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RECONCILING FEDERAL AND STATE INTERESTS IN SECURITIES REGULATION IN THE UNITED STATES AND EUROPE

*Roberta S. Karmel**

I. INTRODUCTION

Securities law in the United States (“U.S.”) is found primarily in the federal securities laws as administered by the Securities and Exchange Commission (“SEC”) and interpreted by the federal courts. The federal securities laws were preceded by state securities laws administered by state securities commissions and stock exchange self-regulatory law. Although some key aspects of state securities regulation have been preempted by federal statutes, other aspects remain intact. Litigation in the state courts, by private parties or public prosecutors, sometimes creates securities law. Furthermore, corporation law is primarily state law, even though it is sometimes overridden by the federal securities laws. Self-regulatory organizations (“SROs”) continue to adopt and administer securities market law under the SEC’s oversight, as well as to administer securities arbitration facilities. In addition to competing with the federal and state courts and with state and SRO agencies as lawmakers, the SEC also competes with other federal financial regulators, in particular with the Commodities Futures Trading Commission, the Federal Reserve Board and the Department of the Treasury, with regard to the parameters of its jurisdiction to regulate securities products and the securities industry. In times of market stress, when investors are dis-

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grunted, some of the fault lines in the competition among securities regulators and lawmakers become more apparent.

Europe is struggling with similar problems in reconciling federal and state law and regulation concerning the capital markets and public companies. Although a series of securities laws, directives, and the adoption of a single European currency have helped to integrate European capital markets, they remain fragmented to a large extent. European Union ("EU") directives are not self-operating and must be translated into national legislation in every EU member state, a slow and cumbersome process. An ambitious Financial Services Action Plan adopted in May 1999 will require the amendment of some directives and the adoption of new directives by 2005. Although the EU does not have a federal securities commission, two new European Securities Committees have been established to facilitate the realization of the Financial Services Action Plan. The European Court of Justice also creates securities law at the federal level. Although securities law and corporation law remain primarily national, much new securities law is derived from EU directives. Every EU member state now has a government securities commission, but the United Kingdom ("U.K.") has consolidated regulation via the Financial Services Authority ("FSA") and other countries are considering this model. In some countries in Europe there continues to be self-regulation by SROs, but as a general matter SRO regulation has been transferred to government securities commissions.

Some scholars believe that competition among financial regulators is beneficial and results in an optimum level of regulatory intrusion upon private business interests. Proponents of this theory frequently are apologists for deregulation. This author is considerably more skeptical of regulatory competition because it frequently undermines the rule of law. Nevertheless, some competition between federal and state regulators is deeply rooted in constitutional federalism. In both the U.S. and the EU the burden is on the proponents of federal regulation to justify its necessity. This Article will attempt to describe the division between federal and state securities regulation in the U.S. and the EU, suggest that the causes of regulatory competition are historical and political, and explore whether there are principled justifications for allocating regulatory responsibilities among federal, state and SRO interests. In addition, this Arti-

cle will inquire as to how competing regulatory interests should be reconciled.

In general, as the securities markets in the U.S. became more national and securities firms matured, federal securities laws came to trump state laws. Similarly, in Europe, a determination to integrate the capital markets of EU member states led to the need for securities regulation at the EU level. Yet, local or state interests, as well as political beliefs have countered this trend toward centralizing securities law. This tension is very well illustrated in the area of takeover law.

Part II of this Article will outline the framework and historical development of securities law in the U. S., and the long term trend toward federal preemption. Part III will outline the framework and historical development of securities law in the EU. Part IV of this Article will discuss the tension between federal and state interests in takeover law in both the U.S. and Europe, as an example of an effort to reconcile competing regulatory goals. The Article will then discuss, in Part V, the views of the proponents of regulatory competition and the author's reservations about these theories. It will suggest that the fundamental purpose of securities regulation, which is the promotion of investor confidence, should be the guiding principle in allocating regulatory responsibilities between federal, state and SRO lawmakers, and administrators.

II. THE DEVELOPMENT OF FEDERALISM IN U.S. SECURITIES REGULATION

A. Constitutionality of Blue-Sky Laws and SRO Regulation

State corporation law, stock exchange listing requirements and market rules, and state securities regulation (or "blue-sky" laws) preceded federal securities regulation. This tripartite regulatory system was recognized when the first federal securities law, the Securities Act of 1933 ("Securities Act")¹ was passed and when the Securities Exchange Act of 1934 ("Exchange Act")² was adopted the following year creating the SEC. The federal-state-SRO system of securities regulation involved conflicting philosophies and considerable overlap and duplica-

1. 15 U.S.C. §§ 77a–77aa (2000).

2. 15 U.S.C. §§ 78a–78mm (2000).

tion. As a general matter, the federal laws covering the flotation of public offerings were based on a full disclosure philosophy, whereas much of the state system was merit based, allowing a blue-sky commissioner to judge whether an issuer's capital structure was fair, just and equitable.

There was not a well articulated allocation of obligations and priorities, and it was not clear that Congress "had any systematic understanding of what the relations of state and federal securities regulations should be, how regulatory responsibilities should be allocated, or how federal disclosure regulation and state merit regulation should be accommodated to each other."³ SRO regulation, by contrast, set forth merit-based listing and offering standards for public companies,⁴ just and equitable principles of conduct for member firms and associated persons,⁵ and regulated trading markets and access fees for using those markets.⁶ The SEC's authority with respect to altering stock exchange listing standards is unclear,⁷ but since 1975 its oversight authority with respect to other SRO rules is fairly well established.⁸ On the other hand, SROs are not considered gov-

3. Mark A. Sargent, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 793 (1986).

4. See A.B.A., *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1489, 1510-14 (2002) [hereinafter ABA, *Market Structure Report*]. See also Rule 2710 (Corporate Financing Rule — Underwriting Terms and Arrangements), N.A.S.D. Sec. Dealers Manual (CCH), at 4501-16 (Mar. 2001) [hereinafter N.A.S.D. Manual].

5. See Business Conduct Rules 2100 (General Standards), 2300 (Transactions with Customers), 2400 (Commissions, Mark-Ups and Charges), N.A.S.D. Manual, at 4111-41, 4261-81.

6. Until 1975 the New York Stock Exchange enforced a fixed minimum commission schedule on its member firms. Although fixed commissions were abolished in 1975, see Rule 19b-3, 17 C.F.R. § 240.19b-3 (2002), SROs continue to levy other fees, for example, with respect to trading data, subject to SEC oversight, see U.S. SECURITIES AND EXCHANGE COMM'N, REPORT OF THE ADVISORY COMM. ON MARKET INFO. (2001), at www.sec.gov/divisions/marketreg/marketinfo/finalreport.htm. The NASD continues to have a ban against granting a selling concession or discount in a fixed price offering to a non-broker-dealer. See Conduct Rule 2740 (Selling Concessions, Discounts and Other Allowances), N.A.S.D. Manual, at 4534. The NYSE and Nasdaq have numerous market conduct rules.

7. See ABA, *Market Structure Report*, *supra* note 4, at 1516-20.

8. See Securities Exchange Act of 1934 §§ 6(a), 15(a), 15 U.S.C. §§ 78f(a), 78o(a) (2000). When the Exchange Act was passed in 1934 the SEC had oversight only of stock exchanges, see Securities Exchange Act of 1934 § 12, 48 Stat. 881, 892, and broker dealers, see *id.* § 15, 48 Stat. at 895-96. The NASD

ernment agencies, although they exercise delegated governmental authority.⁹

Federal preemption of state law under the Supremacy Clause is not a politically popular mode of legislation. Nevertheless, Congress has frequently preempted state law, particularly in the area of financial regulation. Preemption may be express, implied, or by reason of conflict. Preemption is express when there is an explicit statutory command that state law be displaced.¹⁰ A clear example of express preemption in financial regulation is in the Employee Retirement Income Security Act of 1974 (“ERISA”), which states that the provisions of that act “shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan. . . .”¹¹ Pre-

was organized after a 1938 amendment adding section 15A of the Exchange Act. Over-the-Counter Market Act, ch. 677, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. § 78o-1 (2000)). In 1964, the SEC was given jurisdiction over persons associated with broker-dealers and non-listed issuers. *See* Act of Aug. 20, 1964, 78 Stat. 565 (codified as amended at 15 U.S.C. § 78o(b) (2000)). In 1975, the SEC gained further oversight over exchanges and other market participants. *See* Act of June 4, 1975, 89 Stat. 97 (codified as amended at 15 U.S.C. §§ 78f, q-1s(b)(c) (2000)).

9. “Mere approval” of a private regulation by a government agency does not necessarily constitute state action. *Cremin v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 957 F. Supp. 1460, 1466–68 (N.D. Ill. 1997). Whether state action exists depends upon whether there is a sufficient “nexus” between the State and the action that is being challenged. *Lugar v. Edmondson Oil Co.*, 457 U.S. 922, 1004–05 (1982). Courts have rather consistently held that SROs are *not* state actors for purposes of the Due Process Clause of the Fifth Amendment. *See, e.g.*, *Desiderio v. Nat’l Assoc. of Sec. Dealers, Inc.*, 191 F.3d 198, 206–07 (2d Cir. 1999); *Bernstein v. Lind-Waldock & Co.*, 738 F.2d 179 (7th Cir. 1984); *United States v. Solomon*, 509 F.2d 863, 868 (2d Cir. 1975); *Martens v. Smith Barney, Inc.*, 190 F.R.D. 134, 137–38 (S.D.N.Y. 1999). *But see* *Intercontinental Indus., Inc. v. Amer. Stock Exch.*, 452 F.2d 935 (5th Cir. 1971) (holding that the American Stock Exchange is a governmental agency, due to its “intimate involvement” with the SEC); *Villani v. New York Stock Exch.*, 348 F. Supp. 1185, 1188 n.1 (S.D.N.Y. 1972) (holding that Fifth Amendment due process requirements apply to disciplinary hearings of NYSE because “[s]uch hearings are conducted under the self-regulatory power conferred upon it by . . . the [SEC]”). *See also* *Silver v. N.Y. Stock Exch.*, 373 U.S. 341, 366 (1963); *Burton v. Wilmington Parking Auth.*, 365 U.S. 715 (1961); *Clon v. Tompkins Square Neighbors, Inc.*, 294 F. Supp. 134 (S.D.N.Y. 1968). *See also* Richard L. Stone & Michael A. Perino, *Just a Private Club: Self-Regulatory Organizations as State Actors When Enforcing Federal Law*, 1995 COLUM. BUS. L. REV. 453, 483–84 (1995).

10. *See* *Morales v. Trans World Airlines*, 504 U.S. 374, 382 (1992).

11. 29 U.S.C. § 1144(a) (2002).

emption is implied and state law is therefore displaced “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.”¹² This type of implied preemption is often referred to as field preemption. State law may be displaced under a conflict analysis 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.”¹³ An example of conflict preemption in securities law is *Edgar v. Mite Corp.*, where an Illinois takeover statute was found to conflict with the Exchange Act.¹⁴ In all cases involving preemption, the courts look to the intent of Congress, which frequently is unclear due to the political sensitivities involved.

When the Securities Act and the Exchange Act were initially passed, Congress did not explicitly preempt state law. To the contrary, Congress inserted “savings clauses” in both the Securities Act and the Exchange Act.¹⁵ Former Section 18 of the Securities Act provided: “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.”¹⁶ The legislative history of this provision is sparse. However, the initial Securities Act bill, which passed the House,

12. *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 516 (1992). *See also* *Shaw v. Delta Air Lines*, 463 U.S. 85, 95–99 (1983) (finding that state laws having a connection with or reference to employee benefit plans are preempted by ERISA, with which Congress intended to preempt an entire field); *Patenaude v. Equitable Life Ins.*, 290 F.3d 1020, 1024 (9th Cir. 2002) (“[A] statute may so completely preempt state law that it occupies the entire field, barring assertion of any state law claims and permitting removal to federal court.”). In *Patenaude* the court held that a deferred tax variable annuity purchased by the plaintiff fell within the meaning of “covered security” under the Securities Litigation Uniform Standards Act (“SLUSA”), and therefore plaintiff’s state law claims were appropriately discarded by the district court. *See generally id.* The Court stated: “Congress has consistently indicated its intent, particularly with the passage of SLUSA, to displace state regulation insofar as it relates to the marketing of the securities component of variable annuities.” *Id.* at 1027.

13. *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977).

14. *Edgar v. Mite Corp.*, 457 U.S. 624 (1982).

15. *See infra* notes 16–20.

16. Securities Act of 1933, ch. 38, § 18, 48 Stat. 74, 85 (codified as amended at 15 U.S.C. § 77r (2000)).

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.¹⁷ The stated purpose of this prohibition 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.”¹⁸ This clause was later deleted by Senate amendment.¹⁹ Former Section 28(a) of the Exchange Act was similar to former Section 18 of the Securities Act. It provided: “nothing 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.”²⁰

Although these “savings clauses” indicated a congressional intent not to preempt state blue-sky law generally,²¹ the Supreme Court could nevertheless have declared that some or all state securities laws were preempted under field or conflict preemption principles. In addition to being invalidated due to federal preemption, state blue-sky legislation could have been declared invalid under the Commerce Clause. Legislation will be invalidated under the Commerce Clause if it imposes a burden on interstate commerce that is excessive in relation to the local interests served.²² In many instances, state blue-sky regulations imposed burdens on interstate commerce. While such burdens can be justified on the ground that a state has a legitimate interest in capital investment or financial services within its borders, regulation that effectively impedes the interstate capital markets would be invalid.²³

17. H.R. REP. NO. 73-85, at 10–11, 25 (1933).

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

19. See H.R. REP. NO. 73-152, at 27 (1933).

20. Securities Exchange Act of 1934, § 28, 48 Stat. 903 (codified as amended at 15 U.S.C. § 78bb(a) (2000)).

21. See Russell A. Smith, “Blue Sky” Laws and the Federal Securities Acts, 34 MICH. L. REV. 1135, 1160 (1936).

22. *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970).

