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# Dynamic Federalism: Competition, Cooperation and Securities Enforcement

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ESSAY

DYNAMIC FEDERALISM:  
COMPETITION, COOPERATION AND SECURITIES  
ENFORCEMENT<sup>†</sup>

By Renee M. Jones\*

**INTRODUCTION**

The central role of the federal-state relationship in our democracy is receiving renewed attention. In part, the increased attention to this issue forms part of an effort by constitutional scholars to explain and critique the Supreme Court's "new federalism." This discussion focuses on determining what constitutional limits, if any, exist on Congress's power and whether it is appropriate for the courts to define and enforce such limits.<sup>1</sup> Although the question is typically framed as one of constitutional interpretation, the debate inevitably evokes reverence for the social benefits said to flow from federalism as well as admonitions regarding its potential social costs.

At the same time as constitutional scholars struggle to discern the limits of Congressional authority, the recent corporate scandals and Congress's swift reaction have prompted corporate scholars to re-assess the implications of federalism for corporate and securities law policy. For years corporate scholars have debated whether the laws governing a corporation's internal affairs (the relationship among stockholders, directors and officers) were a proper province for federal regulation.

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<sup>1</sup> See generally Todd E. Pettys, *Competing for the People's Affection*, 56 VAND. L. REV. 329; Edward L. Rubin & Malcolm Feely, *Federalism: Some Notes on a National Neurosis*, 41 U.C.L.A. L. REV. 903 (1994); Larry Kramer, *Understanding Federalism*, 47 VAND. L. REV. 1485 (1994).

Two diametrically opposed camps vigorously debated whether the current federal system has led to a “race to the top” or a “race to the bottom” in corporate law.<sup>2</sup>

Recent corporate scholarship has discarded the stark “either/or” perspective that characterizes the “race” debate. Scholars have begun to examine more closely the ways in which federal securities law and state corporate law influence each other and interact to form a complex body of regulation for corporate officers and directors.<sup>3</sup> For example, both Mark Roe and I have argued that the federal securities laws impose significant constraints on the Delaware legislature and its courts and therefore influence the development of corporate law at the state level.<sup>4</sup> Professors Robert Thompson and Hillary Sale similarly argue that civil litigation under the federal securities laws plays a larger role than state law in monitoring the conduct of officers and directors in the performance of their fiduciary duty of care.<sup>5</sup>

Although their theses differ, these recent contributions all emphasize the central role of federal securities law and stock exchange listing standards in the legal framework that creates U.S. corporate governance rules and standards. This recognition of the multi-layered dimension of corporate regulation complicates the debate about how best to allocate authority among state and federal regulators, extending the debate beyond the familiar “race to the top” or “race to the bottom” dialectic.

This essay forms part of an effort to promote a broader discussion about the role of federalism in corporate regulation. It emphasizes the importance of competition between federal and state authorities in the process of developing regulation in the corporate and securities arenas. Rather than seeking to establish that one level of government is inherently superior to the other in these matters, I argue

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<sup>2</sup> For the seminal articles setting forth the opposing viewpoints, see Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (race to the top) and William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974) (race to the bottom).

<sup>3</sup> See, e.g., Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625 (2004); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003); Robert J. Thompson & Hillary A. Sale, *Securities Law as Corporate Governance, Reflections Upon Federalism*, 56 VAND. L. REV. 859 (2003); Robert J. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation*, 38 WAKE FOREST L. REV. 961 (2003).

<sup>4</sup> Roe, *supra* note xx, at 591-93; Jones, *supra* note xx, at 635.

<sup>5</sup> Thompson & Sale, *supra* note xx, at 904.

that the interaction among the regulators, filtered through the prism of public opinion, can help to achieve an appropriate allocation of regulatory authority. I also argue that any allocation of authority must remain fluid so that it may shift from time to time to reflect the public's revised assessments of the dominant regulator's performance.

This essay builds on an argument I have presented elsewhere that the concept of vertical (federal-state) competition in corporate law should replace, or at least supplement, the outmoded horizontal (state-state) model that currently dominates legal scholarship.<sup>6</sup> I have argued that the limited federal preemption imposed by the Sarbanes-Oxley Act of 2002<sup>7</sup> is a necessary component to the dynamic of vertical regulatory competition that helps ensure that state corporate law reflects national concerns, and protects the interests of groups other than corporate managers who dominate the state policy-making process.<sup>8</sup> I also argue against complete preemption of state corporate law because state-level regulation may provide some advantages over federal regulation.<sup>9</sup>

In this Essay, I move beyond the corporate law arena to apply the vertical competition model to the question of how best to allocate authority for securities enforcement between federal and state regulators.<sup>10</sup> A review of recent regulatory responses at the state and federal level to widespread market abuses shows how vertical competition can improve the performance of regulators at both levels of government and increase the public's satisfaction with their representatives. The rising profile of state officials as securities regulators and calls from certain quarters to curtail states' enforcement powers thus presents a paradigm through which to explore the effects of vertical competition on regulatory policies and practices.

Although regulatory competition may sometimes spur more vigorous enforcement action, the political process also works to constrain excessive regulatory zeal and commands diverse regulators to work together to protect the public interest. Lessons from these recent scandals show that efforts to limit states' enforcement powers are misguided. We should instead preserve a wide berth for state action in this field, particularly in light of public perception of regulatory stagnation at the national level.

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<sup>6</sup> Jones, *supra* note xx, at 634-37.

<sup>7</sup> Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 15, 28 U.S.C.).

<sup>8</sup> Jones, *supra* note xx, at 638-39, 641.

<sup>9</sup> *Id.* at 643.

<sup>10</sup> Unlike the corporate law regime which is governed largely by state law, the federal government, acting principally through the SEC, dominates the regulatory system governing securities transactions in the United States.

Part I of this Essay reviews the historical division of power between the federal government and the states in securities regulation and describes the preemption offensive of the 1990s which stripped the states of much of their regulatory authority. Part II describes the recent ascension of state regulators as enforcers of securities laws. Part III analyzes the effects of vertical regulatory competition and concludes that many benefits flow from the states' direct challenge to the Securities and Exchange Commission's position as the nation's premiere securities enforcement agency. Part IV considers objections to continuing regulatory duality and shows why they are misguided.

## I. THE FEDERAL-STATE RELATIONSHIP IN PERSPECTIVE

Securities regulation has long been a key component to corporate governance in the United States. For decades, the securities laws' disclosure requirements, civil and criminal liability under Exchange Act Rule 10b-5, and the stock exchange listing standards have played a leading role in regulating the conduct of corporate officers and directors and protecting shareholder rights. In fact, some scholars argue that the federal securities regime has begun to overshadow traditional corporate law in defining standards of conduct for officers and directors.<sup>11</sup>

This acknowledgement of the securities laws' central role in corporate governance suggests that understanding the federal-state balance in securities regulation is at least as important as prescribing the proper relationship in traditional corporate law. Unfortunately, however, the task of defining the federal-state relationship in policing securities fraud has received far less academic attention than the problem of resolving the similar division of authority over corporate internal affairs.<sup>12</sup> The lack of extensive discussion of the states' role as securities regulators hampers our understanding of federalism issues in corporate law.

### A. THE HISTORIC BALANCE OF FEDERAL AND STATE POWER

Defining the proper limits on the states' power in securities enforcement has emerged as a policy issue because of the states' central role in the investigation of two major securities scandals in recent years.

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<sup>11</sup> See Thompson & Sale, *supra* note xx, at 861-62.

<sup>12</sup> A spate of articles about the role of state securities regulation were published from 1995 through 2000 in reaction to Congress's 1990 reforms. See sources cited *infra* at notes xx-xx. However, these articles do not extensively discuss the allocation of power for public securities enforcement.

States took the lead in addressing the Wall Street analyst conflicts and the mutual fund trading abuses, prompting renewed debate over whether a uniform system of securities regulation is preferable to the current dual system. To fully understand the implications of the debate, it is important to review the historical context in which the dual system of securities regulation developed, its recent demise, and its more recent resurgence.

