The Securities Fraud Deterrence and Investor Restitution Act: More Effective Than Current Regulation?

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I.  INTRODUCTION

Recent events have shown that the securities markets, although regulated both federally and by the states, are still subject to violations and scandals. Congress has addressed this problem by holding hearings and enacting legislation that attempts to decrease violations. A House member introduced H.R. 2179: The Securities Fraud Deterrence and Investor Restitution Act¹ in an attempt to give the Securities and Exchange Commission (SEC) more power to regulate the securities markets. A controversial amendment to the bill would prohibit states from setting any requirements that differ from or add to federal regulations regarding various areas of securities regulation.² Part II of this Note will give a brief description of the history of securities regulation in the United States. Part III will describe the substance of H.R. 2179 and amendments to it, as well as analyze the arguments for and against the bill. Part IV will recommend that more information be gathered before taking any action and will be followed by the conclusion.

II. SECURITIES REGULATION HISTORY

A. State Securities Regulation

State governments, as opposed to the federal government, were the first entities to regulate securities. A security is an instrument that “evidences the holder’s ownership rights in a firm, the holder’s creditor relationship with a firm or government, or the holder’s other rights.”3 The term security encompasses many financial instruments, including a note, stock, treasury stock, bond, debenture, transferable share, and investment contract.4 Before direct regulation of securities began, states regulated them indirectly, by using gambling statutes to prohibit betting on stock price changes and regulatory commissions or other means to supervise corporations’ activities.5 There was also case law in many states that prescribed brokers’ duties to their customers.6

Many states then enacted securities laws called blue-sky laws.7 Kansas was the first state to adopt “blue-sky” laws in 1911,8 and forty-seven states adopted them before 1931.9 These laws attempted to stop the sale of fraudulent securities.10 In Kansas, the statute employed “merit review” by giving the banking commission the power to determine if the public sale of a security should or should not be allowed based on broad criteria, such as if the “issuer ‘does not intend to do a fair and honest business’” or “‘does not promise a fair return.’”11

The Martin Act,12 passed by New York in 1921, is another example of a state blue-sky law. The Act is thought to be even more stringent than current federal regulations because the New York Attorney General only has to show that the perpetrators, which

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3. BLACK’S LAW DICTIONARY 629 (2d Pocket ed. 2001).
6. Id. (citing CHARLES H. MEYER, THE LAW OF STOCKBROKERS AND STOCK EXCHANGES (1931)). These requirements included: actual execution of the customer’s order, see, e.g., Hasbrouck v. Mun. Tel. & Stock Co., 210 N.Y. 533 (1913); Greene v. Corey, 210 Mass. 536 (1912), cited in MEYER, supra; a broker not buying from or selling to himself, see, e.g., Mayo v. Knowlton, 134 N.Y. 250 (1892), cited in MEYER, supra; and not making a “secret” profit by informing the customer he bought at a higher price or sold at a lower price than he actually did, see, e.g., Whiting v. Delozier, 82 Cal. App. 525 (1927), cited in MEYER, supra.
7. Roberta S. Karmel, Reconciling Federal and State Interests in Securities Regulation in the United States and Europe, 28 BROOK. J. INT’L L. 495, 497 (2003). “Blue-sky law” was the colloquial term for state securities laws. Jonathan R. Macey & Geoffrey P. Miller, Origin of the Blue Sky Laws, 70 TEX. L. REV. 347, 348 (1991). According to Macey and Miller, the origin of the term is unclear. The explanation from the literature they deem most plausible is that the term was coined because some brokers in Kansas were so devious that they would “sell building lots in the blue sky in fee simple.” Id. at n.59 (quoting Thomas Mulvey, Blue Sky Law, 36 CAN. L. TIMES 37, 37 (1916)). The authors’ own view is that the term had been used widely in Kansas to describe some type of fraudulent securities transaction. Id.
9. Id. at 229.
10. Id.
12. N.Y. GEN. BUS. LAW § 352-c (1921).
may include corporations, individuals, investment banks or other third parties, have committed an intentional act that constitutes fraud.\textsuperscript{13} The Act does not require that the persons committing the act “willfully or knowingly did something illegal” in order for there to be liability for these parties.\textsuperscript{14} The Martin Act has been in the news many times recently, as New York Attorney General Eliot Spitzer has pursued securities enforcement actions under its authority.\textsuperscript{15}

Although many states enacted blue-sky laws, they were not thought to effectively protect stockholders.\textsuperscript{16} They were difficult to enforce because a change in the politics of a state could change enforcement priorities.\textsuperscript{17} There were also problems with funding as well as various other problems.\textsuperscript{18} These issues were among those that provided the incentive for the enactment of many federal securities laws.

\textbf{B. Federal Securities Regulation and the Formation of the Securities and Exchange Commission}

Although there were several attempts to federally regulate securities before that time, Congress did not enact major legislation regulating securities until the early 1930s. Alexander Hamilton initiated the first attempt when he imposed limitations in the charter of the Bank of the United States.\textsuperscript{19} This was followed by the National Banking Act of 1863,\textsuperscript{20} the Interstate Commerce Act of 1887,\textsuperscript{21} and the Sherman Anti-Trust Act in 1890.\textsuperscript{22} The federal government also formed the Bureau of Corporations in the early 1900s to gather information on large companies.\textsuperscript{23} The Bureau of Corporations was

