DR. SPITZLOVE OR: HOW I LEARNED TO STOP WORRYING AND LOVE "BALKANIZATION"

Johnathan Mathiesen*

I. Introduction ... 312
II. "Balkanization" in Securities Law: Background Developments and Its Failure to Emerge ... 315
  A. Concurrent Federal and State Jurisdiction ... 315
  B. The Martin Act ... 316
  C. Spitzer vs. Merrill ... 318
  D. The Anti-Spitzer Amendment ... 323
  E. Further Proposals for Legislative Preemption ... 326
  F. Is There Any Evidence That "Balkanization" Has Yet Occurred? ... 327
  G. Why Has "Balkanization" Not Yet Occurred? ... 329
  H. The Wider Administrative Preemption Context 330
III. The Potential for SEC Administrative Preemption of "Balkanizing" State Measures ... 331
  A. Regulation MR—An SEC Response to Hypothetical "Balkanizing" State Action ... 331
  B. Regulation MR's Primary Obstacle: The "Savings Clauses" of the 1933 and 1934 Acts ... 334
  C. SEC Preemption Authority ... 336
    1. Congress Has Not Spoken Directly to Forbid This Rule ... 337
      a. Recent, Narrower Legislation Modifies Interpretation of Older, Broader Statutes ... 338

---

* J.D. Candidate 2007, Columbia University School of Law; M.A. International Relations 2000, Yale University; B.S. Foreign Service 1998, Georgetown University; Chartered Financial Analyst designation. The author wishes to thank Professor James Tierney for his guidance on this Note and the staff of the Columbia Business Law Review for editing assistance.

b. A Savings Clause Negates "Field" Preemption but Not "Conflict" Preemption 340
2. SEC's Construction of Section 11A is Reasonable and Permissible 343
a. "Jurisdictional" Nature of Agency Interpretation Does Not Preclude *Chevron* Deference 343
b. Agency Preemption of States Does Not Preclude Deference 345
c. Deference is Favored for Interpretations in Which an Agency Speaks with the Force of Law 346
d. Regulation MR is Consistent with Section 11A's Plain Language 347
e. Deference is Favored Where the Subject Matter is Technical and Dynamic 348
IV. Administrative Preemption: The Doomsday Device 349
A. Effect of Successful SEC Preemption—Net Loss of State Regulatory Prerogative 350
B. Success in Court of SEC Administrative Preemption is Not Certain 352
V. Conclusion 352

I. INTRODUCTION

The peoples of the Balkans have a right to be confused. Theirs is, of course, a troubled region, where the most delicate sprig of stability has germinated only recently from centuries of internecine strife. As citizens of the country that brokered tenuous peaces in Bosnia and Kosovo, should we in the United States not be speaking positively and encouraging harmony among the nations of the region? Instead, we continue to slur the very name of their peninsular home as our synonym for "contentious, destructive fractionalizing," as though conflict were simply expected of them, an immutable feature of the landscape like the snow atop Olympus or the waves lapping the wooded isles of the Croatian coast. Perhaps we might avoid these mixed messages with a little more sensitivity?

Recently, the term "balkanization" has arisen in the context of securities regulation, in reference to the wave of activism by select state attorneys general in prosecuting cases of securities fraud. As certain theorists argue, the creation and enforcement of securities market reforms devised by individual states will destroy the integrity of a single, efficient national market system. In its place would arise a variegated patchwork of different regimes, as occurred on the Balkan peninsula at different points in history. The cacophony of many different and possibly conflicting sets of rules would impose great compliance costs and inject uncertainty into the securities market. The efficiency loss would be tremendous.

In recent years, state attorneys general have indeed become more assertive in policing the securities industry and have been employing a remedial toolkit that transcends traditional state measures. Eliot Spitzer, the Attorney General of New York, launched this era in his April 2002 settlement with Merrill Lynch & Co. The settlement imposed restrictions on the interactions between the firm's investment banking and equity research divisions. It would be difficult, however, to argue that this settlement itself caused any "balkanizing" damage to the national market system, because the Securities and Exchange Commission ("SEC") ratified the April settlement terms in the Global Settlement of December 2002. Yet does not this activism by state attorneys general nevertheless create vast possibilities for "balkanization," by which inexpert state political entrepreneurs may wreck the uniform federal scheme with parochial reforms crafted only for their populist ring? Theorists who believe that "balkanization" presents a real and continuing threat advocate for congressional (*legislative*) preemption to avert it.

The theoretical arguments behind "balkanization" seem plausible. Yet four years have passed since Spitzer's initial settlement with Merrill. Not unlike killer bees from South America and the Y2K bug, "balkanization" has fallen grievously short of the hype. Thus, these political economy theories, which consider only the narrow political selfinterest of state attorneys general, are at best incomplete. Because "balkanization" has not occurred, there must exist countervailing dynamics that weigh against a progressive "balkanizing" trend and toward stability and comity in the federal-state regulatory relationship.

This Note proposes one such dynamic: State officials regulate securities in the shadow of *administrative* preemption by the SEC. Should a state attorney general take action deleterious to an efficient, integrated national securities market, the SEC can use its authority under Section 11A of the Securities Exchange Act of 1934 to promulgate a preemptive measure to void it. Academic literature has widely neglected this observation, likely because federal securities law contains "savings clauses" that appear to guard state prerogatives against any federal curtailment. This Note contends, however, that a state action serving to undermine an integrated, efficient national market actually *conflicts* with federal law, as stated by Congress and explicitly delegated to the SEC for further definition in Section 11A. A savings clause does not prevent "conflict" preemption, and hence, does not "save" efficiency-undermining state rules from invalidation by the SEC.

In Part II, this Note discusses the development of today's state activism in securities regulation. Part III details current federal-state preemption jurisprudence and argues that the SEC already possesses the authority to preempt market-disruptive state enforcement actions administratively. Given the existence of that authority, Part IV addresses the structural decision incentives operating on the SEC and state attorneys general. These forces include the deterrent nature of administrative preemption authority, the delicate equilibrium that results therefrom, and the way in which a legislative initiative to curb state action would undermine that equilibrium and do more harm than good to the investing public.

II. "BALKANIZATION" IN SECURITIES LAW: BACKGROUND DEVELOPMENTS AND ITS FAILURE TO EMERGE

Part II describes the background developments that gave rise to cries of regulatory "balkanization," including Eliot Spitzer's actions in the Merrill Lynch case and the abortive "anti-Spitzer amendment" proposed thereafter. Part II concludes by considering whether any evidence of the balkanization trend has emerged since 2002.

A. Concurrent Federal and State Jurisdiction

The roots of state securities legislation derive from "blue sky" laws passed early in the twentieth century, decades before the federal government passed the Securities Act of 1933[1] ("1933 Act") and the Securities Exchange Act of 1934[2] ("1934 Act"). By the turn of the last century, bogus securities schemes had proliferated so grossly that they were commonly recognized as having no more worth "than the blue sky above."[3] Blue sky laws were an early attempt to protect the investing public from these frauds by regulating the issue and trading of new securities. The first blue sky law was passed in 1911, and most states had enacted one by the time that the federal government entered the field of securities regulation in the wake of the 1929 Stock Market Crash.[4]

In the 1930's, the federal government entered the field of securities regulation, but did not *occupy* it to the exclusion of the states. Several savings clauses in the 1933 and 1934 Acts very specifically left the state blue sky laws intact. Over the years, Congress reduced the scope of state blue sky laws by expressly preempting particular areas of securities

---

[1] Codified at 15 U.S.C. § 77a *et seq.* (2000).

[2] Codified at 15 U.S.C. § 78a *et seq.* (2000).

[3] Robert A. McTamaney, *New York's Martin Act: Expanding Enforcement in an Era of Federal Securities Regulation*, LEGAL BACKGROUNDER (Wash. Legal Found., Washington, D.C.), Feb. 28, 2003, at 2.

[4] *Id.*

regulation. In 1996, the National Securities Markets Improvement Act deprived states of substantive regulation over securities registration and initial offers for sale,[5] thereby draining the blue sky laws of much of their remaining legal effect.[6] Yet even this sweeping measure explicitly preserved the authority of states "to investigate and bring enforcement actions with respect to fraud or deceit . . . in connection with securities or securities transactions."[7] Through sixty years and multiple adjustments by Congress of the federal-state regulatory relationship, states still possess the authority to prosecute and to seek appropriate redress for securities fraud that comes to their attention.

B. The Martin Act

In 1921, New York enacted its blue sky law, known as the Martin Act.[8] It permits the Attorney General to initiate civil or criminal charges against any person or corporation involved in the fraudulent sale of securities. Following the advent of federal securities regulation in the 1930s, the Martin Act lay rather dormant. The New York Attorney General initiated some actions in the 1970's against corrupt practices, but even these cases eventually proceeded to the SEC for corrective action.[9] During his first term as New York Attorney General, however, Eliot Spitzer revived the Martin Act from disuse.