Historically, states led the way in providing legislation to protect investors from exploitation by unscrupulous securities promoters. Until the adoption of the Securities Act of 1933 (the “Securities Act”) states were the only regulators of securities transactions. Kansas adopted the first blue sky statute in 1911.<sup>13</sup> Other states quickly followed suit, so that by the time Congress adopted the Securities Act, every state except Nevada had a securities law.<sup>14</sup> Despite their prevalence, state securities laws were largely ineffective in eradicating fraud.<sup>15</sup> The failure of state regulation and the abuses that preceded the Great Depression set the stage for the adoption of the federal securities laws.<sup>16</sup>

When Congress enacted the first securities statutes, it opted for a uniform system of national regulation, which would supplement the state’s securities laws already on the books.<sup>17</sup> With the adoption of the Securities Exchange Act of 1934 (the “Exchange Act”), Congress also vested considerable authority in self-regulatory organizations (“SROs”), such as New York Stock Exchange (“NYSE”), and the National Association of Securities Dealer (“NASD”), subject to SEC oversight.<sup>18</sup>

The dual regulatory structure created by Congress was deliberate, and recognized the states’ experience and expertise in the field would be necessary to provide remedies beyond those which the

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<sup>13</sup> State securities laws are popularly known as “blue sky” laws, reportedly because they were aimed at unscrupulous stock promoters who “would sell building lots in the blue sky.” See LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION I*, 36 (3d. ed 1998).

<sup>14</sup> Today all 50 states have a securities statute. *Id.* at 40-41.

<sup>15</sup> THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 21 (4<sup>th</sup> ed. 2002).

<sup>16</sup> *Id.*

<sup>17</sup> The Securities Act and the Exchange Act both contain savings clauses, preserving the continued viability of state securities statutes. See Securities Act § 16(a), 15 U.S.C. § 77r(c) (2004); Exchange Act § 28(a), 15 U.S.C. § 78bb(a) (2004).

<sup>18</sup> See Exchange Act § 6, 15 U.S.C. § 78(c)(a)(26) (2004); Exchange Act § 15A, 15 U.S.C. § 78(f). The SROs police the activities of their members to prohibit manipulative and abusive practices and also maintain disclosure requirements and financial and conduct standards for companies that list securities for trading in the markets they control. See Thompson, *supra* note xx, at 970.

new federal statutes created.<sup>19</sup> This dual system has been criticized as duplicative, inefficient and overly burdensome, as it required companies to deal with the inconvenience of complying with federal securities laws in addition to the laws of every state in which they offered securities.<sup>20</sup> Beginning in the 1990s this dual regulatory regime was subject to a full-scale legislative assault.<sup>21</sup>

## B. THE PREEMPTION OFFENSIVE

Criticism of state blue sky laws led first to efforts to coordinate federal and state exemptions.<sup>22</sup> The objective was to ensure that if a securities offering satisfied the exemption requirements of one state, it would also satisfy similar exemption provisions adopted by all other states and the SEC. Ultimately these coordination efforts failed, as true uniformity was never achieved.<sup>23</sup> Business interests then successfully lobbied Congress to adopt the National Securities Market Improvement Act of 1996 (“NSMIA”),<sup>24</sup> which prohibits states from enforcing their registration requirements for offerings of listed securities and most private placements.<sup>25</sup> NSMIA represented the first in a series of attacks on state regulatory power in securities regulation.

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<sup>19</sup> Manning Gilbert Warren III, *Reflections on Dual Regulations of Securities: A Case Against Preemption*, 25 B.C.L. REV. 495, 515-25 (1984); see also Manning Gilbert Warren III, *Reflections on Dual Regulations of Securities: A Case for Reallocation of Regulatory Responsibilities*, 78 WASH. U. L.Q. 497, 504 (2000).

<sup>20</sup> See H. R. Conf. Rep. No. 104-864, at 39.

<sup>21</sup> See, e.g., Rutherford B. Campbell, Jr., *The Insidious Remnants of State Rules Regarding Capital Formation*, 78 WASH U. L. Q. 407, 411-13 (2000). Although in reality the regulatory system for securities trading is multi-layered, because this Essay focuses on the interaction between state and federal regulators I adopt the more conventional (though perhaps less accurate) duality concept.

<sup>22</sup> See Small Business Investment Incentive Act of 1980 § 505, Pub. L. No 96-477, 94 Stat. 2275, 2292-93 (adding Section 19(c) to the Securities Act); Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT’L L. 495, 507-08 (2003).

<sup>23</sup> See Campbell, *supra* note xx at 419-20.

<sup>24</sup> Pub. L. No. 104-290, 11 Stat. 3416 (1996) (codified in scattered sections of 15 U.S.C.).

<sup>25</sup> Securities Act § 18(a), 15 U.S.C. § 77(r) (2004). NSMIA prohibits states from enforcing registration or qualification requirements for any “covered security”. NSMIA’s definition of “covered security” includes any securities listed, or to be listed, on a national stock exchange or the Nasdaq National

Congress preempted state power again in 1998. This time preemption advocates argued that securities law suits filed in California were undermining the strict procedural rules mandated by the Private Securities Litigation Reform Act (the “PSLRA”).<sup>26</sup> They therefore lobbied for federal preemption of securities fraud actions brought in state court.<sup>27</sup> Congress abided when it adopted the Securities Litigation Uniform Standards Act (“SLUSA”), which preempts most securities class actions based on state law.<sup>28</sup>

The prospect of federal preemption of state securities laws appealed to business interests only because of a complementary trend that had developed in the federal courts and in Congress. This retrenchment trend became evident in the 1970s and has been marked by a series of Supreme Court decisions which have narrowed the remedies available to investors under the federal securities laws.<sup>29</sup> Business

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Market and all securities sold under Securities Act Rule 506, the SEC’s private placement safe harbor.

<sup>26</sup> Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.). Among other reforms, the PSLRA created new lead plaintiff provisions for securities class actions, imposed heightened pleading standards for securities fraud claims, codified the “bespeaks caution” doctrine to immunize companies from liability for false projections, and imposed a mandatory stay on discovery pending a defendant’s motion to dismiss. See DONNA M. NAGY, ET AL., SECURITIES LITIGATION AND ENFORCEMENT 395-402 (2003). Some commentators have challenged the empirical basis for the SLUSA proponents’ claims that state law suits were undermining the PSLRA. See Warren, *supra* note xx, at 178.

<sup>27</sup> See David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California’s Blue Sky Laws*, 54 BUS. LAW. 1, 2 (1998); Michael A. Perino, *Fraud and Federalism: Preempting State Private Securities Fraud Causes of Action*, 50 STAN. L. REV. 273 (1998).

<sup>28</sup> Pub. L. No. 105-353, 112 Stat. 3227 (1998) codified as Securities Act § 16(b), 15 U.S.C. § 77(p)(c) and Exchange Act § 28(f) 15 U.S.C. 78(bb) (2004). SLUSA prohibits the litigation of any “covered class action based upon the statutory or common law of any State” for fraud in connection with the purchase or sale of a covered security. The act defines a “covered class action” as a law suit seeking damages on behalf of 50 or more plaintiffs. A “covered security” is defined as a security that is listed or authorized for listing on a national stock exchange and any other security of the same issuer of equal or higher seniority. Securities Act § 16(b); Exchange Act Section 28(f). See Levine & Pritchard, *supra* note xx, at 2.

