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Article

Origin of the Blue Sky Laws

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I. Introduction

For more than a generation—between 1911 and 1933—securities sales in the United States were regulated nearly exclusively by specialized state statutes known colloquially as “blue sky” laws.¹ Only with the Securities Act of 1933,² adopted by Congress at a time of national economic collapse, did federal regulation begin to any significant extent. And even then federal law was little more than a pastiche of prior experiments in blue sky regulation.³ Because the Securities Act of 1933 expressly preserved the jurisdiction of state securities commissions,⁴ blue sky regulation remained—and remains today—a significant part of securities law practice.⁵

The origin of the blue sky laws is thus a matter of some historical interest. There is, moreover, a normative element to the analysis. Proponents of mandatory federal disclosure rules cite the adoption and enforcement of blue sky laws prior to 1933 as evidence that securities fraud was a major social problem in unregulated markets.⁶ The argument for mandatory disclosure rules would thus be weakened if it were shown that securities fraud was not, in fact, a pervasive problem prior to the advent of specialized securities regulation.

The standard view among historians is that the blue sky laws represented a response by the political system to serious abuses in securities markets.⁷ To combat these abuses, many states adopted

1. For discussion of the origin of the term “blue sky” laws, see *infra* note 59. There was some federal regulation of securities sales during this period under the postal fraud laws, but the level of enforcement was minimal. See Forrest B. Ashby, *Federal Regulation of Securities Sales*, 22 *ILL. L. REV.* 635 (1928) (analyzing defects in the enforcement of postal fraud laws in the securities context, and discussing proposals for a federal blue sky law to remedy the situation).

2. 15 U.S.C. §§ 77a-77aa (1988).

3. See generally JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 39-72 (1982).

4. See 15 U.S.C. § 77r (1988).

5. See 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 51-60 (3d ed. 1989). See generally 1 *id.* at 29-152 (analyzing the history of state blue sky laws and concluding that, since Congress did not eliminate them when it enacted the Securities Act of 1933, it is even less likely to do so now, after over fifty years of dual regulation).

6. See, e.g., Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 *J. CORP. L.* 1, 18-33 (1983).

7. See VINCENT P. CAROSSO, *INVESTMENT BANKING IN AMERICA—A HISTORY* 162-63 (Ralph W. Hidy ed., 1970) (“Suffering heavy losses, the victims of these [securities] frauds and misrepresentations

legislation requiring that securities proposed to be sold in a state be submitted to an administrative agency for review as to their "merit" or intrinsic worth.⁸ Other states adopted less stringent regulations requiring disclosure of information about the issuer and registration of dealers, but not including merit regulation.⁹

According to the standard account, this legislation, although unartfully drafted, reflected a more or less spontaneous response by public-minded legislators to a serious social problem. The early state blue sky laws are viewed, under the standard account, as flawed but well-intentioned precursors to the beneficial system of federal regulation adopted by Congress in the Securities Act of 1933 and the Securities Exchange Act of 1934.¹⁰ Despite the nearly universal acceptance of the standard account of blue sky legislation, however, it is also generally acknowledged that the early history of the blue sky laws has never been studied in depth.¹¹

agitated for protection, then joined with other dissatisfied midwesterners to elect reform administrations that promised them relief from such abuses."); LOUIS LOSS & EDWARD M. COWETT, *BLUE SKY LAW* 7-8 (1958) (asserting that blue sky laws grew out of an awareness of "the many instances in which unsophisticated . . . investors had been bilked of their life savings by sellers of worthless or fraudulent securities"); SELIGMAN, *supra* note 3, at 44-45 (describing Kansas's statute, the first blue sky law, as a response to "the failure of lax state corporation statutes to prevent securities fraud"); Seligman, *supra* note 6, at 18-33 (citing pre-1934 state blue sky laws as evidence of the fact that securities fraud was considered a serious and widespread problem before enactment of the federal securities acts); Jacob M. Edelman, *Securities Regulation in the 48 States (July 1942)* (manuscript published by The Council of State Governments) (citing Justice McKenna's opinion in *Hall v. Geiger-Jones*, 242 U.S. 539 (1917), as a typical justification of state securities legislation as a means of protecting the public from the "evil" of speculative and fraudulent schemes).

Michael Parrish suggests that the blue sky laws sometimes reflected the political influence of local businessmen and securities dealers. Parrish does not develop this thesis in detail, however, and completely misses the principal interest groups supporting the blue sky laws—smaller banks and state bank regulators. See MICHAEL E. PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 1-13 (1970). Moreover, we find no evidence to support Parrish's suggestion that local securities firms supported blue sky laws to prevent competition from out-of-state dealers—most states enacting blue sky legislation did not have a developed securities brokerage industry. See *infra* text accompanying note 221. And, in any event, the blue sky laws were harmful to the interests of local dealers to the extent that the laws excluded potentially profitable securities from sale within the state, leaving mail and telephone solicitation from out-of-state locations as the only means by which such securities could be distributed. See Robert R. Reed, "Blue Sky" Laws, 88 *ANNALS AM. ACAD. POL. & SOC. SCI.* 177, 183 (1920).

8. See JAMES S. MOFSKY, *BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS* 10, 15 (1971) (characterizing the merit regulation contained in the earliest blue sky laws as an emotional reaction to perceived abuses and noting that the test applied under most merit regulation schemes has evolved from "fair, just and equitable" to one of "reasonableness").

9. See *id.* at 11-12 (noting that the general rejection of merit regulation by the commercial Eastern states was based on a fear of inhibiting the formation of "new and risky businesses").

10. See, e.g., Seligman, *supra* note 6, at 18 (using the standard account of blue sky laws as evidence that the federal securities acts were not merely "a response to financial folklore" or imagined fraud).

11. See *id.* at 20 (noting the lack of a comprehensive study of this period); LOSS & SELIGMAN, *supra* note 5, at 199 ("No comprehensive study of blue sky enforcement between 1911 and 1933 has been produced."); see also Edelman, *supra* note 7, at 21 (admitting the difficulty of finding statistical

Thus, the view of blue sky legislation presented in the standard account, despite its widespread popularity, has never been fully substantiated.

Was there in fact a serious problem with securities fraud in unregulated markets? If there was such a problem, did the blue sky laws represent a spontaneous, public-regarding response by the political system to protect investors against fraudulent securities sales? Were there any vested interests behind the blue sky laws whose goal might have been 'something other than protecting the public against fraud? Could the blue sky laws have reflected a mixture of special interest pressures and public sentiment?

This study attempts to answer some of these questions with a detailed investigation into the formative period of the blue sky laws—between 1911 and 1917. We find a history much more complicated than the standard accounts would admit. While frequent complaints about "fraudulent" securities sales persisted in the first decade of the twentieth century, it appears that many of the securities offerings objected to were not so much fraudulent as merely highly speculative. The rhetoric of the times did not distinguish between a security sold through actual fraud and one so highly speculative as to be of questionable value. Similarly, the fact that large amounts of securities were rejected by state officials acting under the authority of the early blue sky laws is not a reliable indicator of the presence of fraud—both because the officials often enjoyed the power to reject issues solely because they viewed them as bad investments, even if no fraud was involved, and because the officials often had reasons other than the quality of the security in question for preventing its sale within their states. Thus, although fraudulent securities undoubtedly occurred during the early decades of the century, the standard account that securities fraud was rampant before the advent of blue sky regulation is not proven.

The brief spate of blue sky legislation which occurred between 1911 and 1913, moreover, appears due at least as much to chance and to general economic conditions as to the prevalence of, and public revulsion against, fraudulent securities sales. The chance element was the unforeseeable presence of a brilliant and energetic regulatory entrepreneur, J.N. Dolley, who as Kansas Banking Commissioner conceived the idea of blue sky legislation and promoted it tirelessly within Kansas and across the nation. Economic conditions—a sustained period of inflation and high nominal interest rates—threatened the ability of small banks and savings institutions to attract or retain consumer deposits in competition with higher yielding securities and restricted the supply of credit to local borrowers. This threat gave both small banks and local borrowers an interest in suppressing the activities of out-of-state securities firms. As one of us has noted in prior

evidence to support his allegation that state staff and funds were inadequate to fully enforce state blue sky laws).

work, interest group activity generally appears to be greater at times when the interest group is suffering an economic downturn, or the threat of a downturn, than when it is enjoying prosperity.¹² This appears to have held true in the securities context as well.

Further, our research reveals that while many proponents of the blue sky laws were attempting to advance the public interest as they perceived it, the statutes themselves were invented, and thereafter promoted in the legislative process, by defined vested interests, including the owners of smaller banks and savings institutions who saw blue sky legislation as a means for suppressing competition for depositors' funds.¹³ State banking regulators, interested in protecting and expanding their regulatory turf and in advancing the financial interests of banks under their supervision, assisted the small bankers.¹⁴ Other special interests supporting the blue sky statutes were farmers and small business owners who saw the suppression of securities sales as a useful means for increasing their own access to bank credit.¹⁵

The principal group opposing blue sky legislation was the nation's elite investment bankers. These bankers had no objection to suppressing speculative securities, which represented as much of a threat to their interests as to small banks and local borrowers. But the investment bankers perceived that the actual purpose and effect of blue sky legislation was not limited to "fly-by-night" operators; these statutes were used to restrict the activities of reputable investment firms as well.¹⁶ Joining the investment bankers in active opposition to the blue sky laws were large issuers of securities—which wanted to preserve their ready access to low-cost financing in the public securities markets—such as railroads, public utilities, and major manufacturing firms.¹⁷ The nation's bigger banks were also generally opposed to blue sky legislation, although, with the exception of banks also engaged in securities underwriting, they do not appear to have engaged in active lobbying on the proposals.¹⁸

12. See Geoffrey P. Miller, *Public Choice at the Dawn of the Special Interest State: The Story of Butter and Margarine*, 77 CAL. L. REV. 83, 87 (1989) (stating that "political activity increased in times of adverse economic conditions," and citing as an example the dairy lobby's more intensive efforts when butter prices were low and less intensive efforts when butter prices were high).

13. See *infra* notes 106-19 (discussing the efforts and enthusiasm of non-"money center" financial institutions and state banking regulators in support of blue sky legislation).

14. See *id.*

15. See *infra* notes 120-27 and accompanying text (discussing support for blue sky legislation from farmers and businesses reliant upon bank credit).

16. See *infra* notes 140-49 and accompanying text (discussing the efforts of investment bankers to distinguish themselves from less reputable competitors while simultaneously fighting Kansas-style blue sky legislation).

17. See *infra* notes 150-55 and accompanying text (describing opposition to blue sky laws among bond issuers).

18. See *infra* notes 176-79 and accompanying text (recounting big bank opposition to blue sky

The diffusion pattern of the blue sky laws among the states documents the influence of these different interest groups. By and large, the early, stringent blue sky statutes were adopted in agricultural states without a significant presence of large banks, investment houses, or major manufacturing firms.¹⁹ States with important securities houses or significant manufacturing interests, as well as states competing to attract corporations to charter within their borders, did not adopt stringent blue sky laws.²⁰

The timing of the blue sky movement also reflects the influence of interest group pressures. The movement to adopt these laws began during a period of relative economic hardship for smaller banks and their borrowers, died down when the securities business fell into disarray in 1914, and remained quiet after the onset of a boom market in 1915 in which all parts of the economy prospered. This evidence tends to substantiate the hypothesis that interest groups are much more likely to seek the help of government in suppressing competition from rival groups when the group seeking protection is suffering hardship than when it is enjoying prosperity.

The blue sky laws, in short, appear to have been formed and adopted through a process of interest group rivalry not significantly different from the process observed in many other legislative contexts. This is not to say that the blue sky laws were solely the product of special interest lobbying, but the evidence does indicate that vested interests played an important role in the adoption of this legislation. The standard histories' picture of the blue sky laws as a spontaneous outburst of public-regarding sentiment, although it captures part of the picture, is thus in need of substantial revision.

II. Speculative Securities Sales in the Early Years of the Twentieth Century

The federal regulation of securities issuance in the United States traces back to the growth of industrial capitalism during the last years of the nineteenth century. A number of factors coalesced to create active public securities markets during this time.²¹ The growth of large industries such

laws).

19. See *infra* notes 180-91 and accompanying text (chronicling the passage of blue sky laws in Kansas and other predominantly agricultural states in 1911, 1912, and 1913).

20. See *infra* notes 194, 202-05 and accompanying text (discussing the opposition to blue sky legislation in states which were active in the corporate chartering market); *infra* notes 195, 197-98 and accompanying text (describing the fate of blue sky proposals in several manufacturing states); *infra* notes 215-20 and accompanying text (detailing the legislative responses in Massachusetts and New York).

21. The discussion that follows applies the "PTML" methodology which we have developed and applied in prior work. This methodology looks at economic history as driven by the dynamic interplay

as railroads and heavy manufacturing stimulated unprecedented demands for capital. At the same time, increases in wealth among the middle classes²² created a new source of capital that could be tapped effectively by means of public securities issuance. Developments in transportation and communication technology made widespread promotion and distribution of securities practicable. Realizing the potential purchasing power of the rising middle class, bond issuers began to offer securities in denominations of \$100 instead of the traditional denominations of \$1,000 or even \$10,000.²³ A surge of new investment followed.²⁴

Most securities sold to investors during this period were reputable and safe—the classic examples being railroad and municipal bonds. Interest rates on these securities were low, however. For the investor with a taste for risk, plenty of speculative issues were available in the market. While today's speculative issues are often in high technology fields such as biological engineering, the speculative securities in the early 1900s were typically equity securities issued by mining and petroleum companies, land development schemes (such as irrigation and tract housing projects), and patent development promotions.

Speculative securities were distributed outside the usual channels for blue chip issues. The elite investment banks would not touch them, and they were not listed on the New York or Curb Exchanges,²⁵ although in the case of mining and oil securities, they often would be listed for trading on the San Francisco, Spokane, or Los Angeles Stock Exchanges. Lacking traditional distribution channels, these securities were marketed by face-to-

and reciprocal interactions of four great systems—politics, markets, technology, and law. See David G. Litt et al., *Politics, Bureaucracies, and Financial Markets: Bank Entry into Commercial Paper Underwriting in the United States and Japan*, 139 U. PA. L. REV. 369, 373-75 (1990) (applying the PTML methodology to bank entry into the commercial paper market in Japan and the United States in order to discover the similarities and dissimilarities between the two economies); Miller, *supra* note 12, at 129-31 (applying the PTML methodology to the dairy industry's early campaign against margarine); Geoffrey P. Miller, *The True Story of Carolene Products*, 1987 SUP. CT. REV. 397, 400-15 (discussing *Carolene Products* in light of the PTML methodology).

22. National savings quadrupled between 1897 and 1913, growing from \$790 million to \$3.69 billion per annum. R.C. MICHIE, *THE LONDON AND NEW YORK STOCK EXCHANGES 1850-1914*, at 224 (1987).

23. See *Baby Bonds*, 77 AM. BANKER 3799, 3799 (1912) (praising the issuance of "baby bonds" for increasing the amount of capital available for development and for enabling the less wealthy to "share in the benefits of current commercial and industrial activity").

24. See *id.* (noting that while the individual amounts invested by "holders of small capital" is small, "the aggregate of their total investments [represent] an immense total"). Even women were identified as potential bond buyers. One leading investment house published a flier especially for women, entitled "A Financial Courtship," designed to help women distinguish between "unsound and speculative propositions" and "investments for safety and income." *Investments for Women*, 77 AM. BANKER 3095, 3096 (1912).

25. The "Curb" Exchange, precursor to today's American Stock Exchange, dealt in securities that were not sufficiently established to warrant listing on the New York Stock Exchange. See SELIGMAN, *supra* note 3, at 47.

face solicitation, newspaper advertisements, and mass mailings. One banking journal described the typical mail promotion as follows:

For some time this office has been pestered with the periodical visitation of the large envelope bearing the usual assortment of yellow dodgers, "confidential" order blanks, donation pool subscription blanks, [and] return envelopes, together with a carefully dictated personal typewritten letter, one-third of which is devoted to an extravagant flattery of the intelligence of the recipient, and the remaining two-thirds to the extolling of the excellent merits of the Gold Hammer Mines and Tunnel Company, from the investment standpoint; after which this most valuable stock is offered at the amazingly low price of seven and one-half cents a share.²⁶

Sales of speculative securities surged in the period from 1910 to 1911. The relatively high inflation prevailing during this period²⁷ spurred investors to seek high-yielding investments such as bonds of smaller railroads, public utilities, and industrial firms. These investments, while still relatively safe, paid as much as 6 percent as compared with blue chip bonds at 4 to 4½ percent.²⁸ Equity securities offered even greater potential yields—albeit coupled with greater risk—while hedging against inflation.²⁹ Meanwhile a strong agricultural economy from 1910 to 1912³⁰ placed disposable income in the hands of the American farmer, who sometimes invested in securities that were as alluring as they were ultimately unwise.³¹

26. *Banking and Mining Shares*, 76 AM. BANKER 1336, 1336 (1911).