The Martin Act affords extraordinary leverage as a prosecutorial weapon in part from its lack of a scienter requirement. Unlike a federal charge of securities fraud based on Rule 10b-5, the Martin Act requires no showing of an intent to defraud, nor proof of a willful and knowing violation of the law. As the New York Court of Appeals stated in noting the remedial nature of the statute, "fraud . .

[5] 15 U.S.C. § 77r (2000).

[6] McTamaney, *supra* note 3, at 3. *See* N.Y. GEN. BUS. LAW §§ 352-359h (McKinney 2005).

[7] 15 U.S.C. § 77r(c)(1) (2000).

[8] McTamaney, supra note 3, at 2.

[9] *Id.*

. should therefore be given a wide meaning, so as to include all acts, although not originating in any actual evil design or contrivance to perpetrate fraud or injury upon others, which do by their tendency to deceive or mislead the purchasing public come within the purpose of the law."[10]

The power of the Martin Act also lies in the profound range of action that it grants prosecutors, including costs that they may impose long before any trial on the merits or even formal filing of an action. Section 352 provides the Attorney General broad investigative authority whenever minimally "it shall appear" that there exists a past, current, or prospective "scheme or artifice to defraud, or for obtaining money or property by means of any false pretense"[11] associated with the sale of securities. In light of such evidence, the Attorney General may "require such . . . information as he may deem relevant and may make such special and independent investigations as he may deem necessary in connection with the matter."[12] Section 354 permits the Attorney General to apply to a trial court to conduct a public hearing, even before he has formally brought an action.[13] In addition to granting the public hearing, a trial judge may issue any injunction considered appropriate.[14] The powers detailed in Section 354, granted *ex parte*, are extremely broad. As Justice Cardozo (then sitting on the New York Court of Appeals) noted, the Martin Act effectively grants a pretrial public examination of witnesses "almost on mere request."[15]

Perhaps the Martin Act's *coup de grace* is Section 352-c, which provides for criminal penalties.[16] Anyone who intentionally engages in conduct to defraud ten or more people, or in so doing wrongfully obtains property in excess

[10] People v. Federated Radio Corp., 244 N.Y. 33, 39 (N.Y. 1926).

[11] N.Y. GEN. BUS. LAW § 352(1) (McKinney 2005).

[12] *Id.*

[13] N.Y. GEN BUS. LAW § 354 (McKinney 2005).

[14] *Id.*

[15] Ottinger v. Civil Serv. Comm'n, 148 N.E. 627, 628 (N.Y. 1925).

[16] N.Y. GEN. BUS. LAW § 352-c (McKinney 2005).

of $250 in value, "shall be guilty of a class E felony."[17] At no point did Spitzer consider criminal charges against Merrill Lynch or his other targets of investigation for securities fraud. Indeed, Spitzer disagreed with the decision of federal authorities to press criminal charges against accounting firm Arthur Andersen, which utterly imploded as a consequence.[18] Spitzer sought structural reform of widespread fraudulent practices at Merrill Lynch, not a Roman legionary-style decimation that would punish a few arbitrarily-selected individuals and serve as a cautionary example to the rest. Regardless, Spitzer's mere authority to bring such charges likely encouraged Merrill Lynch's compliance with his investigation.

C. Spitzer vs. Merrill

As the year 2000 concluded and the stock market's unprecedented boom of the 1990's ended, the continued "buy" and "strong buy" recommendations of Wall Street equity analysts sounded noticeably dissonant with the changed times. The persistence of such overly optimistic recommendations attracted the attention of Eric Dinallo, the head of the ten-person Investor Protection Bureau of the New York Office of the Attorney General. He proposed to his boss, Eliot Spitzer, that the Bureau focus on "abuses by investment advisors" as a high-priority agenda item in the coming year.[19] Spitzer agreed.

To trigger the Attorney General's powers, the Martin Act first requires a showing of a "scheme or artifice to defraud" in connection with the sale of securities.[20] The civil complaint of Debases Kanjilal supplied that basis. Kanjilal was a private individual who claimed to have lost $500,000 following the investment advice of Henry Blodget, a star internet stock analyst at Merrill Lynch. He initially bought

[17] *Id.*

[18] Peter Elkind, *Satan or Savior*, FORTUNE, Nov. 28, 2005, at 86.

[19] John Cassidy, *The Investigation: How Eliot Spitzer Humbled Wall Street*, THE NEW YORKER, Apr. 7, 2003, at 54.

[20] N.Y. GEN. BUS. LAW § 352 (McKinney 2005).

stock of Infospace at $122 per share. As the stock began its precipitous descent to less than $10 per share, Kanjilal considered selling. Yet his Merrill Lynch broker, who was part of a retail sales force tens of thousands strong that relied heavily on recommendations by analysts like Blodget, persuaded him to keep holding Infospace, based on Blodget's still-positive public outlook on the stock.[21] Kanjilal's lawyer alleged that conflict tainted Blodget's analytical independence, as Infospace was seeking to acquire Go2Net, a Merrill investment banking client.[22] Though the fraud case against Merrill was still far from complete, the Attorney General's office had enough evidence to launch an investigation. In April 2001, the office subpoenaed all documentation from Merrill that concerned initial public offerings (IPOs), stock recommendations, and compensation for research analysts like Blodget.[23]

Emails sent by Merrill Lynch's research department, retained pursuant to SEC requirements, yielded the most damaging evidence. They revealed that Blodget and his colleagues privately referred to individual equities, for which they publicly maintained "buy" recommendations, as a "dog," "powder keg," and "piece of junk."[24] To state a colorable fraud case, however, Spitzer's office needed to demonstrate that the research division's duplicity represented part of a coordinated effort with the investment banking department to maximize investment banking revenue at the expense of a trusting investor public.

A subset of the revealing emails provided significant evidence of such coordination. In one, Blodget asked a colleague why her published assessment of Internet Capital Group did not emphasize the extraordinary risk of the company, whose stock had fallen from $212 to $15 in ten months. She responded, "We wanted to protect icg's banking business."[25] In another, a self-conscious Blodget expressed

---

[21] Cassidy, *supra* note 19, at 54.

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.*

concern about his looking ever more ridiculous for not downgrading stocks now in free-fall. He threatened to "just start calling the stocks . . . like we see them, no matter what the ancillary business consequences" (presumably what an equity analyst *should* be doing), unless the director of the research division received some guidance from higher management about reconciling the needs of the investment banking department with banking clients' deteriorating financial positions.[26] Blodget and his colleagues effectively had admitted to adjusting their supposedly independent analyses, on which many thousands of retail brokers and individual investors relied, to the requirements of Merrill's investment banking department.

By March 2002, Spitzer's office felt that enough evidence existed to sustain a fraud case. Merrill made an initial attempt to settle, but the terms—which included complete confidentiality—proved unacceptable to the Attorney General. Spitzer sought structural reform to eliminate a corrupt practice that permeated the whole industry.[27] Thus, Spitzer decided to invoke Section 354 of the Martin Act, which permitted him to seek an order for a public hearing *ex parte*.[28]

When the order was granted on April 8, 2002, Spitzer issued a press release recounting the "shocking betrayal of trust by one of Wall Street's most trusted names."[29] After Merrill's market value fell $5 billion the following week, the firm's management and its board felt that they had no choice but to settle. Merrill accepted a $100 million fine, along with comprehensive structural reforms to separate its investment banking and research departments.[30]

[26] *Id.*

[27] *Id.*

[28] N.Y. GEN. BUS. LAW. § 354 (McKinney 2005).

[29] Press Release, Office of the New York State Attorney General, Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interest (Apr. 8, 2002), *available at* www.oag.state.ny.us/press/2002/apr/apr08b_02.html.

[30] Cassidy, *supra* note 19, at 54.

Critics have excoriated Spitzer for using the Martin Act to leverage the prospect of negative publicity and to force a target company to settle in advance of any trial on the merits. Spitzer repeated this tactic most recently in forcing a settlement on insurance giant Marsh & McLennan for bid-rigging. Thomas Donohue, the president of the U.S. Chamber of Commerce, famously has referred to Spitzer as "judge, jury, and executioner."[31] American Enterprise Institute scholar Michael Greve refers to Spitzer's maneuvers as "government by indictment."[32] In response, Spitzer's defenders note that what he and other state officials have uncovered has been "good old-fashioned lying, cheating, and stealing"[33] and that he has not "drilled a dry hole yet."[34]

In the meantime, Spitzer's Merrill investigation took national securities regulators by surprise.[35] The SEC, the New York Stock Exchange, and the National Association of Securities Dealers ("NASD") quickly launched their own inquiries into research analyst conflicts. Law enforcement officials in many other states jumped on board as well, and several attorneys general launched investigations against the major Wall Street banks. As a result, many banks faced concurrent state and federal investigations.[36] The task of examining the investment bank Salomon Smith Barney fell to Spitzer and his New York team. The investigation revealed star telecom analyst Jack Grubman's cynical manipulations of his own covered companies' ratings, both in the service of the investment banking department and to support Citigroup CEO Sanford Weill during a period of

---

[31] Elkind, *supra* note 18, at 86.