<sup>29</sup> See Levine & Pritchard, *supra* note xx, at 5. The “retrenchment” cases include *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (establishing a purchaser-seller requirement for standing in an Rule 10b-5 case); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (ruling that scienter is a required element of a Rule 10b-5 claim); *Santa Fe Indus., Inc. v. Green*, 430

interests also made headway when Congress adopted the PSLRA which codified many of these defendant-friendly doctrines and created significant new barriers to plaintiffs pursuing securities fraud claims.<sup>30</sup> Ironically, conservative politicians, the purported champions of states' rights, advocated for preemptive legislation that severely restricted state power. Despite the clear ideological consistency of this position, the political, economic and market environment of the 1990's presented a window of opportunity apparently too enticing for the conservatives in power to resist.<sup>31</sup>

## II. THE RISE OF THE STATES

### A. THE STATES' LATENT POWER

The preemption offensive of the 1990s focused on limiting state authority over securities registration and private litigation of fraud claims. These initiatives left intact state power to publicly enforce their securities fraud statutes.<sup>32</sup> At the time, preserving the states' enforcement powers was uncontroversial, because state and federal regulators had informally divided the world in a manner that suited business interests. State regulators focused their enforcement efforts on pursuing small-time fraud (boiler rooms, Ponzi schemes and the like) and left the SEC to pursue cases of national importance.<sup>33</sup> In the aftermath of the bubble-burst in which millions of individual investors lost their savings, this informal equilibrium faltered. Disturbed by the notion that ordinary investors were being misled by self-serving analyst recommendations, New York Attorney General Eliot Spitzer began to

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U.S. 462 (1977) (finding no Rule 10b-5 liability for "constructive fraud" in the absence of false statements); *Lampf, Pleva v. Gilbertson*, 501 U.S. 350 (1991) (establishing a federal statute of limitations for Rule 10b-5 actions); *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (eliminating aiding and abetting liability under Rule 10b-5); *Gustafson v. Alloyd*, 513 U.S. 561 (1995) (limiting liability under Securities Act § 12(a)(2) to statements made in connection with a public offering).

<sup>30</sup> See *supra* note 24.

<sup>31</sup> See generally Manning Gilbert Warren III, *Federalism and Investor Protection, Constitutional Restraints on Preemption of State Remedies for Securities Fraud*, 60 L. AND CONTEMP. PROB. 169 (1997) [hereinafter Warren, *Federalism*].

<sup>32</sup> Securities Act § 18(c)(1); 15 U.S.C. 77r(c); see also Warren, *Federalism*, *supra* note xx, at 176.

<sup>33</sup> See Perino, *supra* note xx, at 279 (describing state regulators as local "cops on the beat" with a traditional "consumer protection" role).

investigate questionable industry practices that the SEC had long tolerated.<sup>34</sup>

The states' newly aggressive posture provoked an outcry from business groups and prompted efforts to expand federal preemption to preclude states' from enforcing their securities laws.<sup>35</sup> A number of public officials lent their voices to this cause. Supporters included SEC chairman William Donaldson,<sup>36</sup> SEC enforcement chief Stephen Cutler,<sup>37</sup> and Congressmen Michael Oxley<sup>38</sup> and Richard Baker. Congressman Baker in his capacity as chair of the House subcommittee on Capital Markets led a legislative attempt to preempt state power. He inserted a provision in pending securities reform legislation that would have prevented state regulators from enforcing state requirements against brokers and dealers that differed from rules established by the SEC or the

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<sup>34</sup> See John Cassidy, *The Investigation; How Eliot Spitzer Humbled Wall Street*, NEW YORKER, Apr. 7, 2003, at 54; see also ARTHUR LEVITT, TAKE ON THE STREET 74-81 (2002) (describing the SEC's inability to satisfactorily address analyst conflicts).

<sup>35</sup> See, e.g., Press Release, Securities Industry Association, SIA Welcomes NY AG's Support for National Standards for Capital Markets, June 26, 2002, available at [http://www.sia.com/press/2002\\_press-release/html/pr\\_nyag.html](http://www.sia.com/press/2002_press-release/html/pr_nyag.html); see also Kathleen Day, *Brokerage Settlement Leaves Much Unresolved: SEC Acknowledges Need for New, Specific Rules*; WASH. POST, Apr. 30, 2003, at E1. Gretchen Morgenson, *State Regulators Win Some, Lose Some*, N.Y. TIMES, Feb. 29, 2004, Sec. 3, 8.

<sup>36</sup> At his confirmation hearings before the Senate, Chairman Donaldson stated, "I think one of the great strengths of our market system is that it is a national market system and has not been Balkanized." Hearing of the Senate Banking, Housing and Urban Affairs Committee: Nomination of William H. Donaldson to be Chairman of the Securities and Exchange Commission, February 5, 2003. In September 2003, Donaldson again warned Congress that "state law enforcement officials are jumping in on securities cases for political gain and may compromise federal investigations in the process." Judith Burns, *Mutual Funds Under Fire: SEC Warns of Uncoordinated Inquiries*, WALL ST. J., Sept. 10, 2003, at C14.

<sup>37</sup> In remarks at a Washington University Law School conference, Cutler argued that state enforcement power can be a problem "because Congress intended that the federal government, not the states, establish the rules and policies governing the securities markets, and that it do so on a national, rather than piecemeal, basis." Remarks of Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission, 81 WASH U. L. Q. 545, 552-53 (2003).

<sup>38</sup> In a letter to the editor of the New York Times, Congressman Oxley asserted that "[s]etting policy for our national capital markets is properly the duty and responsibility of the Securities and Exchange Commission and the self-regulatory organizations." Letter from Representative Michael Oxley to the Editor, N.Y. TIMES, June 9, 2003, at Section 3, 11.

SROs.<sup>39</sup> The Baker provision was ultimately withdrawn after sustained negative commentary from defenders of the states' enforcement efforts.<sup>40</sup>

Some of the academic commentary that has addressed the states' enforcement role also endorses the notion that unchecked state authority in securities regulation could harm the economy.<sup>41</sup> Again, ironically, the very attributes of decentralization (diversity, experimentation, competition, etc.) that defenders of corporate federalism celebrate, are decried by those who advocate for a single central authority to regulate the national securities markets.<sup>42</sup>

## B. RECENT SCANDALS

After a string of high-profile investigations, New York and other states have usurped the SEC's traditional role as the principal overseer of the national securities markets. The states have repeatedly outmaneuvered the SEC in exposing the pervasive conflicts that seem to have infected the financial services industry. The states adopted an agenda that extended beyond the exposure and punishment of fraud. They also sought to implement policy reforms to address the conflicts and abuses exposed by their investigations. To this end, Spitzer and other state officials imposed settlement conditions that require target

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<sup>39</sup> See H.R. 2179 §8(b).

<sup>40</sup> "Anti-Spitzer" Provision to be Removed from Bill, Reuters, Feb. 25, 2004, (Chicago Tribune, p. C3).

<sup>41</sup> See Karmel, *supra* note 20, at 546 (2003). Karmel argues that, "[s]ince the problems are national, and in some respects international in scope, an effective national regulator seems more appropriate than piecemeal state regulation." She also suggests that "continued state regulation might prove costly and may lead to conflicting regulations; if so, the benefits to investors will be problematic"; see also Steve A. Radom, Note, *Balkanization of Securities Regulation: The Case for Federal Preemption*, 39 TEX. J. BUS. L. 295 (2003) (arguing that preemption may be necessary to prevent a "Balkanized" system of securities regulation).

<sup>42</sup> See, e.g., Perino, *supra* note xx, at 278 ("None of the traditional justifications for allocating authority to the states applies to the regulation of private causes of action against issuers whose securities trade on national securities markets"); Stephen Bainbridge, *Can you be a Competitive Federalist and Still Want Spitzer to Shut the #@!% Up?*, Sept. 15, 2003, at [www.professorbainbridge.com/2003/09/can\\_you\\_be\\_a\\_co.html](http://www.professorbainbridge.com/2003/09/can_you_be_a_co.html) (last visited on September \_\_, 2004) ("What then are we to make of Elliot [sic] Spitzer's hyperactive enforcement regime? Must we conclude that Spitzer has raced to the top? NO! A thousand times no! Competitive federalism only works when the entity being regulated has an exit option.").

companies to reform their business practices.<sup>43</sup> As one example, Spitzer brokered a controversial settlement with mutual fund group Alliance Capital which included a condition that Alliance reduce its management fees by twenty percent. The Alliance settlement precipitated a vigorous debate between state and federal regulators about the appropriateness of government intervention in setting fees for the industry.<sup>44</sup>

By initiating the analyst conflict and mutual fund trading investigations the states departed from their traditional role of policing petty fraud and invaded the terrain that in practice had been occupied exclusively by national regulatory bodies. Prior to the states' activism, the SEC's enforcement practices were both predictable and lenient. More than 90% of SEC enforcement actions were resolved through settlement.<sup>45</sup> In the typical settlement a target simply agreed not to repeat the alleged violation and perhaps paid a small fine, without either admitting or denying liability.<sup>46</sup>

State authorities, with their aggressive investigations, disrupted the status quo, disabling defendants' ability to settle charges painlessly. The state-led investigations also cast unwelcome light on the abuse of the public trust by blue chip companies, inflicting serious reputational harm on some of the country's most prestigious financial institutions. With their reputations and goodwill at stake the regulated companies began to embrace the very reforms they had previously thwarted.

