

**PUBLIC CHOICE THEORY, FEDERALISM,
AND THE SUNNY SIDE TO BLUE-SKY LAWS**

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I. INTRODUCTION

At the annual meeting of the North American Securities Administrators Association, which represents state regulators, the chairman of the Securities and Exchange Commission, William H. Donaldson, announced an “initiative to promote increased cooperation between state and federal securities regulators.”¹ Donaldson stated that “everyone in this room is committed to

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1. Riva D. Atlas, *S.E.C. Chief Plays Down Clash with State Attorneys General*, N.Y. TIMES, Sept. 15, 2003, at C2.

rooting out fraud and corruption in our markets and otherwise protecting investors.”² Donaldson was responding specifically to media reports of a clash between state and federal securities regulators.³ Although Donaldson attempted to downplay the “supposed clash,” these clashes are increasingly common.⁴ Indeed, after stating that a commission was being formed to “study and propose ways to improve federal and state cooperation in significant enforcement activities,” Donaldson criticized the actions of Oklahoma’s Attorney General, Drew Edmondson, as potentially undermining the federal investigation and prosecution of WorldCom.⁵ According to Donaldson, Edmondson is “refight[ing] an old battle”⁶ and his actions could “impede and delay the administration of justice.”⁷

In late August of 2003, Edmondson filed criminal charges against WorldCom and several former executives on behalf of the State of Oklahoma.⁸ The complaint accuses Bernard Ebbers, former WorldCom Inc. chief, and other WorldCom executives of “breaking state securities laws by giving false information to investors in 2000.”⁹ Although the SEC had conducted its own investigation into WorldCom and indicted the former chief financial officer and other junior executives, it had not taken action against Mr. Ebbers.¹⁰ According to Edmondson, his actions against both WorldCom and several of its executives were justified because the “WorldCom debacle cost the state pension fund \$64 million.”¹¹ Additionally, Edmondson asserted that WorldCom had

2. *Id.*

3. *Id.*

4. *Id.*

5. *Id.*

6. *Id.*

7. Allan Chernoff, *WorldCom Case Ignites Turf Battle*, Aug. 27, 2003, at http://money.cnn.com/2003/08/27/news/companies/turf_war/ (last visited May 15, 2004).

8. Atlas, *supra* note 1. In November, Edmondson dropped the charges against Mr. Ebbers “but promised to refile them once Mr. Sullivan had been retried.” Kenneth N. Gilpin & Barnaby J. Feder, *Ebbers, Ex-Chief of WorldCom, Is Indicted on Federal Charges*, N.Y. TIMES, Mar. 2, 2004, at C5.

9. Ron Jenkins, *Oklahoma Charges Ebbers, Other Former WorldCom Executives*, MISSISSIPPI SUNHERALD, Aug. 27, 2003, at <http://www.sunherald.com/mls/sunherald/news/politics/6629942.htm> (last visited May 15, 2004).

10. *Id.* Although federal charges were not yet filed when Edmondson filed state criminal charges against Ebbers, the federal government recently indicted Ebbers on federal criminal charges. See Barnaby J. Feder & Kurt Eichenwald, *Ex-WorldCom Chief Is Indicted by U.S. in Securities Fraud*, N.Y. TIMES, Mar. 3, 2004, at A1.

11. Barnaby J. Feder, *Ex-WorldCom Chief Pleads Not Guilty to Fraud*, N.Y. TIMES,

not “purged itself of wrongdoing” by filing for bankruptcy.¹² Rather, according to Edmondson, WorldCom is being “rewarded for its bad acts.”¹³

In contrast, although Donaldson initially criticized New York Attorney General Eliot Spitzer for failing to give the SEC notice of his enforcement actions against mutual funds and hedge funds for improper trading, Donaldson later stated that, unlike Edmondson, Spitzer’s efforts resulted in “state action [which] clearly opened a new front in our efforts to ensure all investors are treated fairly”¹⁴ Last year, Wall Street investors were caught off guard when Spitzer alleged that “research reports generated by Wall Street analysts were tainted.”¹⁵ According to Spitzer, Wall Street firms “wrote glowing reports on companies they knew were flawed” in order to win investment banking business.¹⁶ Spitzer produced “damning e-mails in which analysts trashed stocks they were recommending to investors.”¹⁷ In sharp contrast to his criticism of Edmondson’s actions, Donaldson has applauded Spitzer’s efforts and has stated that “the SEC is working closely with Spitzer to see that appropriate action is taken against all wrongdoers.”¹⁸

Donaldson’s remarks remind us that state action can be both extremely beneficial and problematic. Recognizing the importance and value of state enforcement actions is crucial because the House of Representatives is drafting legislation “that would limit state powers to curb [abuses on] Wall Street”¹⁹ in order to establish the preeminence of the SEC “as the national securities regulator.”²⁰

Mar. 4, 2004, at C5.

12. *Id.*

13. *Id.*

14. Atlas, *supra* note 1; *see also* Charles Stein, *Watchdogs Zero In: Mutual Funds Are on the Hot Seat Over Suspected Unfair Trading: While New York’s Spitzer Grabbed Focus, Galvin Was Conducting His Own Inquiries in Massachusetts*, BOSTON GLOBE, Oct. 5, 2003, at D1 (explaining that Spitzer was not the only state official investigating improper trading by mutual funds; Massachusetts Secretary of State William F. Galvin, like Spitzer, was conducting his own investigation into what he called, “two sets of rules, one for the average citizen and one for the insiders”).

15. Stein, *supra* note 14.

16. *Id.*

17. *Id.*

18. Jeanne Zurlo, *SEC Chairman Announces Cooperative Effort With States*, Sept. 16, 2003, at <http://wallstreet.cch.com/news/headlines/page320.asp> (last visited May 15, 2004).

19. *Fraud Investigations Pressure Those Backing Bill to Curb State Powers*, 30 SECURITIES WEEK 36, 36 (2003).

20. *Id.*

The bill “prohibits states from imposing penalties that differ from the SEC, NYSE, and NASD.”²¹ Its primary sponsor is Representative Richard Baker of Louisiana, the chairman of the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises.²² Baker argues that this legislation is needed “to avoid costly and disruptive overlapping prosecutions by state and federal regulators.”²³ The SEC has not officially taken a position on the legislation but many believe it favors the bill.²⁴ Both state securities regulators and investor advocacy lobbies, not surprisingly, have strenuously opposed it.²⁵

Although passing this legislation will be difficult because of the recent disclosures by both New York and Massachusetts officials that their state-backed investigations have uncovered illegal trading in the mutual funds industry, questions remain as to the proper role of the states in securities enforcement.²⁶ Much has already been written about the general relationship between federal securities laws and state securities laws, but this article will argue that, contrary to the trend found in both academic literature and the proposed legislation, state enforcement of securities laws is essential. This conclusion is drawn from public choice theory, which, as applied to this area, suggests that multiple, independent enforcement agencies will best protect the investing public.

Neither the Securities Act of 1933 (the “33 Act”) nor the Securities and Exchange Act of 1934 (the “34 Act”) completely preempt state securities laws. Much contemporary literature, however, questions the continued role of the states in light of

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.*

25. *Id.*

26. Zurlo, *supra* note 18; *see also* Stein, *supra* note 14.

In fact, state regulators were handed a victory when the “House Financial Services Committee struck language from an investor protection bill that would have diluted the powers of state securities regulators when they pursued fraud cases.” Gretchen Morgenson, *State Regulators Win Some, Lose Some*, N.Y. TIMES, Feb. 29, 2004. With this victory, however, also came a loss. “New regulations issued by the Office of the Comptroller of the Currency, the federal overseer of banks that is part of the Treasury, placed all authority to regulate national banks at the federal level.” *Id.* As a result, “state banking laws have been pre-empted.” *Id.* Many, including Eliot Spitzer, have objected to these new regulations and have cited the fact that state banking regulators themselves have argued that consumers will be hurt because “[t]here are local issues in banking that are best addressed by the states.” *Id.*

recent actions taken by Congress and the Self-Regulatory Organizations (the “SROs”) to strengthen both corporate governance regulation and securities regulation. To make a case for dual enforcement of securities regulation, this article will examine the following: 1) the history of the blue-sky laws; 2) the resulting inadequacies of the state blue-sky laws; 3) the history and justifications for enacting the 33 and 34 Acts; 4) the extent of preemption by the 33 Act and 34 Act; and 5) the present debate over dual enforcement.

This article concludes that public choice theory shows that the states should be involved in the enforcement of securities regulation. Investor confidence is essential to the protection and integrity of the securities market. Because public choice theory is based on the assumption that most politicians, bureaucrats, and other decision-makers are rationally self-interested, the most vigorous method for securities enforcement includes a system of dual regulation. Those who oppose this type of regulatory system might argue that this method of dual securities enforcement is inefficient. This article, however, argues that dual regulation of the securities market is actually extremely efficient. Dual regulation, regulation by both the state and federal government, is an efficient method of regulating the securities market because federalism itself is efficient. This article will illustrate that the core values of federalism, citizen participation in government, efficiency in government, creative experimentation, and diffusion of power are served by having a dual regulatory system.

II. HISTORY OF THE BLUE-SKY LAWS

Between 1911 and 1933, specialized state statutes known as “blue-sky” laws were almost exclusively responsible for the regulation of securities sales in the United States.²⁷ State blue-sky laws were a response by the state legislatures to securities fraud and other serious abuses in unregulated markets.²⁸ In order to combat

27. Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 348 n.1 (1991) (noting that there was “some federal regulation of securities sales during this period under the postal fraud laws, but the level of enforcement was minimal”).