\begin{itemize}
\item \textsuperscript{14} \textit{Id.}
\item \textsuperscript{15} \textit{Id.}
\item \textsuperscript{16} Shalini M. Aggarwal, \textit{From the Individual to the Institution: The SEC’s Evolving Strategy for Regulating the Capital Markets}, 2003 COLUM. BUS. L. REV. 581, 585 (describing the reasons for ineffectiveness of the state laws as leading to the passage of federal legislation to provide “additional protections to investors”).
\item \textsuperscript{17} \textit{Id.}
\item \textsuperscript{18} \textit{Id.}
\item \textsuperscript{19} Markham, \textit{supra} note 5, at 733. The restrictions included voting restrictions on some shareholders and authorization for the federal government to audit its financial statements. \textit{Id.}
\item \textsuperscript{20} Ch. 106, 13 Stat. 99 (1864).
\item \textsuperscript{21} Ch. 104, 24 Stat. 379 (1887).
\item \textsuperscript{22} Ch. 647, 26 Stat. 209 (1890); Markham, \textit{supra} note 5, at 733 (arguing that the Sherman Antitrust Act, for the most part, was a “blunt tool” that did not greatly affect securities).
\item \textsuperscript{23} Markham, \textit{supra} note 5, at 734 (describing the Bureau of Corporations formation and later merger into the Federal Trade Commission).
\end{itemize}
The Journal of Corporation Law

unsuccessful in its attempt to lobby Congress for control over large corporations, as was the Industrial Commission’s lobbying attempt in 1898, which recommended measures requiring corporations to issue annual reports to shareholders.24 Neither initiative led to the passage of new legislation. After the Panic of 190725 there was a congressional investigation into the anti-competitiveness of the American economy, but Congress did not respond with federal securities regulation.26 During World War I, there were more unsuccessful efforts to regulate securities.27

Significant federal securities legislation was finally passed in the early 1930s. The main purpose of the federal securities laws is to promote disclosure of information.28 The Securities Act of 1933 was the first large piece of federal legislation and is known as the “truth in securities” law.29 The two purposes of the Act were to ensure that investors received information about public securities before investing and to “prohibit deceit, misrepresentations, and other fraud” in dealing with securities.30

The second major piece of federal securities regulation was the Securities Exchange Act of 193431 that established the SEC. The primary objective of the SEC is “to protect investors and maintain the integrity of the securities markets.”32 The Exchange Act gives the SEC the power to regulate most aspects of the securities industry, including registration, as well as oversight of the stock exchanges and other self-regulatory

24. Id. (noting that the first federal inquiry for regulating securities activities was initiated by the Industrial Commission).

25. The Panic of 1907 was a banking panic in October of that year, when, following a contraction in the economy where prices rose and production was flat, banks refused to pay depositors currency from their accounts. This restriction of payments ended in early 1908. MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867-1960 157 (1971).


27. Markham, supra note 5, at 735. The federal government formed the Capital Issues Committee which reviewed proposed securities offerings to ensure they were “compatible with the war effort” and did not allow offerings to go forward unless they met that standard. Id. at 736. After the war was over, the Committee recommended to Congress that these operations continue because blue sky laws were not protecting investors from various schemes, but Congress did not act on this recommendation. Id. President Wilson urged Congress to pass the legislation that the Committee recommended to “stop speculation and to prevent the fraudulent methods of promotion by which our people are annually fleeced on many millions of hard earned money” but such legislation was not adopted. Id. (quoting Securities Act: Hearings Before the Senate Comm. on Banking and Currency, S. 875, 73d Cong. 315 (1934)).


29. 15 U.S.C.A. § 77a (1933); The Investor’s Advocate, supra note 28.

30. The Investor’s Advocate, supra note 28.


32. The Investor’s Advocate, supra note 28.
The SEC is organized into four divisions: the Division of Corporate Finance, which regulates disclosure by public companies, the Division of Market Regulation, which establishes standards for the markets, the Division of Investment Management, which regulates the investment management industry, and the Division of Enforcement, which investigates securities violations, actually files the claims and negotiates settlements.\textsuperscript{34}

The SEC can bring actions in federal court, conduct administrative proceedings, or refer cases to the Justice Department, which can press criminal charges.\textsuperscript{35} These actions can lead to injunctions, bar orders, and revocation or suspension of registration.\textsuperscript{36} The SEC annually brings between 400 and 500 civil actions\textsuperscript{37} and brought 598 actions in 2002.\textsuperscript{38} The SEC has the power to impose civil penalties or to require disgorgement of profits gained from the illegal activity.\textsuperscript{39}

\section{Conflict between Federal and State Regulation}

While the Securities Act of 1933 and the Securities Exchange Act of 1934 were among the first important federal securities regulations, Congress has also promulgated several other important federal laws regulating the securities markets. These include: The Trust Indenture Act of 1939,\textsuperscript{40} the Investment Advisers Act of 1940,\textsuperscript{41} the Securities Litigation Uniform Standards Act of 1998,\textsuperscript{42} the National Market Securities Improvement Act of 1996,\textsuperscript{43} and the Private Securities Litigation Reform Act of 1995.\textsuperscript{44} Most recently, Congress passed the Sarbanes-Oxley Act of 2002.\textsuperscript{45}