1. Analyst Conflicts. Eliot Spitzer first entered the national spotlight with his investigation of analyst conflicts on Wall Street. His investigation, conducted under the Martin Act,<sup>47</sup> began in 2001 with a

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<sup>43</sup> This objective has been pejoratively described as "regulation by prosecution." Karmel, *supra* note xx, at 520. See generally ROBERTA KARMEL, REGULATION BY PROSECUTION (1982).

<sup>44</sup> See Mara Der Hovanesian & Paula Dwyer, *Where Will Eliot Spitzer Strike Next?; New York's Crusading Attorney General Isn't Done with Mutual Funds - Or With the Rest of the Financial Services Industry*, BUS. WEEK, Mar. 8, 2004, at 66. (discussing Spitzer's settlement with Alliance). Monica Langley, *The Enforcer: As His Ambitions Expand Spitzer Draws More Controversy*, WALL ST. J., Dec. 11, 2003, A1 (quoting SEC officials as charging that "Spitzer is acting more like a policy czar than a prosecutor.")

<sup>45</sup> NAGY, ET AL., *supra* note xx, at 651.

<sup>46</sup> *Id.* at 651; JAMES D. COX, ET AL., SECURITIES REGULATION 772 (4th ed. 2004). Although a predictable pattern to enforcement activity provides certainty and may help facilitate capital formation, a lenient regime is unlikely to effectively deter fraud or check chronic abuses.

<sup>47</sup> New York Gen. Bus. Law, 23A [hereinafter, the "Martin Act"]. For a more extensive account of the Spitzer's analyst investigation, see Cassidy, *supra* note xx.

probe into Merrill Lynch's analyst recommendations. It was this investigation that uncovered the now-infamous e-mails that revealed that Merrill Lynch's analysts (including star analyst Henry Blodget) did not always believe the advice they gave investors.<sup>48</sup> These e-mails confirmed what many observers suspected: the analysts' recommendations were hopelessly tainted by concerns with maintaining investment banking relationships with the firms they covered.<sup>49</sup>

Merrill Lynch initially resisted Spitzer's settlement offers.<sup>50</sup> The firm hired former Mayor Rudolph Giuliani to intervene on its behalf.<sup>51</sup> Frustrated by Merrill Lynch's intransigence, Spitzer launched the public phase of his investigation into the firms' practices.<sup>52</sup> In a press release he described the case as "a shocking betrayal of trust by one of Wall Street's most trusted names," and vowed that "[t]he case must be a catalyst for reform throughout the entire industry."<sup>53</sup> The attorney general's press release included excerpts from the most damaging Merrill Lynch e-mails. The public release of the incriminating e-mails unleashed a torrent of negative media coverage. In response to this intense scrutiny, Merrill Lynch acceded to Spitzer's demands and agreed to pay \$100 million in penalties. Merrill Lynch also agreed to a set of fundamental reforms which would separate its research and investment banking functions.<sup>54</sup>

The Merrill Lynch settlement was only the opening volley in Spitzer's full scale investigation of Wall Street. His office joined forces with the SEC, the New York Stock Exchange, and the National Association of Securities Dealers and other state regulators. These disparate agencies worked together to conduct a comprehensive investigation of analyst fraud at other Wall Street firms. The agencies paired up into teams, each of which investigated one or two of the

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<sup>48</sup> Cassidy, *supra* note xx.

<sup>49</sup> Charles Gasparino, *Merrill Lynch will Negotiate With Spitzer*, WALL ST. J., Apr. 15, 2002, at C1.

<sup>50</sup> *Id.*

<sup>51</sup> Charles Gasparino, *Merrill Enlists Giuliani in Bid to Battle Spitzer*, WALL ST. J., Apr. 24, 2002 at C1. Giuliani pleaded that Merrill Lynch had been a good corporate citizen that had returned to its headquarters near "ground zero" after the September 11 terrorist attacks. *Id.*

<sup>52</sup> Section 354 of the Martin Act permits the Attorney General to launch a public investigation of fraudulent practices related to securities transactions. Martin Act § 354.

<sup>53</sup> Press Release, Office of New York Attorney General Eliot Spitzer, "Merrill Lynch Stock Rating System Found Biased By Undisclosed Conflicts Of Interest," Apr. 8, 2002, available at [http://www.oag.state.ny.us/press/2002/apr/apr08b\\_02.html](http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html)

<sup>54</sup> Cassidy, *supra* note xx, at 54.

leading firms.<sup>55</sup> The investigation revealed similar conflicts at other firms and led to the \$1.4 billion “global settlement” among 10 Wall Street firms, the SEC, the SROs and all 50 states.<sup>56</sup>

Despite public fascination with the rancor and resentment that bubbled between the SEC and Spitzer during the Wall Street investigations, the achievement of the global settlement required extensive cooperation, coordination and collaboration among state, federal and self-regulatory agencies. By divvying responsibilities, the regulators were able to marshal resources effectively. By collaborating in structuring a settlement, they were able to bring the investigations to closure, and eliminate the cloud that hung over the industry.<sup>57</sup>

2. Mutual Funds. Less than 6 months after finalizing the “global settlement”, Spitzer again stunned the investment community when he announced a \$40 million settlement with hedge fund Canary Capital Partners.<sup>58</sup> Canary was charged with late trading and market timing in a number of mutual funds.<sup>59</sup> Spitzer played a key role in bringing the mutual fund trading abuses to light. Yet, the actions of another state regulator who has received less attention are equally enlightening.

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<sup>55</sup> For example, Credit Suisse First Boston was investigated by both the NASD and the Commonwealth of Massachusetts. Cassidy, *supra* note xx.

<sup>56</sup> See Gretchen Morgenson & Patrick McGeehan, *Wall Street Firms are Ready to Pay \$1 Billion in Fines*, N.Y. TIMES, Dec. 20, 2002, at A1.

<sup>57</sup> Charles Gasparino and Michael Schroeder, *Pitt and Spitzer Butted Heads to Overhaul Wall Street Research*, WALL ST. J., Oct. 31, 2002, at A1.

<sup>58</sup> Randall Smith & Tom Lauricella, *Spitzer Alleges Mutual Funds Allowed Fraudulent Trading*, WALL ST. J., Sept. 4, 2003, at A1.

<sup>59</sup> “Late trading” refers to illegal transactions in mutual fund shares that are executed after the 4:00 p.m. eastern time close of the securities markets, when funds typically price their shares. “Market timing” refers to practices of certain fund investors who make frequent trades in mutual fund shares to exploit temporary disparities between the share value of a fund and the values of the underlying assets in the funds’ portfolio. Although market timing is not *per se* illegal, most funds discourage such trading because it increases their costs and lowers returns for their long-term investors. The prospectus disclosures of these funds frequently recite policies prohibiting or discouraging market timing. The failure to enforce the disclosed policies could make such disclosure false and misleading, thereby violating Rule 10b-5, and other federal and state securities provisions. See generally Statement of Richard J. Hillman, Testimony Before the Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform, House of Representatives, SEC Operations, Oversight of Mutual Fund Industry Presents Management Challenges, April 20, 2004.

