AVOIDING THE INEVITABLE: THE CONTINUING VIABILITY OF STATE LAW CLAIMS IN THE FACE OF PRIMARY JURISDICTION AND PREEMPTION CHALLENGES UNDER THE SECURITIES EXCHANGE ACT OF 1934

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I. INTRODUCTION

Primary jurisdiction is a judicially created doctrine pursuant to which a court may elect to defer consideration of a complex case pending disposition of a salient issue in that case by an appropriate administrative or regulatory body. The result is not to remove the courts totally from the process but rather to allocate the initial decision to an agency, subject to a subsequent judicial review. The doctrine of primary jurisdiction is applied by a court to temporarily stay proceedings in cases where there is a precise legal issue that can be effectively addressed by the agency and a prescribed method exists for the agency to address the issue.[1] Primary jurisdiction arises in

[1] *See* 2 KENNETH CULP DAVIS & RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE § 14.1 (3d ed. 1994). The doctrine of primary jurisdiction is, of course, closely related to that of exhaustion of remedies. The main difference is that in the typical exhaustion case, the administrative agency's adjudicatory function has been invoked, i.e., the agency has been given authority to actually adjudicate the issue. A limited number of statutes, of which the Exchange Act is not one, have a section providing for primary jurisdiction. *Id.* § 14.1, at 276.

securities litigation when allegedly complicated securities practices regulated by the Securities and Exchange Commission (the "SEC") are subject to judicial scrutiny.

Preemption issues arise in securities litigation when conduct that is either explicitly or implicitly regulated by the federal securities laws is the basis of alleged violations of state law. Although there are some common policies underlying these two sets of issues, e.g., uniformity in the application of law, two distinct theories are involved: Primary jurisdiction is a matter of administrative law and judicial economy; preemption is a matter of constitutional law involving the validity of state law.[2] As many of the preemption cases involving the securities industry have arisen under the Securities Exchange Act of 1934 (the "Exchange Act"),[3] this article focuses upon caselaw involving the Exchange Act. The Exchange Act generally regulates securities trading on domestic securities exchanges and in the over-the-counter market, as well as the operation of broker-dealers.[4]

The doctrines of preemption and, to a lesser extent, primary jurisdiction have immense importance in securities litigation and, except in limited contexts, have not been thoroughly analyzed. This lack of analysis in the preemption context reflects the courts' acceptance of the historical coexistence of federal and state securities claims arising out of the same factual predicate.[5] Thus, it is commonplace in federal court to plead federal

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[2] The exact constitutional relationship between supremacy and preemption and the constitutional basis of preemption have been the source of some dispute. *See, e.g.*, Stephen A. Gardbaum, *The Nature of Preemption*, 79 CORNELL L. REV. 757, 769, 782 (1994). Professor Gardbaum argues "that preemption and supremacy are quite distinct legal and constitutional concepts" and, therefore, that the Supremacy Clause is not the basis for preemption. *Id.* at 769, 773-77. He then examines the Commerce Clause because, in exercising preemption, Congress most often acts in the "context of . . . its general authority to regulate interstate commerce." *Id.* at 777. Professor Gardbaum examines a number of arguments for and against the Commerce Clause as "*the source of* preemption," *id.*, but does not resolve these arguments as he finds "an easier and more plausible solution to the problem of source," *id.* at 781. He locates the source of preemption in the Necessary and Proper Clause. The authors of this article do not believe that their analysis is affected by this debate.

[3] 15 U.S.C. §§ 77b-k, 77m, 77*o*, 77s, 78a-*lll* (1994).

[4] 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 228-29 (3d ed. 1989).

[5] *See* LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW § 6-26, at 491 (2d ed. 1988) ("Generally speaking, the Court has come to sanction state regula-

fraud claims pursuant to section 10(b) of the Exchange Act along with state fraud claims, state breach of contract claims, and state negligence claims, without ever facing the issue of preemption. Primary jurisdiction issues have been infrequently litigated because most securities claims involving fraud and misrepresentation do not present the complex issues appropriate for the application of primary jurisdiction.

In the last several years, however, there have been several class action lawsuits challenging certain industry-wide practices that were arguably consistent with federal law but that were subject to attack under various state fraud statutes and state common law doctrines. The prospect of industry participants complying with federal securities law and SEC rules and regulations, while remaining subject to challenge under state common law and statutory schemes, has focused judicial attention upon preemption and primary jurisdiction issues.

To date, there has been extensive caselaw involving preemption and the Exchange Act only in limited areas; there has been almost no caselaw on primary jurisdiction under the Exchange Act. This article discusses these issues in the context of the payment for order flow cases.[6] In the seven ongoing payment for order flow cases, currently pending in state courts in Illinois, Louisiana, Maryland, Minnesota, and New York, the plaintiffs have challenged the practice of certain broker-dealers (such as market makers, wholesale firms, and regional specialists) that make monetary and non-monetary payments to retail brokers, particularly discount brokers, for the purpose of induc-

tions that supplement federal efforts so long as compliance with the letter or effectuation of the purpose of the federal enactment is not likely to be impeded by the state law.").

[6] These preemption and primary jurisdiction issues also have arisen in two other recent securities class actions of which the authors are aware. In the earlier one, the plaintiff class alleged that, in connection with the lending and borrowing of securities, the defendant brokers made false representations, converted property of their customers, and breached a fiduciary duty owed to their customers. *See* Memorandum of Law in Support of Defendants' Motion to Dismiss at 15-22, Rosenfeld v. Bear Stearns & Co., No. 110812-93 (Sup. Ct. N.Y. County filed Aug. 13, 1993). This case has been settled. In the most recent case, the plaintiff class seeks restitution for the benefits that the defendant broker allegedly derived from the use of the plaintiffs' free credit balances. Braunstein v. Merrill Lynch, Pierce, Fenner & Smith, Inc., N.Y. L.J., June 22, 1995, at 29 (N.Y. Sup. Ct. 1995). See *infra* note 415 for a brief discussion of *Braunstein*, which is an ongoing case.

ing the defendant retail brokers to send orders to the market makers for execution.[7] The payment for order flow cases provide a good way to examine the preemption and primary jurisdiction issues, in part because they directly address these issues, especially preemption, in a developing body of caselaw, albeit primarily unpublished caselaw.

Preemption challenges to the application of state law are often raised in conjunction with Commerce Clause challenges to the same state action. The preemption argument arises from the existence of federal legislative or regulatory activity within the area of alleged federal law/state law conflict, while the Commerce Clause argument arises from alleged burdens imposed by the state action on interstate commerce "even absent congressional action."[8] Of the two normally invoked constitu-

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[7] Rachel S. Witmer, *Investors' Actions Against Brokers Seek Return of Cash Paid for Order Flow*, 26 SEC. REG. & LAW REP. 590 (Apr. 22, 1994). There may be additional cases of which the authors are not aware. The term "order flow" describes instances involving more than a single order. The practice of paying for order flow has the most impact on small investors as it is most common with small orders. Note, *The Perils of Payment for Order Flow*, 107 HARV. L. REV. 1675, 1676 (1994). The typical individual shareowner engages in only a few stock transactions per year. One 1989-90 survey found that 70.7% of individual shareowners traded two or fewer times per year, while another 1984-85 survey found the same minimal level of trading by 55.3% of individual shareowners. Division of Market Regulation, SEC, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS Ex. 9 (1994) [hereinafter MARKET 2000].

[8] CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 87 (1987). *CTS* involved both a preemption challenge and a Commerce Clause challenge to an Indiana state statute. *Id.* at 72. *CTS* is discussed at *infra* text accompanying notes 182-204. Traditionally, state laws that conflict with federal law have been invalidated under the Supremacy Clause. State laws which do not conflict with federal law but that unreasonably burden interstate commerce may also be invalidated pursuant to the Commerce Clause. TRIBE, *supra* note 5, § 6-25, at 479.

In making the judicial assessment as to the scope of federal preemption, the balancing of interests is similar to the Supreme Court's approach in ascertaining unconstitutional burdens on interstate commerce. For example, greater deference has been afforded regulation that is traditionally parochial, such as health and safety measures, under both the Supremacy and the Commerce Clauses. 2 RONALD D. ROTUNDA & JOHN E. NOWAK, TREATISE ON CONSTITUTIONAL LAW § 12.3 (1992). The regulation of commerce is considered of national importance and as requiring uniformity; therefore, it is not surprising that most federal preemption problems have arisen in conjunction with Commerce Clause problems. TRIBE, *supra* note 5, §§ 6-1, 6-2, 6-26, 6-27. State laws that regulate

tional bases for refusing to apply state law in the securities regulation context (the Commerce Clause and the Supremacy Clause), the Supremacy Clause is almost always relevant in cases involving the federal securities claims because of the existence of the federal securities laws.[9] The Commerce Clause is applied less frequently.

This article first examines preemption, concluding that state law is rarely preempted pursuant to the Exchange Act because a clear intent to preempt state law cannot be found in the Exchange Act, which in fact expressly preserves the continued application of state law in section 28(a),[10] and because direct conflicts between state and federal law in the securities area are infrequent. This conclusion is strengthened by the fact that state statutes and common law that augment federal law or provide additional claims or remedies for actions that also violate federal securities laws are not, under enunciated preemption standards, preempted by the Exchange Act. This article then examines primary jurisdiction, concluding that primary jurisdiction should have little application in the securities context because of the substantial judicial experience with the application of the federal securities laws and the SEC's active policy of intervening as an amicus curiae in securities cases to advise the courts.

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activities in an area also regulated by federal legislation are invalid under the Supremacy Clause if such state laws conflict with federal law. "If Congress may regulate an area of private sector activity through legitimate use of any federal power, such as the federal tax or commerce powers, it may bar state regulation of that activity by specifically preempting the area for federal action." 2 ROTUNDA & NOWAK, *supra*, § 12.3. Therefore, the Supremacy and Commerce Clauses work together. The Commerce Clause establishes plenary federal power in the area of interstate commerce and the Supremacy Clause works to preempt any state law inconsistent with that plenary power.

[9] *See* Richard J. Pierce, Jr., *Regulation, Deregulation, Federalism, and Administrative Law: Agency Power to Preempt State Regulation*, 46 U. PITT. L. REV. 607, 629 (1985). The defendants in the payment for order flow cases also have argued that the Commerce Clause applies because applying state agency law would burden national commerce. *See, e.g.*, Defendant's Memorandum in Support of Its Motion to Dismiss or Stay at 18-20, Guice v. Charles Schwab & Co., No. 94-100875 (Sup. Ct. N.Y. County filed Mar. 22, 1994) (relying on the "'negative' or 'dormant' component of the Clause [that] prevents states from impeding the flow of interstate commerce, even absent congressional action in a particular field") [hereinafter *Guice* Defendant's Memorandum].

[10] 15 U.S.C. § 78(bb) (1994).

II. PREEMPTION

A. Introduction

Preemption of state law can occur in one of three situations: (i) federal occupation of "an entire field of regulation to the exclusion of all state regulation," which can be based either on an explicit statement of congressional intent or a congressional intent implied by a pervasive federal regulatory scheme;[11] (ii) "[d]irect conflicts between federal and state regulatory requirements" that arise when it is "impossible to comply with both federal and state law" or the state and federal requirements have conflicting objectives; and (iii) state action that "frustrates policies underlying federal regulation."[12] Under any of these three branches of preemption analysis, "the question raised by preemption analysis is always one of statutory interpretation," i.e., whether there was an intention to preempt state law.[13]

Under the Supremacy Clause of the Constitution, federal law will preempt any state law with which there is a conflict if Congress intends such a result. In initiating a new regulatory scheme, however, Congress seldom articulates an express intent to preempt an entire field of law.[14] Therefore, the judicial

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[11] This article will refer to this first type of preemption as "field preemption." Implied field preemption is usually more relevant than explicit field preemption to a discussion of the federal securities laws because there are only a limited number of explicit statements of congressional intent to occupy entire areas of securities regulation under the Exchange Act. For a description of these preempted areas, see *infra* text accompanying notes 81-93 and 105-12. Gardbaum, *supra* note 2, at 801-02, 811-12 (describing development of the doctrine of field preemption and criticizing it "as a holdover from the period before the radical expansion in the scope of Congress's interstate commerce power").

[12] Pierce, *supra* note 9, at 630.

[13] *Id.* at 629. Not all writers on statutory construction in general, *see, e.g.*, REED DICKERSON, THE INTERPRETATION AND APPLICATION OF STATUTES 162-64, 195-97 (1975); RONALD DWORKIN, A MATTER OF PRINCIPLE 48-57 (1985); Peter C. Schanck, *An Essay on the Role of Legislative Histories in Statutory Interpretation*, 80 LAW LIBR. J. 391, 413-14 (1988), or on preemption specifically, *see, e.g.*, Kenneth L. Hirsch, *Toward a New View of Federal Preemption*, 1972 U. ILL. L. REV. 515, 542-49, would agree that congressional intent should be a relevant factor in determining the meaning of a statute.

[14] Hirsch, *supra* note 13, at 542-43. In arguing that courts should acknowledge their own creative role in preemption cases involving "occupying the field," Professor Hirsch focuses on the twin facts that "[q]uestions of the relation of

branch has shouldered the responsibility for discovering congressional intent as to preemption. The Supreme Court has held that "[i]t will not be presumed that a federal statute was intended to supersede the exercise of the power of the state unless there is a clear manifestation of intention to do so."[15]

A federal agency may also preempt state law by regulation, if the federal agency is "acting within the scope of its congressionally delegated authority."[16] This is especially true when considering direct conflicts between federal and state law.[17] Federal regulations are subject to the same preemption analysis as federal statutes, although courts are more hesitant to find preemption arising from the comprehensiveness of the federal scheme when dealing with rules rather than a statute.[18] Since "agencies normally deal with problems in far more detail than does Congress[,] [t]o infer pre-emption whenever an agency deals with a problem comprehensively is virtually tantamount to saying that whenever a federal agency decides to step into a field, its regulations will be exclusive."[19] The Supreme Court has required that the federal agency, like Congress, manifest its intention to preempt with reasonable clarity.[20] Indeed, if the federal regulations contemplate concurrent state regulations, then the federal regulations are authority for the proposition that there is no federal preemption.[21]

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federal law to existing and potential state law are seldom considered in detail in the drafting of federal legislation" and that, even when consideration is given to such state laws, it is usually given to a limited group of already existing state laws. *Id.*

[15] New York State Dep't. of Social Servs. v. Dublino, 413 U.S. 405, 413 (1973) (*quoting* Schwartz v. Texas, 344 U.S. 199, 202-03 (1952)).

