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GUEST EDITORS' INTRODUCTION

The Interactions of Law, Finance, and Markets

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A popular fiction in finance is to assume that markets are perfect in the sense of having no taxes, transactions costs, or other market frictions. Viewing markets in this way is akin to looking at the earth from the vantage point of the space shuttle; the earth appears to be a beautiful orb moving effortlessly through space. A closer inspection of either the earth or the markets would reveal a different story. While markets may often appear to be operating efficiently, this behavior is the result of a wide variety of constraints, rules, and legal structures that underlie the market. These legal rules determine the incentives, strategies, and gains and losses of participants, which in turn determine the behavior the market exhibits. Viewed at this ground level, the behavior of markets is a complex process that is crucially dependent on these legal rules and structures.

The papers in this issue all consider some aspect of this interaction of the financial markets and the legal system. An interesting facet of this interaction is that while both the legal and financial aspects of markets evolve over time, they do so at different rates. That is, the legal structure of markets often involves political considerations, whereas the financial function of markets is typically market-driven. For example, the derivatives markets today are largely a product of financial innovations in the 1980s, but their legal structure is largely defined by laws and regulations promulgated in the 1930s. This divergence can create difficulties, or frictions, in how the markets operate, and these frictions can be exacerbated by uncertainty over how the legal framework actually applies in certain settings. Conversely, the existence of an exogenous set of rules, unaffected by market forces at least in the short run, can reduce other frictions in the market by removing some of the uncertainty surrounding the agency conflicts that arise in market settings. Thus, the interaction of the legal and financial both hinders and abets the efficient functioning of markets.

The papers published here were presented as part of a symposium on law, finance, and markets held at Cornell University in May 1999. There are a wide

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range of issues that fall under the rubric of law and finance, but the focus of the symposium was on topics involving financial markets. These topics include debt contracting, investor protection, security market regulation, and corporate governance. What is particularly intriguing about this area is that the law–finance interaction is not always precisely defined. In particular, for questions such as the efficiency of the takeover market, the legal structure of the corporate governance system is clearly relevant and is generally well defined. But for other areas, such as whether particular market practices by securities dealers are desirable, the legal framework may be more amorphous, involving legal duties rather than specific rules. These gradations in legal responsibilities give rise to a number of interesting and important policy questions.

The four papers in this issue illustrate this range in legal–financial interaction. The paper by Boehmer, "Business Groups, Bank Control, and Large Shareholders: An Analysis of German Takeovers," looks at how corporate governance systems affect takeover behavior. Corporate governance rules essentially define the rights of investors with respect to firm management. Corporate governance systems differ across countries, but they can generally be divided into more dispersed market-oriented systems (as in the United States and United Kingdom) and more concentrated block-holder systems (as in Germany and Japan). Which system leads to better decision making? As Shleifer and Vishny (1997, p. 737) note, "Even in advanced market economies there is a great deal of disagreement on how good or bad the existing governance mechanisms are." Boehmer addresses this issue by looking at a sample of 715 German takeovers and examining how the bidders' ownership structure determines the value of takeovers to its shareholders. If concentrated ownership leads to better decision making, then one would expect to find greater returns to bidders with greater block ownership such as banks. His findings suggest that the conventional wisdom regarding the efficiency of monitoring by large blockholders may be incorrect.

The second paper in this issue considers how best to compensate shareholders in securities litigation. The Securities Acts of 1934 specify precise disclosure requirements for companies, and securities litigation often arises because a shareholder has been harmed by a company's failure to disclose some piece of relevant information. But what is the correct compensation? If markets are not entirely sure how to evaluate new information, then security prices could show short-run overreactions to adverse news, leading to a windfall to claimants if this temporary low price is used to measure losses. In response to this concern, Congress passed the "Private Securities Litigation and Reform Act of 1995" mandating that losses be measured relative to the average price over a 90-day window, or until the security is sold if that occurs sooner.

Dybvig, Gong, and Schwartz in "Bias of Damage Awards and Free Options in Securities Litigation" demonstrate the problems inherent in such an approach. Using option pricing analysis, these authors show that the free option problem is actually greater under this average price technique than it is using the simple one price calculation. Moreover, these authors identify another type of timing option that arises when claimants are allowed to shorten the loss calculation period by selling their security. By focusing on these underlying options, the authors are able to demonstrate how well-intended legislation can result in unintended consequences. The authors then suggest an alternative way to compensate claimants that minimizes these option-induced effects.

The third paper in this issue, “Incomplete Financial Contracts and Noncontractual Legal Rules: The Case of Debt Capacity and Fraudulent Conveyance Law,” by Heaton, investigates an important issue in debt contracting. The willingness of a creditor to lend funds to a debtor depends upon his ability to get the funds back. Debt contracts typically specify remedies should the borrower default, but these are only relevant if the borrower is solvent. What if the borrower had funds but transferred them to a third party? The contract between the lender and borrower cannot specify every possible third party, or indeed every possible strategy to avoid repayment, leading to a breakdown in contracting.

Problems in contracting are well-known (see Hart (1995)), but Heaton’s paper raises a new aspect of this difficulty by focusing on the role of the third party. He shows that legal rules outside of the contract play an important role in ameliorating these difficulties. In particular, fraudulent conveyance rules augment the standard legal structure of the contract to provide legal protection to the lender. Thus, this paper demonstrates that the legal environment of the debt market involves not only specific contractual rules, but a set of broader legal doctrines as well.

The final paper extends this legal environment ever further by considering the impact of legal duties on the market. In “Indicating Ahead: Best Execution and the Nasdaq Preopening,” Ciccotello and Hathaway examine the consistency of dealer quoting behavior in the 30 min before the market opens with the dealer’s duty of best execution. Best execution refers to the obligation the dealer owes to his customer to provide the best possible execution for his trade. As Macey and O’Hara (1997) note, the complex nature of trade execution makes it difficult to even define this obligation, let alone determine if a dealer is fulfilling it. Ciccotello and Hathaway raise the concern that by “indicating ahead” his willingness to trade, a dealer may be putting his own interest ahead of his customers. However, while this practice may be detrimental to individual customers, these authors show that it may also improve the efficient functioning of the price discovery process in the market. The analysis here raises a number of important policy issues regarding both the design of market preopening practices and the feasibility of a best execution standard.

The research in this issue demonstrates the important role played by the legal structure in affecting financial market behavior. An equally important role of this research is to provide policy guidance as to what this legal structure should be. Such guidance should enhance the efficiency of markets by removing the frictions that impede market performance. There are clearly a wide variety of issues for which such research is needed.

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