28. *Id.* at n.7 (citing VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA—A HISTORY 162-63 (Ralph W. Hidy ed., 1970) (“Suffering heavy losses, the victims of these [securities] frauds and misrepresentations agitated for protection, then joined with other dissatisfied midwesterners to elect reform administrations that promised them relief from such abuses.”); LOUIS LOSS & EDWARD M. COWETT, BLUE

these abuses, many states “adopted legislation requiring that securities proposed to be sold in a state be submitted to an administrative agency for review as to their ‘merit’ or intrinsic worth.”²⁹ Other states, not wanting to impose this type of “merit” regulation, required only disclosure of information “about the issuer and registration of dealers.”³⁰

This wave of blue-sky legislation was, at least in part, due to the work of Kansas Banking Commissioner J.N. Dolley.³¹ Dolley is credited with developing blue-sky legislation and promoting it throughout the nation.³² In 1911, Dolley persuaded the Kansas legislature to become the first state to adopt his proposal.³³ The Kansas law “generally required that firms selling securities in Kansas obtain a license from the bank commissioner and file regular reports of financial condition.”³⁴ In addition, “[i]nvestment companies were . . . required to file reports of their business plan and financial condition and to file a copy of all securities they proposed to sell in Kansas.”³⁵ The statute also authorized the bank commissioner

to bar an investment company from the state if he concluded, upon examining these documents, that the information about the investment company or security

SKY LAW 7-8 (1958) (asserting that blue-sky laws grew out of an awareness of “the many instances in which unsophisticated . . . investors had been bilked of their life savings by sellers of worthless or fraudulent securities”); JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 44-45 (1982) (describing Kansas’s statute, the first blue-sky law, as a response to “the failure of lax state corporation statutes to prevent securities fraud”); Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 18-33 (1983) (citing pre-1934 state blue-sky laws as evidence of the fact that securities fraud was considered a serious and widespread problem before the enactment of the federal securities acts); Murray J. Edelman, *Securities Regulation in the 48 States* (July 1942) (manuscript published by The Council of State Governments) (citing Justice McKenna’s opinion in *Hall v. Geiger-Jones*, 242 U.S. 539 (1917), as a typical justification of state securities legislation as a means of protecting the public from the “evil” of speculative and fraudulent schemes)).

29. Macey & Miller, *supra* note 27, at 348-49 (internal citations omitted).

30. *Id.* at 349 (internal citations omitted).

31. *Id.* at 350; *see also* LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 7 n.22 (1958); Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J.L. & ECON. 229, 231 (2003).

32. *See* Macey & Miller, *supra* note 27, at 361; *see also* Mahoney, *supra* note 31, at 231-32.

33. *See* Mahoney, *supra* note 31, at 231; *see also* JAMES D. COX ET AL., SECURITIES REGULATION 16 (2d ed. 1997).

34. *See* Macey & Miller, *supra* note 27, at 361.

35. *Id.*

proposed to be sold contained any “unfair, unjust, inequitable or oppressive” provision, or that the investment company was “not solvent and did not intend to do a fair and honest business, and . . . did not promise a fair return on the stocks, bonds, or other securities . . . offered for sale.”³⁶

Dolley’s efforts, both in Kansas and throughout the country, combined with the economic conditions of the time³⁷ and pervasive public revulsion against fraudulent securities practices, helped blue-sky legislation gain national attention.³⁸

As awareness increased, however, so too did interest group activity.³⁹ State blue-sky legislation was both supported and opposed by defined vested interests.⁴⁰ Interest groups supporting the Kansas model included the owners of small banks and savings institutions “who saw blue-sky legislation as a means for suppressing competition for depositors’ funds,”⁴¹ state banking regulators who were “interested in protecting and expanding their regulatory turf and in advancing the financial interests of banks under their supervision,”⁴² and farmers and small-business owners who “saw the suppression of securities sales as a useful means for increasing their own access to bank credit” by excluding competition from out-of-state borrowers.⁴³ The nation’s elite investment bankers were the

36. *Id.* (quoting Act of Mar. 10, 1911, ch. 133, 1911 Kan. Sess. Laws 210).

37. *See id.* at 350.

Economic conditions—a sustained period of inflation and high nominal interest rates—threatened the ability of small banks and savings institutions to attract or retain consumer deposits in competition with higher yielding securities and restricted the supply of credit to local borrowers. This threat gave both small banks and local borrowers an interest in suppressing the activities of out-of-state securities firms.

Id.

38. *Id.*

39. *Id.* at 351 (“[I]nterest group activity generally appears to be greater at times when the interest group is suffering an economic downturn, or the threat of a downturn, than when it is enjoying prosperity.”); *see also* Elisabeth Keller & Gregory A. Gehlmann, *Symposium: Current Issues in Securities Regulation: Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities and Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 332-34 (1988).

40. *See* Macey & Miller, *supra* note 27, at 351; *see also* Keller & Gehlmann, *supra* note 39.

41. *See* Macey & Miller, *supra* note 27, at 351.

42. *Id.*

43. *Id.* at 367 (stating that farmers were supporters of blue-sky laws because they needed both mortgage financing and temporary credit between planting and harvest seasons).

group principally opposed to this type of blue-sky legislation.⁴⁴ Although the bankers did not object to suppressing speculative securities, they believed blue-sky legislation would “restrict the activities of reputable investment firms.”⁴⁵ Joining the investment banks in opposing blue-sky legislation were large issuers of securities, who wanted to “preserve their ready access to low-cost financing in the public securities markets,” and the nation’s bigger banks, although they do not appear to have been lobbying as actively against the legislation.⁴⁶

The type of regulation adopted by the states varied depending on which interest groups were active in that state.⁴⁷ For example, the more stringent blue-sky statutes—those similar, if not identical to, the Kansas model—were “adopted in agricultural states without a significant presence of large banks, investment houses, or major manufacturing firms.”⁴⁸ The agricultural states following, at least in part, the Kansas blue-sky model were Arizona,⁴⁹ Vermont,⁵⁰ Louisiana,⁵¹ Arkansas,⁵² Idaho,⁵³ Michigan,⁵⁴ Montana,⁵⁵ North Dakota,⁵⁶ Ohio,⁵⁷ South Dakota,⁵⁸ Tennessee,⁵⁹ and West Virginia.⁶⁰

44. *Id.* at 351.

45. *Id.*

46. *Id.*

47. *Id.*

48. *See id.* at 352, 377-78.

49. *Id.* at 377 n.180 (citing Act of May 18, 1912, ch. 69, 1912 Ariz. Sess. Laws 338 (vesting enforcement powers in the state corporation commission)).

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

51. *Id.* n.182 (citing Act of July 1, 1912, No. 40, 1912 La. Acts 47).

52. *Id.* n.184 (citing Arkansas Securities Act, No. 214, § 6, 1913 Ark. Acts 904, 909-11).

53. *Id.* n.185 (citing Idaho Securities Act, ch. 117, 1913 Idaho Sess. Laws 454, 455-56).

54. *See id.* at 377 n.186 (citing Act of May 2, 1913, No. 143, § 5, 1913 Mich. Pub. Acts 243, 245-46).

55. *Id.* n.187 (citing Act of Mar. 13, 1913, ch. 85, § 9, 1913 Mont. Laws 367, 370-71).

56. *Id.* n.188 (citing Supervision of Investment Companies, ch. 109, § 5, 1913 N.D. Laws 137, 139-40).

57. *Id.* at 378 n.193 (citing Act of Apr. 28, 1913, § 16, 1913 Ohio Laws 743, 751-52).

58. *Id.* at 377 n.189 (citing Act of Mar. 14, 1913, ch. 319, § 5, 1913 S.D. Laws 522, 524).

59. *Id.* at 378 n.190 (citing Act of Sept. 27, 1913, ch. 31, § 5, 1913 Tenn. Pub. Acts 500, 502-03).

60. *See id.* at 378 n.191 (citing Act of Feb. 6, 1913, ch. 15, § 5, 1913 W. Va. Acts 114, 117-18).

In contrast, in states with securities houses or significant manufacturing interests, as well as in states competing to attract corporations to charter within their borders, Kansas-style legislation was not as successful.⁶¹ Efforts to enact these laws failed in Nevada, Maryland, and Delaware, three states that were active participants in the market for corporate charters.⁶² In Indiana, the legislature approved a blue-sky statute but intense lobbying by investment bankers and manufacturers resulted in the statute being vetoed by the governor.⁶³ Blue-sky legislation in Colorado was also vetoed.⁶⁴ States with active securities industries and large manufacturing firms—Illinois and Pennsylvania—rejected proposals for legislation based on the Kansas model.⁶⁵ In Minnesota, a blue-sky statute was proposed but later defeated.⁶⁶

In still other states, some form of blue-sky legislation was adopted, but lacked several key features of the Kansas model.⁶⁷ For example, both Missouri and Florida adopted legislation modeled in part on the Kansas statute, but the legislation omitted “the crucial power to reject a sale of securities if the offering did not promise a fair return on the investment.”⁶⁸ Maine, a state competing in the market for corporate charters, adopted a disclosure regulation “patterned generally on legislation recommended by the Investment Bankers Association [“IBA”].”⁶⁹ Georgia,⁷⁰ Iowa,⁷¹ Nebraska,⁷² North Carolina,⁷³ Oregon,⁷⁴ Texas,⁷⁵ and Wisconsin⁷⁶ adopted legislation “requiring registration and disclosure and prohibiting fraud, but not permitting the exclusion of securities

61. *Id.* at 380.

62. *Id.* at 378.

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.* at 378 n.204 (citing Act of April 9, 1913, ch. 209, §§ 12, 21, 1913 Me. Laws 291, 292, 297).

70. *Id.* at 379 n.206 (citing Act of Aug. 19, 1913, No. 263, 1913 Ga. Laws 117).

71. *Id.* n.207 (citing Act of April 19, 1913, ch. 137, 1913 Iowa Laws 137).

72. *See id.* at 379 n.208 (citing Act of Apr. 21, 1913, ch. 199, 1913 Neb. Laws 603).

73. *Id.* n.209 (citing Act of Mar. 12, 1913, ch. 156, 1913 N.C. Sess. Laws 249).

74. *Id.* n.210 (citing Act of Feb. 28, 1913, ch. 341, 1913 Or. Gen. Laws 668).

75. *Id.* n.211 (citing Act of Aug. 21, 1913, 33d Leg., 1st C.S., ch. 32, 1913 Tex. Gen. Laws 66).

