

BOOK REVIEW

BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS. By *James S. Mofsky*. New York: Matthew Bender & Company, 1971. Pp. vii, 168.

Professor Mofsky's thesis is that state securities laws, popularly called "blue sky laws," raise substantial entry barriers to new businesses. His book is short, with barely 61 pages of text. His style is argumentative, for he is interested in showing that the anti-competitive effects exist, not in measuring them. But this is a book every securities lawyer should read to appreciate that there is a serious question as to the social value of the law he practices.

Professor Mofsky begins by outlining the history of "merit regulation" in state securities laws beginning with the Kansas statute of 1911.¹ The concept of merit regulation is that the state should make an official judgment as to the risks involved in the securities offering proposed, and prevent the securities from being offered if the dangers to the investor are too great. The weakness of this concept, when tested against the capitalistic system, is that it analytically divorces the risk of loss from the chances for gain. To an investor, risk is not a dirty word. The essence of his investment decision is a weighing of the risks of loss against the chances for gain. The outcome of this weighing is, in effect, his judgment as to the value of the investment. There are circumstances where even the wisest poker player will draw to an inside straight.² Insofar as state securities laws ignore this decision-making process, they interfere with the optimal allocation of resources under conventional theories of capitalism—that is, that capital should be allocated through an aggregation of individual judgments in the institution of the free market place.

The lopsidedness of merit regulation on the theoretical level has led on the practical level to making merit judgments by rules of thumb, rules that finesse the ultimate question of value by identifying particular characteristics of the issuer and the securities in question. These rules, by and large, indicate that a security is worth what it is

1. Act of March 10, 1911, ch. 133, §§ 1-17, [1911] Kan. Laws 210-16.

2. In draw poker with nothing wild, the odds indicate the player should draw when the ratio of the amount already in the pot to the amount of the bet necessary to draw is more than 43 to 4.

being offered for: for example, the universal exemption for securities listed on the New York Stock Exchange, and the frequent regulations limiting the amount and price of cheap stock sold to the promoters before stock is offered to the public. The general problem with this type of rule of thumb is simply that it is not designed with new business promotions in mind—that is, securities of an issuer not yet publicly held cannot be listed, or approved for listing on notice of issuance, on the New York Stock Exchange.³ A new business is invariably formed around a “thing” of debatable value—a possible mineral deposit, or a new service, product or idea. The capitalistic system is based on the notion that the power of that “thing” to attract capital in the free market is the best test of its value; yet, the new business promotion falls into the dilemma that only the market can establish its value, but until its value is established it cannot have access to the market.

Professor Mofsky works out his idea in terms of the application of the restrictive rules in Florida to a hypothetical new business promotion. A man with limited capital wishes to start his own business producing promotional items to be included in the containers of household products. Unable to raise capital from banks, the Small Business Administration or other institutional sources, he turns to the idea of a stock offering. He soon finds that if the offering is to be exempt from registration in Florida, he is limited to twenty-five subscribers and cannot avail himself of the help of an investment banker or other intermediary, unless the intermediary is willing to work for nothing. He must also preserve his exemption from the registration provisions of the Securities Act of 1933 by restricting the number and type of offerees to ensure the availability of the “private” or “intra-state” offering exemptions. On the other hand, if he is willing to undergo the expenses of state and federal registration, the percentage share of the stock he can obtain for his intangible contributions is limited by the Florida rule providing that securities of a promotional company will not be permitted to be registered for public sale unless

3. The New York Stock Exchange generally will not list a stock unless there are at least 2,000 stockholders with 1,800 holders of 100 shares or more, 1,000,000 outstanding shares with 800,000 shares publicly-held, with the market value of the publicly-held shares at least \$14,000,000, earnings before federal income taxes in the last fiscal year of \$2,500,000, and \$2,000,000 in each of the two preceding years. NEW YORK STOCK EXCHANGE, LISTING PROCEDURE AND DIRECTIONS FOR THE PREPARATION OF APPLICATIONS FOR ORIGINAL LISTING I (1969).

the equity investment of the promoters or insiders in tangible assets amounts to at least fifteen percent of the total equity investment in the corporation resulting from the sale of the entire offering, regardless of the value the market place might put on the contribution of intangible property. This rule, like others discussed by Professor Mofsky, does not require an effort to evaluate the intangible property, but fixes an arbitrary limit to what the promoter can obtain from a market that presumably may be willing to pay more.

