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Foreword: Revisiting Gilson and Kraakman's Efficiency Story

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Gilson and Kraakman's *Mechanisms of Market Efficiency*[1] is part of the canon of modern corporate law scholarship, one of a handful of articles that has profoundly influenced the way we think about the field. It is also enigmatic, warranting a fresh look by those who think they know what it says from some long-ago reading or second-hand references by other authors.

Obligatory citations to *Mechanisms* often treat it as the kind of faithful embrace of a strong vision of capital market efficiency so common in the early 1980's—citing Easterbrook and Fischel for the normative implications of market efficiency, Gilson and Kraakman for how markets become efficient. But the latter is something of a citation half-truth. True, the article is an explanation of the various ways information becomes impounded in market price, and optimistically concedes that this is often a rapid and effective process. A reader inclined toward efficiency finds enough to justify his own faith.

But that is not all—or really what—the article is about. The underlying insight is that there is a repertoire of mechanisms that operate with different levels of power as efficiency-drivers, depending on the relative availability and initial distribution of the information in question. In turn, relative availability is a function of the costs of acquiring and verifying it. Institutions—like underwritten public offerings—may arise to lower the costs of verifying issuer disclosures, contributing to efficiency in primary capital raising transactions. The punch line, however, is that markets will demonstrate different levels of efficiency in impounding different kinds of information. This transaction cost story means that even informational efficiency is a relative concept, filled with imperfections when the costs associated with discovery and verification are significant—hardly a born-again confession of faith.

The residual agnosticism becomes clear toward the end of the article. Gilson and Kraakman take aim at prevailing claims that insider trading should not be prohibited because it contributes to more efficient pricing for failing to recognize the difficulty the market has in decoding the informational content of an insider's trades. They then also take aim at George Benston's famous claim that the mandatory disclosure regime imposed by the federal securities laws in the 1930's delivered no appreciable value to investors. In the early 1980's, these claims held great influence over the thinking of efficiency-minded academics. Gilson and Kraakman issue a cautionary warning about

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1. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) [hereinafter *Mechanisms*].

assuming too much about the mechanisms of efficiency, and not paying enough attention to the cost problem.

Had they been a bit bolder, then, they might have stricken "mechanisms" from their title and substituted something like "limits" or, borrowing from Grossman and Stiglitz, "impossibility."[2] In any event, the limits to the efficiency aspect of the article anticipates and inspires a line of scholarship that evolved over the next twenty years about market failures—particularly in the form of agency cost problems—that make strong deregulatory claims problematic.

This Symposium pays tribute to *Mechanisms*' originality, dispassion, rigor, and influence. The idea was to ask a diverse mix of scholars—with an emphasis on some of the best young minds that have come into this field to work recently—to take inspiration from Gilson and Kraakman and write whatever they wished about the contemporary state of mind regarding market efficiency. Some are strong critics of the efficient market hypothesis; others still work happily within its framework. Their subjects run from the stock markets themselves to matters like the law of trusts, using antitrust in securities market regulation, and how the takeover market differs in terms of the diffusion of information. Afterwards, Gilson and Kraakman respond, both commenting on the papers and offering their own reflections on *Mechanisms*, many years (and much thinking) later.

One question that intrigued many of the Symposium's participants when the papers were presented is why an unconflicted vision of efficiency gained such a hold in academia for such a long time. In other words, why was *Mechanisms* cited far more for the support it gives to the market's efficiency properties, than its just-as-clear warnings about too readily assuming informational efficiency in the presence of significant acquisition or verification costs? Today, market efficiency is highly contested. Many scholars believe that markets are efficient enough, and decidedly superior to other mechanisms (e.g., judicial or bureaucratic intervention) for assessing the value of securities or firms—others do not. The working consensus, however, is that Gilson and Kraakman's fundamental point about the limits of efficiency with respect to costly or hard-to-verify information is right, and hence efficiency is a matter of degree. But that more ambivalent intellectual stance is of relatively recent vintage. For most of the 1980's, at least, and to some extent well beyond, efficiency ruled.

The reasons for that domination are complicated. No doubt the story begins, as Gilson and Kraakman note at the outset of their article, with the seemingly solid empirical support it had garnered during the 1970's. Financial economists marshaled an impressive case in favor of the efficient market hypothesis—the study of anomalies was in its infancy, largely uninteresting to legal academics, and behavioral finance scholarship was an invention yet to come. There was ample support for assuming a high degree of "semi-strong" market efficiency, and as many have noted, those implications led to a series of unconventional, challenging, and rigorously demonstrable normative insights—the scholar's holy grail. At just this time, in turn, two related phenomena about which efficiency theory had much to say—hostile corporate takeovers and insider trading—were quickly becoming matters of cultural and political fascination. Scholars embracing efficiency therefore could not only be challenging but important, with

2. *See* Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980).

currency outside their otherwise obscure discipline. But bold, confident claims were necessary to establish the scholarly voice here: doubt or ambiguity was disfavored.