76. *Id.* n.212 (citing Act of Aug. 21, 1913, ch. 756, 1913 Wis. Laws 1108).

solely because they were bad investments.⁷⁷ In Massachusetts, the location of a leading securities exchange,⁷⁸ the legislature adopted a blue-sky statute similar to legislation proposed by the IBA, not one similar to the Kansas model.⁷⁹ Finally, in New York a battle was waged between the interest groups favoring the Kansas model and those opposed to it. In the end, the IBA was able to stop the adoption of a Kansas-style blue-sky law.⁸⁰

Between 1911 and 1913, there was a flurry of legislative activity. States were called upon to respond to abuses in the securities market and most did so by enacting some form of blue-sky legislation.⁸¹ In 1914, legislative activity abruptly came to an end.⁸² Perhaps the most important reason was the constitutionality of blue-sky legislation being attacked by the IBA.⁸³ In a series of decisions, courts undercut blue-sky statutes for a variety of reasons.⁸⁴ In 1915, however, the economic conditions began to drastically improve both because interest rates lowered and war-related orders caused exports to increase.⁸⁵ As a result, the interest groups involved began to pay less attention to blue-sky legislation.⁸⁶ Representatives for both sides attempted to achieve a compromise by writing a new model blue-sky law that would be accepted by everyone. But the compromise failed,⁸⁷ resulting in heightened tensions once again between those supporting, and those opposing, blue-sky legislation.⁸⁸

Many of the lower court decisions striking down state blue-sky

77. *Id.* at 379.

78. *See id.* (noting that the Boston Stock Exchange was the primary market for industrial securities before 1900).

79. *Id.*

80. *Id.*

81. *See supra* notes 48-80 and accompanying text.

82. *See Macey & Miller, supra* note 27, at 380.

83. *Id.* at 381.

84. *See, e.g., Ala. & New Orleans Transp. Co. v. Doyle*, 210 F. 173 (E.D. Mich. 1914) (stating that Michigan's blue-sky statutes went far beyond their stated purpose of prohibiting fraudulent practices; the statute exceeded the state's police powers); *William R. Compton Co. v. Allen*, 216 F. 537 (S.D. Iowa 1914) (*per curiam*) (stating that blue-sky legislation infringed on the privileges and immunities of national citizenship) *cert. dismissed*, 239 U.S. 652 (1915); *Bracey v. Darst*, 218 F. 482 (N.D.W. Va. 1914) (holding that the blue-sky legislation violated the privileges and immunities clause, violated due process and burdened interstate commerce).

85. *See Macey & Miller, supra* note 27, at 383.

86. *Id.*

87. *Id.* at 384-85.

88. *Id.* at 386.

laws were appealed to the United States Supreme Court.⁸⁹ The Court “flatly repudiated all the lower court opinions in the IBA’s favor and . . . ruled against the IBA point-by-point on the constitutional issues.”⁹⁰ Interestingly, while the IBA lost the individual battles, it largely won the war.⁹¹ The Court made clear that the blue-sky statutes could pass constitutional muster only if they did not regulate interstate commerce but instead regulated the disposition of securities *within* a state.⁹² This language confirmed what the IBA and others had believed for the past few years—that blue-sky legislation could be circumvented by “mail solicitations” or “other modalities of interstate commerce.”⁹³ Thus, although the Court’s decisions appeared to validate blue-sky legislation, they instead “proved to be a charter for the business of unregulated interstate securities sales by mail”⁹⁴

III. RESULTING INADEQUACY OF STATE BLUE-SKY LAWS

Blue-sky legislation appeared, at least initially, to effectively combat securities fraud and other abuses of the market. It was soon apparent, however, that state legislation by itself was inadequate.⁹⁵ The “increasingly interstate nature of modern business,” the “reluctance of many, if not most, state legislatures to provide for effective enforcement of . . . Blue-sky laws,” and the illusory nature of many of the blue-sky laws are the three reasons advanced to account for the inadequacy of state regulation.⁹⁶

As a result of the earlier discussed Supreme Court opinions, blue-sky laws could easily be evaded by disposing of securities out of

89. *Id.*

90. *Id.*; see also Keller & Gehlmann, *supra* note 39, at 332.

In *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568, 587 (1917), Justice McKenna conceded that the statute burdened honest business, but only to the extent that “dishonest business may not be done.” Additionally, Justice McKenna made clear that the blue-sky legislation in question applied only to the disposition of securities within the state, thus “incidentally” affecting interstate commerce. *Id.* at 587-89.

In *Geiger-Jones Co. v. Turner*, 230 F. 233 (S.D. Ohio 1916), *rev’d*, 242 U.S. 539, 559 (1917), the blue-sky legislation was once again upheld because, as Justice McKenna pointed out, the legislation governed only the sale or disposition of securities within a state’s borders.

91. See Macey & Miller, *supra* note 27, at 388.

92. *Id.*

93. *Id.*

94. *Id.* at 389.

95. 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* § 1-B-6, at 146 (3d ed. 1991).

96. 1 *Id.* at 146-47, 150.

state. In addition to the problems caused by the increasingly interstate nature of the economy, “parsimonious state budgets meant [an] understaffing of state securities law programs.”⁹⁷ It is hard to imagine how states with undersized programs could be expected to control “corporate entities that are sometimes bigger in terms of assets than the states themselves.”⁹⁸ Additionally, the stock market crash of 1929 resulted in a crisis of investor confidence and a widespread panic ensued.⁹⁹ Finally, by the 1930s, it was apparent that many of the blue-sky laws were fraught with so many exemptions that they were essentially an illusory protection.¹⁰⁰ As a result, Congress had no choice but to draft legislation involving the federal government in the regulation of securities.

IV. FEDERAL 33 AND 34 ACTS: THE 33 AND 34 ACTS

Having finally reached the point of legislating, “Congress was faced with a choice of conflicting philosophies.”¹⁰¹ Before drafting legislation defining the federal government’s role in securities regulation, Congress had to choose one of three philosophies as its model. Some wanted a fraud act similar to New York’s Martin Act¹⁰²

97. 1 *Id.* at 147-49.

98. 1 *Id.* at 150.

99. See SELIGMAN, *supra* note 28, at 2-5 (1982).

100. See 1 LOSS & SELIGMAN, *supra* note 95, § 1-B, at 150.

101. 1 *Id.* § 1-G, at 169.

102. New York’s Martin Act grants broad investigatory power to the Attorney General:

Whenever it appears to the attorney general that, in connection with any security (or commodity) or investment advice, any person shall have employed, or employs, or is about to employ any device, scheme, or artifice to defraud or for obtaining money or property by means of any false pretense, representation or promise . . . or he believes it to be in the public interest that an investigation be made, he may in his discretion either require or permit such person . . . to file with him a statement in writing under oath or otherwise as to all the facts and circumstances concerning the subject matter which he believes it is to the public interest to investigate . . . The attorney-general may also require such other data and information as he may deem relevant and may make such special and independent investigations as he may deem necessary in connection with the matter.

1 *Id.* § 1-B, at 76 (quoting the Martin Act currently codified at N.Y. GEN. BUS. LAW § 352 *et seq.* (McKinney 1996)). The Martin Act centralizes all enforcement, including criminal prosecutions, with the Attorney General. *Id.* at 78-79. Additionally, the words “fraud and fraudulent practice are given ‘a wide meaning’” in New York. *Id.* at 81 (quoting *People v. Federated Radio Corp.*, 154 N.E. 655, 657 (N.Y. 1926)). “[A]ll acts, although not originating in any actual evil design or contrivance to perpetuate fraud or injury upon others, which do by their

or, better yet, stern enforcement of the penal laws.¹⁰³ They argued that preventive laws would not work and would hinder honest businesses.¹⁰⁴ Others wanted to have a law similar to the Kansas blue-sky law—that is, a law based on “merit standards.”¹⁰⁵ This group would have liked the new federal act to provide for “revocation of registration upon an administrative finding (among other standards) that the enterprise or business of the issuer . . . or the security is not based upon sound principles, and that the revocation is in the interest of the public welfare,” or that the issuer “is in any other way dishonest” or “in unsound condition or insolvent.”¹⁰⁶

The intermediate position sought a disclosure law more or less like the English Companies Act,¹⁰⁷ which rejected the idea of a regulatory policy by stating that “[i]t would be an attempt to throw what ought to be the responsibility of the individual on the shoulders of the State, and would give a fictitious and unreal sense of security to the investor, and might also lead to grave abuses.”¹⁰⁸ A strong proponent of this option as the preferred model for federal legislation was then Supreme Court Justice Louis D. Brandeis.¹⁰⁹ According to Brandeis, “the law should not try to keep investors from making bad bargains”¹¹⁰ He cited the Pure Food Law as an example of what the law should strive for—the law should “help the consumer to judge quality by requiring the disclosure of ingredients.”¹¹¹

Ultimately, it was this latter philosophy that won out and was effectively the philosophy of the 33 Act,¹¹² which became effective in May of 1933.¹¹³ In substance, it provided “for the filing of a registration statement and the use of a prospectus in connection

tendency to deceive or mislead the purchasing public come within the purpose of the [Martin Act].” *Federated Radio*, 154 N.E. at 657.

103. See 1 LOSS & SELIGMAN, *supra* note 95, § 1-G, at 169.

104. 1 *Id.*

105. 1 *Id.* at 169-70.

106. 1 *Id.* at 170 (quoting S. 875 & H.R. 4313, 73d Cong., §6(c), (e), (f) (1933)).

107. 1 *Id.*

108. See 1 *id.* at 171 (quoting The Lord Davey Committee, Cmd. 7779, § 42 (1895)).

109. 1 *Id.*

110. 1 *Id.*

111. 1 *Id.* at 172.

