

REMARKS ON THE LEWIS & CLARK LAW SCHOOL BUSINESS
LAW FORUM: BEHAVIORAL ANALYSIS OF CORPORATE LAW:
INSTRUCTION OR DISTRACTION?

by
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I want to put the notion of behavioral economics, or behavioral finance, into some historical intellectual perspective. There is always a danger when an intellectual development comes on very quickly, as this one has, that there is an unseemly rush to claim too much for it. Law professors, who are not normally well versed in secondary disciplines, are especially prone to this error. They may make extravagant claims for “revolutions” that are really minor, albeit important, intellectual blips. Because of the influence law professors have on legal policy in the United States, there can be real dangers in this kind of rush to judgment.

A good place to start the correction process in connection with behavioral finance is with a short list of a few of the more dramatic intellectual “discoveries” that were claimed in their day to destroy the credibility of standard neoclassical economics. Each will be seen to have served a valuable purpose but to have fallen far short of a revolution. As we shall see, the over-

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He is a member of numerous professional organizations and boards, and an Honorary Life Member of the American Law and Economics Association, which honored him as one of the four founders of the field of Law and Economics. Professor Manne has published many books and articles, with emphasis on law and economics, the free market, and securities regulation. His development of the theory of a “market for corporate control” is credited with opening the entire field of corporate law to economic analysis, and his 1966 book, “Insider Trading and the Stock Market,” began, and still heavily influences, the vast literature on that subject. He is a frequent contributor to the Wall Street Journal.

Among his notable educational innovations were the Law and Economics Center (LEC), the first academic center devoted to the development of the field of Law and Economics (presently part of the George Mason University School of Law); the Economics Institutes for Law Professors; the Law Institutes for Economists; the Economics Institutes for Federal Judges; the first specialized law degree program for Ph.D.’s in economics; and the first law school (George Mason) whose curriculum was built around the use of economics in law.

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reaching claim made for modern behavioral finance is that it destroys the “efficient market” concept. That theory holds that stock market pricing quickly and accurately measures the real objective value of new information about a company and implies a smoothly and effectively functioning market for new financial information.

Perhaps the earliest form of a correct yet only marginally significant attack on the standard canon came with the view that there really was not any such thing as perfect competition in most industries. Simple naïve observation disclosed that prices of the same goods varied more than this idea would suggest. Maybe the perfect competition notion worked for wheat or potatoes, but it did not seem to hold for any product that was not perfectly fungible. Out of that criticism developed some very useful ideas, including recognition of time and location as variables in the definition of a product and the idea of product differentiation, which moved into mainstream economics after this correction of the underlying paradigm. The critical observation turned out to generate a valuable marginal correction but not a revolution.

Then there was the related argument that the Adam Smith model, the perfect competition model, was premised on the idea of perfect information, the notion that everyone functioning in any market had the exact same information about what goods were available and at what price in the market. (There are other aspects of this argument as well, but one version will serve our purposes here.) This assumption was thought to be essential to the idea that market participants could only maximize by finding the lowest price for commodities. Out of this eventually came the modern idea of “search costs” and information theory, a tremendous improvement on the old model. It was nonetheless merely an improvement and by no means a displacement.

Then there was the important accusation in the very late nineteenth and early twentieth centuries that the capitalist world was full of monopolies and cartels, and that a competitive system just did not exist. That claim generated an enormous literature and the new field of industrial organization economics. Out of this concern for whether or not markets are competitive have come any number of valuable intellectual insights, including modern cartel theory, new learning about various forms of contracts, and insights into marketing and pricing practices.

For a while during and after the New Deal it looked like the newer theories of imperfect competition might actually displace the older paradigm, but ultimately these market-critical notions proved to be either wrong in their main thrust (as with the view that private cartels could last for long periods of time) or they generated new scholarship to let us understand the rich variety of processes at work in competitive markets. The revolution fizzled, and while today we at least recognize in our standard canon the possibility of monopolies and cartels, what can be done about them, what kind of economic consequences they have, and so forth, the fundamental market theory, much enriched, still reigns supreme.