No doubt there is a political dimension to all this. We tend to think today of the pro-efficiency move as innately conservative. In the late 1970's and very early 1980's, however, proponents of increased market competition, invoking the mantle of economic efficiency, were often politically progressive, attacking governmentally-supported monopolies and oligopolies as rent-extracting "big business." In securities regulation, the challenges of that decade to the hegemony of the New York Stock Exchange, and the emergence of the idealized national market system were examples of conventional economic theory enlisted in the name of pro-investor reform. The rhetoric of efficiency in the name of open competition had a small hint of populism to it. The generation of legal scholars who learned conventional economic analysis at that time did so without necessarily carrying any right-wing baggage.

The 1980's gradually moved the idealization of "free markets" to the right, in an ever more aggressive search for forms of regulation that could be challenged as unnecessary interference with competition in order to shrink the governmental domain. More and more of corporate and securities law was questioned as bureaucratically misguided paternalism or, invoking public choice theory, rent-seeking protectionism by entrenched interests. Some of this, of course, was on the mark. But the enthusiastic reception was also the product of support from those who found these intellectual ideas good cover for a political agenda. Those favoring a largely unfettered hostile takeover market, or the elimination of mandatory disclosure requirements, were happy to promote the scholarship and enlist the scholars on their behalf. While this political transformation was happening, however, its background was one in which market-oriented economic analysis still attracted a broad range of scholars and policy-makers. When Gilson and Kraakman published *Mechanisms* in 1984, the market for scholarship was primed for pro-efficiency work, and it was read largely in that light.

The brief embrace of strong market efficiency by the SEC illustrates the demand side story of which *Mechanism* takes note in its opening paragraph.[3] In a handful of rule adoptions by the Commission in the early 1980's, the efficient market hypothesis was highlighted as justification for deregulation. As I have tried to show elsewhere, the Commission's embrace was more façade than substance: the deregulatory steps could easily be justified on cost-benefit grounds even without any strong assumptions about efficiency.[4] But the very fact that even the SEC was, for a short time, willing to pledge its allegiance to the rhetoric of market efficiency testifies to its allure during that period.

Eventually, the idealization of the markets faded and, as noted above, the scholarly consensus began to accept a more ambivalent view of marketplace efficiency and its limits. Here, again, the story is more complicated than it seems. Abuses in the takeover market and the string of insider trading scandals in the mid and late 1980's made strong deregulatory positions less appealing than they had been. Economists were challenging the empirical underpinnings of the efficient market hypothesis, and alternative theories of market price behavior were emerging rapidly. In the early 1990's, the political climate

3. *Mechanisms*, *supra* note 1, at 550, n.3-4.

4. Donald C. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1991) (analyzing the "gulf" that has developed between current economics literature and the conception of market efficiency in the legal culture).

shifted, albeit briefly, altering the balance of intellectual influence in policy-making. Had *Mechanisms* been published even five years later than it was, its substantive contribution would have been much the same and just as valuable, but I suspect it would have been interpreted differently by many of its readers. Now, of course, we have had scandals like Enron and Worldcom that have further weakened the faith.[5]

A re-reading of *Mechanisms* shows how well it actually anticipated many of the scholarly moves that followed in the next two decades. There are two footnotes, for example, taking note of early work doubting whether market efficiency is as well-grounded empirically as its proponents were claiming.[6] Gilson and Kraakman observe that departures from efficiency are "precisely what we would expect where publicly-announced information is genuinely new and difficult to value, and where large numbers of traders consequently elect not to invest in valuation costs."[7]

The authors are also careful to focus their attention on the informational efficiency of the markets in contrast to fundamental efficiency—markets can have a rapid speed of adjustment without necessarily producing a rational equilibrium. To be sure, *Mechanisms* at many places assumes that noise trading is largely unsystematic and, therefore, nets out in an unbiased fashion. But it does not deny that noise trading could lead to sustained departures from fundamental value. Indeed, that very idea was pursued four years later by Reinier Kraakman in a thoughtful paper on hostile takeovers, not cited as frequently as it should be, showing that evidence of noisy stock prices makes it hard to devise an optimal regulatory policy. If stock prices can be "irrationally" depressed over a sustained period, takeovers directed at such firms are a form of cherry-picking without efficiency benefits.[8] In making this claim, he was not repudiating anything in *Mechanisms*. And it is hardly a large step to go from *Mechanisms*' discussion of derivatively informed trading to models of momentum trading that are commonplace in the contemporary finance literature.[9]

Paying tribute to *Mechanisms* is not to say that it got everything right. Its scholarly virtue is subtlety and restraint; it is careful not to over-claim at a time when other scholars seemed sure and confident in their roles as intellectual norms entrepreneurs. It recognized the difficulties and challenges of regulation, and the need for much more work. Gilson and Kraakman provoked hard thinking about market mechanisms among a generation of scholars, and helped set in motion a progressive research program still on-going today. For this, as well as its many enduring insights, it deserves its place in the canon.

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5. *E.g.*, Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002).

6. *Mechanisms*, *supra* note 1, at 551 n.10, 626 n.205.

7. *Id.* at 626 n.205.

8. Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891 (1988).

9. *E.g.*, Harrison Hong & Jeremy Stein, *A Unified Theory of Underreaction Momentum Trading and Overreaction in Asset Markets*, 54 J. FIN. 2143 (1999).