[32] Barrie McKenna, *Corporate America Declares War on 'Spitzerism,'* GLOBE AND MAIL, May 27, 2005, at B8.

[33] Tim Reason, *Corporate Wrong-Doers Finding State Cops More Aggressive*, CFO MAGAZINE, Feb. 2, 2004, at 1 (quoting former Colorado state official Phil Feigin).

[34] *Id.* (quoting former Massachusetts Attorney General Scott Harshbarger).

[35] Cassidy, *supra* note 19, at 54.

[36] *Id.*

corporate infighting. Most infamously, Grubman apparently altered his rating of AT&T in exchange for Weill's help in securing his children's admission into a prestigious preschool.[37]

Contrary to talk of regulatory "balkanization," the denouement of the analyst conflict-of-interest scandal was notable for the close coordination between state and federal officials. SEC Chairman Harvey Pitt may have resented what he perceived as Spitzer's politicization of securities litigation, but ultimately, SEC Enforcement Chief Stephen Cutler and NYSE chairman Dick Grasso convinced Pitt that their interests aligned with Spitzer's.[38] In September 2002, Spitzer, Pitt, and a few others sat down to dinner and agreed in principle to coordinate their investigations and to join in a single comprehensive settlement. Spitzer was enthusiastic at this prospect; he knew that structural reform would prove easier to achieve by collaborating with federal regulators, rather than relying solely on the limited manpower and expertise of the Attorney General's office.[39]

The regulators agreed on the contours of a comprehensive settlement at another dinner meeting in October 2002 and fleshed out its details in the following months. At first, Spitzer sought a complete separation between research analysts and the investment banking departments, to the extreme of requiring banks to spin off their research divisions as separate companies. But he backed away from this proposal when his SEC counterparts convinced him of its economic impracticality.[40] Though Spitzer dropped the idea quickly, commentators who would like to see state power curbed still frequently bring up this abortive proposal to warn of imminent "balkanization."[41]

---

[37] *Id.*

[38] Charles Gasparino, *The Stock Research Pact: How Settlement Train Was Kept on Track*, WALL ST. J., Dec. 23, 2002, at C1.

[39] Cassidy, *supra* note 19, at 54.

[40] Gasparino, *supra* note 38, at C1.

[41] John C. Coffee, *Competitive Federalism: The Rise of the State Attorney General*, N.Y. L. J., Sept. 18, 2003, at 5.

In December 2002, the regulators announced the preliminary terms of the so-called "Global Settlement" with ten Wall Street banks.[42] The settlement required the insulation of research from investment banking divisions and prohibited equity analysts from participating in investment banking road shows.[43] The regulators also banned "spinning" stock to CEOs of potential banking clients, at the insistence of Spitzer, who considered the practice to be tantamount to bribery. "Spinning" refers to the practice of allocating blocks of underpriced, and therefore, oversubscribed IPO shares. "Flipping" such stocks on the general market subsequently can yield a quick arbitrage profit. The settlement also required banks to contract with independent firms to supply research to brokerage customers for a five-year period. The ten major banks that acceded to the settlement paid a total of $875 million in fines, with Salomon Smith Barney alone disgorging $400 million.[44]

Spitzer and his peers certainly did not halt investigation of the financial services industry with the analyst conflict-of-interest scandal. Indeed, as Professor John Coffee noted, Spitzer boasts a *Tigerwoodsian* string of successes in uncovering egregious frauds on the investing public, including late-trading by mutual funds.[45] Yet the analyst conflict scandal sufficiently illustrates the themes relevant to this Note: the tremendous power of the Martin Act and certain other state blue-sky laws, with initial investigation by state officials who beat federal regulators to the punch, and subsequent coordination with federal officials in fashioning remedies.

D. The Anti-Spitzer Amendment

Spitzer's activism caused concern among some observers of securities regulation. After Spitzer struck his initial

---

[42] Cassidy, *supra* note 19, at 54.

[43] *Id.*

[44] HAL S. SCOTT, INTERNATIONAL FINANCE 45 (12th ed. 2005).

[45] Coffee, *supra* note 41, at 5.

settlement with Merrill, Representative Michael Oxley, the chairman of the House Committee on Financial Services, opined in the *New York Times*:

> What we are witnessing is nothing less than a regulatory coup that would usurp the proper role of the S.E.C. and the self-regulatory organizations. This could result in a disastrous balkanization of oversight, meaning that every Wall Street firm would have to cut its private deal with every state attorney general or face the potential threat of fraud charges.[46]

SEC Chairman William Donaldson (successor to Harvey Pitt) expressed a similar sentiment: "What's at issue is the remedy, and the remedy, I believe is the responsibility of the Securities and Exchange Commission . . . . I do not believe that we can have fifty state regulators coming up with remedies."[47]

Meanwhile, several other states, having noticed the success with which Spitzer employed New York's powerful Martin Act, have taken steps to expand the securities law enforcement power vested in their own attorneys general.[48] Among his last acts, outgoing California Governor Gray Davis in 2003 signed a securities regulation bill into law that arguably confers more power on the California Attorney General than even the Martin Act does upon the New York Attorney General.[49]

In this atmosphere, concern over the prospect of "balkanization" crystallized into an amendment to H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act of 2003. Republican Representative Richard

---

[46] Michael G. Oxley, *Who Should Police the Financial Markets?*, N.Y. TIMES, June 9, 2002, at 11.

[47] Alan Murray, *For the SEC Chief, Feud With Spitzer is No-Win Situation*, WALL ST. J., July 22, 2003, at A4.

[48] Reason, *supra* note 33, at 1.

[49] Nicholas Campins, *A New Paradigm for Securities Regulation in California: Senate Bill 434 and Its Implications* (2004) (unpublished student note), *available at* http://www.law.columbia.edu/center_program/ag/AG_Library (discussing the new California securities law).

Baker of Louisiana sponsored the measure, affectionately known as the "anti-Spitzer amendment."[50] As a point of background, several years earlier the National Securities Market Improvement Act of 1996 had expressly preempted any state law or requirement concerning "capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers [and] dealers . . . that differ from, or are in addition to, the requirements in those areas established under this chapter."[51]

The "anti-Spitzer amendment" would have inserted "disclosure" and "conflict of interest" into this catalog of legislatively-preempted state requirements. Had it been in place at the time, such "conflict of interest" preemption would have prevented Spitzer from enforcing his settlement with Merrill. And as Professor Coffee explains, the "disclosure requirements" preemption is probably broad enough to foreclose any state action on mutual fund late-trading,[52] as well as many other yet-unknown fraudulent practices that may come to the attention of a state attorney general in the future.

Congress' attempt to preempt the enforcement efforts of state attorneys general ignited a storm of protest. The "anti-Spitzer amendment" was derided as "an industry-sponsored bill"[53] pushed by lobbyists for Wall Street behemoths who had grown comfortable with Harvey Pitt's "kinder, gentler" SEC.[54] Given Spitzer's visibility and the place of corporate misdeeds at the forefront of public consciousness, few elected officials could afford politically to back an "anti-Spitzer

[50] Jaret Seiberg, *Spitzer Again Outpoints SEC*, DAILY DEAL, Feb. 27, 2004, at A1.

[51] 15 U.S.C. §78o(h)(1) (2000).

[52] Coffee, *supra* note 41, at 5.

[53] Reason, *supra* note 33, at 1 (quoting Ralph Lambiase, president of the North American Securities Administrators Association).

[54] Jeffrey H. Birnbaum, *The SEC Embraces a Kinder, Gentler Pitt*, FORTUNE, Dec. 9, 2002, at 39 (referring to Pitt's call at his confirmation hearing for a "kinder, gentler SEC").

amendment." Thus, Oxley dropped the measure from H.R. 2179 in February 2004.

E. Further Proposals for Legislative Preemption

While the corpse of the "anti-Spitzer" amendment was still warm, further proposals for legislative preemption by Congress began emanating from legal academia. Professor Coffee proposed a draft statute that would have given the SEC standing in federal court to seek an injunction for state actions that "threatened in the commission's reasonable judgment to unduly burden, hamper or impede the national market system," as specified in Section 11A of the 1934 Act.[55] As Professor Coffee explains, this reform would prevent private parties from raising spurious claims of preemption against state enforcers, for it would only grant standing to sue to the SEC.