\textsuperscript{34} The Investor’s Advocate, \textit{supra} note 28.
\textsuperscript{36} Id. at 36-38.
\textsuperscript{37} The Investor’s Advocate, \textit{supra} note 28.
\textsuperscript{39} Hazen, \textit{supra} note 35, at 37.
\textsuperscript{40} 15 U.S.C.A. § 77 (1939).
\textsuperscript{45} Pub. L. No. 107-204, 116 Stat. 745 (2002). The statutes cited in the previous five notes are only cited to give examples of more recent federal legislation. The main focus of this Note is on the role of the SEC, which is most relevant to the Securities Exchange Act of 1934. The bill which is the focus of this Note proposes to amend the Sarbanes-Oxley Act of 2002 [hereinafter Sarbanes-Oxley]. Sarbanes-Oxley was enacted in response to the multitude of corporate scandals that occurred in 2001 and 2002. Larry E. Ribstein, \textit{Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes–Oxley Act of 2002}, 28 J. CORP. L. 1, 3 (2002). Sarbanes–Oxley was a significant attempt to change corporate governance by Congress, and proposed to do this by, among other things, requiring an independent audit committee of corporations to hire auditors, requiring certification of financial reports and internal controls, providing for SEC rules that prohibit “fraudulently influencing or misleading auditors,” and protecting whistleblowers. It also requires attorneys to report fraud, bars auditors from doing non-audit work for audit clients, requires rotation of auditors, requires more reporting from auditors to boards, prohibits insider loans, and changes the penalties for fraud by requiring return from profits from the sale of stock as well as incentive–based compensation. \textit{See id.} Sarbanes-Oxley also
Although Congress has passed this federal legislation, the state securities laws remain in effect. States, such as New York under the Martin Act, have pursued actions under state securities laws several times in recent years in high-profile cases. The state and federal systems of securities regulation attempt to combat problems in the securities market based on fundamentally different assumptions. The federal system is generally based on promoting disclosure of information, while many state systems are more merit-based, giving discretion to a state official to determine if a corporation should be allowed to complete an offering of securities. State and federal securities laws cover many of the same issues, and at the time Congress promulgated the Acts of 1933 and 1934, 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.’” Congress is still trying to resolve the issue of how state and federal regulation of securities can co-exist to be optimally effective today. H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act, is one attempt to do so.

Congress did not explicitly preempt state law with the Securities Act of 1933 and the Securities Exchange Act of 1934, but in fact included provisions in them that stated that they would not affect the states’ securities jurisdiction. In the late 1970s and early 1980s, the Supreme Court began to hear cases that raised issues of federalism in securities laws. The Court determined that, for the most part, state law governed the “internal affairs” of corporations and federal securities laws governed the issuances and obligations of the officers and directors of public companies.

However, more recent federal securities legislation has expressly preempted some state securities regulation. The National Market Securities Improvement Act expressly preempted state law in much the same way as the Securities Fraud Deterrence and Investor Restitution Act of 2003. The National Market Securities Improvement Act was passed in 1996 and includes a section amending the Securities Exchange Act of 1934 by expressly prohibiting states from making any rule that “shall establish capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers, dealers . . . that differ from, or are in


46. See supra note 15.
47. Karmel, supra note 7, at 497.
48. Id. at 498. See supra note 11 and accompanying text for additional information on the merit-based system.
49. Id. (quoting Mark A. Sargent, Report on State Merit Regulation of Securities Offerings, 41 BUS. LAW. 785, 793 (1986)).
50. Id. at 500.
52. Karmel, supra note 7, at 503.
53. Id. at 510-11.
54. H.R. 2179, 108th Cong. (2003); see infra notes 55, 95-96 and accompanying text.
addition to, the requirements in those areas established under this title.\textsuperscript{55} However, this did not deter states from aggressively pursuing securities fraud, as evidenced by recent events described in the following Part.

D. State Regulators Respond to Recent Securities Violations

Over the last ten years, in many instances, federal responses to issues in securities regulation have come only after states have pursued action in those areas. In 1996, many investors were losing billions of dollars investing in companies with very small market capitalizations, or companies whose value, as determined by the public market, was not very large.\textsuperscript{56} Thirty-three states investigated broker firms which “aggressively” marketed these securities with small market capitalizations to investors and found fraud in the manipulation of shares of these companies, “most of which had no operating history.”\textsuperscript{57} Congress held hearings in 1997 on fraud in the selling of these micro-cap securities, but took no action until the passage of the Sarbanes-Oxley Act in 2002 which disqualified players from the securities industry based on certain state investigations and actions.\textsuperscript{58}

Also in 1996, states issued guidance on the use of the internet for securities offerings and distributing material regarding securities.\textsuperscript{59} In 1998, the SEC used the guidance of state regulators to issue interpretative guidance on the use of the internet.\textsuperscript{60} States also took the lead on requiring disclosure to individual investors about the risks associated with various types of trading.\textsuperscript{61}

This trend of action by state securities regulators has continued in the more recent past, and several investigations remain underway today. New York State Attorney General Eliot Spitzer conducted a lengthy investigation into the practices of Merrill


\textsuperscript{57} Id. at 7.

\textsuperscript{58} Id. (citing Opening Statement of Senator Susan Collins, Chair, Senate Permanent Subcommittee on Investigations, Sept. 22, 1997).

\textsuperscript{59} Id. (citing Resolution of the North American Securities Administrators Association Regarding Securities Offering on the Internet, Jan. 7, 1996, NASAA Reports (CCH) ¶ 7040; Resolution of the North American Securities Administrators Association Regarding Internet Advertising on Products and Services, Apr. 27, 1997, NASAA Reports (CCH) ¶ 2191).

\textsuperscript{60} Id. (citing Statement of the Commission Regarding use of Internet Websites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore, U.S. Securities and Exchange Commission, Release No. 33-7516, 63 Fed. Reg. 14813 (Mar. 23, 1998)).

