

## Symposium

# Federalism in Securities Regulation: A Brief Introduction and Reflection

By CHRISTOPHER M. WOOD\*

ON FEBRUARY 25, 2006, the University of San Francisco Law Review hosted its spring symposium: *Federalism in Securities Regulation: Rethinking the Balance*.<sup>1</sup> Those in attendance may have noticed a large banner hanging in the rotunda of the University of San Francisco School of Law. This banner proclaims the mission of the law school—“pursuing excellence and educating for justice.” The symposia hosted by the University of San Francisco School of Law strive to place this abstract mission into a practical context by emphasizing social justice issues facing the legal community today.<sup>2</sup> While the esoteric details of federal securities law seem sometimes far removed from conventional social justice debate, recent scandals have put questions of corporate management and securities regulation on center stage.

Within the last seven years we have seen some of the most shocking and incredible stories of accounting scandals and corporate malfeasance to come to light since the savings and loans scandals of the 1980s. Enron, once the seventh biggest company on *Fortune*'s list of the top 500 with a market capitalization of over \$60 billion, was forced to file for bankruptcy protection when, amongst other scandalous revelations, it was brought to light that shell companies were being used

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\* U.S.F. L. Rev. Vol. 40 Symposium Editor; Class of 2006. B.A., Vanderbilt University, 2003. Thank you to Professor Reza Dibadj for making my study of corporate and securities law such a fascinating and rewarding endeavor. Thank you to Julia Dunbar for her invaluable assistance in organizing and coordinating the symposium. Lastly, thank you to all my colleagues on the Law Review Board for indulging me in the selection of this topic.

1. Video footage from the live event may be viewed online at <http://www.usfca.edu/lawreview/secregvideo.html>.

2. In addition to the Law Review symposia, the University of San Francisco hosted the second annual California Water Law Symposium and Invisible Chains: Human Trafficking and Forced Labor in the United States, a symposium on human trafficking and forced labor, during the 2005–2006 school year.

to hide hundreds of millions of dollars of debt.<sup>3</sup> Brought down with them was Arthur Andersen, once one of the nation's most prestigious accounting firms, after it was found guilty of obstruction of justice for its role in the scandal.<sup>4</sup>

The accounting improprieties plaguing corporate America were not limited to Enron and Arthur Andersen, and many other scandalous disclosures soon came to light. Not long after news of the Enron scandal broke, the telecommunications giant WorldCom filed the largest bankruptcy in United States history after disclosing that it had booked nearly \$4 billion in expenses as profits in previous years.<sup>5</sup> In the next several years, New York State Attorney General Eliot Spitzer embarked on numerous investigations of nefarious Wall Street conduct—from the under-pricing of initial public offerings, to market timing schemes by mutual fund brokers, to systematic fraud and market manipulation by some of the nation's largest insurance brokers.<sup>6</sup> And the Securities and Exchange Commission ("SEC") recently concluded an investigation of improprieties and suspicious trading by NASDAQ employees, which made clear that even the nation's Self-Regulating Organizations ("SROs") were not immune from scandal.<sup>7</sup>

The recent scandals have had a tremendous impact on United States financial markets, investors, and regulators. These scandals have obliterated the life savings and retirement accounts of thousands of investors and company employees<sup>8</sup> and have resulted in the removal of trillions of dollars in capitalization from United States mar-

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3. See generally, BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUY IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* (2d ed. 2004).

4. See *United States v. Arthur Andersen*, 374 F.3d 281 (5th Cir. 2004), reversed and remanded by *Arthur Andersen v. United States*, 544 U.S. 696 (2005) (holding that the jury instructions regarding intent were erroneous). Although the conviction was later overturned, it was not enough to save Anderson from collapse.

5. See *The Biggest Stock Scams of All Time*, Investopedia.com, Oct. 9, 2000, <http://www.investopedia.com/articles/00/100900.asp>.

6. See Daniel Gross, *Eliot Spitzer: How New York's attorney general became the most powerful man on Wall Street*, SLATE, Oct. 21, 2004, <http://www.slate.com/id/2108509/>.