Several law student notes also propose various legislative preemption measures. Steve Radom suggests a limited preemption statute by which amendment of the savings clause in Section 18 of the 1933 Act would preserve states' fraud-policing powers, to the extent that state law would not contain a lower evidentiary standard, and that the federal government would not have already launched an investigation.[56] Christopher Lane discusses congressional legislation that would compel the states to notify federal authorities before launching any enforcement action.[57] Mindy Olson counsels caution and continued factfinding, yet like the other policy proposals, with the ultimate goal of fashioning an optimal congressional preemption statute.[58]

---

[55] Coffee, *supra* note 41, at 5.

[56] Steve A. Radom, Note, *Balkanization of Securities Regulation: The Case for Federal Preemption*, 39 TEX. J. BUS. L. 295, 322 (2003).

[57] Christopher R. Lane, Note, *Halting the March Toward Preemption: Resolving Conflicts Between State and Federal Securities Regulators*, 39 NEW ENG. L. REV. 317, 344-45 (2005).

[58] Mindy Olson, Note, *The Securities Fraud Deterrence and Investor Restitution Act: More Effective Than Current Regulation?*, 30 J. CORP. L. 425, 442-43 (2005).

All of these proposals, however, neglect to recognize the same critical obstacle that felled Representative Baker's bill. The prevailing political climate nationwide remains extremely unfavorable to any legislation branded "anti-Spitzer." For the foreseeable future, legislative preemption by the democratically elected Congress will continue to be politically nonviable. But in contrast to the Congress, a federal administrative agency maintains a much lower profile in the public eye. Thus, *administrative* preemption remains politically possible. As Part III below contends, it is also legally possible.

F. Is There Any Evidence That "Balkanization" Has Yet Occurred?

Nearly four years have passed since Spitzer struck his initial settlement with Merrill in April of 2002, launching this era of state activism. If balkanization is anything more than an abstract hypothesis, there should be some evidence of a balkanization trend since 2002. Otherwise, Spitzer's critics have overstated the potential for regulatory conflict between the SEC and state attorneys general. Before investigating this proposition, it is necessary to define exactly which phenomena constitute balkanization, and which do not.

Balkanization does not include ordinary competitive tension. Certainly the relationship between the SEC and Eliot Spitzer has not always been warm, as when Spitzer publicly accused the SEC of being "asleep at the switch."[59] Staff morale at the SEC suffered so severely after Spitzer beat the agency to several punches that the SEC sought a staff psychologist to boost agency morale.[60] Nonetheless, bruised egos and sore feelings among regulatory competitors, while unfortunate, must not be confused with actual market-destructive "balkanization."

---

[59] Cassidy, *supra* note 19, at 54.

[60] *SEC Seeks Shrink to Help With Stress*, GLOBE AND MAIL, May 29, 2004, at B2.

Balkanization also does not cover traditional state measures in policing securities fraud. Critics of state attorney general activism singled out Oklahoma Attorney General Drew Edmondson, who filed criminal charges against WorldCom executives based on the harm caused to Oklahoma investors, though WorldCom had no other connection to the state. SEC Chairman Donaldson cited concerns about the "politicization" of enforcement,[61] while others complained that prosecuting defendants in Oklahoma might interfere with their availability as witnesses in federal cases. Despite these contentions, it is difficult to argue that Edmondson's suit resulted in regulatory "balkanization." Indeed, to avoid interfering with any federal trials, Edmondson temporarily suspended his charges.[62] Clearly, logistical coordination poses no great obstacle to consecutive federal and state cases. As former SEC chairman Arthur Levitt quipped, if corporate leaders "want to commit a crime in [fifty] damn jurisdictions . . . they should answer to law enforcement in all those jurisdictions."[63] In response to Edmondson's detractors, others maintain that he merely sought to impose traditional state penalties for a traditional state law crime. For these reasons, Edmondson's actions against WorldCom do not represent any clear evidence of "balkanization."

Rather, "balkanization" refers to state officials' choices to overstep the boundaries of traditional punishments for state securities fraud, such as damages, fines, and criminal liability for guilty parties. Actual balkanization would see state attorneys general attempting to restructure the securities market with "reforms" that would in reality prove deleterious to the integrity and efficiency of a national market system.

Evidence of any such balkanization is underwhelming. To quote Representative Barney Frank of Massachusetts, "I have asked and asked and asked, and no one at the SEC, on

[61] Reason, *supra* note 33, at 1.

[62] *Id.* The charges were later dismissed altogether.

[63] *Id.*

the majority side or anywhere else, has given me an example of where a state regulator has taken action that interfered with our ability to have a uniform, sensible national scheme."[64] One may point to a number of policy junctures that presented a clear opportunity for balkanization to materialize, yet it did not. For instance, instead of forcing his own ideas about a proper market structure on Wall Street, Eliot Spitzer closely coordinated with the SEC in restructuring the finance industry to redress analyst conflicts of interest. As mentioned above, when the SEC criticized one of Spitzer's proposals as impractical, he dropped it.

Perhaps the best evidence for any balkanization is Spitzer's settlement with Alliance Capital in the mutual fund late-trading scandal. Spitzer extracted a temporary commitment for lower fund management fees after the SEC had stated explicitly that a fee reduction was inappropriate.[65] A state-federal policy difference over the mode of compensation for defrauded investors hardly represents a serious blow to an integrated national market system.

G. Why Has "Balkanization" Not Yet Occurred?

The idea of regulatory balkanization is intellectually appealing, as the vast majority of state attorneys general are popularly elected officials. By taking on corporate fraudsters for their contempt for the small investor, a state attorney general stands to inflate his or her public profile exponentially. Critics of activist state officials contend that, given these narrow political incentives, some attorneys general eventually will overstep the appropriate authority of the office and impose a raft of ill-considered and inefficient "reforms" on the national securities market.

Yet if "balkanization" has *not* yet occurred, despite incentives for political haymaking, one must ask why. Some argue that temporary self-restraint on the part of attorneys

---

[64] *Representative Oxley Holds Markup of Pending Legislation: Hearing Before the House Fin. Serv. Comm.*, 108th Cong. 2d Sess. (2004).

[65] Reason, *supra* Note 33, at 1.

general explains this result, but contend that balkanization remains a real threat, absent some manner of congressional legislative preemption to curtail it.[66]

This argument is incorrect, however. No transient discretionary self-restraint among state officials has prevented balkanization. Rather, a *structural* restraint operates: If state officials were to exceed their regulatory authority by taking measures that would significantly burden the national market system, then they would subject themselves to the strong possibility of *administrative* preemption by the SEC. Part III that follows examines the SEC's legal basis for preemption.

H. The Wider Administrative Preemption Context

Some may object that the idea of an unelected agency shutting down the efforts of a popular state official does not pass a "smell test": All statutory interpretive contrivances aside, such a scenario is simply too undemocratic to be allowed to occur. In response, it should be noted that in the wider regulatory context, federal agencies have recently been ambitious and successful in administratively preempting popular state regulatory efforts. The October 2005 monthly newsletter of the Columbia University State Attorneys General Program details two fights raging over agency preemption of state officials. With strong encouragement by the telemarketing industry lobby, the Federal Communications Commission has now taken under advisement the possibility of preempting the extremely popular "do-not-call" programs in individual states.[67]

As another example, the Office of the Comptroller of the Currency ("OCC") recently ruled that state officials cannot exercise visitational powers and thus cannot enforce state

[66] *See generally* Radom, *supra* note 56.

[67] Mark Hamblett, *Judge Halts N.Y. AG Probe of Loan Discrimination by Banks*, NEWSLETTER (Nat'l State Attorneys Gen. Program, Colum. Univ.), Oct. 14, 2005.

law at federally-chartered banks.[68] The District Court in the Southern District of New York upheld the OCC's broad interpretation of its enabling statute under the *Chevron* standard.[69] Like Merrill Lynch, federally-chartered banks had become targets of Eliot Spitzer's unprecedented scrutiny concerning their compliance with New York's anti-discriminatory lending laws, and the OCC looked to its enabling legislation for a way to bar the door to him.

There are many other recent examples of industry-sponsored federal preemption efforts. Thus, the thesis of this Note—namely that the SEC possesses the authority to preempt state regulators administratively—cannot be dismissed solely from a gut reaction to the supposed undemocratic nature of the measure. The discussion that follows takes place in a wider regulatory environment in which unelected federal agencies have in fact been ambitious and successful in preempting popular state programs.

III. THE POTENTIAL FOR SEC ADMINISTRATIVE PREEMPTION OF "BALKANIZING" STATE MEASURES

Part III briefly discusses what an actual market-disruptive or "balkanizing" state regulatory action might look like, and then it posits a hypothetical preemptive response by the SEC. At first glance, the savings clauses of the 1933 and 1934 Acts seem to present a daunting legal hurdle to such preemption. Yet, application of current law can overcome this apparent obstacle.