Massachusetts Secretary of State William Galvin outflanked the SEC when he opened an investigation into market timing at Putnam Investments, the nation's fifth largest mutual fund complex. This case is particularly instructive because Galvin followed up on a lead from a whistleblower who was reportedly ignored by the SEC.<sup>60</sup> According to press reports, a Putnam employee and his lawyer met with representatives of SEC's Boston office to report alleged market-timing in Putnam funds by members of certain labor unions. When the SEC failed to act, the whistleblower brought his complaints to Secretary of State Galvin's office. Galvin immediately opened an investigation, which ultimately exposed significant market timing violations at Putnam.<sup>61</sup> Senior Putnam employees, including portfolio managers, had repeatedly engaged in market-timing transactions.<sup>62</sup> More troubling were revelations that Putnam executives knew about the improper trading but failed to discipline the managers involved. They also failed to report the employee misconduct to the funds' trustees.<sup>63</sup>

In the wake of the scandal, Putnam CEO Larry Lasser was forced to resign as were more than a dozen other employees.<sup>64</sup> For Putnam, the market impact of these revelations was equally severe. Investors withdrew more than \$50 billion from Putnam funds, and the stock of parent company Marsh & McLennan dropped 14%.<sup>65</sup>

The SEC opened its own investigation into the abuses revealed by the New York and Massachusetts regulators.<sup>66</sup> The agency also embarked on a comprehensive regulatory initiative to address the abuses

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<sup>60</sup> Jeffrey Krasner & Andrew Caffrey, *SEC Missed a Chance in its Probe of Putnam*, BOSTON GLOBE, Nov. 16, 2003, at A1. Controversy surrounding this incident led to the resignation of the Juan Marcelino, Director of the SEC's Boston District Office. Jeffrey Krasner, *SEC Boston Chief Quits Over Putnam: Office Failed to Act on Market Timing*, BOSTON GLOBE, Nov. 4, 2003, at A1

<sup>61</sup> Steve Bailey, *Asleep at the Switch*, BOSTON GLOBE, Oct. 24, 2003, at D1 ("While the SEC was 'reviewing,' Galvin's office was acting like a real regulator."). By this time the SEC had begun to investigate Putnam in response to an anonymous tip to enforcement chief Stephen Cutler.

<sup>62</sup> Andrew Caffrey, *State SEC Hit Putnam, 2 Managers Personal Profit Tied to Excessive Rapid Trading*, BOSTON GLOBE, Oct. 29, 2003, at A1.

<sup>63</sup> Steve Bailey & Andrew Caffrey, *Putnam Chief Lasser Agrees to Resign: Officials of Parent Firm Meet in Boston*, BOSTON GLOBE, Nov. 3, 2003, at A1.

<sup>64</sup> Andrew Caffrey & Jeffrey Krasner, *Putnam Fires 9 More for Improper Trades; A Coordinated Market Timing Effort also Revealed*, BOSTON GLOBE, Dec. 17, 2003 at C1.

<sup>65</sup> By August, 2004 the volume of withdrawals had grown to \$83 billion. Andrew Caffrey, *Putnam as Pariah*, BOSTON GLOBE, Aug. 25, 2004 at D1.

<sup>66</sup> Judith Burns, *SEC Chief Pledges Action on Funds*, WALL ST. J., Nov. 10, 2003, at C19.

uncovered.<sup>67</sup> The SEC reached a partial settlement with Putnam in November, 2003. This agreement provoked pointed criticism from both Spitzer and Galvin, who complained that the SEC had “gone around them to cut a quick deal with Putnam.”<sup>68</sup> Donaldson responded in kind. In testimony before Congress he called his critics “misguided and misinformed.”<sup>69</sup> Concerned senators urged Donaldson to make peace with state regulators, and Donaldson promised to try work with his state counterparts.<sup>70</sup>

Ultimately, Massachusetts and the SEC did coordinate their efforts. In April 2004, the state and the SEC announced a final settlement with Putnam. Putnam agreed to pay \$110 million in disgorgement and penalties, and Massachusetts won a rare admission of guilt in its agreement with Putnam.<sup>71</sup>

### PART III. THE BENEFITS FROM VERTICAL COMPETITION

#### A. THE CONCEPT

The concept of competition between the state and federal

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<sup>67</sup> See, e.g. Press Release, U.S. Securities and Exchange Commission, SEC Approves NYSE Governance Structure Changes; Proposes Mutual Fund Disclosure Rules; Solicits Comment on Fund Transaction Cost Issues, Dec. 17, 2003, available at <http://sec.gov/news/press/2003-173.htm>; SEC Release No. IA-2204, Compliance Programs of Investment Companies and Investment Advisers, Dec. 17, 2003; SEC Release No. IC-26288, Amendments to Rules Governing Prices of Mutual Fund Shares, Dec. 11, 2003; SEC Release No. IC-26323, Investment Company Governance, Jan. 15, 2004.

<sup>68</sup> See Brooke A. Masters, *States, SEC Split Again in Attack on Investment Abuses*, WASH. POST, Nov. 15, 2003, at E1; Andrew Caffrey & Jeffrey Krasner, *Settlement, New Trouble for Putnam; Galvin Rips Deal with the SEC, Vows More Charges*, BOSTON GLOBE, Nov. 14, 2003, at A1.

<sup>69</sup> Andrew Caffrey, *SEC Chief Calls Critics “Misguided”*, BOSTON GLOBE, Nov. 19, 2003, at D1; Deborah Solomon, *SEC Chairman Defends Decision to Quickly Settle Putnam Charges*, WALL ST. J., Nov. 18, 2003, at D9; William H. Donaldson, *Investors First*, WALL ST. J., Nov. 18, 2003, at 20.

<sup>70</sup> Senator Christopher Dodd warned Donaldson, “We can’t have you and Spitzer and the guy from Massachusetts screaming at each other in a public forum every day.” Andrew Caffrey, *SEC Chief Calls Critics “Misguided”*, BOSTON GLOBE, Nov. 19, 2003, at D1. This type of sparring and bickering can be an unfortunate by-product of regulatory competition. Yet, because such bickering plays poorly with the public it is likely to detract from each regulator’s standing. Conversely, competing regulators can boost their public esteem when they are seen as cooperating to effectively address market abuses.

<sup>71</sup> Beth Healy, *Putnam Agrees to \$110 million Settlement: Trading Penalty is 10 Times More than Investor Restitution*, BOSTON GLOBE, Apr. 9, 2004.

governments was part of the framers' vision of the federalist system.<sup>72</sup> The framers anticipated that a dual system would allow the public to "giv[e] most of their confidence where they may discover it to be most due."<sup>73</sup> Thus, the framers envisioned that state and federal governments would compete to persuade the public as to which was better suited to regulate in a particular field.<sup>74</sup> As James Madison stated in Federalist No. 46:

[i]f . . . the people should in [the] future become more partial to the federal than to the State governments, the change can only result from such manifest and irresistible proofs of a better administration, as will overcome all their antecedent propensities.<sup>75</sup>

In this view, vertical competition is fueled by the rival regulators' desire to preserve or expand their regulatory domain by competing for the public's confidence in their competence as regulators. Such competition gives voters a primary role in achieving a desirable balance between federal and state power. If the public becomes dissatisfied with a federal regulator's performance in a substantive area, citizens can appeal to state regulators to address their concerns. Conversely, if the public loses confidence in a state-based regime, voters can pressure Congress to adopt laws that either supplement or supplant state regulation.<sup>76</sup>

Certainly, our democracy functions in a more complex manner than this abbreviated analysis admits. The legislative and administrative processes are prone to corruption, manipulation and domination by moneyed interests at both the state and federal levels. Such reality undermines any idealistic hope that the public's will ultimately determines the rules that govern our society.

Yet, even when we acknowledge the pitfalls of our democracy, a dual system of regulation should help to alleviate these dangers. A dual system provides two related safeguards. First, the existence of multiple layers of government makes regulatory capture a more arduous task for interest groups. To influence the regulatory process at the federal level

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<sup>72</sup> See Pettys, *supra* note xx, at 338-45 (2003) (discussing the Federalist papers).

