



PAUL MAHONEY 

## Looking for Proof of Law's Purpose and Effect

PAUL MAHONEY IS A PIONEER in the use of empirical methods in legal scholarship. His writings on the federal securities reforms of the 1930s challenge conventional wisdom about the nature of the securities markets of the 1920s and the effects of the statutory reforms. His combination of law and empirical finance inaugurated a new wave of corporate and securities law scholarship that has attracted scholars such as Rob Daines at Stanford and John Coates and Allen Ferrell at Harvard.

When he joined the faculty after four years in private securities practice, Mahoney was eager to re-examine the basic assumptions underlying the federal securities laws. "Financial history, like political history, is written by the winners," Mahoney notes. "The New Dealers wrote extensively on the background of the securities laws, portraying the 1920s as a Dark Age of finance and the federal reforms as necessary to save capitalism from itself. Those conclusions survived almost unchallenged until very recently." Mahoney himself has mounted some of the most important and interesting challenges.

In an early article, "Mandatory Disclosure as a Solution to Agency Problems," 62 *Chi. L. Rev.* 1047 (1995), Mahoney

advanced a novel claim about the history of the federal securities laws. Disclosure provisions are generally described as a means of enabling investors to determine the value of a security. Mahoney noted, however, that the English statutory and common law rules on which the Securities Act of 1933 is based were developed with a different purpose in mind—to uncover hidden profits that the seller might make in connection with a public offering. Early English corporate promoters sometimes claimed to be acting only as middlemen while actually owning a stake in the business being sold. Mandatory disclosure arose to force revelation of these hidden interests. Mahoney argued that these so-called agency-cost disclosures are the most important feature of disclosure statutes. The article has influenced a recent literature within economics on the purposes and effects of the regulation of securities markets.

Mahoney bridged the methodological gap between securities law and financial economics in “The Stock Pools and the Securities Exchange Act,” 51 *J. Fin. Econ.* 343 (1999). The article was published in the *Journal of Financial Economics*, the top-ranked finance journal, and used empirical finance to reopen a foundational factual debate. The primary motivation for federal regulation of stock exchanges was the belief that stock-price manipulation was rampant on the New York Stock Exchange in the late 1920s. As evidence, Congress cited the so-called “stock pools,” trading accounts formed by groups of market professionals. Congressional investigators concluded that pools made massive purchases in order to drive up the price of a stock, then quietly dumped the stock on unsuspecting investors at artificially high prices that inevitably collapsed once the pool exited.

Mahoney researched the congressional investigators’ records in the National Archives and carefully examined the stock pools that traded in NYSE stocks in 1929. He found that, indeed, the market-adjusted price of these stocks climbed at about the time of pool formation. However, contrary to Congress’s conclusion, there were no subsequent collapses—the pool stocks earned returns approximately equal to the market return after the initial run-up. Thus, Mahoney concluded, the evidence suggested that the pool traders had superior infor-

mation, not that they were engaged in manipulation.

Mahoney’s subsequent article with economists Guolin Jiang and Jianping Mei, “Market Manipulation: A Comprehensive Study of Stock Pools,” 77 *J. Fin. Econ.* 147 (2005), brought an expanded data set and more recent theoretical and empirical techniques to bear on the stock pools. It similarly concluded that the pools’ trading activities were likely motivated by information. Interestingly, then, it appears that one of the central factual claims underlying the New Deal financial reforms is incorrect. As Mahoney and his co-authors note, this conclusion has implications for the design of regulatory systems in developing markets. They argue that manipulation is likely a problem only in the smallest, most illiquid stocks.

If some of the main factual predicates for the federal securities laws prove unfounded, the question naturally arises whether the statutes were a product of misunderstanding, ideology, or interest-group politics. Securities law scholars have generally rejected the notion that the financial industry was a beneficiary, rather than a target, of the 1930s reforms. After all, they argue, the industry vigorously opposed those reforms. Mahoney, however, finds the issue more complicated. “In fact, the top-tier investment banks and brokerage houses supported the New Deal securities reforms, and certainly the big players in the market prospered under the federal securities laws.”