[16] Louisiana Pub. Serv. Comm'n. v. FCC, 476 U.S. 355, 369 (1986). If the federal agency enacts a rule or regulation outside of the power granted to it by Congress, such rule or regulation is subject to being vacated by a court. *See, e.g.,* Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (vacating rule 19c-4, adopted by the SEC, because SEC exceeded its statutory authority under section 19 of the Exchange Act).

[17] TRIBE, *supra* note 5, § 6-26, at 481.

[18] *Id.* § 6-27, at 498 n.11; § 6-28, at 501 n.1.

[19] Hillsborough County v. Automated Medical Lab., Inc., 471 U.S. 707, 717 (1985).

[20] 2 ROTUNDA & NOWAK, *supra* note 8, § 12.4, at 81 (1992).

[21] Silkwood v. Kerr-McGee Corp., 464 U.S. 238, 255 (1984).

Historically, the Supreme Court has applied a presumption against preemption.[22] In three recent cases that did not involve the Exchange Act, the Supreme Court has fashioned additional interpretative tools that make a finding of implied preemption even more unlikely.

B. The Current Standard for Preemption

Three recent Supreme Court cases have addressed the impact that the presence or absence of an express preemption provision in a federal statute has on implied preemption. In two of these cases, an express preemption provision was present[23] while in the third case there was no express preemption provision.[24] All three cases evince a considerable hostility by the Supreme Court to a continued use of implied preemption analysis. Where there are express provisions in a statute preserving state law, such as those contained in section 28 of the Exchange Act,[25] then the analysis set forth in *Freightliner Corp. v. Myrick*[26] is relevant. *Freightliner* involved a claim of preemption involving the National Traffic and Motor Vehicle Safety Act of 1966 (the "Safety Act").[27] The plaintiffs had sued under state tort law. The district court granted summary judgment to the defendants on preemption grounds, and the Court of Appeals for the Eleventh Circuit reversed, finding that there was no express preemption or preemption arising from a conflict between state and federal law. Relying upon *Cipollone v. Liggett Group Inc.*,[28] the plaintiffs argued before the Supreme Court that "implied pre-emption cannot exist when Congress has chosen to include an express pre-emption clause in a statute."[29] The

[22] TRIBE, *supra* note 5, § 6-5, at 479-80.

[23] Freightliner Corp. v. Myrick, 115 S. Ct. 1483 (1995); Cipollone v. Liggett Group Inc., 505 U.S. 504 (1992).

[24] O'Melveny & Myers v. FDIC, 114 S. Ct. 2048 (1994).

[25] See *infra* text accompanying notes 50-93 for a description of section 28(a).

[26] *Freightliner*, 115 S. Ct. 1483 (1995).

[27] Pub. L. 89-563, § 1, 80 Stat. 718, *repealed by* Pub. L. § 103-272, § 7(b), 108 Stat. 1379 (1994) (formerly codified at 15 U.S.C. § 1381).

[28] 505 U.S. 504 (1992).

[29] *Freightliner*, 115 S. Ct. at 1487. This interpretation had been adopted by many of the circuit courts that had considered this issue subsequent to *Cipollone*. *See, e.g.*, Myrick v. Fruehauf Corp., 13 F.3d 1516, 1522-23 (11th Cir. 1994) (citing eight cases in other circuits and two other opinions in the Elev-

Supreme Court found that this argument was "without merit."[30] The Supreme Court held that *Cipollone* did not create a "categorical rule[;]" rather, "[a]t best, *Cipollone* supports an inference that an express pre-emption clause forecloses implied pre-emption."[31] The opinion written by Justice Thomas went on to make a preemption analysis based on both branches of implied conflict preemption: impossibility of compliance and frustration of Congressional purpose.[32] After a brief analysis, *Freightliner* concluded that there was no preemption because there was no applicable federal standard for the safety devices and the Safety Act did not require such safety devices.[33] The conclusion of these two recent Supreme Court cases is that implied preemption will be difficult to find when express preemption provisions exist. Other than enunciating a presumption against implied preemption, these cases have no direct relevance to Exchange Act preemption because of the express reservation of state legal rights in section 28(a).

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enth Circuit supporting this interpretation), *aff'd sub nom.* Freightliner Corp. v. Myrick, 115 S. Ct. 1483 (1995). Early commentators had the same broad interpretation of *Cipollone. See, e.g.*, John A. Chatowski, Note, *Cipollone and the Clear Statement Rule: Doctrinal Anomaly or New Development in Federal Preemption*, 44 SYRACUSE L. REV. 769, 791 (1993); Jeffrey R. Stern, Note, *Preemption Doctrine and the Failure of Textualism in Cipollone v. Liggett Group*, 80 VA. L. REV. 979, 1008 (1994). The sweeping language of the *Cipollone* opinion readily lent itself to this interpretation. Justice Stevens, the author of the majority's opinion in *Cipollone*, at one point wrote, "In our opinion, the preemptive scope of the 1965 Act and the 1969 Act is governed *entirely* by the express language in § 5 of each Act." 505 U.S. at 517 (emphasis added).

[30] *Freightliner*, 115 S. Ct. at 1487.

[31] *Id.* at 1488. *See also* CSX Transportation, Inc. v. Easterwood, 113 S. Ct. 1732, 1742 n.12 (1993) (rejecting implied "conflict" preemption claim when express statutory preemption provisions did not apply to challenged action). Justice Scalia, the author of the *O'Melveny* opinion, did not join in the *Freightliner* opinion although he did concur in the result. The authors assume that Justice Scalia would have favored an opinion more in line with his concurrence in part, dissent in part from the *Cipollone* case, which Justice Thomas had also joined. In this concurrence/dissent, Justice Scalia reasoned that an express preemption provision might eliminate implied field preemption as a relevant category but that implied conflict preemption should be preserved. *Cipollone*, 505 U.S. at 547. As the *Freightliner* Court did not address this distinction, implied field preemption remains alive, although as an endangered species under current Supreme Court jurisprudence.

[32] *Freightliner*, 115 S. Ct. at 1487.

[33] *Id.* at 1488.

The fundamental issue at stake in the payment for order flow cases, and in other securities cases in which preemption issues are raised, is the coordination of state and federal law in the commercial context. The most important recent Supreme Court decision to address the issues of coordinating state and federal law in a commercial context is *O'Melveny & Myers v. FDIC*.[34] The Supreme Court, in an opinion written by Justice Scalia, rejected the FDIC's attempts to create federal common law when the FDIC was attempting to pursue state law malpractice claims against a large California law firm. *O'Melveny* involved the issue of whether state law would determine whether the FDIC, as receiver of a failed federally insured savings and loan (the "S&L"), would be presumed to have had knowledge of certain fraudulent conduct by officers and directors of the S&L. The defendant argued that, if such knowledge was attributable to the FDIC, as provided for under California law, there could be no malpractice claim, as the malpractice claim was defensible by a showing that the S&L's officers had such knowledge and because any defense good against the S&L would also be good against the receiver.[35]

The FDIC argued that the relevant federal statute, the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA"), evidenced an overriding federal interest in regulating the subject matter covered by FIRREA and, therefore, justified the creation of federal common law to be used in determining the issue of attribution of knowledge to the FDIC as receiver. The FDIC offered this argument even though the underlying claim was derived solely from state law, contending that federal common law should be applied because, even though the specific claim was a state claim, the FDIC was a federal actor enforcing federal rights under FIRREA. In addition, the FDIC argued that applying state rules on the imputation issue might reduce the size of the deposit insurance fund.[36]

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[34] 114 S. Ct. 2048 (1994).

[35] *Id.* at 2052. The issues arising from *O'Melveny* involving failed S&L litigation in particular are not discussed in this article. For an excellent discussion of these issues, as well as a thoughtful discussion of the broader implications of *O'Melveny*, see Warren L. Dennis, *The O'Melveny Decision: End of an Era*, 10 REV. OF BANKING & FIN. SERVICES 105 (1994).

[36] *O'Melveny*, 114 S. Ct. at 2054-55.

The Supreme Court initially turned to FIRREA as the relevant federal statute. In examining FIRREA, the Supreme Court went through a two step analysis.[37] First, the Supreme Court looked for an "explicit statutory provision" dealing with the issue of displacement of state law and found no such provision, nor any specific provision governing displacement of state tort law principles.[38] Second, the Supreme Court examined the scope of FIRREA and found it to be a "comprehensive and detailed" statute, which contained certain specific federal rules of decision regarding claims by and defenses against the FDIC.[39] The Supreme Court held that it would not create "federal common-law" to "supplement" such a statutory scheme simply because a federal receiver was enforcing the claim at issue.[40] In some of the opinion's most far-reaching language, Justice Scalia wrote that "matters left unaddressed in such a [comprehensive and detailed] scheme are presumably left subject to the disposition provided by state law."[41]

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[37] Justice Scalia first dealt with the potential *Kimbell Foods* issue. See *infra* note 296 for a brief discussion of *Kimbell Foods*. Without overruling or explicitly criticizing *Kimbell Foods*, Justice Scalia noted that the analysis dictated by *Kimbell Foods*, which first asks the question of whether "federal law governs," "does not much advance the ball." *O'Melveny*, 114 S. Ct. at 2053. Even if "federal law governs," the appropriate law under *Kimbell Foods* may still be state and not federal law. *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 727-29 (1979). "The issue in the present case *is* whether the California rule of decision is to be applied to the issue of imputation or displaced, and if it is applied it is of *only theoretical interest* whether the basis for that application is California's own sovereign power or federal adoption of California's disposition." *O'Melveny*, 114 S. Ct. at 2053-54 (second emphasis added).

[38] *O'Melveny*, 114 S. Ct. at 2054.

[39] *Id.*

[40] *Id.*

[41] *Id.* In effect, the Supreme Court was reversing the accepted view that had treated comprehensiveness of a statutory or regulatory scheme as evidence of a Congressional intent to preempt even in areas not specifically addressed. *See* TRIBE, *supra* note 5, § 6-27, at 497-501. Under the *O'Melveny* analysis, comprehensiveness is now evidence that Congress did not intend to preempt what it did not directly address nor to apply federal common law in the areas not specifically addressed.

Theresa A. Gabaldon, *State Answers to Federal Questions: The Common Law of Federal Securities Regulation*, 20 J. CORP. L. 155 (1994), a pioneering article addressing the issue of federal common law and the federal securities laws, appeared before *O'Melveny* was decided. Professor Gabaldon recommended that the courts adopt a four step analysis of whether to apply federal common law in the hope of bringing some clarity to this area. *Id.* at 213-14. Her recommenda-

As FIRREA was enacted after the FDIC became receiver of the pertinent failed S&L, the Supreme Court continued by asking whether "assuming the inapplicability of FIRREA[,] this is . . . one of those cases in which judicial creation of a special federal rule would be justified."[42] In making this further inquiry, the Supreme Court noted that situations in which the creation of such a special federal rule is appropriate are "'few and restricted,' limited to situations where there is a 'significant conflict between federal policy or interest and the use of state law.'"[43] The Supreme Court, in examining the federal policies or interests identified by the FDIC as supporting such a special federal rule, used language casting doubt on whether the interest in uniformity would ever alone be sufficient to warrant the creation of federal common law. The Supreme Court found that "[t]here is not even at stake that most generic (and lightly invoked) of alleged federal interests, the interest in uniformity."[44] This interest in uniformity did not arise in *O'Melveny* because the FDIC, when it was acting as a receiver, was not the United States or one of its agents or contractors. Accordingly, California law would be applied to "primary conduct on the part of private actors that has already occurred."[45]

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tions, however, do not have the stark simplicity of Justice Scalia's approach, although they would often yield the same results because her second step, after first dealing with congressional intent, "is whether state law applies on its own terms." *Id.* at 208. And if the answer is "yes," state law should "operate unless it is inconsistent with federal purposes. This proposal calls for no more judicial activism than standard preemption analysis." *Id.* at 207. Professor Gabaldon does discuss as her final recommendation the situation where state law is inapplicable or preempted. *Id.* at 207-10. Her recommendation is that federal courts honestly confront the issue of whether they have authority in this situation to interpret, although she sketches out an approach that preserves state law as much as possible. *Id.* Justice Scalia had no need to go to this final step in *O'Melveny* because California law did apply. *But see* Kevin R. Johnson, *Bridging the Gap: Some Thoughts About Interstitial Lawmaking and the Federal Securities Laws*, 48 WASH. & LEE L. REV. 879, 934 (1991) (rejecting notion that judges should borrow from either state law or analogous federal law and advocating that "judges filling in the interstices of the federal securities laws should fashion the *best* law by considering the policies underlying those laws and the practicalities of enforcement litigation").

[42] *O'Melveny*, 114 S. Ct. at 2055.

[43] *Id.* (*quoting* Wallis v. Pan American Petroleum Corp., 384 U.S. 63, 68 (1966)).

[44] *Id.*

[45] *Id.*

The desire of the FDIC to eliminate uncertainty in its nationwide litigation did not qualify as a legally cognizable interest in uniformity, sufficient to preempt state law, otherwise "we would be awash in 'federal common-law' rules."[46] *O'Melveny*, in its reluctance to create federal common law, thus results in the application of state law to quasi-federal actors who are enforcing state law rights unless there is a clear federal statement in the statutory scheme to the contrary, thereby avoiding the creation of discrete bodies of federal law with respect to each quasi-federal agency.

O'Melveny, *Freightliner*, and *Cipollone* are decisions of a conservative Supreme Court and constitute a restatement of applicable law on preemption and the interaction of federal and state law, primarily in a commercial context. These three cases indicate that unless preemption is clearly expressed in the statutory scheme, state law will not be preempted. If the securities industry wants to be subject exclusively or primarily to uniform federal law, at least in certain business lines, there is a clear need to lobby Congress in the legislative process and the SEC in the rulemaking process to clearly enunciate the preemptive scope of the federal securities laws and SEC rules and regulations. Absent such an effort, the securities industry will continue to be subject to class action attack pursuant to a variety of state statutes and common law doctrines that have general application in all commercial contexts.