A. Regulation MR—An SEC Response to Hypothetical "Balkanizing" State Action

This Note maintains that state regulators have not yet undertaken market-disruptive actions; no balkanization of

[68] Chris Conkey, *State AGs Fight to Preserve Jurisdiction in Light of Federal Inaction on Do Not Call Enforcement*, NEWSLETTER (Nat'l State Attorneys Gen. Program, Colum. Univ.), Oct. 14, 2005.

[69] OCC v. Spitzer, 396 F. Supp.2d 383 (S.D.N.Y. 2005). See *infra* Part III.C for a more detailed discussion of the *Chevron* decision.

the securities market has yet occurred, nor will it. Rather, a market-disruptive action by a state attorney general would provoke administrative preemption by the SEC. That prospect will continue to deter state officials from taking damaging actions.

Consider the possible results of actual balkanization via a hypothetical. A state attorney general may uncover egregious violations of "soft dollar" payment regulations among brokerage firms.[70] While traditional state penalties could punish fraudulent behavior, the state official could instead attempt wholesale reform of the brokerage industry by imposing market-restructuring standards of business conduct, as Eliot Spitzer did. However, unlike the reforms that Spitzer insisted on receiving from Merrill as a condition of settlement, the hypothetical state official could impose an actual balkanizing rule that undermines market efficiency. For instance, he could prohibit altogether the practice of brokers doing business in his state supplying research directly to clients. Such a measure would take care of "soft dollar" abuses, but it would also have wider and potentially more destructive effects. This "reform" would effectively require brokerages to spin off their research divisions into separate companies. Because many of these companies would not be viable standing alone, this measure would contract the total supply of research generated and impose significant inefficiencies on the national securities market. Further, the measure would inhibit competition for brokerage services. Some brokers include research as a component of a premium brokerage product, while others focus on cheap bare-bones execution. The hypothetical state market "reform" would completely destroy this form of competition through product design.

[70] Soft dollar payments are rebates that brokers provide to large traders, such as investment managers, for channeling their trades to the broker. The investment manager, however, has a fiduciary duty to seek the best trade execution for his clients and not to let "kickbacks" influence his decision. Thus, soft dollar payments are permissible only if the rebate is spent wholly in the service of the client, often for purchasing research. Yet, the potential for abuse is substantial.

The SEC would not stand by idly. In response, it could look to its enabling legislation for a solution. Section 11A of the Securities Exchange Act of 1934, entitled "National Market System for Securities," provides:

> The Congress finds that . . . it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure—(i) economically efficient execution of securities transactions; [and] (ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets.[71]

Further, "The Commission is directed . . . to use its authority . . . to carry out [these] objectives."[72] That authority consists, in part, of a delegation of rulemaking power to

> (E) assure that all . . . brokers, and dealers transmit and direct orders for the purchase or sale of qualified securities in a manner consistent with the establishment and operation of a national market system, and
> (F) assure equal regulation of all markets for qualified securities and all exchange members, brokers, and dealers effecting transactions in such securities[73]

in furtherance of the chapter's purposes, which, as stated above, include fostering efficiency through competition.

Pursuant to this rulemaking authority, SEC officials could draft a new regulation to deal with the state regulator's pernicious market-restructuring measure. A hypothetical regulation, which this Note will term "MR" (for Market Restructuring), could read as follows:

> When a state authority shall enact a law or impose a regulation, in a legal settlement or otherwise, that would have the effect of restructuring the rules

[71] 15 U.S.C. § 78k-1(a)(1)(C)(2000).

[72] 15 U.S.C. § 78k-1(a)(2)(2000).

[73] 15 U.S.C. § 78k-1(c)(1)(2000).

> governing transacting in the national market system, as defined in Section 11A, by brokers and dealers of qualified securities, and thus could be detrimental to system efficiency, through inhibition of competition, information generation, or otherwise, that law or rule is without effect unless approved by the SEC as consistent with the continued efficient operation of a national market system.

The regulation clearly has a prophylactic component: While its target is those state-imposed rules that would actually undermine market efficiency, Regulation MR would preempt *any* market-restructuring state rule, including any well-considered and common sense reform. Some prophylaxis is necessary and inevitable. The efficiency impact of any state-originated market "reform" can be expensive or impossible to assess *ex ante*, thus Regulation MR must cast a wide net to promote administrability. Regulation MR thus employs a readily identifiable–if imperfect–surrogate for economic impact by its applicability to all state market restructuring attempts.

B. Regulation MR's Primary Obstacle: The "Savings Clauses" of the 1933 and 1934 Acts

Despite Regulation MR's ability to preserve market efficiency, those who object to it might argue that it violates the "savings clauses" in the 1933 and 1934 Acts. These savings clauses express Congress's intent to uphold state authority in the area of securities regulation, and thus, function to "save" state powers from implied federal preemption. Section 16(a) of the 1933 Act reads:

> Remedies Additional—Except as provided in subsection (b) [which concerns class actions], the rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist at law or in equity.
>
> Preservation of State Jurisdiction—The securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under

> the laws of such State to investigate and bring enforcement actions.[74]

Section 18(c)(1) of the 1933 Act, entitled "Preservation of Authority," provides:

> Fraud Authority—Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.[75]

Section 28(a) of the 1934 Act, entitled "Effect on Existing Law," also discusses preservation of the securities regulation prerogative of the states:

> Addition of Rights and Remedies—Except as provided in subsection (f) [which concerns class actions] of this section, the rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity . . . . Except as otherwise specifically provided in this chapter, 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.[76]

Regulation MR's opponents would argue that the savings clauses clearly evidence congressional intent to preserve the powers of state attorneys general to redress securities fraud.

Indeed, some writers believe that the savings clauses completely foreclose the possibility of administrative preemption through a Regulation MR-type measure. Steve Radom asserts that only Congress can preempt state action: "The SEC cannot merely issue a rule that would preempt

[74] 15 U.S.C. § 77p (2000).

[75] 15 U.S.C. § 77r(c)(1) (2000).

[76] 15 U.S.C. § 78bb (2000).

state law. Courts have long held that the rules and regulations of the SEC . . . have no statutory authority to preempt [state securities laws]."[77] Similarly, Christopher Lane has concluded that "[t]hrough these 'savings' clauses it is evident that Congress envisioned a dual system of regulation and did not intend to preempt state securities enforcement authority."[78]

Nonetheless, accepted rules of statutory interpretation should lead courts to transcend the isolated verbiage of the savings clauses and uphold a Regulation MR-type preemption. First, newer, more specific statutes (notably the 1975 Amendment to Section 11A) modify judicial construction of older, broader statutes (like the 1930's-era savings clauses). Second, although savings clauses disclaim any intent by Congress to effect "field" preemption, they do not prevent "conflict" preemption. Because the hypothetical scenario involves an alleged *conflict* between state power and the language of Section 11A rather than *field* preemption, the savings clauses should not foreclose federal administrative preemption in the form of Regulation MR.

C. SEC Preemption Authority

One should evaluate the permissibility of hypothetical Regulation MR under the framework that the Supreme Court laid out in *Chevron USA, Inc. v. Natural Resources Defense Council*.[79] Courts have long accorded federal agencies different degrees of deference in interpreting their enabling statutes in light of their relative expertise, procedural sufficiency, and positional persuasiveness.[80] The *Chevron* court, however, specified that courts should afford agencies an especially obliging deference where a statute is silent or ambiguous on a matter and where Congress has implicitly delegated to the agency the responsibility of filling

[77] Radom, *supra* note 56, at 320.

[78] Lane, *supra* note 57, at 325.

[79] Chevron USA, Inc. v. Natural Res. Def. Council, 467 U.S. 837 (1984).

[80] United States v. Mead Corp., 533 U.S. 218, 228 (2001).

the gaps in the rules. As restated by a later court, *Chevron* deference is appropriate where "it is apparent in the agency's generally conferred authority and other statutory circumstances that Congress would expect the agency to be able to speak with the force of law when it . . . fills a space in the enacted law, even one about which Congress did not actually have an intent."[81] In such a case, only two questions confront a reviewing court: whether Congress has already spoken directly on the issue, and if not, whether the agency's construction is permissible.[82] If these requirements are met, the agency's interpretation must stand; a court cannot substitute its own interpretation of a statute when Congress has implicitly delegated interpretive authority to the administrative agency.[83]

1. Congress Has Not Spoken Directly to Forbid This Rule

In the first prong of the *Chevron* framework, a court must determine whether Congress has spoken clearly to resolve the precise question of administrative authority at hand. If it has, then the judicial inquiry ends because an agency cannot derogate from Congress' expressed statutory intent.[84] If not, and if the relevant federal statute is silent or ambiguous on the question, then analysis proceeds to the second *Chevron* prong. When courts consider whether Congress has "spoken directly," they are not confined solely to the text of the statute in isolation. In *FDA v. Brown & Williamson Tobacco, Inc.*, for example, the Supreme Court held that Congress had "spoken directly" to forbid FDA jurisdiction over tobacco products, not because of a direct statement, but because a separate regulatory regime for tobacco products already existed.[85]

---

[81] *Id.* at 229.