7. Press Release, United States Securities and Exchange Commission, SEC Issues Report of Investigation Regarding NASDAQ, as Overseen by Its Parent, NASD, Arising Out of Investigation of Suspicious Trading Activity and Net Capital Violations By MarketXT (Feb. 9, 2005), <http://www.sec.gov/news/press/2005-14.htm>. In the context of securities regulation, the two main self-regulatory organizations are National Association of Securities Dealers and the national stock exchanges. These SROs are given the authority and responsibility to enforce standards and requirements related to their securities trading and brokerage practices, and should provide a "critical line of defense for investors." *Id.*

8. Letter from George Miller, Congressman, to Elaine Chao, Secretary of Labor (May 1, 2003), <http://edworkforce.house.gov/democrats/rel5103.html>.

kets.<sup>9</sup> The political fallout from these events brought about major reforms, such as the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”),<sup>10</sup> designed to ensure that similar incidents do not occur in the future. Despite the enactment of legislation to combat future abuses, the public assailed federal regulators with criticism for failing to detect and prevent the immense losses suffered by the public and the securities markets as a result of these scandals.<sup>11</sup> The question, “where were the regulators?” has now become a mantra for those who think that the SEC and other federal agencies should bear a level of responsibility for failing to detect or act on these abuses earlier.<sup>12</sup>

In contrast, state regulators managed to avoid much of the criticism leveled at federal regulators—presumably through either aggressive ex post prosecution and investigation, as in the case of New York, or because the expectations were so low that no one thought to criticize them.<sup>13</sup> Similarly, few, if any, people were nailing their grievances to the doors of the Delaware Chancery Court. This seems curious given that the “I didn’t know” defense, recited by virtually every corporate executive who has since been indicted, seems intuitively like an issue for state corporate governance law rather than federal securities regulation.<sup>14</sup>

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9. William K. Black, *Criminologists Needed*, Markkula Center for Applied Ethics, Santa Clara University, <http://www.scu.edu/ethics/publications/ethicalperspectives/criminologist.html> (last visited Aug. 1, 2006).

10. Pub. L. No. 107–204, 116 Stat. 745 (2002) (codified in scattered sections of 15 U.S.C. and 18 U.S.C.).

11. See Anna Pha, *Enron: Capitalism in a Nutshell (Part 4), Auditors: Watchdogs or Partners in Crime?*, THE GUARDIAN (AU), Mar. 13, 2002, <http://www.cpa.org.au/garchve5/1083en.html>; Mike McNamee, *Commentary: The SEC Opens The Door—Wide*, BUS. WK. ONLINE, July 12, 2004, [http://www.businessweek.com/magazine/content/04\\_28/b3891078\\_mz011.htm?campaign\\_id=search](http://www.businessweek.com/magazine/content/04_28/b3891078_mz011.htm?campaign_id=search); Bill Mann, *Outraged Over Enron*, THE MOTLEY FOOL, Jan. 17, 2002, <http://www.fool.com/news/foth/2002/foth020117.htm>.

12. See Pha, *supra* note 11.

13. As Professor Mark Sargent notes, few people involved with state blue-sky laws have a vested interest in their survival. The securities industry sees no benefit from the seemingly duplicative state regulation, the securities bar does not count on state practice for much of their business, and while the state may have an interest in maintaining their laws, this interest may only be because of the financial gains from keeping them. The individual investor, while the clear beneficiaries of laws, are too dispersed to have any say in the process. Mark A. Sargent, *A Future for Blue Sky Laws*, 62 U. CIN. L. REV. 471, 492–500 (1993). Also, Professor Langevoort notes in his article, the National Securities Market Improvement Act seriously limited state ‘blue-sky’ regulation. Donald Langevoort, *Federalism in Corporate/Securities Law: Reflections on Delaware, California, and State Regulation of Insider Trading*, 40 U.S.F. L. REV. 879, 881, n.10 (2006).