Lynch’s securities research analysts, uncovering emails sent within Merrill Lynch revealing that its analysts released “misleadingly” optimistic ratings and reports on certain companies.62 In May of 2002, the state of New York and Merrill Lynch reached an agreement regarding Merrill’s securities research analysts.63 According to the New York State Attorney General’s office, the agreement should “bolster the integrity of stock analyst research” and it “substantially outstrips any current requirements or mandated reforms.”64 Massachusetts filed a similar suit, based on its state securities statutes, against Credit Suisse First Boston.65 State regulators in Arizona filed suit against Arthur Andersen and won damages on the basis of its statutes.66

In New York, Spitzer continued his aggressive action in April of 2003 when he filed suit against five executives who received shares of “hot” initial public offerings (IPOs).67 “Hot” IPOs are those offerings that go up drastically in price on the first day of trading.68 These allegations involved “spinning,” a practice where underwriters of a securities offering allocate shares in the offering to outside company executives or other individuals so these individuals can quickly sell the shares and make a profit. This is done by the underwriters to gain favor with these individuals in the hopes of receiving investment banking business from them in the future.69 Following Spitzer’s probe, the SEC Chairman stated that the SEC would be addressing the issues of allocation and spinning of “hot” IPOs in the months following.70

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63. Karmel, *supra* note 7, at 519 (describing the “resurgence of state securities regulators”).

64. Press Release, *supra* note 62. Under the agreement, Merrill Lynch agreed to disclose on equity research reports any compensation it will receive from the covered company, a disclaimer that Merrill is seeking to do investment banking business with the covered company, separate research analyst compensation from investment banking business generated, establish a Research Recommendations Committee which will monitor equity research recommendations and approve research analyst involvement in the solicitation of investment banking business, among other provisions. Merrill also agreed to pay $100 million—$48 million to the New York State Department of Law, $50 million to the remaining 49 states and $2 million to the North American Securities Administrators Association. *Agreement Between the Attorney General of the State of New York and Merrill Lynch, Pierce, Fenner & Smith, Inc.*, dated May 21, 2002, available at http://www.oag.state.ny.us/investors/merrill_agreement.pdf (last visited Sept. 30, 2004).


66. Id. The Securities Division of the Arizona Corporations Commission filed a complaint against Andersen for issuing a clean unqualified audit opinion for the Baptist Foundation of Arizona after warning signs of financial fraud and information from a former employee about the financial fraud perpetrated by Baptist Foundation management. *Complaint and Application for Injunctive and Other Relief, State of Arizona v. Arthur Andersen, L.L.P.*, available at http://www.ccsd.cc.state.az.us/hot_topics/BFA/jan19-01.pdf (last visited Sept. 30, 2004). Andersen did not make extensive attempts to determine if the allegations were true, but simply accepted the limited information it got from management and issued the unqualified opinion. *Id.* There is also evidence that Andersen modified its papers to hide knowledge of the fraud, misleading the Board of Directors of the Baptist Foundation and the investing public. *Id.*


70. *Id.* The firms involved in the research settlement agreed to end this practice in part, but SEC Chairman
Another recent instance of state securities regulators conducting their own investigations into securities violations has created a very contentious situation between Spitzer and the SEC. On September 3, 2003, Spitzer announced that he had launched a probe into the mutual fund practices of late trading and market timing. Late trading is a practice where some investors are allowed to place orders to buy or sell shares in a mutual fund after the market close, where these orders are executed at the 4 p.m. market close price. Market timing is a practice where investors make trades in a fund on a daily basis, much more rapidly than the typical mutual fund investor. While market timing is legal, most funds discourage it because it increases transaction costs for all investors and may make it more difficult to manage the fund effectively, thereby lowering returns for all investors.

Spitzer initiated the investigation even though the SEC has been discussing greater oversight of the mutual fund industry for a long time and has done nothing.

After Spitzer began his investigation, the SEC started paying closer attention to the mutual fund industry as well. Spitzer spoke out against the SEC for not taking quicker action: “This has been an outrageous betrayal of the public trust by that agency. The regulators who were supposed to be watching this industry were asleep at the switch. And I’m going to pull that switch.” Spitzer will most likely push for several changes to be made at mutual fund companies, including requiring fund-board chairmen that are independent from the mutual fund management companies and prohibiting money managers from charging mutual funds higher fees for managing their portfolios than large institutional investors, as well as possible restitution by the mutual fund companies to investors.

After being behind Spitzer again in the investigation of mutual funds, the SEC, whose officials “privately admit . . . [it] dropped the ball,” is also calling for reforms, such as a 4 p.m. deadline for share orders to reach the fund companies. The SEC and the state of Massachusetts have brought civil charges against Putnam Investments, and the U.S. Attorney for the Southern District of New York has subpoenaed Putnam for documents. The head of Putnam quit his job over the controversy, and a new chief

William Donaldson stated that he considered this a “temporary solution to the problem of spinning . . . we will explore addressing these issues with revised or new rulemaking.”

72. Id.
73. Id.
74. Id.
75. Id.
77. Id. Most fund-management companies charge mutual-fund investors a higher advisory fee rate than institutional investors such as pension funds. Id. In fact, Spitzer, at a Senate Hearing in November of 2003, stated that Putnam Investments charged mutual-fund investors, which are mostly smaller investors, 40% more than large institutional investors, resulting in the mutual fund investors paying $290 million more in fees at their rate than if they would have been charged the lower rate. Christopher Oster & Tom Lauricella, Mutual Funds Defend Their Greenest Turf, WALL ST. J., Dec. 5, 2003, at C1.
78. Lauricella et al., supra note 76.
79. Id.
executive has taken over.\textsuperscript{80} Strong Funds and Canary Partners have also been at the center of the controversy.\textsuperscript{81} The SEC is now considering implementing new rules and trying to stay ahead of the problems in the industry by reviewing its inspection and compliance procedures.\textsuperscript{82} New York Attorney General Spitzer and the SEC have implicated many more firms in the mutual fund scandal, including Bank of America, Charles Schwab, Franklin Templeton, Invesco, Janus, Merrill Lynch, Morgan Stanley, Massachusetts Financial Services, Prudential Securities, Putnam Investments, and Smith Barney.\textsuperscript{83}