27. The banking journals contain frequent comments about the high rate of inflation. See, e.g., John C. Shirley, *Banking as a Public Trust*, 82 BANKERS MAG. 461, 461 (1911) (noting that inflation was the sole cause of high prices and a significant cause of speculation); Frederick Carles et al., *The Demand for a Larger Income from Investments*, 85 BANKERS MAG. 264, 265 (1912) (noting the prevalence of commentary on the inflated cost of living).

28. Carles et al., *supra* note 27, at 265. Customers also became increasingly willing to purchase unlisted securities with the hope of obtaining higher returns. See *Listed and Unlisted*, 85 BANKERS MAG. 262 (1912) (commenting on the rising demand for unlisted securities).

29. See I. FISHER ET AL., HOW TO INVEST WHEN PRICES ARE RISING 144 (1912) (noting that in times of rising prices the "most desirable form of investment is one which gives the investor a share in the ownership of a property or enterprise; i.e., stocks, real estate or bonds carrying a stock bonus"); Carles et al., *supra* note 27, at 265 (discussing investment in higher yielding securities as a buffer to inflation).

30. See Charles M. Harger, *Driving Out the Investment Sharks*, 84 BANKERS MAG. 674, 677 (1912) (discussing the rising profits of American farmers); William A. Law, *Address of the President*, 76 AM. BANKER 1942, 1943 (1911) ("The last year has been marked by prosperity among farming interests . . .").

31. Many farmers apparently speculated in dubious securities during this period. As one commentator phrased it,

despite the proverbial acumen of the farmer in money matters, a great harvest has been gathered . . . [A]nd sums running into hundreds of thousands of dollars are cited by the

The dramatic emergence of financial advertising during the first decades of the century also facilitated securities speculation. Promoters of speculative securities painted their wares in exciting, vibrant tones, stimulating the imaginations of wishful investors with tales of earth-shaking inventions, new projects, and vast wealth.³² Securities sellers were also among the first to exploit the device of the mailing list—denigrated by bankers as a “sucker list.”³³ For fifty cents each they purchased names of persons who had bought speculative securities in the past and were therefore considered likely prospects for new promotions.³⁴ All this contrasted vividly with the marketing philosophy of banks and elite securities firms, which disdained all except the drabest and most unimaginative advertising.³⁵

The public's growing appetite for speculative securities sparked intense public concern about fraudulent promotions. Speculative securities were typically “hyped” by sales puffery that bordered on misrepresentation—and undoubtedly sometimes crossed the line.³⁶ Issues of speculative securities, moreover, were sometimes “watered”³⁷ by sales to promoters and other insiders on terms more favorable than those offered to the public.³⁸ The

bankers as representing the amount wasted by those who toiled through long years to earn a little surplus for a rainy day. Mortgaged farms even have been a part of the wreckage.

Harger, *supra* note 30, at 677.

32. See Euphemia Holden, *The Delusion of Sudden Riches: Its Phenomena and Its Cure*, 83 BANKERS MAG. 186, 188-89 (1911) (describing speculative offerings' appeal to the imagination of prospective investors).

33. H.B. Matthews, *The “Sucker List,”* 86 BANKERS MAG. 174, 174 (1913).

34. *Id.*

35. Cf. Fred W. Ellsworth, *Building a Bank's Business*, 88 BANKERS MAG. 558, 558 (1914) (“It was only relatively a few years ago when practically all bankers honestly believed that it was unethical to advertise. It was considered the height of treason to the established traditions of the business for a banker to express or display in any way whatsoever a desire for business.”).

36. For an example, see *Banking and Mining Shares*, *supra* note 26, at 1337 (describing a misrepresentation by a “private banker and broker who, counting upon the influence of the established reputation and prestige of the honest and reliable banker, seeks to peddle his questionable wares among the unsuspecting public”).

37. The metaphor was probably from the dairy industry, where farmers could increase their profits by adding a little water to the milk.

38. See generally DAVID L. DODD, STOCK WATERING (1930) (discussing the law of stock watering and the principles of judicial valuation of stock). The classic stock watering scheme is illustrated by the famous *Old Dominion* cases. *Old Dominion Copper Mining & Smelting Co. v. Lewisohn*, 210 U.S. 206 (1908); *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, 89 N.E. 193 (Mass. 1909), *aff'd*, 225 U.S. 111 (1912). Two promoters, Bigelow and Lewisohn, purchased certain mining properties for \$1,000,000 in an arm's length transaction. *Bigelow*, 89 N.E. at 197. They subsequently organized a corporation, *Old Dominion*, and sold it the properties at \$25/share in exchange for 130,000 shares of the corporation's stock. *Lewisohn*, 210 U.S. at 210. The properties were then held on the company's books at \$3,250,000. *Bigelow*, 94 N.E. at 197. Bigelow and Lewisohn paid over 80,000 of their 130,000 shares to a syndicate of investors who had advanced to the promoters the \$1 million in funds needed to buy the mining properties. *Id.* The members of the syndicate thus realized a paper profit of \$1 million, since they received shares with par value of \$2 million in exchange for their investment of \$1 million. This left Bigelow and Lewisohn holding 50,000 shares, or \$1,250,000 in

United States Post Office, acting under the authority of federal postal fraud laws, fuelled public sentiment in favor of stricter regulation by announcing frightening—although probably inflated—statistics about the losses to the public from fraudulent promotions, including an unspecified amount of securities promotions.³⁹ All this was reinforced by existing popular resentment against banks, securities firms, and big business generally—a prominent feature of progressive politics in the early decades of the twentieth century.⁴⁰

paper profits, as recompense for their efforts organizing the corporation. *Id.* at 198. Bigelow and Lewisohn then issued and sold an additional 20,000 authorized shares to the public, presumably at par. *Id.* at 197. And, although the cases do not say so, it is evident that Bigelow, Lewisohn, and the members of the syndicate were also busily selling their own stock in the company to the public at the same time. The result of the scam was that the public was duped into buying stock at more than three times the actual value as measured in a nearly contemporaneous arm's length transaction.

One might ask why the investing public was so easily duped. The answer is at least three fold. First, these events occurred during the early days of large-scale securities flotation in the United States. There was not then, as there is now, a well-established group of investment banks and professional securities analysts with expertise in appraising the value of new securities offerings. Thus the public did not have easy access to publicity about the offer which might have warned them off. Second, a responsible investor might well have asked to see the corporation's books before investing. But the books themselves would not have disclosed the scam; the mining properties were held on the books at \$3,250,000, which supported the par value of the stock. Third, Bigelow and Lewisohn cleverly chose *mining* properties as the subject of their machinations. Characteristically, a mine's value is hidden in the ground, and thus is not readily observable to investors. Accelerating operations can generate the appearance of large profits in the early years. Bigelow and Lewisohn undoubtedly used the funds received in the corporate treasury as a result of the public stock subscription to step up production and create the appearance of hefty profits while they and the syndicate were selling their stock to the public. Significantly, the wrongdoing did not come to light until seven years after they organized the corporation. DETLEV F. VAGTS, *BASIC CORPORATION LAW* 53 (3d ed. 1989).

Stock watering proved quite resistant to legal regulation in the early decades of the century. The corporate law rules against self-dealing transactions were not well adapted to controlling stock watering schemes because the corporation, under the control of the promoters, typically consented to the stock sales to the insiders. *See Lewisohn*, 210 U.S. at 206 (holding that a corporation cannot disregard its previous assent to a stock watering scheme). The "par value" rules of state corporation statutes provided a theoretical remedy against corporate insiders shown to have paid less than par value for stock. However, these rules failed on several levels: they were enforceable only by creditors after insolvency, suffered from enormous valuation problems, impaired the marketability of stock, deterred valuable entrepreneurial activity in the formation of new corporations, and were eventually vitiated by "low par" and "no par" stock. *See See v. Heppenheimer*, 61 A. 843, 846-49 (N.J. Ch. 1905) (demonstrating the particular difficulty in valuing property exchanged for stock); WILLIAM Z. RIPLEY, *MAIN STREET AND WALL STREET* 47-49 (1929) (describing the difficulties caused by "par value" and the use of "no par" stock as a more attractive alternative). It would have been possible for chartering states to regulate securities issuance by their domiciliary corporations, but vigorous competition in the market for corporate charters made this regulatory approach impracticable as well. *See, e.g.*, REPORT OF THE COMMISSIONER OF CORPORATIONS, H.R. DOC. NO. 165, 58th Cong., 3d Sess. 40 (1904) (noting the tendency of state legislation "toward the lowest level of lax regulation and of extreme favor toward [speculative promoters]").

39. *See Talks on Thrift*, 86 BANKERS MAG. 180, 180 (1913) (reporting the Post Office's estimate that \$100 million was lost each year due to fraudulent mail promotions).

40. The Report of the Commissioner of Corporations, published in 1904 and heavily laced with progressive rhetoric, lambasted the existing system of state corporate regulation as lacking in uniformity and tending towards extreme regulatory laxity, and recommended federal licensing of corporations.

Concerns about speculative securities sales were especially pronounced among banks—organizations which in other respects had little in common with the populist resentment toward Wall Street and financial institutions. As early as 1910 the matter had drawn the attention of the president of the American Bankers' Association, Lewis B. Pierson, whose keynote address to the annual convention that year railed against "get rich quick" schemes, most of which, he said, were nothing more than "impudent and bare-faced swindles."⁴¹ "It is a daily experience at the banks," warned Pierson, "particularly at the savings banks, to have money withdrawn to pay for 'investments' of this character or to meet losses sustained through them."⁴²

Pierson's theme reappeared frequently in the banking trade journals between 1910 and 1913. Fast-talking securities promoters, said a *Bankers Magazine* editorial in 1911, were "rogues" who feathered their "gaudy nest[s]" with investors' savings (presumably withdrawn from bank accounts) while attempting to clothe themselves with the bank's reputation for probity by listing a well-known bank as their depository agents.⁴³ Equally colorful, a speaker at an Indiana bankers meeting disclaimed that "[t]hese high-toned grafters offering bastard securities have seized the spirit of the times and feed upon it like sea gulls on the carcass of a disabled fish."⁴⁴ The attempt by securities promoters to cast themselves as "private bankers," in the view of *American Banker*, did not "reflect creditably on the general prestige of the profession."⁴⁵ Another editorial observed that "probably the Louisiana Lottery was a conservative business enterprise compared with many of the schemes now appealing to the gullible under the guise of 'investments.'"⁴⁶

See REPORT OF THE COMMISSIONER OF CORPORATIONS, *supra* note 38, at 39-40, 45-46 (noting that a federal licensing system would "reform the present condition of corporate business in all its important features"). Resentment against "Wall Street" and centralized financial power of any sort increased after the Panic of 1907, which was widely attributed to questionable securities speculation. Even the Taft Administration, no enemy of big business, recommended voluntary federal incorporation for industrial firms in 1910 and took on the big investment houses with major antitrust litigation. See 45 CONG. REC. 378-83 (1910) (statement of President William H. Taft); RON CHERNOW, THE HOUSE OF MORGAN 148 (1990) (describing suits filed by the Taft Administration against International Harvester and U.S. Steel, trusts dominated by Morgan). By 1912, Charles A. Lindbergh, Sr. was denouncing the Wall Street "Money Trust," and the House Banking and Currency Committee's Pujo Hearings were attempting to demonstrate the existence of an antitrust conspiracy among the big investment houses. See CHERNOW, *supra*, at 149-56.

41. "Get Rich Quick" Schemes, 81 BANKERS MAG. 609, 613 (1910) (quoting Lewis B. Pierson, Annual Address of the American Bankers' Association).

42. *Id.*

43. See *Using Banks as Decoys for Promotion Schemes*, 83 BANKERS MAG. 301, 301 (1911).

44. Dick Miller, *Blue Sky Law*, 77 AM. BANKER 3769, 3770 (1912).

45. *Banking and Mining Shares*, *supra* note 26, at 1337.

46. *Get-Rich-Quick Advertising*, 82 BANKERS MAG. 564, 564 (1911).

One thoughtful article from 1911 analyzed the “astonishing phenomenon” among the “plain working-people” who had suddenly changed from “practising for years the most stringent economy and careful saving to taking risks that involve their entire future welfare.”⁴⁷ These individuals, said the writer, “may previously even have been suspicious of the advice of individuals whose integrity they knew well”—an implicit reference to the local banker—“yet they will listen to a stranger who offers them something that is, without doubt, plausibly presented but which violates all their previous prejudices and should be judged and condemned by their common sense.”⁴⁸ Presumably the common working person was susceptible to these promotions both because of greed—“their spoken and written prospectuses . . . emphasize the great profits to be made within a few years without effort and for only a small investment”⁴⁹—and overstimulated imagination—“[t]o a man who has lived all his life in a little town where nothing ever happened but the ‘up’ train in the morning and the ‘down’ train at night,”⁵⁰ the “wonderful inventions”⁵¹ and “great activit[ies]”⁵² touted in the promoters’ “glittering manifestoes”⁵³ was irresistible.

Bankers were also stunned and threatened by the power of the uninhibited marketing techniques used by securities promoters. An editorial in *Bankers Magazine*, displaying perhaps a smidgeon of publisher’s self-interest, warned that the promoters of “get-rich-quick” schemes were “successful[ly] bidd[ing] for the people’s money” by the use of effective advertising and suggested that false ideas of decorum should not deter banks from “talk[ing] face to face with those whose money [promoters were] expected to get.”⁵⁴ Also expressing interest in helping the banks develop effective promotional practices of their own was a group of advertising men formed in 1913, the Bank Publicity Association of New York, which stated one of its goals to be “the elimination of fraudulent and

47. Holden, *supra* note 32, at 188.

48. *Id.*

49. *Id.*

50. *Id.* at 189.

51. *Id.*

52. *Id.* at 188.

53. *Id.* at 191.

54. *Weeding Out the “Get-Rich-Quick!” Concerns*, 82 BANKERS MAG. 162, 162 (1911). The reference was to an unwritten rule of bankers’ ethics which prohibited advertising. See *supra* note 35. Bankers were quick to accept the invitation to advertise. By 1913 savings banks were touting their four percent interest as being “ABSOLUTELY SAFE” and “an exceedingly generous interest rate” and complimenting their depositors for possessing “sturdy common sense and a STEADINESS quite unknown to some of our more venturesome ‘financiers.’” T.D. MacGregor, *Out-of-the-Ordinary Advertising, A Los Angeles Bank that Uses Big Space and Does Not Waste It*, 86 BANKERS MAG. 459, 461 (1913) (emphasis in original).

misleading financial advertising.”⁵⁵ Getting to the root of the matter, the advertising men observed that “[d]eposits are often withdrawn from banks to be utterly lost in foolish ventures, which have been called to the attention of the public by advertisements, and money is thus taken out of the legitimate channels of investment.”⁵⁶

In addition to banks, reputable securities houses also objected to the sudden popularity of speculative securities. In the view of one dealer who attempted to organize a national association of bond dealers in 1911, issues of worthless securities had limited or blocked the sale of good bonds that could readily be marketed under proper conditions.⁵⁷ According to this dealer, a national association would distinguish good bonds from bad and prohibit any of its members from dealing in dubious securities, thus lifting the “imaginary cloud of distrust” which at times enveloped the bond market.⁵⁸

III. The Kansas Blue Sky Laws of 1911

Against this backdrop of public and private antagonism to securities speculation emerged the state blue sky laws.⁵⁹ By all accounts the

55. See *Bank Publicity Association of New York*, 87 BANKERS MAG. 50, 52 (1913) (quoting a June 17, 1913 speech by the association’s president, E.B. Wilson).

56. *Id.* In addition to promoting their own product, the banking industry sought to retaliate by denigrating the competition. In 1913 the Savings Bank Section of the American Bankers Association distributed a press release on the “get-rich-quick” folly, painting a grim picture of fraudulent securities promotions, to newspapers across the country. *Talks on Thrift*, *supra* note 39, at 180-81. The savings bankers encouraged newspapers to editorialize:

We sincerely believe that for a small sum there is no better investment in the country than a savings bank account and that no one makes a mistake in leaving his surplus money there until he has better use for it. Stick to your savings account until you have accumulated something worth while [sic] to invest. Then consult somebody you can depend upon in regard to its permanent investment. . . . When you have saved sufficient money to make an investment worth while [sic], consult a banker or newspaper in your community, and above all things, DON’T BE A SUCKER!

Id. at 181 (emphasis in original). The author of this article suggested that some “missionary work” might be necessary to induce the editor to use the press release for free and recommended that the editor be informed “that the savings bank men have no personal axe to grind in this matter and that publishing the articles will help the newspaper to get and hold more paid bank advertising.” *Id.*

57. *National Bond Dealers’ Association*, 76 AM. BANKER 1941, 1941 (1911).