23. See *Metro. Life Ins. Co. v. Ward*, 470 U.S. 869 (1985) (holding that the Alabama domestic preference tax statute violated the Equal Protection Clause); *Lewis v. BT Inv. Managers, Inc.*, 447 U.S. 27 (1980) (deeming unconstitutional a Florida statute that prevented out-of-state bank holding compa-

The constitutionality of state blue-sky laws was first tested in three Supreme Court cases decided in 1917, sixteen years before the first federal securities law was enacted.²⁴ While a variety of constitutional arguments were raised in these cases, the cases particularly focused upon the possible limitations imposed by the Fourteenth Amendment on the power of a state to prevent fraudulent securities issuances. Only one of the opinions, however, specifically discussed the contention that the blue-sky laws burdened interstate commerce. In *Hall v. Geiger-Jones Co.*, the Court upheld the blue-sky statute under review, on the ground that the statute was only applicable to dispositions of securities *within* the state and, thus, could not burden interstate commerce.²⁵ The Court found that:

Upon their transportation into the State there is no impediment — no regulation of them or interference with them after they get there. There is the exaction only that he who disposes of them there shall be licensed to do so, and this only that they may not appear in false character and impose an appearance of a value which they may not possess — and this certainly is only an indirect burden upon them as objects of interstate commerce, if they may be regarded as such.²⁶

This reasoning clearly suggests that in-state corporations that participate in purely local financing ventures are subject to blue-sky merit regulation and that blue-sky merit regulation limited to intrastate issuances is valid. It remained an open question, however, whether this reasoning would insulate blue-sky merit regulation that had the effect of compelling an out-of-state corporation, which had registered an offering with the SEC and made the full disclosure required by federal law, to change its capitalization in order to syndicate a securities offering nationally.

nies from owning or controlling any business within the state that sold investment advisory services); *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 329, 329–32 (1977) (invalidating a section of the New York Tax Law on Commerce Clause grounds, because law provided a “direct commercial advantage to local business” by imposing a greater tax burden on out-of-state securities transactions than on like in-state transactions).

24. See *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917); *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917).

25. *Hall*, 242 U.S. at 539.

26. *Id.* at 557–58.

In the period between 1977 and 1987 the Supreme Court addressed securities law federalism issues in the context of drawing a line 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. From a political standpoint, the Court seemed concerned with restricting the coverage of the federal securities laws, especially in the corporate governance area. In view of the Court's deference to congressional determination of the scope of the commerce power since 1937, the Court did not rest its rulings on constitutional grounds as much as on its construction of congressional intent in enacting the securities laws. Nevertheless, these decisions should be viewed as part of the Court's renewed interest in constitutional federalism as a means to constrain the growth of federal power.²⁷

Beginning in the mid-1970s the Court articulated a distinction between state corporate law and the federal securities law that has long been less than clear-cut.²⁸ In 1995, in a non-securities law case, the Supreme Court stated: "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."²⁹

Thereafter, in *Santa Fe Indus., Inc. v. Green*,³⁰ the Court applied this principle in a case arising under the federal securities laws involving a short form merger. Under Delaware law owners of at least 90% of a subsidiary's stock may merge with that subsidiary without requesting the consent of minority shareholders — who, in turn, must receive fair value for their

27. See Calvin Massey, *Federalism and the Rehnquist Court*, 53 HASTINGS L.J. 431, 432–34 (2002); A. C. Pritchard, *Constitutional Federalism, Individual Liberty, and the Securities Litigation Uniform Standards Act of 1998*, 78 WASH. U. L. Q. 435, 491, 494 (2000).

28. See Arthur Fleicher, Jr., *Federalism and Corporation Law: An Assessment*, 78 HARV. L. REV. 1146, 1179 (1965); Roberta S. Karmel, *Qualitative Standards for "Qualified Securities": SEC Regulation of Voting Rights*, 36 CATH. U. L. REV. 809 (1987); Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L. J. 545 (1984).

29. *Cort v. Ash*, 422 U.S. 66, 84 (1975).

30. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

shares.³¹ The plaintiff, the minority shareholders in *Santa Fe*, did not allege any material misrepresentation or omission.³² Rather, they argued that the antifraud provisions of the federal securities laws were applicable to a breach of corporate fiduciary duty, because the majority shareholders were not pursuing a legitimate corporate purpose.³³ The Court, however, refused to apply Rule 10b-5 to the allegations of “internal corporate mismanagement.”³⁴ It stated: “Absent 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.”³⁵

In *Schreiber v. Burlington N., Inc.*,³⁶ the Supreme Court indicated that *Santa Fe* would not be confined to its facts, but rather was a general holding concerning federalism. *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.³⁷ The Court held that the term “manipulation” in sections 10(b) and 14(e) of the Exchange Act should be similarly interpreted and that manipulative acts require misrepresentation or nondisclosure.

The conflict between state law and the Williams Act also was presented to the Court in cases raising the issue of whether state statutes adopted to protect corporations against hostile takeovers were unconstitutional. At about the same time as the Williams Act was passed, a variety of state statutes sought to control bids for “local” companies by subjecting such bids to administrative delays and permitting a state securities commissioner to determine the fairness of the bid. In the 1982 case of *Edgar v. MITE Corp.* the Supreme Court held such a state se-

31. DEL. CODE ANN. tit. 8, §§ 253, 262 (2001).

32. *Santa Fe*, 430 U.S. at 474.

33. *Id.*

34. *Id.* at 479.

35. *Id.*

36. *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985).

37. The Williams Act, which regulates tender offers, is contained in sections 13(d)–(e) and 14(d)–(f) of the Exchange Act, 15 U.S.C. §§ 78m(d)–(e) (2002); 15 U.S.C. §§ 78n(d)–(f) (2002) and the regulations thereunder, 17 C.F.R. §§ 240.13d-1 to 13e-101, 240.14a-1 to 14f-1.

curities regulatory statute — the Illinois takeover law — inconsistent with the U.S. Constitution.³⁸ There were six separate opinions issued in this case, and a majority found only that the state law imposed an indirect burden on interstate commerce.³⁹ A plurality of Justices found direct burdens on commerce,⁴⁰ and another plurality found preemption of the state law by the Williams Act.⁴¹ The Court explained that its traditional rationale for upholding state blue-sky laws against commerce clause invalidity “was that they only regulated transactions occurring within the regulating States.”⁴² The Court stated, however, that the Illinois regulatory scheme went beyond regulating intrastate transactions.⁴³ In *CTS Corp. v. Dynamics Corp. of America*,⁴⁴ a subsequent case raising the issues of whether a state control share statute was unconstitutional under the Supremacy or Commerce Clauses, the Supreme Court upheld an Indiana statute because: (1) it preserved the neutrality of the Williams Act; (2) left to shareholders the decision whether to accept the offer; and (3) regulated internal corporate affairs.⁴⁵

It is frequently stated that SROs exercise delegated governmental authority.⁴⁶ In fact, stock exchange regulation preceded the federal securities laws and SEC oversight was overlaid upon an existing regulatory framework. The NASD was established pursuant to an amendment to the Exchange Act and all SEC registered broker-dealers are required to be NASD mem-

38. *Edgar v. MITE Corp.*, 457 U.S. 624 (1982).

39. *Id.* at 643–46.

40. *Id.* at 641–43.

41. *Id.* at 630–34.

42. *Id.* at 641 (citing *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917)).

43. *Id.*

44. *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987).

45. *See id.* at 82, 83, 91, 94.

46. *See, e.g., Silver v. N.Y. Stock Exch.*, 373 U.S. 341, 366 (1963) (describing the relationship between the New York Stock Exchange and the SEC as “a type of *partnership* between government and private enterprise”) (emphasis added); *Bruan, Gordon & Co. v. New York Stock Exchange*, 502 F. Supp. 897, 903 (S.D.N.Y. 1980) (describing the NASD as “an arm or agent” of the SEC); Stephen J. Ware, *Employment Arbitration and Voluntary Consent*, 25 HOFSTRA L. REV. 83, 154 (1996); Richard L. Stone & Michael A. Perino, *Not Just a Private Club: Self-Regulatory Organizations as State Actors When Enforcing Federal Law*, 1995 COLUM. BUS. L. REV. 453, 483–84 (arguing that, because Congress has delegated substantial powers to SROs in securities matters, SROs should be deemed state actors when enforcing federal law under the Exchange Act).

bers.⁴⁷ Therefore, NASD regulation, in contrast to stock exchange regulation, can more appropriately be viewed as delegated governmental regulatory authority. An important reason for putting the SEC umbrella over SRO activity is that this gives SROs qualified immunity from the antitrust laws.⁴⁸

The relationship between the SEC and SROs raises some interesting constitutional questions that have never been tested. Can an administrative agency with delegated authority sub-delegate that authority to SROs? Should SRO regulations be viewed as state law or federal law? Is there a difference between listing standards, which were once a matter of contract between exchanges and listed companies, and regulations of stock exchange members and stock markets?

The uncertain status of stock exchange listing standards was tested in *Business Roundtable v. SEC*, in which the U.S. Court of Appeals for the District of Columbia (“D.C. Circuit Court”) abrogated an SEC rule attempting to impose a uniform voting rights standard upon all national marketplaces.⁴⁹ The court found that the SEC regulation was a “rule” under Sections 19(b) and 19(c) of the Exchange Act,⁵⁰ but that it was not in furtherance of the purposes of the Exchange Act.⁵¹ The court’s rationale was that there was no indication in the statute that Congress intended to permit such a broad federal preemption over corporate governance and shareholder rights — matters traditionally left to state law.⁵² Presumably, however, the exchanges could have adopted the SEC’s rule as a matter of non-federal

47. The NASD was created under the authority of Section 15A of the Exchange Act, 15 U.S.C. § 78o-1 (2000). See Robert N. Rapp, *Rethinking Risky Investments for That Little Old Lady: A Realistic Role for Modern Portfolio Theory in Assessing Suitability Obligations of Stockbrokers*, 24 OHIO N.U. L. REV. 189, 197 n.32 (1998).

48. See *Gordon v. N.Y. Stock Exch.*, 422 U.S. 659 (1975).

49. *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

50. *Id.* at 409. Under section 19(b), SROs are required to receive SEC approval of any and all new rules and any proposed changes to existing rules. 15 U.S.C. § 78s(b)(1). The Commission then either approves the proposed rule, or schedules a hearing in order to decide whether a proposal will be accepted. *Id.* § 78s(b)(2). Under section 19(c), the Commission also retains the authority to itself amend the rules of a self-regulatory organization, “as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization.” *Id.* § 78s(c).

51. *Business Roundtable*, 905 F.2d at 410–17.

52. *Id.*

law, and they subsequently did so.⁵³ Nevertheless, the SEC was required under the Exchange Act to approve these “voluntary” rules.⁵⁴

B. Deregulation through Statutory Preemption

While the Supreme Court was allocating regulatory responsibility for takeovers and other corporate restructurings based on whether statutes involved matters of express federal policy regarding the protection of investors or internal corporate governance, the securities industry was advocating preemption of state blue-sky laws concerning securities offerings and the regulation of broker-dealers and investment advisers. This move to preempt state blue-sky laws found favor in the deregulatory politics of Presidents Ronald Reagan and George H.W. Bush, and the Contract with America advocated by Newt Gingrich.⁵⁵ Initially, complaints concerning duplication and inconsistency of unnecessary regulatory burdens were answered by a 1980 statute⁵⁶ adding Section 19(c)(1) to the Securities Act authorizing the SEC to cooperate with state government representatives in securities matters to achieve effective, uniform securities regulations with a minimum interference with the business of capital formation.⁵⁷ The statute mandated an annual conference of SEC and state regulators for the purpose of developing uniform securities forms and procedures and a small issues ex-

53. See Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 346 (2001).

54. Exchange Act § 19(b), 15 U.S.C. § 78s(b) (2000). See also Self-Regulatory Organizations, Exchange Act Release No. 34-27,554, 54 Fed. Reg. 53,227 (Dec. 27, 1989) (release by which the SEC approved NYSE's original voting rule); Self-Regulatory Organizations, Exchange Act Release No. 34-28,517, 55 Fed. Reg. 41,626-01 (Oct. 12, 1990) (release by which SEC approved NASD's adoption of the former SEC Rule 19b-4); Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards under the Securities Exchange Act*, 47 BUS. LAW 1461, 1472 n.70 (1992) (“[A]lthough [SEC] Rule 19c-4 is invalid, its verbatim counterpart adopted by the NYSE still binds listed companies.”).

55. See Pritchard, *supra* note 27, at 436 n.5; Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 29 (1998).

56. Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, Sec. 505, § 19(c), 94 Stat. 2275, 2292–93 (adding Section 19(c) of the Securities Act).

57. 15 U.S.C. §§ 77s(d)(1)–(2) (2000).

emption from registration.⁵⁸ Whether this act could have mandated the states to develop such forms, procedures and exemptions is unclear under constitutional federalism.⁵⁹ Further, the act provided that “[n]othing in this Act shall be construed as authorizing preemption of State law.”⁶⁰

Pursuant to this directive the SEC worked with the North American Securities Administrators Association (“NASAA”) to develop a state law uniform limited offering exemption (“ULOE”). By 1996, thirty-eight states had adopted a form of ULOE and ten other states had similar exemptions.⁶¹ A uniform system of registration for securities salesmen was also worked out with the NASD.⁶² However, there was considerable securities industry dissatisfaction with the slow and essentially voluntary progress of the SEC and NASAA in achieving uniform regulations pursuant to Section 19(c).⁶³

Much more sweeping deregulation of the state blue-sky laws through preemption was accomplished in the late 1990s, first by the National Securities Markets Improvements Act of 1996

58. *Id.* §§ 77s(d)(3)–(4).

59. Such action appears to be unconstitutional “commandeering” of states by federal government. *See* Massey, *supra* note 27, at 433–34; *Printz v. United States*, 521 U.S. 898, 935 (1997) (holding that Congress cannot compel states to enact a federal regulatory program); *New York v. United States*, 505 U.S. 144 (1992). Yet, it is unclear whether Congress might be able to accomplish this goal through preemption. *See* Massey, *supra* note 27, at 453–63, 505–06, 512–13. Recently, Congress adapted a more pointed threat of preemption of state insurance regulation of agents in the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 321, 113 Stat. 1338, 1422–24 (1999).

60. 15 U.S.C. § 77s (c)(3)(C).

61. *See* THOMAS LEE HAZEN, *LAW OF SECURITIES REGULATION* § 4.19 (4th ed. 2002).

62. *See* Securities Uniformity: Annual Conference on Uniformity of Securities Law, Securities Act. Release No. 33-7050, 56 S.E.C. Docket 764 (Nov. 2, 1994), available at 1994 WL 95225.