III. H.R. 2179: THE SECURITIES FRAUD DETERRENCE AND INVESTOR RESTITUTION ACT OF 2003

\textit{A. Substance of the Bill and Amendments}

The latest Congressional attempt to increase the power of federal securities regulators comes in the form of a bill introduced in the House Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises in the spring of 2003. Representative Richard Baker, a Republican from Louisiana, introduced the Securities Fraud Deterrence and Investor Restitution Act of 2003\textsuperscript{84} on May 21, 2003. One provision of this bill would prohibit the states from making securities regulations that are more stringent than federal securities regulation or add different requirements than do the federal securities regulations in several areas. Congressman Baker noted two purposes to the bill: returning money to investors and strengthening the SEC for more effective regulation and enforcement.\textsuperscript{85}

The bill covers various aspects of the SEC’s activities. The original provisions of H.R. 2719 included: amending the Sarbanes-Oxley Act of 2002\textsuperscript{86} to allow the SEC to collect judgments even when assets are protected by a state’s homestead statutes,\textsuperscript{87} giving the SEC authority to impose damages in cease-and-desist proceedings,\textsuperscript{88} and increasing the maximum money penalties the SEC can impose.\textsuperscript{89} The bill also would


\textsuperscript{81} Kadlec, supra note 71 (describing New York Attorney General Spitzer’s investigation into a multitude of companies, including Strong Funds and Canary Partners).

\textsuperscript{82} Lauricella et al., supra note 76 (describing the SEC’s consideration of various rules in response to the mutual fund scandal, including one that would require that fund companies employ a compliance officer and state their market timing policies in fund prospectuses).

\textsuperscript{83} Stephanie D. Smith, Scandals at a Glance, MONEY, Feb. 1, 2004, at 65.

\textsuperscript{84} H.R. 2179, 108th Cong. (2003).


\textsuperscript{87} H.R. 2179 § 2. A homestead statute is a law exempting a homestead, defined as “the house, outbuildings, and adjoining land owned and occupied by a person or family as a residence,” from “execution or judicial sale from debt . . . .” BLACK’S LAW DICTIONARY 323 (2d Pocket ed. 2001).

\textsuperscript{88} H.R. 2179 § 3.

\textsuperscript{89} Id.
The provision most relevant to this analysis is Section 8(c), entitled Civil Penalties and Disgorgement Funds in Actions Brought by States. This section requires that if any State:

[E]stablishes, as a result of an agreement of judgment obtained by such State . . . any requirements for brokers or dealers . . . relating to capital, custody, margin, financial responsibility, recordkeeping, bonding, or financial or operational reporting or disclosure that differ from or are in addition to the requirements . . . established under the securities laws . . . or by the Commission or by any national securities exchange . . . the amount of such penalty or disgorgement shall be remitted to the Commission . . . .

This list of matters over which states are not allowed to set new rules is the same as the list included in the National Securities Market Improvement Act, with the addition of disclosure. The House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises offered several amendments at a hearing on the bill on July 10, 2003. The Subcommittee approved an amendment that changed mandatory disgorgement of funds by the states to the federal regulators to voluntary disgorgement, but completely prohibited states from making additional regulations. This amendment provided that:

[N]o law, rule, regulation, judgment, agreement or order . . . of any State . . . shall establish capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting, disclosure or conflict of interest requirements . . . for broker, dealers . . . that differ from, or are in addition to, the requirements in those areas established by the Commission or by any national securities exchange or other self-regulatory organization. The Commission shall consult periodically with the securities commissions . . . of the States concerning the adequacy of such requirements . . . .

The amendment offered by Representative Baker added “conflict of interest”

90. Id.
91. Id. § 5.
93. Id. § 7.
94. Id. § 8(c).
95. Id. (emphasis added).
requirements to the original bill as a subject where federal law would expressly preempt state law, prohibiting states from entering into settlement agreements which would change or add to federal requirements in this area. This amendment would have added two new subjects of federal preemption—disclosure and conflict of interest—to the list of those areas of securities regulation included under the National Market Securities Improvement Act.99 The addition of conflict of interest and disclosure was very timely, considering the states, led by Eliot Spitzer of New York, had just led the way in an investigation and settlement with major investment banks concerning the conflict of interest of research analysts at investment banks, the resolution of which requires disclosure of much more information on the research reports than previously.100 As previously noted, Spitzer specifically stated that the agreement “substantially outstrips any current requirements or mandated reforms.”101 Baker’s amendment preserved the right of the states to pursue and enforce fraud actions.102 It also modified the disgorgement provision in the original bill to allow states to contribute money from settlement payments to an SEC fund, created to make payments to investors, on a voluntary basis, instead of requiring it.103 States would be allowed to keep any settlement money or fines if they so chose.

Several other amendments to the bill also passed in this hearing, including one that requires the SEC to review the most recent financial reports of the 250 largest issuers submitted to the SEC104 and two that granted five million dollars from a recent settlement as grants to non-profit investor education programs.105 The bill was approved by the House Financial Services Capital Markets Subcommittee on July 10, 2003,106 and was forwarded by the subcommittee to the full House Financial Services Committee as amended in the July 10 hearing.107 However, the vote on the bill was postponed until September 2003.108 In February of 2004, it was considered and amended again, and reported and referred on April 27, 2004 to the House Committee on the Judiciary. In June 2004, the Committee on the Judiciary discharged and it was placed on the Union calendar.