In the 1930s, under heavy pressure from worldwide depression and with no little help from apologists for the Soviet Union’s kind of economic planning, came the intellectual, or more correctly academic, dominance of the idea of

socialism. The central idea was that the newer and sophisticated planning mechanisms could solve all the messy problems of production, poverty, inequality, and alienation. As a result, the world suffered an enormous growth of central economic planning, the baleful remnants of which still plague many economies worldwide. This episode also left a small but valuable addition to modern economics. This episode made us reformulate notions of market resource allocation and efficiency, but its most lasting intellectual result came in the form of theories of why socialism did not and could not work. Out of that same scholarly work came some of the modern ideas of price theory, to which I shall return below.

In the early '30s also, the large, publicly-held corporation became a center of focus for the newer *dirigiste* ideas of economics. The Berle and Means theory of the separation of ownership and control rapidly assumed a totally dominant position in reference to large corporations. The received wisdom was that these enterprises had none of the justification or legitimacy theoretically provided by notions of free markets and private property. Ultimately the Berle and Means insight was relegated to a small aspect of modern corporate theory called "agency costs," and the counter idea of a market for corporate control as a device that prevented runaway problems in large corporations eventually came to be universally recognized. We also integrated into corporate economic theory ideas of transactions costs and efficient markets, all of which make our market theory of corporations far more realistic and useful than it had been. Again the end result of an announced revolution was a series of valuable additions and corrections to our basic understanding of how markets function.

More recently we have had any number of market-failure theories, most of which, along with their market-oriented counters, have been absorbed into the conventional corpus of modern economics. Principal among these are various notions of externalities or third-party effects from private arrangements. When this notion was first formalized by the English economist Arthur Pigou in the 1930s, he came up with a wrong solution to the problem. That led in turn to some insightful criticism of Pigou's work by Ronald Coase, which in turn led to the really revolutionary development of the field of law and economics—just another bit of trivia about how good comes out of errors in economics.

Other market-failure themes related to ideas like public goods, prisoner's dilemmas, and transactions costs. Today these—and the reactions these ideas generated—are all very standard parts of economic theory, and yet in the early conception it was thought that they would probably undermine the foundations of traditional theory. But, like the claims that had gone before, they simply are not powerful enough for that; each of them deals with only a small aspect of the total integrated apparatus that is the neoclassical economic model, and that structure is simply too big ever to be brought down by localized criticisms.

We can start our consideration of behavioral finance by noting that the process described above is already well underway. As critics of behavioral economics have already pointed out, a large number of the "anomalies" behavioralists were thought to have discovered in finance were not so anomalous at all. Still, the criticisms, as usual, forced scholars to go back and find real explanations for apparent anomalies not previously noted or noticed.

Thus the ordinary process of intellectual advance has already been at work in this field.

Nonetheless, there are still some pretty sharp differences of opinion about how seriously to take some of the implications of the behavioral anomalies that have been found. Lynn Stout, of UCLA Law School, a frequent derider of traditional economics, has an article, the title of which says it all: "Behavioral Economics Has Destroyed the Efficient Market Theory." Well it hasn't. But it sure has forced us to sharpen our descriptions and understanding of how some securities markets function, and most assuredly, we have been forced to correct some of the misleading aspects of efficient market theory as it has come down to us.

The first thing wrong with over-hyped behavioral theory, as Choi and Pritchard have strongly implied at this conference, is that critics like Professor Stout are simply claiming too much. All you have to do is look around you. If a market were really dominated by the irrational, you just would not have the degree of orderliness that we see in financial markets today. This observation shifts the burden of persuasion back to the behavioralists, who must now come up with some comprehensive and usable theory of why things work as well as they do, since dominant irrationality would imply that they should not work well at all. No such theory has been forthcoming, nor is it expected any time soon.

We know that to a very meaningful extent the traditional finance system does work well and that traditional theory is the best explanation we have of why that is so. There is little disagreement about the fact that our securities markets do an extremely good job of integrating new information into security prices. Anomalies to the contrary, we have so much evidence of this fact that it is really beyond question. But for our purposes it is very important to notice that the notion of an efficient securities market did not originally grow out of economic theory. It was not the mere ultimate extension of some hair-brained Chicago economist's idea of perfect markets.

The discoverers of the efficient market concept were pure empiricists, and the earliest studies that "proved" or "discovered" an efficient market were statistical regression analyses to show that the market quickly (they thought instantaneously) reflected the correct value of whatever new event they were measuring. Eugene Fama, others at the University of Chicago, and then hosts of others in the late 1960s and early 1970s, tested the efficiency hypothesis empirically and inevitably came to the same conclusion: the stock market was incredibly efficient. A new piece of information developed, and, before you could say "Milton Friedman," it was accurately integrated into the price of a security.