63. *State Regulators Adopt Model Commodity Code*, 17 Sec. Reg. & L. Rep. (BNA) No. 15, at 622 (Apr. 12, 1985); 12 JOSEPH C. LONG, *BLUE SKY LAW* § 7:32, at 7-71 to 7-73 (2002); Hugh H. Makens, et al., *Blue Sky Practice Part I: Doing it Right: Avoiding Liability Arising from State Private Offerings under ULOE and Limited Offering Exemptions*, in AMERICAN LAW INSTITUTE-AMERICAN BAR ASSOCIATION, *REGULATION D OFFERINGS AND PRIVATE PLACEMENTS* 271, 280 (2001); David F.E. Banks, *Hawaii Response to Regulation D*, 23 HAWAII B.J. 1, 3 (1991); Mark A. Sargent & Hugh H. Makens, *ULOE: New Hope, New Challenge*, 45 BUS. LAW. 1319, 1319–20 (1990).

(“NSMIA”)⁶⁴ and then by the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”).⁶⁵ The NSMIA preempted state securities law in three areas. First, it preempted blue-sky securities registration, merit review and prospectus disclosure requirements for SEC registered investment companies and stock exchange and Nasdaq listed securities. It also preempted blue-sky law in most private placements.⁶⁶ Prior to the NSMIA, blue-sky laws all contained a requirement for registration of securities, but most state laws had an exemption from their registration requirements for issuers listed on a national securities exchange.⁶⁷ The NASD had lobbied for Nasdaq listed securities to be similarly exempt, but the NASAA wished for greater control over the criteria for a blue chip exemption.⁶⁸ The NSMIA essentially mandated a blue chip exemption for all nationally traded securities. This preemption did not completely eliminate merit standards because the NASD regulates underwriting terms and conditions with respect to offerings underwritten by broker-dealers.⁶⁹ Further, this SRO regulation is a uniform national standard. Whether it is federal law or state law is an interesting question.

Second, the NSMIA preempted state regulation of broker-dealers with respect to capital, custody, margin, financial responsibility, records, bonding and reporting requirements to the extent inconsistent with federal law.⁷⁰ Third, the SEC was given exclusive regulatory authority over investment advisers to SEC registered investment companies and advisers with \$25 million or more in assets under management.⁷¹ The differing language used by Congress in preempting state regulation of

64. National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.)

65. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.).

66. 15 U.S.C. §77r (2000).

67. Sargent, *supra* note 3, at 833-35.

68. See NASAA *Proposes '56 Uniform Act Amendments at Spring Meeting*, 18 Sec. Reg. & L. Rep. (BNA) No. 12, at 399 (Mar. 21, 1986).

69. Conduct Rule 2710-2730, N.A.S.D. Manual, at 4501-31.

70. National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, § 103(a), 110 Stat. 3416, 3420-22 (codified as amended at 15 U.S.C. §78o(h)(1) (2000)).

71. The Investment Adviser Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2000).

broker-dealers and investment advisers is of interest. With respect to broker-dealers, the NSMIA provided that:

No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers, dealers, municipal securities dealers, government securities brokers, or government securities dealers that differ from, or are in addition to, the requirements in those areas established under this title.⁷²

Although state licensing of persons associated with broker-dealers was not preempted, the SEC was directed to conduct a study of the impact of disparate state licensing requirements for such persons.⁷³

With respect to investment advisers, the NSMIA provided that “[n]o law of any State or political subdivision thereof requiring the registration, licensing, or qualification as an investment adviser . . . shall apply to any person . . . that is registered [with the SEC] as an investment adviser.”⁷⁴ Further, advisers exempt from the definition of “investment advisor” in the federal securities laws were similarly exempt.⁷⁵ Associated persons could be licensed or registered only if any such person had a place of business within a state.⁷⁶ The preemption of state regulation of SEC regulated broker-dealers and investment advisers and their associated persons was not complete. The states retained authority to investigate and bring enforcement actions for fraud or deceit or other unlawful conduct by a broker-dealer or investment adviser or their associated persons.⁷⁷

72. National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, § 103(a), 110 Stat. 3420, (codified as amended at 15 U.S.C. § 78o(h)(1) (2000)).

73. *See id.* § 510(d), 110 Stat. 3416, 3451. *See also* Susan S. Krawczyk, *Recent Developments of Interest to Sellers of Variable Insurance Products*, in AMERICAN LAW INSTITUTE-AMERICAN BAR ASSOCIATION, CONFERENCE ON LIFE INSURANCE COMPANY PRODUCTS: CURRENT SECURITIES, TAX, ERISA, AND STATE REGULATORY ISSUES 239, 252–55 (1998) (discussing the objectives and conclusions of the study).

74. National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, sec. 303, §203A(b)(1)(A), 110 Stat. 3416, 3437 (codified as amended at 15 U.S.C. § 80b-3a(b)(1)(A) (2000)).

75. *Id.*

76. *Id.*

77. 15 U.S.C. § 80b-3a(b)(1) (2000).

The congressional justification for the preemption provisions of the NSMIA was that the system of dual federal and state securities regulation was unnecessary, because it was redundant, costly and ineffective.⁷⁸ Therefore regulatory responsibility was allocated based on the nature of the securities offering.⁷⁹ Inherently national offerings were made subject only to federal regulation.⁸⁰ There is some irony to such sweeping preemption of state law emanating from a Republican Congress supposedly committed to lessening federal regulation, but the NSMIA was a deregulatory statute favored by business groups.⁸¹

The SLUSA was even more deregulatory and its way of effecting preemption was more radical. It 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 ("PSLRA")⁸² by using state court class actions. The PSLRA did not change the provisions of the law covering securities anti-fraud actions, but it made plaintiff class action suits more difficult by, among other things, reducing the control of plaintiff's counsel over class action litigation;⁸³ imposing stricter pleading standards⁸⁴ and providing a safe harbor for forward looking information.⁸⁵ These procedural reforms were aimed at curbing abusive litigation in the federal courts; they left state

78. H.R. CONF. REP. NO. 104-864, at 39 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3920, 3920-21.

79. *Id.* at 40.

80. *Id.*

81. See Manning Gilbert Warren III, *Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies for Securities Fraud*, 60 LAW & CONTEMP. PROBS. 169, 170 (1997).

82. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

83. "Appointing lead plaintiff on the basis of financial interest, rather than on a 'first come, first serve' basis, was intended to endure that institutional plaintiffs with expertise in the securities market and real financial interests in the integrity of the market would control the litigation, not lawyers." *In re Donnkenny, Inc. Sec. Litig.*, 171 F.R.D. 156, 157 (S.D.N.Y. 1997) (citing H.R. CONF. REP. NO. 104-369, at 31-35 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730-34). Also, there is a stay of discovery while a motion to dismiss is pending. 15 U.S.C. §78u-4(b)(3)(B) (2000).

84. Specific factual allegations raising a strong inference of scienter must be pled. 15 U.S.C. §78u-4(b)(3)(B) (2000).

85. 15 U.S.C. §78u-5 (2000).

securities fraud actions alone.⁸⁶ Some plaintiffs' lawyers reacted by bringing class actions in securities fraud cases in state courts, particularly in California.

High technology companies and other business groups then lobbied for federal preemption on the grounds that the PSLRA was being undermined and Congress obliged.⁸⁷ Finding that national uniformity was preferable to fragmentation because of the need for predictability,⁸⁸ Congress engaged in selective preemption by depriving state courts of the power to adjudicate securities fraud class actions in cases involving securities listed on a national stock exchange or the Nasdaq. The SLUSA provides that no class action based on state law alleging fraud in connection with the purchase or sale of a "covered security" may be maintained in state or federal court and any such action shall be removable to a federal district court and dismissed.⁸⁹ Although the Congress that passed the SLUSA was generally committed to federalism, it found that promoting efficient national securities markets was a more convincing and compelling interest than reinforcing state rights.⁹⁰

Although the Republican majority succeeded in pushing through the SLUSA, there were strong dissents by Democrats in both the Senate and the House. Senators Sarbanes, Bryan, and Johnson pointed out that roughly 60% of state class action suits filed after the PLSRA were filed in California and although one state should not set a "pro-plaintiff" national standard for securities fraud, Congress should not second-guess California judgments in balancing the interests of local businesses against the interests of local investors.⁹¹ Dissenters in the House similarly felt this avoidance of the PLSRA was a problem for the California legislature. Further, they pointed out the irony in "the Republican-led Congress that campaigns

86. See Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 287 (1998).

87. See Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 64 CORNELL L. REV. 1, 4-5 (1998).

88. See S. REP. NO. 105-182, at 3 (1998).

89. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, sec. 101, § 16, 112 Stat. 3227 (codified as amended at 15 U.S.C. § 77p(b)-(c) (2000)).

90. See S. REP. NO. 105-182, at 5.

91. *Id.* at 13.

on returning power to the states and protecting individual choice [championing] a federal mandate abolishing important state prerogatives along with protections and rights.”⁹²

C. Preemption of State Common Law in the Payment for Order Flow Cases

Payment for order flow is the remuneration in the form of monetary or other benefits given to retail securities broker-dealers for routing customers' orders for execution to particular wholesale dealers, market makers, or exchanges.⁹³ With the advent of computer advances and automated trading systems, this practice became increasingly widespread in the 1980s and 1990s,⁹⁴ although it may have diminished as a result of securities trading decimalization.⁹⁵ Payment for order flow is a controversial practice.⁹⁶ At one extreme it could be viewed as commercial bribery. At the other extreme it could be viewed as welcome competition to the monopolistic trading practices of the stock exchanges and the NASD.⁹⁷ In any event, it raises questions about whether payment for order flow arrangements are inconsistent with a broker's duty of best execution. There also has been controversy as to whether payment for order flow should be abolished or be regulated by federal or state law.⁹⁸

Concerned with the “securities industry's languor,” such as “misallocation of capital, widespread inefficiencies, and unde-

92. H. R. REP. NO. 105-640, at 46 (1998).

93. Payment for Order Flow, Exchange Act Release No. 34-34,902, 59 Fed. Reg. 55,006, 55,008 (Nov. 2, 1999).

94. Payment for Order Flow, Exchange Act Release No. 34-33,026, 58 Fed. Reg. 52,934, 52,936 (Oct. 6, 1993). *See also* SEC, DIVISION OF MARKET REGULATION, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS 8-9 (1994).

95. Since decimalization lowered spreads, the incentive for payment for order flow arrangements decreased. *See Unger, Exchange Officials Testify Decimals Have Affected Depth, Liquidity of Trading*, 33 Sec. Reg. & L. Rep. (BNA) No. 21, at 803 (May 28, 2001).

96. Payment for Order Flow, Exchange Act Release No. 34-33,026, 58 Fed. Reg. 52,934, 52,935 (Oct. 6, 1993).

97. *See Self-Regulatory Organizations*, Exchange Act Release No. 34-19,047, 47 Fed. Reg. 41,896 (Sept. 22, 1982). For a review of the debate concerning payment for order flow, see Note, *The Perils of Payment for Order Flow*, 107 HARV. L. REV. 1675 (1994).

98. *See id.*

sirable and potentially harmful fragmentation of trading,”⁹⁹ in 1975 Congress enacted extensive amendments to the Exchange Act and directed the SEC to facilitate the development of a national market system to promote efficiency and fair competition in the securities industry. Pursuant to this mandate, the SEC adopted Rule 10b-10 in 1977, which required brokers and dealers to disclose, among other things, the amount of remuneration received and the source and amount of any other remuneration received.¹⁰⁰ The 1977 version of Rule 10b-10 did not specifically mention order flow as one of the “other remunerations.”¹⁰¹

The growth and pervasiveness of the practice, however, aroused extensive debate over its merits and harms. In response, the SEC conducted a comprehensive study of order flow payments. The SEC concluded that the practice produced the following economic benefits to customers: lower unit costs; increased retail brokerage firm revenues; lowered commissions; more expeditious executions; enhanced customer services; increased competition from automated execution systems and related practices; increased competition between wholesale dealers and exchanges and vertically integrated firms; and reduced execution costs in all markets, including the exchanges.¹⁰² The SEC also recognized the opposing concerns as to the possible conflict of interest and breach of duty of best order execution.¹⁰³

In an attempt to address the issue with more particularity, the SEC amended Rule 10b-10 in 1994.¹⁰⁴ The amended Rule 10b-10, which became effective in October 1995, defined order flow payment as any form or arrangement compensating brokers or dealers in return for the routing of orders.¹⁰⁵ The SEC rejected as too burdensome and unworkable proposals that order flow payments be passed through to the customers,¹⁰⁶ as well as its own initial proposal that brokers disclose the amount

99. S. REP. NO. 94-75, at 1 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 180.

100. 17 C.F.R. § 240.10b-10 (2002).

101. *See* Exchange Act Release No. 34-13,508, 12 S.E.C. Docket No. 299 (May 5, 1997).

102. Payment for Order Flow, Exchange Act Release No. 34-33,026, 58 Fed. Reg. 52,934, 52,939–40 (Oct. 13, 1993).

103. *Id.* at 52,936–37.

104. *See* Payment for Order Flow, Exchange Act Release No. 34-34,902, 59 Fed. Reg. 55,006 (Nov. 2, 1994).

105. *Id.* at 55,008.

106. *Id.* at 55,010–11 n.42.

of payments for order flow.¹⁰⁷ Amended Rule 10b-10, however, requires a broker-dealer to disclose in each transaction confirmation slip whether payment for order flow was received, and that the source and nature of the payment would be available at the customer's request.¹⁰⁸ In addition, the SEC adopted a new rule, 11Ac1-3, which requires annual disclosure to customers of a broker's or dealer's policies regarding receipt of payments for order flow, the market makers to which customer orders are routed, and the aggregate amount of payments received for order flow in the previous year.¹⁰⁹

Subsequently, payment for order flow was tested in a number of state courts in cases claiming breach of fiduciary duty. The highest courts of New York,¹¹⁰ Minnesota,¹¹¹ Illinois,¹¹² and Pennsylvania,¹¹³ as well as two other states' intermediate appellate courts¹¹⁴ found that the 1975 amendments to the Exchange Act and SEC disclosure regulations impliedly preempted state common law regarding any breach of fiduciary duty involved in payment for order flow practices.¹¹⁵ Courts that considered the issue of payments for order flow found express preemption principles inapplicable because no clear language indicated such a congressional preemptive intent.¹¹⁶ The question then became whether and what kind of implicit preemption could be inferred. In their determinations, courts devoted most of their attention to the history of the Exchange Act, as amended in 1975, and the evolution of SEC regulations relevant to order flow payments.¹¹⁷ The Supreme Court of Minnesota and the New York Court of

107. *Id.* at 55,010 n.39.

108. *Id.* at 55,010.