99. See supra text accompanying note 55.
100. See supra note 63 and accompanying text.
101. Id.
103. Id.
B. Analysis of Arguments For and Against H.R. 2179

As the bill stood in 2003, which included the preemption provision, there were parties who supported the bill and parties who opposed it. In general, the SEC supports it, as do several House Republicans. 109 It is, of course, opposed by state securities regulators, including New York Attorney General Spitzer, congressional Democrats, and various citizens’ groups including the American Association for Retired Persons. 110

Much of the bill enjoys fairly widespread support. 111 House members testified against the bill based on their opposition to the original provision providing for mandatory release of settlement money by the states if they set different regulations. Ranking Democratic Member Kanjorski noted that the legislation adopted many of the “meritorious” recommendations of the SEC that the SEC felt were necessary to enhance its abilities, including increased access to information and larger fines. 112 Representative William Lacy Clay also supported much of the bill, especially the increased access for the SEC to grand jury information, but did not approve of the preemption of state homestead laws. 113 Even the North American Securities Administrators Association (NASAA), an organization composed of state securities regulators, approved of many of the provisions of H.R. 2179 of 2003. 114 The NASAA supported giving the SEC the authority to impose civil monetary penalties in cease and desist proceedings, to increase the maximum fines the SEC is allowed to impose, and giving the SEC authority to obtain financial records from a financial institution without the requirement of informing the customer. 115 NASAA did not support the provision in the original bill that required states to remit monetary penalties to the federal government. 116 The NASAA also opposed the amended version of the bill absolutely prohibiting the states from setting any requirements in a settlement that are different from or in addition to national regulations. 117

This Note focuses on the most controversial provisions in the bill. One is the original section 8(c), which, as previously stated, required a state to give up monetary penalties received as a result of an enforcement action if, as part of the settlement, the

110. Id.
111. See infra notes 112-115 and accompanying text.
114. Testimony of Christine A. Bruenn, supra note 56.
115. Id.
116. Id.
117. See NASAA Letter to the House Financial Services Committee Regarding H.R. 2179, July 22, 2003, (stating the NASAA’s opposition to the amended version of the bill based on the expansion of areas of preemption which “cuts directly into the daily regulatory and enforcement activities of the state securities offices in your states... [and] would hurt investor protection initiatives in the future”), available at http://nasaa.org/nasaa SCRIPTS/FU_DISPLAY_LIST.ASP?PTID=23 (last visited Sept. 27, 2004).
State prescribed other requirements to the perpetrator that either differed from or exceeded the federal requirements made by statute or the SEC.\textsuperscript{118} Also, the Baker Amendment to the bill, which was approved, is possibly even more controversial, because even though it makes remittance of penalties to the federal government optional, it absolutely prohibits the states from making any agreements in a settlement that would increase or differ from federal regulations.\textsuperscript{119} For the most part, the arguments presented in this Note specifically address the original disgorgement provision of the bill because many of them relate to testimony that was given before the bill was amended. Most of the arguments against the original disgorgement provision would also apply to the amended preemption version because it was an even greater reduction of state regulatory powers.

There are very strong arguments to be made both for and against the provision of the bill in question. In support of the bill, there is arguably a need for uniform securities law throughout the country. When states can set different standards in settlements for participants in the securities market, a difficult situation can occur. There is concern about the “Balkanization” of securities regulation, where states pursue prosecutions against various players and each can set different standards for these players to meet.\textsuperscript{120} This process could lead to different rules in many states, making it much more difficult for participants in the market, such as investment banks, to conduct business. The SEC should also be the preeminent securities regulator as it was established to be, while the country should not have “50 state regulators coming up with remedies.”\textsuperscript{121}

This bill also does not require that the states give up enforcement. Although Baker’s amendment to H.R. 2179 prohibited states from making any law, rule or agreement regarding “capital, custody . . . financial or operational reporting, disclosure, or conflict of interest requirements . . . that differ from, or are in addition to, the requirements in those areas established by the Commission [or other federal body],”\textsuperscript{122} it continued to state specifically that “a State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit in connection with securities or securities transactions.”\textsuperscript{123} States remain free to pursue securities violators, but are not free to fashion a remedy that involves requirements different from or greater than federal requirements. In the words of the proponent of the amendment, “He [Spitzer] can prosecute, he can find them guilty, he can fine them and New York can keep the money. All the bill says is that if he is going to affect market practice, the SEC must be in the room.”\textsuperscript{124}

However, it is conceivable that this bill might reduce the incentives for states to pursue securities violations vigorously, thereby leading to decreased enforcement. By

\begin{itemize}
\item \textsuperscript{118} H.R. 2179, 108th Cong. (2003).
\item \textsuperscript{119} Amendment to H.R. 2179 offered by Mr. Baker, available at http://financialservices.house.gov/media/pdf/108cmhr2179am1p1.pdf (last visited Sept. 27, 2004). As previously noted, this amendment has been removed from the bill. See superscript note 98.
\item \textsuperscript{120} Amendment to H.R. 2179 offered by Mr. Baker, available at http://financialservices.house.gov/media/pdf/108cmhr2179am1p1.pdf (last visited Sept. 27, 2004).
\item \textsuperscript{121} Alan Murray, \textit{Political Capital: For the SEC Chief, Feud With Spitzer is No-Win Situation}, WALL ST. J., July 22, 2003, at A4.
\item \textsuperscript{123} Id. § (b)(1)(B).
\item \textsuperscript{124} Murray, superscript note 121.
\end{itemize}
restricting the remedies states are allowed to use in pursuing and settling securities actions, states will not be able to be as effective as they should be, and this could have a chilling effect on state regulators.125 States will be restricted in pursuing enforcement actions because they will not be able to impose the most effective remedy—a fine along with an agreement to change practices.126 Reduced regulation, if this is what occurs, is obviously not good for investors. It is always helpful to have “as many cops on the beat as possible,”127 and this measure could inhibit state regulators from protecting their citizens through “higher standards for the securities business in their state.”128