[82] *Chevron*, 467 U.S. at 843.

[83] *Id.* at 844.

[84] *Id.* at 842-43.

[85] FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 143 (2000).

In analyzing hypothetical Regulation MR, the first *Chevron* prong yields three possible answers: First, Congress has spoken directly to *prohibit* a rule like Regulation MR; second, Congress' language is ambiguous; or third, Congress has spoken directly to *permit* Regulation MR. The third response would immediately terminate analysis in the SEC's favor, but this Note conservatively assumes away that possibility, leaving only the first and second possibilities. If Congress has *not* directly forbidden the rule, then the first prong of the *Chevron* test does not foreclose Regulation MR. Thus, it is necessary only to examine and to eliminate the first possibility, at which point the inquiry proceeds to the second *Chevron* prong.

Indeed, the opponents of SEC administrative preemption would claim that the savings clauses constitute direct statements of congressional intent to forbid any abridgment of state authority by the SEC, with Regulation MR or otherwise. It is, however, a "fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme."[86] In keeping with this well-established tradition of statutory construction, the savings clauses cannot represent intent by Congress to preserve state enforcement actions that conflict with federal law.

a. Recent, Narrower Legislation Modifies Interpretation of Older, Broader Statutes

In a conflict between competing federal statutes, whereby one is broad and expressed in much earlier legislation, and the second is more recent and specific enough to leave much of the first statute intact, the more recent and specific statute controls the interpretation of the older, broader statute. As Justice O'Connor stated,

> The 'classic judicial task of reconciling many laws enacted over time, and getting them to make sense in combination, necessarily assumes that the implications of a statute may be altered by the

[86] Davis v. Mich. Dep't of Treasury, 489 U.S. 803, 809 (1989).

> implications of a later statute.' This is particularly so where the scope of the earlier statute is broad, but the subsequent statutes more specifically address the topic at hand.[87]

Justice Stevens put it even more succinctly: "A specific policy embodied in a later federal statute should control our construction of the [earlier] statute, even though it ha[s] not been expressly amended."[88]

In the case of Regulation MR, the competing federal policies include a congressional intent to preserve state fraud enforcement authority as expressed in the savings clauses on one hand, and a purpose to maintain an efficiently integrated national market system on the other. The savings clauses, enacted in the 1930's, broadly safeguard "any and all other rights and remedies that may exist at law or in equity" and provide that "nothing in this chapter shall affect the jurisdiction of the [state] securities commission."[89] Much later, in 1975, Congress expressed a desire to exploit the economic benefits of a national market system that recent technological advances had made possible. Upholding the validity of Regulation MR would vindicate the more modern congressional policy, while preserving the broad authority of states to prosecute securities fraud, subject only to the narrow and specific limitation that states could not freely take action to restructure the national market system without the participation of the SEC.

In response, challengers to Regulation MR could note that one savings clause, which provides that the "State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer,"[90] was enacted as part of the National Securities Market Improvement Act ("NSMIA") in 1996, over twenty years after adoption of the national market system legislation in 1975.

[87] *Brown & Williamson*, 529 U.S. at 143 (internal citations omitted).

[88] United States v. Estate of Romani, 523 U.S. 517, 530-31 (1998).

[89] 15 U.S.C. § 78bb(a) (2000).

[90] 15 U.S.C. § 77r(c)(1) (2000).

However, this concern is likely insufficient to defeat Regulation MR. Despite the relative youth of the NSMIA savings clause, the collision between state anti-fraud enforcement prerogatives and an integrated national market system has originated more recently with activism by Eliot Spitzer and other state attorneys general. A 1996 federal law cannot represent a congressional statement of intent bearing on a controversy that would arise several years later.

b. A Savings Clause Negates "Field" Preemption but Not "Conflict" Preemption

A savings clause plays a particular role in the machinery of federal preemption by exerting a legal effect that is not readily apparent when such language is viewed in isolation. The congressional intent that courts read into savings clauses depends intensely on the *type* of preemption at issue, whether express preemption, field preemption, or conflict preemption.

By *express preemption*, "Congress has manifested its intent to preempt state law explicitly in the language of the statute"[91] and has specifically removed a set of actions from the prerogative of state authorities. Indeed, the 1933 and 1934 Acts contain many instances of express preemption. For example, Section 18 of the 1933 Act expressly preempts state registration requirements for securities offerings. Therefore, opponents of Regulation MR could argue that, because Congress has specifically delineated such areas of express preemption, then it must have specifically intended *not* to preempt all other facets of securities regulation and enforcement. In fact, the Supreme Court rejected this reasoning in *Freightliner Corp. v. Myrick* in holding that the existence of express preemption in one area of a statute "does not mean that the express clause entirely forecloses any possibility of implied pre-emption" over other matters.[92]

[91] Hughes v. Attorney Gen. of Fla., 377 F.3d 1258, 1265 (11th Cir. 2004).

[92] Freightliner Corp. v. Myrick, 514 U.S. 280, 288 (1995).

Unlike express preemption, *field preemption* is not stated directly but implied. Courts infer "field" preemption where federal regulation is "so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it, or where an Act of Congress touches a field in which the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject."[93] Congress specifically disclaimed any intent to displace state securities regulatory power via "field" preemption: The savings clauses presume the continued existence of state authority. Yet while the savings clauses prevent "field"-type preemption, they do not serve to legitimize specific state actions that conflict directly with federal law.

Whenever federal and state laws collide, "state law is preempted to the extent that it actually conflicts with federal law."[94] Also an implicit type of preemption, *conflict preemption* operates where state law "stands as an obstacle to the accomplishment of the full purpose and objectives of Congress."[95] A state attorney general's attempt to impose onerous and disruptive rules on the national securities market would obstruct Congress' expressed purpose to maintain the system's integrity and efficiency, and therefore, would conflict with federal law.

While the savings clauses in federal legislation negate any potential for "field" preemption, they do not similarly prevent *conflict* preemption. As the Supreme Court stated in *Geier v. American Honda Motor Co.* in resolving the meaning of the National Traffic and Motor Vehicle Safety Act, "[w]e now conclude that the saving clause . . . does *not* bar the ordinary working of conflict pre-emption principles."[96]

The Supreme Court construes savings clauses narrowly in the face of conflicting state law, for if a federal savings clause actually saved contrary, conflicting state law, that federal

---

[93] English v. Gen. Elec. Co., 496 U.S. 72, 79 (1990) (citing Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947)).

[94] *English*, 496 U.S. at 79.

[95] *Id.*

[96] 529 U.S. 861, 869 (2000).

law would "defeat its own objectives, or potentially . . . destroy itself."[97] In determining the scope of the relevant savings clause in *Geier*, the court examined it for positive evidence of a congressional "intent to save state-law tort actions that conflict with federal regulations."[98] Finding none, the Court ruled that the savings clause did not preserve a conflicting state law.[99]

The result is the same when *Geier's* reasoning is applied to hypothetical Regulation MR. To interpret a statute to be self-undermining, a rather implausible reading, a court would have to find very specific language stating that Congress *intended* such a reading. As one might expect, there is no specific textual evidence in the 1933 and 1934 Acts that Congress intended for these laws to defeat themselves, just as none was found in *Geier*. Thus, courts cannot interpret these statutes to preserve state laws that run contrary to them.

The Supreme Court in *Geier* also indicated its strong preference for an interpretation that would not render a savings clause totally ineffectual. For example, if a given federal vehicular regulation was only intended to provide a minimum safety level, the NTMVSA savings clause would still protect state legislation that instituted a more stringent safety standard.[100]

Likewise, a court could rule the hypothetical Regulation MR valid without nullifying the savings clauses of the 1933 and 1934 Acts, which would still function to preserve a broad scope of traditional state securities fraud enforcement measures. Only if state attorneys general attempted to impose new operating rules on the market would their actions fall outside the savings clauses' expansive protection.

Because Congress has not spoken directly to forbid Regulation MR, analysis of its validity may proceed to the second prong of the *Chevron* framework, which considers

---

[97] *Id.* at 872 (internal quotations omitted).

[98] *Id.* at 869.

[99] *Id.*

[100] *Id.* at 870.

whether the agency's interpretation of the applicable enabling statute is reasonable[101] and permissible,[102] as defined under federal case law.

