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Editorial
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A Note on Market Trading Activities and Corporate Decisions

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"…The link between microstructure and corporate finance, another area where it must surely exist, but has yet to be firmly established. Again part of the difficulty in looking for this linkage is that we do not have many well-functioning corporate finance theories." – Maureen O'Hara [1].

Traditional theories in financial economics suggest that stock (and related derivatives) market is driven solely by news about fundamentals. This notion leaves limited or no role of financial market trading activities to have any material impact on real activities. Recent research findings suggest perhaps other factors, such as market liquidity [2], and investor sentiments [3] could also be important. With the proliferation of market microstructure research and high frequency data, more empirical evidences suggest that the stock market trading activities may affect real activities, for example financing decision [4], costs of issuance [5,6], investment sensitivities [7,8], governance [9,10], firm value [11].

One may find it intriguing about the causality from market trading activities to corporations. In fact this notion has been developed among economists in more general settings. Theories in contracting [12] and insider incentives [13], shareholder activism [14] all suggest that trading activities in financial markets have important impacts in real activities.

Trading activities is valuable for firms in general. Liquid equity lowers costs of equity, mitigate information asymmetry and improve corporate governance. However trade due to heterogeneous beliefs, speculation in derivative markets may do the reverse. Liquidity in stock market allows price to be informative, aggressive informed traders to profit from the costly information, making market more efficient and of better quality. Liquidity in derivative markets, however, may have ambiguous effects: option that complete the market not only allow informed traders to trade more but also construct more complicated strategies, therefore information efficiency may increase or decrease [15]. Dow and Gorton [16] model the equilibrium relation between stock market efficiency and economic efficiency. However their model also suggests that even if the stock market is in strong-form efficiency, investment decisions of a firm could still be sub-optimal. These models suggest that the ultimate effect of financial market liquidity on real activities is yet to be conclusive.

What we need to establish is no longer the existence of linkage between market trading and real activities but the intensity, underlying mechanism(s), characteristics, and functional form(s). I believe findings in this research area would be important to reconcile many debates and unsolved issues in other finance areas.

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