: consider the damage before jumping into the wreckage. In five sections, *Corporate Aftershock*, edited by Culp and William A. Niskanen, A.M. '55, Ph.D. '62 (social science), examines the special financial instruments the company used as well as the markets in which Enron traded. Topics include corporate innovation and governance, energy and derivatives markets after Enron's collapse, structured finance, credit risk mitigation, and regulating corporate innovation following Enron's collapse. The book also includes a chapter by **Keith Andrew Bockus, M.B.A. '95, Ph.D. '98**, adjunct assistant professor of accounting; **W. Dana Northcut**, adjunct

associate professor of accounting; and **Mark E. Zmijewski**, Leon Carroll Marshall Professor of Accounting and deputy dean for part-time M.B.A. programs. The authors argue that in some cases, Enron may not have broken accounting rules, but rather knew them well enough to find the loopholes that would produce the results they wanted.

Christopher L. Culp, Ph.D. '97,
adjunct professor of finance
Risk Transfer: Derivatives in Theory
and Practice, Wiley, 2004



In *Risk Transfer*, Culp offers a comprehensive look at the issues and problems in derivatives markets. Based on Culp's derivative instruments and applications course at the GSB, the book is geared toward both students and professionals and can be a resource for those studying for the Global Association of Risk Professionals Financial Risk Manager (GARP FRM) exam.—A.R.

ON THE WEB To read more about research by Fogel and Culp, visit gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html.