109. 17 C.F.R. § 240.11Ac1-3 (2002).

110. *Guice v. Charles Schwab & Co.*, 674 N.E.2d 282 (N.Y. 1996).

111. *Dahl v. Charles Schwab & Co.*, 545 N.W.2d 918 (Minn. 1996).

112. *Orman v. Charles Schwab & Co.*, 688 N.E.2d 620 (Ill. 1997).

113. *Shulick v. PaineWebber & Co.*, 722 A.2d 148 (Pa. 1998).

114. *Eirman v. Olde Discount Corp.*, 697 So. 2d 865 (Fla. Dist. Ct. App. 1997); *Mickey v. Charles Schwab & Co.*, 79 Cal. Rptr. 2d 213 (Cal. App. 1998).

115. Some critics argued that these cases holding preemption of state law threatened the dual securities regulatory regime Congress intended to preserve. *See, e.g.*, Anthony Szydlowsky, *Comment, Preemption In The Securities Industry: A Diminished Standard?* 74 ST. JOHN'S L. REV. 259, 261 (2000) (arguing that *Guice* was decided incorrectly and created a bad preemption analysis, that Congress explicitly preserved state law causes of action).

116. *See Dahl*, 545 N.W.2d at 923–24.

117. *See, e.g., id.* at 921–24.

Appeals were among the earliest to find preemption of state law in payment for order flow cases.¹¹⁸

In *Dahl v. Charles Schwab*, Minnesota's highest court rejected both the plaintiffs' and the defendant's theory of express preemption.¹¹⁹ The court held that implicit preemption, specifically under the obstacle principle, was applicable to the case.¹²⁰ The court was very concerned with the national, and even international, ramifications of its decision, since payment for order flow was pervasive in the securities industry.¹²¹ Although complying with both state and federal disclosure requirements was not entirely impossible, the court reasoned, it was expensive and difficult for brokers to determine order flow payments on a case-by-case basis.¹²² Usually, such payments were made on an aggregate basis, and remuneration could take the form of research service or other non-monetary services. Therefore, requiring broker-dealers to disclose the amount of each individual order flow payment as the plaintiffs urged would operate to terminate the practice, which the SEC found to have produced more benefits than harms to investors.¹²³ The court concluded that since a state law cause of action could frustrate the national market system objectives of the SEC and Congress, it was impliedly preempted.¹²⁴

Six months later, in *Guice v. Charles Schwab* the New York Court of Appeals agreed with the *Dahl* court's decision.¹²⁵ That court — the highest in New York — performed a similarly thorough analysis of the legislative history of the 1975 amendments to the Exchange Act and the SEC's relevant regulations.¹²⁶ The court emphasized the agency's acknowledgment that order flow payments furthered the purposes of Congress by enhancing more efficient and less costly execution of customers' orders and by promoting competition for order executions among all markets.¹²⁷ The court maintained that the SEC regulations regard-

118. See *supra* notes 110–11.

119. *Dahl*, 545 N.W.2d at 922–24.

120. *Id.* at 925.

121. See *id.* at 925–26.

122. *Id.* at 925.

123. *Id.*

124. *Id.* at 925–26.

125. *Guice v. Charles Schwab & Co.*, 674 N.E.2d 282, 290 (N.Y. 1996).

126. See *id.* at 286–87.

127. *Id.* at 289–90.

ing disclosure requirements were less stringent than the applicable state common law.¹²⁸ A mandatory disclosure of specific monetary receipts, in its view, might have a deleterious effect on the securities industry.¹²⁹ Securities broker-dealers, facing potentially nationwide class action civil liability, would be compelled to comply with the different disclosure requirements of each individual state. The resulting chaos in the securities regulatory regime would frustrate the Congress's intent of establishing a nationally "coherent and rational regulatory structure" under the leadership of the SEC.¹³⁰ Because state law would interfere with the methods by which the federal statute was designed to reach a congressional goal, it was preempted.¹³¹ As for the effect of the savings clause, the court interpreted it as negating only implied field preemption, not conflict preemption.¹³²

Other courts followed the reasoning of the *Dahl* and *Guice* courts. The Illinois Supreme Court in *Orman v. Charles Schwab* noted that the SEC in the 1994 amendments to Rule 10b-10 had "struck a deliberate balance" by requiring broker-dealers to provide investors with key information while rejecting "impractical and burdensome disclosure requirements that might compromise the contributions of the practice to market competition."¹³³ Significantly, even though the 1994 amendments to Rule 10b-10 were not in effect at the time of the defendants' challenged practice, the court found these amendments "instructive as to the scope of the 1977 version of Rule 10b-10."¹³⁴ Citing *Guice* and *Dahl* the *Orman* court held that the plaintiffs' state claims obstructed the purposes and objectives of the Congress and thus were preempted.¹³⁵

In *Shulick v. PaineWebber*, the Supreme Court of Pennsylvania also found the *Guice* court's rationale convincing.¹³⁶ The majority in *Shulick* emphasized that the purpose of Rule 10b-10 was to establish uniformity in the disclosure requirements per-

128. *See id.* at 290.

129. *See id.*

130. *Id.*

131. *Id.* at 291.

132. *Id.* at 291-92.

133. *Orman*, 688 N.E.2d at 623.

134. *Id.* at 626.

135. *Id.*

136. *Shulick*, 722 A.2d at 151.

taining to order flow payments.¹³⁷ However, as the concurring opinion pointed out, the majority's preemption theory was field preemption, differing from *Guice's* implied conflict preemption.¹³⁸ The majority stated that "federal regulation of the narrow subject of disclosure of order flow payments is so thorough that we have no difficulty finding the "reasonable inference . . . that no room has been left for a state to impose additional requirements."¹³⁹ The concurring opinion questioned the soundness of this theory, finding it inappropriate to apply field preemption to a particular issue within securities regulation rather than the field as a whole.¹⁴⁰

In *McKey v. Charles Schwab*, the court adopted the implied preemption theory.¹⁴¹ The court admitted that the preemptive intent evidenced by the 1994 amendments to Rule 10b-10 and the new rule 11Ac1 were not applicable before October 1995, the time of the challenged practice.¹⁴² However, it found the old Rule 10b-10 dispositive.¹⁴³ The fact that the old rule did not specifically mention order flow payments, in the *McKey* court's view, did not mean that the rule was inapplicable.¹⁴⁴ The court believed that the old rule clearly evidenced an intent by the SEC to "regulate any and all remuneration received by brokers,

137. *See id.* at 149.

138. *See id.* at 152 (Cappy, J., concurring).

139. *Id.* at 151.

140. Two other states' intermediate courts also have held federal securities law preempted state law by implication. In *Eirman v. Olde*, 697 So. 2d 865 (Fla. Dist. Ct. App. 1997), the District Court of Appeal of Florida for the Fourth District found the reasoning of *Guice*, *Dahl*, and *Orman* to be persuasive and declined to follow two 1995 cases that reached different decisions. *See id.*; *Dumont v. Charles Schwab & Co.*, 1995 WL 262262 (E.D. La. 1995), *rev'd*, 717 So.2d 1182 (9th Cir. 1998); *Thomas v. Charles Schwab & Co.*, 1995 WL 626522, at *2 (W.D. La. 1995). *See also* *Gilman v. Wheat, First Securities, Inc.* 896 F. Supp. 507 (D. Md. 1995). In *Dumont*, the U.S. District Court for Eastern Louisiana, decided that there was no diversity and no federal question because there was no complete federal preemption of the field of securities. *See Dumont*, 1995 WL 262262, at *2. In *Thomas*, the Tenth Judicial District Court for the Parish of Natchitoches, Louisiana found no express preemption nor inferred congressional preemptive intent. *See Thomas*, 1995 WL 626522, at *2.

141. *McKey v. Charles Schwab*, 79 Cal. Rptr. 2d 213, 219 (Cal. Ct. App. 1998).

142. *Id.* at 214-15, 219.

143. *Id.* at 219.

144. *Id.*

no matter what the form.”¹⁴⁵ In addition, the *McKey* court adopted *Guice’s* rationale that allowing each state to enforce its own disclosure requirements would disturb the promotion of a national market system, a goal expressed in the 1975 amendments to the Exchange Act.¹⁴⁶

In short, the majority of the state courts that considered cases alleging that payment for order flow was a breach of fiduciary duty have held that federal law and regulations impliedly preempted state law. Except for the Supreme Court of Pennsylvania, which found field preemption, all other courts found implicit conflict preemption, because permitting state common law cases to go forward would present an obstacle to the national market system mandated by the Exchange Act.

D. The Resurgence of State Securities Regulators

On May 21, 2002, New York State Attorney General Eliot Spitzer announced an agreement by Merrill Lynch to enact significant and immediate reforms to insulate securities research analysts from its investment banking division and to change the way analysts are compensated.¹⁴⁷ Under this settlement, Merrill Lynch 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.¹⁴⁸ A NASAA task force chaired by New York, California, and New Jersey led the investigation leading to this settlement.¹⁴⁹ The agreed upon fine is \$48 million payable to the New York State Department of Law, \$50 million to the remaining 49 states, the District of Columbia,

145. *Id.* at 219 n.6.

146. *Id.* at 219.

147. Press Release, Office of N.Y. State Attorney General Eliot Spitzer, N.Y. State Dep’t of Law, Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices (May 21, 2002), at http://www.oag.state.ny.us/press2002/may/may21a_02.html.

148. *Id.*

149. *Id.*

and Puerto Rico, and \$2 million to NASAA.¹⁵⁰ This fine is only required to be paid, however, if all 50 states, the District of Columbia, and Puerto Rico agree.¹⁵¹ The settlement agreement between the New York Attorney General and Merrill Lynch goes into considerable detail as to how Merrill Lynch analysts will be compensated in the future and the types of disclosures research reports will contain.¹⁵² This case is a prime example of regulation by prosecution. Although the settlement does not by its terms apply to the entire securities industry, there are similar ongoing investigations of other firms that could result in similar settlements.¹⁵³

The case against Merrill Lynch brought by the New York Attorney General was based on broad and general antifraud provisions of the Martin Act, which prohibit any device scheme or artifice to defraud or obtain money by means of any false pretense, representation or promise, fictitious or pretended purchase or sale, any concealment, suppression, fraud, false pretense or false promise in connection with the sale of securities or offering investment advice.¹⁵⁴ In the New York Attorney General's view, in contrast to the requirements of the federal securities laws, no purchase or sale of stock is required, nor are intent, reliance or damages required elements of a violation.¹⁵⁵ The gist of the Merrill Lynch case was that the internet research analysts at Merrill Lynch regularly published ratings for internet stocks that were misleading because: (1) the ratings in many cases did not reflect true opinions; (2) no "reduce" or "sell" recommendations were ever issued; and (3) Merrill Lynch did

150. Agreement Between the Attorney General of the State of N.Y. and Merrill, Lynch, Pierce, Fenner & Smith, Inc., May 21, 2002 ¶ 24, *available at* <http://news.findlaw.com/wsj/docs/merrillynch/nymerrill52102agr.pdf>.

151. *Id.*

152. *Id.* at ¶¶ 5–11, 15.

153. See Charles Gasparino, *Deals & Deal Makers: Citigroup Suggests Rules for Analysts*, WALL ST. J., July 15, 2002, at C5; Charles Gasparino, *Cleaning Up Wall Street: Morgan Stanley Goes to Washington*, WALL ST. J., June 21, 2002, at C1 [hereinafter Gasparino, *Cleaning Up Wall Street*].

154. N.Y. GEN. BUS. LAW § 352(i) (McKinney's 1996).

155. Aff. in Support of Application for an Order Pursuant to General Business Law 354, at 7, *In re Eliot Spitzer* (N.Y. Sup. Ct. N.Y. County Apr. 2002) (No. 02-4015-22), *at* <http://news.findlaw.com/hdocs/docs/merrillynch/nyagmerrill0402aff.pdf>.

not disclose that the analysts were acting as quasi-investment bankers for the companies rated.¹⁵⁶

The role and conduct of securities analysts during the boom years of the 1990s were subject to criticism and scrutiny by securities regulators before the New York Attorney General sued Merrill Lynch. As a result of the congressional hearings after the collapse of Enron Corp., the SROs developed new regulations governing analysts' conflicts of interest, which the SEC approved in May 2002.¹⁵⁷ The rules prescribe mandatory disclosures about analysts' conflicts of interest and prohibit analysts from receiving compensation directly tied to investment banking fees.¹⁵⁸ After the action by the New York Attorney General, Congress enacted the Sarbanes-Oxley Act of 2002, which contains provisions to improve the objectivity of research analysts.¹⁵⁹ The SEC, or SROs under the authorization and direction of the SEC, are required to adopt rules addressing analysts' conflicts of interest by erecting firewalls between analysts and investment bankers and by mandating disclosures of analysts' conflicts of interest.¹⁶⁰

The action by the New York Attorney General against Merrill Lynch was controversial. House Financial Services Committee Chairman Michael Oxley criticized the case as duplicative regulation threatening to undermine the national securities regulatory regime and that it had the capability of balkanizing the securities industry.¹⁶¹ The securities industry generally favors

156. *Id.* at 3.

157. *See SEC Gives Nod to Analyst Rules Aimed at Boosting Independence*, 34 *Sec. Reg. & L. Rep. (BNA)* No. 19, at 749 (May 13, 2002); *Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the NASD and NYSE, Securities Exchange Act Release No. 34-45,908*, 67 *Fed. Reg.* 34,968-01 (May 15, 2002).

158. *See* NYSE Rule 472, 2 *N.Y.S.E. Guide (CCH)* ¶ 2472 (1995) (amended); NASD Rule 2210, *N.A.S.D. Manual*, at 4171-80 (new). *See also* *Order Approving Proposed Rule Changes and Notice of Filing and Order Granting Accelerated Approval*, Exchange Act Release No. 34-45,908, 67 *Fed. Reg.* 34,968 (May 16, 2002).

159. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

160. *Id.* § 501(a).