Another problem with the Baker Amendment was that it could lead to wasted resources. It does not deal with who would resolve a difference of opinion, should it occur, about whether the requirements of the bill had been met.129 It also was not clear what would happen if state and federal regulators pursue parallel actions and settlements, both of which go beyond current requirements of federal regulation.130

Taking any power away from the states might have reduced the overall effectiveness of securities regulation, considering the states have been the first movers on many recent scandals.131 The states have proven that they are very effective regulators. State and federal regulators have also worked together on recent investigations, including the mutual fund late trading interest investigation, thus negating the need to take power away from state regulators.132 This bill, if it did have a chilling effect on state regulators, would have simply reduced the number of regulators who were watching the markets, while the dual system is “having two sets of eyeballs” on regulatory issues, leading to more effective regulation.133

C. Should H.R. 2179 with the Preemption Amendment Have Been Passed as a Reaction to Recent Events in the Market?

It is difficult to determine if, overall, this bill would have been helpful or harmful to investors who want the most effective and widespread regulation of the securities markets possible. In support of the bill, the argument that the passage of H.R. 2179 and its provision that prohibits states from entering into agreements that add to federal regulations will have a “chilling” effect on regulators does not make much sense.134 State securities regulators should still have an incentive to do their jobs as effectively as possible even if they are not allowed to set new regulations without the SEC being involved in the process. The incentive should be that they are employed by the state to, in fact, regulate securities. Many of the state securities regulators are employed solely for

125. See generally Testimony of Christine A. Bruenn, supra note 56 (highlighting several potential regulatory problems associated with H.R. 2179).
126. See id.
128. Id.
129. Testimony of Christine A. Bruenn, supra note 56.
130. Id.
131. See supra notes 56-83 and accompanying text.
133. Countryman, supra note 109 (quoting Roy Green of the AARP).
134. See supra notes 122-128 and accompanying text.
that function. Employment by the state and responsibility to that state’s citizens should be enough incentive to do a job as effectively as possible. The National Market Securities Improvement Act also uses very similar language to that used in H.R. 2179 to expressly preempt state securities regulators, without including disclosure and conflict of interest, and it did not lead to state regulators being less willing to do their jobs effectively, as evidenced by all of the recent action by states in pursuing securities violations.

However, the SEC also has not shown that state regulation of securities has presented a problem in terms of how well federal regulators can do their jobs. It has not shown that state regulation can hurt it or the effectiveness of securities regulation in general. SEC Chairman William Donaldson thinks state regulators are out for political gain and their “jumping” on securities cases may “compromise federal investigations in progress” and also that “there shouldn’t be competition for glory . . . .” States have been the first movers in many recent cases of securities violations, so it is quite possible that they are actually pushing the SEC to be a better regulatory body. The SEC counts on state regulators to “clamp down in cases that fly under the SEC’s radar screen.”

Spitzer’s announcement of the investigation into mutual fund companies led the SEC to bring its own investigation, and Spitzer also began his own investigation of conflicts of interest between research analysts and investment bankers at the same institution and led the settlement process with investment banks. States have led the way in the regulation of the Internet in securities transactions and various issues with micro-cap securities. The SEC remains active, as evidenced by the number of enforcement actions it has brought in recent years; however, the most widespread recent scandals have been broken by state securities regulators. SEC officials have even privately admitted they “dropped the ball” on stopping some abuses. If Congress passed this legislation and the reduced incentive led to a chilling effect among state securities regulators who are less eager to uncover and pursue securities violations, the SEC would have had to become a more effective investigative body to uncover the violations which the states, not the SEC, have done recently.

Obviously, with all of the major scandals uncovered recently, something must be done to make sure that securities regulation in the United States is as strong as possible, because there are likely more scandals to be uncovered. An even bigger problem has been created by bickering between state and federal regulators, and Congress’ criticism of the SEC. Spitzer recently said about SEC Chairman Donaldson, who tepidly backed H.R. 2179: “He hasn’t read the bill properly . . . he doesn’t understand it, and it’s really too bad . . . the SEC, once again, unfortunately, is failing the investors. I see them kowtowing

135. According to the Testimony of Christine A. Bruenn, supra note 56, some state securities regulators are appointed, while others are career employees, but only five state securities regulators are under the jurisdiction of the Attorney General of that state, so they are not responsible, as is the Attorney General, for other matters within the state.
137. Id.
138. Id.
139. Lauricella et al., supra note 76; see also supra notes 62-64 and accompanying text.
140. See supra notes 57-60 and accompanying text.
141. See supra note 38 and accompanying text.
142. Lauricella et al., supra note 76.
to Capitol Hill, instead of standing up. They don’t have the guts to be independent.”

Spitzer also said, regarding H.R. 2179: “Proposing state preemption is particularly outrageous because federal regulators and the Congress failed to act against these well-known frauds. As a result, the states were forced to take the lead in achieving substantive reforms.”

He also stated that the SEC committed an “outrageous betrayal of the public trust” by not going after the mutual fund industry sooner.

Donaldson responded by saying Spitzer’s comments were “unproductive.”

