

An Industrial Organization Approach to Finance

By David Ong

Class time: Monday and Thursday 10:30-12:20pm 335.

Office hours: by appointments Mondays-Fridays 4-6pm.

Introduction

Financial institutions in emerging markets are generally far from meeting the assumptions of most standard models in finance. In emerging markets, institutions are underdeveloped, participants are strategic and information is scarce. As a consequence, participants trade on insider information and try to learn from and manipulate each other. A growing body of financial research has begun to take these factors into account for Western markets. This course will explore that new literature and seek out applications in emerging markets, in particular, China.

This will be a new course that will cover many disciplines. The pace will be relatively relaxed and necessarily require some flexibility. I expect a lot of discussion and participation since the scope will be broad, and you will know more on many issues than I will, especially in regards to China. Your participation will be very important.

The first phase of the development of this course is the working out of topics. I motivate the course with Wong and Piotroski (2010) “Institutions and Information Environment of Chinese Listed Firms” which describes the effects on market performance of the two features which define the Chinese financial market: implicit bureaucratic control and scarcity of reliable information. Once the Chinese context is established, I will discuss Putniņš (2010) “Market Manipulation: a Survey,” which goes into specific strategies of market manipulation found in empirical studies. This will be followed by Hu & Noe (1997) “The Insider Trading Debate” which surveys the literature on insider trading. I will discuss my field experiment on detecting and punishing insider trading using market forces without government intervention.

This year, I will also introduce a new section on demography. This course will allow you an opportunity to explore the financial market consequences of skewed sex ratios in China, and an aging population for most of the world, as well as the rise of the financial power of women.

While I lecture on these topics, the student’s role is to find an issue of particular interest. The student may choose any area of finance not covered in a traditional finance course and related to emerging markets. The student is required to make two presentations. For the first literature

review presentation, the student with my guidance should find a paper(s) which is (are) closest to their interest which they will present in a ½ hr presentation. See my suggested list below. They will then adapt the methodology of the paper to address an issue of particular interest to the student for the research proposal presentation (½) hr.

Grading

Grading will be based upon class participation, a midterm quiz, and 2 presentations:

25% literature review presentation:

45% research proposal presentation and defense, and finding data, data analysis:

15% from midterm quiz on lecture materials.

15% class participation

Doing Well in the Course

This is a research oriented course. Research is full of risk. However, I am willing to largely insure you against risk. If you attend, participate, and make an honest effort with your presentations, then, you will definitely pass, and are likely to do ok, e.g., have a grade >80%. Two students who have failed another course like this in the past had poor attendance, did terrible presentations, and one even plagiarized.

Rules for Course

Here are things that I've come to expect from students in my classes. I'm sure that you know most of these things already, but I thought I would explain it all at once to avoid case by case corrections.

Turn off cell phones in class and during our office hours discussions. Laptop computers must be closed at all times. I will provide handouts, so there is no need for them. You are required to pay attention in class regardless of whether I or a student are presenting. To encourage you to pay attention and participate, I will often ask you questions. Of course, no sleeping in class.

I will likely be quite free with office hours. However, I will ask that you make notes during and after discussion so I don't have to repeat things, then to send me the notes through email so we have a permanent record.

Menu of Possible Presentation Topics

Market Manipulation

Allen, F. & Gale, D. (1992), 'Stock-price manipulation', *Review of Financial Studies* **5**(3), 503--529.

Chakraborty, A. & Yilmaz, B. (2008), 'Microstructure bluffing with nested information', *The American Economic Review* **98**(2), 280--284.

Chakraborty, A. & Yilmaz, B. (2004), 'Informed manipulation', *Journal of Economic Theory* **114**(1), 132--152.

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Benabou, R. & Laroque, G. (1992), 'Using privileged information to manipulate markets: Insiders, gurus, and credibility', *The Quarterly Journal of Economics* **107**(3), 921--958.

Barbosa, António M.R.G., Manipulation and Information Acquisition (August 27, 2011). Midwest Finance Association 2012 Annual Meetings

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Charness, G. & Garoupa, N. (2000), 'Reputation, honesty, and efficiency with insider information: An experiment', *Journal of Economics & Management Strategy* **9**(3), 425--451.