After numerous studies reached the same conclusion, Eugene Fama did us all an enormous disservice when he dipped into some general theorizing about this work. Fama advanced his famous trilogy of comparatively efficient markets: the strong form where new information was instantaneously integrated into the price of a security as soon as it happened; semi-strong, in which the price adjustment occurred but with some delay for the information to be disclosed; and a weak form that took even longer for the information to get out.

He should have recognized that nothing in economics breaks into three such cleanly distinguishable categories and that there is always a continuum (in this case actually numerous continuums along different dimensions).

At a conference at which he and I spoke in 1967 he gave a talk on the strong-form theory. His seat was next to mine, and when he sat down I leaned over and whispered ironically, "Gene, you know, you really ought to allow a few minutes at least in your theory for people to give orders to brokers and for the brokers to send the order to the floor of the exchange." He looked at me disdainfully and said, "I'm not interested in that; I am not an institutional economist." That was his way of saying he didn't care about the logic of what I was suggesting, only his empirical findings. Well that was very unfortunate because it misled many economists and lawyers for many years (yea, some unto this very day) into thinking that this tripartite division accurately described the real world, when in fact, it did not even come close. The strong empirical conclusions did, however, lead Gilson and Kraakman to develop their magnificent 1987 article on why the stock market is so efficient, even though that work incorporated a number of Fama's errors.

In a more recent article Gilson and Kraakman have come back a long way from what they said originally, but in 1987 they offered up a lot of good reasons for thinking the stock market would be as precise and sensitive as Fama said it was. While they bought into the idea of an efficient market, they at least implicitly recognized that it was not 100% efficient because of the presence of "noise." The concept of noise in the finance literature is used generically to refer to the price effects of any trades not based on perfect information (correct, fresh information correctly evaluated). We can take noise trading for present purposes as a surrogate for irrational trading, the bugaboo of some of the finance behavioralists. The overlap is not perfect, however, since noise trading includes partially informed trading, which would not seem on the face of it to be inherently irrational, as well as totally uninformed trading (pure gambling).

Behavioral finance would suggest, I presume, that noise traders are not trading rationally, even though gambling can be quite rational if one loves to take risks or gets sufficient entertainment value from the exercise. The gambler should, however, be distinguished from the trader who mistakenly (though not irrationally) believes that he or she has correct information, when in fact the presumed information is in error. But neither of these fits the definition of "irrational" trading, as some loose use of behavioralist concepts would suggest.

Clearly we cannot pour too many problems with the market into the one word, "noise." What we talk about as noise, should instead be seen as the trading of people who have anywhere from zero valuable information to those with information which is up to 99% correct. Trading on any information that is less than 100% true or that is not perfectly and correctly evaluated has some degree of noise in it, but there is a very big difference between people trading with no information, that is the pure gamblers (who because of error cancellation may have little effect on price, though some scholars argue their importance in providing market liquidity) and the partially informed traders (as Gilson and Kraakman termed them) who may not only have some effect on price but, as we shall see below, may be essential to the ultimate formation of

the correct price. Still all these are noise traders in modern finance literature, and each of these suggests to some behavioralist-oriented law professors that the stock market cannot be “efficient.”

Gilson and Kraakman recognized that some traders with partial information contribute to the efficiency of the stock market. But they didn't really develop this notion, and perhaps this was because no theory existed at the time for explaining why partially informed traders might be useful. In fact, the partially informed trader may be playing a surprise role in all of this, but not at all the one Gilson and Kraakman posited.

Let me step back a moment. I need to point out that in modern economics there is not and has never been a good theory of price formation,¹ not merely for the stock market but for all markets. The notions of supply and demand are merely descriptive of a process, but they do not explain the underlying mechanism. The efficient market concept finessed this problem by assuming that price formation was a given, an automatic one at that. In fact, at times, Fama would use the word “mystical,” and he never tried to explain why the results he found happened.

Gilson and Kraakman basically worked on Fama's assumptions; they accepted the empirical finding that the market was efficient, and they went in search of the “empirical” mechanisms that generated that conclusion. Again, there was no theory of price formation, merely a cataloging of the mechanisms involved in that process. And without such a theory traditional finance economists and behavioralists can duke it out, but they will not be able to resolve their differences. Let me now examine what scholarship there is on this subject and perhaps offer an approach to the development of a richer theory.