In “The Political Economy of the Securities Act of 1933,” 30 *J. Legal Stud.* 1 (2001), Mahoney analyzed the politics and effects of the first federal securities statute. He observed that although the act is famous as a disclosure statute, many of its substantive provisions forbid issuers and underwriters from communicating with the markets during the registration process. This, he concluded, was the key to understanding why high-prestige investment banks favored the statute. They used underwriting methods that were slow and involved multiple intermediaries. The most prestigious houses, such as J.P. Morgan & Co., stood at the top of the hierarchy and acted as wholesalers, selling to regional, retail-oriented houses at the bottom of the pyramid. In the late 1920s, however, new entrants such as the National City Company began to offer a rapid, integrated underwriting process in which the lead under-

writer sold directly to the public using a nationwide network of retail salesmen.

The Securities Act neutralized these new competitive methods by slowing down the offering process and banning “gun-jumping,” or retail selling efforts in advance of the offering. Mahoney argues that these restrictions benefited the established, high-prestige investment banks at the expense of new entrants. Using hand-collected data on underwritten public offerings from 1925 through 1940, he demonstrates that the market share of the top underwriting firms declined steadily during the 1920s but increased after enactment of the Securities Act.

In “The Origins of the Blue Sky Laws: A Test of Competing Hypotheses,” 66 *J.L. & Econ.* 229 (2003), Mahoney shows that the interests of financial intermediaries also shaped the state “blue sky” laws that preceded the federal securities laws. The paper employs hazard-rate analysis, a statistical technique that looks for patterns in the timing of events (here, various states’ enactment of a blue sky law) and asks which variables can best explain that pattern. The paper explores three factors that could explain a state’s adoption of a blue sky law: the amount of securities fraud in that state, the strength of progressive political sentiment, and the relative importance of the securities and banking industries in the state. Mahoney notes that banks (particularly small, local banks) competed for household savings with securities firms and stood to gain if in-state sales of securities could be curtailed.

The paper reaches an interesting conclusion: the order in which states adopted blue sky laws can be largely explained by the relative importance of progressive political parties and candidates in a given state, but the type of blue sky law adopted depended strongly on the lobbying strength of small banks in that state. States dominated by small banks tended to adopt the most restrictive type of blue sky law, a so-called “merit review” statute that gave a state administrator wide discretion to deny permission to offer securities in the state. Mahoney notes that neither the traditional public choice analysis nor a standard model of ideological politics explains the entire picture. Instead, both must be combined to understand the blue sky laws.

In addition to his securities law scholarship, Mahoney has contributed to recent literature that asks whether a country’s “legal origin” (that is, whether its legal system is derived from English common law or continental civil law) effects economic outcomes. In a series of papers beginning in the late 1990s, a group of economists demonstrated that common law countries tend to have more developed financial markets, controlling for other relevant factors. It is not clear, however, why such a link exists.

In “The Common Law and Economic Growth: Hayek Might be Right,” 30 *J. Legal Stud.* 503 (2001), Mahoney argues that the economically relevant difference between common and civil law countries lies not in the specifics of legal rules, but in the relative importance each system attaches to private ordering versus government intervention. Mahoney provides empirical evidence that common law countries experienced faster per-capita growth in gross domestic product over a substantial period and that a significant portion of the difference can be attributed to stronger protections against government interference in property and contract rights.

A later article written with legal historian Dan Klerman, “The Value of Judicial Independence: Evidence from Eighteenth Century England,” 7 *Am. L. & Econ. Rev.* 1 (2005), explores a key feature of English law—a judiciary independent of the executive. Until the 18th century, English judges were formally servants of the crown, who could compensate and remove them as he saw fit. In a series of statutes beginning with the Act of Settlement in 1701, Parliament gave the judges life tenure and a fixed salary. Klerman and Mahoney hypothesize that if judicial independence improves the security of property and contract rights, then independence would boost the private economy and the value of traded equities. Using a database of daily prices of London Stock Exchange stocks for this period, they discovered that markets reacted favorably to legislation that increased judicial independence.

Mahoney has supplemented his empirical scholarship with theoretical work that uses game theory to understand the role of law. Recent scholarship in law and economics argues that social norms, rather than formal legal rules and sanctions, are the primary forces maintaining social order. In a pair of articles,

Mahoney and co-author Chris Sanchirico re-examine some of the key issues in the field using careful game theoretic analysis. “Competing Norms and Social Evolution: Is the Fittest Norm Efficient?,” 149 *Penn. L. Rev.* 2027 (2001), challenges the notion that norms generally evolve in efficient directions, showing that whether an evolutionary process results in efficient or inefficient outcomes depends critically on the precise structure of the game. Mahoney and Sanchirico argue that many settings of interest to law are most plausibly modeled in ways that would likely generate inefficient norms absent some legal intervention.

