Summer School: Frictions in Firms and Markets

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Communication, corporate governance, and organizational structure

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Valuable information about the company is often dispersed among agents. These differences in information can lead to inefficient decision-making. However, if agents try to communicate their information to each other, information may not be perfectly transmitted, primarily due to conflicts of interest between them. For example, an empire-building manager who wants his company to acquire a target, may want to inflate the value of synergies when communicating it to the board or the shareholders. Similarly, an activist investor who wants to convince the manager to make value-improving changes, may try to inflate their benefits, knowing the manager's reluctance to implement them. How much information can be transmitted in such situations? How much control should different parties have, so that information is used most efficiently and firm value is maximized? This lecture will focus on these questions.

We will start by analyzing the canonical model of communication when information is non-verifiable and communication is costless – the "cheap talk" model of Crawford and Sobel (1982). We will study the structure of the equilibrium and the key determinants of communication effectiveness.

Next, we will discuss the applications of this model to finance, focusing on the implications for corporate governance, the structure of corporate boards, and the allocation of control in organizations. We will first analyze Dessein (2002), who studies the optimal allocation of authority in organizations and asks whether decision-making should be centralized, with the principal (e.g., headquarters or board) retaining authority, or decentralized, with the agent (e.g., divisional manager or CEO) having decision-making power. Next, we will discuss communication between directors and the CEO (or between outside and inside directors) in the context of corporate boards and its implications for board composition and corporate governance (e.g., Adams and Ferreira, 2007; Harris and Raviv, 2008; Levit and Malenko, 2011; Levit, 2018).

Finally, we will discuss some recent developments in the literature, in particular, the role of dynamic communication. Many decisions in organizations concern the timing of taking a certain action: When should a new product be introduced? When should an underperforming plant be closed? It turns out that implications for such dynamic decisions are very different from those of static decisions (e.g., Grenadier, Malenko, and Malenko, 2016).

While the focus of this lecture will be on cheap talk communication, we will also briefly discuss other types of communication, such as those involving verifiable information and, more generally, settings where the sender can commit to a certain information structure.

Main references

We will cover the papers marked by (*) in most detail.

1. Adams R. B., and D. Ferreira, 2007. A theory of friendly boards, *Journal of Finance* 62, 217-250.
2. (*) Crawford, V. P., and J. Sobel, 1982. Strategic information transmission, *Econometrica* 50, 1431-51.
3. (*) Dessein, W., 2002. Authority and communication in organizations, *Review of Economic Studies* 69, 811-838.
4. (*) Grenadier, S. R., A. Malenko, and N. Malenko, 2016. Timing decisions in organizations: Communication and authority in a dynamic environment, *American Economic Review* 106, 2552-81.
5. Harris, M., and A. Raviv, 2008. A theory of board control and size, *Review of Financial Studies* 21, 1797-1832.
6. Levit, D., 2018. Words speak louder without actions, *Journal of Finance*, forthcoming.

Additional references

We will not discuss the papers below in any detail. They would be useful further reading if you would like to learn more about the topic of this session.

Corporate governance and other finance applications

- Benabou, R., G. Laroque, 1992. Using privileged information to manipulate markets: Insiders, gurus, and credibility, *Quarterly Journal of Economics* 107, 921-958.
- Chakraborty, A., and B. Yilmaz, 2017. Authority, consensus and governance, *Review of Financial Studies* 30, 4267-4316.
- Harris, M., and A. Raviv, 2005. Allocation of decision-making authority, *Review of Finance* 9, 353-83.
- Kakhbod, A., U. Loginova, A. Malenko, and N. Malenko, 2019. Advising the management, Working paper.
- Levit, D., 2017. Advising shareholders in takeovers. *Journal of Financial Economics* 126, 614-634.
- Levit, D., 2019. Soft shareholder activism, *Review of Financial Studies* 32, 2775-2808.
- Levit, D., and N. Malenko, 2011. Nonbinding voting for shareholder proposals, *Journal of Finance* 66, 1579-1614.
- Malenko, N., 2014. Communication and decision-making in corporate boards, *Review of Financial Studies* 27, 1486-1532.
- Ottaviani, M., and P. N. Sørensen, 2006. The strategy of professional forecasting, *Journal of Financial Economics* 81, 441-466.

Other models of communication

- Dye, 1985. Disclosure of nonproprietary information, *Journal of Accounting Research* 23, 123-145.
- Grossman, S., 1981. The role of warranties and private disclosure about product quality, *Journal of Law and Economics* 24, 461-483.
- Kamenica, E., and M. Gentzkow, 2011. Bayesian persuasion, *American Economic Review* 101, 2590-2615.

- Milgrom, P.R., 1981. Good news and bad news: Representation theorems and applications, *Bell Journal of Economics* 21, 380-391.

Dynamic communication

- Bizzotto, J., J. Rüdiger, and A. Vigier, 2018. Dynamic persuasion with outside information, Working paper.
- Ely, J. C., 2017. Beeps, *American Economic Review* 107, 31-53.
- Ely, J. C., and M. Szydlowski, 2017. Moving the goalposts, *Journal of Political Economy*, forthcoming.
- Orlov, D., A. Skrzypacz, and P. Zryumov, 2018. Persuading the principal to wait, *Journal of Political Economy*, forthcoming.