58. *Id.*

59. The derivation of the term “blue sky law” is a matter of considerable uncertainty. The most plausible explanation in the literature, advanced by a careful and informed student of blue sky laws, is that the term referred to the fact that the fly-by-night operators in Kansas operated so blatantly that they would “sell building lots in the blue sky in fee simple.” Thomas Mulvey, *Blue Sky Law*, 36 CAN. L. TIMES 37, 37 (1916). The author supplies no authority for this etymology, however. An earlier explanation, offered by a prominent investment banker and opponent of blue sky laws, is that the term referred to the idea that the “maker of bad paper might just as well be capitalizing the blue sky and selling shares therein.” Warren S. Hayden, *Blue Sky Laws and Their Relations to the Investment Banker*, in PROC. OF THE ORGANIZATION MEETING AND OF THE FIRST ANN. CONVENTION OF THE INVESTMENT BANKERS’ ASS’N AM. 139, 139 (1912) [hereinafter 1912 IBA PROCEEDINGS]. This

inventor of blue sky legislation was the Kansas Commissioner of Banking, a regulatory entrepreneur by the name of J.N. Dolley of Maple Hill, Kansas.⁶⁰ In addition to running a vigorous, reputable, and well-funded banking department,⁶¹ Dolley was a retired "grocery man" and either a

sounds too much like the argot of the investment banker to be credible as an account of a phrase widely circulating in popular culture. Another author explained that "[w]e may say the promoter of these [speculative] corporations capitalizes an idea of business, rather than the substance, and therefore, gives . . . in the form of certificates of stock nothing more than the blue sky, and many times it is not as good as our October sky." Miller, *supra* note 44, at 3770.

Our own investigation of the primary sources has not succeeded in clarifying the matter. The earliest use of the term "blue sky" we have discovered is from 1910 in a press release issued by Kansas Banking Commissioner J.N. Dolley (whose activities in promoting blue sky legislation are discussed at length in this Article), which complained about the "enormous amount of money the Kansas people are being swindled out of by these fakers and 'blue-sky merchants.'" Letter from J.N. Dolley (Dec. 16, 1910), *reprinted in* Brief for Appellees at 33, *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917) (No. 413) [hereinafter Dolley Letter]. Dolley here appears to refer to a term already extant in the culture, as he offers no explanation for the unusual terminology. The phrase had unquestionably come into common parlance by 1912. An editorial in *Bankers Magazine* referred to the "so-called 'blue sky' laws" with the assumption that the reference was already well known. *See The "Blue Sky" Laws*, 84 BANKERS MAG. 635 (1912). Others made reference to "blue-sky and other fake promotion schemes," John R. Lindburg, *Kansas Bankers' Association Convention President's Address*, 77 AM. BANKER 1883, 1883 (1912), and the laws adopted in response as "ant[i]-blue-sky scheme[s]," Geo. W. Martin, *A Chapter from the Archives*, 77 AM. BANKER 1884, 1888 (1912). By 1914 the origin of the term was forgotten: a comment in *Bankers Magazine* observed that "[h]y some accident of fate the nomenclature of 'Blue Sky Laws' has been given such endeavors." *"Blue-Sky" Legislation*, 88 BANKERS MAG. 460, 460 (1914).

Our view—itself highly speculative—is that the phrase could not have been newly minted in 1910 without some explanation appearing in the historical record. Since the term evidently came out of Kansas, it seems most likely that it had long been in use there to describe some other type of fraudulent conduct outside the securities area, most likely fraudulent land promotions during pioneer days, and was simply borrowed for the context of securities fraud laws.

60. *See* Mark A. Sargent, *State Disclosure Regulation and the Allocation of Regulatory Responsibilities*, 46 MD. L. REV. 1027, 1040 n.67 (1987) (calling Dolley "the first blue sky commissioner"); *see also* Martin, *supra* note 59, at 1888 (referring to "Dolley's ant[i]-blue-sky scheme"); Alexander H. Robbins, *The Kansas "Blue Sky Law"*, 75 CENT. L.J. 221, 221 (1912) (noting that Dolley is an "authoritative and accurate" source on blue sky laws). Dolley had been appointed bank commissioner in 1910 by Kansas Governor Walter R. Stubbs, a Republican and an admirer of Theodore Roosevelt. CAROSSO, *supra* note 7, at 163.

Rhode Island had adopted a statute in 1910 that required certain issuers to file statements of condition with the Secretary of State before selling securities in that state. Act of July 1, 1910, ch. 557, 1910 R.I. ACTS & RESOLVES 61. A few years earlier California and a few other states adopted legislation that imposed criminal penalties on persons who knowingly misrepresented a corporation's financial affairs. *See "Blue Sky" Bill: Hearings on H.R. 10102 Before the House Comm. on Interstate and Foreign Commerce*, 67th Cong., 2d Sess. 111 (1922) (statement of James Callbreath) [hereinafter *Blue Sky Hearings*]. We do not treat these earlier state ventures into securities regulation as "blue sky" bills because they had no general influence on the subsequent development of state securities regulation.

61. The state of Kansas was generous to Dolley and his department; his budget of approximately \$35,000 exceeded those of banking departments in all but ten states. *See ANNUAL REPORT OF THE COMPTROLLER OF THE CURRENCY* 220-21 (1911) [hereinafter 1911 REPORT]. At the same time as he was drafting blue sky legislation, Dolley was working actively to improve bank profits by restricting the number of banks. Dolley gained national publicity when he refused several charter applications in 1911, professing that "one of the greatest evils and most dangerous conditions in the banking world to-day [sic] is the indiscriminate granting of bank charters. . . . In the past, charters have been granted

director or the president of a local bank.⁶² A man of considerable promotional talents, he advanced the idea of blue sky regulation in a series of newspaper articles in 1910,⁶³ complaining that Kansas widows were being fleeced by fraudulent securities salesmen and voicing an intent to seek legislation to "remove these financial cancers entirely from our State."⁶⁴

Dolley successfully lobbied the Kansas legislature in 1911 for passage of his proposal.⁶⁵ The Kansas law⁶⁶ generally required that firms selling securities in Kansas obtain a license from the bank commissioner and file regular reports of financial condition.⁶⁷ Investment companies were also required to file reports of their business plan and financial condition and to file a copy of all securities they proposed to sell in Kansas.⁶⁸ The bank commissioner was authorized to bar an investment company from the state if he concluded, upon examining these documents, that the information about the investment company or security proposed to be sold contained any "unfair, unjust, inequitable or oppressive" provision,⁶⁹ or that the investment company was "not solvent and d[id] not intend to do a fair and honest business, and . . . d[id] not promise a fair return on the stocks, bonds or other securities . . . offered for sale."⁷⁰ The bank commissioner was also authorized to conduct examinations of investment companies and to seek appointment of a receiver to wind up the affairs of any investment company found to be insolvent or to be run in an "unsafe, inequitable, or unauthorized manner."⁷¹ State and national banks, trust companies, building and loan associations, real estate mortgage companies, and nonprofit corporations were exempted from the requirements of this

indiscriminately to whoever might make application for them, regardless of the public's interest. . . . The proper organization of a bank in the first instance is more than half responsible for its ultimate success." *Too Many Banks*, 83 BANKERS MAG. 413, 413 (1911). Dolley also instituted a rigorous examination requirement for bank presidents and cashiers. See J.N. Dolley, *Educating the Banker and Keeping a Watch on Him*, 85 BANKERS MAG. 494, 494 (1912).

62. Thomas Mulvey has Dolley as a bank director, Mulvey, *supra* note 59, at 37, while IBA General Counsel Robert R. Reed makes him out to be the president of a local savings bank. Reed, *supra* note 7, at 178. It should be noted that Reed was the principal lobbyist for the Investment Bankers Association, the leading group in opposition to the blue sky laws, and the accuracy of his account may therefore be somewhat doubtful on this point. See *id.* at 177 n.1 ("Mr. Reed has been intimately connected with the development of 'Blue Sky' legislation both individually and as counsel for the Investment Bankers Association of America.")

63. See Reed, *supra* note 7, at 178.

64. Dolley Letter, *supra* note 59, at 34.

65. See J.N. Dolley, *Blue Sky Law*, 77 AM. BANKER 1705, 1706 (1912).

66. Act of March 10, 1911, ch. 133, 1911 Kan. Sess. Laws 210.

67. *Id.* §§ 6-8.

68. *Id.* § 2.

69. *Id.* § 5.

70. *Id.*

71. *Id.* § 11.

statute.⁷² The statute also exempted a few classes of securities: federal, state, and municipal bonds and notes secured by mortgages on Kansas real estate.⁷³

We have not uncovered direct evidence as to whether this legislation was solely the result of Dolley's personal efforts in mobilizing the generalized public resentment against securities frauds, or whether Dolley enjoyed the backing of any organized interests in his campaign. There is good reason to believe, however, that the legislation enjoyed the approval, if not the active support, of state-chartered banks in Kansas. Dolley, as we have noted, was a banker himself as well as the state banking commissioner. He would have been able to exercise considerable leverage on the banks under his supervision to support the proposed legislation. And the legislation itself served the interests of Kansas bankers. It protected the secondary market in mortgage notes by exempting these securities from regulation, thus propping up the value of assets that represented a significant part of state bank portfolios. It protected banks from competition in the securities business by regulating the activities of nonbank securities firms while exempting banks from these regulations. Most importantly, it reduced the danger that depositors would withdraw their funds from banks and invest them in higher yielding securities.

This last concern was particularly important in 1911, when Kansas enacted a statute which, at the behest of state banks, authorized the banking commissioner to cap deposit interest rates.⁷⁴ To the delight of the Kansas State Bankers' Association,⁷⁵ Dolley limited all state banks to a maximum interest rate on time deposits of three percent, explaining that the rate was necessary to "protect the State banks . . . from ruinous competition."⁷⁶ With rates capped at three percent, state banks were hard pressed to compete on the basis of a promised return even with conservative industrial bonds which were paying around five percent at the time⁷⁷—much less with speculative securities which, while presenting greater risk, also promised large profits if the enterprise in question proved successful.

72. *Id.* § 1.

73. *Id.*

74. Act of Feb. 27, 1911, ch. 61, 1911 Kan. Sess. Laws 61; see also *New Banking Law for Kansas*, 76 AM. BANKER 918, 918-19 (1911) (noting with approval the enactment of the Kansas statute).

75. See *Topeka, Kan.*, 76 AM. BANKER 1110, 1110 (1911) ("The executive committee of the Kansas State Bankers' Association . . . endorsed the action of Mr. Dolley in connection with the rates of interests permissible to be paid upon time deposit.").

76. *New Banking Law for Kansas*, *supra* note 74, at 919. The commissioner retained the power to allow higher rates on a county-by-county basis if national banks in the area started paying higher rates. *Id.*

77. Industrial bond quotations are contained in the volumes of *American Banker* for the years in question. Most high-grade industrial bonds paid about 5% in 1911. See, e.g., *Kansas City, Mo. Securities*, 76 AM. BANKER 990, 990-91 (1911) (chart).

Total deposits in state-chartered banks in Kansas dropped off in 1911, falling from \$96,254,685 in March to \$92,755,922 in June.⁷⁸ Not surprisingly, Kansas bankers were enthusiastic about the new blue sky law. The President of the Kansas Bankers' Association marveled that Dolley had "become a terror to all blue-sky and other fake promotion schemes."⁷⁹ The only question raised about the new statute at the Kansas Bankers' Association Convention in 1912 was whether "Dolley's ant[i]-blue-sky scheme could . . . be extended" even more.⁸⁰

Dolley immediately began to enforce the Kansas statute with the energy befitting its creator. Before the statute was enacted, in Dolley's estimation, Kansans were investing as much as six million dollars a year in worthless securities.⁸¹ Not so after the blue sky law. By May 1912 Dolley reported that of approximately eight hundred applications for permission to do business in Kansas under the law, he had approved only about seventy.⁸² By September he announced that he had investigated between fourteen and fifteen hundred companies since the enactment of the law and granted permits to less than one hundred.⁸³ Dolley disclosed that about half the applications were from mining, oil, or gas stocks and intimated that all of these had been rejected: "I believe I am safe in saying that where there has been one dollar invested in mining, oil and gas stocks there has been ninety-eight cents lost."⁸⁴ Most companies, said Dolley, "never got further than making the application. . . . As soon as they found out what information we were going to ask them for and what the nature of our investigation was going to be, they suddenly changed their minds and withdrew their applications."⁸⁵ According to Dolley, at least, enforcement of the law had other dramatic effects as well. The stiff penalties and fines threatened under the Kansas legislation caused as many as fifteen hundred "crooks," "confidence men," and "undesirables" to flee the state.⁸⁶

Ironically, in light of Dolley's insistence on honesty in securities dealings, many of his claims about the scope and success of the Kansas law were subsequently found to have been grossly overstated. Thomas Mulvey conducted a personal investigation of the files of the Kansas Bank

78. *Banks of Kansas*, 76 AM. BANKER 2573, 2573 (1911). J.N. Dolley issued a statement with this report attributing the decrease in deposits to the use of money to plant and harvest crops, *id.*, but disintermediation seems the more likely explanation.

79. Lindburg, *supra* note 59, at 1883.

80. Martin, *supra* note 59, at 1888.

81. See Dolley, *supra* note 65, at 1705.

82. *Id.*

83. Mulvey, *supra* note 59, at 38.

84. Dolley, *supra* note 65, at 1705.

85. *Id.*

86. *Promotion Schemes in Texas*, 77 AM. BANKER 1386, 1386 (1912).

Commissioner's office and found that Dolley's claims about the number of companies refused permission to do business in the state were unsupported, as were his boasts about the ability of the Kansas law to prevent fraud.⁸⁷ Mulvey found that through April 1, 1913—three years into the operation of the statute—permits had been granted to forty-nine companies and refused to only sixty-two.⁸⁸ Dolley had also issued a number of temporary permits on his personal authority, without statutory authorization; the result was that “serious frauds” were committed.⁸⁹ Mulvey found “no basis whatever” for Dolley's claims that he had saved as much as six million dollars for the people of Kansas: “[t]here were no statistics or other evidence in the office of the Bank Commissioner in May, 1913, upon which such a statement could be founded.”⁹⁰

IV. Political Support and Opposition: 1912-1913

Regardless of its actual impact, the apparently unprecedented nature of the Kansas law, coupled with Dolley's penchant for publicity⁹¹—which rivalled that of the blue sky operatives themselves—sparked great interest in the statute. Dolley received requests for copies of the new law from nearly every state in the union and bragged that “all the leading magazines of the world had written about the measure.”⁹² The governments of England, Germany, and Canada requested copies.⁹³

Not coincidentally, various political interest groups also began to organize both for and against blue sky legislation in the immediate aftermath of the Kansas statute. Those favoring blue sky legislation on the Kansas model were small banks, state bank regulators, and businesses and farms which relied on bank financing.⁹⁴ Opposing the Kansas law—although not necessarily hostile to other types of regulation—were the elite investment bankers, large industries which enjoyed access to securities markets for financing, and, to a lesser extent, larger banks which were active in the securities business at the time.⁹⁵

87. Mulvey, *supra* note 59, at 39.

88. *Id.*

89. *Id.*

90. *Id.*

91. See CAROSSO, *supra* note 7, at 189 (observing that “[f]ew laws were so well advertised”).

92. Dolley, *supra* note 65, at 1706.

93. *Id.*

94. See *infra* notes 106-19 and accompanying text (discussing support for blue sky legislation from the smaller banks and state regulators); *infra* notes 120-27 and accompanying text (discussing support for blue sky legislation from farmers and businesses reliant upon bank credit).

95. See *infra* notes 140-49 and accompanying text (discussing the efforts of investment bankers to distinguish themselves from less reputable competitors while simultaneously fighting Kansas-style blue sky legislation); *infra* notes 150-55 and accompanying text (describing opposition to blue sky laws among bond issuers); *infra* text accompanying notes 155-75 (outlining the different agendas of the big,

A. *Interests Favoring Blue Sky Legislation 1912-1913*

1. *Smaller Banks and State Bank Regulators.*—Perhaps the most important group favoring blue sky legislation on the Kansas model were smaller banks and state bank regulators. Encouraging these interests was the effervescent J.N. Dolley, who embarked on a nationwide campaign for blue sky legislation in 1912 after his victory in Kansas the previous year. He spoke at Oklahoma⁹⁶ and Tennessee⁹⁷ bankers' conventions, corresponded with his fellow state bank commissioners,⁹⁸ and trumpeted the virtues of his scheme in press releases to national banking journals.⁹⁹

As Dolley was quick to point out, the great benefit that blue sky legislation afforded to small banks was that it stifled competition for the funds of potential depositors. "There is nothing which the banker dislikes so much," he told Oklahoma bankers, "as to see one of his customers withdrawing some of his money for the purpose of investing it in some sort of an investment which the banker knows is questionable and from which the banker knows he will get no returns."¹⁰⁰ That is why, Dolley continued, "bankers should be interested in legislation of this character and why you should lend all the aid and assistance you can towards securing such legislation and towards its enforcement, after it has been secured."¹⁰¹

Dolley backed up his warnings about lost deposits with glowing accounts of the benefits of the Kansas law. Of the millions of dollars in fraudulent securities once sold in Kansas, he remarked, "98 [percent] of it was either borrowed from the banker or taken from his deposits."¹⁰² Not so after the blue sky law. Dolley issued a press release to *The American Banker* boasting that deposits in Kansas state banks had increased dramatically due to the exodus of "blue sky speculators."¹⁰³

Dolley cleverly used his own success in driving out the blue sky operators as a lever to encourage other states to do the same. He painted a vivid picture of armies of grifters, confidence men, and bunco artists descending like locusts on other states. He warned the Texas Bank Commissioner that his own success in evicting the miscreants "probably

money-center banks and their smaller counterparts); *infra* notes 176-79 and accompanying text (recounting big bank opposition to blue sky laws).