Mahoney and Sanchirico follow up this point in “Norms, Repeated Games, and the Role of Law,” 91 *Cal. L. Rev.* 1281 (2003). They first show that the norms literature’s focus on the so-called “tit for tat” strategy in which players “do unto others as they do unto you” has led scholars to draw conclusions that do not hold up when the universe of all possible cooperative strategies is considered. The article goes on to show that game theory’s equilibrium concepts are questionable bases on which to build a theory of social norms because so much of the observed behavior that norm theorists seek to describe could not occur in equilibrium. Mahoney and Sanchirico argue that law is essential precisely because norm violations leave rational players without a basis on which to predict other players’ future behavior. Law, by contrast, is credible not because it is the equilibrium of a game but because it is backed by the state’s monopoly of force.

Mahoney is currently busy continuing his examination of the history of the federal securities laws. His work with Jiang and Mei, described above, attracted the interest of the Center for Research in Security Prices (CRSP) at the University of Chicago’s business school, which runs the primary research database of U.S. stock prices. Currently, CRSP’s data set contains daily closing prices and trading volumes for all NYSE stocks back to 1962. Mahoney and his co-authors demonstrated the feasibility of gathering comprehensive data from earlier periods, and CRSP has accordingly decided to extend its daily data set back to 1926. Mahoney is excited by the prospect: “This will offer an extraordinary opportunity to analyze how the federal securities laws

affected the markets. I have several projects on the drawing board that await the release of the full data.”

Mahoney has challenged conventional wisdom regarding the historical purpose of securities laws, offered intriguing explanations of why common law countries typically have more robust financial markets and greater economic growth, and called into question basic assumptions about the relationship between law and social norms. He has reached back into our legal past to offer new insights into old debates, and he has advanced ideas at the cutting edge of legal theory. He has done so by employing a combination of painstaking historical research, sophisticated empirical techniques, and a nose for great topics. The result is a body of work that has rightly attracted a great deal of attention and accolade, and has cemented Mahoney’s reputation as not simply one of the leading scholars of securities regulation, but as one of the leading legal scholars of his generation. ✦

# The Political Economy of the Securities Act of 1933

30 *J. Legal Stud.* 1 (2001)

[C]ommentators have tended to [take] at face value that the “truth in securities” act is a disclosure statute. Less well understood is that the Securities Act is equally a secrecy statute. It forbids most public disclosure of pending offerings prior to the filing of a registration statement with the Securities and Exchange Commission (SEC). The statute also mandates a minimum delay of 20 days between the filing of the registration statement and the beginning of retail selling. While traditionally described as mere pieces of the technical apparatus of “full disclosure,” these provisions imposed important limitations on both retail and wholesale competition.

I try to show that these “technical” details can be best understood as means of eliminating several specific competitive techniques that low-status securities dealers used successfully against high-status dealers in the late 1920s and early 1930s.



#### IV. THE CRISIS OF THE SYNDICATE METHOD

As competition increased at the retail level, sellers began to seek an advantage over their rivals by violating those provisions of syndicate agreements that specified the timing and price of the distribution. The increased speed of distributions and the focus on retail selling during the 1920s made it difficult for managing underwriters to monitor and control the behavior of hundreds, or occasionally thousands, of securities dealers participating in the sale of a new issue. By the late 1920s, investment bankers realized

that the viability of the syndicate system was threatened.

Established bankers described the phenomenon as a decline in the professionalism of the investment banking business. Like lawyers or doctors today, many investment bankers of the 1920s viewed themselves as members of a learned profession, the standards of which were being eroded by new entrants who were mere salesmen. A measure of that concern is the creation, at the [Investment Banker’s Association of America (IBAA)] annual convention in the fall of 1926, of the Committee on Business Problems. The bulk of that committee’s first report, delivered at the 1927 convention... addressed changes in distribution methods.

The report noted two tactics in particular: “beating the gun,” or selling prior to the agreed-upon distribution period, and selling at discounted prices....

#### *A. Beating the Gun*

In the late 1920s, a practice known as “beating the gun” became common. Under the normal underwriting practice, underwriting and selling syndicate agreements contained an undertaking not to sell securities until they were “released” by the managing underwriter through a telegram or telephone call. To beat the gun was to violate the syndicate agreement by taking orders from customers before the securities had been released for sale.