2. SEC's Construction of Section 11A is Reasonable and Permissible

a. "Jurisdictional" Nature of Agency Interpretation Does Not Preclude *Chevron* Deference

Opponents could portray hypothetical Regulation MR as an SEC "jurisdictional grab": an attempt to assert sole authority in a regulatory domain to which state officials previously had access. The opponents would argue that courts should not defer to an administrative agency's construction of the limits of its own power. Indeed, the Supreme Court has indicated a discomfort with unrestrained deference to an agency's interpretation of its own regulatory boundaries. Writing for the Supreme Court in *FDA v. Brown & Williamson Tobacco Corp.*, Justice O'Connor opined that "in extraordinary cases, there may be reason to hesitate before concluding that Congress has intended such an implicit delegation"[103] of jurisdictional interpretation to an agency. In *Mississippi Power & Light Co. v. Mississippi* ex rel. *Moore*, Justice Brennan argued against deference on a jurisdictional question. As he wrote in his dissent, "Our agency deference cases have always been limited to statutes the agency was entrusted to administer . . . . Agencies do not 'administer' statutes confining the scope of their jurisdiction, and such statutes are not 'entrusted' to agencies."[104]

On the other hand, there is also language emanating from the Court stating the opposite principle, namely that it

[101] Holly Farms Corp. v. NLRB, 517 U.S. 392, 398 (1996).

[102] FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 132 (2000).

[103] *Id.* at 159.

[104] Miss. Power & Light Co. v. Mississippi, 487 U.S. 354, 386-87 (1988).

should review an agency's jurisdictional interpretations according to the same standards that it would apply to the agency's construction of any statutory provision. In *NLRB v. City Disposal Systems*, a case that technically antedated *Chevron*, the Court observed:

> Respondent argues that because the . . . clause . . . is essentially a jurisdictional or legal question concerning the coverage of the Act, we need not defer to the expertise of the Board [an administrative agency] . . . . We have never, however, held that such an exception exists to the normal standard of review of Board interpretations.[105]

Similarly, Justice Scalia's concurrence in *Mississippi Power & Light Co.* identified "settled law that the rule of deference applies even to an agency's interpretation of its own statutory authority or jurisdiction."[106] As he continued,

> there is no discernible line between an agency's exceeding its authority and an agency exceeding authorized application of its authority. To exceed authorized application is to exceed authority. And deference is appropriate because it is consistent with the general rationale for deference: Congress would naturally expect that the agency would be responsible, within broad limits, for resolving ambiguities in its statutory authority or jurisdiction.[107]

According to Justice Scalia, the question of whether an agency has exceeded its congressionally-conferred authority is the same in any case that turns upon agency interpretation of a statute.

Most tellingly, courts *have* in fact given *Chevron* deference to agency interpretations with regard to jurisdictional questions, as in *Mississippi Power & Light*[108]

---

[105] NLRB v. City Disposal Sys., 465 U.S. 822, 830 (1984) (internal quotations omitted).

[106] *Miss. Power & Light*, 487 U.S. at 381.

[107] Id. at 381-82.

[108] Id. at 355.

and in *Commodity Futures Trading Commission v. Schor.*[109] In *Schor*, the CFTC interpreted its enabling statute to grant jurisdiction over state law counterclaims.

> The Court of Appeals was incorrect to state that . . . the CFTC's expertise was not deserving of deference because of the 'statutory-interpretation jurisdictional' nature of the question at issue. An agency's expertise is superior to that of a court when a dispute centers on whether a particular regulation is "reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes" of the Act the agency is charged with enforcing; the agency's position, in such circumstances, is therefore due substantial deference.[110]

b. Agency Preemption of States Does Not Preclude Deference

Further, Regulation MR's opponents may argue that mere federal technocrats should not possess authority to preempt the regulatory prerogatives of sovereign states. However, like Congress, an agency may do so if it is "acting within the scope of its congressionally-delegated authority."[111]

The Supreme Court explicitly acknowledged the ability of administrative agencies to preempt state law in *Medtronic, Inc. v. Lohr.*[112] In that case, the Court held that Food and Drug Administration ("FDA") regulations did *not* preempt the plaintiff's state law claims, primarily because the FDA *itself* argued that there was no preemption. Yet the Court acknowledged that the FDA did possess the authority necessary to preempt, if it so chose:

> Congress has given the FDA a unique role in determining the scope of § 360k's pre-emptive effect. Unlike [many other instances], pre-emption under the [Medical Device Amendments] does not arise

[109] 478 U.S. 833 (1986).

[110] *Id.* at 845.

[111] La. Pub. Serv. Comm'n. v. FCC, 476 U.S. 355, 369 (1986).

[112] 518 U.S. 470 (1996).

> directly as a result of the enactment of the statute; rather . . . a state law will be pre-empted only to the extent that the FDA has promulgated a relevant federal requirement. Because the FDA is the federal agency to which Congress has delegated its authority to implement the provisions of the Act, the agency is uniquely qualified to determine whether a particular form of state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.[113]

In *Medtronic*, Congress' language in Section 360k did not preempt state law directly but established a sort of preemption "potential energy." In particular, Section 360k stated, "no State or political subdivision of a State may establish . . . any [medical device] requirement . . . which is different from, or in addition to, any [safety or effectiveness] requirement applicable under this chapter."[114] But the FDA retained responsibility for defining those requirements. Thus, Congress itself created, and the Supreme Court approved, a scheme involving an inchoate preemptive "potential energy" which only an agency could actualize.

Congress also created a similar preemption "potential energy" in Section 11A, which recognized how unlimited state regulatory prerogative could conflict with the regulatory needs of an integrated national market system. However, Congress did not precisely define those needs (and thus the scope of the conflict) in Section 11A. Rather, Congress charged the expert SEC with assessing the regulatory needs of a national securities market, making the relevant rules, and actualizing potential conflict preemption where necessary.

c. Deference is Favored for Interpretations in Which an Agency Speaks with the Force of Law

The Supreme Court held in *United States v. Mead Corp.* that judicial deference to an agency's interpretation of an

---

[113] *Id.* at 495-96.

[114] 21 U.S.C. § 360k(a) (2000).

implicit statutory gap is necessary where it is "apparent from the agency's generally conferred authority . . . that Congress would expect the agency to be able to speak with the force of law"[115] on the matter. To identify this congressional expectation, the Court "[has] recognized a very good indicator of delegation . . . in express Congressional authorizations to engage in the process of rulemaking."[116] Similarly, "Congress empowered the [CFTC] 'to make and promulgate such rules and regulation as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of [the Commodity Exchange Act].'"[117] In contrast, a mere agency opinion letter, as opposed to notice-and-comment rulemaking, does not carry the force of law.[118]

Pursuant to Section 11A, the SEC is responsible for prescribing rules for a national market system for securities. "No [securities market participant shall violate] such rules and regulations as the Commission shall prescribe as necessary . . . to assure equal regulation of all markets [and market participants]."[119] Accordingly, hypothetical Regulation MR is targeted to "assure equal regulation" and to protect the national securities market from parochial state-imposed rules. Regulation MR is perfectly consonant with an explicit delegation of rulemaking authority by Congress, and its decisions under that authority deserve deference.

d. Regulation MR is Consistent with Section 11A's Plain Language

An agency's statutory interpretation "may not be disturbed as an abuse of discretion if it reflects a plausible construction of the plain language of the statute."[120] Section

[115] United States v. Mead Corp., 533 U.S. 218, 229 (2001).

[116] *Id.* at 229.

[117] CFTC v. Schor, 478 U.S. 833, 842 (1986).

[118] Christensen v. Harris County, 529 U.S. 576, 587 (2000).

[119] 15 U.S.C. §78k-1(c)(1)(F) (2000).

[120] Rust v. Sullivan, 500 U.S. 173, 184 (1991).

11A of the 1934 Act directs the SEC to "use its authority under [the section] to [establish] a national market system for securities . . . and to carry out the objectives,"[121] including "economically efficient execution of securities transactions" and "fair competition among brokers and dealers."[122] Specifically, the SEC may promulgate rules to ensure that transactions are conducted "in a manner consistent with the . . . operation of a national market system" and to ensure "equal regulation of . . . all brokers and dealers."[123]

Hypothetical Regulation MR is consistent with the express congressional purposes of efficiency, fair competition, and equal regulation in a national securities market. These purposes require a prohibition on the imposition of market-restructuring actions by state attorneys general. Thus, Regulation MR faithfully implements Congress' charge in Section 11A.

e. Deference is Favored Where the Subject Matter is Technical and Dynamic

As *Chevron* acknowledged, "the principle of deference to administrative interpretations has been consistently followed by this Court whenever . . . a full understanding of the force of the statutory policy in the given situation has depended upon more than ordinary knowledge respecting the matters subjected to agency regulations."[124] An agency's "expertise is superior to that of a court when a dispute centers on whether a particular regulation is 'reasonably necessary . . . to accomplish any of the purposes' of the Act the agency is charged with enforcing."[125]

The SEC bears responsibility for drafting, administering, and enforcing a highly complex raft of regulations. This body of rules includes those already promulgated under Section

---

[121] 15 U.S.C. §78k-1(a)(2) (2000).

[122] 15 U.S.C. §78k-1(a)(1)(C) (2000).

[123] 15 U.S.C. §78k-1(c)(1) (2000).