96. Dolley, *supra* note 65, at 1705.

97. *Program for Tennessee Bankers' Convention*, 77 AM. BANKER 1523 (1912).

98. *Promotion Schemes in Texas*, *supra* note 86, at 1386.

99. *Topeka, Kan.*, *supra* note 75, at 1574.

100. Dolley, *supra* note 65, at 1705.

101. *Id.*

102. *Id.* The fact that the money used to buy these securities might have been borrowed from bankers would not have suggested that bankers benefitted from speculative securities. In Dolley's portrayal, at least, all the money borrowed was lost, so the borrower would not be a good customer of the bank and would be very likely to default.

103. See *Topeka, Kan.*, *supra* note 75, at 1574.

has been unfortunate for our sister States,” and expressed little doubt “that Texas will get her share of these grafters.”¹⁰⁴ The Texas Banking Commissioner quoted this correspondence in an article in the *Texas Bankers Record*, alerting Texas bankers that “because other States are adopting laws to control the sale of stocks, . . . these sharks are coming in droves to those States, like Texas, which have no laws controlling stock selling.”¹⁰⁵

Small bankers and state bank regulators enthusiastically supported blue sky legislation in 1912 and 1913. Leaders of state bankers’ associations were thoroughly briefed on the merits of the Kansas statute at a meeting in Chicago early in 1912.¹⁰⁶ State bankers’ associations circulated copies of the Kansas statute to their members.¹⁰⁷ Blue sky legislation was a leading theme at the convention of the National Association of State Bank Superintendents in 1913.¹⁰⁸ The President of the Florida Bankers’ Association recommended a blue sky statute for his state to control the sale of “securities that are steeped in fraud.”¹⁰⁹ The President of the Illinois Bankers’ Association wrote to bankers throughout his state advocating the “desirability of adopting in Illinois some such legislation as the ‘blue sky’ law enacted in Kansas.”¹¹⁰ Calling on Texas bankers to lobby for “a bill to control and stop this legal robbery” (*i.e.*, questionable securities sales), the Texas banking commissioner predicted that “powerful lobbies” would arise to fight such legislation, but that they would be shown “no more consideration than the commonest crook.”¹¹¹ A speaker at the Texas Banking Convention railed against the “conscienceless robberies” of the “Blue Sky” salesmen and called on the bankers of the state to “rise as one man and fight this practice.”¹¹² Indiana bankers heard a jeremiad against the “financial parasites” who “preyed upon the investing public, your depositor.”¹¹³ The Executive Committee of the Washington Bankers’ Association endorsed the Kansas law and called for its passage as modified to account for conditions in that state.¹¹⁴ The vice president of a national

104. *Promotion Schemes in Texas*, *supra* note 86, at 1386.

105. B.L. Gill, *Promotion Schemes*, TEX. BANKERS REC., Apr. 1912, at 4.

106. See Karl J. Farup, *North Dakota State Bankers’ Association Convention*, 77 AM. BANKER 2659, 2659 (1912) (reporting a meeting of state bankers’ association secretaries in Chicago at which “the Blue Sky Law of Kansas . . . was thoroughly explained to us”).

107. See, *e.g.*, Miller, *supra* note 44, at 3771 (noting that attendees of the Indiana convention had received copies of the Kansas statute “[b]y the courtesy of [their] organization”).

108. See *Minneapolis and St. Paul*, 78 AM. BANKER 1924 (1913).

109. George W. Allen, *Florida Banking Resources Increase*, 78 AM. BANKER 1322 (1913).

110. *Chicago, Ill.*, 77 AM. BANKER 658, 658-59 (1912) (statement of B.F. Harris).

111. Gill, *supra* note 105, at 4.

112. C.A. Sanford, *Conscience in Banking*, 77 AM. BANKER 1610, 1611 (1912).

113. Miller, *supra* note 44, at 3770.

114. See P.C. Kaufman, *Washington Bankers’ Association Convention*, 77 AM. BANKER 2498, 2500 (1912).

bank sponsored blue sky legislation in Oregon.¹¹⁵ The President of the North Dakota State Bankers' Association told his state's convention that "[w]e all know the evils of unlimited freedom of stock-jobbing, . . . and our legislative committee would do well in trying to get [a Kansas-style] law grafted into our statute."¹¹⁶ The President of the Colorado Bankers' Association approved the general thrust of the Kansas statute, although he cautioned that the Kansas law vested too much power in the bank commissioner.¹¹⁷ The Secretary-Treasurer of the Alabama Bankers' Association cautioned that

[t]he people of Alabama have been literally robbed of thousands of dollars by pure fake and near fake enterprises. The Legislature should protect the public from this shameless stock jobbing. I believe if the association stood for the 'Blue Sky Law of Kansas' it would meet with the approval of all honest people.¹¹⁸

The Alabama Superintendent of Banking heartily concurred, observing that "[m]uch money is annually withdrawn from banks for these fraudulent schemes" and promising, if given the enforcement responsibility, to "drive these swindlers out of your borders, as Mr. Doll[e]y, of Kansas, has driven them out of his State."¹¹⁹

2. *Farmers and Smaller Businesses.*—In addition to small bankers and state bank regulators, nonbank business elements supported blue sky legislation as a means of enhancing their access to credit by excluding competition from out-of-state borrowers. Farmers, with their need for mortgage financing as well as for temporary credit between planting and harvest, were an obvious beneficiary. It is, accordingly, probably no accident that Kansas, a farming state, was the first to adopt blue sky legislation. Further, many of the strictest blue sky statutes were adopted by states with the greatest reliance on agriculture.¹²⁰

But the potential support for blue sky legislation was by no means limited to farmers. For similar reasons, local industries of all sorts were also potential beneficiaries. Local chambers of commerce, which at the time were only beginning to come into their own as a political and social

115. See *Portland, Oreg.*, 78 AM. BANKER 708, 708 (1913) (discussing the proposal of John A. Keating, vice president of Lumbermen's National Bank).

116. Farup, *supra* note 106, at 2659.

117. See Frank N. Briggs, *Banking Conditions in Colorado*, 77 AM. BANKER 2905, 2906 (1912).

118. McLane Tilton, Jr., *Alabama Bankers' Association Convention*, 77 AM. BANKER 1714, 1716 (1912).

119. A.E. Walker, *The First Year Under the New Banking Law*, 77 AM. BANKER 1719, 1720 (1912).

120. See *infra* notes 180-91 and accompanying text (chronicling the passage of blue sky laws in Kansas and other predominantly agricultural states in 1911, 1912, and 1913).

force,¹²¹ were among the leading interests pressing for blue sky legislation in Ohio¹²² and Oregon.¹²³ The National Citizens' League, an umbrella organization dedicated to enhancing the supply of credit to smaller businesses,¹²⁴ also seems to have endorsed the concept of blue sky merit regulation. The Chairman of its Executive Committee, addressing Alabama bankers in 1912, proclaimed that the "duty of the hour is to protect normal business from the sharks, whether in New York or across the Mississippi."¹²⁵ He went on to note that "[t]here is a tendency of commercial capital to move into the hands of promoters; therefore, abolish it by discriminating against investment securities [in favor of] loans by commercial banks."¹²⁶

Supporters of blue sky legislation were quite explicit about their wish to direct capital to local borrowers rather than see it drained out of state. A speaker at the Kansas bankers association convention in 1912 observed that

it is unfortunate that Commissioner Dolley's ant[i]-blue-sky scheme could not be extended to protect our own people who have invested . . . against the swamps of Florida, and the mesquite, cactus, sage brush, Alkali and orange ranches of the Southwest. . . . But Mr. Dolley is not omnipresent nor is he the personal guardian of each individual, and so gossip about a month ago had much to say about \$28,000 leaving Topeka and going into a hole as certain as the descent of the Titanic. Untold thousands have gone out of Kansas in this way—how can we stop the waste?¹²⁷

121. During the early part of the twentieth century these chambers of commerce became much more active than before, with nearly six thousand organizations nationwide, ranging from small groups to large organizations with thousands of members such as the Chicago Association of Commerce and the Boston Chamber of Commerce. *American Commercial Bodies*, 77 AM. BANKER 727, 727 (1912). Chambers of commerce were not, however, organized in national or even regional organizations at the time. *See id.* Attempts were made to organize a national board of trade in 1912, *see A National Board of Trade*, 77 AM. BANKER 729 (1912), resulting in the establishment of the United States Chamber of Commerce in that year. *See* Robert F. Maddox, *The Banker in Politics*, 81 AM. BANKER 1690, 1690 (1916) (noting that before the creation of the United States Chamber of Commerce there had been "no organization in the United States where the businessmen of the country could meet on common ground at the Capitol of our country").

122. *See* Hayden, *supra* note 59, at 140 ("[O]ne of the most influential chambers of commerce in the state [of Ohio] has had a definite intention for several months to see to it that a blue sky bill is introduced at Columbus this coming winter.").

123. *See Portland, Ore.*, *supra* note 115, at 2648 (observing that the Portland Chamber of Commerce and Portland Realty Board lobbied for the proposed blue sky law).

124. The National Citizens' League promoted currency reform to encourage bank investment in commercial paper, thus channelling funds to local businesses and away from Wall Street. *See* J. Laurence Laughlin, *The Money Trust and Banking Reform*, 77 AM. BANKER 1722 (1912).

125. *Id.* at 1723.

126. *Id.*

127. Martin, *supra* note 59, at 1888.

Dolley himself frankly acknowledged that one purpose of the statute was to keep credit from being taken out of Kansas. He observed proudly that before the blue sky law went into effect millions of dollars a year were being "taken from Kansas."¹²⁸ This money, said Dolley, "was being taken by the promoter from our State to the headquarters of his company, a large [percent] of it going to New York and the East."¹²⁹ The Kansas statute, said Dolley, had changed all that. Of the seventy applications to sell securities in Kansas which Dolley had granted under the new law, "the greater majority . . . have been for Kansas industrial and home enterprises."¹³⁰ Dolley went on to boast that he had put a stop to one out-of-state company that had been selling securities in the state at a rate of \$300,000 per month, thus saving millions of dollars for the "widows, orphans and the poorer class of people, who form the investing public."¹³¹ Later he issued a press release commenting on the effects of the Kansas law and observing, in words that must have pleased local borrowers, that

[t]here is an unlimited field for investment in Kansas to develop Kansas and such investments will bring a fair rate of interest and a more sure investment can not be placed in the investment world. Keep Kansas money in Kansas to develop the unlimited resources of the greatest State in the American Union should be the watchword.¹³²

Kansans were not alone in emphasizing the importance of keeping credit in-state. The President of the bankers' association in Louisiana—one of the first states after Kansas to adopt blue sky regulation—told his group that "the sooner we learn the lesson of keeping our money at home and patronizing home industry," instead of putting it into the hands of the "New York Stock Exchange speculators and gamblers," the "better it will be for our State and the South."¹³³ The President of the Tennessee Bankers' Association echoed these sentiments, observing that

[i]t is a mistake on the part of the citizens of this State to invest their surplus elsewhere which should be used in developing properties at home. The facilities for all to trade in the Stock Exchange have been so extended that any one with a few dollars to invest is tempted to try his luck in a share of stock in some large or small corporation

128. Dolley, *supra* note 65, at 1705.

129. *Id.*

130. *Id.*

131. *Id.* at 1706.

132. *Topeka, Kan.*, *supra* note 75, at 1574.

133. Joseph Gottlieb, *Louisiana Bankers' Association Convention*, 77 AM. BANKER 1431, 1443 (1912).

concerning which he knows practically nothing rather than invest his money in some local enterprise¹³⁴

The parochial purpose of many blue sky laws was well understood by knowledgeable observers in later years. Congressman Edward Denison of Illinois observed in 1923 that

[t]here are unfortunately those in legislative positions in some States who do not take a broad view of this subject; they would prefer that outside securities be not allowed to come into their State to absorb the capital of their own citizens, because they want their citizens to invest their money in their own developments and enterprises. This is not a mere imaginary case. I have been informed that some State [blue sky] laws have been administered with that end in view.¹³⁵

A representative of the elite investment bankers concurred in 1922, quoting a state securities commissioner as saying, "I have not approved any more securities in my State in the last few months than I could help. Money is mighty scarce down there and I don't propose to let any of our money get out in the securities of corporations of other States."¹³⁶

B. *Opponents of Blue Sky Legislation*

1. *Elite Investment Bankers.*—The principal opponents of blue sky legislation were the elite investment bankers who broke away from the American Bankers Association in 1912 and established their own organization, the Investment Bankers Association (IBA).¹³⁷ The IBA's members came from a variety of states, but most were headquartered in New York, Illinois, Pennsylvania, Massachusetts, and Maryland.¹³⁸

An important part of the IBA's agenda was to distinguish themselves from the "fly-by-night operators" and the "get-rich-quick" artists who were casting the entire securities industry in a bad light.¹³⁹ Although the IBA

134. Wesley Drane, *Address of the President*, 77 AM. BANKER 1988, 1988 (1912).

135. *Regulating the Sale of Securities: Hearings on H.R. 10598 Before a Subcomm. of the Senate Comm. on Interstate Commerce*, 67th Cong., 4th Sess. 9 (1923) (statement of Rep. Denison) [hereinafter *Regulating the Sale of Securities*].

136. *Blue Sky Hearings*, *supra* note 60, at 54 (statement of George W. Hodges).

137. See 1912 IBA PROCEEDINGS, *supra* note 59, at 5 ("This gathering [gives] to the public its first assurance of an association, constituted purely of investment bankers, organized primarily to improve the standard of those engaged in investment banking and for the general protection of the investing public."); CAROSSO, *supra* note 7, at 165-70 (describing the formation of the IBA in "response to mounting public criticism and increasing demands for regulatory legislation"). Members of this association appear to have been engaged almost exclusively in the distribution of corporate bonds, as there is little if any reference to equity securities during the early meetings.

138. As of 1913, the IBA included 110 New York firms, 81 Chicago firms, 39 Philadelphia firms, 26 Boston firms, and 21 Baltimore firms. INVESTMENT BANKERS ASSOCIATION, PROCEEDINGS OF THE ANNUAL CONVENTION 287 (1913) [hereinafter 1913 IBA PROCEEDINGS] (Membership List). Very few IBA members were located in states adopting blue sky legislation in 1912 or 1913. *Id.*

139. In the view of one early proponent of a bond dealers association:

members did not say so, many of the firms distributing such "doubtful" securities were also new entrants into the securities business who represented potential competition for the elite firms in the IBA. Thus to the extent that the blue sky laws were actually used to stamp out the marginal operators, the IBA had a common interest with the small bankers and their regulators.

Although the IBA wanted to extinguish the purveyors of speculative securities, it did not favor doing so by means of blue sky legislation on the Kansas model.¹⁴⁰ Blue sky legislation imposed greatly increased administrative burdens on securities distribution and was likely to be administered in favor of local interests and to the detriment of the Wall Street or LaSalle Street firms. The IBA's members understood, moreover, that on the blue sky issue their interests were opposed to those of smaller banks that supported such legislation. One investment banker characterized the blue sky legislation in 1912 as follows: "Taking into account the exceptions made by the law, it says in effect, that anybody *but a bank* must satisfy the Commissioner if he wants to sell private corporation bonds."¹⁴¹ This speaker warned deposit bankers "not to think that [they] can gain advantage by getting back of legislation of this kind upon the theory that the banks would acquire the bond business of the country."¹⁴²

Kansas-style blue sky legislation, according to the IBA's general counsel, did not represent a "fair and proper attack on irresponsible and fraudulent or so-called 'fly-by-night' schemes of stock flotation."¹⁴³ It was, rather, an "unwarranted" and "revolutionary" attack upon legitimate business.¹⁴⁴ The problem, according to one IBA member, was that the state legislatures had confused the functions of the investment banker with those of the "mere broker."¹⁴⁵ The mere broker "has no moral responsibility. He does not endorse, even in a moral way, the investments he may

Only swindlers profit by floating worthless securities, and reliable houses have no desire to share in this kind of profit. With the weeding out of the unreliable concerns and the black-listing of dubious issues, the legitimate concerns in the bond business would obtain such an expansion of their field of operation that the result would be a golden harvest of new business.

National Bond Dealers' Association, supra note 57, at 1941.

140. See, e.g., *Chicago, Ill.*, 78 AM. BANKER 1506, 1507 (1913) (describing the IBA's distribution of a seventy-five page comprehensive survey of every state's blue sky legislation); *Investment Bankers Meet in St. Louis*, 78 AM. BANKER 1693, 1693 (1913) (claiming that while the IBA did not wish to suppress wise laws, it would oppose those laws which would "unnecessarily and unjustly hamper legitimate business"); Robert R. Reed, *Annual Report of Counsel*, 1913 IBA PROCEEDINGS, *supra* note 138, at 164, 166-67 (expressing the opinion that the Kansas blue sky law was unconstitutional).

