Marquette Law Review

Volume 60
Issue 2 *Winter 1977*

Article 4

Demerit in Merit Regulation

James S. Mofsky

Robert D. Tollison

Follow this and additional works at: http://scholarship.law.marquette.edu/mulr

Part of the Law Commons

Repository Citation

James S. Mofsky and Robert D. Tollison, *Demerit in Merit Regulation*, 60 Marq. L. Rev. 367 (1977).
Available at: http://scholarship.law.marquette.edu/mulr/vol60/iss2/4

This Article is brought to you for free and open access by the Journals at Marquette Law Scholarly Commons. It has been accepted for inclusion in Marquette Law Review by an authorized administrator of Marquette Law Scholarly Commons. For more information, please contact megan.obrien@marquette.edu.

DEMERIT IN MERIT REGULATION

JAMES S. MOFSKY* and ROBERT D. TOLLISON**

Over the past fifteen or so years, the federal securities laws have been increasingly criticized on theoretical and empirical grounds as being more costly than beneficial to society.[1] For example, the full disclosure provisions of those laws turn out on empirical testing to generate more costs than benefits from a social point of view.[2] One key aspect of this analysis has come to be known as the "efficient market hypothesis." That hypothesis, not refuted in numerous statistical studies, maintains that all known information about a firm is very quickly reflected in stock prices, *well before* disclosure mandated by the securities laws occurs.[3] Accordingly, detailed disclosure of past events in a firm's life are already fully reflected in current stock prices, and knowledge of historical sequences of events is therefore of no value for investors in forming future expectations of stock prices.[4] Furthermore, it has been demonstrated that mandatory financial disclosure has not reduced the amount of fraudulent activity in the securities markets.[5] Yet the cost of generating such disclosure is indeed high.[6] The federal securi-

---

* B.A. 1956, Wesleyan University; J.D. 1959, Cornell University; LL.M. 1966, University of Miami; S.J.D. 1971, George Washington University; Professor of Law, Law and Economics Center, University of Miami School of Law.

** B.A. 1964, Wofford College; M.A. 1965, University of Alabama; Ph.D. 1969, University of Virginia; Research Professor of Economics, Law and Economics Center, University of Miami School of Law.

The authors gratefully acknowledge the comments of Professors Henry G. Manne and M. Bruce Johnson on an earlier draft of this article.

1. *See* MANNE, WALL STREET IN TRANSITION 23-103 (1974); Fama, Fisher, Jensen & Roll, *The Adjustment of Stock Prices to New Information,* 10 INT'L ECON. REV. 1 (1969); Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934,* 63 AM. ECON. REV. 132 (1973); *see also* the sources collected in J. LORIE & M. HAMILTON, THE STOCK MARKET—THEORIES AND EVIDENCE 70-97 (1973).

2. Authorities cited *supra* note 1.

3. Jensen, *The Performance of Mutual Funds in the Period 1945-64,* 23 J. FINANCE 389 (1968); Jensen, *Risk, the Pricing of Assets, and the Evaluation of Investment Portfolios,* 42 J. BUS. 167 (1969); Williamson, *Measuring Mutual Fund Performance,* FINANCIAL ANALYSTS J. 79 (Nov.-Dec. 1972).

4. J. LORIE & M. HAMILTON, *supra* note 1.

5. Benston, *Required Disclosure and The Stock Market: An Evaluation of the Securities Exchange Act of 1934,* 63 AM. ECON. REV. 132 (1973).

6. *See* discussion in J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 1971, at 31.

ties laws, from the standpoint of economic analysis, have thus created higher costs for raising capital than would exist in the absence of such regulation, and they have not generated commensurate benefits for investors either with respect to enhancing the predictability of future stock prices or in connection with reducing fraudulent conduct by corporate operatives.

It has been argued that state securities regulation, the so-called blue sky laws, has, like federal securities regulation, generated net costs for society.[7] This argument contains several lines of analysis, one of which is similar to that underlying criticism of the federal securities laws. Mandatory disclosure is required at the state level in a form similar to that required by the federal laws.[8] Thus disclosure via the blue sky laws has been criticized on grounds related to the efficient market hypothesis. Namely, the information generated by such laws is already reflected in stock prices and is of no benefit to investors. Additionally, state-mandated disclosure often creates information revealing nothing more than that which has already been processed and filed with the Securities and Exchange Commission, the federal agency. Accordingly, it may be unnecessarily duplicative and wasteful.[9]