161. *See* Press Release, House Comm. on Financial Services, Oxley Comments on Spitzer Testimony (June 26, 2002), available at <http://financialservices.house.gov/news.asp>. *See also Spitzer Spars With Ox-*

national regulation rather than regulation by 50 states. The Securities Industry Association took the position that “the U.S. needs a national securities framework from which to work, not a patchwork.”¹⁶² Morgan Stanley lobbied to attach a provision preempting state securities regulators from examining securities analysts’ conflicts of interest, but such a provision was not included in the Sarbanes-Oxley Act of 2002.¹⁶³ The new activism of state prosecutors against business is widespread and — as is exhibited by the Merrill Lynch case — has its roots in local governments’ efforts to protect consumers against the deregulatory initiatives of the Reagan administration.¹⁶⁴ Defenders of the case against Merrill Lynch claim that the states have stepped in to fill the void left by weak federal regulation.¹⁶⁵ Eliot Spitzer, in justifying his activism, claimed that “the SEC was not doing enough.”¹⁶⁶

Within a year following the enactment of the Sarbanes-Oxley Act, the SEC is required to adopt or compel the SROs to adopt new regulations governing the conduct of securities analysts.¹⁶⁷ Although Congress did not directly preempt state action against securities analysts, issues of implied or field preemption could arise as a result of disparities between state securities regulators’ views of analysts’ conflicts and those of the SEC. Furthermore, not all state securities regulators agree with Spitzer’s approach; therefore, there could be fragmentation and inconsistency in state securities regulation.¹⁶⁸

The battle between the SEC and NASAA, as is true of many battles over national versus state or federal regulation, is politi-

ley, *Baker After Urging Tough Conflict Rules*, 34 Sec. Reg. & L. Rep. (BNA) No. 26, at 1042 (July 1, 2002).

162. See Susanne Craig, *Local Enforcers Gain Clout on Street*, WALL ST. J., June 21, 2002, at C1.

163. See Gasparino, *Cleaning Up Wall Street*, *supra* note 153.

164. See Russell Gold & Andrew Caffrey, *United Crime Busters*, WALL ST. J., Aug. 1, 2002, at B1.

165. See Craig, *supra* note 162.

166. *New Cops on the Beat*, INSTITUTIONAL INVESTOR, July 2002, at 77, 78. It appears that the SEC did not cooperate with the New York Attorney General’s investigation. See Michael Schroeder, *SEC Welcomes Prosecutions*, WALL ST. J., June 11, 2002, at A2.

167. Sarbanes-Oxley Act of 2002 § 501, 15 U.S.C. § 78o-6 (adding § 15D to the Exchange Act).

168. See Matt Fleisher-Black, *Spitzer Faces Hurdle Over Merrill Deal*, N.Y. L.J., July 22, 2002, at 1; Gold & Caffrey, *supra* note 164.

cal and philosophical. It may also become a matter of law for the courts to address. Under the payment for order flow cases, it would not be difficult to find conflict or even field preemption if SEC or SRO rulemaking results in regulations that take a different approach from the settlement made between Merrill Lynch and the New York Attorney General. But the payment for order flow cases were private actions for damages. A court might be reluctant to apply this analysis to prosecutions by a state attorney general. Further, if the conflict that arises is between regulatory action by a state official and a rule of an SRO, is the conflict a federal constitutional conflict? Can an SRO rule trump state law in all cases where the regulation was mandated by a federal statute and approved by the SEC?¹⁶⁹

In addition, where a state action brought either by a prosecutor or a private plaintiff is instituted as a broad statutory or common law antifraud claim, it is difficult to find preemption unless the SEC has acted by adopting detailed regulations as it did with respect to payments for order flow. In *Zuri-Invest AG v. NatWest Finance, Inc.* a federal district court held that a state fraud action was not preempted by the federal securities laws, including the NSMIA.¹⁷⁰ Rather, the primary purpose of the NSMIA was to preempt state blue-sky laws regulating the registration and underwriting of securities. It did not preclude states from regulating fraudulent conduct or extinguish state

169. It may be relevant to note that all SEC registered broker-dealers are required by federal law to join the NASD. Securities Exchange Act of 1934 § 15(a), 15 U.S.C. § 78o(a) (2000). *See also* Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1573, 1574 n.19 (9th Cir. 1990). Further, the NASD was created pursuant to federal authorization in 1938. The Maloney Act of 1938, Pub. L. No. 719, 52 Stat. 1070 (codified at 15 U.S.C. § 78o-3 (2000)) (adding § 15A to the Exchange Act of 1934). In a pending case, SROs are seeking to invalidate disclosure rules of the Judicial Council of California that conflict with rules for SRO arbitrators. *See NYSE Sue to Block California Rules in Securities Arbitrations; Preemption Cited*, 34 Sec. Reg. & L. Rep. (BNA) No. 31, at 1296 (Aug. 5, 2002).

170. 177 F. Supp. 2d 189 (S.D.N.Y. 2001). *See also* IDS Bond Fund, Inc. v. Gleacher NatWest Corp., 2002 WL 373455 (D. Minn. Mar. 6, 2002); Gabriel Capital, L.P. v. NatWest Finance, Inc., 122 F. Supp. 2d 407 (S.D.N.Y. 2000); Gabriel Capital, L.P. v. NatWest Finance, Inc., 94 F. Supp. 2d 491 (S.D.N.Y. 2000). *But see* Myers v. Merrill Lynch, 1999 WL 696082, at *8-10 (N.D. Cal. Aug. 23, 1999), *aff'd*, 249 F.3d 1087 (9th Cir. 2001).

claims based on fraud.¹⁷¹ Similar issues have arisen under the SLUSA.¹⁷²

III. FRAMEWORK AND HISTORICAL DEVELOPMENT OF SECURITIES LAW IN THE EU

A. Sources of Law

The EU is not a national federal system, but rather a federation by treaty of member nations for limited purposes. The EU aspires to reach certain goals expressed in the various treaties that serve as the legal foundation for the EU¹⁷³ through legal actions initiated by the European Commission ("Commission"), which may take the form of directives or regulations.¹⁷⁴ Such

171. See also H.R. REP. NO. 104-622 (1996), reprinted in 1996 U.S.C.C.A.N. 3877, 3896 ("Committee's intention not to alter . . . State statutory or common law with respect to fraud or deceit . . .").

172. See *Green v. Ameritrade, Inc.*, 279 F.3d 590 (8th Cir. 2002) (state contract claim not preempted by SLUSA).

173. See TREATY ESTABLISHING THE EUROPEAN COMMUNITY, Nov. 10, 1997, O.J. (C 340) 3 (1997), arts. 9, 99, 105, 108 (as in effect 1957) (now arts. 46, 103, 105, 107) [hereinafter EC TREATY]. The Treaty on European Union significantly amended the earlier treaties and set forth the framework for monetary and fiscal union and the establishment of the European Central Bank. TEU OR MAASTRICHT TREATY: TREATY ON EUROPEAN UNION (EU), Feb. 7, 1992, 1992 O.J. (C 191) 1, 31 I.L.M. 253.

The founding treaties leading to the establishment of EU include: ESCS or PARIS TREATY: TREATY ESTABLISHING THE EUROPEAN COAL AND STEEL COMMUNITY, Apr. 18, 1951, 261 U.N.T.S. 140; EEC or TREATY OF ROME: TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY, Mar. 25, 1957, 298 U.N.T.S. 3; EAEC or EURATOM Treaty: TREATY ESTABLISHING THE EUROPEAN ATOMIC ENERGY COMMUNITY, Mar. 25, 1957, 298 U.N.T.S. 167; MERGER TREATY: TREATY ESTABLISHING A SINGLE COUNCIL AND A SINGLE COMMISSION OF THE EUROPEAN COMMUNITIES, Apr. 8, 1965, 1967 J.O. 152/1 (in French); SEA: SINGLE EUROPEAN ACT, Feb. 17, 1986, 1987 O.J. (L 169) 1, 25 I.L.M. 506 (an act modifying the basic treaties); TEU OR MAASTRICHT TREATY: TREATY ON EUROPEAN UNION (EU), Feb. 7, 1992, 1992 O.J. (C 191) 1, 31 I.L.M. 253; TREATY OF AMSTERDAM AMENDING THE TREATY ON EUROPEAN UNION, THE TREATIES ESTABLISHING THE EUROPEAN COMMUNITIES AND CERTAIN RELATED ACTS, Oct. 2, 1997, O.J. (C 340) 1 (1997).

174. The European Commission is composed of twenty Commissioners, two from each of the five largest member states, and one from each of the smaller states, appointed by their respective national governments. EC TREATY, art. 157. Since directives are given legal effect only through national laws, rights and duties are not conferred on individuals by a directive. *Id.* art. 189. Sometimes, however, a member state will be held liable for its failure to timely adopt a directive. *Id.* art. 171. See *Case 9/70, Franz Grad v. Finanzamt*

legislation is then sent to the European Parliament¹⁷⁵ and adopted by the Council of Ministers.¹⁷⁶ Directives are not generally self operating but must be implemented through the national laws of the various member states, whereas regulations are directly applicable throughout the EU. In addition, the provisions of the treaties which govern the EU directly apply to the member states. The EU does not have any treaty provision comparable to the Supremacy Clause, so preemption of national law is not possible, but federal enforcement mechanisms do exist.

The Commission can, at the request of a member state, bring an action against another member for failing to adopt a law implementing a directive, or for having legislation that is contrary to a directive, regulation or treaty provision. Also, the European Court of Justice may strike down a national law as contrary to a treaty provision in a case instituted by the Commission or by one member state against another.¹⁷⁷ Although the EU does have some administrative bodies, with the exception of the European Central Bank, these agencies do not have regulatory powers comparable to U.S. federal agencies such as the SEC.¹⁷⁸

The primary thrust of the European Economic Community Treaty (“EEC Treaty”) was to create a single European economic market, primarily through harmonization and mutual recognition of national laws providing for the free movement of goods, services, people and capital. The Treaty of the European Union (“TEU”) further advanced economic integration through

Traustein, [1970] E.C.R. 825. The direct applicability of regulations is based on Article 249 of the EC Treaty.

175. The TEU changed the power of Parliament with respect to legislation from purely advisory to one of cooperation and co-decision. See EC TREATY, *supra* note 173, arts. 249, 251, 252 (as in effect 1957) (now arts. 189, 189b, 189c). Members of the European Parliament are directly elected by the peoples of Europe. *Id.* art. 190 (now art. 138).

176. The Council of Ministers is composed of one national representative from each member state and has the capacity to enact EU legislation and is the principal decision making body of the Union. *Id.* arts. 202, 203 (now arts. 145, 146).

177. *Id.* arts. 226, 227 (now arts. 169, 170). See also Case C-483/99, *Re Golden Shares: Commission v. French Republic*, 2 C.M.L.R. 49 (2002).

178. See Andrea M. Corcoran & Terry L. Hart, *The Regulation of Cross Border Financial Services in the EU Internal Market*, 8 COLUM. J. EUR. L. 221, 232–33 (2002).

the establishment of a common European currency and central bank and moved beyond economic union with the introduction of the concept of European citizenship, but then retreated from federalism by adopting the principle of subsidiarity.¹⁷⁹ It has been argued that this was a political reaction against the use of mutual recognition as a smoke screen for deregulation at a national level.¹⁸⁰ The subsidiarity principle requires EU action to be taken only where the objectives of the treaties cannot be adequately achieved at a national level and can be better achieved by EU action. However, these tests apply only when the EU acts outside its exclusive competence. This attempt at allocating power between member states and the EU has not resolved the ambiguities of shared legal power.¹⁸¹

B. Incomplete Harmonization of Securities Regulation

The Treaty of Rome, which laid the foundation for the European Economic Communities ("EEC") in 1957, was designed to remove all restrictions on the free movement of goods, persons, services and capital within the EU.¹⁸² This plan was furthered by the EC White Paper of 1985, which set forth a program for creating a single European market by 1992. The single market was envisioned as expansive and flexible in order to ensure that resources, including capital and investment, would flow into the areas of greatest economic advantage.¹⁸³ National regulators would continue to play a supervisory role, but financial services would be liberalized by putting into effect EU-wide minimum standards that would supersede former national regulations.¹⁸⁴ A timetable for the adoption of securities law directives was included in the White Paper.¹⁸⁵ The White Paper was then implemented by the Single European Act amendments to the Treaty of Rome, which encouraged and facilitated the use of

179. EC TREATY, *supra* note 173, arts. 4, 5, 8, at 17–22.

180. See Imelda Maher, *Legislative Review by the EC Commission*, in NEW LEGAL DYNAMICS OF EUROPEAN UNION 235, 236 (Jo Shaw & Gillian Moore eds., 1995).

181. *Id.* at 237.

182. EC TREATY, *supra* note 173.

183. Commission of the European Communities, *Completing the Internal Market: White Paper from the Commission to the European Council*, COM(83)310 final at 8 [hereinafter White Paper].

184. *Id.* at 103.

185. *Id.* Annex, at 26–27.

directives to harmonize the laws of Member States.¹⁸⁶ The TEU or Maastricht Treaty which came into effect in 1993 then provided for an economic and monetary union including a common currency.¹⁸⁷ The objective of these efforts was to remove technical barriers, which either added costs or restricted entry into particular markets, thereby impeding the free movement of goods, services, persons and capital.

The Commission recognized that abolition of anticompetitive practices was not sufficient to create a common financial market. There was a need for EU-wide rules to underpin the stability of the financial system and to provide a satisfactory level of protection for consumers. The mechanism chosen for integration of the financial markets was a series of directives to harmonize essential standards throughout the EU and to enable financial regulators to practice home country control, but oblige them to honor principles of mutual recognition. Four groups of financial law directives were adopted relating to the efforts to develop a single securities market in the EU. These were directives on financial disclosure, directives covering public securities offerings and stock exchange listings, directives regulating trading markets, and directives regulating financial intermediaries.

As a result of these directives, securities regulation has been partially but incompletely harmonized. There still is not an integrated European capital market enabling issuers to float public offerings or savers to invest and trade across national borders in a single market.¹⁸⁸ The author previously advocated the creation of a European Securities Commission to achieve the integration of European capital markets comparable to the integration of European monetary markets that was achieved by the creation of the euro and the European Central Bank.¹⁸⁹ Other commentators have similarly argued in favor of a Euro-

186. Single European Act, 1987 O.J. (L 169) 1, 25 I.L.M. 503 (1987).

187. TEU, 1992 O.J. (C 224) 1, 31 I.L.M. 247 (1992).

188. Financial Services: Implementing the Framework For Financial Markets: Action Plan, COM(99)232 final at 6 [hereinafter Financial Services Action Plan].