141. Hayden, *supra* note 59, at 142-44 (emphasis added).

142. *Id.* at 144.

143. Reed, *supra* note 140, at 168.

144. *Id.*

145. See S.W. Straus, *The Ethics of Investment Banking*, 87 BANKERS MAG. 411, 412 (1913).

purchase for a customer. If loss is incurred, the broker is by no means to blame.¹⁴⁶ But the position of the investment banker was radically different:

His reputation and the reputation of his house is bound up in the securities he sells. . . . He must stand sponsor for those bond issues which his House handles alone and with which its name is indissolubly bound up. If these "specialities" are not listed in the stock exchange—and the great majority of sound bond issues are not listed—he must maintain a market for them for the accommodation of his clients. He must exercise supervision to make certain that the interests of his clients are protected, not only before the loan is sold, but after it is sold and throughout its life until its final maturity.¹⁴⁷

In place of Kansas-style blue sky legislation, the IBA pushed its own model legislation that would have effectively distinguished between the functions of the investment banker and the mere broker. Significantly, the proposal lacked any provision for regulatory scrutiny of the merits of proposed securities offerings. The IBA's proposal required the registration of securities dealers and imposed a strengthened fraud remedy for misstatements in connection with the sale of securities.¹⁴⁸ The IBA did not offer its proposal as a model for federal regulation, even though federal regulation had obvious potential as a means of achieving uniformity of enforcement.¹⁴⁹

2. *Bond Issuers.*—Aligned with the IBA in opposing blue sky legislation were larger industries whose ability to obtain funds on capital markets was threatened by the blue sky phenomenon. These industries included manufacturing firms, railroads, and public utilities, all of which raised a significant amount of capital by bond issues in securities markets.¹⁵⁰ In the words of the counsel for the Michigan Bankers' Associa-

146. *Id.*

147. *Id.* at 413.

148. *See Reed, supra* note 140, at 164 ("The general plan of this proposed act provided for the registration of dealers, upon an investigation of their business character and repute and of the character of the securities in which they dealt."); *Regulation of the Sale of Securities*, 86 BANKERS MAG. 418, 418-19 (1913) (outlining the main purpose of the proposed act and questioning whether "the proposed measure would accomplish this laudable aim without injuring legitimate investment offerings").

149. *Bankers Magazine* criticized the proposal on this ground, observing, sensibly, that if new legislation were needed—which the periodical doubted—it should be federal in order to reduce hardship to legitimate securities issuers and to achieve uniformity. *See Regulation of the Sale of Securities, supra* note 148, at 419.

150. *See MICHIE, supra* note 22, at 222, 222-23 (providing data to support the assertion that, although "numerous enterprises . . . did not rely on the issue of securities to meet their capital requirements," by 1913 the "major undertakings in such areas of the economy as transportation, communications, urban utilities, banking, insurance, mining, manufacturing and distribution were financed by way of publicly held stocks and bonds").

tion, one of the few individuals associated with state banks to speak out against blue sky legislation between 1911 and 1913, the Michigan blue sky law "can and will stop the Michigan industry which should have immediate financing. It will tend to create foreign corporations and stop the issue of investment bonds and stocks on our Michigan industries. It will not hurt the broker but the manufacturer who needs new capital."¹⁵¹

The IBA enlisted the aid of these larger industries in the fight against blue sky laws.¹⁵² In Indiana, a state with significant manufacturing interests but without major commercial or investment banks, the state legislature passed a blue sky bill in 1912.¹⁵³ The Indiana Manufacturers Association joined with the state's investment bankers to lobby against the legislation before the state's governor, who had endorsed the concept of blue sky legislation in his election campaign. Conveniently advised by his Attorney General that the measure was open to constitutional attack, the Governor vetoed the bill early in 1913,¹⁵⁴ observing that while the bill was "commendable in its attempt to annihilate the schemer or illegitimate dealer, its methods put too great a hardship upon legitimate business."¹⁵⁵

3. *Bigger Banks.*—A final group opposing blue sky legislation was the nation's larger (or "money center") banks. The larger banks were located in urban areas and usually (although not always) operated under federal charter. Their interests, as they bore on blue sky regulation, thus differed significantly from those of smaller banking institutions which were typically (although not always) state-chartered institutions located in small towns or rural areas.

First, the larger commercial banks mostly served the needs of businesses and wealthy individuals.¹⁵⁶ These were not customers whose deposit business was likely to be lost to speculative securities promotions. And while these customers had ready access to securities markets, they had enjoyed such access for years. In contrast, the typical depositor in a small bank was exactly the type of person to whom the speculative securities

151. Hal H. Smith, *Tendencies of Recent Banking Legislation in Michigan*, 78 AM. BANKER 2297, 2298 (1913).

152. See *Blue Sky Laws*, 78 AM. BANKER 1158, 1159 (1913) (quoting George B. Caldwell, President of the IBA: "the average honest manufacturer, railroad operator, or public utility owner, or promoter of any legitimate enterprise, does not appreciate the undue hardships that would accrue to him were the average pending measure enacted into law").

153. "Blue Sky" Legislation in Indiana, 78 AM. BANKER 921, 921 (1913).

154. *Id.*

155. *Hearing on "Blue Sky" Bill*, 78 AM. BANKER 1008, 1008 (1913).

156. See CAROSSO, *supra* note 7, at 96 (stating that large, urban commercial institutions responded to early twentieth-century industrial and financial expansion by becoming "great banks" serving "[b]ig men" and "great enterprises").

were being marketed and who might be inclined to withdraw deposits and take a flier on a speculative security.

Second, unlike the smaller banks, the larger commercial banks appear to have done well in 1911 and the preceding years. Average individual deposits per national bank increased from \$672,000 to \$753,000 between 1907 and 1911.¹⁵⁷ In contrast, average individual deposits per state-chartered bank *decreased* from \$308,000 in 1907 to \$215,000 in 1911,¹⁵⁸ while average individual deposits in savings banks decreased from \$2,470,000 to \$2,240,000.¹⁵⁹ Although some of these reductions reflected new chartering of start-up firms, the overall picture for the smaller depository institutions was not rosy as of 1911. Thus, the smaller banks had good reason to worry about further competition for deposits from any quarter, and the advent of a new competitor in the form of the securities industry was a particularly unwelcome development. The larger banks were not as threatened by the possible competition.

Third, national banks invested heavily in government bonds and other securities, owning an average of \$242,000 in such securities in 1911.¹⁶⁰ The average state-chartered bank, by contrast, owned only \$25,000 in bonds and other securities in 1911,¹⁶¹ while the average stock savings banks owned an average of \$107,000.¹⁶² The only savings institutions exceeding national banks in terms of average bond investments were mutual savings banks, which—evidently serving as precursors to today's mutual funds—held an astounding average of \$2,702,000 in bonds in 1911.¹⁶³

Large bond holdings were unfavorable investments in times of high interest rates. As interest rates rose, bond portfolios fell in value, reducing the banks' net worth.¹⁶⁴ National banks were thus hurt by their bond investments in inflationary times. On the other hand, national banks' bond portfolios gave them an interest in maintaining a ready market both for the purchase of new bonds and for the sale of old bonds from their vaults. In this respect, their large bond holdings gave them an interest in protecting

157. See 1911 REPORT, *supra* note 61, at 797.

158. See *id.* at 798.

159. See *id.* at 799.

160. See *id.* at 37.

161. See *id.* at 44.

162. See *id.*

163. See *id.* Mutual savings banks in general served a completely different class of customers and had different interests than stock savings banks during this period. Unfortunately, however, the data do not usually break out stock and mutual savings institutions. If the data did separate out these institutions, the characteristics of the stock savings banks would probably appear similar to those of state-chartered banks.

164. After hitting a low in 1908, interest rates crept steadily upward through 1911, causing a concomitant loss in long-term bond prices. For example, the United States bond maturing in 1925 fell from a high of 122¾% in 1908 to a low of 113¾% in 1911. See *id.* at 834-41.

securities markets against state interference under the blue sky laws. In addition, the biggest banks had also begun to value the securities markets for the liquidity which a market listing would give their own stock.¹⁶⁵

Fourth, aside from such bonds, national banks were overwhelmingly committed to commercial loans, with virtually no interest in real estate mortgage loans. The average national bank held \$762,000 in secured and unsecured commercial loans in 1911, but less than \$10,000 in real estate mortgage loans.¹⁶⁶ For state banks and savings institutions the situation was nearly the reverse—depository institutions other than national banks owned an average of \$173,000 in real estate mortgage loans and \$258,000 in secured and unsecured commercial loans in 1911.¹⁶⁷ In times of inflation, the national banks were better off than state institutions. A substantial percentage of national banks' portfolios in commercial loans could be rolled over each year and thus tagged with new nominal interest rates. State institutions, on the other hand, with their heavy commitment to long-term mortgage lending, took on a substantially greater interest rate risk which redounded to their disadvantage in times of high nominal interest rates. In this respect, smaller institutions appear to have suffered more than larger ones during the period from 1907 to 1911.

Fifth, larger banking institutions were often themselves engaged in a securities business.¹⁶⁸ Banks underwrote corporate bonds by purchasing them and reselling them to customers. They also provided investment counseling to customers,¹⁶⁹ including individuals of limited resources, "advising against their tendency to sacrifice strength for large yield."¹⁷⁰ Most of the banks engaged in bond underwriting were the large institutions in New York, Chicago, and other "money centers," but even some smaller commercial banks provided investment services. The Commerce Trust Company of Toledo, for example, instituted a program under which customers could purchase Toledo City Bonds for ten dollars down on an "easy payment plan."¹⁷¹ Privately held bond portfolios also increased the demand for bank safe deposit services, which produced income and, more

165. As of 1914 bank stocks with par value of \$119 million were listed on the New York Stock Exchange. ANNUAL REPORT OF THE COMPTROLLER OF THE CURRENCY 106 (1914) [hereinafter 1914 REPORT].

166. See 1911 REPORT, *supra* note 61, at 58.

167. See *id.*

168. At the time, such activities were perfectly legal for banks. Indeed, the distinction between banks and investment banks, so common today, was not well defined in 1911. Investment bankers would not split from the American Bankers Association and establish their own Investment Bankers Association until 1912. See George B. Caldwell, *Address of Chairman*, 1912 IBA PROCEEDINGS, *supra* note 59, at 16.

169. See Robert D. Coard, *Service Rendered to Investors by a Properly Conducted Bond Department*, 84 BANKERS MAG. 44-45 (1912).

170. *Id.* at 45.

171. See *How Banks Are Advertising*, 88 BANKERS MAG. 200, 204 (1914).

importantly, brought the customer into the bank on a regular basis where he or she might be inclined to make deposits or apply for loans. Banks with bond departments also enjoyed an inside track with the customer for making loans on the security of the customer's portfolio and, by clipping the customer's coupons, could gain substantial influence over the customer's reinvestment decisions.¹⁷² Small banks and savings institutions, on the other hand, were ordinarily not engaged in the securities business to any appreciable extent,¹⁷³ and so could not share in these benefits.

Finally, the big banks, like the big securities firms, had come under fire in the popular resentment against Wall Street during the first decade of the century.¹⁷⁴ Big banks thus had good reason to oppose new regulatory initiatives which might result in precedents harmful to their long-run interests. Small banks were never the targets of populist resentment of this sort.¹⁷⁵

Larger banks, while sympathetic in some respects with the general objectives of blue sky regulation, opposed the statutes themselves from the start. *Bankers Magazine*, a journal principally serving the interests of urban commercial banks, reflected these attitudes when it editorialized against the blue sky laws in 1912. *Bankers Magazine* warned that the blue sky laws would create "a nation of fools and weaklings" by protecting people against their own folly.¹⁷⁶ The editorial continued that in states adopting Kansas-style statutes, "through ignorance, prejudice—and possibly from some unworthy motive—many excellent securities may be debarred from some of the States."¹⁷⁷

172. See Coard, *supra* note 169, at 45 (stating that a bank should act as a friend to investors by negotiating loans against their holdings, encouraging their savings habits, and collecting and reinvesting their interest and principal for them).

173. See CAROSSO, *supra* note 7, at 84-85 (observing that not until assets held in banks "more than doubled" in the first decade of the twentieth century did "country banks in the Middle and Far West, which previously had invested almost exclusively in farm mortgages, [start] buying railroad, industrial, and utility bonds"); see also *id.* at 95-96 (setting out a two-level hierarchy of banks involved in securities between 1900 and 1910: the four "great international banking houses" and some two hundred "secondary firms").

174. See *id.* at 110 (discussing "popular concern with . . . the increasing concentration of economic and financial power in New York" which climaxed in 1914 and manifested itself as distrust of big banks, securities firms, and life insurance companies).

175. See *id.* (noting that "Americans traditionally harbored hostility toward monopoly, privilege and concentrated wealth" and that they shared their concern about big banks with small bankers and businesspeople).

176. *The "Blue Sky" Laws*, *supra* note 59, at 635.

177. *Id.* at 635-36. In contrast to the position taken by *Bankers Magazine*, the *American Banker*, which placed greater emphasis on smaller banks than its competitor, took a somewhat schizophrenic position in 1913, commenting that blue sky laws were "good, some better," but that Kansas-style legislation was inappropriate for "conditions such as exist in New York State—and City." *Blue Sky Laws in New York*, 78 AM. BANKER 1000, 1000 (1913).

Larger banking interests' opposition to Kansas-style blue sky laws also reflected an awareness of the possibility that state regulation might itself represent competition for banks offering investment advisory services or securities placement services. That attitude was evident in another *Bankers Magazine* editorial, which, after excoriating "get-rich-quick" artists, concluded that "[i]f all legitimate promotion schemes were required first to secure the partial approval of a bank of recognized standing, it would go a long ways toward curtailing the operations of fraudulent schemers."¹⁷⁸ The "most reliable certificate of the quality of any security," said another editorial, is "that to be had from a responsible bank, trust company or bond house. In fact, this [e]ndorsement is worth more than that of any State official, for it generally represents sound financial judgment."¹⁷⁹

V. State Legislation in 1912-1913

The actual success—or lack of it—of the Kansas law notwithstanding, its impact as a precedent was unmistakable. News of the legislation quickly sparked efforts to regulate the sale of speculative securities in other states. Arizona¹⁸⁰ and Vermont¹⁸¹ adopted blue sky legislation patterned on the Kansas model in 1912. Louisiana enacted a statute that year requiring securities dealers to obtain a license and post bond, and creating civil and criminal liability for false statements in connection with securities sales.¹⁸² The Louisiana statute differed significantly from the Kansas model because it did not authorize the banning of a security from the state on the ground that it did not promise a fair return on the investment.¹⁸³

State regulatory activity accelerated through 1913. Eight states adopted legislation closely patterned on the Kansas model, granting a designated agency the power to reject proposed issues which did not offer a fair return on a buyer's investment: Arkansas,¹⁸⁴ Idaho,¹⁸⁵ Michigan,¹⁸⁶ Montana,¹⁸⁷ North Dakota,¹⁸⁸ South Dakota,¹⁸⁹

178. *Using Banks as Decoys in Promotion Schemes*, *supra* note 43, at 302.

179. *The "Blue Sky" Laws*, *supra* note 59, at 636.

180. Act of May 18, 1912, ch. 69, 1912 *Ariz. Sess. Laws* 338 (vesting enforcement powers in the state corporation commission).

181. Act of Feb. 13, 1913, No. 170, 1912 *Vt. Laws* 196 (vesting enforcement power in the state bank commissioner).

182. Act of July 1, 1912, No. 40, 1912 *La. Acts* 47.

183. *Id.* § 1, 1912 *La. Acts* at 47.

184. Arkansas Securities Act, No. 214, § 6, 1913 *Ark. Acts* 904, 909-11.

185. Idaho Securities Act, ch. 117, 1913 *Idaho Sess. Laws* 454, 455-56.

186. Act of May 2, 1913, No. 143, § 5, 1913 *Mich. Pub. Acts* 243, 245-46.

187. Act of Mar. 13, 1913, ch. 85, § 9, 1913 *Mont. Laws* 367, 370-71.

188. Supervision of Investment Companies, ch. 109, § 5, 1913 *N.D. Laws* 137, 139-40.

189. Act of Mar. 14, 1913, ch. 319, § 5, 1913 *S.D. Laws* 522, 524.

Tennessee,¹⁹⁰ and West Virginia.¹⁹¹ The Province of Manitoba enacted the Kansas blue sky law almost verbatim in 1912.¹⁹² Ohio enacted a statute which, while not directly patterned on the Kansas model, permitted the relevant state authority to reject a security if the issuer's "proposed disposal of its securities . . . is . . . on unfair terms."¹⁹³

Blue sky legislation based on the Kansas model proved less successful elsewhere. Securities regulation laws made no headway in states such as Nevada, Maryland, and Delaware which were active participants in the corporate chartering market.¹⁹⁴ The Indiana legislature approved a blue sky statute only to see it vetoed by the governor after intense lobbying by a coalition of investment bankers and manufacturers.¹⁹⁵ Blue sky legislation was also vetoed in Colorado.¹⁹⁶ Illinois and Pennsylvania—states with active securities industries and large manufacturing firms—rejected proposals for Kansas-style statutes.¹⁹⁷ A blue sky law was also proposed, and apparently defeated, in Minnesota.¹⁹⁸

Other states, while adopting securities regulation statutes, rejected essential features of the Kansas model. Missouri¹⁹⁹ and Florida²⁰⁰ adopted legislation modeled on the Kansas statute, but omitting the crucial power to reject a sale of securities if the offering did not promise a fair return on the investment.²⁰¹ Maine, another competitor for corporate charters,²⁰² adopted a modified disclosure regulation patterned generally on legislation recommended by the Investment Bankers Association (IBA),²⁰³ which required registration of securities dealers²⁰⁴ and imposed

190. Act of Sept. 27, 1913, ch. 31, § 5, 1913 Tenn. Pub. Acts 500, 502-03.

191. Act of Feb. 6, 1913, ch. 15, § 5, 1913 W. Va. Acts 114, 117-18.

192. Sale of Shares Act, 1913, 2 Geo. 5, ch. 75.

193. Act of Apr. 28, 1913, § 16, 1913 Ohio Laws 743, 751-52.

194. See RIPLEY, *supra* note 38, at 219 (noting that Delaware and Nevada had no securities regulation and that Maryland had "merely investigation and injunction laws"); see also *id.* at 16-20 (discussing Delaware and Nevada as highly active in producing "corporate progeny"). South Dakota, however, adopted blue sky legislation in 1913 despite its active participation in the competition for charters. See *id.* at 29.