The second line of critical comment of the state securities laws goes to the merit rules. Merit regulation is a device which attempts to lessen the investment risks for investors in newly promoted firms. Its proponents argue that, because there is no seasoned market for the securities of such firms, the securities are unduly speculative and therefore appropriate subjects for direct government regulation going well beyond mere disclosure. Merit regulation has most often taken the form of rules regulating the maximum expenses of public offerings;[10] requiring a minimum equity investment by promoters;[11] regulating the price that insiders must pay for their stock relative to the proposed price for public investors;[12] regulating securities offering prices in relation to earnings ratios;[13] regulating the amount

7. *Id.*

8. *See* Form U-1, 1 CCH BLUE SKY L. REP. ¶ 4473 (1969).

9. Mofsky, *Reform of the Florida Securities Law*, 2 FLA. ST. UNIV. L. REV. 1, 15-23 (1974).

10. *See* discussion and citations collected in Goodkind, *Blue Sky Law: Is There Merit In The Merit Requirements?*, 1976 WIS. L. REV. 79, 87-90.

11. *Id.* at 103-15.

12. *Id.* at 90-03.

13. *Id.* at 95-98.

of warrants and options granted to officers, key employees and underwriters;[14] establishing minimal shareholder voting rights;[15] and regulating interest and dividend coverage with respect to senior securities.[16]

Beyond an efficient market type of criticism, merit rules have been criticized on the grounds that seasoned firms, not subject to the rules, are in effect granted a comparative advantage in raising capital over newly promoted ventures. Newly promoted firms must either adjust the terms of their offerings and their capital structures to the merit rules of particular states or be precluded from publicly offering their securities in those states.[17] Some firm will thus always be at the margin where, for financial and legal reasons, corporate promoters are unwilling to make the adjustment, and a decision not to offer securities in a particular state will be made.[18] Of course, there are a few states that do not have merit rules, and it has been argued that a proposed offering could always be made there, thus avoiding merit regulation altogether.[19] But practical considerations, relating mainly to the local nature of many small offerings, often foreclose capital formation any place except specific areas where the firm and its promoters are well known. There probably exists little geographic choice, based solely on evaluation of local blue sky laws, of the place where capital can be raised.

We do not know how many new firms fail to come into existence because of the blue sky laws. Nor do we know the number of offerings not made in some states but made in others where the merit standards are less intolerable. That information is obviously critical in assessing the costs of state securities regulation. Unfortunately, however, regulators are more often concerned with benefits than they are with costs. In other words, they often focus on only one side of the equation, and if they find some benefits, they immediately conclude that the regulation is good. The cost side of the measurement is sometimes not even addressed as an issue. A recent study of merit

14. *Id.* at 93-95.
15. *Id.* at 98-101.
16. *Id.* at 101-03.
17. J. MOFSKY, *supra* note 6, at 41-54.
18. *Id.* at 36-37.
19. Goodkind, *supra* note 10, at 108.

regulation in Wisconsin[20] is illustrative of this phenomenon, and its findings, derived from highly questionable methodology, must therefore be dismissed as unresponsive to the question of whether merit regulation in Wisconsin has produced *net* benefits.

The Wisconsin study was based on a comparison of the performance of securities registered in Wisconsin with the performance of securities denied registration there. Three indices of performance—price, book value, and dividend distribution—were used. Based on a small sample for a highly limited period, 1968-1971, the Wisconsin study concluded that issues that were denied registration performed on average less well than issues that were granted registration.[21] For reasons that will be elaborated shortly, the testing techniques used in the study were so faulty that no such conclusion was warranted.

But it was not only methodology that flawed the Wisconsin study. It was also marred by *a priori* acceptance that blue sky regulation does not generate unintended costs for consumers and society generally. The study gathered data with respect to only one matter—whether investors who bought issues meeting Wisconsin's merit rules faired better than investors who bought issues denied registration in Wisconsin. The study nowhere acknowledges the significance of other considerations. For example, it can be argued quite persuasively that blue sky regulation has created anticompetitive effects stemming from reduction in the number of newly organized firms.[22] Some entrepreneurs gain more by selling their innovation to an existing firm or, in some instances, by simply giving up a venture rather than by complying with local securities laws. Those are not unimportant considerations, since they are intimately related to the amount of business competition that may exist in Wisconsin. And competitiveness in turn surely bears on the level of prices being paid and quality of goods and services being consumed by Wisconsin consumers. In other words, the Wisconsin study is lopsided. It deals solely with investor protection—the purported benefit side of the equation—and is silent with respect to other segments of society for whom the indirect costs of merit regulations may indeed be high. Thus while an

20. *Id.* at 79.
21. *Id.* at 111.
22. J. MOFSKY, *supra* note 6, at 37.

efficient market hypothesis would indicate no benefit in such regulations for investors, this study also fails to acknowledge and test perceivable costs to consumers, and it cannot be viewed as a cost-benefit analysis supporting the efficacy of merit regulation.