<sup>73</sup> *Id.* at 341 (quoting THE FEDERALIST NO. 46 (James Madison)).

<sup>74</sup> *Id.* at 333.

<sup>75</sup> THE FEDERALIST NO. 46 (James Madison), in 2 THE FEDERALIST: A COLLECTION OF ESSAYS, WRITTEN IN FAVOUR OF THE NEW CONSTITUTION, AS AGREED UPON BY THE FEDERAL CONVENTION, SEPTEMBER 17, 1787, at 84, 85-86 (2001).

<sup>76</sup> See Jones, *supra* note xx, at 635.

and in 50-plus states and territories, interest groups would have to expend significant resources and energy.<sup>77</sup>

Second, in the event of capture at one level of government, the dual system provides an alternate venue through which citizens can seek to effect regulatory reform. If a dominant regulator is controlled by interest groups, effecting popular reforms through that regulator would be difficult. If citizens can instead seek to mobilize an “uncaptured” regulator (whose officials remain unconstrained by prior commitments to the regulated industries), reform becomes a more achievable prospect. In short, regulatory dualism facilitates a more functional democracy because the existence of an alternative venue for reform (even when dormant) helps to forestall and counteract corruption.

#### B. VERTICAL COMPETITION AND SECURITIES ENFORCEMENT

The success of the state-led securities fraud investigations and the SEC’s response shows how competition from a previously inactive sector of government can spur the dominant regulator into more effective action. A comparison of Spitzer’s track record to that of the SEC in addressing analyst fraud demonstrates the importance of this dynamic relationship. SEC chairman Arthur Levitt and his successor Harvey Pitt sought unsuccessfully for years to prod the brokerage firms, the SROs and the media to address the spiraling analyst conflicts.<sup>78</sup> In contrast to the national regulators’ complaisance, Spitzer acted decisively. His aggressive approach forced the powerful investment banks to the

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<sup>77</sup> In corporate law the “internal affairs doctrine” assures that control of the regulatory process in one state is sufficient to set the national tone for corporate regulation. Public choice analysis may help explain the inconsistent application of federalist arguments in corporate and securities law. Capturing a small state such as Delaware has proven a relatively easy task. In order to protect its advantages, management interests need only forestall a federal takeover. Thus scholars have developed elaborate arguments in defense of the state-centered system. On the other hand, because of the difficulties the financial industry has encountered in seeking to dominate 50 different state securities regulators, conservative politicians and scholars cast aside their venerable federalist principles and instead fervently tout the need for a “national solution” in securities regulation.

<sup>78</sup> See LEVITT, *supra* note xx, at 67-80 (detailing Levitt’s efforts to convince the NASD and the media to address analyst conflicts of interests); Charles Gasparino, *New York Attorney General Turns Up Heat on Wall Street*, WALL ST. J., Apr. 10, 2002 at C1.

bargaining table and led to significant monetary penalties and business reforms from the industry.<sup>79</sup>

The Merrill Lynch and Putnam investigations are just two of many fraud investigations initiated by states, and ultimately resolved through cooperation with the SEC.<sup>80</sup> Popular accounts of the intermittent sniping between the SEC and state regulators tend to classify the dispute as a clash of personalities fueled mainly by political ambition.<sup>81</sup> By stepping back and disregarding any personality conflicts, one sees important implications lurking in this dramatic shift in the power from Washington to New York and Boston. These cases, taken together, demonstrate the important benefits that can flow from invigorated competition between state and federal regulators.

1. Defense Against Regulatory Capture. Maintaining multiple levels of regulation provides an antidote to regulatory capture.<sup>82</sup> Former SEC chairman, Arthur Levitt has described the SEC of the 1990s as an agency hobbled by fiscal starvation at the hands of Congress.<sup>83</sup> Levitt reports that members of Congress repeatedly pressured his agency

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<sup>79</sup> Some say the penalties amount to no more than a drop in the bucket. *See, e.g.*, Lucian Bebchuk, *Settling for Less*, N.Y. TIMES, Dec. 27, 2002, at A21.

<sup>80</sup> *See, e.g.*, *See In the Matter of Massachusetts Financial Services Company*, Advisers Act Release No. 2224 (Mar. 31, 2004)(regarding cease-and-desist proceedings); *In the Matter of Alliance Capital Management, L.P.*, Advisers Act Release No. 2205 (Dec. 18 2003) (regarding cease-and-desist proceedings); *In the Matter of Banc of America Securities, LLC*, Exchange Act Release No. 49386 (Mar. 10, 2004) (imposing remedial sanctions and cease-and-desist order); *Pilgrim Baxter & Associates, LTD.*, Advisers Act Release No. 2251 (June 21, 2004) (imposing sanctions and cease-and-desist order).

<sup>81</sup> *See, e.g.*, Brooke A. Masters, *States, SEC Split Again in Attack on Investment Abuses; Spitzer Critical of Settlement with Putnam*, WASH. POST, Nov. 13, 2003, at E 01. Deborah Solomon, *Its Spitzer vs. SEC on Mutual Funds' Fees*, WALL ST. J., Dec. 19, 2003, at C1 (reporting “[a] philosophical debate over regulators’ role in setting mutual fund fees escalated into a showdown yesterday with the Securities and Exchange Commission and New York Attorney General Eliot Spitzer sniping at each other over their respective settlements with Alliance Capital Management Holding, L.P.”).

<sup>82</sup> Under capture theories of regulation, interest groups and policymakers enter into jointly maximizing relationships. Under this theory smaller interest groups with a lot at stake can organize to exercise a distorting influence on government policy. *See, e.g.*, William W. Bratton and Joseph A. McCahery, *Regulatory Competition, Regulatory Capture and Corporate Self-Regulation*, 73 N.C.L. REV. 1861, 1885 (1995); Jonathan Macey & Geoffrey Miller, *Toward and Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 498-99 (1987).

<sup>83</sup> LEVITT, *supra* note xx, at 123, 132-32

to relent in its initiatives, and threatened to cut the SEC's budget if Levitt ignored their demands. According to Levitt, accounting firms and their lobbyists exerted considerable influence over the Congressional representatives responsible for SEC oversight.<sup>84</sup> He describes an oversight structure in which his agency was kept in a stranglehold by representatives in the thrall of the industry they were charged with regulating. Levitt's description of a captured SEC is reinforced by accounts of Harvey Pitt's performance as SEC chair. Pitt, a former accounting industry lawyer notoriously promised accountants to run a "kinder, gentler" agency; a pledge that exposed him to charges of being improperly aligned with the industry. These accounts of industry capture of the SEC underscore the importance of protecting the states' role as an alternate jurisdiction which can counteract the pernicious effects of regulatory capture.

2. Maximization of Government Resources. A second benefit to maintaining multiple enforcement centers is that such a structure facilitates the maximization of scarce government resources. When multiple agencies with distinct funding sources exercise overlapping authority, the costs of complex investigations can be shared.<sup>85</sup> The "global settlement" of the analyst investigation demonstrates the benefits of this strategy. After the Merrill Lynch settlement, the myriad securities regulators adopted a "divide and conquer" strategy. Investigators divided into teams, each of which investigated one or two of the firms implicated in the scandal.<sup>86</sup> Similarly, New Hampshire and Massachusetts joined forces to investigate mutual fund abuses at six fund companies located in Boston.<sup>87</sup> In each of these cases, it would have been overly burdensome for a single regulator to complete an investigation of so many firms within the same time frame.<sup>88</sup>

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<sup>84</sup> *Id.* at 10-13, 131-139, 287-307. A recent GAO study has also documented the chronic underfunding of the SEC.

<sup>85</sup> Mark D. Hunter, *SEC/DOJ Parallel Proceedings: Contemplating the Propriety of Recent Judicial Trends*, 68 MO. L. REV. 149, 177 (2003).

