

## EDITORIAL

### Clinical Papers and Their Role in the Development of Financial Economics

This issue of the *Journal of Financial Economics* contains the first set of studies in the new Clinical Papers section. The objective of this section is to provide a high-quality professional outlet for scholarly studies of specific cases, events, practices, and specialized applications. By supplying insights about the world, challenging accepted theory, and using unique sources of data, clinical studies stand on their own as an important medium of research. Like the medical literature from which the term 'clinical' is borrowed, these articles will frequently deal with individual situations or small numbers of cases of special interest. The *JFE* intends to take a leading role in encouraging clinical studies, guided by the confidence that expanding our research agenda and providing an outlet for this work will enliven and enrich professional knowledge. We expect these clinical studies to stimulate new high-quality empirical and theoretical research.

#### *Perfect markets, imperfect markets, and possibility theorems*

The development of perfect market theory (based on the assumption that all individuals and organizations maximize value in a world with zero transaction and information costs) brought about a major revolution in finance in the late 1950s and 1960s. While the term 'perfect' is unfortunate (because there is nothing imperfect about a world in which individuals are self-interested or in which resources are consumed in the production of transactions or information), perfect market theory became one of the major contributions to economics in this century. First developed and applied to stock price behavior, the theory was next applied to corporate finance, capital asset pricing, and contingent claims pricing. The following two decades witnessed its thorough development in finance applications and its spread throughout economics. The diminishing returns associated with the maturing of this research have led financial economists to concentrate increasingly on relaxing various perfect market assumptions, with growing attention to taxes, agency costs, and information effects.

The unique and well-defined perfect market theory provides a useful standard of comparison as the limit toward which unencumbered markets move. There are, however, an infinite number of imperfect market theories corre-

sponding to the limitless combinations of alternative assumptions. Unfortunately, most of these theories are irrelevant to understanding the world. In this sense they are 'possibility theorems' – propositions that, while logically correct, have little or no probability of explaining any real phenomenon. The imperfect market theories that interest us are those that have a reasonable probability of explaining reality.

Productive research on the empirical side of the profession focuses on identifying and testing both perfect and imperfect market theories. But in the capital markets area sophisticated econometric techniques are being developed and applied to increasingly irrelevant estimation problems whose primary source is the journal literature rather than problems from the world. And in corporate finance, the valuation consequences of increasingly obscure decisions and events are often measured without a framework for linking the findings to interesting questions.

Clinical work can guide theorists and empiricists to empirically relevant imperfect market theories by providing in-depth analysis of the important dimensions of a phenomenon. When successful, such papers influence not only the issues that interest large-sample empiricists and the data they collect but also the hypotheticals and simple characterizations that theorists use in modeling the world. Drawn directly from the world, such characterizations are more likely to be productive than those that come from the journal literature or solely from the researcher's imagination.

Innovation in financing techniques, deregulation, reregulation, and changes in the organization and conduct of commerce are proceeding at a rapid rate. New products and practices are appearing constantly, and the roles and activities of financial institutions are changing dramatically. New ways to communicate these interesting changes to the scientific community are required because the changes provide tests of leading theories and suggest new problems of theoretical interest. Clinical papers, inspired primarily by actual events, can play an important role in this discovery and communication process and, therefore, in the evolution of the science of finance.

The advantages of specialization imply that different groups of researchers will tend to concentrate on theory, empirical tests, and clinical studies. These three groups complement each other. Theory provides logical discipline and precise hypotheses for both empirical and clinical research. Empirical tests direct theorists by identifying irrelevant models and suggest where clinical research might find counterexamples. Clinical studies help set the agenda for both theory and empirical work. Because of this complementarity and the importance of communication between these groups, the *Journal of Financial Economics* is committed to publishing all three types of research.

Clinical papers can enliven classroom discussions by supplying real examples and applications of the theory and empirical results that students are studying. We invite our colleagues to take advantage of the opportunity to use these papers in the classroom. North-Holland policies facilitate such use of

*Journal of Financial Economics* papers by providing free copying privileges for class use to those colleges and universities that subscribe to the journal.