Furthermore, the components of the study's empirical test are not designed to shed any light on the issue it purports to investigate, namely investor protection, even within a range of tolerable imprecision. Only one index of performance used in the study—stock price—is relevant. The other two indices used—dividend distribution and book value—are essentially meaningless and misleading measurements in this context.

Some firms pay dividends; others pay none at all. Some firms pay substantial dividends relative to firm earnings; others do not. Some pay dividends in the form of cash; others pay in stock. The dividend behavior of a firm tells us something about management's assessment of where earnings will find their greatest utility—in the hands of shareholders or left in the coffers of the firm. It also tells us something about the tastes of investors for dividends, and how different firms in different industries cater to those different tastes. However, dividend distribution tells us nothing about the relative wealth of investors. If all other factors are held constant, the payment of a dividend will reduce the market value in a publicly traded security by the size of the dividend.[23] Thus a shareholder's wealth will not be altered by a dividend payment except to the extent a dividend may be taxable in his hands but not when left in a corporation's undistributed earnings.

Book value also reveals little valuable information about corporate and shareholder wealth. Generally accepted accounting principles contain an inherent conservative bias.[24] For example, assets must be carried at their cost or market value, whichever is less.[25] Only under unusual and very limited circumstances may appreciated assets be written up on financial statements to their fair market value.[26] Thus if a firm acquired

23. For example, on the so-called ex-dividend date, New York Stock Exchange specialists adjust stock prices downward by the amount of a dividend (rounded to the nearest 1/8 of a point).

24. G. BENSTON, CORPORATE FINANCIAL DISCLOSURE IN THE UK AND THE USA 1976, at 30.

25. *Id.*

26. *See, e.g.*, Gerstle v. Gamble-Skogmo, Inc., 478 F. 2d 1281 (2d Cir. 1973).

assets at prices sustantially under their current fair market value, the appreciated portion of their value cannot under usual circumstances be reflected on a balance sheet. For an ongoing business, the value of assets lies in the stream of earnings they produce; their value is not an inherent one reflected in accounting versions of book value. In the market, security prices are based on a present value determination of that expected flow of earnings.[27] The inherent value of assets is significant only with respect to firms where shareholder wealth is maximized by liquidation of assets rather than through continued operation of the firm. But even under such circumstances, book value does not necessarily reflect liquidation value. Used equipment sold under forced circumstances may bring considerably less than the value at which it is reflected on a firm's books. On the other hand, real estate on which the firm's plant is located may bring considerably more than the price paid for it sometime earlier.

Thus comparative performance of firms, based on dividend distribution or on book value, establishes no useful information regarding shareholder protection. Accordingly, if investor protection is to be measured by a shareholder wealth standard, the Wisconsin study inappropriately uses book value and dividend distribution as yardsticks. Price performance, which does reflect present value of future earnings, is an appropriate yardstick, but it is employed in a totally misleading way in this study. The study's data were derived from three-year periods, 1968-71, 1969-72, 1970-73. In the category of price, issues denied registration outperformed those registered after one year. However, in that same category, registered issues performed better than those denied registration after three years. The author somehow decided, without supporting rationale, that the particular three year periods were a better standard than the one year time frame, and thus concluded that investors on balance were benefited by Wisconsin's merit regulation.[28]

The study failed to recognize, however, that different investors have different time horizons. Some investors trade securities on a six-months basis; others after twelve months; and still others only after longer holding periods such as three years. Some market participants do not trade on the basis of price or

27. J. LORIE & M. HAMILTON, *supra* note 1, at 143.
28. Goodkind, *supra* note 10, at 111.

time at all, and hold securities until some external event, such as wedding expenses or medical bills, dictate their sale. While Wisconsin's merit rules may have benefited investors who held for the particular three years, those rules were harmful for someone whose time horizon was one year and for those who withdrew from the market for other reasons after only one year. Why is it better to protect three-year holders rather than one-year purchasers? We can find no rational answer to that question. However, the author of the Wisconsin study apparently takes the position that the "true value," whatever that is, of a security is more accurately determined over a longer (three-year) than a shorter (one-year) period. Even if we accepted the arbitrary standard of three years, we do not know how many times the securities in question changed hands over this period. It is possible that the set of investors who lost wealth on the securities registered in Wisconsin after one year sold those securities to a second generation of investors who gained wealth on the same issues after three years. Are the regulations thus designed to protect second and not first generation investors? Again, even if such a question is meaningful, and it should be clear that we do not think it is, the study is not much help in addressing it.

