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Blue Sky Restrictions on New Business Promotions, by James S. Mofsky

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The idea that the offering of securities should be fair and equitable to public investors, which has been embodied in state securities laws for more than half a century, comes under strenuous if not coherent attack in Professor James S. Mofsky's book. His book is a collection of articles, some of which have previously been published, relating to different aspects of state blue sky regulation,[1] including public and private offerings of securities, registrations and exemptions. This is preceded by a historical background of the state blue sky laws, in which the author glowingly refers to the financial speculation which characterized the last half of the nineteenth century, and concludes that had they existed then, these laws would have jeopardized the economic development of the country.[2]

There is a clear need for a book which objectively evaluates the advantages and disadvantages of state blue sky regulation, particularly its economic effects. This book fails to meet that need because of the author's limited purpose and evident bias. As he mentions in his preface, it is only "those disadvantages" of blue sky regulations "which comprise the subject of this treatise."[3] Objectivity under this limitation is impossible.

All of the alleged sins of the state securities laws are lumped into the concept of paternalistic "merit regulation." Under this concept, according to the author, state securities administrators are required "to examine the economic risk inherent in a given issue of stock"[4] and to determine which securities are "too speculative for public investment."[5] While it has occasionally been so described by its defenders,[6] the concept of merit regulation does not appear in the language of any of the state securities laws and certainly cannot be inferred from their administration. Many of the more progressive state laws provide that securities may not be publicly offered if the administrator determines that the offering would be "unfair or inequitable" to purchasers or is being made on "unfair terms."[7] The Uniform Securities Act, which has been adopted by more

1. State securities laws are frequently referred to as blue sky laws, and the terms are used interchangeably.

2. M. JOSEPHSON, THE ROBBER BARONS (1934) contains a good discussion of the financial manipulations and swindling of the public that prevailed during this unregulated period.

3. J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 1 (1971) [hereinafter cited as MOFSKY].

4. *Id.* at 15.

5. *Id.* at 5.

6. *See, e.g.*, Hueni, *Application of Merit Requirements in State Securities Regulation*, 15 WAYNE L. REV. 1417 (1969). This contains an excellent analysis of the purpose and application of the major state registration requirements.

7. *See, e.g.*, MICH. COMP. LAWS § 451.706(a)(2)(E) (1967); MO. REV. STAT. § 409.306(a)(2)(E) (1969).

than half the states, provides that the offering may not be made if it would "tend to work a fraud upon purchasers," or if the offering would involve "unreasonable" underwriters' commissions, promoters' profits, or options.[8] These statutory tests, which have been similarly interpreted, do not authorize an administrator to deny an offering of securities merely because they are too speculative. Moreover, thousands of speculative securities issues have been registered for public offering since the inception of the state blue sky laws.

The real purpose of state securities laws is to prevent promoters, insiders and controlling persons from taking undue advantage of public investors. This purpose is inherent in the statutory language. It is also apparent from the registration policies enunciated by the state administrators pursuant to their statutory mandate; these policies impose limitations on the amount of options that may be granted to promoters and insiders, the amount of "cheap stock" that may be purchased by promoters below the public offering price and the minimum tangible investment required by promoters of a new enterprise[9] but in no way limit the kind of securities that may be offered to the public. These policies are designed to accomplish an equitable sharing between the promoters and the public in the economic risk of companies whose securities are being sold in the public market place. If securities offerings of speculative new ventures run afoul of state registration requirements more frequently than offerings of more seasoned companies, it is because their promoters and insiders too often propose that they reap most of the benefits through cheap stock and low priced options if the enterprise is successful, while the public is asked to absorb virtually all of the risk of loss.

Mofsky's book is written from the viewpoint of the promoter, as its title indicates. The keystone of his argument is the hypothetical case history of the difficulties encountered by an entrepreneur, Mr. E, with the blue sky law of his home state in attempting to finance a new business which proposes to manufacture, naturally enough, promotional products. Mr. E first attempts a limited private offering exempt from registration but is unsuccessful in persuading a group of financially sophisticated persons to contribute 98 per cent of the equity capital of the business in exchange for only 49 per cent of the stock.[10] Mr. E then attempts a

8. UNIFORM SECURITIES ACT §§ 306 (a)(2)(E), (F). *Cf.* IND. CODE §§ 23-2-1-7 (a)(2)(E), (H) (1971), IND. ANN. STAT. §§ 25-861(a)(2)(E), (H) (1970).

9. See Statements of Policy of Midwest Securities Commissioners Ass'n on Cheap Stock, Promoters' Investment and Options and Warrants, BLUE SKY L. REP. ¶¶ 4,761, 4,771, 4,796.