III. PREEMPTION AND THE EXCHANGE ACT

To date, there has been limited caselaw involving preemption and the Exchange Act. In fact, there are numerous federal court cases pleading both federal fraud claims under the Exchange Act and state statutory and common law fraud claims and no preemption argument is made in these cases. These cases evidence an implicit acceptance of the jurisprudential conclusion that generally federal securities claims do not preempt state common law or statutory fraud claims. Only directly conflicting state schemes or state statutes which frustrate a purpose clearly articulated in a federal securities law are preempted. Most challenged state common law or statutory

[46] *Id.*

schemes do not in fact conflict with federal securities regulations but instead augment or supplement those regulations and thus do not typically present preemption issues.

This article discusses three discrete areas where a preemption or preemption-type analysis has been applied by the courts in substantial bodies of caselaw: tender offers; control person liability; and the availability of damages other than "actual damages" for pendent state claims.[47] An examination of the

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[47] Two other areas have seen the development of less substantial bodies of caselaw. The first area involves the preemptive effect of self-regulatory organization rules and regulations. For a brief discussion of these cases, see *infra* note 64.

The second area involves preemption arguments made in connection with demands under state law for shareholder lists. Early cases established that the existence of the Exchange Act provisions on proxies and the SEC's rules promulgated pursuant thereto did not preempt the field with respect to inspection of stockholder lists when such inspection was for the purpose of proxy solicitation. *See, e.g.*, Wood, Walker & Co. v. Evans, 300 F. Supp. 171, 172-73 (D. Colo. 1969) (rejecting argument that rule 14a-7 preempts "the field of access to shareholder lists"), *aff'd on other grounds*, 461 F.2d 852 (10th Cir. 1972); Alabama Gas Corp. v. Morrow, 92 So. 2d 515, 517-18 (Ala. 1957) (rejecting argument that Exchange Act preempts state inspection statute that "does not in any way relate to the manner of soliciting proxies"); *In re* Joslyn, 78 N.Y.S.2d 183, 185 (Sup. Ct. 1948) ("The [Exchange Act] does not contain any such limitation [prior SEC approval] upon the right to an inspection of the stock transfer book, nor should any such restriction be read into the statute."). Where the demands are made in connection with proxy contests, the preemption issue has been litigated when a shareholder seeks a list of non-objecting beneficial owners of corporate stock, *e.g.*, Shamrock Assocs. v. Texas American Energy Corp., 517 A.2d 658, 661-63 (Del. Ch. 1986) (holding that rule 14a-13(b)(2) has no preemptive effect on section 220 of the Delaware General Corporation Law); *cf.* RB Assocs. of New Jersey v. Gillette Co., No. 9711, 1988 Del. Ch. LEXIS 40, at *12-13 (Mar. 22, 1988) (in nonpreemption case, praising *Shamrock* as a "thoughtful opinion"), and when a state passes a law restricting proxy solicitation, *see, e.g.*, NUI Corp. v. Kimmelman, 593 F. Supp. 1457, 1468-71 (D.N.J. 1984) (holding that state statute requiring approval of a state regulatory agency before soliciting proxies was preempted because state statute frustrates purpose of ensuring "fairness to the investor as well as to those actors competing for the investor's vote"), *rev'd on other grounds*, 765 F.2d 399, 403-05 (3d Cir. 1985) (holding that district court did not need to reach preemption issue because there was no evidence statute affected the pertinent shareholder election). Where the demands are made in connection with tender offers, the alleged conflict has been between state statutory rights to shareholder lists and rule 14d-5 of the Williams Act, which gives the target company the right to either mail an offeror's tender offer materials to its shareholder or to give a shareholder list to the offeror. *See, e.g.*, Baron v. Strawbridge & Clothier, No. 86-

jurisprudence with respect to these three areas reveals a consistent judicial reluctance to find that federal securities laws preempt state law unless there is either a direct conflict between the provisions of a state statute or state common law and the provisions of the Exchange Act that makes it impossible to comply simultaneously with both provisions or a clear congressional intent is frustrated by a state statute or state common law. Because of the presence of section 28(a), there has been only a limited consideration in these cases of field preemption.[48]

The tender offer and damage cases pose the classic preemption issue: whether a state law regime regulating a substantive element of a legal claim can survive in the face of a federal law regime which imposes different substantive regulation of the same conduct.[49] The control person cases pose a hybrid preemption issue: whether a state common law theory of secondary liability can be applied to a federal law primary violation when the state law theory of secondary liability may provide for more expansive liability than the comparable secondary liability provision permitted in the federal scheme.

2474, 1986 U.S. Dist. WL 5163 (E.D. Pa. May 1, 1986) (holding that rule 14d-5 does not preempt section 308 of the Pennsylvania Business Corporation Law); *accord* Burlington Indus., Inc. v. C.H. Masland & Sons, No. 86-3295, 1986 U.S. Dist. WL 6746 (E.D. Pa. June 12, 1986) (citing *Baron* and arriving at same nonpreemption holding). The analysis of the courts in these cases has been consistent with that of the Supreme Court in Edgar v. MITE Corp., 457 U.S. 624 (1982) and CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987). The district court in *NUI* comes closest to a different approach. By giving an honest reading of the practical effect of the state statute, something the Supreme Court avoided in *CTS*, *see infra* text accompanying notes 182-204, the district court came to the conclusion that Congress' intention of neutralizing "any inherent situational advantages enjoyed by the incumbent management by promoting equal and honest access to shareholders" would be frustrated by "the obstacles the New Jersey statute introduces to the accomplishment of that goal." *NUI*, 593 F. Supp. at 1470.

[48] It should be noted that in two of the three areas, control person liability and the availability of certain damages, the courts do not even use the word "preemption" in describing the doctrines upon which their holdings are based, although they are in fact engaged in a preemption-type of analysis.

[49] This characterization also applies to the self-regulatory organization cases. *See infra* note 64.

A. Section 28(a)

Section 28(a) of the Exchange Act[50] preserves state law in two ways. First, it preserves statutory and common law rights and remedies by providing that "[t]he rights and remedies provided by this chapter shall be in addition to any and all rights and remedies that may exist at law or in equity."[51] Second, it preserves certain powers of state blue sky agencies[52] by providing that "[n]othing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder."[53] Such sav-

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[50] 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; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. 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.

15 U.S.C. § 78bb(a) (1994).

[51] *Id.* Section 16 is the sister provision in the Securities Act of 1933 (the "Securities Act"). 15 U.S.C. § 77p (1994). The courts and commentators have treated the first clause of the first sentence of section 28(a) and section 16 as identical. *See, e.g.,* Brunette v. Mutual Serv. Corp., No. 86 C 7718, 1987 WL 17846, at *3 n.3 (N.D. Ill. 1987) (citing both section 16 and section 28(a) as authority for holding that Illinois Consumer Fraud Act is not preempted); James L. Burns, Note, *Pruning the Judicial Oak: Developing a Coherent Application of Common Law Agency and Controlling Person Liability in Securities Cases*, 93 COLUM. L. REV. 1185, 1212 (1993) (construing section 16 of the Securities Act and section 28 of the Exchange Act as both preserving state common law actions).

[52] *See, e.g.,* Leroy v. Great Western United Corp., 443 U.S. 173, 182 n.13 (1979) ("[Legislative history indicated that] the purpose of § 28(a) was to leave the states with as much leeway to regulate securities transactions as the Supremacy Clause would allow them in the absence of such a provision. . . . In particular, the provision was designed to save state blue-sky laws from preemption.") (citations omitted); Underhill Assocs. v. Bradshaw, 674 F.2d 293, 295-96 (4th Cir. 1982) (holding that state broker-dealer registration requirements not preempted by Exchange Act because of section 28 and no conflict between pertinent state statute and Exchange Act).

[53] 15 U.S.C. § 78bb(a) (1994). Section 18 is the sister provision in the

ings clauses are found, in similar language, in all of the federal securities laws.[54]

Securities Act. 15 U.S.C. § 77r (1994). The courts and commentators have treated the second sentence of section 28(a) and section 18 as identical in their intent to preserve state law despite some minor language differences. *See, e.g.,* SEC v. National Sec., Inc., 393 U.S. 453, 461 (1969) (citing both sections for the proposition that "under the securities laws state regulation may co-exist with that offered under the federal securities laws"); Crosby v. Weil, 48 N.E.2d 386 (Ill. 1943); Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case Against Preemption,* 25 B.C. L. REV. 495, 516-21 (1984) (arguing that section 18 preserves state role generally while section 28(a) preserves state role with respect to "trading markets in securities").

See *infra* text accompanying notes 199-200 for Justice Scalia's reading of this last clause in this second sentence of section 28(a), which makes much of the word "provisions" and how this word limits possible preemption analysis. This second sentence is both a savings clause through the phrase "any person," and, starting with the word "insofar," an express preemption provision. This fact has significance under the *Cipollone/Freightliner* analysis described at the *supra* text accompanying notes 26-33. At least one court has relied upon the phrase commencing with "insofar" to hold that "[t]he displacement of federal [securities] law through state regulation is therefore fundamentally inconsistent with the coexistence directed by Congress." Holloway v. Peat, Marwick, Mitchell & Co., 879 F.2d 772, 785 (10th Cir. 1989) (holding that comprehensiveness of *state* regulation is not a factor in considering the removal of securities from federal regulatory regime), *vacated on other grounds,* 494 U.S. 1014, *remanded,* 900 F.2d 1485 (10th Cir.), *cert. denied,* 498 U.S. 958 (1990).

[54] *See* Securities Act of 1933, 15 U.S.C. §§ 77p, 77r (1994); Securities Exchange Act of 1934, 15 U.S.C. § 78bb(a) (1994); Public Utilities Holding Company Act of 1935, 15 U.S.C. § 79u (1994); Investment Company Act of 1940, 15 U.S.C. § 80a-49 (1994); Investment Advisers Act of 1940, 15 U.S.C. § 80b-18a (1994); Trust Indenture Act of 1939, 15 U.S.C. § 77zzz (1994). While all of these acts contain savings clauses, the Investment Advisers Act provision was not a part of the original legislation, having been added as an amendment in 1960. *See* Pub. L. No. 86-750, 74 Stat. 888. The Securities Act of 1933 and the Securities Exchange Act of 1934 preserve state jurisdiction and provide for the survival of "any and all other rights and remedies that may exist at law or in equity," Securities Act of 1933, 15 U.S.C. §§ 77p, 77r (1994); Securities Exchange Act of 1934, 15 U.S.C. § 78bb(a) (1994), while the other four acts only preserve state jurisdiction, Public Utility Holding Company Act of 1935, 15 U.S.C. § 79u (1994); Investment Company Act of 1935, 15 U.S.C. § 80a-49 (1994); Investment Advisers Act of 1940, 15 U.S.C. § 80b-18a (1994); Trust Indenture Act of 1939, 15 U.S.C. § 77zzz (1994). While all of the acts preserve state jurisdiction, only the Securities Act does not expressly limit that jurisdiction to the extent that there are no conflicts with the statute itself. *See* Securities Act of 1933, 15 U.S.C. § 77r (1994). The other acts all contain a statement that preserves state jurisdiction only insofar as it "does not conflict with any provision" of the pertinent statute. Public Utilities Holding Company Act of 1935, 15 U.S.C. § 79u (1994); Securities Exchange Act of 1934, 15 U.S.C.

Section 28(a) has been used by courts to establish the principle that the Exchange Act, whatever it may say about preemption with respect to any particular area of securities regulation, has not displaced state law in general with respect to either corporate law[55] or securities fraud,[56] i.e., there has been no

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§ 78bb(a) (1994); Investment Company Act of 1940, 15 U.S.C. § 80a-49 (1994); Investment Advisers Act of 1940, 15 U.S.C. § 80b-18a (1994). In addition to preserving state jurisdiction, the Investment Company Act of 1940, Public Utilities Holding Company Act of 1935, and Trust Indenture Act of 1939 also preserve the jurisdiction of "any other commission, board, agency, or officer of the United States." Investment Company Act of 1940, 15 U.S.C. § 80a-49 (1994); Public Utilities Holding Company Act of 1935, 15 U.S.C. § 79u (1994); Trust Indenture Act of 1939, 15 U.S.C. § 77zzz (1994).

[55] *See, e.g.*, CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 91 (1987) ("It thus is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares."); Business Roundtable v. SEC, 905 F.2d 406, 410-12 (D.C. Cir. 1990) (holding that SEC does not have authority under the Exchange Act to promulgate one share/one vote rule where effect would be "to establish a federal corporate law by using access to national capital markets as its enforcement mechanism"); Herpich v. Wallace, 430 F.2d 792, 809 (5th Cir. 1970); Kaminsky v. Abrams, 281 F. Supp. 501, 504-05 (S.D.N.Y. 1968) (relying on section 28(a) to hold that there is no "federal corporate law with respect to responsibility of officers and directors that has supremacy over state law"); *but cf.* Conkling v. Moseley, Hallgarten, Esterbrook, & Weeden, Inc., 575 F. Supp. 760, 761-62 (D. Mass. 1983) (holding that Supreme Judicial Court of Massachusetts, if faced with the issue, would not extend state mini-FTC act to a securities transaction because "[a]t least since 1933, federal law has largely superseded state regulation of securities transactions"). Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545 (1984) (giving overview of impact of federal law, in particular the securities laws, on corporate governance). Relying in part on section 28, the *Herpich* court wrote that:

> If Congress had intended that the federal courts inquire into every decision affecting the management of corporations and then fashion a new federal law superseding state law on the fiduciary responsibilities of corporate directors, officers, and controlling persons, presumably so revolutionary a federal intervention into an area traditionally handled by the states would have been clearly expressed.