189. See Roberta S. Karmel, *The Case for a European Securities Commission*, 38 COLUM. J. TRANSNAT'L L. 9 (1992).

pean Securities Commission,¹⁹⁰ while some others have either opposed the idea, or argued that the time is not ripe for such a development.¹⁹¹

There is a serious question as to whether a European Securities Commission could be organized under existing treaty provisions. Although power to create such a Commission could be impliedly found in the existing provisions, an amendment to the TEU probably would be necessary.¹⁹² The establishment of the European Central Bank required an amendment to the EC treaty, and since there has been strenuous objection from the British to a European Securities Commission, it is unlikely that a well constructed securities commission could be established without a treaty amendment.¹⁹³

As a result of the adoption of several capital markets directives, especially the Investment Services Directive ("ISD")¹⁹⁴ and the Insider Dealing Directive,¹⁹⁵ and in response to marketplace and political developments, new national government securities regulators were created in some European countries that previously lacked such regulators.¹⁹⁶ Other national regu-

190. See Gilles Thieffry, *The Case for a European Securities Commission*, in REGULATING FINANCIAL SERVICES AND MARKETS IN THE 21ST CENTURY 211, 231 (Eilís Ferran & Charles A.E. Goodhart eds., 2001).

191. See Karel Lannoo, *Does Europe Need an SEC? Securities Market Regulation in the EU* (1996), available at www.ecmi.com (last visited Mar. 20, 2003); BENN STEIL & ERICK BERGLOF, THE EUROPEAN EQUITY MARKETS: THE STATE OF THE UNION AND AN AGENDA FOR THE MILLENNIUM 136 (1996); Andrew Whittaker, *A European Law for Regulated Markets? Some Personal Views*, in EUROPEAN SECURITIES MARKETS, THE INVESTMENT SERVICES DIRECTIVE AND BEYOND 269, 273 (Guido Ferrarini ed., 1998). See also Eddy Wymeersch, *Regulating European Markets: The Harmonization of Securities Regulation in Europe in the New Trading Environment*, in REGULATING FINANCIAL SERVICES AND MARKETS IN THE 21ST CENTURY 189, 192-93.

192. See Thieffry, *supra* note 190, at 222-23; Eddy Wymeersch, *From Harmonization to Integration in the European Securities Markets*, 3 J. CORP. L. & SEC. REG. 1 (1981).

193. See Thieffry *supra* note 190, at n.41.

194. Council Directive 93/22 of 10 May 1993 on Investment in Services in the Securities Field, 1993 O.J. (L 141) 27, as amended by corrigendums to 93/22, 1993 O.J. (L 170) 32, 1993 O.J. (L 194) 27.

195. Council Directive No. 89/592, 1989 O.J. (L 334) 30.

196. See Stephen J. Leacock, *In Search of a Giant Leap: Curtailing Insider Trading in International Securities Markets By the Reform of Insider Trading Laws Under European Council Directive 89/592*, 3 TULSA J. COMP. & INT'L L. 51, 55 (1995). Germany did not have a federal securities regulator until it was required to do so to implement the Insider Dealing Directive. *Id.* at 62-63.

lators were reformed and securities regulation became more centralized.¹⁹⁷ National regulators can be a force for further harmonization, but to some extent their interests diverge, because established national securities commissions do not wish to cede power to one another or to a federal securities commission.

Although securities regulation in Europe has generally improved since the White Paper and Single European Act 1992 deadline, dissatisfaction with the pace of capital markets integration in Europe led to the Financial Services Act Plan¹⁹⁸ in 1999 and the Lamfalussy Report¹⁹⁹ in 2001. The Financial Services Action Plan, which was two years in the making, was an aspirational program by the European Commission for more rapid progress toward a single financial market.²⁰⁰ It was prompted by a sense that despite the introduction of the euro, the capital markets in Europe had remained fragmented. It set forth as strategic objectives the development of a single EU wholesale market where, among other things, capital could be raised on an EU-wide basis and EU companies would produce a single set of financial statements, open and secure retail markets, and state of the art prudential rules and supervision.²⁰¹

The Commission recognized that an overhaul of the way the EU developed financial services legislation was needed to

The Netherlands established the Netherlands Authority for the Financial Markets on March 1, 2002 to oversee the entire financial market sector. *See News: STE becomes Authority for the Financial Markets* (Feb. 28, 2002), at <http://www.autoriteit-fm.nl/>.

197. On December 1, 2001, the U.K.'s Financial Services Authority became a single regulator through the Financial Services and Markets Act 2000. *See* Financial Services Authority, at <http://www.fsa.gov.uk/> (last modified Sept. 5, 2002). On July 2, 1996 France's Commission des Opérations de Bourse was given wider powers (sanctioning ability, etc.). *See* Commission des Opérations de Bourse, at <http://www.cob.fr/cobgb/>. Germany's Bundesanstalt für Finanzdienstleistungsaufsicht (BAFin) took over the function of the earlier BAWe on May 1, 2002 and has much more regulatory power than before. *See* BAFin, at http://www.bawe.de/english/index_re_e.htm (last visited Feb. 21, 2003).

198. Financial Services Action Plan, *supra* note 188.

199. THE COMMITTEE OF WISE MEN, FINAL REPORT OF THE COMMITTEE OF WISE MEN ON THE REGULATION OF EUROPEAN SECURITIES MARKETS (2001), available at http://europa.eu.int/comm/internal_market/en/finances/general/lamfalussyen.pdf. [hereinafter LAMFALUSSY REPORT].

200. Financial Services Action Plan, *supra* note 188, at 3–4.

201. *Id.* at 22–28.

achieve these goals. A European Securities Commission was not recommended but other mechanisms were suggested to avoid piecemeal and reactive protracted decision-making and the inflexibility of regulation by directives.²⁰² One suggestion was a high level forum to consult with affected interest groups and to forge a consensus between national financial regulators on emerging challenges.²⁰³ Another suggestion was acceleration of co-decision procedures of the European Parliament.²⁰⁴ Implementation of these suggestions would impinge on the Commission's legal right of initiative and the European Parliament's hard-won right of the co-decision, and the latter proved politically troublesome.

In response to the Financial Services Action Plan, the EcoFin Council appointed a Committee of Wise Men under the Chairmanship of Baron Alexandre Lamfalussy, which issued its final report on February 15, 2001.²⁰⁵ The Report sets forth the benefits of capital market integration, a long litany of areas in which necessary European rules governing the capital markets are needed, and reasons why the regulatory process is too slow, too rigid, produces ambiguous regulations, and fails to distinguish between core principles and day-to-day implementing rules.²⁰⁶ Blame was assigned to the legislative process itself, especially co-decision procedures and subsidiarity principles.²⁰⁷ The Lamfalussy Report did not recommend the creation of a European Securities Commission, but rather the establishment of two new committees — an EU Securities Committee, with high level members appointed by EU member states, and an EU Securities Regulators Committee, composed of the heads of member state securities regulators. The Lamfalussy Report took a four-tiered approach to regulatory reform:²⁰⁸ (1) framework principles would continue to be decided by normal EU legislative procedures; (2) the two new Committees would assist the Commission in implementing the framework principles; (3) enhanced cooperation and networking among EU securities regulators

202. *Id.* at 16.

203. *Id.* at 16–17.

204. *Id.* at 17–18.

205. LAMFALUSSY REPORT, *supra* note 199, at 189.

206. *Id.* at 9–15.

207. *Id.* at 13–14.

208. *Id.* at 19, 30–33.

would lead to common implementing standards; and (4) the European Commission would be prodded to engage in strengthened enforcement of community law.²⁰⁹ The Lamfalussy Report also recommended a greater use of regulations rather than directives.²¹⁰

Although the Lamfalussy Report was welcomed by the financial community, it was not so well received by the European Parliament, which feared its co-equal legislative powers would be undermined. After a delay of almost a year, however, the European Parliament agreed to have a lesser say on secondary securities legislation and the EU Securities Committee came into existence.²¹¹ In addition, the Committee of European Securities Regulators (“CESR”) was constituted as a successor to the Federation of European Securities Commissions (“FESCO”).²¹²

A report by the European Commission was issued in June 2002 at the half-way stage of the implementation timetable for the Financial Services Action Plan.²¹³ Although of the forty-two original measures in the plan twenty-six have been completed, important initiatives, such as updating the regular reporting requirement for raising capital on an EU wide basis, amending the ISD, and a directive on takeover bids, have not been achieved.²¹⁴ Regulation accomplished, however, one very important achievement. As of 2005, all listed EU companies will be required to report their financial results according to international accounting standards.²¹⁵

It remains to be seen whether harmonization of securities laws and regulations and integration of the European capital markets will be accomplished by way of the fast track procedures recommended in the Lamfalussy Report. Also, it is diffi-

209. *Id.* at 19.

210. *Id.* at 26.

211. See generally Karel Lannoo & Mattias Levin, *Securities Market Legislative Procedures in the EU* (CEPS) (on file with author). See also Commission of the European Communities, Commission Decision Establishing the European Securities Committee, COM(2001)1493 final.

212. See Commission of the European Communities, Commission Decision Establishing the Committee of European Securities Regulators, COM(2001)1501 final. See also Corcoran & Hart, *supra* note 178, at 281–82.

213. European Commission, Financial Services: An Improving Climate — But Quite Some Way to Go, COM(02)267 at 2, available at http://europa.eu.int/comm/internal_market/en/finances/actionplan/index.htm.

214. *Id.* at 10.

215. *Id.* at 4.

cult to predict how the current world wide stock market turmoil will impact both U.S. and EU securities regulation. As the Lamfalussy Report itself pointed out, a failure of its recommended approach could lead to a treaty amendment creating a single EU regulatory authority for financial services.²¹⁶

IV. TAKEOVER REGULATION

A. *Impasse in the U.S.*

A conflict between federal and state interests with respect to securities regulation arises when there is a tender offer to purchase the shares of a target corporation. This collision of law may also be described as a conflict between securities law and corporation law. In a tender offer for cash (or notes),²¹⁷ the shareholders of the target company are deprived of any going forward interest in the profits of the target company; and their rights as shareholders cease. If the tender offer is for securities of the bidder, or results in a merger with the bidder, then the shareholders of the target company become the shareholders of a larger combined enterprise. In either event, the tender offer is an urgent, material transaction affecting the very existence of the target company.²¹⁸ Further, although shareholders generally benefit economically from a takeover because they enjoy a premium for control, other corporate constituencies, particularly management and labor, are likely to be disadvantaged by a takeover.²¹⁹

In 1968, the U.S. Congress passed the Williams Act regulating takeovers, adding Sections 13(d) and 14(e) to the Exchange Act.²²⁰ Although a stated purpose of the Williams Act was to maintain neutrality between the bidder and target in a tender offer contest,²²¹ the statute was intended to protect investors

216. Thieffry, *supra* note 190, at 233.

217. In the U.S., takeovers generally are for cash; in the U.K., due to tax implications, they are generally for notes. This difference leads to a conflict between U.S. and U.K. law concerning takeovers. See Cross-Border Tender Offers, Business Combinations and Rights Offerings, Securities Act Release No. 33-7611, 63 Fed. Reg. 69,136, n.41 (Dec. 15, 1998)

218. See *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

219. Bondholders may also be disadvantaged. See *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 906 F.2d 884 (2d Cir. 1990).

220. See *supra* note 37.

221. See *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987).

confronted by a takeover bid. It accomplished this objective by requiring certain disclosure by the bidder concerning a tender offer and regulating the manner in which a tender offer is conducted.²²² Very generally, many commentators and the SEC were persuaded that takeovers were not only good for shareholders, but also that control contests were a check on management, which weeded out corporate leaders who were not effective.²²³

Managements threatened by hostile takeovers developed a variety of defense mechanisms, including poison pills, selling the crown jewels, staggered boards, control clauses, and golden parachutes. These mechanisms were generally upheld under state corporate law as appropriate unless a corporation was in effect put up for sale by management.²²⁴ Efforts to invalidate anti-takeover mechanisms through suits in the federal courts under the Williams Act failed because the U.S. Supreme Court viewed these defenses as matters of internal corporate management covered by state corporate law so long as full disclosure was made.²²⁵ Although the SEC was able to adopt rules under the Williams Act to prohibit some of the defenses permitted by state corporate law,²²⁶ when the SEC attempted to outlaw the potent anti-takeover device of lesser voting shares for public stockholders, the D.C. Circuit Court struck down the SEC's rule as being beyond its statutory authority.²²⁷

222. See Regulation of Takeovers and Security Holder Communications, Securities Act Release No. 33-7760, 70 S.E.C. Docket 2229 (Oct. 22, 1999).

223. See, e.g., Lucian Arye Bebchuk & Allan Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 159 (2001); Lucian A. Bebchuk, *The Case for Facilitating Tender Offers*, 95 HARV. L. REV. 1028 (1982); William J. Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, A.B.F. RES. J. 341, 347-52 (1983); Frank Easterbrook & Daniel Fischel, *The Proper Role for a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987).

224. See *Paramount Comm. Inc. v. Times Inc.*, 571 A.2d 1140 (Del. 1990); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Moran v. Household Int'l. Inc.*, 500 A.2d 1346 (Del. 1985); *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (Del. 1986).

225. See *Schreiber v. Burlington N. Inc.*, 472 U.S. 1 (1985); *Santa Fe Indus. Inc. v. Green*, 430 U.S. 462 (1977).

226. See, e.g., All Holders and Best Price Rules, 17 C.F.R. § 240.14d-10 (1987) (upheld in *Polaroid Corp. v. Disney*, 862 F.2d 987 (3d Cir. 1988)).

227. *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

In addition to the conflicts between the Williams Act and state corporate law that were fought out in state and federal courts, management and labor groups were able to persuade state legislatures to pass anti-takeover statutes. Early statutes either unduly delayed the takeover process or permitted state blue-sky commissioners to conclude that takeovers were unfair. Such a statute was struck down by the U.S. Supreme Court as unconstitutional.²²⁸ Later state statutes, which imposed delays in the tender offer process, prohibited control share merger transactions for a period of years, or endorsed the consideration by corporate managers of non-shareholder constituencies in control contests, were upheld by the federal courts.²²⁹

The refusal of the federal courts to invalidate most state anti-takeover legislation, or to endorse SEC efforts to curb takeover defenses, left the task of articulating how management should behave in control contests to the state courts. Because a majority of U.S. public corporations are incorporated in Delaware, decisions by the Delaware state courts became determinative of how the relevant law developed.²³⁰ The only national standard applicable to contests for corporate control other than the disclosure and specific procedural provisions of the Williams Act are stock exchange listing standards, which have an ambiguous legal footing. Although they originated in state contract laws, they are SRO "rules" under the Exchange Act, subject to SEC review and approval.²³¹

Most academics have criticized the impasse that developed between federal and state law with regard to takeovers, believing that takeovers are important mechanisms for protecting shareholders and disciplining corporate managers.²³² But the Main Street interests that question the wisdom of encouraging hostile takeovers are probably at least as powerful as the Wall

228. *Edgar v. Mite Corp.*, 457 U.S. 624 (1982).