10. MOFSKY, *supra* note 3, at 47.

registered public offering, but finds that the rules of the Florida Securities Division permit him to retain only 27 per cent of the outstanding stock for his two per cent capital contribution to the business.[11] Mofsky argues that these blue sky restrictions, which prevent Mr. E from controlling his company even though he has invested virtually nothing in it, are bad for the economy since marginal new ventures of this kind will not proceed with their stock offerings. While the blue sky restrictions on the stock offerings which Mofsky describes certainly exist, the case history does not demonstrate that they are unreasonable, and it is difficult to develop much sympathy for Mr. E's problem.

The state securities laws unquestionably lodge a considerable amount of discretion in their respective administrators. After the constitutionality of these laws was affirmed in 1917 in the *Blue Sky Cases*[12] by a nearly unanimous Supreme Court that was not noted for sustaining progressive legislation, the manner in which this broad discretion has been exercised by the administrators has seldom been challenged. This is regrettable, since it tends to encourage arbitrary decisions based on informal unwritten rules. This is not, however, the fault of the laws or even of the administrators, but of securities issuers over the years who failed to appeal from decisions of administrators who overstepped their statutory authority. The broad, fair and equitable philosophy of the state securities laws has been criticized by those, including Mofsky, who prefer the full disclosure philosophy written into the federal securities laws.[13] But the statutory mandate of the state blue sky laws is no more arbitrary or discretionary than that in the regulation of public utilities, for example, where state public utility commissions are directed to determine "fair and reasonable rates."

Since Mofsky incorrectly concludes that the basis upon which state blue sky laws were enacted was merely to prevent fraud in the promotion of new corporate ventures,[14] it is not surprising that he calls for "meaningful reform" of these laws, based on an economic analysis of the

11. *Id.* at 50.

12. Hall v. Geiger-Jones Co., 242 U.S. 539 (1917); Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559 (1917); Merrick v. N. W. Halsey & Co., 242 U.S. 568 (1917). These cases sustained the blue sky laws of Ohio, South Dakota and Michigan.

13. MOFSKY, *supra* note 3, at 10. Section 18 of the Securities Act of 1933 states that nothing therein "shall affect the jurisdiction of the securities commission . . . of any State or Territory . . . over any security or any person." 15 U.S.C. § 77 r (1970). Congress thus decided against federal pre-emption of the state securities laws.

14. Professor Mofsky has an annoying tendency of not citing any authorities for his more controversial assertions and of using his footnotes merely to amplify his text, as in this example.

relative costs and benefits of blue sky regulation.[15] Such an analysis would surely be desirable, but Mofsky is not willing to wait for it, and summarily concludes that the "emphasis of the state regulation should be strong anti-fraud enforcement rather than merit regulation."[16] He also states that reform is unlikely to be sponsored by legislators, investment bankers, blue sky lawyers or the administrators themselves. One wonders from where he expects reform to come. He criticizes those states which "felt free to apply their personal handiwork"[17] in revising the Uniform Act for adoption in their own jurisdictions, thereby making it less uniform, without even mentioning the serious weaknesses in the Act which prompted those revisions.[18]

Mofsky also dismisses the securities law revisions, designed to reflect modern conditions in securities markets, recently completed in California and Wisconsin.[19] He argues that the resulting laws were "complex, severely regulatory, and highly discretionary,"[20] presumably because they retained the fair and equitable philosophy. Structural revision of a state securities law is far different from revision of its underlying philosophy, and Mofsky's dismay at the failure to consider the latter should not have led him to ignore the benefits achieved by the former. Before any radical change is made in the underlying philosophy of the state blue sky laws, which have stood the test of time, the burden of proof rests with the proponents of change.

Blue Sky Restrictions on New Business Promotions contains much worthwhile factual information for a person desiring to become acquainted with the state securities laws. There is a good discussion of state registration requirements and policies, including a flavor of the informality that prevails in many of the states. The private offering exemption from registration is well described, including the anachronistic limitations on this exemption in the older state laws. More than a third of the book is devoted to appendices of comparative state provisions dealing with exempt securities, exempt transactions and types of registration,[21] which

15. MOFSKY, *supra* note 3, at 86.

16. *Id.* at 75.

17. *Id.* at 73.

18. The Act's more glaring weaknesses include its failure to include a civil remedy for defrauded sellers of securities, its exclusion of corporate mergers and sales of assets from the definition of "sale" (thereby also excluding them from the anti-fraud provisions) and its exemption from registration of secondary distributions by controlling persons of issuers listed in recognized securities manuals. *Cf.* UNIFORM SECURITIES ACT §§ 401(j)(6)(C), 402(b)(2), 410(a)(2).

19. CAL. CORP. CODE § 25000 *et seq.* (West 1955); WIS. STAT. § 551.01 *et seq.* (1969).

20. MOFSKY, *supra* note 3, at 82.

21. *Id.* at 99-168.

may be useful to some, although they are well covered in the loose leaf services. It is regrettable that the worthwhile information is so intertwined with the author's imperfect analysis and questionable judgments.

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