430 F.2d at 809.

The most definitive statement of this conclusion is found in Santa Fe Indus. v. Green, 430 U.S. 462 (1977). In arriving at this conclusion, the Supreme Court first examined the language of section 10(b). *Id.* at 472-77. This language was enough to establish that Congress did not intend "to bring within the scope of § 10(b) instances of corporate mismanagement such as this, in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary." *Id.* at 477. The Supreme Court then went on, in what is technically dic-

tum, to explain the policies behind its holding. Among the reasons the Court gave was that it did not want "to bring within the Rule [10b-5] a wide variety of corporate conduct traditionally left to state regulation," in particular "fiduciary self-dealing involving transactions in securities." *Id.* at 478. "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden." *Id.* at 479. Nowhere in *Santa Fe*, however, did the Supreme Court make reference to section 28(a).

[56] *See, e.g.*, Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117, 138 n.16 (1973) (citing section 28(a) as a provision "indicating the intent of Congress that state law continues to apply where the [Exchange] Act itself does not"); Diamond v. Oreamuno, 301 N.Y.S.2d 78, 84-85 (N.Y. 1969). In *Diamond*, the New York Court of Appeals created a common law action for breach of fiduciary duty by officers and directors who traded securities issued by their corporation while in possession of inside information concerning the corporation. Although this cause of action paralleled section 16(b) of the Exchange Act and the defendants "acknowledge[d] that the facts asserted constitute a violation of rule 10b-5," *id.* at 84, the Court of Appeals rejected the argument that "the Federal legislation constitutes a comprehensive and carefully wrought plan for dealing with the abuse of inside information and that allowing a derivative action to be maintained under State law would interfere with the Federal scheme." *Id.* Relying on the fact that the additional remedy they were creating would effectuate "the policy embodied in the Securities Exchange Act" and that section 28(a) was evidence that Congress had not "intended to pre-empt the field," the Court of Appeals held that "[t]here is nothing in the Federal Law which indicates that it was intended to limit the power of States to fashion additional remedies to effectuate *similar purposes*." *Id.* at 85 (emphasis added); *see also* North Star Int'l v. Arizona Corp. Comm'n, 720 F.2d 578, 582 (9th Cir. 1983) ("Although we were cited to no federal court precedent, nor did we find any, we have no difficulty concluding that state merit review of an intrastate securities offering does not conflict with the Securities Act of 1933 or the Securities Exchange Act of 1934."); Crosby v. Weil, 48 N.E.2d 386, 390 (Ill. 1943) ("Forty-seven states had securities laws in force at the time Congress passed the acts of 1933 and 1934, and if it had been the intention of Congress to supersede those State acts, we feel it would have been definitely expressed."); *cf.* Travelers Health Ass'n v. Commonwealth, 51 S.E.2d 263, 271 (Va. 1949) ("It was clearly the intention of Congress to leave the States free to exercise such regulatory control over the sale of securities as does not conflict with the provisions of the [Securities Act], and, in the absence of such a conflict, it is contemplated that the States and the Federal Government shall exercise concurrent jurisdiction in this field."), *aff'd on other grounds*, 339 U.S. 643 (1950). Stephen S. Case, Comment, *Statutory Comments: Takeover Bids in Virginia*, 26 WASH. & LEE L. REV. 322, 333 (1969) ("[T]he Securities Exchange Act of 1934, by its own terms [citing to section 28(a)], negates any inference that the Act was intended to pre-empt the field of securities regulation.") (footnote omitted); Russell A. Smith, *State "Blue-Sky" Laws and the Federal Securities Acts*, 34 MICH. L. REV. 1135, 1158-62 (1936) (pioneering discussion of section 28 of the Exchange Act

field preemption.[57] Field preemption issues have been raised in connection with state law fraud claims that either were[58] or

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and section 18 of the Securities Act that concludes that "[i]t seems probable that only an actual conflict--the existence of a state regulation the effect of whose enforcement would be to nullify or frustrate some federal regulation--would bring into play the doctrine of supersedure" of state law by federal law). *But see* Roberta S. Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?*, 53 BROOK. L. REV. 104, 113 (1987) (maintaining that "a sound legal basis exists for constitutional challenges to state merit regulation" on both preemption and Commerce Clause grounds). One of the broadest interpretations of the area reserved by sections 18 and 28(a) to state law is found in Joseph A. Grundfest, *Disimplying Private Rights of Actions Under the Federal Securities Laws: The Commission's Authority,* 107 HARV. L. REV. 963, 1008-09 (1994). In an otherwise excellent article, Professor Grundfest, applying section 18 and the second sentence of section 28(a) to the SEC's rulemaking authority, comes to the following startling conclusion: "Commission rulemaking therefore cannot affect the remedies available to private parties under state 'blue sky' laws, state common law, or other state statutory regimes." *Id.* Professor Grundfest seems to have forgotten such SEC actions as rule 14d-2, which has been held to have a preemptive effect on state takeover laws. *See infra* text accompanying notes 161-63.

[57] A similar body of caselaw concerning field preemption has developed under section 18 of the Securities Act, which is the sister provision to the second sentence of section 28. *See, e.g.*, ANR Pipeline Co. v. Schneidewind, 627 F. Supp. 923, 930 (W.D. Mich. 1985) (holding that Michigan public utilities statute not preempted by Securities Act), *rev'd on other grounds*, 801 F.2d 228 (6th Cir. 1986) (finding preemption by federal Natural Gas Act), *and aff'd*, 485 U.S. 293 (1988); SEC v. Timetrust, 28 F. Supp. 34, 41 (N.D. Cal. 1939) (holding that section 18 of the Securities Act gives concurrent jurisdiction over intrastate offerings to state securities commissions and SEC), *remanded on other grounds*, 130 F.2d 214 (9th Cir. 1942); Carney v. Hanson Oil Co., 690 S.W.2d 404, 406 (Mo. 1985) (en banc) (relying on section 18 to hold that there was no intention by Congress to supersede state blue sky laws); Haberman v. Washington Pub. Power Supply Sys., 744 P.2d 1032, 1051 (Wash. 1987) (en banc) ("In any event, federal law does not preempt or control state securities acts."), *modified on other grounds*, 750 P.2d 254 (Wash.), *and appeal dismissed*, 488 U.S. 805 (1988). Professor Warren has also looked to the structure of the Securities Act, in particular certain exemptions such as those for intrastate offerings, as evidence that Congress did not intend that the Securities Act should preempt state securities laws. Warren, *supra* note 53, at 519.

[58] *See, e.g.*, E.F. Hutton & Co. v. Rousseff, 537 So. 2d 978, 979 (Fla. 1989) (holding that Florida Securities Act, although similar in language to rule 10b-5, had different standards with respect to loss causation; action brought under section 10(b) and the Florida Securities Act); Jennings v. Roberts Scott & Co., 546 P.2d 343 (Ariz. 1976) (holding that trial court could hear Arizona claims in action to dismiss claims under Exchange Act and Securities Act because federal courts have exclusive jurisdiction over Exchange Act claims under section 27); McCollum v. Billings, 279 N.Y.S.2d 609, 616-17 (Sup. Ct. 1967) (relying on

could have been[59] the basis for a claim under section 10(b) of the Exchange Act, and these claims have typically survived the preemption challenge. Narrower preemption-type arguments have also been rejected by the courts.[60] Of course, limited cir-

section 28(a) to reject arguments that state court should not have jurisdiction over a state cause of action when acts underlying state cause of action are same acts charged in a separate cause of action arising under, inter alia, section 10(b) and rule 10b-5); *cf.* Twomey v. Mitchum, Jones & Templeton, Inc., 69 Cal. Rptr. 222, 234-35 (Ct. App. 1968) (citing *McCollum* for the proposition that section 28 does not deprive state courts of jurisdiction over violations of state law that were also alleged to be violations, inter alia, of rule 10b-5).

[59] *See, e.g.*, Diamond v. Oreamuno, 301 N.Y.S.2d 78, 84 (N.Y. 1969) (finding derivative action against officers and directors for breach of fiduciary duty only brought under New York common law although it could also have been brought under rule 10b-5 promulgated pursuant to the Exchange Act); *cf.* Sullivan v. First Affiliated Sec., Inc., 813 F.2d 1368, 1377 (9th Cir.) (refusing to remove to federal court a state action involving same alleged securities fraud that was the subject of a related federal action because federal judgement would not have res judicata effect on state action), *cert. denied*, 484 U.S. 850 (1987); Errion v. Connell, 236 F.2d 447, 454 (9th Cir. 1956) ("If one is defrauded out of non-securities or securities, his remedy can be an action for common-law fraud in the state courts. The Act of 1934 merely created an additional remedy for one who had been defrauded of his securities."); Gold v. Blinder, Robinson & Co., 580 F. Supp. 50, 54 (S.D.N.Y. 1984) (bringing action exclusively under state law although facts would have supported a claim under section 10(b) of the Exchange Act and possibly section 17(a) of the Securities Act of 1933).

[60] See *infra* parts III.B-III.D for a discussion of preemption holdings in the tender offer, control person, and damage cases. Preemption arguments have also been raised in a number of other legal contexts, which have not generated any bodies of caselaw. *See, e.g.*, State v. Florentino, 456 N.Y.S.2d 638, 647 (N.Y. City Crim. Ct. 1982) (holding that criminal sanctions under New York's blue sky law for insider trading not preempted by the Williams Act); Johnson-Bowles Co. v. Division of Sec., 829 P.2d 101, 110 (Utah Ct. App.) (holding that NASD rules did not preempt state action prohibiting fraudulent trading of securities because compliance with federal and state law was not "a physical impossibility" and state action fulfilled "the purposes and objectives of federal law"), *cert. denied*, 843 P.2d 516 (Utah 1992); *cf.* Kroog v. Mait, 712 F.2d 1148, 1155 (7th Cir. 1983) (arguing that federal law to be applied in preemption analysis of arbitration provision of Wisconsin blue sky law was Federal Arbitration Act as interpreted by Wilko v. Swan, 346 U.S. 427 (1953)) (Eschback, J., dissenting), *cert. denied*, 465 U.S. 1007 (1984); Brunette v. Mutual Service Corp., No. 86 C 7718, 1987 WL 17846, at *3 (N.D. Ill. Sept. 29, 1987) (expressing in dictum doubt that federal securities laws would preempt Illinois Consumer Fraud Act); Mirkin v. Wasserman, 858 P.2d 568, 593-95 (Cal. 1993) (arguing that pleading fraud-on-the-market should be allowed under California tort law even though "victims of securities fraud [have] a remedy through a rule 10b-5 action") (Kennard, J., concurring and dissenting); E.F. Hutton & Co. v. Rouseff, 537 So.

cumstances remain wherein a direct conflict between federal and state law dictates preemption.[61]

The rejection of any general field preemptive effect of the Exchange Act is also consistent with the past two decades of Supreme Court jurisprudence in the federal securities laws. Starting in the mid-1970s, the Supreme Court evinced a great reluctance to expand standing, rights, or remedies under the Exchange Act.[62] Not surprisingly, preemption analysis has not been the primary tool that the Supreme Court has used. In fact, the Supreme Court has only dealt with the preemptive effect of the Exchange Act in two contexts: in the context of state takeover laws[63] and that of self-regulatory organization

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2d 978, 980-91 (Fla. 1989) (holding that Florida legislature did not intend to have a section of Florida's blue sky law that was similar in language to rule 10b-5 interpreted in light of rule 10b-5 caselaw).

[61] *See, e.g.*, Chanoff v. U.S. Surgical Corp., 857 F. Supp. 1011, 1016 (D. Conn. 1994) ("The court agrees, however, that to the extent that plaintiffs' state claims are based on defendant Scipione's duty to disclose to William Chanoff during their personal exchanges, these claims are preempted by the federal securities laws which proscribe such selective disclosure."), *aff'd*, 33 F.3d 50 (2d Cir. 1994) (mem.); First Jersey Sec., Inc. v. SEC, 476 A.2d 861, 868 (N.J. Super. Ct. App. Div. 1984) ("We hold that the supremacy clause bars a New Jersey court from interfering with the federal administrative proceedings [of the SEC]."), *appeal dismissed*, 101 N.J. 208 (1985).

[62] Alfred F. Conrad, *Securities Regulation in the Burger Court*, 56 U. COLO. L. REV. 193 (1985) (describing the growing disparity between the SEC's and the Supreme Court's interpretations of federal securities laws); Grundfest, *supra* note 56, at 985-98 (describing development of implied right of action under rule 10b-5 and the Supreme Court's "seeming hostility to implied private rights under the securities laws"); Louis D. Lowenfels, *Recent Supreme Court Decisions under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891, 892 (1977) ("In these recent holdings, the Supreme Court has consistently decided in favor of the defendants and has enunciated principles that may circumscribe the rights of plaintiffs under the federal securities laws for many years to come."); William C. Tyson, *The Proper Relationship Between Federal and State Law in the Regulation of Tender Offers*, 66 NOTRE DAME L. REV. 241 (1990) (describing this phenomenon in the four Supreme Court cases dealing with the Williams Act); C. Larimore Whitaker & James E. Rotch, *The Supreme Court and the Counter-Revolution in Securities Regulation*, 30 ALA. L. REV. 335 (1979) (discussing five Supreme Court cases in which the "gathering revolution in securities regulation . . . has been dismantled"). For a discussion of this "gathering revolution," see David S. Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 NW. U. L. REV. 185 (1964), and Arthur Fleischer, Jr., *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146 (1965).

[63] *See infra* parts III.B.2 and III.B.3.

rules.[64] The primary means by which the Supreme Court has

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[64] *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117 (1973). *Ware* involved the issue of whether a NYSE rule, that required arbitration of employment disputes, preempted a California state statute that provided that disputes about wages were not subject to arbitration. *Id.* at 125. The Supreme Court's analysis was consistent with its analysis later in *MITE* and *CTS*. See *infra* parts III.B.2 and III.B.3 for a discussion of *MITE* and *CTS*. In rejecting the argument "that nationwide uniformity of an exchange's housekeeping affairs is necessary or desirable," the *Ware* Court noted that "Congress, in the securities field, has not adopted a regulation system wholly apart from and exclusive of state regulation." *Id.* at 137. The *Ware* Court also noted that there was no explicit provision in the Exchange Act or the SEC's rules or regulations favoring arbitration. *Id.* at 135. The *Ware* Court focused its analysis on the purpose behind the SEC's oversight of the NYSE and its rules and practices, concluding that Congress intended the SEC to supervise self-regulatory rules and practices only if they are "germane to fair dealing or investor protection." *Id.* at 130-31. Any other rule or practice does not "fall under the shadow of the federal umbrella; it is, instead, subject to applicable state law." *Id.* As the NYSE rule was not subject to SEC "modification or review" and there was "no allegation that arbitration will lessen fair dealing or decrease investor protection," there was no preemption of the California statute by the NYSE rule. *Id.* at 135-36.