Beating the gun allowed one distributor to get a head start on the others in the competition for retail customers. It was, however, inconsistent with the premise of a syndicated selling effort—that each seller complied with contractual restraints on price, timing, and (sometimes) territory. Managing underwriters were sensitive to the complaints of retailers who complied with syndicate agreements and, in so doing, lost customers to others who had not complied.

In order to prevent the practice, originating houses tried to keep the timing and price of the issue secret until the last minute. This was not always possible, however, particularly for issues of large companies. These companies were closely followed by the financial press, and newspapers or investment magazines might print the details of a coming large issue of securities before the issuing house had formally released the information to the syndicates. Thus selling group members were able to take orders

from customers with reasonable confidence that they would be able to provide the security at the time and price quoted, even though they were contractually obligated to wait.

The IBAA Subcommittee on Distribution concluded that the root of the problem was excessive preoffering publicity. . . . The chairman of the subcommittee spoke approvingly of issuing houses that kept a tight lid on information about the timing and price of offerings but recognized that this “ideal condition” was difficult to achieve. Speaking of the large houses of issue, he noted, “They are doing all they can to get the information to every one of you men at the same time, and what they want is someone to tell them a practical way, someone to also try and keep publicity out of the paper.”



#### V. THE REGULATORY SOLUTIONS

The Securities Act and other New Deal financial reforms addressed the specific competitive concerns outlined above. They had, in broad terms, three effects. They provided the government’s aid in enforcing the syndicate system by outlawing beating the gun and discounting. They slowed down the distribution process and divided it into distinct wholesale and retail phases. Finally, they removed commercial banks as competitors for underwriting business. The consequence was to neutralize the competitive advantages of integrated firms and return to a system in which wholesale banks originated new issues and sold them through stand-alone distributors. This section shows how the technical details of the Securities Act achieved those results.

##### *A. Beating the Gun*

The Securities Act achieved precisely what the IBAA’s Committee on Business Problems wanted to achieve but could not—it made it possible for a lead underwriter to provide distributing houses with detailed information about a pending issue secure in the knowledge that the latter could not agree to sell securities until the official offering date. The act also assured the absence of retail solicitation prior to the offering date by suppressing preoffering publicity.

The Securities Act requires that a registration statement be filed and become effective before any person may sell the securities.... Before the registration statement was filed, all public discussion of the issue was banned. Securities lawyers today still counsel their clients against any premature public statements relating to the offering—to make such a statement is to “jump the gun,” although I doubt many securities lawyers know that the phrase antedates the Securities Act.

The statute also directly attacked newspaper and radio advertisements by defining each as a “prospectus” that, with limited exceptions, could not be published prior to effectiveness. The prohibition on newspaper publicity was broad enough to cover a story printed after interviewing a company officer about the pending offering. No longer would detailed information about pending offerings appear in the morning papers prior to the offering date, stimulating customers to call their brokers.



#### VII. CONCLUSION

The Securities Act pursued socially useful goals. In particular, its disclosure requirements forced the promoters of corporations undertaking initial public offerings to disclose their financial stake in the new corporation, thus combating an abuse that had persisted in both England and the United States since the mid-1800s. Its starting point for solving the problem was the same as that developed in the Companies Act in England—mandatory disclosure of promoters’ and underwriters’ fees and stakes in a company.

The statute did more than this, however. It prohibited contact with potential retail buyers in advance of an offering, making it difficult for one retailer to poach another’s customer. In tandem with the NIRA and the Maloney Act, it enabled the IBAA to prohibit and monitor the use of price discounts in connection with public offerings. It also effectively divided offerings into wholesale and retail periods. These features helped leading wholesale and retail firms enforce restrictions on retail competition that were central to the syndicate system of underwriting, thus protecting their market against incursions from integrated firms.

None of these things was necessary in order to achieve the simple goal of requiring full disclosure. They benefited investment banks, particularly high-prestige investment banks, and likely raised costs to issuers and investors.

The Securities Act accordingly provides a useful cautionary tale about the efficacy of economic regulation. The act is generally regarded as one of the greatest success stories of the New Deal. Unlike many regulatory statutes, it has been largely untouched by claims that it raises entry barriers or enforces cartel agreements among members of the regulated industry. Yet a closer look at the statute, in light of the competitive conditions in the underwriting market in the 1920s, shows that even the Securities Act was a likely source of rents for the firms it subjected to regulation. ↻

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