112. 1 *Id.*

113. 1 *Id.*

with the public offering of securities, and subjected the issuer and those connected with the offering to civil and criminal liabilities in the event of material misstatements or omissions.”¹¹⁴ Importantly, the 33 Act is essentially a combination of both the Companies Act and the Martin Act, with some modifications.¹¹⁵ The Act was appropriately termed the “truth-in-securities act”¹¹⁶ because Congress required only the disclosure of information that, if not revealed, could harm and fool the investing public.¹¹⁷ In 1934, the Securities Exchange Act was enacted because of the complexities of the 33 Act and “the need for an independent administrative body to enforce the federal securities laws, regulate stock market practices, and curb the evils in the stock exchanges themselves.”¹¹⁸ Although the enactment of the 33 and 34 Acts may have helped solve the problem of inadequate state blue-sky legislation, it also “introduced the new problem of federal-state coordination.”¹¹⁹

V. PREEMPTION: STATE AND FEDERAL REGULATION OF SECURITIES

The 33 and 34 Acts were to act as supplemental regulation to the state blue-sky laws because it became obvious that state legislation could not, by itself, effectively regulate the securities market. As a result, when the 33 and 34 Acts were initially passed, Congress did not preempt state law.¹²⁰ In fact, Congress wrote “savings clauses” into both acts, evidenced by former section 18 of

114. 1 *Id.*

115. 1 *Id.* at 177.

116. 1 *Id.*

117. 1 *Id.*

118. Keller & Gehlmann, *supra* note 39, at 347.

119. 1 LOSS & SELIGMAN, *supra* note 95, § I-B-2, at 44.

120. Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT'L L. 495, 500 (2003).

Although this article does not make any attempt to fully analyze preemption doctrine and all of its complexities, a brief foray into preemption doctrine generally is required. As noted by Professor Karmel, “[p]reemption may be express, implied, or by reason of conflict.” *Id.* at 499. Preemption is express when the statute explicitly mandates that state law is displaced. *Id.* Preemption is implied, and therefore displaces state law, “if federal law so thoroughly occupies a legislative field as to make reasonable the inference that Congress left no room for the states to supplement it.” *Id.* at 500 (quoting *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 516 (1992)). Often, this type of preemption is referred to as field preemption. *Id.* Finally, conflict preemption may result in the displacement of state law if “either it is impossible to comply with both a state and a federal law, or if the state law ‘stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.’” *Id.* (quoting *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977)).

the 33 Act,¹²¹ and former section 28 of the 34 Act.¹²² According to available legislative history, the initial 1933 Act bill, which made it through the House, “set forth a clause prohibiting the sale of securities in interstate commerce into any state if such sale would have violated the blue-sky laws of that state.”¹²³ The apparent purpose of this clause was “to assure the states that the [Securities Act] was not an attempt to supplant their laws, but an attempt to supplement their laws and to assist them in enforcing their laws in those cases where they have no control.”¹²⁴ Although this clause was later deleted by a Senate amendment,¹²⁵ the “savings clauses” clearly illustrate that Congress’ intent in enacting the Securities Act was *not* to preempt state blue-sky laws generally.¹²⁶

Even though there was no field preemption of the state blue-sky legislation by the 33 and 34 Acts, in 1947 the House of Delegates of the American Bar Association concluded that the National Conference of Commissioners on Uniform State Laws “should be requested to consider ‘a new uniform or model State Sale of Securities Act’ in cooperation with the ABA ‘to the end that the existing diversity of legal requirements preliminary to the issuance of securities be minimized to the greatest possible extent.’”¹²⁷ Drafting this legislation was an extremely difficult task because each state had its own regulatory philosophy.¹²⁸ In 1956, nine years later, the Uniform Securities Act was finally promulgated and approved by the ABA.¹²⁹ It is primarily a regulatory law¹³⁰ with a

121. *Id.* at 500-01 (“Nothing in this Subchapter shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person.”).

122. *Id.* at 501 (“[N]othing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.”).

123. *Id.*

124. *Id.* (quoting *Federal Securities Act: Hearing Before the Comm. on Interstate and Foreign Commerce on H.R. 4314*, 73d Cong. 117 (1933) (statement of Ollie M. Butler, Foreign Service Div., Dept. of Commerce)).

125. Karmel, *supra* note 120, at 501 (citing H.R. REP. NO. 73-85, at 10-11, 25 (1933)). Although the reasons behind the Senate’s actions are not clear, it may have deleted the clause in an effort to maximize commerce, guarding against the possibility that the state laws proved to be too restrictive.

126. *Id.*

127. See 1 LOSS & SELIGMAN, *supra* note 95, § 1-B-2, at 46 (quoting 72 ABA Rep. 98, 297 (1947)).

128. 1 *Id.* at 47.

129. 1 *Id.* This Uniform Securities Act was also approved in principle by the

four-part structure whose “first three parts [are] designed to stand alone or in any combination.”¹³¹ Although there were later attempts to write Revised Uniform 33 and 34 Acts, these discussions failed.¹³² Currently, more than 30 jurisdictions have all, or substantially all, of the 1956 Act in effect.¹³³

This dual system of securities regulation continued for some time without any major changes. In 1994, the political balance in Congress shifted and Congress “began a broad reexamination of the current dual system of securities regulation.”¹³⁴ During its deliberations over new legislation, Congress heard testimony that “duplicative regulation tends to raise the cost of capital to American issuers of securities without providing commensurate protection to investors or to . . . [the] markets.”¹³⁵ Congress also heard testimony that technological advances required changes to facilitate the information flow to the investing public.¹³⁶ The culmination of Congress’ deliberations was the enactment of the National Securities Markets Improvement Act of 1996 [the “NSMIA”].¹³⁷ Congress explained its decision to enact NSMIA as follows: “The system of dual federal and state securities regulation has resulted in a degree of duplicative and unnecessary regulation. Securities offerings and brokers and dealers engaged in securities transactions are all currently subject to a dual system of regulation that, in many instances, is redundant, costly, and ineffective.”¹³⁸

The NSMIA constituted a partial preemption of state law in

NASAA and endorsed by the SEC. 1 *Id.*

130. 1 *Id.*

131. See 1 LOSS & SELIGMAN, *supra* note 95, at 51. Part I of the Uniform Securities Act is entitled, “Fraudulent and Other Prohibited Practices.” 1 *Id.* It is based on Rule 10b-5 and “outlaws fraudulent practices in connection with the sale or purchase of a security,” as well as “other undesirable investment advisory activities.” 1 *Id.* at 52. Part II is entitled “Registration of Broker-Dealers, Agents, and Investment Advisors,” and deals with registration procedures and post-registration requirements. 1 *Id.* Part III of the Uniform Securities Act is entitled “Registration of Securities,” and it describes the registration procedures that must be adhered to before any security, unless the security or transaction is exempted, is offered or sold in the state. 1 *Id.* at 53. Finally, Part IV is a general provision that details how the first three parts are to be implemented. 1 *Id.*

132. See 1 LOSS & SELIGMAN, *supra* note 95, § 1-B-4, at 52.

133. 1 *Id.* at 50.

134. 1 *Id.* at 60.

135. 1 *Id.* at 61.

136. 1 *Id.*

137. 1 *Id.* at 60.

138. 1 *Id.* at 61.

the securities offering and shareholder report areas.¹³⁹ The NSMIA did not, however, completely preempt state blue-sky laws. Section 18(c)(1) of the Act preserves state authority “to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with the securities or securities transactions.”¹⁴⁰ The NSMIA preempts the authority of state securities regulators to regulate the securities registration and offering process by imposing requirements on the contents of prospectuses or other offering documents.¹⁴¹ Essentially, the NSMIA “preempts aspects of securities registration and reporting processes for specified covered securities” but does not “diminish state authority to investigate and bring enforcement actions generally with respect to securities transactions.”¹⁴²

The NSMIA expressly preserved state authority to bring enforcement actions with respect to securities transactions. Consequently, three distinct types of blue-sky laws remained in effect after 1996: antifraud provisions, provisions requiring the registration or licensing of certain persons engaged in the securities business, and provisions requiring the registration of securities.¹⁴³ This article is concerned with a state’s involvement in the enforcement of its antifraud provisions. These provisions “operate by means of investigation, injunction, and prosecution independently of any registration system, and typically there are no exemptions from their coverage.”¹⁴⁴ A state’s antifraud provisions are “intended to enable the administrator to issue public warnings, to investigate suspected fraudulent activities, to take injunctive or other steps to stop them, and as a last resort, to punish them.”¹⁴⁵

Some forty-three jurisdictions have antifraud provisions. Many of these jurisdictions have adopted the basic fraud provision found in the Uniform Securities Act of 1956.¹⁴⁶ Still other jurisdictions have added provisions proscribing more specific manipulative practices.¹⁴⁷ The remaining jurisdictions have adopted their own fraud provisions, not modeled after the Uniform Securities Act but

139. 1 *Id.* at 62.

140. 1 *Id.* at 63.

141. 1 *Id.* at 61-62.

142. 1 *Id.* at 63-64.

143. 1 *Id.* at 67.

144. 1 *Id.*

145. 1 *Id.*

146. 1 *Id.* at 69.

147. 1 *Id.*

nevertheless addressing the same abuses of the market.¹⁴⁸

Although the states' antifraud provisions have not been preempted by federal legislation,¹⁴⁹ the debate continues as to whether states should have a role in the enforcement of securities laws given the recent legislation by Congress and the new requirements of the SROs. This article will argue that public choice theory supports the involvement of the states in the enforcement of securities laws.

VI. SHOULD THERE BE DUAL ENFORCEMENT OF THE SECURITIES LAWS?

When the 33 and 34 Acts were enacted, they were supposed to act as an additional method of securities law enforcement because it was obvious that the states could not adequately police nationwide securities markets. Regardless of the stated purpose of the 33 and 34 Acts, it became increasingly harder to draw a line between the coverage of state and federal securities laws. Concededly, purely duplicative regulation is in nobody's best interests. Something had to be done to ensure that what had the potential to be a comprehensive system of dual securities enforcement did not become redundant and ineffective.