Lower court cases such as Buckley v. Chicago Board Options Exch., Inc., 440 N.E.2d 914 (Ill. App. Ct. 1982), have also addressed the preemptive impact on state law of the Exchange Act and self-regulatory organization rules subject to SEC review and modification. In *Buckley* the plaintiff sought a state judicial equitable remedy to enforce a contract concerning membership in a self-regulatory organization. Although the *Buckley* court couched its analysis in terms of conflict preemption, the holding that there was preemption would rest more securely on a field preemption theory based on implied congressional intent. *See id.* at 917-19. The *Buckley* court agreed with the defendant that

> the state remedy which [the plaintiff] seeks would conflict with this comprehensive statutory scheme of exchange membership regulation and would stand as an obstacle to the accomplishment of the evident Congressional intent to allow the [SEC] and not the courts in the first instance to determine whether a person has been denied exchange membership in accordance with the [Exchange] Act.

Id. at 919. In coming to this conclusion, the *Buckley* court distinguished *Ware* by noting that the Exchange Act included the membership provisions upon which the defendant in *Buckley* relied. *Id.* In addition, the *Buckley* court relied on the fact that the pertinent provision of the defendant's articles of incorporation was subject to SEC "review and modification," unlike the arbitration provision in *Ware*. *Id.*

In *Ware* there was no dispute about the construction of the self-regulatory organization rule while the construction of defendant's articles of incorporation was the main issue in *Buckley*. *Id.* at 917. The real issue in *Buckley* was whether a state court or the SEC would be the first forum to review the articles of incorporation. *Id.* at 920. Thus, *Ware* is a case concerning the preemption of a

restrained the growth of federal law into the areas of state corporate law and state securities regulation has been the limited philosophy behind the federal securities laws that the Supreme Court has ascribed to Congress,[65] combined with a literalist reading of the statutory language.[66] The effect of these cases has been to defer to state judicial and legislative initiatives in most areas of corporate law.[67]

In and of itself such a savings clause does not answer the preemption issue as applied to any particular provision of the federal securities law and the allegedly conflicting provision of state law.[68] The difficulty arises in part from basic principles of statutory construction. First, the savings clause itself must be interpreted.[69] For example, in the case of section 28(a),

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substantive provision of state law while *Buckley* is a case concerning the preemption of a procedural provision of state law.

[65] "[T]he Court repeatedly has described the 'fundamental purpose' of the [Exchange] Act as implementing a 'philosophy of full disclosure'; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute." Santa Fe Indus. v. Green, 430 U.S. 462, 478-79 (1977). *See also* SEC v. Capital Gains Research Center, 375 U.S. 180, 186 (1963) ("A fundamental purpose, common to these [federal securities] statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor."); SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) ("The design of the [Securities Act] statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.").

[66] *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 198-99 (1976).

[67] *See, e.g.*, Tyson, *supra* note 62, at 246, 338-39 (describing Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977) and Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985), as laying "the groundwork for a growing prominence of state *judicial* regulation of the tender offer process" and *CTS* as countenancing "state *legislative* regulation").

[68] *See* Note, *Pre-emption as a Preferential Ground: A New Canon of Construction*, 12 STAN. L. REV. 208, 211-15 (1959).

[69] The Court must begin its analysis of a general savings clause [such as section 28(a)] by recognizing that Congress is not able to anticipate all of the preemption problems which may arise in the broad field covered by the clause. Accordingly, the Court should infer that a literal application of the clause would not serve the statutory purpose. The Court, however, cannot use this analysis to deny all effect to a savings clause; Congress quite evidently intends to save some state laws from preemption when it enacts such a clause.

Hirsch, *supra* note 13, at 540-41.

The general savings language contained in section 28(a) should be contrasted to the more specific savings language found in some federal statutes that, in Professor Tribe's generic paraphrase, provides that such a statute "preempts

what is meant by the phrase "all rights and remedies that may exist at law or in equity" in the first sentence of section 28(a)? Insofar as the pertinent right or remedy in any case did not exist in 1934 when the relevant language in section 28(a) was passed, the applicability of section 28(a) is questionable.[70]

The second sentence has generated its own controversy that is particularly relevant to state takeover statutes. This issue

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only those laws which purport to require or permit conduct which would be a violation of the federal statute." TRIBE, *supra* note 5, §§ 6-26, at 482 n.8. When such a specific savings clause is present, Professor Tribe would restrict conflict preemption analysis to whether such prohibited conduct is required or permitted by the pertinent state statute, rather than engaging in a conflict analysis focussed on the objective of the federal statute:

> To engage in such a broader inquiry is to forget that preemption is ultimately a matter of *construing* a federal statute; when the statute contains its own preemption or anti-preemption provision, a court that fails to give dispositive effect and instead applies its own preemption criteria is illegitimately disregarding the source of its authority and, regardless of where its preemption inquiry leads it, is pursuing a fundamentally lawless path.

Id.

[70] *Cf.* Michigan Canners & Freezers Ass'n, Inc. v. Agricultural Marketing & Bargaining Bd., 467 U.S. 461, 469 n.9 (1984) (considering this argument in a case involving federal Agricultural Fair Practice Act of 1967 but rejecting it on the facts); Independence Shares Corp. v. Deckert, 108 F.2d 51, 54 (3d Cir. 1939) (construing section 16 of the Securities Act, the sister provision to the first sentence of section 28(a), to hold that "Congress by the language employed sought only to make it abundantly clear that it was not pre-empting this field to the federal jurisdiction, thereby prohibiting recovery to defrauded individuals under the law of the states as that existed *prior* to the passage of the Securities Act") (emphasis added), *cert. granted*, 309 U.S. 648, *and decree rev'd*, 311 U.S. 282 (1940). As the relevant savings language of section 28(a) has been part of this section since the original enactment of the Exchange Act, Securities Exchange Act of 1934, ch. 404, Title I § 28, 48 Stat. 903 (1934), a more general issue of statutory interpretation is presented by section 28(a). Such language does not necessarily effect "subsequent legislation because of the principle that one Congress cannot bind a later Congress." Note, *supra* note 68, at 213; Hirsch, *supra* note 13, at 540. The same principle should apply to a federal agency, such as the SEC, acting in accordance with its congressionally delegated powers. If a later Congress supplements or amends the act that is subject to a savings clause, but fails to explicitly mention the effect that the savings clause should have on this new material, two diametrically opposed conclusions can be implied from the congressional silence. Either Congress intended the savings clause to apply to the new material because it "could easily have made a specific exception if it wished to," or Congress repealed or limited the savings clause by implication. Hirsch, *supra* note 13, at 540.

has been framed as a debate over whether the second sentence should be applied only to state blue sky laws, which had been in existence for some three decades prior to the passage of the Exchange Act,[71] or also to state takeover laws,[72] which did not come into existence until more than five decades after passage of the Exchange Act.[73]

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[71] Louis Loss & Edward M. Cowett, BLUE SKY LAW 3-10, 17 (1958) (tracing blue sky laws back to 1903, and reporting that, by 1913, twenty-four states had blue sky laws and that, by 1933, all states but Nevada had a blue sky law).

[72] *Compare* Donald C. Langevoort, *State Tender - Offer Legislation: Interests, Effects, and Political Competency*, 62 CORNELL L. REV. 213, 247 (1977) (arguing that the application of section 28(a) to state takeover laws "is extremely questionable") *with* AMCA Int'l Corp. v. Krouse, 482 F. Supp. 929, 935 (S.D. Ohio 1979) ("Congress has amended the Williams Act and other provisions of the Exchange Act on several occasions since Ohio adopted and applied its Act, without explicitly preempting state tender regulation or disturbing the original text of Section 28, which remains as it was enacted in 1934. . . ."); Robert C. Rasmussen & Jeffrey M. Fuller, *Florida Takeover Law: Control Share Acquisitions*, 16 FLA. ST. U. L. REV. 103, 129 (1988) (suggesting application of section 28(a) to state takeover laws appropriate because Williams Act did not attempt to amend section 28(a)). The Supreme Court avoided a direct confrontation with this issue in CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987). By analogizing the state control share acquisition statute involved in *CTS* with traditional state controls over corporate voting rather than treating such statutes as new types of state legislation, the Supreme Court was able to write that "[t]he longstanding prevalence of state regulation in this area suggests that, if Congress had intended to pre-empt all state laws that delay the acquisition of voting control following a tender offer, it would have said so explicitly." *Id.* at 86. Although the Supreme Court may have been alluding to section 28(a) in this statement, there is nothing in the text of the opinion to indicate this. *But see* Dennis Honabach & Roger Dennis, *The Seventh Circuit and the Market for Corporate Control*, 65 CHI.-KENT L. REV. 681, 735 n.318 (1989) ("The Court noted that section 28 of the 1934 Act was specifically intended to allow state law to remain in place. [*CTS*,] 481 U.S. at 86. This provision was previously thought to be directed at preserving the role of the states in the Blue Sky administration.").

In addition, insofar as a state securities administrator is not involved in administering a state takeover statute, the language of section 28 would appear to make section 28 "inapplicable." Theodore R. Boehm, *State Interests and Interstate Commerce: A Look at the Theoretical Underpinnings of Takeover Legislation*, 36 WASH. & LEE L. REV. 733, 749 (1979).

[73] This argument could be made with respect to both state rights and remedies and new federal rights and remedies, such as implied causes of action under section 10(b) of the Exchange Act and rule 10b-5 promulgated thereunder, when such right or remedy came into existence after 1934. *See* William J. Fitzpatrick & Ronald T. Carman, *Respondeat Superior and the Federal Securities Laws. A Round Peg in a Square Hole*, 12 HOFSTRA L. REV. 1, 24 n.157

The legislative history of the original enactment of section 28(a) is sparse and sheds little light on what Congress intended, beyond foreclosing the field preemption argument. Section 16 of the Securities Act is the comparable section to the first clause of the first sentence of section 28(a), and section 18 of the Securities Act is the comparable section to the second sentence of section 28(a). Bills introduced in the House of Representatives were the source for both sections 16 and 18;[74] the

(1983) (Section 28(a) "permits a damaged investor to utilize state statutory or common law causes of action which existed prior to the passage of the federal securities laws in addition to those created by the federal securities laws."); John J. Musewicz, *Vicarious Employer Liability and Section 10(b): In Defense of the Common Law*, 50 GEO. WASH. L. REV. 754, 790 n.218 (1982) ("Obviously no causes of action had been implied under the 1934 Act prior to its original enactment with the § 28(a) savings clause."). Section 10(b) and rule 10b-5 are the bases for most of the control person cases discussed in part III.C *infra*.

[74] H.R. 4500, 73d Cong., 1st Sess. (1933). This bill, introduced on March 30, 1933, contained a section 15 and a section 17 that were identical in all material respects with what became sections 16 and 18 in the enacted Securities Act. In addition, this bill contained a section 18 that made it unlawful to "sell or deliver" any security into any state "where such sale or delivery, if it had taken place wholly within such [s]tate, . . . would be in violation of the laws thereof relating to the sale of securities." The intent of the prior section 18 was to make state blue sky laws "more effective" by making "it unlawful to use the instruments of interstate or foreign commerce in an effort to evade protective State legislation." H.R. Rep. No. 85, 73d Cong., 1st Sess. 10 (1933). (Although this report was on H.R. 5480, H.R. 5480 was the May 4, 1933 successor bill to H.R. 4500 and contained an identical section 18. H.R. 5480, 73d Cong., 1st Sess. § 18 (1933).) Two members of the House Committee of Interstate and Foreign Commerce strenuously objected to this section because it gave too much power to the states and because the federal government would have become an enforcer of state blue sky laws. One of the objections was that "[t]his section would impose unwarranted burdens on the sale of securities. The dealer, in addition to establishing his right to engage in interstate commerce by complying with the Federal act, would be forced to register and meet the individual requirements of each of the 48 States in which he transacts business." H.R. Rep. No. 85, *supra*, at 28; *see also* 77 Cong. Rec. 2914 (1933) (containing statement by Representative Samuel B. Hill to the effect that prior section 18 "is absolutely vicious" as it would defeat uniformity). It is important to note that the objection was only to the prior section 18 and not to section 17, which was to become the present section 18. The prior section 18 was deleted from the bill that became the Securities Act without any explanation. H.R. Rep. 152, 73d Cong., 1st Sess. 27 (1933) ("The House bill (sec. 18) contained a provision prohibiting the selling of securities in interstate commerce in any State, Territory, or the District of Columbia where such a sale would have been a violation of the laws thereof relating to the sale of securities if it had taken place wholly therein. This

bill originally introduced in the Senate contained no such provisions.[75] The legislative history does not speak in detail concerning the two sections found in the Securities Act.[76] But the legislative history does make clear that there was no intent to preempt the field of securities regulation and that section 18 was intended to preserve state regulation of securities.[77] As the legislative history speaks mainly about the future role of state blue sky laws, there is almost no legislative history material addressing the intent behind section 16.

The legislative history of section 28(a) of the Exchange Act is even sparser than the comparable legislative history for the Securities Act.[78] There was no discussion, as there was with

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provision is not in the Senate amendment and is eliminated from the substitute.").

[75] S. 875, 73d Cong., 1st Sess. (1933) (introduced Mar. 13, 1933).

[76] This may be due in part to the fact that the hearings were held on the predecessor House bill to H.R. 4500 and on S. 875, neither of which contained comparable sections to the present sections 16 and 18. *See Federal Securities Act: Hearings on H.R. 4314 Before the House Interstate and Foreign Commerce Comm.*, 73d Cong., 1st Sess. (1933) [hereinafter *1933 House Hearings*]; *Securities Act: Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. (1933) [hereinafter *1933 Senate Hearings*].