<sup>86</sup> See Cassidy, *supra* note xx; Gasparino, *supra* note xx, at A1.

<sup>87</sup> BOSTON GLOBE, Nov. 19, 2003.

<sup>88</sup> Competing regulators might also work at cross-purposes and frustrate their public mission. Ambition, self-righteousness or an ideological agenda may prompt a regulator to adopt an uncooperative posture. However, such posturing by regulators risks alienating the public support they need to retain their regulatory authority.

3. Improvement in the Public's Satisfaction with their Government. Finally, regulatory competition can improve public satisfaction with *both* levels of government.<sup>89</sup> As Spitzer took action to confront industry corruption, his political fortunes rose.<sup>90</sup> The political failure of Congressman Baker's efforts to limit states' enforcement power reinforces the notion that the public approves of the states' performance. Press commentary on the Spitzer phenomenon also reflects general approval of his actions.<sup>91</sup> Spitzer has won accolades from such unlikely sources as the Wall Street Journal, Fortune, and Business Week.<sup>92</sup>

Having an alternate regulator also gives investors a place to turn if one regulator ignores their concerns. This benefit is starkly illustrated by the Putnam case, where the SEC reportedly ignored the Putnam whistleblower.<sup>93</sup> The Canary Capital whistleblower also chose to contact Spitzer's office rather than the SEC, demonstrating that the public has come to appreciate Spitzer's reputation for responsiveness.<sup>94</sup> The SEC's

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<sup>89</sup> As SEC enforcement chief Stephen Cutler has acknowledged, "A visible and aggressive state enforcement regime may motivate federal regulators, like me, to respond more quickly to potential securities related misconduct. Of course if we in the federal government want to be the dominant securities enforcement authority, we must be vigilant in protecting the investing public." Cutler, *supra* note xx, at 551.

<sup>90</sup> Spitzer is one of New York State's most popular public figures. A 2003 Quinnipiac University poll reported that Spitzer had the highest job approval rating of any New York state official. Quinnipiac University, *Pataki Approval Inches Up, But Spitzer's Is Better*, (Oct. 2, 2003) available at <http://www.quinnipiac.edu/x8347.xml>. As he continued his investigations Spitzer's job approval ratings improved while his disapproval ratings fell. Siena New York Poll, *The Siena New York Poll for May: Approval Ratings: New York State Officials*, (June 16, 2004) available at <http://www.siena.edu/sri/results/2004/040616StateOfficials.htm>.

<sup>91</sup> Steve Bailey, *Asleep at the Switch*, BOSTON GLOBE, Oct. 24, 2003 ("Where was the SEC?" is becoming part of the lexicon"); Steven Syre, *Piling on the SEC*, BOSTON GLOBE, Nov. 18, 2003, at E1.

<sup>92</sup> Time magazine named Spitzer "Crusader of the Year" for 2002. See Adi Ignatius, *Crusader of the Year/Eliot Spitzer*, TIME, Dec. 20, 2002, at 64; see also Editorial, *Revenge of the Investor Class*, WALL ST. J., Oct 23, 2003, at A20 (praising Spitzer's investigation of mutual fund trading abuses); Editorial, *Eliot Spitzer, Once Again*, BUS. WEEK, Sept. 15, 2003, at 120 (praising Spitzer).

<sup>93</sup> See *supra* text at note xx.

<sup>94</sup> Henny Sender & Gregory Zuckerman, *Behind the Mutual Fund Probe: Three Informants Opened Up*, WALL ST. J., Dec. 9, 2003. ("Ms. Harrington [the Canary Capital whistleblower] decided to talk. She said she didn't go to the Securities and Exchange Commission because she wasn't confident the agency

embarrassment at Spitzer's hands caused the agency to revise its intake procedures so that its staff can better respond to tips and complaints from the public.

#### **PART IV. OBJECTIONS TO REGULATORY DUALITY**

##### **A. THE RATIONALE FOR PUBLIC ENFORCEMENT**

Before evaluating the arguments against maintaining regulatory competition in securities enforcement, we must first consider the characteristics of an ideal regulatory regime. A primary objective of any securities regime must be to maintain justifiable public confidence in the integrity of the securities markets by ensuring the flow of reliable information to investors. To accomplish this goal, a securities regime must provide investors adequate remedies for fraud and deter wrongdoing by promising public enforcement efforts to detect and punish fraud. Such a regime can be maintained more readily when multiple agencies with differing strengths, resources and enforcement tools work together to exploit their regulatory power.<sup>95</sup> Because the SEC lacks adequate resources to effectively police the national securities market, supplemental enforcement is essential to achieve an appropriate level of deterrence.<sup>96</sup> Judicial and legislative reforms of the 1980s and 1990s limited the deterrent effect of private securities litigation, making the emergence of new regulatory forces whether from states, or from a wave of more restrictive federal regulation (i.e. Sarbanes-Oxley) seemingly inevitable.<sup>97</sup>

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would follow up on her allegations. She says she trusted Mr. Spitzer's team, which had just finished its big investigation of Wall Street research analysts.”).

<sup>95</sup> Endowing multiple agencies with complementary enforcement power does not, by itself, ensure optimal cooperation. Competition for public approval should push all agencies into a cooperative posture.

<sup>96</sup> A recent study by the U.S. General Accounting Office documents the SEC's chronic underfunding. See Statement of Richard J. Hillman, Testimony Before the Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform, House of Representatives, SEC Operations, Oversight of Mutual Fund Industry Presents Management Challenges, April 20, 2004; see also Mark Maremont and Deborah Solomon, *Missed Chances: Behind SEC's Failings: Caution, Tight Budget, '90s Exuberance*, WALL ST. J., Dec. 24, 2003, at A1 (exploring the reasons for the SEC's recent failures in securities enforcement).

<sup>97</sup> See *supra* text at notes xx-xx.

## B. PERCEIVED PROBLEMS WITH THE DUAL SYSTEM

1. Balkanization. Those who criticize the dual regulatory system for securities enforcement often warn of the ominous dangers of “balkanization.”<sup>98</sup> They argue that allowing states to continue their independent enforcement efforts will result in a confusing patchwork of conduct standards throughout the nation.<sup>99</sup> Although the term “balkanization” has become a favored catch phrase for state critics, a close examination of the law of securities fraud reveals that critics exaggerate when they complain of an unjustified need to comply with 50 or more conduct standards. The problem of “balkanization”, if it exists, relates mainly to enforcement policies and practices, and is not caused by contradictory or conflicting legal standards.

Contrary to the assertions of preemption advocates, similar standards for fraud *do* exist across all securities regimes, state and federal. There is an inexorable connection between Rule 10b-5, the principal federal anti-fraud provision, and state common law of fraud and deceit. The judicially-distilled elements of a Rule 10b-5 action track the elements of a common law action for fraud.<sup>100</sup> In a bid for uniformity, the civil liability provisions of most blue-sky statutes also mirror federal statutory standards.<sup>101</sup> Overall, then, securities industry participants are guided by uniform legal principles that prohibit making false statements or misleading investors. It is of course true that the elements of proof for fraud are not identical under federal law and the state statutory and common law. Nonetheless, careful reflection reveals the state and the

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<sup>98</sup> For example, Congressman Oxley warned “what we are witnessing is nothing less than a regulatory coup that would usurp the proper role of the SEC and the self-regulatory organizations. This could result in a disastrous balkanization of oversight.” Oxley, *supra* note xx; *see also* Cutler, *supra* note xx, at 550 (arguing “our mutual goal should be to avoid “re-balkanizing” . . . the securities markets, and effectively, undoing the work Congress has done.”); Michael S. Greve, *Free Eliot Spitzer!*, FEDERALIST OUTLOOK, AEI ONLINE, at [www.aei.org/include/pub\\_print.asp?pubID=13928](http://www.aei.org/include/pub_print.asp?pubID=13928). (“The strongest argument for federal intervention is that it constitutes the only alternative to regulatory balkanization.”).