It starts with an older notion that has recently received renewed interest in the economic literature. The idea originates in a famous keynote speech by Friedrich Hayek at the 1947 American Economic Association annual meeting called “The Uses of Knowledge in Society.” Basically the speech was not focused on developing a theory of price formation. His purpose rather was to explain why the then-admired socialist planners had gotten it wrong. He argued that no one central planner could ever amass the information really needed to make intelligent allocational decisions. Hayek said that such information only came into being when a large number of people, each with little bits of information known only to that person, aggregated all of that information in a market to generate a market price. In other words, only through the mechanism of a market could the “correct” price of goods be determined, and even then it had a very subjective and amorphous quality. Another famous economist, Armen Alchian, made a similar or related point that the notion of price was not

¹ Although I shall continue in these Remarks to refer to the absence of a theory of price formation, the point might be clearer if I referred to “the absence of a theory of how new information is integrated into price.” There is, of course, a vast “theory of price” in conventional economics, and the similarity of terms might cause some confusion. The reference to new information as a factor that determines price changes might clarify the point for some readers, but, for now at least, I will stick with the more elegant “theory of price formation” by which I mean substantially the same thing.

what was represented by a hard data point, the dollar price as it were, though that is how Fama and others treated it. Rather Alchian said that the notion of price was best thought of as a distribution around a mean, certainly a complementary notion to Hayek's. Together those two notions mark the beginnings of a theory of price formation.

A recent minor best-seller, "The Wisdom of Crowds," by James Surowiecki, a financial writer for the New Yorker, adds some much needed clarity to Hayek's and Alchian's thoughts on this subject. The book begins with a little anecdote about a well known statistician and geneticist in England who went to a county fair in 1906. At the county fair there was a contest to guess the correct dressed weight of an ox that was on display. There was a nice prize for the closest guess. No one's guess came very close to the actual final weight, but the mean (average) of all of the answers given was only one pound off the actual weight of 1788 pounds, a completely negligible difference. The average of all those guesses from people with only the slight knowledge they obtained from looking at this ox, as well as their own endowments, was to all intents and purposes perfect. That is very analogous to the process by which a market price is determined, and it is perfectly consistent with what both Hayek and Alchian were saying about the process by which a price is determined.

Now we can have a better appreciation for the role played by the partially informed traders in the stock market, and we are beginning to learn a lot more about this process from the modern development and use of so-called virtual or prediction markets. This invention is best known perhaps from the ill-fated Defense Department's pilot program called a "Policy Analysis Market" to help predict various kinds of possible future events in the Middle East, including terrorist attacks. Another famous prediction market is the Iowa Electronics Market, an Internet betting scheme that beats every standard opinion poll in the world. It works in very much the same way that the ox-weight-guessing contest in 1906 worked and, with due allowances for different subject matter, with approximately the same accurate prediction power.

As a result of work already going on in connection with these prediction markets, we know, for instance, that the more participants there are in the "game" the more accurate will be the result, even though many of these additional participants will have erroneous information and some will even be trying to manipulate the results. Precisely why this is so must await further development of this subject, but some implications of this work for financial market policy are already clear. One is certainly that mere "irrationality" on the part of some stock market participants cannot foil an otherwise efficient market. Another is that any effort to restrain trading, such as restrictions on short sales or on insider trading, is probably counterproductive. This may even offer a new device by which we can test the desirability of mandated financial disclosures and accounting regulation.

The behavioral economists have not yet come to grips with these new tools, but the integration of prediction market theory into behavioral finance must come soon, if it is not already underway. We can now claim that we have the first glimmer of a theory of why the stock market is really so efficient. The various institutional mechanisms used may be part of the story, but until now

there was no theory in which to integrate that information. Regulatory agencies like the SEC will in time have to rethink their basic assumptions and perhaps modify regulations that no longer can be defended.

Economists should have no difficulty integrating the useful findings of the psychologists into this newer understanding of how markets function, and I suspect that behavioral finance will end up as an important sub-field of the theory of price formation. We seem on the verge of developing this new theory of price formation, a theory which to some extent grows, perhaps more tangentially than directly, out of the searching questions the behavioralists have raised. That role will not be what they were looking for (just as critics of the perfect competition model were not looking for a theory of uncertainty), but it may again prove the value for intellectual advancement of having tough critics around.