A. *The Initial Distinction Between State and Federal Securities Law and Its Subsequent Erosion*

Between 1977 and 1987, the Supreme Court "addressed securities law federalism issues in the context of drawing a line

148. See 1 *id.*

149. Although not mentioned in the text of this article, the Securities Litigation Uniform Standards Act of 1998 [the "SLUSA"] did preempt "covered" securities fraud class actions under the common law and statutes of all fifty states. See Karmel, *supra* note 120, at 511-13. The SLUSA was adopted as "a reaction against attempts to evade the obstacles to federal securities class actions erected by the Private Securities Litigation Reform Act of 1995 by using state court class actions." *Id.* at 511-13. Although SLUSA did provide that securities fraud class action suits covered by the statute could not be brought in state court, "state law continues to provide remedies for plaintiffs suing in an individual capacity and in class actions brought by state and local governmental entities and their pension funds." Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 7 (1998).

This article's focus is on the states' ability to bring enforcement actions for violations of securities laws. As a result, this article makes no attempt to cover the intricacies of either SLUSA or the Private Securities Litigation Reform Act of 1995.

between state corporate law concerning the fiduciary duties of managers and directors and federal securities law obligations placed on public companies and their officers and directors.”¹⁵⁰ It seemed, at least from a political standpoint, that the Court was concerned with “restricting the coverage of the federal securities laws, especially in the corporate governance area.”¹⁵¹

In *Cort v. Ash*,¹⁵² the Court attempted to articulate a distinction between state corporate law and federal securities law: “Corporations are creatures of state laws and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stock holders, state law will govern the internal affairs of the corporation.”¹⁵³ Soon after deciding *Cort*, the Court applied its newly articulated distinction in another case arising under the federal securities laws, *Santa Fe Industries, Inc. v. Green*.¹⁵⁴ The plaintiffs in *Santa Fe* wanted the Court to apply Rule 10(b)(5) of the 1934 Act to a breach of corporate fiduciary duties.¹⁵⁵ The Court, however, declined to apply federal securities law to the plaintiff’s claims of “internal corporate mismanagement.”¹⁵⁶ Instead, the Court noted that “[a]bsent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.”¹⁵⁷ The Court went further in *Schreiber v. Burlington Northern, Inc.*¹⁵⁸ indicating that *Santa Fe* “would not be confined to its facts, but rather was a general holding concerning federalism.”¹⁵⁹

Despite these initial decisions attempting to fine-tune the distinction between state securities law and federal securities law,

150. See Karmel, *supra* note 120, at 503.

151. *Id.*

152. 422 U.S. 66 (1975).

153. *Id.* at 84.

154. 430 U.S. 462 (1977).

155. *Id.* at 474 n.14.

156. *Id.* at 479.

157. *Id.*

158. 472 U.S. 1 (1985).

159. See Karmel, *supra* note 120, at 504. *Schreiber* raised the issue of “whether the withdrawal of a hostile tender offer bid and the substitution of a partial bid, following negotiations with the target company’s management, constituted a manipulative act under the Williams Act, an amendment to the Exchange Act which regulates tender offers.” *Id.*

the distinction articulated in cases such as *Cort* has slowly eroded; in fact, after recent actions by Congress and the SROs, the distinction has since become virtually non-existent. Through the years, the role of the federal government in securities regulation has become less of a supporting role and more of a lead role and new legislation has taken central aspects of corporate governance law away from the states.¹⁶⁰

The newly enacted Sarbanes-Oxley Act of 2002 [the “SOX Act”] does “not even pretend to stay on the disclosure and trading side of the rhetorically federal-state division of power, not even offering perfunctory respect for state rules governing the corporation’s internal affairs.”¹⁶¹ The SOX Act “mandates that the SEC require attorneys representing securities issuers to report evidence of material securities laws violations up the corporate chain of command, ultimately to the CEO.”¹⁶² The SOX Act further requires that should the CEO not respond appropriately by “adopting . . . remedial measures or sanctions,” then the lawyer must seek out the board’s independent directors, audit committee, or the board as a whole.¹⁶³ Provisions such as these require that an attorney be a gatekeeper not just for securities law violations, but for any “breach of fiduciary duty or similar violation.”¹⁶⁴ This is just one example of how the SOX Act has taken what was perceived to be a matter subject to state control—corporate control of fiduciary duties—and turned it into a matter controlled by federal law.¹⁶⁵

Additionally, SROs such as the New York Stock Exchange have proposed new listing requirements in 2002 that “intrude more into traditional state governance than ever before and . . . appear to be occurring as part of an interaction with federal regulators so that th[ey] may be part of an indirect federalization of corporate

160. See Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588, 621 (2003) (discussing such burgeoning federal incursions into state law as “regulating going-private transactions, instituting an all-holders rule, barring dual-class recapitalizations, . . . mandating how shareholders with almost half of the country’s shares treat their votes,” and the Sarbanes-Oxley Act of 2002); see also Robert Thompson, *Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 967 (2003) (discussing the idea that federal law “no longer fits into the supporting role category”).

161. Roe, *supra* note 160, at 633.

162. *Id.* at 623.

163. *Id.* (citing Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (2002)).

164. *Id.* (citing Sarbanes-Oxley § 307).

165. *Id.*

law.”¹⁶⁶ The NYSE proposed listing requirements “require a majority of independent directors, and three important board committees made up of only independent directors.”¹⁶⁷ The proposed listing requirements also would “change the role of shareholders in terms of requiring their approval of compensation plans beyond that required by state law.”¹⁶⁸ These new listing requirements illustrate that just as the SOX Act has encroached upon areas traditionally left to state control, so too have the SROs. The question that remains is what role, if any, is left for the states in the securities regulation and enforcement arena.

B. The Debate Surrounding Dual Regulation vs. National Federal Regulation

Although this article will argue that public choice theory supports the idea that states should maintain some role in the enforcement of securities laws, there have been other arguments raised on both sides of this debate that need mentioning. Those against the states having a role in securities regulation often argue that blue-sky laws are too complex—they are a “crazy-quilt of state regulations no longer significant or meaningful in purpose, and usually stultifying in effect, or just plain useless.”¹⁶⁹ Commentators have also noted that piecemeal state enforcement may prove burdensome in that it costs too much and can lead to conflicting results, as opposed to increased investor protection.¹⁷⁰ A recent example of state enforcement that fueled the arguments of those opposed to state action was Oklahoma Attorney General Drew Edmondson’s decision to bring criminal charges against former WorldCom chief Bernard Ebbers and several other executives.¹⁷¹ Edmondson’s actions are a response to what he perceives as

166. See Thompson, *supra* note 160, at 963 (noting the proposed changes to NYSE listing requirements can be found at www.nyse.com/pdfs/xlnv9n06.pdf). Other SROs, such as NASDAQ, have proposed revisions to current listing requirements, which can be found at http://www.nasdaq.com/about/Seb_Corp_Gov&uscore;SummaryFeb-revised.pdf (last visited May 15, 2004). *Id.*

167. *Id.* at 965.

168. *Id.*

169. See, e.g., J. Sinclair Armstrong, *The Blue Sky Laws*, 44 VA. L. REV. 713, 714-15 (1958).

170. See Karmel, *supra* note 120, at 546; see also Roberta S. Karmel, *Striking the Right Balance: Federal and State Regulation of Financial Institutions: Securities Regulation: Blue Sky Merit Regulation: Benefit to Investors or Burden on Commerce?*, 53 BROOK. L. REV. 105 (1987).

171. *Ex-WorldCom Chief Ebbers Is Charged*, WASH. TIMES, Aug. 27, 2003, at C8.

insufficient punishment of WorldCom by the SEC and the bankruptcy process.¹⁷² Concededly, bringing state enforcement action just because one is unhappy with the results of an intense investigation led by the SEC is not an example of the good that state enforcement action can bring. Such action, brought without any new or independent evidence, is the type of duplicative state action that is costly and, for the most part, largely ineffective in preventing future abuses or setting new precedents.

The other side of the argument, however, is that aggressive state action can highlight gaps and problems in the federal regulatory scheme, as evidenced by the actions of New York Attorney General Eliot Spitzer.¹⁷³ Spitzer's investigation uncovered an illegal trading scheme, opening the eyes of both the SEC and the investing public. As a result of the investigation led by New York, California, and New Jersey,

Merrill Lynch [has] agreed, among other things: to sever the link between compensation for analysts and that for investment banking; prohibit investment banking input into analysts' compensation; to create a new investment review committee responsible for approving all research recommendations; to disclose in its research reports whether it has received or is entitled to receive any compensation from a covered company over the past 12 months; and to pay a \$100 million fine.¹⁷⁴

Seeing such zealous law enforcement is arguably a boost for investor confidence. The actions of Spitzer have been cited as a prime example of the states stepping in to "fill the void left by weak federal regulation."¹⁷⁵

Additionally, commentators have posited that eliminating the states' involvement in enforcing securities regulation will result in only selective enforcement by the federal government.¹⁷⁶ Responding to arguments that blue-sky laws are just too complex, one author has acknowledged that each state has varying blue-sky

172. *Id.*

173. See Karmel, *supra* note 120, at 546.

174. *Id.* at 520; see also Press Release, Office of N.Y. State Attorney General Eliot Spitzer, N.Y. Dep't of Law, *Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices* (May 21, 2002), at <http://www.oag.state.ny.us/press/2002/may/may21a02.html> (last visited May 15, 2004).

175. Karmel, *supra* note 120, at 522 (citing Susanne Craig, *Local Enforcers Gain Clout on Street*, WALL ST. J., June 21, 2002, at C1); see also *New Cops on the Beat*, INSTITUTIONAL INVESTOR, July 2002, at 77, 78.

176. See, e.g., Roe, *supra* note 160, at 634.

laws but notes that “there are a number of uniformity initiatives” that have been put before the states for approval.¹⁷⁷ Moreover, the lack of uniformity among the state blue-sky laws is less of an issue today now that the states are limited to antifraud enforcement.¹⁷⁸

Finally, two practical arguments weigh in favor of leaving the dual enforcement scheme in place. First, it is unrealistic to believe that the federal government can effectively oversee the securities markets and prevent securities abuses in all fifty states. The SEC neglected to notice an improper trading scheme to the tune of almost a billion dollars taking place right under its nose in the biggest securities market in the United States. This raises serious questions as to its ability to detect other, perhaps smaller, abuses taking place in other markets. Additionally, even if there were one national federal standard, this standard might not be interpreted uniformly throughout the separate federal jurisdictions. As it stands, federal courts do not interpret the same federal laws in a uniform manner.¹⁷⁹ In fact, it is quite possible for each circuit to interpret a federal law in a different manner, thus creating twelve differing interpretations of one federal law. The potential for confusion clearly exists even with one national federal standard.