We might also note that the aggregate market value comparisons presented by the author are meaningless. He computes figures for the aggregate increase (or decrease) in market value (the number of issues times the increase in price) for the set of issues registered in Wisconsin and for the set denied registration. Unfortunately, there is a problem with this procedure. There were 137 issues in the sample of securities denied registration and 211 in the sample of those registered in Wisconsin.[29] Hence, any effect of price movements on the aggregate value of the two samples of securities is weighted by a larger number of issues for those registered in Wisconsin—a sure, but fallacious, way to find supporting (or unsupporting) evidence for the requirements!

Even if some rationale could be established for the use of three, three-year periods of comparison, one must be careful in analyzing stock prices over the 1968-73 period as an evaluative standard. Too many other exogenous forces were affecting

29. *Id.*

stock prices over this period. For example, 1968 was a particularly good year for the stock market. Securities prices appreciated considerably throughout the year. Speculative securities, so called "hot issues," did especially well during the 1968-69 period of rising prices.[30] Then in 1969, the market retreated dramatically. For example, during 1969, the Dow Jones Industrial Index lost approximately 350 points, more than one-third of its peak value.[31] That index did not recover to its 1968 high until 1972, and speculative issues did not recover until well after less speculative securities had recovered or commenced recovery.

Securities failing to meet state merit standards are generally regarded as being more speculative than those meeting such standards. Indeed, the very purpose underlying the blue sky laws is reduction of risk for purchasers of risky securities. Since speculative securities often rise faster in an active and rising market than do less risky ones, it would not be particularly surprising to find that, in terms of price, securities denied registration in Wisconsin outperformed those that were registered during some periods covered by the Wisconsin study sample. Furthermore, since more speculative securities often lose ground at a rate faster than less speculative ones and since the appreciation rate during the early stages of recovery for more speculative securities is often lower than the rate for less speculative ones, the study's price performance findings for certain three year periods should not be surprising either. Of course, the study offers no evidence for longer periods. If results showed, for example, that securities denied registration and held for, say, eight years outperformed those held for the same time but registered, about all one could conclude is that different time periods produce different results. In any event, periods should have been chosen and adjustments made to compensate adequately for spurious elements like those market factors that probably distorted, after one-and three-year periods, the performance of issues denied registrations compared to those registered. In other words, the author presents not only a badly specified but an underspecified model.

An equally serious deficiency in methodology resulted from

30. Sowards & Mofsky, *The "Hot Issue": Possible Hidden Causes*, 45 ST. JOHN'S L. REV. 802 (1971).

31. MOODY'S HANDBOOK OF COMMON STOCKS 27a (Spring ed. 1976).

the two groups of securities being compared. A control sample of debt and equity securities registered was compared to all securities denied registration during the applicable time period. Assuming securities not meeting merit standards are inherently more speculative than those that do, the very structure of the study forced a comparison of groups having vastly different degrees of risk. We are not told the specific identity of those securities included in the control sample of registered issues. Some securities, because of the particular industry in which their issuers are engaged as well as for other reasons, are significantly less speculative than other securities. In the Wisconsin study, the degree of risk associated with the control sample of registered securities could have been, and probably was, so much less than that attached to the group denied registration that a comparison of performance would be meaningless unless adjusted for that differential. Along those same lines, promotional firms are often expected to lose money or, at least, generate only modest earnings in their early years, while seasoned firms are not affected by such start-up costs. Accordingly, a comparison of promotional firms—those denied registration—with seasoned firms—those granted registration—for only three years cannot be expected to produce useful information about the efficacy of merit regulation. In addition, investors typically exhibit a wide array of risk-return preferences, and hence investors in Wisconsin who preferred relatively more risky investments were discriminated against by the regulations.