14. In the words of Enron’s Kenneth Lay, “I cannot take responsibility for criminal conduct that I was not aware of.” Mike France et al., *Commentary: Corporate America’s New Accountability*, BUS. WK. ONLINE, Jul. 26, 2004, <http://www.businessweek.com/magazine/content/>

The scandals of the past seven years, and the subsequent political fallout, triggered a renewed debate in the academic community over the respective roles of the state and federal governments in regulating the securities markets and prosecuting corporate fraud. The University of San Francisco Law Review symposium sought to engage both scholars and practitioners in an open discussion of past events and the best course for future action in an effort to rethink the role of federalism in securities regulation. The papers that follow reflect the central discussion of the symposium, and it is our hope that the debate will make a positive contribution in this area of law.

Professor Donald Langevoort's paper, *Federalism in Corporate/Securities Law: Reflections on Delaware, California, and State Regulation of Insider Trading*, touches on two aspects of the federalism debate.<sup>15</sup> First, he discusses his thoughts on the political considerations and theoretical underpinnings of the current divide between state and federal control of corporate law and securities regulation.<sup>16</sup> Following this discussion, Langevoort compares the insider trading laws of California and Delaware in an effort to put the federalism question in context.<sup>17</sup>

Responding to critics of federal involvement in state corporate law, Langevoort concludes that the federal government has shown remarkable restraint in its regulation of corporate governance.<sup>18</sup> As he poignantly states, "[s]tates' rights' do not exist . . . apart from Congress' preferences."<sup>19</sup> Langevoort notes that the SEC often achieves the equivalent of substantive regulation through disclosure requirements, and he rejects the idea that state-level regulatory competition produces an advantage over a "monopolist federal regulator."<sup>20</sup> According to Langevoort, one reason that Delaware manages to retain a de facto monopoly over corporate law-making is because it allows managers and major suppliers of capital to insulate negotiations from the "interference" of organized labor and "populist voices."<sup>21</sup> Langevoort posits that much of Delaware's corporate law can be understood as an attempt to avoid alienating managers, investors, and

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04\_30/b3893038\_mz011.htm; and as eloquently stated by WorldCom's Bernie Ebbers, "I know what I don't know." Ken Belson, *Ebbers Mounts an 'I Never Knew' Defense*, N.Y. TIMES, Mar. 1, 2005, at C1 (referring to his lack of understanding of the technology sold by WorldCom, as well as its finances).

15. Langevoort, *supra* note 13.

16. *Id.* at 881-886.

17. *Id.* at 886-889.

18. *Id.* at 891.

19. *Id.* at 890.

20. *Id.* at 881-883.

21. *Id.* at 884.

Congress to such an extent that any of these interests attempt to change the status quo and increase federal control.<sup>22</sup> Langevoort says that securities regulation can be understood “in light of the same set of ideas,” but that the stock market crash of 1929 and the Great Depression created populist sentiment that forced the hand of Congress.<sup>23</sup>

Langevoort then compares the California and Delaware insider trading laws to put the federalism question in context.<sup>24</sup> He attempts to bring focus to the debate by contrasting the ruling of a California appellate court with statements made by Delaware Chancellor Leo Strine.<sup>25</sup> In *Friese v. Superior Court*,<sup>26</sup> the court held that California insider trading laws extended to companies incorporated out-of-state as long as the transaction occurred in California.<sup>27</sup> In contrast, Chancellor Strine has signaled that “Delaware might abandon the field [of regulating insider trading]” and leave it entirely up to the federal securities laws.<sup>28</sup>

For Langevoort, neither California nor Delaware has the approach quite right. Langevoort views the California court ruling as overly aggressive because the insider trading in question had only a deminimus effect on most individual California investors, and any harm to the corporation through the acts of an insider is “squarely within the realm of corporate law.”<sup>29</sup> On the other hand, Langevoort does not share Chancellor Strine’s view that Delaware should give up on enforcing insider trading at the state level.<sup>30</sup> While the SEC regulates insider trading through Rule 10(b)-5,<sup>31</sup> Langevoort sees no reason why states should not offer similar or greater protections themselves.<sup>32</sup> He suggests that while state regulation is valuable, the reason why states will not push too hard in their constitutionally ag-

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22. *Id.*

23. *Id.* at 885.