195. See *supra* note 154 and accompanying text.

196. Brief for Appellees Other than the Weis Fibre Container Corporation at 45, *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917) (No. 413).

197. See Reed, *supra* note 140, at 66.

198. Cf. *Minneapolis and St. Paul*, 78 AM. BANKER 709, 709 (1913).

199. Act of Apr. 7, 1913, C.S.S.B. 78, 79, 1913 Mo. Laws 112.

200. Act of May 20, 1913, 1913 Fla. Laws ch. 6422.

201. Despite the difference between this statute and the Kansas law, the Missouri official charged with its administration journeyed to Topeka to study the administration of that state's law in preparation for the implementation of the new Missouri statute. *St. Louis, Mo.*, 78 AM. BANKER 1988, 1989 (1913).

202. See RIPLEY, *supra* note 38, at 31-33 (describing Maine's aggressive attempts to lure corporate charters).

203. For a description of the IBA's activities in opposing blue sky legislation on the Kansas model, see *supra* notes 140-49 and accompanying text (describing efforts by the IBA to block passage or

penalties for fraudulent statements about securities or dealers.²⁰⁵ Other jurisdictions requiring registration and disclosure and prohibiting fraud, but not permitting the exclusion of securities solely because they were bad investments, were Georgia,²⁰⁶ Iowa,²⁰⁷ Nebraska,²⁰⁸ North Carolina,²⁰⁹ Oregon,²¹⁰ Texas,²¹¹ and Wisconsin.²¹² California adopted a statute which applied only to initial securities offerings, not secondary trading,²¹³ and which permitted securities brokers to obtain a general exemption to sell securities of any sort upon proof of good reputation.²¹⁴

In Massachusetts—a state with a significant population of issuing firms and the location of a leading regional securities exchange²¹⁵—a legislative commission recommended against adoption of a Kansas-style law in 1912. The commission noted that securities sales in Massachusetts were usually made through bankers and brokers in the state and “no complaints had been presented . . . as to their operations.”²¹⁶ The commission recommended a version of the IBA’s proposed statute without merit regulation.²¹⁷ Such a statute was introduced in the Massachusetts legislature in 1913.²¹⁸

In New York a fierce battle broke out between those favoring Kansas-style legislation—presumably agrarian and upstate interests—and the securities industry and stock exchanges. The state assembly adopted a Kansas-style bill in 1913,²¹⁹ but the IBA organized to kill the bill in the state senate.²²⁰

enactment of such laws); and *infra* notes 227-34 and accompanying text (describing the IBA’s efforts to force repeal or amendment of newly enacted blue sky provisions).

204. Act of Apr. 9, 1913, ch. 209, § 21, 1913 Me. Laws 291, 292.

205. *Id.* § 12, 1913 Me. Laws at 297.

206. Act of Aug. 19, 1913, No. 263, 1913 Ga. Laws 117.

207. Act of Apr. 19, 1913, ch. 137, 1913 Iowa Laws 137.

208. Act of Apr. 21, 1913, ch. 199, 1913 Neb. Laws 603.

209. Act of Mar. 12, 1913, ch. 156, 1913 N.C. Sess. Laws 249.

210. Act of Feb. 28, 1913, ch. 341, 1913 Or. Gen. Laws 668.

211. Act of Aug. 21, 1913, 33d Leg., 1st C.S., ch. 32, 1913 Tex. Gen. Laws 66.

212. Act of Aug. 21, 1913, ch. 756, 1913 Wis. Laws 1108.

213. Investment Companies Act, ch. 353, § 2(e), 1913 Cal. Stat. 715, 715.

214. *Id.* § 6, 1913 Cal. Stat. at 718.

215. See CAROSSO, *supra* note 7, at 44 (“The Boston Stock Exchange was the principal market for industrial securities before 1900.”).

216. C.A. Dykstra, *Blue Sky Legislation*, 7 AM. POL. SCI. REV. 230, 232-33 (1913).

217. *See id.* at 233.

218. *See Massachusetts’ “Blue Sky” Law*, 78 AM. BANKER 1825, 1825 (1913) (describing the principal features of the Massachusetts statute, which included: financial disclosure by companies whose securities are for sale in the state; mandatory licensing requirements and reporting regulations for brokers doing business in the state; and state-sponsored oversight of securities marketing and transactions).

219. *See Blue Sky Laws in New York*, *supra* note 177, at 1000 (explaining the bill as a “crude attempt to copy some of the ‘blue sky’ legislation of other states”).

220. *See Hearing on “Blue Sky” Bill*, *supra* note 155, at 1008 (reporting that the New York

Thus, between 1911 and 1913, the states adopting Kansas-style blue sky legislation were generally ones without a significant investment banking industry and with powerful farming interests.²²¹ States rejecting blue sky regulation altogether tended to fall into one of two categories: states such as Maine, Delaware, Nevada, and Maryland, which, although generally rural and hence natural candidates for blue sky laws, were bidding for corporate charters at the time;²²² and states with large securities or manufacturing interests—namely, New York, Pennsylvania, Massachusetts, Illinois, and Indiana.²²³ However, the drive for blue sky legislation made some headway in two of these states with powerful farming interests—New York and Indiana.²²⁴ The remainder of the states that adopted modified blue sky laws, without the feature of merit regulation that distinguished the Kansas statute,²²⁵ appear to have effected a compromise between competing political forces.

VI. The Hiatus of 1914

Surprisingly, although blue sky laws flourished in 1913, the legislative activity stopped abruptly in 1914. No state adopted a blue sky statute that year. The collapse in the momentum for blue sky legislation after 1913 was the result of four principal factors.

First, the drive for blue sky laws in 1913 had been given an artificial push by the election of 1912, which was deeply concerned with attitudes towards the financial industry. To tap the prevailing public distrust of "Wall Street," many candidates for office at the state level endorsed the general concept of regulating securities swindlers.²²⁶ In light of the tenor of the times, it would probably have been unwise for a candidate to take any other position. The political promises made in 1912 had been cashed in by 1913.

Second, states in which blue sky legislation was likely to be most popular—rural states without large manufacturing interests or major

members of the IBA were opposed to the bill and were calling for hearings on the matter); PARRISH, *supra* note 7, at 11 ("The IBA's powerful New York constituency persuaded the state senate to kill the [license law] . . .").

221. *See supra* notes 180-91 and accompanying text (chronicling the passage of blue sky laws in Kansas and other predominantly agricultural states in 1911, 1912, and 1913).

222. *See supra* notes 194, 202-05 and accompanying text (discussing the opposition to blue sky legislation in states which were active in the corporate chartering market).

223. *See supra* notes 195, 197-98 and accompanying text (describing the fate of blue sky proposals in several manufacturing states); *supra* notes 215-20 and accompanying text (detailing legislative responses in states with strong securities interests).

224. *See supra* text accompanying notes 195, 219-220.

225. *See supra* notes 199-201, 206-14.

226. *See "Blue Sky" Legislation in Indiana*, *supra* note 153, at 921 (observing that in recent campaigns many governors promised legislation regulating dealers in fraudulent securities).

securities firms—had already adopted legislation by 1913. Additional legislation would be more difficult to achieve in the remaining states.

Third, the constitutionality of blue sky legislation, which had not been a substantial issue during the outpouring of statutes the previous year, was called into serious question in 1914, largely due to vigorous test-case litigation by the IBA.²²⁷ These litigation tactics proved stunningly successful in a series of decisions in 1914 and 1915.²²⁸

In *Alabama & New Orleans Transportation Co. v. Doyle*,²²⁹ the court condemned the Michigan blue sky law for going far beyond its stated purpose of “stop[ping] the sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines and other like fraudulent exploitations.”²³⁰ The statute would have been perfectly constitutional if its effect were merely to prohibit fraudulent practices. But, in the court’s view, it exceeded the state’s police powers by prohibiting the sale of securities that were “honest, valid and safe” and by preventing experienced investors from purchasing securities which in the investor’s estimation gave “sufficient promise of gain to offset the risk of loss.”²³¹ Courts also invalidated blue sky statutes on the ground that they interfered with the free flow of interstate commerce²³² and infringed on the privileges and immunities of national citizenship. In a decision striking down the Iowa blue sky law, the court observed:

The mere reading of the act in question makes entirely clear . . . that it does impose burdens upon and denies privileges to citizens of other states which are not imposed upon and which are granted to citizens of Iowa. That such favoritism of the law of a state to its citizen subjects as this act grants cannot be successfully defended, no matter

227. The IBA spent the then enormous sum of \$22,429 supporting test cases during the year ending August 31, 1914. INVESTMENT BANKERS ASSOCIATION, PROCEEDINGS OF THE THIRD ANNUAL CONVENTION 66 (1914) [hereinafter 1914 IBA PROCEEDINGS].

228. See, e.g., *Geiger-Jones Co. v. Turner*, 230 F. 233 (S.D. Ohio 1916), *rev'd*, 242 U.S. 539 (1917); *N.W. Halsey & Co. v. Merrick*, 228 F. 805 (E.D. Mich. 1915), *rev'd*, 242 U.S. 568 (1917); *Bracey v. Darst*, 218 F. 482 (N.D. W. Va. 1914); *William R. Compton Co. v. Allen*, 216 F. 537 (S.D. Iowa 1914) (*per curiam*), *cert. dismissed*, 239 U.S. 652 (1915). In several of these cases, the plaintiffs were securities firms located in New York, Illinois, or other states with active securities industries and their lawyers were the elite corporate bar of the day. See *Reed*, *supra* note 7, at 180 n.3.

229. 210 F. 173 (E.D. Mich. 1914).

230. *Id.* at 175.

231. *Id.*

232. See *id.* at 182-83. Significantly, the plaintiffs in the *Doyle* case—rather clearly selected by the IBA for test-case purposes—were out-of-state securities firms and a holder of the securities of an out-of-state issuer. *Id.* at 177-78. The decision earned the praise of the editors of *Bankers Magazine*, who denigrated the Michigan statute as a “ridiculous and wholly unnecessary infringement on the rights of legitimate business.” “Blue-Sky” Laws Obscured by a Judicial Cloud, 88 BANKERS MAG. 283, 283 (1914). The magazine again called for a “clear, simple Federal enactment prescribing regulations under which those offering stocks and bonds for sale might be admitted to the use of the mails.” *Id.* at 284.

how laudable the purpose sought to be accomplished thereby may be thought to be, would appear settled²³³

As a result of these decisions, many IBA members were confident by 1914 that they had overcome the blue sky threat.²³⁴ It would have been difficult for even the most sanguine advocates of blue sky legislation to disagree with this assessment after reading the sweeping and apparently unanimous decisions striking down the blue sky laws.

A final reason for the cessation of blue sky activity was that the economic situation of larger banking and securities firms, although not that of the smaller (mostly state-chartered) banks, changed dramatically during 1914.²³⁵ The outbreak of war in Europe precipitated a crisis in big banks and securities firms in 1914 as a result of massive gold hoarding by foreign investors that depleted the gold reserves held at New York banks.²³⁶ The New York Stock Exchange closed on July 31, 1914, "[t]o prevent threatened demoralization," and did not fully reopen until mid-December.²³⁷ The average deposit base at national banks, which had grown to \$827,000 in June 1914,²³⁸ dropped after the crisis in July and August, falling to \$810,000 by September 1914.²³⁹ The Comptroller of the Currency evaluated the situation and opined: "The financial situation in New York was acute, and it was apparent that the effect of the European war on the banks and other financial institutions in the country would be threatening and deep-reaching."²⁴⁰ It seems probable that these highly adverse financial conditions, which affected the major banks, securities firms, and

233. *William R. Compton Co. v. Allen*, 216 F. 537, 549 (S.D. Iowa 1914), *cert. dismissed*, 239 U.S. 652 (1915).

234. *See* 1914 IBA PROCEEDINGS, *supra* note 227, at 67 (report of the committee on legislation) (asserting that IBA members need not worry about the threat of the blue sky laws any longer).

235. Conditions at the smaller banks appeared to have been quite similar to those prevailing over the previous several years. The inflation and high interest rates which contributed to the initial blue sky movement, *see supra* notes 27-31, 164 and accompanying text, continued unabated. Bond prices continued to drop, falling in the case of the bellwether 1925 United States issue from a low of 113¾ in 1911 to a low of 108¾ in 1914. *Compare supra* note 164 with 2 ANNUAL REPORT OF THE COMPTROLLER OF THE CURRENCY 51 (1916) [hereinafter 1916 REPORT]. State banks had increased their deposit bases and holdings of investment securities since 1911, but not dramatically—their average securities holdings in 1914 were \$27,000, compared with \$25,000 in 1911. *Compare* 2 1914 REPORT, *supra* note 165, at 676-77, with *supra* text accompanying note 161. Over the same period, average total individual deposits at state banks rose from \$215,000 to \$222,400. *See* 2 1914 REPORT, *supra* note 165, at 680-81. The indication from these figures is one of slight improvement, but not enough to alter the political stance of state bankers with respect to the blue sky laws.

236. *See* 1 1914 REPORT, *supra* note 165, at 12 (reporting that New York banks "faced a serious crisis" because a large amount of gold exports to Europe had drawn heavily on their resources).

237. *Id.* *See generally* ROBERT SOBEL, *THE BIG BOARD, A HISTORY OF THE NEW YORK STOCK MARKET 206-13* (1965) (chronicling the background of the 1914 closure of the Exchange).

238. *See* 1 1914 REPORT, *supra* note 165, at 44-45.

239. *See id.*

240. *Id.* at 13.

securities markets far more than state-chartered banks or smaller businesses, may have contributed to the general loss of momentum for blue sky legislation during 1914.

VII. The Failed Compromise of 1915 and the New Blue Sky Laws of 1916

Economic conditions changed dramatically in 1915. European money suddenly flooded into the country for safekeeping,²⁴¹ interest rates eased,²⁴² and war-related orders from abroad brought unprecedented increases in exports.²⁴³ The Comptroller of the Currency exulted in 1916 that the country was experiencing “the greatest prosperity it has ever known” and that “[t]he activity manifested in virtually every occupation and in every kind of industry and in all sections has been unprecedented.”²⁴⁴

Major beneficiaries were the state-chartered banks, especially outside major urban areas, that had suffered from a dearth of deposits in previous years,²⁴⁵ as well as smaller businesses that obtained financing from these banks.²⁴⁶ The Comptroller remarked that “banking capital is to-day more widely and more equitably distributed over the country than ever before in this generation.”²⁴⁷ National banks grew even more explosively during the period,²⁴⁸ with average total individual deposits in national banks rising from \$810,000 in 1914 to \$1,115,000 in 1916.²⁴⁹

The greatly improved financial position of smaller banks—and their significantly increased portfolios of bonds and other securities—seems to have reduced their interest in blue sky legislation. Complaints about speculative securities are virtually absent from the leading banking journals

241. “[G]old came to New York to settle accounts for imports, for investment in safe industries, and for participation in the American bull market. Gold imports in 1915 were 661.9% over those of 1914.” SOBEL, *supra* note 237, at 213-14.

242. The bellwether U.S. bonds of 1925, which had been trading at a low of 108¾ in 1914, reached a high of 112 in 1916. *See* 2 1916 REPORT, *supra* note 235, at 52-53.

243. The nation’s trade surplus increased 438.8% over the previous year. SOBEL, *supra* note 237, at 213.

244. 1 1916 REPORT, *supra* note 235, at 1.

245. Total deposits in state banks rose from \$3,227 million in 1914, to \$4,296 million in 1916. *Compare* 2 1914 REPORT, *supra* note 165, at 861 *with* 2 1916 REPORT, *supra* note 235, at 863.