229. See *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987); *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496 (7th Cir.), cert. denied, 493 U.S. 955 (1989). See Roberta S. Karmel, *The Duty of Directors to Non-Shareholder Constituencies in Control Transactions*, 25 WAKE FOREST L. REV. 61, 66-70 (1990).

230. See Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. 317, 339 (1998).

231. See ABA, *Market Structure Report*, supra note 4, at 1516-27.

232. See Edward B. Rock, *America's Shifting Fascination with Comparative Corporate Governance*, 74 WASH. U. L.Q. 367, 375-78 (1996).

Street interests favoring hostile takeovers. Therefore it is unlikely that state anti-takeover statutes or state corporate law giving corporate management considerable leeway in responding to takeover bids will be overturned, unless economic developments create a new consensus with respect to contests for corporate control.²³³

B. Impasse in Europe

Like the U.S., the EU has thus far been unable to reconcile the political and legal interests that clash in the takeover arena. On July 4, 2001, a twelve year effort by the European Commission to adopt an EU Takeover Directive failed by a tie vote of 273-273 in the European Parliament.²³⁴ This was a serious set-back for economic liberalization and integration of the European capital markets. The Takeover Directive was mired in politics from its inception and its various iterations and final defeat over the past decade illustrate the problems of developing a single European capital market.

In the U.K., management of corporations works primarily for the benefit of shareholders; whereas, on the continent, management and directors owe equal loyalty to shareholder claims and those of creditors and labor. This fact accounts for the key differences in business environments for hostile takeovers in the U.K. and on the continent, and resulted in impediments to the adoption of the Takeover Directive.²³⁵ Hostile takeovers are common in London and are regulated by the Panel on Takeovers and Mergers, a self-regulatory body that operates pursuant to the City Code on Takeover and Mergers ("City Code"). The two most important principles in the City Code are that the shareholders of an offeree company must decide whether or not an offer should succeed, and that all equity holders must be treated equally. In addition, after an offer is communicated to the board, or even when a board has reason to believe an offer is imminent, the offeree board is prohibited from taking any action without the approval of shareholders at a general meeting "which could effectively result in any bona fide offer being frus-

233. See Pinto, *supra* note 230, at n.59.

234. See *Pull up the Drawbridge*, *ECONOMIST*, July 7, 2001, at 67.

235. See Ingrid Depser, *Amended EC Proposal for a 13th Council Directive on Company Law Concerning Takeovers and Other General Bids*, 19 *INT'L BUS. LAW.* 483, 484 (1991).

trated or in the shareholders being denied an opportunity to decide on its merits.”²³⁶ The initial draft of the Thirteenth Directive on Company Law, patterned after the City Code to some extent, was concerned with the equal treatment of the parties involved in takeovers and the transparency of corporate takeovers while a takeover bid was in progress.²³⁷

Since capital formation depends upon equity capital in the U.K. there is a constant monitoring of management performance, protection of minority shareholders, and efficient resource allocation. In contrast, in Germany and in other continental states, management is given a long-term mandate, and its first duty is to the business and then to the employees and the company's bankers. Further, in Germany there is stable and knowledgeable business ownership with close ties to banks. Given this difference, the British regarded takeovers as the ultimate discipline over bad management, whereas the Germans considered hostile bids as inimical to the three ingredients of their post-war success — management's ability to take a long-term view, harmonious labor relations, and the disciplinary function of German banks. Accordingly, German law countenanced numerous barriers to hostile takeovers.²³⁸ The Germans and other continentals opposed the Thirteenth Directive, because they believed it adopted the pro-takeover underpinnings of the U.K. system. The British also opposed it, because they did not wish to see their self-regulatory system be replaced by a statutory system.

However, the Commission insisted that there was a need to facilitate the restructuring of European companies to meet international competition, so an amended version of the Thirteenth Directive was put forth.²³⁹ By this time, takeover activity had increased somewhat and the need for shareholder pro-

236. PANEL ON TAKEOVER AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS AND THE RULES GOVERNING SUBSTANTIAL ACQUISITIONS OF SHARES 7 (3d ed. 1990).

237. Proposal for a Thirteenth Council Directive on Company Law Concerning Takeover and Other General Bids, 1989 O.J. (C 64) 8. There was a provision for a mandatory bid once a threshold position of one-third of the voting shares was acquired. Also, controlling target-company shareholders would have been required to act in the interests of all shareholders by not frustrating the bid.

238. See Depser, *supra* note 235, at 484.

239. 1990 O.J. (C 240) 9.

tection had become more apparent.²⁴⁰ The amended Thirteenth Directive required each Member State to designate a supervisory authority to put it into effect, a requirement that previously had been included in the EU Insider Trading Directive.²⁴¹ There was also provision for mutual recognition.²⁴² The amended Thirteenth Directive fared no better, however, in achieving acceptance and a consensus in favor of adopting it, than the original proposed directive. In 1997, a new and streamlined proposal for a takeover directive was put forward by the Commission.²⁴³ This proposal took into account the subsidiarity principle and left member states some latitude in deciding how to achieve the goals of the directive. The directive would have applied to a company's securities traded on a regulated market governed by the law of an EU member state. Nevertheless, the general principles of the amended Thirteenth Directive that would have been followed in national law were unchanged.²⁴⁴

240. See Lois Moore, *The EC's Proposed Takeover Directives*, N.Y. L.J., May 28, 1991, at 1.

241. The supervisory authorities were then given the mandate to assure, among other things, that holders of securities in the target company would be treated equally; target company shareholders would have time and information to reach an informed decision on the bid and the target company board would not frustrate the bid. Mandatory bid provisions and mandated disclosure in offering documents also were specified. See Amended Commission Proposal for a Thirteenth Council Directive on Company Law Concerning Takeover and Other General Bids, art. 6, 1989 O.J. (C 240) 7, 15.

242. See *id.* art. 6(3).

243. See Amended Commission Proposal for a Thirteenth European Parliament and Council Directive on Company Law Concerning Takeover Bids, 1997 O.J. (C 378) 10.

244. The general principles were: (1) holders of securities in target companies who are in the same position must be treated equally; (2) the addressees of a bid must have sufficient time and information to enable them to reach a properly informed decision; (3) the board of an offeree company must act in the interests of the company as a whole; (4) false markets must not be created in the securities of companies involved in a bid; and (5) target companies must not be hindered in the conduct of their business beyond a reasonable time. See Amended Commission Proposal for a Thirteenth Council Directive, art. 5, 1997 O.J. (C 378) 15. Further, the establishment of national rules would have been necessary in order to make public a decision to bid once the supervisory authority and target company were notified and the bidder would have been required to draft a disclosure document and submit it to the supervisory authority. *Id.* art. 6, at 16–17. The Directive recognized that prompt announcement of an intention to launch a takeover bid reduces opportunities for

The twice amended directive remained an anathema to the British, who feared that, despite the recognition of the Takeover Panel as a proper supervisory authority, it would change the workings of the Panel by tangling its operations in endless legal challenges.²⁴⁵ When the British finally agreed to support it, the Directive became mired in a spat between Britain and Spain over Gibraltar. In the meantime, pressure in Europe grew to harmonize an array of takeover laws that had been adopted in the major European economies and had provisions that differed widely. Some were based on shareholder protection principles. Others were more friendly to target managements by permitting defense mechanisms.²⁴⁶ Then, in April 2001, just as the Council and the European Parliament were on the verge of reaching an agreement to reconcile their differences over the Takeover Directive, Germany withdrew its support for the measure because of its concerns that U.S. companies would prey on German companies.²⁴⁷ Until this time, all fifteen EU member states had agreed that company boards would be required to get shareholder approval before adopting poison pills, but Germany wanted to water down this provision and let management decide on poison pills.²⁴⁸ It was pressure from German companies, which, following the hostile takeover of Mannesmannröhren-Werke AG by Vodafone, feared takeovers of companies such as Volkswagen, that ultimately defeated the Takeover Directive in the European Parliament, where a tie vote constitutes a veto, since a majority vote is required to approve a directive.

insider trading. *Id.* art. 7, at 17. The target company board would have been prohibited from taking action to affect the success of the bid after receiving notification of the bid. *Id.* art. 8, at 17–18. Rules would have had to have been published on withdrawal or nullity of bids, revision of bids, treatment of competing bids, and disclosure of the outcome. *Id.* art. 9, at 18. Whether mandatory bids would have been required at any point was left to the laws of the Member States. *Id.* art. 10, at 18.

245. See *More Talks on Defining Takeover Bids Directive*, EUR. REP., Jan. 19, 1999, available at 1999 WL 8305668; *Euro-Takeovers*, FIN. TIMES, Jan. 14, 1997, at 17.

246. See Anita Raghavan & Thomas Kamm, *Pressure Grows to Unify Europe's Takeover Laws*, WALL ST. J., Dec. 13, 1999, at A28.

247. See *EU Expects Corporate Takeover Directive To Pass Despite Loss of German Backing*, 33 Sec. Reg. & L. Rep. (BNA) No. 31, at 683 (May 7, 2001).

248. See Paul Meller, *Europe Plan on Mergers Hits a Snag*, N.Y. TIMES, May 3, 2001, at W1.

This was not the end of the story, however. A week after the defeat of the Takeover Directive, the German government approved a draft takeover law intended to provide options for target companies to defend against hostile takeovers, and stated that it intended to continue pushing for an EU directive on takeovers.²⁴⁹ After several drafts were presented, a new German Takeover Act, offering legal rules generally in line with international standards and providing for effective enforcement, became effective on January 1, 2002.²⁵⁰ As a result, German managements are now more limited in adopting defensive measures to unwelcome takeovers, but they will continue to have more latitude in erecting barriers to takeovers than managements of U.K. companies.²⁵¹

In addition, the Commission continued to push for an EU-wide takeover regime. It acted on two fronts. First, it set up a High Level Group of Company Law Experts ("High Level Group") to provide advice on issues related to pan-European rules for takeover bids.²⁵² Second, it successfully prosecuted a case invalidating France's golden share in Société National Elf-Aquitaine.²⁵³ These two developments have laid the foundation for a new EU Takeover Directive which may eventually be adopted.

The High Level Group determined that takeover bids are basically beneficial. It endorsed a level playing field for takeovers, that is, takeover bids should be undertaken with a similar expectation of success across the EU, and shareholders should in all member states have corresponding opportunities to tender their shares.²⁵⁴ The High Level Group set forth two principles for achieving a level playing field. First, in the event of a take-

249. See *Cabinet Adopts Draft Takeover Law Meant to Protect Target Companies*, 7 World Sec. L. Rep. (BNA) No. 31, at 5 (July 2001).

250. See Hans-Michael Giesen, *The New German Public Takeover Law*, 31 INT'L L. NEWS 1, 23 (2002).

251. *Id.* at 22.

252. See EUROPEAN COMMISSION, REPORT OF THE HIGH LEVEL GROUP OF COMPANY LAW EXPERTISE ON ISSUES RELATED TO TAKEOVER BIDS (Jan. 10, 2002), available at http://europa.eu.int/comm/internal_market/en/company/company/news/hlg01-2002.pdf. [hereinafter REPORT OF THE HIGH LEVEL GROUP].

253. See Case C-483/99, *Re Golden Shares: Commission v. French Republic*, 2 C.M.L.R. 49 (2002).

254. See REPORT OF THE HIGH LEVEL GROUP, *supra* note 252, at 2, 18–20.

over bid, the ultimate decision as to tendering shares to a bidder and for what price should rest with the shareholders.²⁵⁵ Second, shareholders should normally carry control rights in proportion to the risk their shares carry.²⁵⁶

The decision of the European Court of Justice, in *Commission v. French Republic*,²⁵⁷ meshed well with the Report of the High Level Group. In this case, the Court invalidated a critical defense mechanism used by European companies in France and some other states that is commonly called a "golden share." Such a golden share gives the state the power to approve or disapprove any takeover. France argued that any restrictions on the free movement of capital resulting from its golden share in Elf-Aquitaine, a petroleum company, were justified under the principles of necessity and proportionality, because an interruption of supplies of petroleum products could affect public security.²⁵⁸ The Court disagreed, finding that the golden share was a serious interference with the free movement of capital, went beyond what was needed to prevent the disruption of petroleum supplies, and was therefore in derogation of the EC Treaty.²⁵⁹ The decision is important because it suggests that other laws preventing takeovers could be similarly invalidated by the court.

The Report of the High Level Group discusses the absence of a level playing field between the U.S. and the EU that would have been created by the failed Thirteenth Directive or a new directive drafted in accordance with the Report. With the adoption of such a directive, European companies would be severely restricted in putting up defenses against takeover bids, while U.S. companies could use a number of devices to defend against

255. *Id.* at 20.

256. *Id.* at 21. To implement this principle, there were two important proposals. First, after the announcement of a takeover bid, the board of the offeree company should only be able to take actions frustrating the bid with the authorization of shareholders at a general meeting. *Id.* at 27. Second, a bidder who has acquired 75% or more of risk-bearing capital should be able to break through any mechanisms held by the target to frustrate the exercise of control by the bidder, including golden shares carrying special control rights held by member states. *Id.* at 30–31.

257. Case C-483/99, *Re Golden Shares: Commission v. French Republic*, 2 C.M.L.R. 49 (2002).

258. *Id.* ¶¶ 27–30.

259. *Id.* ¶ 51.

a takeover bid.²⁶⁰ The Report argues that there is no level playing field within the U.S. because of differing state laws, and that the general legal and capital market environment in the U.S. differs widely from the European environment, especially as to transparency and the pressure to enhance shareholder value.²⁶¹ Further, the High Level Group suggested that, in adopting takeover legislation, the EU should consider what type of regulation is needed to enhance the development of efficient, integrated capital markets in the EU, rather than what advantages such regulation might give to U.S. companies.²⁶²

V. THEORIES CONCERNING FEDERALISM

Not all of the overarching theories concerning the value of federalism are relevant to financial regulation or securities regulation in particular. For example, the enhancement of democratic values and the protection of individual liberties²⁶³ are only tangentially, if at all, related to the sometimes competing interests of protecting investors, promoting capital formation, and preventing systemic risk to the financial system, the latter being the primary goals of securities regulation.²⁶⁴ Although federalism has strong defenders, even in the case of economic regulation,²⁶⁵ others have argued that national regulation is a better way of reaching public policy goals.²⁶⁶

260. REPORT OF THE HIGH LEVEL GROUP, *supra* note 252, at 40.

261. *Id.* at 40–41.