24. *Id.* at 886.

25. *Id.* at 886–887.

26. 36 Cal. Rptr. 3d. 558 (Cal. Ct. App. 2005).

27. Langevoort, *supra* note 13, at 886 (citing *Friese v. Superior Court*, 36 Cal. Rptr. 3d. 558 (Cal. Ct. App. 2005)).

28. *Id.* at 886.

29. *Id.* at 887.

30. *Id.* at 888.

31. 17 C.F.R. § 240.10b-5 (1999).

32. Langevoort, *supra* note 13, at 888. As Langevoort says, “concurrent jurisdiction increasingly has become the order of the day.” *Id.* at 888. This is a line of argument that Professor Reza Dibadj argues for at length in his article. See Reza Dibadj, *From Incongruity to Cooperative Federalism*, 40 U.S.F. L. REV. 845 (2006).

gressive competition with federal regulation is to avoid triggering a congressional “backlash.”<sup>33</sup>

Professor James Cox’s article, *The Role of Empirical Evidence in Evaluating the Wisdom of the Sarbanes-Oxley Act*, addresses the federalism question by discussing the broad accounting reforms encompassed in Sarbanes-Oxley.<sup>34</sup> For Cox, the primary value of Sarbanes-Oxley lies in the “tectonic regulatory shifts it introduces to a handful of issues: creating an independent standard setter for accounting principles and auditing standards, strengthening the internal and external financial reporting procedures, and accelerating disclosure requirements to include more ‘real time’ revelations of financially significant events.”<sup>35</sup> Cox discusses how increased competition among accounting firms led to a greater emphasis on non-audit services following the relaxation of professional restrictions on accounting firms in the 1970s.<sup>36</sup> In his view, Sarbanes-Oxley helps produce more reliable financial reporting by remedying many of the conflicts accepted as common practice in the accounting profession in the last few decades.<sup>37</sup>

Cox addresses criticism leveled at Sarbanes-Oxley in recent years by those who argue that the reforms it mandates, measured empirically, do not actually produce any measurable value.<sup>38</sup> Professor Roberta Romano is the principal proponent of this view.<sup>39</sup> For Romano, the empirical data did not show a link between accounting abuses, audit committee independence, and non-audit fees.<sup>40</sup>

Cox’s article responds to one of the criticisms of Sarbanes-Oxley and questions whether Romano’s compilation of empirical studies really provides the necessary support for a rejection of Sarbanes-Oxley’s main provisions.<sup>41</sup> He gives several examples of areas where “empiricism is not useful in assessing the social welfare associated with a regulatory choice.”<sup>42</sup> First, Cox cites examples of instances where the implementation of socially desirable rules does not lead to observable

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33. Langevoort, *supra* note 13, at 891.

34. 40 U.S.F. L. REV. 795, 823 (2006).

35. *Id.* at 824 (internal citations omitted).

36. *Id.* at 825.

37. *Id.* at 825–831.

38. Cox, *supra* note 34, at 831.

39. *Id.* at 9; see also Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521 (2005).

40. Cox, *supra* note 34, at 831–833.

41. *Id.* at 832–833.

42. *Id.* at 833. Cox notes that “[t]hose who prefer that economic activity be guided solely by the invisible hand of market forces” view the “optimal regulatory approach . . . [an] empirical question.” *Id.* at 831. For a continuation of the discussion on the role of

changes in the value of the implementing firm.<sup>43</sup> He discusses derivative suits and governance rules as examples of this phenomenon.<sup>44</sup> Cox then considers the problem of the “indefiniteness of the inputs which are inherent in an empirical evaluation of the benefits of governance.”<sup>45</sup> He cites two different studies that “examined whether independent directors increase the returns of the companies on which they serve,”<sup>46</sup> and notes that by using different inputs, the studies came to opposite conclusions.<sup>47</sup>