177. See 1 LOSS & SELIGMAN, *supra* note 95, at 146.

178. 1 *Id.*

179. For example, federal courts have taken differing approaches to the question of whether a secondary actor may be held liable as a primary violator under § 10(b) of the Securities Exchange Act of 1934. Some courts have held that a secondary actor may not be held liable as a primary violator under § 10(b) unless he or she makes material misstatements or omissions. See, e.g., *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994) (holding that an accountant’s “review and approval” of financial statements and prospectuses is insufficient for primary actor liability); *Vosgerichian v. Commodore Int’l*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994) (holding that allegations that an accountant “advised” and “guided” a client in making allegedly fraudulent misrepresentations is insufficient for primary actor liability). Other courts have held that secondary actors may be held liable as primary actors for statements made by others in which the defendant had significant participation. See, e.g., *In re Software Toolworks, Inc.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994) (stating that an accountant may be held liable as a primary actor based on his “significant role in drafting and editing” a letter sent by the issuer to the SEC); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) (holding that an accounting firm that was “intricately involved” in the creation of false and misleading documents may be held liable as a primary actor under § 10(b) of the Securities Exchange Act of 1934).

VII. PUBLIC CHOICE THEORY

A. *Dual Enforcement of the Market Is Necessary*

The 33 and 34 Acts, as well as state blue-sky laws, were enacted to protect the people and institutions investing in the market, and the integrity of the securities market as a whole. Public confidence in investor protection is essential to the functioning and integrity of the securities market.¹⁸⁰ Today, a crisis in investor confidence exists due to both the corporate financial scandals of Enron Corp., WorldCom, and other companies, as well as the market decline of technology stocks.¹⁸¹ The problem, of course, is how to achieve public confidence. Public choice theory provides reason to be skeptical about the success of this endeavor because it is based on the assumption that “politicians, bureaucrats, and other decision-makers in public life are rationally self-interested,” thereby “maximiz[ing] their personal power and wealth even when these selfish ends conflict with public-spirited goals.”¹⁸² Public choice theory, therefore, suggests that the mechanisms to obtain vigorous market enforcement in order to maintain investor confidence must be designed with this limitation in mind.

Public choice theory, in its simplest terms, refers to the belief that “well-organized groups, seeking to advance their members’ self-interest at someone else’s cost, tend to win out in the public policy market.”¹⁸³ Public choice theory “understands legislative

180. See Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 783, 834 (2001) (discussing early empirical research noting the correlation between investor protection and the strength of a country’s securities markets); see also John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 17 (1999).

181. See Karmel, *supra* note 120, at 545.

182. See Enrico Colombatto & Jonathan R. Macey, *The Decline of the Nation State & Its Effect on Constitutional and International Economic Law: Contribution: A Public Choice Model of International Economic Cooperation and the Decline of the Nation State*, 18 CARDOZO L. REV. 925, 929 (1996) (noting that “the assumption of self-interest means that law is traded for political support, money, power, and other things that politicians and bureaucrats demand”).

183. Cynthia R. Farina & Jeffrey J. Rachlinski, *Getting Beyond Cynicism: New Theories of the Regulatory State: Foreword: Post-Public Choice?*, 87 CORNELL L. REV. 267, 268 (2002); see also Herbert Hovenkamp, *Legislation, Well-Being, and Public Choice*, 57 U. CHI. L. REV. 63 (1990); Peter L. Kahn, *The Politics of Unregulation: Public Choice and Limits on Government*, 75 CORNELL L. REV. 280 (1990); Paul B. Stephan III, *Interdisciplinary Approaches to International Economic Law: Barbarians Inside the Gate: Public Choice Theory and International Economic Law*, 10 AM. U. J. INT’L L. & POL’Y 745

outcomes to result from the supply and demand for political outcomes.”¹⁸⁴ The interests of competing groups “may be affected, positively or negatively, by actions of the government.”¹⁸⁵ Presumably, individuals are willing to pay a price for government outcomes that will benefit them. “[O]ther individuals, with conflicting interests, are willing to pay for opposite results.”¹⁸⁶ A central assumption of this theory is that legislators are prepared to give the highest effective bidder the legislative results that it desires.¹⁸⁷ Additionally, there necessarily will be interest groups seeking government inaction just as vigorously as opposing interest groups are seeking government action.¹⁸⁸

“The success of a group in outbidding competing interest groups and achieving legislative success depends largely on the total level of aggregated demand in the group for a particular legislative result and on the ability of the group to manifest that demand in an effective bribe to the legislator.”¹⁸⁹ Whether a group submits an effective “bribe” is determined “by the costs the group encounters in achieving collective ends.”¹⁹⁰ The costs will vary depending on the size of the interest group:

The smaller the group, the more likely it is that an individual group member will prefer to bear the cost of the action rather than risk its not occurring The larger the group, the less likely it is that the individual will be willing to pay for the group’s consumption, and the greater is the individual’s incentive to try to pass the cost to other group members. Larger groups will therefore encounter more difficulty organizing and securing the desired good . . . for its members Larger groups, particularly those as large as the “general public,” . . . may be entirely unable to make effective bribe offers to legislators.¹⁹¹

Thus, the victim under a public choice theory model is not likely to be the minority. Instead, the victim appears to be the “majority

(1995); Thomas S. Ulen, *Economic and Public-Choice Forces in Federalism*, 6 GEO. MASON L. REV. 921 (1998).

184. See Kahn, *supra* note 183, at 288.

185. *Id.*

186. *Id.*

187. *Id.* at 288-89.

188. *Id.* at 289.

189. *Id.* at 290.

190. *Id.*

191. *Id.*

who [has] been legislatively robbed by a well-organized minority.”¹⁹²

The interest groups lobbying for regulation that benefits their interests, often to the detriment of others, generally prefer federal regulation to state regulation, especially when dealing with interjurisdictional issues such as securities market regulation.¹⁹³ For starters, it is generally “cheaper to obtain passage of one federal bill rather than fifty separate ones.”¹⁹⁴ Moreover, even if interest groups succeed in getting a regulatory bill passed at the state level, they must still appeal to the federal level to prevent federal law from preempting the bill.¹⁹⁵ Finally, “federal law is more difficult to avoid than is state law.”¹⁹⁶ Those trying to avoid state law may escape the effects of that law by relocating, but one cannot so easily avoid federal law.¹⁹⁷ As a result, the federal government and its agencies may be subject to more pressure from these various interest groups than are state governments and agencies when it comes to securities regulation and enforcement areas.

Therefore, because of the potential for defects and abuses in the federal market for securities regulation, secondary avenues of enforcement must exist. If securities regulations are not adequately enforced, investor confidence will suffer, as will the market as a whole. In order for the investing public to be confident that their interests are being protected in an environment dominated by interest groups, the states must be allowed to function as a secondary avenue of enforcement.¹⁹⁸

192. See Hovenkamp, *supra* note 183, at 87.

193. See Ulen, *supra* note 183, at 940.

194. *Id.*

195. *Id.*

196. *Id.*

197. *Id.*

198. Arguably, the only feasible options for the enforcement of securities laws are to have total federal preemption or have some form of dual enforcement. It is the position of this article that dual enforcement can be a benefit and is a necessary consequence of public choice theory. Some commentators, however, have made the argument that perhaps SROs are better suited than the government to regulate corporate governance. See Thompson, *supra* note 160; see also, e.g., Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 327 (2001); Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997); A.C. Pritchard, *Market as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925 (1999); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998).

Although this article does not attempt to evaluate the potential strength of such an argument, there is one obvious flaw with this argument that works in favor of the position advanced by this article—not every company that trades securities is

The events of the past few months have shown us that the investing public cannot rely solely on the federal government for protection. For example, current and former officials of the SEC said that the current mutual fund scandal is a result of the SEC being held “captive to the [mutual fund] industry.”¹⁹⁹ A former official in the Clinton administration stated that,

There have been decades of looking the other way
At its core, the scandals reflect the fact that mutual fund governance is broken and Washington has stood by and allowed it to remain broken, for a long time, without any real effort to reform the system to the benefit of investors.²⁰⁰

Current SEC officials have stated that “none of the more than a dozen cases that have now been brought resulted from routine inspections by the commission.”²⁰¹ In fact, before state regulators exposed the recent mutual fund scandals, the SEC’s examination unit was not even assigned to look for these kinds of abuses.²⁰²

Furthermore, critics of the SEC and former officials claim that the Investment Company Institute (the “ICI”), the mutual fund industry’s trade organization, exerted enormous influence over both the SEC and Congress, resulting in lax enforcement policies for mutual funds.²⁰³ A recent example of the mutual fund industry’s clout is evidenced by certain provisions in the Sarbanes-Oxley Act of 2002 that were enacted at the insistence of the ICI. “[T]he drafters granted the mutual fund industry significant exemptions from some of the more important provisions” of the Act, including conflict-of-interest rules, disclosure rules, and internal monitoring controls.²⁰⁴ Additionally, Lynn E. Turner, a former chief accountant at the SEC, said it was routine for SEC

subject to the listing requirements of the national exchanges. Therefore, the potential would still exist for small-scale securities fraud. Arguably, the federal government would not find such scams worthy of its involvement even if securities regulation were not totally up to the SROs, but such fraud would still be subject to state securities laws if the dual enforcement scheme were left in place.

199. Stephen Labaton, *S.E.C.’s Oversight of Mutual Funds Is Said to Be Lax*, N.Y. TIMES, Nov. 16, 2003, at B2.

200. *Id.*

201. *Id.*

202. *Id.*

203. *Id.*; see also David D. Haddock & Jonathan R. Macey, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315, 361 (1985) (noting that the SEC is captured by special interests and therefore protects entrenched institutions rather than the investing public).