[77] H.R. Rep. 85, *supra* note 74, at 10 ("This bill carefully preserves the jurisdiction of the State security commissions to regulate transactions within their own borders."). Both the House and the Senate hearings reproduced a study from the Department of Commerce that discussed blue sky laws in detail. *1933 House Hearings*, *supra* note 76, at 87-111; *1933 Senate Hearings*, *supra* note 76, at app. 312-35. This study reported that state blue sky laws had yielded "beneficial results," *1933 Senate Hearings*, *supra* note 76, app. at 312, 323, but that there were structural weaknesses in the blue sky regime, *id.* at 323-25; therefore, a federal statute was necessary to "*supplement* the State Blue-sky laws, and to supervise interstate transactions that they cannot reach," *id.* at 334 (emphasis added).

[78] Both the early House and Senate bills contained sections with identical language that were the progenitor of the first clause of the first sentence of section 28(a). H.R. 7852, 73d Cong., 2d Sess. § 26(a) (1934) (introduced on Feb. 10, 1934); S. 2642, 73d Cong., 2d Sess. § 26(a) (1934) (introduced on Feb. 6, 1934). The first sentences of both of these sections 26(a) were identical in all material respects with what became the first clause of the first sentence of section 28(a) in the enacted Exchange Act.

The second sentence of section 28(a) was not part of the original bills and there is almost nothing in the legislative history discussing the addition of this second sentence. The only reference is in a memorandum to the House committee that considered two early predecessor bills to the Exchange Act. In this memorandum the writer advocated that the identical language from section 18 of the Securities Act be added to the Exchange Act. *Stock Exchange Regulation:*

the Securities Act, of preserving state blue sky laws. This may be due in part to the fact that the issue was thoroughly ventilated when the Securities Act was originally passed. And in part this lack of discussion may be accounted for by the fact that the Exchange Act grew to some extent out of a concern over the lack of effective self regulation by securities exchanges,[79] an area in which state law was much less important than it was in securities offerings. But, at least with respect to federal regulation of exchanges, there was consideration given to superseding state law, although this was rejected by Congress very quickly.[80]

Hearings on H.R. 7852 and H.R. 8720 Before the House Interstate and Foreign Commerce Comm., 73d Cong., 2d Sess. 670 (1934) (memorandum from Adolph Johnson, chief counsel, Public Service Commission of Wisconsin) [hereinafter *1934 House Hearings*].

The House and Senate reports on section 27, which became section 28, are just paraphrases, in almost identical language, of the statutory language, S. Rep. 792, 73d Cong., 2d Sess. 22 (1934); H. Rep. 1383, 73d Cong., 2d Sess. 28 (1934), and provide no illumination concerning the legislative intent behind section 28.

[79] *See* 1 LOSS & SELIGMAN, *supra* note 4, at 221-24.

[80] Both H.R. 7852 and S. 2693, the early predecessor bills to the Exchange Act, contained sections 26(a) with second clauses in their first sentence that provided that "[t]his Act shall supersede such laws of any state as are inconsistent with the provisions or purposes of this Act and such laws of any state as provide for the supervision or regulation of the administration or conduct of business on an exchange which is licensed by the Commission." H.R. 7852, *supra* note 78, § 26(a); S. 2693, *supra* note 78, § 26(a). This language would have allowed the federal government, by its power over security listings on exchanges, to supersede "the regulation and authority of State insurance commissioners and banking commissioners, and public utility commissioners, at least insofar as they affect the accounting and financial practices of the companies." *1934 House Hearings*, *supra* note 78, at 507 (statement of John Dickinson, Assistant Secretary of Commerce and Chairman of the Interdepartmental Committee on Stock-Exchange Regulation). Concerns were raised that this language was unconstitutional. *Stock Exchange Practices, Hearings on S. Res. 84, S. Res. 56 and S. Res. 57 Before the Senate Committee on Banking and Currency*, 73d Cong., 2d Sess. 6577 (statement of Thomas G. Corcoran, Office of Counsel for the Reconstruction Finance Corporation), 6640 (statement of Richard Whitney, president of the NYSE), 7022 (letter from Lowell R. Burch, president of New York Airbrake Co.) (1934) [hereinafter *1934 Senate Hearings*]. Since the early 1930s, the Supreme Court's position has changed considerably and there is no doubt that a broadly preemptive Congressional measure in the securities regulation area would withstand judicial scrutiny. *See* William F. Swindler, COURT AND CONSTITUTION IN THE TWENTIETH CENTURY: THE NEW LEGALITY, 1932-1968 102-104 (1970); *cf.* Note, *Federal Chartering of Corpora-*

As part of the 1975 amendments to the federal securities laws, section 28 also was amended, expressly preempting two areas of state law. These amendments are particularly important in light of recent Supreme Court cases such as *Cipollone* and *Freightliner* and the great weight these cases have placed on express preemption provisions in federal statutes.[81] The 1975 amendments added two new sections to section 28(a). The first expressly preempted taxation of securities based upon any change of ownership or upon any transfer of securities in either case effected through a clearing agency or transfer agent, unless the securities would be otherwise taxable if the clearing agency or transfer agent were not located within the taxing state.[82] The second expressly preempted any already existing

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tions: Constitutional Challenges, 61 GEO. L.J. 123, 148 (1972) ("Under the long line of decisions in the commerce clause field, it is apparent that Congress can at least require all corporations engaging in, or whose activities affect, interstate commerce to obtain a federal license or convert to a federal charter."). This potentially preemptive provision vanished on March 19, 1934, from the House bill, *see* H.R. 8720, 73d Cong., 2d Sess. § 27(a) (1934), and on April 20, 1934, from the Senate bill, *see* S. 3420, 73d Cong., 2d Sess. § 27(a) (1934). There is no further material in the legislative history concerning this potentially preemptive provision because it was not part of the draft bills that were the subject of public Congressional debate that began in the House on April 30, 1934, and in the Senate on May 7, 1934. *See* 4 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934 v-vi (J. S. Ellenberger & Ellen P. Mahar eds., 1973).

[81] See *supra* text accompanying notes 26-33 for a discussion of these cases.

[82] (d). . . No State or political subdivision thereof shall impose any tax on any change in beneficial or record ownership of securities effected through the facilities of a registered clearing agency or registered transfer agent or any nominee thereof or custodian therefor or on the delivery or transfer of securities to or through or receipt from such agency or agent or any nominee thereof or custodian therefor, unless such change in beneficial or record ownership or such transfer or delivery or receipt would otherwise be taxable by such State or political subdivision if the facilities of such registered clearing agency, registered transfer agent, or any nominee thereof or custodian therefor were not physically located in the taxing State or political subdivision. No State or political subdivision thereof shall impose any tax on securities which are deposited in or retained by a registered clearing agency, registered transfer agent, or any nominee thereof or custodian therefor, unless such securities would otherwise be taxable by such State or political subdivision if the facilities of such registered clearing agency, registered transfer agent, or any nominee thereof or custodian therefor were not physically located in the taxing State or political subdivision.

state laws by creating a "safe harbor" from claimed breaches of fiduciary duty for a money manager placing discretionary investment account orders with a broker-dealer that charged more than the lowest available commission. This safe harbor applied if the money manager received certain types of non-cash benefits from the broker that in general benefitted its clients.[83] This second provision allows orders to be placed with broker-dealers that offer "soft dollar" inducements.[84] The legislative history of the 1975 amendments demonstrates that Congress intended that the limitation on state taxes should have only a limited preemptive effect.[85] Although the preemption of existing state laws concerning soft dollar inducements was meant to be total, Congress did provide that the states

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15 U.S.C. § 78bb(d) (1994).

[83] (e). . . (1) No person using the mails, or any means or instrumentality of interstate commerce, in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to the date of enactment of the Securities Acts Amendments of 1975 solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion. This subsection is exclusive and plenary insofar as conduct is covered by the foregoing, unless otherwise expressly provided by contract: *Provided, however*, that nothing in this subsection shall be construed to impair or limit the power of the Commission under any other provision of this title or otherwise.

15 U.S.C. § 78bb(e) (1994).

[84] *See* SECURITIES ACTS AMENDMENTS OF 1975, S. REP. NO. 75, 94th Cong., 1st Sess. 69-71 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 247-49.

[85] *See supra* note 84, at 60, *reprinted in* 1975 U.S.C.C.A.N. at 238 (restriction on state taxes meant to "preserv[e] the state taxing powers over transactions with which the taxing state has a traditional jurisdictional basis for taxation"); *id.* at 139, *reprinted in* 1975 U.S.C.C.A.N. 316 (section (d) "is designed to work the least interference with State law while at the same time facilitating the purposes of the bill"); H. Rep. No. 123, 94th Cong., 1st Sess. 87 (1975) (same comment with respect to comparable provision in H.R. 4111, which bill was set aside in favor of the Senate bill).

could reimpose different statutory fiduciary duties subsequent to the effective date of the amendments.[86]

In 1982, the Securities Act and the Exchange Act were both amended to clearly specify that the SEC had jurisdiction over options on securities. These amendments were prompted by a Seventh Circuit case[87] that had held that options on GNMA Securities were not securities.[88] One motivation behind these amendments was the desire to preserve not only the SEC's jurisdiction but also that of state securities administrators.[89] The NYSE took advantage of this legislative activity to request an unrelated amendment to section 28 that would preempt the application of state gaming or "bucket shop" laws to the trading of options regulated by the SEC.[90] The last sentence of section 28(a)[91] was added at this time.[92] The legislative history of the 1982 amendments is similar to that of the 1975 amendments as the scope of this preemptive last sentence clearly was intended to be a limited one.[93]

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[86] *Supra* note 84, at 70, 139, *reprinted in* 1975 U.S.C.C.A.N. 248, 316; H.R. REP. NO. 229, 94th Cong., 1st Sess. 339 (1975), *reprinted in* 1975 U.S.C.C.A.N. 339 (comparing H.R. 4111 to the Senate bill and reporting that "[a]lthough the two provisions were nearly identical, the Senate version more clearly preempted both statutory and common law"); H.R. REP. NO. 123, *supra* note 85, at 95 (in commentary on H.R. 4111, stating that "no preemption would be effected in the face of an express and specific legislative decision at the state or federal level" that "redefine[s] the responsibilities and duties of particular fiduciaries with respect to the use of "soft dollar inducements").

[87] Board of Trade v. SEC, 677 F.2d 1137 (7th Cir. 1982).

[88] SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, SECURITIES COMMODITIES ACCORD AMENDMENTS OF 1982, S. REP. NO. 390, 97th Cong., 2d Sess. 3 (1982).

[89] 128 Cong. Rec. 24,909 (1982) (statement of Rep. Dingell).

[90] *NYSE Seeking Amendment to Void State Laws that Block Index Option*, SEC. REG. & L. REP., June 4, 1982, at 1014-15; *CFTC/SEC Bills Amended, Approved by House Energy and Commerce Committee*, SEC. REG. & L. REP., June 18, 1982, at 1107.

[91] No State law which prohibits or regulates the making or promoting of wagering or gaming contracts,or the operation of "bucket shops" or other similar or related activities, shall invalidate any put, call, straddle, option, privilege, or other security, or apply to any activity which is incidental or related to the offer, purchase, sale, exercise, settlement, or closeout of any such instrument, if such instrument is traded pursuant to rules and regulations of a self-regulatory organization that are filed with the Commission pursuant to section 78s(b) of this Act.

15 U.S.C. § 78bb(a) (1994).

[92] Pub. L. 97-303, § 4, 96 Stat. 1409.

[93] *See* HOUSE ENERGY AND COMMERCE COMM., H. DOC. 626 (I), 97th Cong.,

These amendments to section 28 of the Exchange Act indicate that Congress has, when lobbied by the securities industry, passed amendments preempting relevant state law. These specific preemptive amendments support the contention that field preemption pursuant to the Exchange Act was not intended as these amendments would be superfluous if field preemption was intended.

In fact, Congress has periodically addressed the issue of preemption as it applies to both state securities regulation and state corporate law. Although there was significant deference paid in the legislative process leading up to the Securities and the Exchange Acts to the preservation of state law, there was consideration in the legislative process leading up to the Exchange Act of preempting the area of stock exchange regulation.[94] Without attempting to discuss every instance in which the preemption issue has been addressed in connection with the Exchange Act or the Securities Act by Congress or the SEC, the following are some of the more significant preemption discussions since 1933.[95]

2d Sess. 10 (1982). "A *limited* preemption of state anti-gaming and bucket shop laws is also provided for options contracts approved by the SEC for trading on securities exchanges. These contracts would remain subject to all applicable state anti-fraud, securities and other laws." *Id.* (emphasis added). *See also* 128 CONG. REC. 26,862 (1982) (statement of Sen. D'Amato) (the amendment to section 28(a) "does not interfere with State blue sky or antifraud authority"); 128 CONG. REC. 24,910 (1982) (statement of Rep. Dingell) (the amendment is "a limited preemption of state gambling laws"); 128 CONG. REC. 24,914 (1982) (statement of Rep. Rinaldo) ("I want to stress that this section applies only to options trading on securities exchanges, and it does not preempt state securities [blue sky] laws.").

[94] See *supra* text accompanying notes 74-80 for a description of this legislative history.

[95] Prior to the 1930s, there had been extensive debate over whether the federal government should enact a federal incorporation law or license corporations. FEDERAL TRADE COMM'N, UTILITY CORPORATIONS, S. DOC. NO. 92, Part 69-A, 70th Cong., 1st Sess. (1934). Such proposals had been made at least as far back as 1885. *Id.* at 3. Proposed legislation peaked in the period from 1904-1914, *id.* at 32, with proposed legislation being introduced at a reduced rate in the period of 1917-1930, *id.* at 42. Some such proposed legislation was preemptive with respect to certain categories of corporations while other legislation would have allowed a corporation to chose either federal or state incorporation. *Compare id.* at 24-26 (describing 1912 proposal by Congressman Roberts for "compulsory Federal incorporation" of "those corporations engaging in any form of interstate commerce whose total valuation exceeds five millions of dollars")

In 1963, the SEC completed a massive special study of the securities markets at the mandate of Congress.[96] Among the topics that the SEC considered was the regulatory scheme to which the securities industry was subject. In particular, the SEC considered the need for coordination between the federal and state regulators and the "role of the States in the regulatory pattern."[97] The special study concluded that federal preemption of state blue sky laws would be inappropriate.[98]

As discussed earlier in this part III.A, in 1975 and 1982, Congress amended the Exchange Act, adding, among other things, several explicit preemptive provisions to section 28.[99]

In 1983, the SEC's Advisory Committee on Tender Offers issued a report making fifty recommendations concerning takeover regulation.[100] Among these recommendations was the recommendation that "[s]tate regulation of takeovers should be confined to local companies."[101] This report was the beginning

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with id. at 8-10 (describing 1910 proposal by President Taft and his Attorney General, Mr. Wickersham, for a "permissive Federal incorporation" statute).