Cox also discusses the problem of correlation, causation, and statistical significance in interpreting the results of an empirical study.<sup>48</sup> In particular, Cox questions what a regulator or legislator should do in the face of conflicting studies—as was the case in some of the studies linked to Romano’s research.<sup>49</sup> In this regard, Cox concludes that Sarbanes-Oxley is a “measured course,” compared with the more extreme approaches that could have been taken in the face of more conclusive empirical results.<sup>50</sup>

Lastly, Cox addresses the problems associated with the limitations on available databases, and how this relates to the accuracy of the results obtained from empirical research.<sup>51</sup> Cox concludes that Sarbanes-Oxley provides “thoughtful and integrated responses to the many ills that plagued financial reporting.”<sup>52</sup>

Professor Reza Dibadj’s article, *From Incongruity to Cooperative Federalism*, goes beyond recent events and proposes that securities regulation should operate within a system of cooperative federalism, whereby “the federal government would set minimal shareholder protections, but leave implementation and the creation of enhanced standards to the states.”<sup>53</sup> In doing so, Dibadj rejects both dual federalism and preemptive federalism as solutions.<sup>54</sup>

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Adam Smith’s invisible hand, see Professor Stiglitz’s remarks in *Federalism and Securities Regulation: An Economist’s Perspective* 40 U.S.F. L. Rev. 805 (2006).

43. Cox, *supra* note 34, at 833–835.

44. *Id.*

45. *Id.* at 836.

46. *Id.*

47. *Id.* at 835–837.

48. *Id.* at 838–841.

49. *Id.* at 838–841.

50. *Id.* at 840–841.

51. *Id.* at 841–842.

52. *Id.* at 844.

53. Dibadj, *supra* note 32, at 866.

54. *Id.* at 864.

According to Dibadj, dual federalism, particularly as embodied in Delaware corporate law, has failed to provide adequate protections for investors because its "impressive-sounding obligations can be carefully skirted through clever process."<sup>55</sup> On the other hand, "attorneys general have begun vigorously enforcing blue sky laws in a manner that critics find too protective."<sup>56</sup> This unbalanced pose, combined with the lack of coordination and strained relations between some federal and state regulators, leads Dibadj to conclude that dual federalism "has proven itself to be an ambivalent mess."<sup>57</sup>

Similarly, Dibadj rejects preemptive federalism as a solution.<sup>58</sup> He views recent federal preemption as having "often decreased shareholder protections," and argues that "federal institutions simply lack the capacity to be the sole arbiters of securities regulation."<sup>59</sup>

Dibadj finds a solution in cooperative federalism.<sup>60</sup> He sees cooperative federalism as a middle ground, retaining state autonomy while allowing for the possibility of a minimum federal standard.<sup>61</sup> The central concern for Dibadj is fighting fraud.<sup>62</sup> Under his system, the federal government would set minimum disclosure requirements and allow states the opportunity to increase protections for their citizens through state anti-fraud provisions.<sup>63</sup> While Dibadj's position flows against the recent trend of minimizing state involvement in securities cases, his article presents an intriguing alternative to the status quo, proposing solutions that warrant further discussion and debate.

To provide another perspective on the symposium topic, this issue includes an edited version of Professor Joseph E. Stiglitz's keynote

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55. *Id.* at 849.

56. *Id.* at 856. Blue sky laws are state securities laws that may offer investors alternative or additional protections from the federal securities laws. As stated by Justice Joseph McKenna, "[t]he name that is given to the law indicates the evil at which it is aimed; that is, to use the language of a cited case, 'speculative schemes which have no more basis than so many feet of 'blue sky;'" or, as stated by counsel in another case, 'to stop the sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines, and other like fraudulent exploitations.'" *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917). Critics of state blue sky laws would argue that the protections they afford are duplicative and unnecessary in the current United States system which emphasizes federal securities laws. *See, e.g.*, Mark A. Sargent, *A Future for Blue Sky Law*, 62 U. CIN. L. REV. 471, 509 (Fall 1993).

57. Dibadj, *supra* note 32, at 856-857.

58. *Id.* at 857.