<sup>99</sup> Congressman Baker accused Spitzer of a “failed attempt to usurp federal rulemaking and oversight” that would “cause confusion in the markets.” Ben White, *Lawmaker Vows to Thwart Spitzer*, WASH. POST, May 24, 2002, at E01.

<sup>100</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

<sup>101</sup> Forty states have adopted either the 1956 Uniform Securities Act or the Revised Uniform Securities Act of 1985. The anti-fraud provision of both versions of the Uniform Securities Act (and new Uniform Securities Act of 2002) are substantially the same as Rule 10b-5. LOSS & SELIGMAN I, *supra* note xx, at 43.

federal governments speak with one voice in establishing a conduct standard for securities issuers and their representatives. The states emergence in the securities enforcement arena has not changed the prevailing legal standard. It has only altered the prior reality that federal and state authorities rarely imposed serious penalties against major firms for securities fraud.<sup>102</sup>

Although there is a fairly uniform standard of conduct under all securities laws, jurisdictions vary widely in the resources they devote to policing securities fraud.<sup>103</sup> There are also important variations among jurisdictions in available enforcement tools and the range of remedies for misconduct. These variations mean that the risks of detection and punishment for fraud can vary from one jurisdiction to the next.

New York's Martin Act, for example, is singular in granting the Attorney General broad investigatory powers and in limiting the rights afforded to subjects of an investigation.<sup>104</sup> In addition, an action for fraud under the Martin Act does not require the Attorney General to establish the defendant's intent to defraud.<sup>105</sup> These differences (and, of course, the willingness to exploit them) likely explains the contrasting outcomes of state and federal regulatory efforts.<sup>106</sup> The fact that the SEC joined Spitzer and Galvin in the analyst and mutual fund investigations supports the proposition that the conduct targeted by the states also breaches the federal securities laws.

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<sup>102</sup> Before its conviction for obstruction of justice in connection with Enron's collapse, Arthur Andersen had been the subject of a number of major SEC enforcement actions for falsely certifying its clients' financial statements. Andersen settled the SEC's investigation of the \$1.7 billion fraud at Waste Management by paying a modest fine and agreeing to an injunction against future violations. Andersen was later implicated in four of the major accounting frauds of 2002, including Qwest, Global Crossing, Enron and WorldCom. See Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And it Just Might Work)*, 35 CONN. L. REV. 915, 926 (2003).

<sup>103</sup> LOSS & SELIGMAN I, *supra* note xx, 147-50, n. 336 & 337.

<sup>104</sup> Martin Act §§ 353.2-3; 353-1; and 354. Under the Martin Act, a subject of an Attorney General's investigation must comply with the Attorney General's subpoena, and the failure to comply constitutes *prima facie* evidence of fraudulent conduct. In addition, a subject of an investigation has no right to have an attorney present during questioning (although Spitzer has allowed attorney presence). LOSS & SELIGMAN I, *supra* note xx, at 75-82; see also Cassidy, *supra* note xx.

<sup>105</sup> *People v. Federated Radio Corp.*, 244 N.Y. 33 (1926). In contrast, the U.S. Supreme Court has ruled that *scienter* is an essential element for a securities fraud claim under Rule 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

<sup>106</sup> See *supra* text at notes xx – xx.

Few of Spitzer's critics have argued publicly that the disgraced securities analysts and market timers complied fully with federal securities laws, or that their legal problems can be traced to conflicting state and federal conduct standards. Instead they seem to advance a defense based on the industry's "detrimental reliance" on regulatory inaction, by positing that federal regulators' prior tolerance of alleged misconduct, makes it unscrupulous for state regulators to enforce *their* anti-fraud provisions.

Rather than explicitly advance this untenable argument, critics instead launch *ad hominem* attacks against Spitzer as they warn about the crippling of the system of capital formation caused by requiring companies to comply with fifty different legal standards.<sup>107</sup> These critics conveniently ignore the reality that unchecked fraud, once revealed, does more to weaken capital formation, than does a vigorous system of enforcement.<sup>108</sup>

2. Unfairness of Parallel Proceedings. Critics also argue that it is unreasonable for companies to have to answer to multiple regulators investigating the same conduct.<sup>109</sup> This argument also fails to withstand scrutiny. Complexities associated with parallel enforcement investigations<sup>110</sup> extend beyond the context of securities fraud, and are inevitable in our federal system of government. State and federal enforcement authority frequently overlaps in areas ranging from crime

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<sup>107</sup> See Oxley, *supra* note xx; Ben White, *Lawmaker Vows to Thwart Spitzer; La. Congressman Decries State Move*, WASH. POST, May 24, 2002 at E01 (quoting Congressman Richard Baker); Bainbridge, *supra* note xx.

<sup>108</sup> See Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711, 713 (1996). Stout argues that "[w]hen securities scholars get together, they often find they agree on very little. But there is one thing they do agree on: fraud is very, very bad for securities markets. In lay terms, fraud is bad for securities markets because it erodes investor confidence. This occurs because fraud makes it difficult for investors to detect differences in the quality of the securities they buy. Companies issuing bad securities--poorly run firms that throw away money and do a poor job for their investors--can sell their securities at about the same price as well-managed firms, because fraud makes it impossible for investors to easily distinguish between high-quality and low-quality firms." *Id.*

<sup>109</sup> See Oxley, *supra* note xx (describing the need to "cut a separate deal with 50 state regulators").

<sup>110</sup> Abbe David Lowell and Kathryn C. Arnold, *Corporate Crime after 2000: A New Law Enforcement Challenge or Déjà vu?* 40 AM. CRIM. L. REV. 219, 233 (2003) ("Parallel proceedings are simultaneous or successive investigations, prosecutions, or other actions by federal and state governmental departments or agencies or by a governmental entity and a private party.").

and drug enforcement to the environment and workplace safety.<sup>111</sup> In all of these areas, state and federal regulators have found ways to cooperate to fulfill their public duties.<sup>112</sup> The SEC, in particular, has extensive experience in inter-agency cooperation because it must coordinate any of investigations with a criminal component with the U.S. Justice Department.

Although targets understandably bristle at being subject to parallel investigations, the regulators have demonstrated their ability to coordinate action, despite occasional rivalries and differing policy perspectives. Targets do suffer a tactical disadvantage when multiple investigations co-exist.<sup>113</sup> The corresponding advantage to government regulators enhances their ability to protect the public interest.

### CONCLUSION

State regulators emerged as significant securities enforcement agents only because of the prolonged failure of the SEC and the SROs to competently confront systemic problems affecting the financial services industry. The SEC's inaction created a vacuum that state regulators moved to fill. The states' actions, in turn, have prompted the SEC to address squarely the chronic abuses exposed by the states, through a combination of regulatory and enforcement efforts. This pattern of actions and reactions by state and federal regulators illustrates how vertical regulatory competition can lead to more effective government regulation. Efforts to limit states' enforcement power are not only misguided, they are also contrary to the framers' vision of our democracy.

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<sup>111</sup> For discussions about, and proposed solutions to, the challenges of concurrent enforcement in various fields see generally Jamie S. Gorelick & Harry Litman, *Prosecutorial Discretion and the Federalization Debate*, 46 HASTINGS L. J. 967 (1995) (discussing criminal law enforcement); John C. Dernbach, *Pennsylvania's Implementation of the Surface Mining Control and Reclamation Act: An Assessment of How "Cooperative Federalism" Can Make State Regulatory Programs More Effective*, 19 U. MICH. J. L. REF. 903 (1986) (discussing environmental law); Susan Bartlett Foote, *Administrative Preemption: An Experiment in Regulatory Federalism*, 70 VA. L. REV. 1429 (1984) (discussing health and safety regulation).

<sup>112</sup> Gorelick & Litman, *supra* note xx, at 976-78.

<sup>113</sup> See Lowell & Arnold, *supra* note xx, at 234 ("Parallel proceedings change everything about the planning and strategy of a case. Whether to allow a client to testify in a civil deposition or before a congressional committee for example is a much different question when there is a grand jury just waiting to review a copy of that testimony.").