What exactly is "raising the grain"? I've heard three explanations so far, but I don't know which to believe.

While the phrase has undeniable alliterative and rhythmic appeal, it would make a lot more sense if we said "making all the loose fibers stand up". (No wonder we call it "raising the grain" instead.) In any case, that's what it is: causing torn and partially severed wood fibers to contort themselves so they arise and stand clear of the surface around them. This makes it possible to cut them away, leaving a surface as clean and smooth as possible prior to finishing.

Sanding wood almost always tears up the surface and leaves lots of small, stringy fibers ripped from their moorings but not completely detached. They're so small and weak they're hard to feel when dry. Wipe the surface with a moderately wet rag, and the moisture instantly soaks into the tiny fibers, warping them severely. Stroke your formerly smooth surface, and it now feels rough and hairy. Let the moisture dry, then sand very lightly with the finest grit you used previously, moving the sandpaper just a few degrees askew from the grain direction so you don't simply push the loose fibers back down into the grooves from which they were torn. You must hold your tongue just right to avoid partially severing a new crop of fibers; sand lightly and stop as soon as the hairy surface feels smooth again. It's a very old fine finishing technique, one that makes finished wood look cleaner and clearer, and which minimizes between-coats finishing hassles as well.