Clarkson, P.; Joyce, D. & Tutticci, I. (2006), 'Market reaction to takeover rumour in Internet Discussion Sites', *Accounting & Finance* **46**(1), 31--52.

Chou, H.; Tian, G. & Yin, X. (2010), 'Rumors of Mergers and Acquisitions: Market Efficiency and Markup Pricing', .

Fotak, Veljko, The Impact of Blog Recommendations on Security Prices and Trading Volumes (September 15, 2007).

Huber, J.; Angerer, M. & Kirchler, M. (2011), 'Experimental asset markets with endogenous choice of costly asymmetric information', *Experimental Economics* **14**(2), 223--240.

Indjejikian, Raffi J., Lu, Hai and Yang, Liyan, Rational Information Leakage (August 1, 2011).

Iori, G. & Tedeschi, G. (2010), 'Herding Effects in Order Driven Markets: The Rise and Fall of Gurus', *City University Economics Discussion Papers*.

Jouini, E. & Napp, C. (2011), 'Gurus and beliefs manipulation', .

Kong, Dongmin and Wang, Maobin, The Manipulator's Poker: Order-Based Manipulation in the Chinese Stock Market (May 29, 2011).

Khwaja, A. & Mian, A. (2005), 'Unchecked intermediaries: Price manipulation in an emerging stock market', *Journal of Financial Economics* **78**(1), 203--241.

Kimmel, A. (2004), 'Rumors and the financial marketplace', *The Journal of Behavioral Finance* **5**(3), 134--141.

Kyle, A. & Viswanathan, S. (2008), 'How to define illegal price manipulation', *The American Economic Review* **98**(2), 274--279.

Lerman, Alina, Individual Investors' Attention to Accounting Information: Message Board Discussions (April 2011).

Smith, N. (2011), 'Herding and Speculation in Experimental Asset Markets',

Tālis J. Putniņš, Market Manipulation: A Survey,

Veiga, H. & Vorsatz, M. (2010), 'Information aggregation in experimental asset markets in the presence of a manipulator', *Experimental Economics* **13**(4), 379--398.

Veiga, H. & Vorsatz, M. (2009), 'Price manipulation in an experimental asset market', *European Economic Review* **53**(3), 327--342.

Insider Trading

Bruno Biais, Larry Glosten, Chester Spatt, Market microstructure: A survey of microfoundations, empirical results, and policy implications, *Journal of Financial Markets* **8** (2005) 217--264

Choi, J.; Jin, L. & Yan, H. (2012), 'Informed Trading and Expected Returns', .

Jie Hu, Thomas H. Noe 1997 "The insider trading debate" Federal Reserve Bank of Atlanta in its journal *Economic Review*.

Glosten, L., and P. Milgrom. 1985. "Bid, Ask, and Transaction Prices in a Specialist Market with Heterogeneously Informed Agents." *Journal of Financial Economics*, vol. 14, no. 1 (March): 71--100.

Kyle, A. 1985. "Continuous Auctions and Insider Trading." *Econometrica*, vol. 53, no. 6 (November): 1315--35.

Ananth Madhavan 2002, *Market Microstructure: A Practitioner's Guide*, AIMR

Agrawal, A. & Nasser, T. (2012), 'Insider trading in takeover targets', .

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- Frijns, B.; Gilbert, A. & Tourani-Rad, A. (2011), 'Do Criminal Sanctions Deter Insider Trading', .
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- Korczak, A.; Korczak, P. & Lasfer, M. (2010), 'To trade or not to trade: the strategic trading of insiders around news announcements', *Journal of Business Finance & Accounting* **37**(3-4), 369--407.
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Social Learning and Herding in Financial Markets

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Cipriani, Marco and Antonio Guarino, "Herd Behavior in a Laboratory Financial Market", *American Economic Review*, Vol. 95, No. 5 (Dec., 2005), pp. 1427-1443

Chen, G. (), 'Herd Induced By Uninformed Traders In Efficient Financial Markets', .

Choi, S.; Gale, D. & Kariv, S. (2009), 'Social learning in networks: A quantal response equilibrium analysis of experimental data', *WP, May*.

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The political economy of finance

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Political Connections

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