Proposals for federal incorporation resurfaced in the mid-1970s and early 1980s. In 1976, the Senate Committee on Commerce of the United States held six days of hearings on "why we should continue the present arrangements of state chartering of corporations or arguments for alternatives." *Corporate Rights and Responsibilities, Serial No. 94-95, Hearings Before the Senate Committee on Commerce, United States Senate*, 94th Cong., 2d Sess. (1976) (statement of Sen. Durkin). By 1981, one Senate bill that provided for federal minimum standards in certain areas of corporate law had advanced far enough for a hearing to be held. *Protection of Shareholders' Rights Act of 1980: Hearing on S. 2567 Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs*, 96th Cong., 2d Sess. (1980). Professor Seligman, one of the most prominent writers on securities regulation, continues to advocate a limited set of federal minimum standards for corporations. Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947 (1990).

[96] SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt.1 at 1-2 (1963) (describing the background of the special study). The SEC described its study as a "survey [of] almost all aspects of the securities business and the securities markets." *Id.* at 6.

[97] *Id.*, pt. 4, at 728.

[98] *Id.* at 734. The state blue sky administrators were praised by the SEC for "handling certain essentially local problems and . . . complement[ing] Federal regulation in important ways." *Id.* at 738.

[99] See *supra* text accompanying notes 81-93 for a description of these amendments.

[100] SEC, ADVISORY COMMITTEE ON TENDER OFFERS, REPORT OF RECOMMENDATIONS v-xv (1983).

[101] *Id.* at 17 (footnote omitted). On the other hand, the Advisory Committee

of a five year debate in which the SEC proposed legislation and the Congress considered a number of bills that would have preempted in various ways certain types of state takeover laws.[102] None of these measures ever became law although they provoked a vigorous debate pitting the White House, certain segments of the American business world, and state officials[103] against the SEC and other portions of the American business world.[104]

Finally, Congress passed the Market Reform Act of 1990 in response to the October 1987 market crash. Among its provi-

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also recommended that "federal takeover regulation should not preempt or override state corporation law." *Id.* at 18. As CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987), was not decided until 1987, the Advisory Committee presumably did not know how large a loophole this preservation of state corporate law left. See *infra* text accompanying notes 182-204 for a discussion of *CTS*.

[102] For a general description of these proposals, see *The Battle Over Tender Offer Reform: From the States and the Courts to Congress*, SEC. REG. & L. REP., Jan. 15, 1988, at 60. One of these proposals sought to overturn *CTS*. *SEC One Share/One Vote Decision May Spark Takeover Reform, Rinaldo Says*, SEC. REG. & L. REP., Feb. 19, 1988, at 251. Representative Rinaldo, one of the sponsors of this bill, reported that there was intense lobbying against this bill by members of the Business Roundtable, who "think preemption is the worst thing in the world." *Id.* In the end, the Senate proposed legislation that did not address the preemption issue, leaving the hard decisions to the courts, as the Congress has done with so many areas of securities regulation. *See* S. REP. 265, 100th Cong., 1st Sess. 55 (1987) ("[T]he Committee believes that congressional action in this area is presently unwarranted: The State and Federal courts should be permitted to work out the parameters of the *CTS* decision on a case-by-case basis.").

[103] *See, e.g., Reagan Administration Formally Opposes House Bill to Limit Tender Offer Abuses*, SEC. REG. & L. REP., Sept. 28, 1984, at 1546 (Reagan administration advocated abolition of the Williams Act); *Witnesses at Takeover Bill Hearing Split on Preemption of State Regulation*, SEC. REG. & L. REP., June 12, 1987, at 851; *NAAG Endorses State Jurisdiction Over Tender Offers Acquisition*, SEC. REG. & L. REP., Dec. 23, 1983, at 2296-97 (National Association of Attorneys General reaffirms commitment to state regulation of takeovers).

[104] *SEC Should Have Authority to Preempt Some State Takeover Laws, Ruder Says*, SEC. REG. & L. REP., Sept. 18, 1987, at 1383-84 (statement by David Ruder, SEC Chairman, to Telecommunications and Finance Subcommittee of the House Energy and Commerce Committee); *Ruder Defends Position on Preemption of State Takeover laws*, SEC. REG. & L. REP., Oct. 9, 1987, at 1525 (speech by Chairman Ruder to conference of corporate lawyers); *Ruder Restates Support for Measure to Preempt State Antitakeover Laws*, SEC. REG. & L. REP., Nov. 20, 1987, at 1759 (address by Chairman Ruder to American Corporate Counsel Association); *Securities Groups Urge Congress to Preempt State Takeover Regulation*, SEC. REG. & L. REP., June 26, 1987, at 943.

sions, the Market Reform Act amended the Exchange Act by adding section 17A(f).[105] Section 17A(f) grants to the SEC the power through regulation to preempt state law concerning the transfer of interests in certain securities.[106] This limited preemptive grant was so controversial that first the bill was amended[107] to require the SEC to make certain rulemaking findings[108] and to follow a specified consultative procedure before preempting state law.[109] This procedure was not enough to as-

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[105] Market Reform Act of 1990, Pub. L. No. 101-432, § 5b, 104 Stat. 973.

[106] Notwithstanding any provision of State law, except as provided in paragraph (3), if the Commission makes each of the finding described in paragraph (2)(A), the Commission may adopt rules concerning—
(A) the transfer of certificated or uncertificated securities (other than government securities issued pursuant to chapter 31 of title 31, United States Code, or securities otherwise processed within a book-entry system operated by the Federal Reserve banks pursuant to a Federal book-entry regulation) or limited interests (including security interests) therein. . . .
15 U.S.C. § 78q-1(f)(1) (1994).

[107] *See* SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, The Market Reform Act of 1990, S. DOC. No. 300, 101st Cong., 2d Sess. 64 (1990) [hereinafter 1990 Senate Report]; HOUSE COMM. ON ENERGY AND COMMERCE, Coordinated Clearance and Settlement Act of 1990, H.R. DOC. No. 477, 101st Cong., 2d Sess. 16 (1990) ("It is also intended that the [SEC] will not use its rulemaking authority expansively, for example to write a federal commercial code with the scope and depth of existing state commercial laws.").

[108] The findings described in this paragraph are findings by the Commission that —
(i) such rule is necessary or appropriate for the protection of investors or in the public interest and is reasonably designed to promote the prompt, accurate, and safe clearance and settlement of securities transactions;
(ii) in the absence of a uniform rule, the safe and efficient operation of the national system for clearance and settlement of securities transactions will be, or is, substantially impeded; and
(iii) to the extent such rule will impair or diminish, directly or indirectly, rights of persons specified in paragraph (1)(B) under State law concerning transfers of securities (or limited interests therein), the benefits of such rule outweigh such impairment or diminution of rights.
15 U.S.C. § 78q-1(f)(2)(A) (1994).

[109] In making the findings described in subparagraph (A), the Commission shall give consideration to the recommendations of the Advisory Committee established under paragraph (4), and it shall consult with and consider the views of the Secretary of the Treasury and the Board of Governors of the Federal Reserve System. If the Secretary of the Treasury objects, in writing, to any proposed rule of the Commission on the basis of the Secretary's view on the issues described in clauses (i), (ii), and (iii) of subparagraph (A), the Commission shall consider all feasible

suage the Congressional critics of preemption,[110] so a second amendment was added[111] allowing each state to individually opt out of any SEC promulgated rule concerning transfers of securities within two years of the rule's promulgation.[112]

Congress has considered and rejected field preemption twice. Limited field preemption of state regulation of stock exchanges was considered in the 1930s; limited field preemption of state takeover laws in the 1980s. Former SEC Chairman Richard Breeden kept the issue of preemption of state blue sky and takeover laws alive in the early 1990s, regularly raising the issue in public speeches,[113] although he did not want the SEC

> alternatives to the proposed rule, and it shall not adopt any such rule unless the Commission makes an explicit finding that the rule is the most practicable method for achieving safe and efficient operation of the national clearance and settlement system.

15 U.S.C. § 78q-1(f)(2)(B) (1994).

[110] These critics were so vociferous that eight members of the twenty-one member Senate Committee on Banking, Housing, and Urban Affairs added a single page statement to the Senate Report stating that the "power . . . to preempt state law should be reserved to Congress" and not delegated to the SEC. 1990 Senate Report, *supra* note 107, at 83.

[111] 136 CONG. REC. 13,777 (daily ed. Sept. 25, 1990) (statement of Sen. Dodd).

[112] 15 U.S.C. § 78q-1(f)(3) (1994). Luckily, the SEC has felt no need to exercise this authority and, therefore, there has been no opt out opportunity for individual states. As Representative Lent stated, "The consequences of destroying the rationale behind a national system by opting out six or eight states are so dire that it is hoped our colleagues in the State Legislatures will act with their usual levels of responsibility and recognize the preeminent national interest." 136 CONG. REC. 8,383 (daily ed. Sept. 28, 1990) (statement of Rep. Lent).

[113] *See, e.g.*, *The SEC Speaks*, INSIGHTS, Apr. 1990, at 39 (1990) (at 1990 SEC Speaks conference, Chairman Breeden twice mentioned burden that dual state/federal regulation of securities regulation and takeovers imposes, especially when U.S. competing against single European and Japanese markets); *Universal Banking System Not Likely for Many Years*, 54 BNA'S BANKING REPORT 1,039 (1990) (Chairman Breeden at ABA conference in New York City); *SEC Chief Has Doubts on Antitakeover Laws*, BOSTON GLOBE, July 4, 1990, at 11 (Chairman Breeden at meeting of bankers and business executives in Manchester, NH); *SEC to Repropose System to Promote Cross-Border Offerings by Canadians*, 22 SEC. REG. & L. REP. 1,440 (1990) (at SEC meeting, Chairman Breeden "noted that securities regulators from other countries have told him that 'the blue sky laws are the single greatest obstacle to mutual recognition' of other countries' securities laws"); Don Finefrock, *Brady: Overhaul of Federal Banking Laws Needed*, UNITED PRESS INTERNATIONAL, Nov. 30, 1990 (at annual meeting of Securities Industry Association, Chairman Breeden called for state regulators to focus on enforcement); *Breeden Repeats Call for Permitting U.S.*

to take independent action on the issue.[114] Currently a new field preemption proposal is before Congress in the form of the Capital Markets Deregulation and Liberalization Act of 1995,[115] introduced by Representative Jack Fields, Republican Chairman of the Telecommunications and Finance Subcommittee of the Home Commerce Committee.[116] This act would preempt state laws with respect to the "registration or qualifica-

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Firms to Invest in Domestic Banks, 23 SEC. REG. & L. REP. 115 (1991) (Chairman Breeden at annual Securities Regulation Institute). Chairman Breeden's position found support from one important Republican congressman, *Rinaldo Argues for Pre-emption of State Securities Laws*, WALL STREET LETTER, Dec. 10, 1990, at 8, although it provoked opposition from state securities regulators, *Breeden's Attempts to Preempt State Blue-Sky Laws Called Arrogant*, SEC. WK., Feb. 25, 1991, at 4.

[114] *Blue Sky Laws Draw Discussion, But No Federal Legislation*, CORP. FIN. WK., Mar. 23, 1992, at 7 ("'I don't think it would be appropriate for the SEC to get involved,' Breeden said, adding that any effort to override blue sky laws would have to be a congressional rather than an agency initiative.").

[115] H.R. 2131, 104th Cong., 1st Sess. (1995).

[116] The Fields bill has caused great controversy, failing to win support even from the securities industry. *See* Scott J. Paltrow, *How Fields' Dream to Cozy Up to Wall Street Backfired*, L.A. TIMES, Sept. 14, 1995, at D1; *Consumer Groups Blast Market Deregulation Measure*, 27 SEC. REG. L. REP. at 1710 (Oct. 27, 1995). The Fields bill is, however, only one of a number of ongoing initiatives involving reform of state and federal relations in the securities regulation area. Arthur Levitt, Chairman of the SEC, recently released an address, motivated in part by the Fields bill, in which he characterized the present as a "crucial moment for the securities industry and its regulators." Arthur Levitt, Chairman of the SEC, The SEC and the States: Towards a More Perfect Union, Remarks Before the North American Securities Administrators Association, Vancouver, British Columbia 1 (Oct. 23, 1995). Chairman Levitt mentioned "six key areas" where he believed that there should be dialogue on the appropriate roles of the SEC and the state blue sky regulators: "investment advisers; investment companies; registration of brokers; broker-dealer examination; registration of corporate securities; and enforcement authority." *Id.* at 4. The North American Securities Administrators Association ("NASAA") has just appointed a Task Force on the Future of Shared State and Federal Securities Regulation, which includes several prominent members of the securities bar. North American Securities Administrators Association, Inc., Major Task Force Launched to Outline Future of Federal/State Investment Regulation (news release). Although NASAA started the process of reviewing state and federal relations approximately fourteen months before appointing the Task Force and, therefore, before the Fields bill was proposed, the news release did note, in an oblique reference to the Fields bill, that "[t]oday it is more important than ever that we devote the time needed to hear all viewpoints relevant to the question of how the federal and state governments should regulate the investment marketplace." *Id.* at 2.

tion" of all securities offerings other than intrastate offerings[117] and with respect to the "registration, licensing or qualification" of a broker or dealer.[118] Finally, there would be general preemption of "all securities and transactions" covered by the Investment Company Act of 1940 and the Investment Advisers Act of 1940.[119] Even with Representative Fields' broad ranging preemption proposals, state common law and state takeover laws, at least those based on state corporation law, would not be preempted.[120]

The SEC has considered the preemptive effect of its rules on a number of occasions. But just as the congressional preemptive steps have been limited in scope, so have the SEC's. In the area of tender offer regulation, for example, the SEC, in promulgating rule 14d-2(b) which defined one method by which a tender might be commenced, noted that there was "a direct conflict between rule 14d-2(b) and state anti-takeover statutes."[121] The conflict arose from the fact that the typical state takeover statute required filing of public information prior to the commencement of a tender offer, which filing would meet the requirements of rule 14d-2(b) for a "public announcement."[122] In other words, the tender offer would have commenced for federal law purposes while the state law would delay effectiveness of the tender offer until a waiting period, which commenced with the required state filing, and hearing process had both finished. Although the SEC never stated that such state laws were preempted, a conclusion only a court could reach, it did state that it was "impossible to comply with both sets of [federal and state] requirements as they presently ex-

[117] H.R. 2131, *supra* note 115, § 3(a)(1). Certain filing requirements would be preserved.