246. *See* 1 1916 REPORT, *supra* note 235, at 2 (noting that “[b]usiness men, large and small, in the smaller cities and also in towns and rural districts, as well as in the centers of wealth, are now enabled to obtain capital . . . on terms more favorable than ever experienced in the past”).

247. 1 1916 REPORT, *supra* note 235, at 1.

248. *See Good Year for the National Banks*, 94 BANKERS MAG. 241, 241 (1917) (reporting that national banks received their highest earnings in history in 1916, both net and gross, according to figures compiled by the Comptroller of the Currency).

249. *Compare* 1 1914 REPORT, *supra* note 165, at 44-45 *with* 1 1916 REPORT, *supra* note 235, at 2, 37.

in 1915. Such evidence as we have suggests a considerable softening of views among smaller banks. The *American Banker*, which had taken the editorial position in 1913 that blue sky legislation was "good" in smaller states but ill-advised in New York,²⁵⁰ now reprinted with apparent approval a *Wall Street Journal* editorial fiercely attacking Kansas-style statutes.²⁵¹

By 1915, accordingly, events had transpired to narrow the differences between investment bankers and their chief rivals in the blue sky fight—the state bank regulators. The constitutionality of blue sky legislation—at least legislation based on the Kansas model—was very much in doubt. Even the state bank supervisors accepted this fact.²⁵² The IBA had consolidated an effective lobby of bond issuers and investment banks to combat future Kansas-style regulation.²⁵³ Meanwhile the smaller banks and borrowers, which had been the chief proponents of blue sky legislation, had begun to prosper, thus greatly reducing concerns about losing deposits or loan funds. Conditions appeared propitious for a compromise that would finally settle the blue sky issue.

Representatives of the two groups—state bank supervisors and the IBA—met in 1915 and hammered out new model legislation²⁵⁴ under which persons proposing to sell securities in a state were required to notify a state official, who would be authorized to investigate and to prosecute persons found to be selling securities by means of any scheme or artifice to defraud.²⁵⁵ State securities administrators would not be authorized under this model legislation to prohibit sales of securities on the ground that they did not promise a sufficient profit or were otherwise not "fair" or meritorious.²⁵⁶ This draft legislation provided the basis for a Virginia statute enacted in 1916.²⁵⁷

This compromise might have resolved the controversy if it had been achieved in 1913 instead of 1915. But by 1915, when the IBA finally

250. See *supra* note 177.

251. *Blue Sky Laws*, 80 AM. BANKER 4011 (1915).

252. See 1914 IBA PROCEEDINGS, *supra* note 227, at 76 (report of Caldwell, Masslich & Reed).

253. See CAROSSO, *supra* note 7, at 186 (noting that "the IBA was fighting the spread of state regulation in the courts" and that "[t]he association's fire was directed specifically against statutes of the Kansas type").

254. Reed, *supra* note 7, at 180 n.3; INVESTMENT BANKERS ASSOCIATION, PROCEEDINGS OF THE FOURTH ANNUAL CONVENTION 186 (1915) (report of Robert R. Reed) [hereinafter 1915 IBA PROCEEDINGS]. The recommendations of the National Association of Supervisors of State Banks are reported in *Blue Sky Legislation*, 80 AM. BANKER 3931 (1915).

255. Reed, *supra* note 7, at 180 n.3; see 1915 IBA PROCEEDINGS, *supra* note 254, at 192-94 (report of Robert H. Reed).

256. Counsel for the IBA issued an opinion explaining how the investment bankers' bill passed constitutional scrutiny, as a reasonable police power regulation, while Kansas-style regulation did not. See *The Blue Sky Laws*, 91 BANKERS MAG. 588, 589-90 (1915).

257. Act of Mar. 23, 1916, ch. 499, 1916 Va. Acts 835.

settled its differences with the banking commissioners, the administrative power over blue sky regulation had fallen into other hands in many states. Although some states vested blue sky enforcement in their banking commissioners, others placed the authority in the hands of the railroad commissioner,²⁵⁸ the commissioner of corporations,²⁵⁹ the secretary of state,²⁶⁰ the state auditor,²⁶¹ or in specialized securities regulators.²⁶² It is not clear whether the state banking commissioners carried proxies from these other regulators into their negotiations with the IBA.

Moreover, the IBA's test case litigation strategy, effective as it had been at casting constitutional doubt on the blue sky statutes, also introduced state attorneys general into the picture, who were charged with defending their states' statutes in court. It is clear that the state banking commissioners did not negotiate on behalf of these officials. To the IBA's dismay, the association of state attorneys general refused to go along with the deal that had been struck between the IBA and the state banking commissioners.²⁶³ The attorneys general insisted both on prosecuting the appeals in the blue sky cases to the Supreme Court and on drafting their own model legislation.²⁶⁴

This legislation departed from the Kansas model in that it did not explicitly authorize paternalistic rejections of proposed securities sales when the government official felt that the instrument in question did not offer a fair return. It did, however, substitute a prohibition on the sale of securities which would "work a fraud" upon the purchaser.²⁶⁵ The Michigan legislature enacted a statute based on the attorneys general's model,²⁶⁶ and several other states followed suit.²⁶⁷

We do not have information on the interests pushing this mini-revival of blue sky legislation. Our inference is that the states adopting the attorneys general's model did so principally at the behest of the attorneys general themselves rather than as a result of any renewed outpouring of political pressure from small banks or local borrowers, but the matter is conjectural without firmer evidence. Whatever the cause of these statutes,

258. *See, e.g.*, Act of Apr. 21, 1913, ch. 199, 1913 Neb. Laws 603.

259. *See, e.g.*, Act of May 18, 1912, ch. 69, 1912 Ariz. Sess. Laws 338.

260. *See, e.g.*, Act of July 1, 1912, No. 40, 1912 La. Acts 47.

261. *See, e.g.*, Act of Feb. 6, 1913, ch. 15, § 5, 1913 W. Va. Acts 114.

262. *See, e.g.*, Act of May 2, 1913, No. 143, 1913 Mich. Pub. Acts 243.

263. *See* Brief for Appellees at 48-49, *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917) (No. 413).

264. *See id.*

265. *See* Amicus Curiae Brief at 11, *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917), *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917), *Merrick v. Halsey & Co.*, 242 U.S. 568 (1917) (Nos. 413, 438-40, 860).

266. Act of Apr. 9, 1915, No. 46, 1915 Mich. Pub. Acts 63.

267. *See Reed, supra* note 7, at 181 n.4.

however, it was evident that the 1915 attempt at compromise failed to resolve the problem.

VIII. The Blue Sky Cases of 1917

Despite the failure of the compromise of 1915, the IBA hoped for vindication in the Supreme Court. A Supreme Court decision affirming the lower court blue sky cases would severely cripple the Kansas-style regimes of merit regulation. States wishing to continue securities regulation would have to overhaul their statutes and substitute some version of the IBA's proposed registration and antifraud legislation.

When the decisions were announced in 1917, however, it was the Kansas-style blue sky laws, and not the IBA, that received vindication.²⁶⁸ Writing for the Court in *Merrick*, Justice McKenna held that it was within a state's police power to prevent deception in the sale of securities.²⁶⁹ The statute admittedly burdened honest businesses, but only so that "dishonest business may not be done."²⁷⁰ Although this might admittedly cause expense and inconvenience, said McKenna, "to arrest the power of the state by such considerations would make it impotent to discharge its function. It costs something to be governed."²⁷¹

With respect to the alleged burdens on interstate commerce, the Court observed that the statute in question applied only to dispositions of securities *within* the state: "Upon their transportation into the state there is no impediment."²⁷² Thus, because the statutes in question affected the securities in question only when a disposition of them was attempted within the state, the interference with interstate commerce was "only incidental[]" and therefore within the state's constitutional authority.²⁷³

The decisions in the *Blue Sky Cases*, on first blush, could not have been worse for the IBA or better for its opponents. The Supreme Court had flatly repudiated all the lower court opinions in the IBA's favor and had ruled against the IBA point-by-point on the constitutional issues. It was perfectly evident, in the wake of the Supreme Court's decisions, that any state wanting to adopt Kansas-style blue sky legislation was free to do

268. See *Merrick v. Halsey & Co.*, 242 U.S. 568 (1917); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917); *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917). Of these three cases, only the Michigan statute represented a true test case for the securities industry; the other two, to the dismay of securities industry strategists, involved the sort of fly-by-night enterprises that the blue sky laws were ostensibly designed to prevent. See *Reed*, *supra* note 7, at 180 n.3.

269. *Merrick*, 242 U.S. at 588.

270. *Id.* at 587.

271. *Id.*

272. *Hall*, 242 U.S. at 557.

273. *Id.* at 559.

so as far as the federal Constitution was concerned. The IBA's litigation strategy had apparently ended in catastrophe.

Yet the *Blue Sky Cases* did not, in fact, represent a defeat for the investment bankers—at least as far as their actual business interests were concerned—for two important reasons. First, because the IBA had already effectively vitiated the most burdensome elements of the state blue sky laws by 1917, the Supreme Court's endorsement of those laws did little but subject the IBA's members to additional annoyance. Throughout the period from 1913 to 1917 the IBA had been continuously active in the state legislatures. Its strategy was not to seek a repeal of blue sky statutes, but rather to obtain reasonable exemptions to allow "safe" securities to be sold without the need to comply with the burdensome rules applicable to more speculative issues. The IBA was quite successful in this strategy. We have already seen that even by 1913 the IBA was able to influence a large number of states to reject Kansas-style merit regulation in favor of milder regulatory approaches, including nine states which adopted legislation patterned on the IBA's proposed statute.²⁷⁴

The IBA continued to enjoy success in this campaign during 1915 and thereafter. Many states added exemptions to their blue sky statutes to allow the sale of most of the securities with which the IBA dealt.²⁷⁵ Even Kansas amended its statute in 1915, restricting its coverage to "speculative" securities, defined to include "securities into the specified par value of which the element of chance or hazard . . . equal[s] or predominate[s] over the elements of reasonable certainty, safety and investment" and "securities to promote or induce the sale of which, profit, gain, or advantage unusual in the ordinary course of legitimate business is in any way advertised or promised."²⁷⁶ Other states followed the lead of Nebraska and Wisconsin and exempted securities listed on major stock exchanges.²⁷⁷ Still others exempted securities listed on a standard manual of information approved by the designated authority²⁷⁸—this would exempt aftermarket trading in the securities of most large corporations listed on major exchanges.²⁷⁹ The effect of these statutory changes was

274. See *supra* notes 202-14 and accompanying text.

275. See, e.g., Act of Mar. 15, 1915, ch. 275, 1915 S.D. Laws 657, 659; Act of Apr. 12, 1915, ch. 149, 1915 Iowa Acts 182, 183.

276. Act of Mar. 23, 1915, ch. 164, 1915 Kan. Sess. Laws 195. J.N. Dolley had acknowledged as early as 1912 that the original 1911 law was too harsh and that an exception should be added for the issuance of general licenses to reputable investment bankers to sell stocks and bonds of their choosing, provided that "they handle nothing but first class securities and their reputations along other lines are found satisfactory [to] the Bank Commissioner . . ." J.N. Dolley, *Dolley Defends Kansas Blue Sky Law*, 77 AM. BANKER 4416, 4416 (1912).

277. See *supra* notes 208, 212 and accompanying text.

278. See, e.g., Act of Mar. 15, 1915, ch. 275, 1915 S.D. Laws 657; Act of Apr. 9, 1915, No. 46, 1915 Mich. Pub. Acts 63.

279. An example of a standard manual was Moody's Manual of Railroads, listing information on

to provide a relatively free market within many states for the types of securities underwritten by the IBA's members and issued by major manufacturers, railroads, and public utilities—the IBA's allies in the campaign against Kansas-style legislation from 1912 to 1913.

The other reason the *Blue Sky Cases* did not represent a defeat for the investment bankers is found in the *Hall* case. While upholding the blue sky statute at issue in the case, Justice McKenna pointedly observed that it imposed no impediment on the transportation of securities to a state, only on the sale or disposition of securities once they had entered the state's borders.²⁸⁰ The clear implication was that the sale of a security by mail could not constitutionally be regulated at the state level. By the same token, promotion of a security by interstate mail or telephone calls could not be regulated by the blue sky laws. And, although McKenna's opinion did not speak to this issue directly, it also seemed clear, given First Amendment considerations, that states would incur a substantial risk of invalidation if they attempted to regulate the promotion of securities by means of newspapers or other media—at least as long as the advertisement in question proposed a transaction to take place outside of the state's borders.

By 1917, in short, a wide variety of alternative marketing mechanisms were available to the IBA—and indeed, available to the “fly-by-night” hawkers of speculative securities—and there appeared to be little that the states could do to prevent this activity under their blue sky laws. The IBA and others in the banking and investment community had been aware of the potential for securities sales by means of the mails or other modalities of interstate commerce for years.²⁸¹ The Kansas blue sky law was being circumvented by mail solicitations as early as 1912.²⁸² In 1915, two years before the Supreme Court's *Blue Sky Cases*, the IBA's counsel had circulated an opinion concluding that “dealers may, as a matter of law, safely ignore these [blue sky] laws in strictly interstate transactions.”²⁸³ The opinion went on to advise dealers “that in handling interstate business

railroad lines. See Brief for Appellees at 20, *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917) (No. 413). Because listing was in the discretion of publishers and did not discriminate between sound and questionable corporations, the standard manuals may not have provided accurate information about security values. See *id.* at 19-20.

280. *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 559 (1917).

281. See, e.g., *Smith*, *supra* note 151, at 2999 (“[A blue sky law] cannot stop the United States mails from other States, nor the salesman who does not himself deliver his goods, but takes the order back to Chicago or New York. It can and will stop the Michigan industry which should have immediate financing.”).

282. See *Topeka, Kans.*, 78 AM. BANKER 358, 358 (1913) (reporting that some companies refused permission to sell securities in Kansas under the blue sky law “have evaded it by advertising in the Kansas papers, and a considerable number of Kansas people invested money in the concerns”).

283. *The Blue Sky Laws*, *supra* note 256, at 590.

by mail they endeavor as far as possible . . . to meet the views of the administrative officials of the States," but that "they should feel practically safe in ignoring the laws, at least for the purpose of making offerings by mail."²⁸⁴ This opinion proved to be a charter for the business of unregulated interstate securities sales by mail that burgeoned in the wake of the Supreme Court's *Blue Sky Cases*.

We reach the end of our chronological study with what might be called a Pyrrhic defeat for the IBA. Blue sky legislation had been adopted in many states, yet even states that followed Kansas with merit regulation were enacting broad exemptions allowing elite investment bankers to sell high-grade securities with only minimal regulatory interference. The IBA was soundly trounced in the Supreme Court, yet emerged with broad powers to sell securities in all states—even those which had not granted generous exemptions from the regulatory requirements by affirmative legislation. These conditions would generate a new round of concerns about speculative securities sales after the Armistice and renewed calls for legislation, this time primarily at the federal level, ultimately leading to the enactment of the Federal Securities Act of 1933. That, however, is a different story.

IX. Justifications for Blue Sky Legislation

It may be useful to examine the justifications advanced by the proponents of blue sky legislation, especially legislation on the Kansas model that permitted prohibition of securities sales solely on the ground that they did not promise an adequate rate of return for the investor or that they were too speculative. To what degree were these justifications actually supported by the evidence?

At the time of their enactment, the blue sky laws were typically justified in political rhetoric as a means to thwart the schemes of a class of people who were denigrated repeatedly as fly-by-night operators, fraudulent promoters, robbers, cancers, vultures, swindlers, grafters, crooks, gold-brick men, fakirs, parasites, confidence men, bunco artists, get-rich-quick Wallingfords, and so on.²⁸⁵ Against this class of bad operators was counterpoised a class of victims, usually portrayed as innocent, weak minded, vacillating, foolish, or guileless, and usually cast in the roles of widows, orphans, farmers, little idiots or working people.²⁸⁶ The

284. *Id.*

285. *See, e.g., National Bond Dealers' Association, supra* note 57, at 1941 (decrying such characters as "swindlers" and "unscrupulous speculators"); *Promotion Schemes in Texas, supra* note 86, at 1386 (warning of "crooks," "confidence men," "undesirables," and "grafters").

286. *See, e.g., Miller, supra* note 44, at 3770 (characterizing the victims of securities fraud as "foolish," "weak minded," "innocent," and "vacillating," among other things).

justification for the statutes was therefore simple: the fraudulent salesmen were palming bad merchandise off on the innocent and unsophisticated public, and the blue sky laws were the way to stop the practice. Usually the statutes were supported in terms no more sophisticated than this.

Beneath this rhetoric, so full of the epithets of the progressive movement, we may tease out three separate justifications for blue sky laws. Rephrased in today's analytic categories, these were: (1) preventing fraud in the sale of securities; (2) combating market failure arising from informational problems; and (3) paternalism.

A. Fraud

The social value of preventing fraud in the sale of securities is too clear to require elaboration. If buyers could not rely on the truthfulness of statements made by the sellers in connection with securities transactions, many otherwise beneficial transactions would not occur. The functioning of capital markets in facilitating capital formation would be severely impaired, to the detriment of issuers, buyers, and the economy at large. Thus, the prevention of fraud is a potentially appealing public-interest justification for these laws.