### *Standards for clinical papers*

There is currently no standard or accepted model for clinical financial papers. We will, over time, uncover the principles that ensure the integrity and reliability of these efforts. Like empirical or theoretical papers published in the professional literature, clinical papers will seldom provide complete answers to the issues they address. It is important for editors and referees to avoid applying to a particular paper the standards applicable to the scientific process as a whole; the quality of a single paper – clinical, theoretical, or empirical – must not be judged on whether it definitively poses *and* answers a major question. Such answers are seldom provided by any paper, but rather are the result of the entire scientific process, including replication and extension.

Our intention is to establish standards of excellence for clinical papers equivalent to those the *JFE* applies to its other articles. We recognize, however, that clinical papers will be different in form, scope, and content and will often be more conjectural. The papers will probably deal with issues that are less quantifiable and more descriptive and normative than usual. Because the most important contributions to science are often papers that raise a new question or pose an old one in an innovative way, the evaluation process will place more emphasis on whether clinical papers raise new questions or puzzles for the profession than on whether they provide new answers. Successful clinical papers preserve the essence of the world while achieving parsimony in description and theory. Clinical papers will be subject to peer review, which will define and set the appropriate standards. The Board of Associate Editors of the *Journal of Financial Economics* is well suited to work with authors in this process.

### *Clinical papers in this volume*

The five clinical papers in this volume provide examples of the types of work we encourage. Scholes and Wolfson describe a trading system they devised to examine trading profits on corporate discount stock purchase plans. While the \$400,000 profits they earned over a two-year period do not indicate that stock prices are incorrect, the results do indicate that investors do not respond instantly to profit opportunities in these plans. The results also raise questions about the efficiency of the market for investment banking services. The large profits will remind students and scholars alike that, although capital markets are highly efficient, efficiency does not imply an absence of rewards to entrepreneurial effort, initiative and innovation.

Mitchell and Netter analyze the economic causes of the more than 10% decline in the stock market on October 14–16, 1987 that immediately preceded the October 19 crash. This pre-crash decline was greater than any one-, two-,

or three-day decline in the previous 47 years. They present evidence that the tax bill containing strong antitakeover provisions proposed by the U.S. House Ways and Means Committee on October 13, 1987 and approved by the Committee on October 15 was the fundamental event that caused the pre-crash decline on October 14–16. The decline appears to have played an important role in triggering the breakdown in the trading and contracting process that was associated with the October 19 stock price crash of 22.6%.

Karpoff and Rice highlight the importance of transferable common stock on organizational efficiency by studying the effects of legislatively mandated nontransferability of common stock claims on the efficiency of the 13 Alaskan Native (ANCSA) regional corporations. The paper addresses an important question that would be difficult to present in the traditional *Journal of Financial Economics* article. They find that the firms have frequent control contests, high turnover among directors and managers, and that they have dissipated much of the wealth granted them through the ANCSA legislation (almost one billion dollars and 40 million acres of Alaskan land).

Christensen, Moore, and Roenfeldt investigate the role of organizational form by measuring the valuation effects of shifting assets from corporations to master limited partnerships. They find that the rollout of assets into these partnerships increases equity values in ways that are consistent with tax advantages, reduced free cash flow, and information signaling.

Muscarella and Vetsuypens examine the underpricing of initial public offerings of 38 investment banks that distributed their own securities. If underpricing occurs because of information asymmetries between issues and underwriters, as in Baron's model, these self-underwritten initial public offerings should show less underpricing. The data indicate, however, that the underpricing in these self-underwritten offerings is comparable to that in other initial public offerings.

The clinical section provides new opportunities for the *JFE* and its contributors and readers. The authors of the five papers in this issue experiment successfully with nonstandard research methods. We are excited about the prospect of discovering more about clinical research methods and about sharing these discoveries with readers of the *Journal of Financial Economics*.

Papers for the Clinical Papers section will be subject to the usual submission fees and refereeing. Authors should submit four copies of papers to:

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