59. *Id.*

60. *Id.* at 864.

61. *Id.* at 865-868.

62. *Id.* at 866-868.

63. *Id.* at 865.



address.<sup>64</sup> We specifically invited an economist to give the keynote address in order to create a dialogue around the economic principles that, while frequently cited by practitioners and academics, are seldom subject to the critical analysis necessary to make informed decisions.

Stiglitz's address begins by discussing the theoretical underpinnings of our market system and moves into a discussion of some of the more troubling practices that contributed to the stock market bubble in the late nineties.<sup>65</sup> Stiglitz highlights the non-expensing of stock options, systematic under-pricing of initial public offerings, and the widespread conflicts of interests at accounting firms as some of the worst problems during this time.<sup>66</sup> He then discusses the considerations that influence where, and at what level, regulation should occur.<sup>67</sup>

Stiglitz then briefly addresses his work in New York with Eliot Spitzer, and why the Martin Act<sup>68</sup> has been an effective tool for fighting financial fraud in New York. In Stiglitz's opinion, the effectiveness of the Martin Act stems from its adaptability to evolving forms of financial fraud, and its ability to provide varying scales of punishment.<sup>69</sup>

Stiglitz draws on some of his work in banking regulation in the 1980s to frame the debate over the appropriate level of duplicative regulation.<sup>70</sup> For Stiglitz, duplication is most important when the costs of the possible mistakes are highest.<sup>71</sup> He also suggests that where political influence is being exercised to design a regulatory environment that does not address the real societal concerns, it is most important to have duplication.<sup>72</sup> Lastly, Stiglitz discusses his work with global trade regulation, and how thinking about regulation in terms of globalization presents parallels with American federalism in this area.<sup>73</sup>

Stiglitz concludes by noting that the legal profession must take into account new economic analyses and thinking, rather than relying

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64. Joseph E. Stiglitz, *Federalism and Securities Regulation: An Economist's Perspective*, 40 U.S.F. L. REV. 805 (2006).

65. *Id.* at 806–816.

66. *Id.*

67. *Id.* at 816–819.

68. N.Y. GEN. BUS. LAW, Art. 23-A § 352 (West 2006).

69. Stiglitz, *supra* note 67, at 818–819.

70. *Id.* at 819.

71. *Id.*

72. *Id.* at 816–819.

73. *Id.* at 819–820.

on the badly flawed paradigm of neo-classical economics.<sup>74</sup> Stiglitz states that the challenge facing the legal profession is to find an alternative to this model.<sup>75</sup>

The University of San Francisco Law Review members hope that this symposium, and the articles following, will contribute to the growing debate about how to best manage our economy, our financial markets, and our corporations. In the end, the only consensus on these issues is that any reform of our corporate and securities laws will be a highly political and highly contentious process. In the past, changes have frequently occurred in a climate of scandal and public outrage. Whatever the resulting legislation, this cannot be the most efficient way of creating a consistent body of law that will both protect investors and strengthen capital markets. Achieving such a body of legislation requires a vigorous debate aimed at trying to create proactive solutions, not just reactive policies to quell the scandal of the day.

In addition to the contributions of the authors and the keynote speaker, the symposium would not have been possible without the thoughtful engagement of the panelists and moderators: Joshua P. Davis (Professor, University of San Francisco School of Law); Mel Eisenberg (Professor, Boalt Hall School of Law, U.C. Berkeley); Cheryl L. Evans (Special Counsel, United States Chamber Institute for Legal Reform); John H. Hemann (Partner, Morgan Lewis & Bockius); Giovanni Prezioso (Former General Counsel, United States Securities & Exchange Commission); Catherine J.K. Sandoval (Professor, Santa Clara University School of Law); Mark J. Breckler (Senior Assistant Attorney General, Office of the California Attorney General); and Richard M. Phillips (Partner, Kirkpatrick & Lockhart Nicholson Graham LLP). Our warmest thanks to you all.

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74. *Id.* at 820–821.

75. *Id.* at 821.