The justification for blue sky laws as fraud-prevention devices, however, is based on two empirical premises: first, that securities fraud was a significant problem at the time that was not being adequately addressed either by existing law or by market forces, and, second, that the blue sky laws were reasonably tailored to prevent such fraud. Neither of these premises is strongly borne out by the evidence.

There were, to be sure, many complaints about fraudulent securities promotions between 1910 and 1913, although they died off thereafter. Securities frauds unquestionably occurred during this period. The actual extent of fraudulent sales, however, is uncertain. Many of those complaining about securities fraud had an interest in exaggerating the extent of the problem, and their reports should be discounted accordingly. Further, the rhetoric of the times often labeled securities as "fraudulent" when, in all probability, they were merely highly speculative. And, although securities salesmen no doubt engaged in frequent puffery, they were in this respect acting no differently than salesmen of other goods. If actual fraud had been truly widespread, we would expect to see extensive evidence in the historical record of criminal prosecutions or private damages actions against fraudulent promoters. We simply do not find such evidence.

Small bankers and other proponents of blue sky laws frequently asserted that the purchasers of speculative securities were widows, orphans,

or poor people.²⁸⁷ Yet this claim was far-fetched. Widows, orphans, and poor people did not have the money to buy speculative securities. In fact, the purchasers of these securities appeared to be, for the most part, members of a rising middle class and an established upper middle class—including, apparently, numerous bankers²⁸⁸—who had liquid wealth and who found low-interest bank deposit accounts to be unattractive forms of investment in a time of high nominal interest rates. These individuals appeared to be making a rational choice about what to do with their money. It is unlikely that they would confuse a speculative security—such as an interest in a gold mine or venture to develop a new invention—with a gilt-edged corporate bond. Moreover, if the securities in question were truly fraudulent, we would not expect customers to return to the poisoned well and get more. Yet customers frequently wanted to buy more securities, even if those purchased previously had not panned out.²⁸⁹ There were so many repeat customers that an active trade in mailing lists of past purchasers of speculative securities grew up.²⁹⁰

The available evidence suggests that many of the securities attacked by the proponents of blue sky legislation were not, in fact, inherently fraudulent. Among those securities alleged to be fraudulent were stock in metal mines, oil companies, gold mines, and cooperative farms, often sold by mail order at a low price per share.²⁹¹ Such securities were undoubtedly speculative, and many investors lost money in them. Yet some investors also profited. Many of the California oil firms denigrated as “speculative” by proponents of blue sky legislation were paying out large dividends in these years, and the success rate for exploratory wells was apparently quite high.²⁹² One thoughtful investment banker, analyzing the surge of speculative issues in 1912, observed that many of these involved the

promotion by inexperienced parties of what are known as “construction propositions;” that is to say, enterprises in process of establishment, as, for instance, the many irrigation systems whose bonds have been placed before the public during the last few years and whose

287. See *supra* text accompanying note 131.

288. See E.S. Wagenheim, *The Promoter and the Banker*, 77 AM. BANKER 1875, 1875 (1912) (criticizing members of the banking profession whose investment in questionable securities lends credence to “schemes . . . to fleece the unwary”).

289. J.N. Dolley resorted to metaphor in explaining the Kansans’ penchant for repeatedly purchasing speculative securities, observing: “The innocent investor might be compared to the fertile subsoil of the tropical regions. From it may be taken several crops a year without exhausting its infinite confidence.” Dolley, *supra* note 65, at 1706.

290. See *supra* text accompanying note 33.

291. See Matthews, *supra* note 33, at 175.

292. Cf. John O. Dresser, *The New Oil Industry in California*, 82 BANKERS MAG. 494, 495 (1911).

completion in only a few cases has become a fact. And the same applies in many other lines.²⁹³

Again, the evidence seems to indicate that the securities in question were not so much fraudulent as merely highly speculative.

There is, to be sure, considerable evidence that state securities commissioners rejected large volumes of proposed offers during the early years of blue sky enforcement. Kansas Banking Commissioner J.N. Dolley reported in 1912 that he had rejected all but seventy of eight hundred applications to sell securities in his state.²⁹⁴ His successor announced in 1915 that "Kansas' annual toll to get-rich-quick concerns has been reduced from \$4,000,000 to less than \$100,000" as a result of that state's blue sky law.²⁹⁵ From 1915 to 1916, the California blue sky administrator approved securities totalling \$246 million in selling price and disapproved \$53 million in par value securities²⁹⁶—and this in a state in which one would expect high levels of approval because of its significant petroleum and mining interests. The Michigan Securities Commission prevented the sale of over \$200 million in securities between 1913 and 1918.²⁹⁷ Between 1920 and 1923 the Nebraska securities commissioner rejected \$51 million out of \$200 million in securities for which license applications were filed.²⁹⁸

Professor Seligman, the leading analyst of blue sky enforcement during the formative period, accepts such figures as indicating that "securities fraud was a substantial problem" in the states prior to the adoption of the Securities Act of 1933.²⁹⁹ In truth, however, the large volume of rejected securities does not necessarily indicate high levels of fraud because of the enormous discretion involved in the decision to exclude a security, especially in states with merit regulation.

Some inkling of the actual bases for rejecting securities can be gleaned from the comments of an official in the Kansas blue sky department in 1918. Speaking to his fellow securities officials from other states, this administrator identified the following securities as ones that should be

293. Carles et al., *supra* note 27, at 266.

294. See *supra* text accompanying note 82. But see *supra* notes 87-90 and accompanying text (discounting Dolley's claims).

295. "Blue Sky" Law Effective in Kansas, 80 AM. BANKER 2715, 2715 (1915) (quoting S.T. Seaton, head of the "blue sky" department in the State Bank Commissioner's office).

296. Gerald D. Nash, *Government and Business: A Case Study of State Regulation of Corporate Securities, 1850-1933*, 38 BUS. HIST. REV. 144, 156-57 (1964).

297. Seligman, *supra* note 6, at 21. Seligman's data is taken from Note, *Uniform Sale of Securities Act*, 30 COLUM. L. REV. 1189, 1196 n.45 (1930) (citing REPORT OF THE MICHIGAN SECURITIES COMMISSION (1918)).

298. *Regulating the Sale of Securities*, *supra* note 135, at 65 (statement of Commissioner Touvelle).

299. Seligman, *supra* note 6, at 20.

discouraged under wartime conditions: “[C]ompanies that propose to develop lands . . . by irrigation or drainage or by any other enhancing improvement or utility which necessarily will require time, labor, or capital”; “[e]nterprises for the manufacture and distribution of automobiles and pleasure cars”; “[e]nterprises for the erection of buildings”; and “[e]nterprises to develop or produce sales companies for the sale or distribution of luxurious commodities, goods or accessories.”³⁰⁰ To the applause of his fellow securities administrators, the official went on to boast:

As an evidence of the manner in which we have been trying to administer this law in the State of Kansas, having had a Blue Sky law now over seven years, at the present time the number of companies authorized under that law . . . is less than 250. The capital stock in these companies in my judgment will not average more than \$100,000. This is the accumulation of over seven years' work. . . . I throw this in as a suggestion as to the amount of business that is being done in our state, which is I believe the pioneer in Blue Sky legislation.³⁰¹

Given the evidence that many of the securities rejected by state officials during the early years of the blue sky laws may not have been fraudulent, it appears that the data showing apparently high levels of enforcement do not, in themselves, establish the existence of a serious problem of securities fraud during the period in question.

Even if there was a serious problem with securities fraud, it is not clear that the Kansas-style blue sky laws were appropriate measures to combat the problem. A full disclosure statute—perhaps with a system of administrative control of marketing such as that later incorporated into the federal Securities Act of 1933³⁰²—would appear, at least on the surface, better crafted to cope with fraud while allowing bona fide sales to continue. But the early Kansas-style blue sky statutes went further, giving state securities commissioners virtually unfettered discretion to reject proposed securities sales even when the sales literature made full disclosure of the risks. This appears grossly overinclusive. An argument might be made that the overinclusiveness was necessary for reasons of administrative convenience, but it does not appear particularly persuasive. Thus, the need to combat securities fraud, at least standing alone, does not provide a convincing public policy justification for these statutes.

300. NATIONAL ASSOCIATION OF SECURITIES COMMISSIONERS, PROCEEDINGS OF THE FIRST ANNUAL CONVENTION 47 (1918) (remarks of Special Assistant Bank Commissioner Organ).

301. *Id.* at 47-48.

302. 15 U.S.C. §§ 77a-77aa (1988).

B. Informational Problems

A different potential justification for these statutes is that they were designed to deal with severe informational problems in securities markets.³⁰³ If consumers could not discover accurate information about the quality of securities offered for sale, a loss of confidence in securities markets generally might result. As one banking journal observed, "So many people have lost their money on 'fake' investments that they seem to be incapable of distinguishing the false from the genuine, and hence are distrustful of all."³⁰⁴ This is a straightforward application of George Akerlof's "lemons" model for markets subject to large informational asymmetries.³⁰⁵ Some good securities could have been driven off the market, to the detriment of the offering firm, the underwriters, and the public at large.

The problem of informational asymmetry provides a potentially plausible justification for the blue sky laws, but the analysis appears vulnerable in a number of respects. First, if a "lemons" problem actually existed, many potential buyers, unable to distinguish good investments from worthless ones, would respond by declining to invest at all. This does not appear to have been the case. In fact, it is not clear how serious the information problem was. It was probably not too difficult for someone seeking assurances of return to distinguish blue-chip bonds from stock in a new gold mining venture, for example. Moreover, there were vigorous efforts in the private sector to assist the public in distinguishing between good and bad securities. The New York Stock Exchange began to insist on increasingly detailed disclosure as a precondition for listing on the exchange.³⁰⁶ And quite apart from the information disclosed, the mere fact of listing on an exchange served as a signal of quality.³⁰⁷ The

303. The rhetoric of blue sky laws did not clearly distinguish between the problem of actual fraud or misrepresentation, on the one hand, and the problem of public confusion and failure to differentiate between good and bad securities, on the other. A worthless or highly speculative security was typically labeled as fraudulent, even if the seller made no affirmative misrepresentations, because the security was seen as being palmed off on the public as a worthwhile investment, when in fact it was not.

304. *The Investment Bankers' Organization*, 77 AM. BANKER 1302, 1303 (1912).

305. See generally George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970) (discussing generally the relationship between quality and uncertainty). Akerlof uses the used car market to illustrate the potential breakdown of a market system when informational asymmetries exist. See *id.* at 489-92.

306. See NEW YORK STOCK EXCHANGE, MARKETPLACE: A BRIEF HISTORY OF THE NEW YORK STOCK EXCHANGE (1982) (reporting that after 1903 listing agreements on the NYSE became more rigorous, generally requiring that listed firms publish annual reports and quarterly income statements, prohibiting speculation by listed firms in their own securities, and mandating prior notice to shareholders on the exchange of new issues and actions on dividends). Even commentators otherwise highly critical of the securities industry, such as Harvard political scientist William Ripley, lauded the New York Stock Exchange as "[b]eyond peradventure . . . the leading influence in the promotion of adequate corporate disclosure the world over." RIPLEY, *supra* note 38, at 210.

307. See Hideki Kanda & Jonathan Macey, *The Stock Exchange as a Firm: The Emergence of*

elite investment bankers attempted to combat the “lemons” problem in 1912 by forming their own organization, the IBA, with a view, in part, toward establishing a reputation for reliability and integrity that the public could trust.³⁰⁸ For the most part, a consumer could know a blue chip security when he or she saw one, although distinguishing among grades of more speculative securities could have remained difficult.

Even if a serious informational problem remained despite these efforts to provide reliable signals of quality to consumers, however, it is not clear that Kansas-style blue sky legislation was well tailored to the goal of assuring quality. Although securities commissioners were authorized to reject a security simply because it was of low quality, it is not evident how the quality determination was to be made. Securities commissioners were not fortune tellers. They could not accurately predict which securities would do well and which would not.³⁰⁹ Even when low-quality securities could be identified, it is not evident why a disclosure requirement would not have been equally efficacious at alerting consumers to the dangers of a particular issue, while not foreclosing the market entirely to consumers willing to take the risks in order to get a chance at the rewards.

C. *Paternalism*

A third possible justification for the blue sky laws—one which would not find acceptance everywhere, but which nevertheless represents an important strain in the pattern of American law—is paternalism. The argument would be that even if no fraud occurred in the sale of securities, and even if the consumer were fully informed about the riskiness of the securities in question prior to sale, there would still be a justification for regulation on the ground that the consumer simply did not know his or her own best interests.

Paternalistic justifications—implicit in the repeated characterization of the purchasers of blue sky securities as widows and orphans—can be found among supporters of the state blue sky statutes. The classic statement is that of J.N. Dolley, the father of blue sky regulation, who remarked: “It has been said that the people do not need a guardian to supervise their investments, but I want to say to you . . . that a large [percent] of them do need a guardian, especially in matters of this kind.”³¹⁰ The President of

Close Substitutes for the New York and Tokyo Stock Exchanges, 75 CORNELL L. REV. 1007, 1009-10 (1990).

308. See *The Investment Bankers' Organization*, *supra* note 304, at 1303 (discussing the possible formation of an IBA, the calibre of people involved in its formation, and the impact such an organization would have on the industry's professionalism).

309. If they could make such predictions, they probably would have taken up playing polo rather than sitting in an office reviewing applications and forms.

310. Dolley, *supra* note 65, at 1705.

the Florida Bankers' Association was even more explicit, recommending Kansas-style legislation on the ground that "[w]e should have some legislation in this State to protect the public against its own weakness. I refer to the means by which the public is tempted by the prospect of quickly acquired wealth, to part with its money in exchange for securities that are steeped in fraud."³¹¹

Putting aside the question of whether paternalism is an appropriate justification for government intervention in markets, there remains the question of whether it could justify the Kansas-style blue sky laws. We have observed that many customers of securities appeared to be fully able to protect themselves against unwise investments.³¹² On the other hand, many customers were also new at purchasing securities and probably were relatively unsophisticated at dealing with fast-talking securities salesmen. Accordingly, while we doubt that paternalism constituted an adequate reason for enacting blue sky laws, it seems possible that the blue sky movement's success would not have been possible but for strong feelings of paternalism among the lawmakers.

* * *

Based on the above analysis, there appear to be at least two (three, if you accept paternalism) potential public interest justifications for blue sky statutes. These justifications do not appear particularly strong, however, especially as applied to Kansas-style legislation with merit regulation. This Article has advanced evidence that blue sky legislation was promoted in the legislative process by a coalition of groups—small banks, state banking supervisors, small businesses, and farmers—which stood to benefit financially from the legislation. There would thus appear to be solid grounds for suspicion of these supposedly "public interest" rationales. Again, this is not to say that we find no evidence for the public interest rationales, only that the purpose and effect of the blue sky laws appear to have been far more heavily influenced by special private interests than standard historical accounts admit.

X. Conclusion

Standard histories portray blue sky laws as a public-spirited, spontaneous populist response to serious abuses in securities markets. The rapidity with which the states enacted blue sky legislation is taken to indicate the

311. Allen, *supra* note 109, at 1322. *But see* Smith, *supra* note 151, at 2998 (observing that the blue sky law "hardly squares with the old maxim, 'let the buyer beware,' that has made wits sharp and money conservative for centuries").

312. *See supra* notes 306-08 and accompanying text.

severity of the problem of fraudulent securities distributions. And the diffusion pattern of these laws is taken to indicate that where the economic might of the securities industry was not overwhelming—that is, in rural states such as Kansas—it was possible for states to adopt legislation intended to suppress securities fraud, even if the means chosen to accomplish the task may have been somewhat crude in the early statutes.

There is some plausibility to this standard account: the blue sky laws were undoubtedly popular at the grass-roots level in many states, and the efforts by regulators such as J.N. Dolley, and later by the state attorneys general, appear to have been motivated by an honest, even admirable sense of public service rather than any selfish or venal concerns. However, that account is incomplete. It fails to recognize that among the principal determinants of legislative behavior were the influence of organized special interests lobbying for or against different legislative proposals. To our knowledge, the literature has never fully explored this latter hypothesis.

We find that while there was a public-regarding element to these statutes—securities fraud undoubtedly did occur during the period in question, and members of the public demanded protection against high-pressure securities salesmen with low business morals—among the principal determinants of the spate of statutes between 1911 and 1913 was the rivalry between the political coalition favoring Kansas-style blue sky legislation, which included smaller banks, state banking commissioners, and local borrowers, and the coalition opposing such legislation, which included the elite investment houses, the large banks, and bond issuers such as major manufacturing firms, railroads, and public utilities. We also find that the interest group activity in question was extremely sensitive to economic conditions, tending to substantiate the hypothesis that interest groups are much more likely to seek legislative protection against competition when they are experiencing economic distress than when they are enjoying prosperity.

Our study questions the assumption made by prior writers that securities fraud was a significant problem during the period before the advent of specialized regulation. The actual extent of securities fraud during the period we study is unknown, but almost certainly was much lower than is assumed in the standard histories.