The study attempts to break down offerings according to specific merit rules and to compare performance of firms denied registration for failure to meet specific merit standards with firms denied registration for failure to meet other merit standards.[32] Additionally, the study compares performance of firms denied registration for failure to meet specific merit standards with performance of registered issues.[33] This procedure, of course, is objectionable on all the preceding grounds. Moreover, it is also not an adequate test of the independent effect of different merit requirements. A firm failing to comply with one merit rule often violates other merit standards. This effect is due to the intrinsic interrelationship of several of the merit

32. Goodkind, *supra* note 10, at 110.
33. *Id.*

rules themselves as well as to the relationship among capital structure adjustments, percentage promoters' participation, promoters' contributions, and stock prices.[34] Accordingly, the study's attempt to segregate performance based on violation of specific merit standards is misleading. It offers an objectified analysis attempting to illustrate the independent consequences of a specific rule, when the adjustments giving rise to compliance with or violation of the rule are not independent of factors bearing directly on other merit rules.

Many businesses avoid registration in specific states because they are advised in advance of possible denial. Probability of denial discourages registration in some states, not only because of the direct costs involved, but also because of the unfavorable stigma associated with merit rule violation. Therefore, no attempt is made to register some issues in particular states. While the Wisconsin study recognizes this problem,[35] its results are not adjusted for it. Of course, it may not be possible to adjust for those results. But there is no more reason to believe that such consequences result in net benefits to consumers or investors than they do in net costs. Indeed it is more likely that they cause net costs since they are bound to produce anticompetitive effects stemming from the organization of fewer firms.

The Wisconsin study is so methodologically flawed that it yields no useful information on the very interesting problem it posed. We have tried to illustrate how the model employed in the study was badly specified. At one level, there were no reasons, *a priori*, to believe that the model specified would yield useful information on the costs and benefits of these regulations. At another level, for the samples chosen and the time period analyzed, no account is given by the model for other forces that could have influenced the results. We suspect that financial markets work in such a way as to make the net benefit of state securities regulation nonexistent or negative. At this point we do not have empirical evidence in hand to support this suspicion. It should also be clear by now that we do not view the evidence in the Wisconsin study as supporting the efficacy of such regulation. A more useful approach would be a model where share price was a function of various independent factors

34. These interrelationships are illustrated in J. MOFSKY, *supra* note 6, at 41-57.
35. Goodkind, *supra* note 10, at 109.

(basically those affecting the demand for and supply of shares, such as the expected present value of the firm), including the independent effect of origin of registration by state. One would then determine whether differences in state registration requirements exert an independent effect on share prices and hence on investor welfare. A finding, for example, that, other things being equal, share prices are independent of the origin of their registration would be powerful evidence of the futility of these regulations.

To end a rather critical commentary on a more optimistic note, we would stress that, though we find the Wisconsin study disconcerting in its use of economic methodology, it does underscore the need for a careful analysis of the costs and benefits of state securities regulation. Such analysis is certainly in the mainstream of law and economics and brings together the best skills of both disciplines on a policy question of current interest. More often than not, the application of the law-and-economics approach has shown that generally accepted institutions often generate more costs than benefits. As we said, however, this has yet to be done for the blue sky laws. However, we now have on the drawing board a project, based on the model alluded to above, that should provide some useful information on this score.

Subsequent to submission of this article for publication, an important new study of merit regulation has come to our attention.[36] For the states of South Carolina and North Carolina, a sample of securities denied registration was compared with one that was registered. The study sought to determine whether securities in the sample denied registration generated returns over different time periods that were different than returns for the sample of registered securities. Computations of returns on investment were made for holding periods of one, two and three years, and the study found, for those periods, that there were no statistical differences in rate of return for the two samples.

It is interesting to note that statistical differences *were* found with respect to the financial information contained in balance sheets and income statements for the two samples. It was based upon those differences contained in financial state-

36. R. Clifton Poole, Blue Sky Laws and the Registration of New Issues of Common Stock: An Empirical Study (an unpublished manuscript 1976).

ments that securities commissioners applied the merit rules to deny or permit registration. Since the financial statements of newly promoted firms often tend to exhibit greater financial risks than do the financial statements for more seasoned companies, it should come as no surprise that the securities commissioners denied registration to the firms that were apparently (based on the financial statements) more speculative. However, when those securities came to market in states other than South Carolina and North Carolina, differences in performance did not occur and, on balance, returns on securities denied registration were as high as those for securities registered. This finding is perfectly consistent with the efficient market hypothesis, a corrolary of which is that one cannot predict future stock prices from past financial information.