Massachusetts Secretary of State William Galvin also blasted H.R. 2179 and the SEC by saying: “Massachusetts has proven its ability to protect investors . . . . We would hope that the federal government would not prevent that effort . . . . Given recent abuses, now is not the time to diminish enforcement.”

Congress is also taking shots at the SEC. At a congressional hearing in late October, Representative Paul Kanjorski, a Democrat, said that “it appears the federal regulator is not ahead of the game.”

Senator Joseph Lieberman said that the SEC was “far too late to the table in addressing these problems,” and Senator Susan Collins questioned “why the SEC . . . has failed to detect these practices, to impose appropriate restrictions on them or to penalize those who appear to be misusing investors’ money.”

Everyone on all sides of the issue seemed to have been using it for political gain. Representative Barney Frank, a Democrat from Massachusetts, argued that this bill was a Republican effort to help the investment banks and hurt investors:

This maneuver is further evidence of the hypocrisy in Republicans’ claim of their commitment to states’ rights. This Administration hasn’t protected investors . . . and now the Republican Congress, which last year was dragged kicking and screaming to pass a strong investor protection law, wants to stop the states from aggressively punishing corporate wrongdoing. If they have their way, there won’t be anything left to give back to investors.

Spitzer may also be using the publicity for political gain: it as been suggested he wanted to garner as much publicity as possible and force the SEC to take action and use its knowledge and resources while Spitzer got credit for bringing the scandal to light and for bringing the wrongdoers to justice.

The bickering between state and federal securities regulators, on top of all of the widespread scandals that have recently surfaced, must be hurting investor confidence.

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143. Murray, supra note 121.
145. Lauricella et al., supra note 76.
146. Id.
148. Lauricella et al., supra note 76.
150. Press Release, Frank and Galvin, supra note 147.
151. Lauricella et al., supra note 76.
Investors need to see either one strong regulator or a united front of regulators at all levels to give them confidence that it is safe to invest in the market. Investors need to be confident that regulators will uncover wrongdoing, punish the responsible parties, and deter others from committing wrongs.

IV. RECOMMENDATION

Something clearly needs to be done to resolve the feud between state and federal securities regulators. Even though many scandals have recently been uncovered under the current securities regulation environment, it would most likely be more effective if regulators’ time and attention was not focused on trying to gain more power at the expense of another group of regulators. It is also important to focus solely on the task at hand—regulating the markets—for the benefit of the investors who are placing their wealth in the market so they can feel confident in their investments.

There are several ways to address the issue: do nothing and hope it resolves itself either by one side conceding power to the other or by increased cooperation, pass a law making securities regulation solely in the realm of state power, pass a law making it only subject to federal power, or attempt to pass some compromise with a bill such as H.R. 2179 with the preemption amendment. Whether the compromise proposed by this particular bill is the most effective solution to the problem is an open question. However, it was prudent for the House to not implement H.R. 2179 at this time as it stood. There is pressure on legislators to act to combat the spate of scandals uncovered in the capital markets, but Congress should not have succumbed to the pressure to take action by passing this bill without ensuring that it was the most effective solution. At the same time, Congress should not entirely give in to state regulators by giving up on preemption completely until it is certain that is not the best way to regulate.

In his testimony in front of the House Subcommittee on Capital Markets about the original version of H.R. 2179, the Director of the Division of Enforcement of the SEC, Stephen Cutler, testified that more consideration of the bill should be undertaken. He testified that the original provision 8(c) in H.R. 2179, requiring the states to disgorge funds they received in settlements adding to federal regulations, should be studied to determine how it would “affect incentives to, and fiscal constraints on, states’ ability to pursue securities-related misconduct aggressively and vigorously.” The bill, as amended, might have had the same, or even a greater effect on the states’ incentives, because this provision was changed to completely forbid states from making settlements that differ from, or add to, federal requirements, although it might not financially affect the states in the same way.

Even though the preemption amendment was dropped, the best course of action would still be to gather more information about whether preempting state regulators in this drastic manner is the best way to solve the problem in the securities market.

153. See supra notes 97-98.
Legislators need to ensure that preemption will make securities regulation more effective by lessening conflicts between regulators and allowing firms to do business more proficiently because they only have to consider one set of rules, not less effective through the weakening of incentives for the states. This analysis should occur before the new bill without the preemption amendment is passed to ensure the legislation does not become law just so something is done about the major securities violations occurring in the market today.

V. CONCLUSION

In light of all of the recent scandals involving widespread securities violations by many of the major players in the markets, it would seem that something different must be done to prevent them from occurring in the first place. Recently, regulators seem to have become adept at discovering them, but inevitably, more scandals are yet to be uncovered. Various methods of regulation have been employed in the United States over time, starting with securities being regulated only at the level of the states and moving toward a dual regulatory system between the states and the federal regulation with the passage of major federal legislation in the 1930s.

H.R. 2719: The Securities Fraud Deterrence and Investor Restitution Act of 2003 attempted to shift the balance of power toward federal regulation by preempting state regulation in certain areas. There is not a clear cut answer as to whether this would have been an effective piece of legislation if passed, and both sides fought hard for their position. The parties opposing the bill gained an early victory, as the vote in the full House was first postponed until September. Then the most controversial amendment which provided for federal preemption was dropped, and the new version of the bill is still pending. In the meantime, more information should still be gathered to determine whether the new controversial bill will have less of a chilling effect on state regulators, and if the incentives in the bill are properly aligned so both federal and state regulators can do the most effective job possible. Most likely, if there is another bout of scandals that spark public outrage, federal preemption of state securities regulation will resurface. If this type of regulation ever becomes law, the question of whether it is an effective solution will be definitively answered.