Professor Mofsky's conclusion is that this form of regulation produces substantial anticompetitive effects for the promoter who wishes to maximize his participation in control of the new enterprise because he is blocked from access to capital markets and is compelled to sell in a limited market—for example, institutional investors. It also has anti-competitive effects for the promoter who wishes to act as an intermediary between the new enterprise and sources of capital because he is barred not only from many markets but is also arbitrarily limited as to the compensation he may receive. The chances for reform in this area of the law are, moreover, described as poor. The organized power blocs—the stock exchanges, the major underwriting firms and established businesses in general—have no desire to reduce entry barriers. The state securities commissioners and the S.E.C. are responsive to those power blocs alone, and, in any event, take pleasure in their positions of power. Although Professor Mofsky observes that securities lawyers do not oppose the entry barriers of the present law, he does not suggest that they would oppose a reformed law without such entry barriers, but which yet included a sufficient degree of complexity to protect their jobs.

It would be a mistake to read this book as more than a statement of the single hypothesis “that for all the good that administrative regulation ought to do, there are inevitable effects of such regulation which were originally unintended and which may be costly to the public.”⁴ It is no more than a statement because it makes no attempt to measure or weigh the economic effect of “merit regulation” either in dollars or against countervailing benefits. For example, Professor Mofsky argues that some inventors are deterred from putting their inventions into production by the costs of surmounting the regulatory scheme. This may be true, but need not represent social cost if the

4. J. MOFSKY, *BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS* 1 (1971).

invention will come into production for less than what the investor would have been able to obtain. In other cases, if the effect of the entry barriers is only to make the entrepreneur sell cheap to richer men, but the product is offered to the public at the same price, the social cost may be insignificant—merely a matter of how the spoils are divided.

The absence of a broad objective evaluation cannot be blamed on Professor Mofsky. To come up with a dollar evaluation of the economic loss or gain of "merit regulation" requires an accurate appraisal of the value of the enterprises thwarted by the pattern of regulation, and it is the very impossibility of making such a determination, except through the mechanism of the free market, that is a postulate of his book. But while a general evaluation is impossible, some comparison of the relative economic costs of certain techniques of securities regulation may be possible. In the familiar shibboleth of the plaintiff's antitrust bar, there may be "less restrictive alternatives" that would achieve nearly the same social benefit without as much economic cost; for example, a statute restricting the individual investor in the percentage of his capital which he may place in highly speculative securities.

Another place where a relative judgment as to the amount of economic cost involved could be formed is in the distinction between the promoter who seeks to manage the new business and is willing to share its fortunes and the promoter who merely seeks to act as an intermediary between the business and capital markets—that is, the underwriter. Restrictions that prevent the manager from competing on an equal basis for capital in the public market seem more harmful than restrictions on underwriters' compensation. If the limit of underwriters' compensation is safely above the price of finding informed investors, this limit may keep the underwriter from having an incentive to seek another market more difficult to penetrate: uninformed investors.

The book may also be criticized for limiting its analysis to merit regulation without any comparison to regulation by disclosure, the other popular theory. Regulation on a pure disclosure theory may have similar anticompetitive effects. Professor Henry Manne has, for example, argued emphatically that information is not a costless good⁵ and Professor Mofsky supports this by pointing out that the cost of

5. H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 47-57 (1966).

a full-fledged registration under the Securities Act of 1933 generally ranges between \$17,000 and \$35,000 in attorneys' fees and approximately \$12,500 in printing costs.

The approach of the book can be criticized on yet another level. The idea that there are substantial economic costs in merit regulation rests on the notion that our capital markets do improve the allocation of capital. This may be demonstrated in terms of particular economic models, but it is not the notion behind such direct and indirect governmental subsidies as the oil depletion allowance, special depreciation for low-income housing and pollution control facilities, or the ship building subsidies.

But the point of the book is a good one. The social costs of merit regulation are largely ignored, and this is well illustrated by the recent revisions of the Wisconsin and California blue sky laws discussed by Professor Mofsky. Perhaps arbitrary laws are the hardest to change because, lacking a reasonable premise, there is no basis for modification; the choice appears to be all or nothing, and the idea of the state securities commissioner as a public watchdog fending off the ruthless confidence men has popular appeal. So while one wishes that each state securities commissioner would spend the hour necessary to read this short book, one is forced to recognize that it probably would not change anything.

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