262. *Id.* at 42.

263. See, e.g., Akhil Reed Amar, *Of Sovereignty and Federalism*, 96 YALE L.J. 1425 (1987); William J. Brennan, Jr., *The Bill of Rights and the States: The Revival of State Constitutions as Guardians of Individual Rights*, 61 N.Y.U. L. REV. 535 (1986); William J. Brennan, Jr., *State Constitutions and the Protection of Individual Rights*, 90 HARV. L. REV. 489 (1977); D. Bruce La Pierre, *Political Accountability in the National Political Process — The Alternative to Judicial Review of Federalism Issues*, 80 NW. U. L. REV. 577 (1985); Deborah Jones Merritt, *The Guarantee Clause and State Autonomy: Federalism for a Third Century*, 88 COLUM. L. REV. 1 (1988).

264. See SEC, *Who We Are, What We Do*, at <http://www.sec.gov/about/whatwedo.shtml> (last visited Mar. 20, 2003). See also Heidi Mandanis Schooner, *Regulating Risk Not Function*, 66 U. CIN. L. REV. 441, 468 (1986).

265. See, e.g., Jonathan R. Macey, *Displacing Delaware: Can the Feds Do a Better Job Than the States in Regulating Takeovers?*, 57 BUS. LAW 1025 (2002); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998). See also A.C. Pritchard, *Constitu-*

Much of the academic debate regarding the value of federalism in securities regulation focuses on competition among the states for corporate charters, rather than competition among federal regulators or between federal and state regulators. This literature discusses whether the competition among the states in the corporate law area leads to a race to the bottom, a race to the top or an optimal level of regulation.²⁶⁷ Further, much of this discussion concerns the specific issue of defenses erected by target companies against hostile takeovers.²⁶⁸

When Congress was in the process of preempting state securities regulation in the NSMIA and the SLUSA, critics of the two acts claimed they would diminish investor protection, whereas their supporters argued that they would eliminate duplicative and unnecessary regulation and therefore be efficient and effective.²⁶⁹ Much of the rhetoric in discussions about the value of

tional Federalism, Individual Liberty, and the Securities Litigation Uniform Standards Act of 1998, 78 WASH. U. L.Q. 435 (2002).

266. See, e.g., Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); Edward L. Rubin & Malcolm Feeley, *Federalism: Some Notes on a National Neurosis*, 41 U.C.L.A. L. REV. 903 (1994).

267. This debate was initiated by William Cary, *Federalism and the Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974), arguing that the competition for corporate charters led to a race to the bottom respecting legal standards. For a response to the effect that such competition leads to a race to the top see Ralph K Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977). See also FRANK H. EASTERBROOK AND DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1-40 (1991); ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 1-2 (1993).

268. For the most recent debate on these issues see Bebchuk & Ferrell, *supra* note 223; Lucian Ayre Bebchuk & Allen Ferrell, *On Takeover Law and Regulatory Competition*, 57 BUS. LAW 1047 (2002); Stephen J. Choi and Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961 (2001); Macey, *supra* note 265; Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV. 1103 (2002).

269. See Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case for Reallocation of Regulatory Responsibilities*, 78 WASH. U.L.Q. 497 (2000); Manning Gilbert Warren III, *Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies For Securities Fraud*, 60. LAW & CONTEMP. PROB. 169 (1997). See also Rutheford B. Campbell, *The Insidious Remnants of State Rules Respecting Capital Formation*, 78 WASH. U. L.Q. 407 (2000); David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. LAW. 1, 51 (1998); Richard H. Walker, *Evaluating*

state securities regulation deals with substantive issues of what kind of regulation is appropriate, rather than whether the SEC should be the sole regulator in a particular area or whether there should be dual regulation by the SEC and the states. Discussions of regulatory competition between the SEC and other federal regulators also have more to do with politics than principle.²⁷⁰

Some regulatory competition can prevent an agency like the SEC from making serious policy mistakes and give voice to interest groups that are ignored by a single national agency due to so-called “agency capture” by another interest group.²⁷¹ Nevertheless, much state securities regulation over the years has been duplicative, unnecessarily burdensome, and expensive for the securities industry, without adding sufficient value in terms of investor protection. Also, state securities regulation is uneven from state to state and even from administration to administration within a particular state.²⁷² Further, regulatory competition between national regulators frequently is an unseemly jurisdictional battle fueled by politics. Moreover, such

The Preemption Evidence: Have The Proponents Met Their Burden?, 60 LAW & CONTEMP. PROBS. 237 (1977).

270. An independent commission recommended a single federal regulatory agency for financial market regulation after the 1987 stock market crash. See THE BRADY COMMISSION, REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (1988). Similar recommendations were made with regard to banking regulation during the Bush Administration. See Kenneth H. Bacon, *White House Alters Plan on Bank Laws*, WALL ST. J., Feb. 5, 1991, at A3. But Congressional oversight committees have never been enthusiastic about such consolidation.

271. See John C. Coffee, Jr., *Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation*, 50 BUS. LAW. 447, 454 (1995). See also Macey, *supra* note 265, at 1044–46.

272. In some states there are separate securities commissioners; in others the securities commissioner may also be the banking and/or insurance commissioner. See North American Securities Administrators Association, NASAA Member Representative List, at http://www.nasaa.org/nasaa/abtnasaa/find_regulator.asp (last visited Nov. 14, 2002). The budgets of these commissions vary widely. In New York the Martin Act was rarely enforced for many years except to prosecute local scams. Spitzer, who is a Democrat in a Republican administration and who may be interested in higher office, decided to use the Martin Act against prominent investment banking firms. See Editorial, *New York's Bubble Boys*, WALL ST. J., May 22, 2002, at A26; Editorial, *Spitzer's Telecom Meltdown*, WALL ST. J., April 29, 2002, at A18.

competition can lead to disrespect for the law, as one regulator undermines the laws and regulations of another regulator.²⁷³

The theory that regulatory competition produces the most efficient regulatory structure is based on principles of economics that fail to sufficiently take into account the psychological factors affecting investor confidence. Although the primary goal of securities regulation is frequently articulated as investor protection, this understanding is too simplistic. Capital formation is at the heart of the capitalist system. The reason securities regulation became a matter of federal concern is that there was a need to increase investor confidence in order to generate capital formation in the 1930s. There was also a need to assure against systemic collapses caused by excessive stock market speculation leading to the bursting of the stock market bubble in 1929 and the bankruptcy of numerous financial institutions. State securities regulation and SRO regulation had proved inadequate in performing this task, which was national in scope.

A similar crisis of investor confidence exists today due to the bursting of the technology stock market bubble and the corporate financial scandals of Enron Corp., Worldcom, and other companies.²⁷⁴ The SEC reacted to this crisis by prosecuting wrongdoers and proposing new regulations on a number of fronts, ranging from a new regulatory system for the accounting profession, certifications of financial statements by CEOs, to certain restrictions on research analysts.²⁷⁵ Congress then attempted to address this crisis by enacting the Sarbanes-Oxley

273. See Coffee, *supra* note 271, at 473 (1995). See also *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979); *Am. Bankers Ass'n. v. SEC*, 804 F.2d 739 (D.C. Cir. 1986).

274. See Harold S. Bloomenthal, *Financial Fraud and the New Face of Securities Regulation — Part I*, 24 Sec. & Fed. Corp. L. Rep. (West) 65 (July 2002); Albert A. DeStephano, *Lecture On Corporate Securities & Financial Law: Panel Discussion: Enron: What Went Wrong?*, 8 FORDHAM J. CORP. & FIN. L. 1 (2002).

275. See *Enactment of Broad Accounting, Corporate Governance Reform Act Brings New Prohibitions, Requirements for Executives and Auditors*, 34 Sec. Reg. & L. Rep. (BNA) 1281, 1290–95 (Aug. 5, 2002). See also Michael Schroeder, *Deals & Dealmakers: SEC Proposes Rules to Improve Disclosure by Public Companies*, WALL ST. J., May 1, 2002, at C5; Paul Beckett, *SEC Order Forces Executives To Swear by Their Numbers*, WALL ST. J., July 5, 2002, at A1; Michael Schroeder, *Audit-Rules Overhaul Is Proposed in Senate*, WALL ST. J., May 9, 2002, at C11.

Act.²⁷⁶ The NASAA and the New York Attorney General tried to address these problems by investigating and prosecuting Merrill Lynch and other securities firms.²⁷⁷

The issue addressed by this Article is whether problems of this magnitude should be solved by a national regulator, the SEC, or a dual regulatory system of the SEC and state regulators. Since the problems are national, and in some respects international in scope, an effective national regulator seems more appropriate than piecemeal state regulation. On the other hand, aggressive state action, such as the New York Attorney General's action against Merrill Lynch, can highlight gaps and problems with the federal regulatory scheme. But now that Congress has dealt with this issue and ordered the SEC and SROs to find regulatory solutions, should state regulation be permitted to continue? Continued state regulation might prove costly and may lead to conflicting regulations; if so, the benefits to investors will be problematic. Hopefully, the SEC, the SROs, and the state regulators will cooperate to produce a uniform national standard for dealing with analysts' conflicts.

VI. CONCLUSION

The allocation of regulatory responsibilities between federal and state securities regulators has not always been logical or even coherent, because it is affected by politics and economic history. Even as this Article was being written, the traditional lines between federal and state responsibility for overseeing the conduct of public corporations was being changed in the U.S. by the passage of the Sarbanes-Oxley Act, which federalized the law governing corporate audit committees and yet left implementation of this legislation to SROs as well as to the SEC.²⁷⁸ Similarly, implementation of the Financial Services Action Plan was limiting the ability of member state regulators to maintain national standards in the face of further harmonization of EU

276. See Sarbanes-Oxley Act of 2002, 107 Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.). See also Greg Hitt, *Bush Signs Sweeping Legislation Aimed at Curbing Corporate Fraud*, WALL ST. J., July 31, 2002, at A4.

277. See *supra* text accompanying notes 147–53.

278. Sarbanes-Oxley Act of 2002 § 301.

law.²⁷⁹ Yet, in the wake of the financial fraud scandals roiling the stock markets in the U.S. and Europe, both federal and state securities regulators were endeavoring to assert their jurisdiction over wrongdoers. In short, the subject of this Article is current and fluid.

Although some long-term principles would appear to animate legislators in their reactions to financial crisis, fixing an immediate problem often compromises such principles. As a general matter, in the U.S. regulation of financial institutions and products has been given to federal regulators and the rules pertaining to corporate governance have been left to the states. Investor protection historically has been a matter of dual federal and state regulation. Yet, when Congress believed that duplicative regulation and strike suits were impairing capital formation, it enacted the NSMIA and then the SLUSA, impinging upon both state securities and common laws.²⁸⁰ When Congress believed that corporate law was not adequately protecting investors from fraud, it impinged upon state corporate law through the Williams Act and then the Sarbanes-Oxley Act.²⁸¹

In Europe, there has been an overriding concern with the need for economic integration and recognition that uniform financial regulation can be a barrier to competition. Yet, despite the importance of the single passport, host countries have thus far been able to impose customer protection principles upon financial institutions from other countries.²⁸² Further, the principle of subsidiarity has been utilized as a brake upon harmonization and integration. Impatience with the progress of financial market integration and a fear that the European capital markets were not sufficiently competitive with U.S. capital markets led to the Financial Services Action Plan and the Lamfalussy Report — initiatives that evidenced regulatory competition on an international level.²⁸³

279. See *United Kingdom Moves to Protect EC-Threatened Stock Listing Regime*, 34 *Sec. Reg. & L. Rep.* (BNA) No. 31, at 1309-10 (Aug. 5, 2002).

280. See *supra* notes 64–65.

281. See *supra* note 167.

282. See Gerard Hertig, *Imperfect Mutual Recognition for EC Financial Services*, 14 *INT'L REV. L. & ECON.* 177, 181 (1994).

283. See *supra* text accompanying notes 188–199. See also Amir N. Licht, *Regulatory Arbitrage for Real*, 38 *V.A. J. INT'L L.* 563 (1998).

As securities markets have become national and even international and significantly affect the national economic welfare in the U.S. and the EU-wide markets in Europe, there has been a trend toward federalizing securities regulation. This trend probably will continue. Yet, when local investors and constituents are implicated, state regulators become active.²⁸⁴ Only when dual regulation becomes unnecessarily costly or at odds with federal regulation, is it likely to be supplanted by federal regulation.

The availability of the Supremacy Clause under the U.S. Constitution appears to provide a mechanism for dealing with policy conflicts between federal and state law that is not available in Europe. The European Court of Justice has nevertheless managed to invalidate national law that is contrary to the principles of the TEU.²⁸⁵ In both the U.S. and Europe, the political process whereby securities regulation is allocated between federal (or EU) and state authorities is extremely complex and time consuming. This means that regulatory change generally is incremental. Further, interest group pressure is a factor not only with regard to the substance of regulation but also whether regulation is imposed by federal, state, or SRO administrators.

U.S. constitutional law and the TEU provide theoretical frameworks for reconciling federal and state interests in securities regulation. Developments in the securities markets, including corporate scandals, financial failures, and political compromises explain how such theory is applied, sometimes logically but often haphazardly. Although investor protection should be the guiding principle for allocating regulatory responsibility, so many complex factors go into promoting investor confidence that it is difficult to determine whether the SEC (or an organ of the EU) or state regulators should necessarily be the guardians of investors. Prevention of systemic risk, for example, gives federal securities regulators some responsibility for maintaining the long-term financial health of the securities industry. Further, promotion of capital formation is a federal goal that underlies investor protection. Concern about the viability of pension plans is another growing policy consideration in balanc-

284. See *supra* text accompanying notes 147–56.

285. See *supra* note 177.

ing the interests of investors against those of business. State regulators tend to view investors more as consumers than as capitalists, but on the other hand have an interest in encouraging businesses to incorporate and do business within their jurisdictions. These classic tensions between finance and industry frequently translate into constitutional law tensions.

Regulatory competition exists between federal and state agencies and courts, as well as between federal financial regulators, and between regulators in different countries. This competition frequently is fomented by affected business interests, but can be reconciled through coordination and cooperation. In order for competing regulatory interests to be reconciled, however, regulators must have the same vision of which investor interests require protection and how that protection should be achieved.