[124] Chevron USA, Inc. v. Natural Res. Def. Council, 467 U.S. 837, 844 (1984).

[125] CFTC v. Schor, 478 U.S. 833, 845 (1986).

11A in support of a national market system, such as Regulation NMS, which arose as the product of thorough consideration of potentially conflicting policy goals to optimally serve the investing public. In a recent notice of additional proposed rulemaking, the SEC discussed some of these contrasting goals, including promotion of the most vigorous competition for individual customer orders, as served by centralization and uniformity, as opposed to the need to foster competition among different markets via *de*centralization.[126] Despite the SEC's best efforts to reconcile these policy aims, well-intentioned judicial intrusions into policymaking for the national market system might upset delicate policy balances. The highly complex nature of securities law favors deference to the SEC's construction of its complex statutory provisions.

In conclusion, Part III has outlined the argument that the SEC can preempt disruptive market restructuring initiatives by state officials. The shadow of administrative preemption constitutes an effective deterrent to balkanization, notwithstanding the savings clauses in the 1933 and 1934 Acts. Despite the language of those clauses, a state's attempt to impose idiosyncratic rules that disrupt the national market system would directly conflict with federal law as declared by Congress in Section 11A. Furthermore, a hypothetical preemption measure like Regulation MR can constitute a reasonable and permissible interpretation of the legislation that enables the regulatory authority of the SEC.

IV. ADMINISTRATIVE PREEMPTION: THE DOOMSDAY DEVICE

Part II noted the absence of empirical evidence for any securities market balkanization caused by activist state attorneys general, while Part III argued that the SEC already possesses the authority to preempt balkanizing state actions that significantly burden the national market system. Part IV proposes a model that uses the proposition established in Part III to help explain the contention from

[126] Joint Industry Plans, 70 Fed. Reg. 37495, 37499 (June 29, 2005).

Part II. The actual success in court of a Regulation MR-type preemptive measure bears some uncertainty. On the one hand, activist attorneys general would not desire to provoke the SEC to promulgate a rule like Regulation MR, while on the other, the risk of failure could deter the SEC from attempting preemption unless its hand is forced. Thus, a measure like Regulation MR constitutes a sort of a "nuclear option," a button that neither the SEC nor the states would like to press unless absolutely necessary. The current stability of the federal-state regulatory relationship in securities regulation, which features greater-than-traditional activism by state attorneys general but no pernicious balkanization, represents a state of equilibrium that Congress should not disrupt legislatively.

A. Effect of Successful SEC Preemption—Net Loss of State Regulatory Prerogative

Figure 1 - Before Administrative Preemption

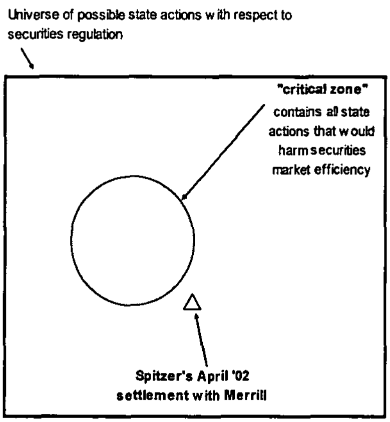
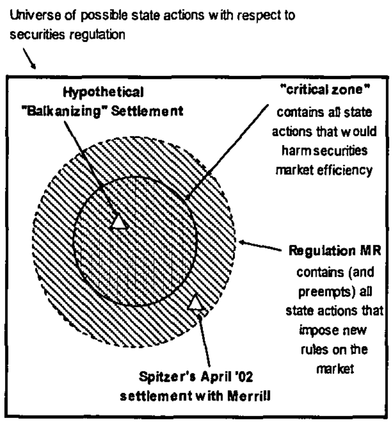


Figure 2 - After Administrative Preemption



Consider a highly abstract representation of the range of possible state securities fraud enforcement actions, as depicted in Figures 1 and 2. Let a rectangle represent the unconstrained universe of securities regulatory actions that a state could possibly undertake, bounded only by the imagination of a state attorney general. Within that universe, let a circular area represent the range of state securities regulatory actions that would harm national market efficiency. While every state action within this "critical zone" would hurt market efficiency and integrity, every act outside of this zone would not. In this rendering, no state has yet attempted to take an action within the critical zone, so the SEC has never had occasion to respond with preemption. However, if a state *were* to attempt a regulatory or enforcement action within this critical zone, the SEC could impose a preemptive measure like Regulation MR, represented as another circular area that overlaps the critical zone and excludes states from taking any regulatory action contained therein.

States possess a significant incentive to avoid provoking administrative preemption by the SEC, namely to prevent suffering a net loss in their regulatory prerogative. The loss does *not* arise from preemption's action to exclude the state from acting within the critical zone, because any such action therein would prompt SEC preemption regardless; preemption was a foregone conclusion. Instead, the net loss results from a "prophylactic zone" that extends preemption beyond the critical zone.

Within this prophylactic zone lie state actions that do not actually affect the efficiency and integrity of the national market system. Yet for its protection of the critical zone to be effective, a preemption measure must be reasonably practical to administer. It must target state actions not in terms of their ultimate economic impact, which is difficult to evaluate in advance, but in terms of a readily identifiable characteristic that serves as an imperfect surrogate for that impact. For example, Regulation MR aims to protect the critical zone by preempting *any* state action that would impose new rules or restructure the market, even those actions that would not hurt market efficiency and integrity. A market restructuring effect is the imperfect but easy-to-identify surrogate for an efficiency-reducing effect.

Within Figure 2 is an example of a non-balkanizing market reform imposed by a state attorney general that would have rested inside the prophylactic zone. Eliot

Spitzer's original April 2002 settlement with Merrill lies within the outer circle because it imposed new rules applicable to Merrill's business conduct. Yet the settlement did not harm market efficiency; the SEC ratified its terms in the December 2002 Global Settlement. Thus it lies outside of the critical zone. Unfortunately, a measure like Regulation MR would preempt settlements like Spitzer's in future fraud cases. Administrative preemption would deprive state attorneys general of their ability to enforce common sense market reforms in the face of widespread corrupt market practices, a net loss in their law enforcement prerogative.

B. Success in Court of SEC Administrative Preemption is Not Certain

Faced with the possible loss of regulatory prerogative, the states do not desire SEC preemption of their authority and should choose to refrain from provocative market-disruptive measures as a result. In turn, the SEC also possesses an incentive not to attempt administrative preemption immediately, due to lingering uncertainty over whether the courts will actually uphold an administrative preemption measure. While, as argued in this Note, an SEC attempt to preempt state market-restructuring action is *likely* to succeed in court, it is certainly not guaranteed. Currently, the mere *possibility* of successful administrative preemption can sufficiently deter the states from regulating inside the critical zone. Were the SEC to lose its preemption argument in court, however, that deterrent would be eliminated, and the SEC would lose any ability to prevent states from disrupting market efficiency. Thus, the SEC has no incentive to attempt preemption unless the present deterrent ceases to operate and unless a state forces its hand by taking efficiency-disruptive actions.

V. CONCLUSION

In an era that has undoubtedly seen increased state activism in securities fraud enforcement, the national market system in the United States has experienced little efficiency-reducing disruption at the hands of state attorneys general, and certainly less than any self-interested political entrepreneurship incentive would suggest by itself. Other dynamics must tend toward stability and comity in the federal-state regulatory relationship. One of these stabilizing dynamics is the fact that state officials regulate in the shadow of administrative preemption. Should a state step clearly over a line that demarcates injury to market integrity, the SEC likely possesses authority under Section 11A of the 1934 Act to preempt the state action administratively. This preemptive option has enjoyed little academic attention, likely due to the perception that the savings clauses in the 1933 and 1934 Acts have erected an impenetrable barrier that only congressional legislative preemption can pierce. Yet the savings clauses should not prevent "conflict" preemption, which the hypothetical Regulation MR described in this Note effects.

The model proposed in Part IV suggests that the uncertain prospect of preemption sufficiently deters the states from undertaking efficiency-destroying regulation. The uncertainty of success in court also cautions the SEC against prematurely attempting administrative preemption, especially while the mere threat of preemption keeps state regulators in check. These reciprocal forces result in a stable equilibrium that renders the American securities markets far from any road to balkanization. In fact, "the public has benefited" from vibrant regulatory competitiveness between the SEC and the states, according to former SEC Chairman Arthur Levitt.[127] As more states increase the potency of their blue sky laws, state attorneys general can continue to police the securities markets for fraudulent practices to supplement the enforcement efforts of an underfunded and overstretched SEC. The titans of the securities market now understand that there are multiple cops on the beat. Among them are state enforcers who currently possess the ability to impose tough remedial measures, including reasonable market reforms, to redress egregious cases of fraud. If

[127] Reason, *supra* note 33, at 1.

Congress completely preempts such state regulation, the balance of the regulator-industry relationship will tilt dramatically in favor of the latter.