204. Labaton, *supra* note 199, at B2.

officials to consider the views of the ICI and that it was rare for the SEC to adopt a regulation that went against ICI's interests.²⁰⁵

The size of the SEC staff charged with overseeing the mutual fund industry is also problematic. For the past decade the Office of Compliance Inspections and Examinations has been both neglected and understaffed.²⁰⁶ Until earlier this year the staff had "a total of 350 examiners and support staff to monitor an industry of 13,000 mutual funds and investment advisors."²⁰⁷ Although the mutual fund industry has grown significantly through the years, inspectors did not significantly increase the rate or depth of inspections.²⁰⁸ Inspections went from once every five years to once every two for the largest firms.²⁰⁹ Thus, had the state regulators not begun their own investigations into the mutual fund industry, improper trading might have continued indefinitely.

Another reason for state enforcement is that federal government enforcement is selective. There have been many instances of federal intervention in corporate lawmaking.²¹⁰ Some of the more notable instances are: 1) "issues of antitrust and corporate reorganization"; 2) "1930s issues of shareholder voting and insider trading"; 3) SEC's 1950s proxy rules that impeded proxy fights the states had allowed; 4) the 1960s Williams Act that softened the tough takeover bidder tactics that the states had been permitting; 5) "1970s issues of going private"; 6) "1970s issues of fiduciary duties"; 7) "1980s issues of power in takeovers"; and 8) "early twenty-first century issues of scandals and effective internal governance."²¹¹ In each case, "one could argue that ouster . . . was 'special'—so important to the national economy that the 'normal science' of state corporate law-making did not apply. But that is exactly the point: when the issue is important, federal players oust

205. *Id.*

206. *Id.* Some might argue that even if the SEC had a substantial increase in resources, it would continue to inadequately investigate every incident involving fraud or abuse, thus calling into question its stated goals of investor protection. *See, e.g.,* Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 969 (1994) (citing *Securities Fraud Hearings Before the Subcommittee of the Senate Committee on Banking, Housing & Urban Affairs*, 183d Cong. 5 (June 17, 1993) (statement of William R. McLucas)).

207. Labaton, *supra* note 199, at B2.

208. *Id.*

209. *Id.*

210. *See* Roe, *supra* note 160, at 634.

211. *Id.*

the states, or threaten to.”²¹² Unfortunately, by the time the federal government does become involved, it is often too late.²¹³

This is evidenced once again by the recent mutual fund scandal. Arguably, the SEC and the states both had the ability to enforce the improper trading and fees charged by mutual funds—the states, however, uncovered the improper trading and fee-charging schemes and brought them to the attention of the SEC. The SEC, despite its assertions that it should be the primary regulator of the securities market, was caught totally unaware that this scandal was taking place. Only after the scandal became front-page news and threatened to undermine the authority of the SEC did the SEC “[lay] firm claim to mutual fund turf” and voice disapproval at the possibility “that state regulators . . . might try to set new rules.”²¹⁴ Once again, the federal government decided to take action, but only after the scandal publicly called into question the ability of the SEC to effectively enforce the securities market. Arguably, the SEC had a chance to strengthen its policies regarding mutual funds when it passed Sarbanes-Oxley in 2002. However, the influence of the ITI on the SEC appears to have hampered any such attempt.²¹⁵

In light of the foregoing arguments, dual regulation of the securities market appears to be the most effective method of both maintaining investor confidence and ensuring the continued viability of the securities market. Additionally, dual regulation of the securities market is an efficient method of securities regulation.

B. Dual Enforcement, Better Known As Federalism, Is Not Inefficient

Contrary to what some might argue, dual regulation of the securities market is not inefficient. Having both state and federal securities enforcement is efficient because federalism itself is efficient. The core values of federalism, “citizen participation in government, efficiency in government, creative experimentation, and diffusion of power” are served by a dual regulatory system.²¹⁶

212. *Id.*

213. *See id.*

214. Floyd Norris, *Is the Mutual Fund Issue Abuses, or Is It Fees?*, N.Y. TIMES, Nov. 19, 2003, at B4.

215. Labaton, *supra* note 199, at B2.

216. *See* Thomas M. Jorde, *Antitrust and the New State Action Doctrine: A Return to Deferential Economic Federalism*, 75 CAL. L. REV. 227, 230-31 (1987).

1. *Competition*

In a market-driven economy, competition is usually seen as the engine that drives efficient outcomes; conversely, monopoly is viewed as inefficient, both because of the allocative inefficiencies inherent in monopoly pricing and, more relevant to the present problem, because absence of competition removes the incentive to achieve efficient utilization of resources in pursuing the task at hand.²¹⁷ Competition can, of course, be wasteful and inefficient, but our national commitment to the market and competition suggests that it is better to err by permitting competition than to assume that some centralized control will match the invisible hand in assuring both allocative and productive efficiencies.²¹⁸

While we do not usually view law enforcement as a competitive enterprise, there has often been competition between different jurisdictions for the law enforcement service they are producing. Federalism itself necessarily envisions a kind of competition. Some of this competition is in law production, with different jurisdictions enacting different laws. In the United States, this competition is regulated by the notion of enumerated powers²¹⁹ and preemption²²⁰

217. See, e.g., RICHARD A. POSNER, *ANTITRUST LAW* 1-2 (2d ed. 2001).

[E]conomic theory provides a solid basis for the belief that monopoly pricing, which results when firms create an artificial scarcity of their product and thereby drive price above its level under competition, is presumptively inefficient in the sense most commonly used by economists in discussing issues of monopoly and competition (the Kaldor-Hicks, or potential Pareto, sense of efficiency). Since efficiency is an important social value, this conclusion establishes a prima facie case for having an antitrust policy. It also implies the limitations of that policy: to the extent that efficiency is the goal of antitrust enforcement, there is no justification for carrying enforcement into areas where competition is less efficient than monopoly because the costs of monopoly pricing are outweighed by the economies of centralized production in one or a very few firms. That is why I referred to monopoly pricing as “presumptively” inefficient and as creating merely a “prima facie” case for having an antitrust policy.

Id. (footnote omitted).

218. See, e.g., *N. Pac. Ry. Co. v. United States*, 356 U.S. 1, 4-5 (1958) (“[U]nrestrained interaction of competitive forces will yield the best allocation of our economic resources . . .”).

219. Federalism, in the context of the Tenth Amendment, refers to the division of powers between the state and federal governments. U.S. CONST. amend. X. Specifically, “[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” *Id.* In *New York v. United States*, 505 U.S. 144 (1992), the Court held that the Tenth Amendment imposes a limit on Congress’s power. According to the Court, “the preservation of the States, and the

(in regulating competition between the states and the federal government) and by a variety of mechanisms, including the full faith and credit clause,²²¹ the privileges and immunities clause,²²² the right to travel,²²³ and the dormant commerce clause²²⁴ (in

maintenance of their governments, are as much within the design and care of the Constitution as the preservation of the Union and the maintenance of the National Government.” *Id.* at 162 (quoting *Texas v. White*, 74 U.S. 700, 725 (1869)). Therefore, “Congress may not simply ‘commandee[r] the legislative processes of the States by directly compelling them to enact and enforce a federal regulatory program.’” *Id.* at 161 (internal citations omitted) (alteration in original) (quoting *Hodel v. Va. Surface Mining & Reclamation Ass’n.*, 452 U.S. 264, 268 (1981)).

220. Under the Supremacy Clause of the Constitution, “federal law will preempt any state law with which there is a conflict if Congress intends such a result.” Francis J. Facciolo & Richard L. Stone, *Avoiding the Inevitable: The Continuing Viability of State Law Claims in the Face of Primary Jurisdiction and Preemption Challenges Under the Securities Exchange Act of 1934*, 1995 COLUM. BUS. L. REV. 525, 531; *see also* U.S. CONST. art. VI, § 1, cl. 2; *cf.* LAURENCE H. TRIBE, *AMERICAN CONSTITUTIONAL LAW* § 6-26, at 491 (2d ed. 1988) (“Generally speaking, the Court has come to sanction state regulations that supplement federal efforts so long as compliance with the letter or effectuation of the purpose of the federal enactment is not likely to be significantly impeded by the state law.”).

221. U.S. CONST. art. IV, § 1 (“Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof.”).

222. U.S. CONST. art. IV, § 2, cl. 1 (“The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several states.”).

223. *See, e.g.*, *Shapiro v. Thompson*, 394 U.S. 618, 629 (1969) (“[T]he nature of our Federal Union and our constitutional concepts of personal liberty unite to require that all citizens be free to travel throughout the length and breadth of our land uninhibited by statutes, rules, or regulations which unreasonably burden or restrict this movement.”).

224. In absence of affirmative consent, a congressional negative will be presumed against state action that in its effect upon interstate commerce constitutes an unreasonable burden or interference. The dormant commerce clause thus assumes that Congress prohibits state action until or unless it authorizes it. *See, e.g.*, *W. Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 194-95 (1994) (holding that a state tax imposed on both local and out-of-state dairy farmers was unconstitutional because the revenue received from the tax was used to subsidize only local, in-state farmers, thus giving them an advantage over out-of-state farmers); *C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383, 394 (1994) (holding that an ordinance subsidizing a private waste transfer station was unconstitutional because while the immediate effect was to direct local transport of waste to a designated site within the local jurisdiction, its economic effects were interstate in reach); *City of Philadelphia v. New Jersey*, 437 U.S. 617, 629 (1978) (holding that a New Jersey statute prohibiting the importation of out-of-state waste was unconstitutional); *Hunt v. Wash. State Apple Adver. Comm’n*, 432 U.S. 333, 352-54 (1977) (holding that a state statute requiring all apples sold or shipped in the state to use a USDA quality label was unconstitutional); *cf.* *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117, 133-34 (1978) (holding that a state statute

regulating competition among the states in law production).

Other competition is in law enforcement—either of the same laws, where different enforcers can bring suits challenging the same conduct under the same statute, or of different but analog laws with different enforcers being authorized under different regimes to attack the same or very similar conduct. Although some statutes permitting private suit introduce yet another set of entrants in the law enforcement market, the current focus is on maximizing the efficiency of law enforcement by state authorities, typically the state attorney general.

2. *Citizen Participation in Government*

Active participation by citizens is “a means of strengthening the representativeness of governmental institutions and enhancing the perception of its legitimacy.”²²⁵ When government operates on a smaller scale, “individuals can participate more effectively and more directly.”²²⁶ If citizens are able to organize at the local or state level, they can have a greater influence at the federal level.²²⁷ This can help combat against interest groups lobbying the federal government to get certain self-serving legislation passed or held up.

Proximity is also believed to “increase[] access, communication, and accountability between citizens and public officials.”²²⁸ In a system where dual regulation exists, citizens are better able to participate in market enforcement. For example, Spitzer’s investigation into the mutual funds was the result of a “whistle-blower’s tip.”²²⁹ It is unclear whether that same person attempted to contact the SEC and was stonewalled or whether only state officials were contacted. Regardless, state officials were the ones who received and acted on the tip.

Additionally, political accountability supports the argument for

providing that a producer or refiner of petroleum products could not operate a retail service station within the state was constitutional because the fact that a burden of a state regulation falls on some interstate companies does not, by itself, establish a claim that the statute violates the constitution).

225. Jorde, *supra* note 216, at 231 (internal citations omitted). See generally Robert P. Inman & Daniel L. Rubinfeld, *Making Sense of the Antitrust State-Action Doctrine: Balancing Political Participation and Economic Efficiency in Regulatory Federalism*, 75 TEX. L. REV. 1203 (1997).

226. See Jorde, *supra* note 216, at 231.

227. See Anthony J. Bellia, Jr., *Federal Regulation of State Court Procedures*, 110 YALE L.J. 947, 999 (2001).

228. See Jorde, *supra* note 216, at 231.

229. See Atlas, *supra* note 1.

dual enforcement. Neither the state nor the federal government wants to be seen as allowing market abuses to occur at the expense of the investing public because they will be held accountable for their actions, or inaction. The inevitable result is a regulatory competition between the state and federal government to see who can eliminate potential market abuses. This will promote investors' interests and the integrity of the market as a whole.

3. *Efficiency in Government*

Allowing state enforcement of securities regulations as a secondary enforcement mechanism means that only fifty attorneys general could potentially bring suit for violation of securities laws. The scope of state enforcement is not unlimited. Concededly, allowing private rights of action in these types of situations could very well lead to inefficient uses of resources and time. This article, however, is limited to state enforcement by the attorneys general.

Additionally, the existence of overlapping state and federal jurisdiction does not mean that both the state and federal government will take action in any given situation, as evidenced by the recent mutual fund scandal. Overlapping jurisdiction did exist but it was far from being inefficient. To begin with, the federal government did not take any action until after the states had spent their own resources investigating and uncovering the scandal. Thus, there was no initial cost attributed to the federal government as enforcer because the federal government was not involved until much later in the process. Moreover, the existence of prosecutorial discretion necessarily means that overlapping jurisdiction does not necessarily result in duplicative enforcement.

Dual regulation also results in government efficiency because a national securities regulator would possess "neither the systematic knowledge of local conditions nor the flexibility required for wise administration."²³⁰ In contrast, "[s]tates and localities are sensitive

230. See Jorde, *supra* note 216, at 232.

A recent example illustrating the importance of dual regulation is the financial demise of Metropolitan Mortgage and Securities, a financial services firm in Spokane, Washington, and its subsidiary, Summit Securities. Gretchen Morgenson, *Call In the Feds. Uh, Maybe Not*, N.Y. TIMES, Feb. 29, 2004, at 3-1. Metropolitan Mortgage was a financial firm known for its dependability and many Washington residents invested in securities issued by the company. *Id.* Unfortunately, about 35,000 local investors have lost significant amounts of money in the last few months. *Id.* "[L]ate last year, Metropolitan and . . . Summit . . . stopped paying interest on some \$600 million of securities . . ." *Id.* Then, in

to local interest and residents.”²³¹ States are more likely to be concerned with local interests that might otherwise be missed by the SEC and the federal government. Although the mutual fund scandal is arguably of national interest, many of the firms involved do business in New York City. This supports the argument that Spitzer’s actions were part of an effort to protect the interests of the citizens of New York, and that states are often more in tune with local interests than the federal government.

Assuming that some inefficiencies do exist here, the benefits of dual regulation outweigh any costs. The SEC, in response to the recent mutual fund scandal, issued proposals that “would require more independent directors, . . . require directors of funds to perform annual evaluations of their effectiveness, and would permit [directors] to hire their own staff so they would not rely too heavily on the fund’s investment advisors.”²³² These new proposals would not have been issued if the states had not brought the scandal to light. Additionally, Congress “is considering its own measures to beef up penalties for mutual fund fraud, amid concern the SEC was slow to act.”²³³ If state enforcement can drive a national effort for reform, the benefits are clear—investor

January of 2004, “Ernst & Young, the companies’ auditor, resigned, saying it had found ‘material misstatements’ in their financial reports going back three years.” *Id.* Finally, on February 4, both Metropolitan and Summit filed for bankruptcy protection. *Id.*

One investor was understandably upset by the firm’s sudden demise: “The company looked like a good company . . . everybody trusted what they were being told. . . . With people’s money at stake, where in heck were the regulators at, and the people who are supposed to keep an eye on this?” *Id.* (internal quotations omitted). The question is a fair question and the answer is that the regulators were in Washington. *Id.* “Because of a federal law intended to streamline securities regulation, the toughest cops on Metropolitan’s turf—officials in Washington State’s department of financial institutions—were essentially taken off the beat in 2000.” *Id.* Thus, state regulators, “who had kept Metropolitan on a short leash, could only watch . . . as the company sold more securities . . . than it could easily repay.” *Id.*

This is exactly the kind of situation that calls for there to be both state and federal regulation of the securities industry. It lends support to the argument that “federal regulators have recently been less vigilant than some of their state counterparts in supervising financial companies.” *Id.*

231. See Ulen, *supra* note 183, at 946.

232. Stephen Labaton, *S.E.C. Outlines Plan for Tightening Grip on Mutual Funds*, N.Y. TIMES, Nov. 19, 2003, at C1.

233. SEC, *Under Fire, Outlines New Fund Rules* (Nov. 18, 2003), at http://www.boston.com:80/business/articles/2003/11/18/sec_under_fire_outlines_new_fund_rules (last visited May 15, 2004).

confidence and the integrity of the market are strengthened by aggressive state action leading to national reforms.

4. *Creative Experimentation*

Decentralization, the result of having a dual regulatory system, allows for greater experimentation to satisfy local interests and needs.²³⁴ In celebrating the potential role of the states, Justice Brandeis once stated, “[i]t is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory and try novel social and economic experiments without risk to the rest of the country.”²³⁵ “The opportunity for creative experimentation, innovation, and invention is probably most important [when] economic activity [is involved].”²³⁶ “Economies are dynamic and change is often fast-paced.”²³⁷ “Economic federalism permits states to respond rapidly and in a variety of ways to perceived market and regulatory needs.”²³⁸ Allowing the states to develop different, and perhaps more effective, regulatory mechanisms to protect the integrity of the securities market will ultimately benefit the investing public. Should a state create a more effective system than that of another state, or of the federal government, the latter jurisdictions can benefit by adapting their own systems to make them more effective.

5. *Diffusion of Power*

Finally, dual sovereignty and limited central government promote the sharing of governmental control.²³⁹ A balance of power between governments reduces risk of abuse, thereby helping reduce potential inefficiencies.²⁴⁰ As noted by Justice Powell:

234. See Bellia, *supra* note 227, at 999-1000 (arguing that federalism “serves the diverse needs of a heterogeneous society and promotes experimentation with different programs”); see also Inman & Rubinfeld, *supra* note 225, at 1217-18.

235. See 1 LOSS & SELIGMAN, *supra* note 95 (citing Justice Brandeis’s dissenting opinion in *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932)).

236. See Jorde, *supra* note 216, at 233.

237. *Id.*

238. *Id.*

239. *Printz v. United States*, 521 U.S. 898, 919-20 (1997) (stating that the system designed by the Framers is one in which federal and state governments exercise concurrent authority, rather than the federal government acting through the states); *New York v. United States*, 505 U.S. 144, 162 (1992) (stating that “the Constitution has never been understood to confer upon Congress the ability to require the States to govern according to Congress’ instructions”).

240. *Printz*, 521 U.S. at 921.

The Framers believed that the separate sphere of sovereignty reserved to the States would ensure that the States would serve as an effective “counterpoise” to the power of the Federal Government. The States would serve this essential role because they would attract and retain the loyalty of their citizens. The roots of such loyalty, the Founders thought, were found in the objects peculiar to state government.²⁴¹

A dual regulatory system protects against the reality that the federal government is not, and cannot, always protect the investing public. Eliminating the possibility of state enforcement of securities laws takes away a strong alternative means of enforcement. Given the savvy nature of the key players in the securities markets today, eliminating the only feasible alternate method of enforcement is not in the best interests of the investing public.

VIII. CONCLUSION

States do have an important role to play in the enforcement of securities laws because of the limitations placed on the federal government by the public choice theory. An alternative method of enforcement is needed for the following scenarios: 1) instances in which federal regulation is too lax, and 2) instances in which state action can highlight gaps in federal enforcement either because gaps exist in the regulations themselves, or because the federal government is not aware of certain abuses of the market. When state action is used as an alternative means of enforcement, as done by Eliot Spitzer in New York, the investing public can reap the benefits of this state action. Where state action does not fit into the above model but is instead similar to the actions taken by Drew Edmondson in Oklahoma, state action is duplicative, costly, and largely ineffective. It is this latter form of state action—based solely on personal distaste for what is an informed decision by the SEC to not bring charges against Bernard Ebbers and to allow WorldCom to enter Chapter 11 proceedings—that fuels the arguments against allowing state enforcement of securities laws.

241. *Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528, 571 (1985) (Powell, J., dissenting).