[118] *Id.* § 3(b)(1). A state would be allowed to require registration, licensing or qualification if this was done "through a central registration depository system" and "the state's requirements are substantially similar to the [SEC's] registration requirements and do not include any provisions that are inconsistent with, or *in addition to*, the [SEC's] registration requirements." *Id.* (emphasis added).

[119] *Id.* §§ 3(c) & (d).

[120] In fact, the Williams Act would be repealed by the Fields bill. *Id.* § 5.

[121] Tender Offers, Exchange Act Release No. 34-16,384, 44 Fed. Reg. 70,326, 70,329 (Dec. 6, 1979).

[122] *Id.*

ist."[123] In addition, the SEC expressed its view that rule 14d 2(b) "is necessary for the protection of investors and to achieve the purposes of the Williams Act," which were being frustrated by state takeover statutes.[124] The SEC's implicit position on preemption found support in a series of cases that preempted state takeover statutes insofar as they conflicted with rule 14d 2(d).[125] In contrast, there are situations in which the SEC has not intended to preempt state law and has made its intentions clear.[126]

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[123] *Id.* at 70,330.

[124] *Id.*

[125] *See infra* text accompanying notes 162-63. A different preemption issue would be raised by a SEC rulemaking that impinged not on state securities laws but rather on state corporate laws. George W. Dent, Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865, 913-22 (1983) ("Whenever the SEC has suggested direct regulation of, or disclosure rules affecting, corporate governance, commentators and the bar have questioned the Commission's authority.").

The SEC also considered uniformity issues when adopting rule 14e-1(a), which provides that a tender offer must be open for at least 20 days, although the SEC did not address preemption explicitly. 44 Fed. Reg. at 70,337. Why the SEC did not deal with potential conflicts between state law and rule 14e-1(a) is unclear. Perhaps the SEC believed that state minimum offering periods that were greater than 20 days would only supplement the rule, rather than conflict with it, even though the SEC had justified the rule on the basis that "a *uniformly* applied federal regulation will better serve the purposes and policies of the Williams Act." *Id.* (emphasis added). The Supreme Court in CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987), dealt with an argument that rule 14e-1 conflicted with an Indiana statute that provided that voting rights for certain shares were not exercisable until a shareholder vote granting such rights occurred. The alleged conflict was between the fifty days mandated for the holding of such shareholder meeting by state law and the twenty days mandated by the rule 14e-1. The Supreme Court held that there was no conflict. The offeror could purchase the shares whether or not voting rights had been granted; the offeror could make a conditional offer; and even if there was some delay imposed by the state law, it was not unreasonable. *Id.* at 84. See *infra* text accompanying notes 182-204 for further discussion of *CTS*.

[126] *See, e.g.*, Amendments to Tender Offer Rules: All-Holders and Best-Price, Securities Act Release No. 33-6,653, 51 Fed. Reg. 25,873, 25,877, 25,878 (July 16, 1986) (adopting exemptions to both all-holders and best-price rules to clarify that the SEC "does not intend to cause the invalidation of otherwise constitutional state statutes by preempting such statutes"). There are also situations in which the SEC has expressed its opinion that certain provisions of the federal securities laws do not preempt state law. *See, e.g.*, Opinion of Director of Trading and Exchange Division, Relating to Section 206 of the Investment Advisers Act of 1940, Section 17(a) of the Securities Act of 1933, and Sections 10(b) and

Commentators have also entered the preemption debate. One strand in this secondary material has been an ongoing debate over state blue sky laws, in which some commentators advocate broad[127] or narrow[128] preemption of state securities regulation while others defend state securities regulation.[129] The spread of state takeover laws has engendered a comparable debate over the regulation of tender offers, with many commen-

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15(c)(1) of the Securities Exchange Act of 1934, Investment Advisers Act Release No. IA-40, 11 Fed. Reg. 10,997 (Jan. 5, 1945) ("It is clear, however, that investment advisers, in addition to complying with the federal law, are subject to whatever restrictions or requirements the common law or statutes of the particular state impose with respect to dealings between persons in a fiduciary relationship."); Opinion of the General Counsel Relating to the Use of the Name "Investment Counsel" Under Section 208(c) of the Investment Advisers Act of 1940, Investment Advisers Act Release No. IA-8, 11 Fed. Reg. 10,997 (Dec. 12, 1940) ("As a practical matter, if the investment adviser confines himself as an 'investment counsel' to those situations in which there is common sense justification for pointing out his legal status under a State law, he will run no other risk of violating section 208(c).").

[127] *See, e.g.*, Russell A. Smith, *The Relation of Federal and State Securities Laws*, 4 LAW & CONTEMP. PROBS. 241, 252-54 (1937) (advocating preemption of state law insofar as it applies to "transactions in securities of a clearly interstate character"); Smith, *supra* note 56, at 1162; Brian J. Fahrney, Comment, *State Blue Sky Laws: A Stronger Case for Federal Pre-Emption Due to Increasing Internationalization of Securities Markets*, 86 NW. U. L. REV. 753, 776-81 (1992) (advocating preemption of state securities laws except insofar as they deal with intrastate offerings, fraud and broker-dealers); J. Sinclair Armstrong, Comment, *The Blue Sky Laws*, 44 VA. L. REV. 713, 721 (1958) (advocating preemption of state statutory regulation but not state common law); Robert I. Millonzi, Comment, *Concurrent Regulation of Interstate Securities Issues: The Need For Congressional Reappraisal*, 49 VA. L. REV. 1483, 1498 (1963) (advocating preemption of state statutes governing securities registration requirements); Eugene V. Rostow, Book Review, 62 YALE L.J. 675, 677 (1953) (advocating federal preemption as a measure that "could immeasurably simplify financial practice without weakening the protection of investors").

[128] *See, e.g.*, Hal M. Bateman, *State Securities Registration: An Unresolved Dilemma and a Suggestion for the Federal Securities Code*, 27 SW. L.J. 759, 785 (1973) (proposing the preemption of "state regulation only to the extent that it is based on the inconsistent merit standard philosophy, but not to the extent that it is based on the disclosure philosophy").

[129] *See, e.g.*, Warren, *supra* note 53, at 537-38 ("Preemption of state securities laws would erase decades of progress in the development and coordination of regulatory standards to protect the economic environment for securities, locally and nationally."); Thomas Z. Wright, *Correlation of State Blue Sky Laws and the Federal Securities Acts*, 26 CORNELL L. REV. 258, 294 (1941) ("Blue Sky laws are a necessary part of any comprehensive national plan of security regulation.").

tators advocating that Congress preempt the area of tender offers.[130]

The high point of the preemption tide with respect to both blue sky laws and state takeover laws was reached in the American Law Institute's proposed Federal Securities Code, a project that occupied many prominent members of the securities bar from the mid-1960s until the late 1970s.[131] From the first, the drafters of the proposed code advocated "at the very least . . . preempting the field and making the states stay out unless they coordinate their [securities registration] procedure with the federal procedure."[132] The end result was a code that provided for preemption of a state's blue sky laws procedurally with respect to national or multi-state distributions if the state law's procedures for registration were not "substantially coordinated" with the federal procedure[133] and substantively if the

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[130] These proposals have been periodically put forth over the last twenty years. For recent articles advocating this position, see, e.g., Ted J. Fiflis, *Of Lollipops and Law - A Proposal for a National Policy Concerning Tender Offer Defenses*, 19 U.C. DAVIS L. REV. 303, 329-39 (1986) (advocating expansion of SEC's rulemaking authority to cover all manipulative devices, not just those related to misrepresentations or nondisclosures); Seligman, *supra* note 95, at 972-73 (advocating a limited preemption of state takeover laws "to prohibit the moratorium and kindred state statutes that significantly tilt the odds against shareholders receiving a tender offer"). For earlier articles, see, e.g., James J. Moylan, *State Regulation of Tender Offers*, 58 MARQ. L. REV. 687, 702-03 (1975) (suggesting Congress and SEC preempt the field of tender offer regulation); Susan H. Schmid, *Commerce Clause Limitations upon State Regulation of Tender Offers*, 47 S. CAL. L. REV. 1133, 1133 (1974) (suggesting amendment to the Williams Act to expressly preempt the regulation of the field of tender offers); Diane S. Wilner & Craig A. Landy, *The Tender Trap: State Takeover Statutes and Their Constitutionality*, 45 FORDHAM L. REV. 1, 32 (1976) (suggesting Congress expressly preempt the field of tender offer regulation because of the need for uniformity).

[131] FEDERAL SECURITIES CODE, introduction at xx to xxiv (1980) (describing the history of the Federal Securities Code); Louis Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27, 31 (1969) (covering the early history).

[132] Loss, *supra* note 131, at 36. The article that was the initial impetus for the Federal Securities Code was written by the former Director of the SEC's 1963 Special Study of Securities Markets. Milton H. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340 (1966). This article was focused on the coordination and integration of the Securities Act and the Exchange Act, and did not discuss preemption issues.

[133] FEDERAL SECURITIES CODE § 1904(a)(1) (1980). The substantive standards of state law were preserved so long as procedural disclosure uniformity

registrant met certain requirements indicating that it was an experienced issuer.[134] In addition, the Federal Securities Code contemplated preempting state takeover laws except for the takeover law of a state where both the target's principal place of business and a majority of its shares were held of record or beneficially by the state's residents.[135] There was no intention to preempt the entire field of securities regulation.[136] For all the work that went into it, the Federal Securities Code never got very far, including the fact that publicly scheduled Congressional hearings with respect to the code were not held.[137]

The fierce debate that has occurred among commentators with respect to preemption has borne surprisingly little fruit; the few preemptive steps that have been taken by Congress or the SEC have been hesitant ones.

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was achieved. *Id.* § 1904 cmt. (4).

[134] *Id.* § 1904(b).

[135] *Id.* § 1904(c). In addition, section 1904(e) of the Federal Securities Code provided that state law would apply extraterritorially "only to the extent that this Code applies." The comments summarize the approach taken by the Federal Securities Code to the "preemption problem" as follows: "[T]he limited use of the Supremacy Clause to achieve what is not so much partial preemption (except in a constitutional sense) as federal-state integration or harmonization with reduction of unnecessary duplication of regulation." *Id.* at § 1904 cmt. (1)(c).

[136] *Id.* § 1904(j)(1), § 1904 cmts. (1)(a) & (16)(b). Section 1904(j)(1) incorporated the conflict language of section 28(a) and was intended to leave the determination of whether any conflict existed to the courts. *Id.* § 1904 cmts. (16)(a) & (b).

[137] *See* 1 LOSS & SELIGMAN, *supra* note 4, at 281-83. Some of the concepts underlying the Federal Securities Code are resurfacing, in particular the concept of registering companies rather than issues of securities. John C. Coffee Jr., *Company Registration: Has Its Time Come?*, N.Y. L.J., May 25, 1995, at 5 (reporting on possible fundamental changes to federal securities regulation that the SEC has asked the SEC's Advisory Committee of the Capital Formation and Regulatory Processes to consider).

B. Preemption of State Statutes Pursuant to the Williams Act of 1968[138]

The preemption of state statutes pursuant to the Williams Act of 1968[139] has been addressed in two Supreme Court

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[138] This part III.B treats the Williams Act preemption issue as involving only state statutes. This reflects the fact that the caselaw only involves state statutes. Admittedly, the same type of preemption arguments could be made with respect to state common law. Lyman Johnson & David Millon, *Does the Williams Act Preempt State Common Law in Hostile Takeovers?*, 16 SEC. REG. L.J. 339 (1989). Professors Johnson and Millon point to Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985), as an example of a case where the court should have applied preemption analysis to its own construction of a Delaware statute as authorizing certain actions by a board of directors. *Id.* at 1349 n.19.

> [T]he gist of the argument is that the Williams Act preempts certain aspects of the common-law duty of care and its cognate, the business judgment rule, as applied to target company conduct in hostile takeovers. Simply put, *if* the new wave of state takeover statutes conflicts with, and thus frustrates, the purposes of the Williams Act, so too do these traditional common-law precepts.

Id. at 351. *See also In re* General Tire & Rubber Co. Sec. Litig., 726 F.2d 1075, 1081-82 (6th Cir. 1984), *cert. denied*, 405 U.S. 858 (1985) (considering argument in a shareholder derivative suit that section 14(a) of the Exchange Act preempts Ohio business judgment rule because business judgment rule would deprive shareholders of means of enforcing rights under section 14(a) but rejecting argument because no connection existed between shareholder claims and proxy process).

[139] The Williams Act has been incorporated into sections 13(d), (e) and 14(d)-(f) of the Exchange Act. 15 U.S.C. §§ 78m(d), (e), 78n(d)-(f) (1994). The primary subject matter of the Williams Act is tender offers. Section 78m(d) provides target companies with information about the identity, financing, and intentions of the offeror in order to provide shareholders with adequate information in order to respond to an offer. Elliott J. Weiss, *What Lawyers Do When the Emperor Has No Clothes: Evaluating* CTS Corp. v. Dynamics Corp. of America *and Its Progeny - Part I*, 78 GEO. L.J. 1655, 1660 (1990) [hereinafter Weiss, *Part I*]. Section 78m(e) provides that a corporation that purchases its own stock must disclose information for the protection of shareholders and may not engage in any fraudulent practices. P. Joseph Campisi, Jr., Edgar v. MITE Corp. *and* CTS Corp. v. Dynamics Corp. of America*: A Subjective Look at State Takeover Legislation*, 18 HOFSTRA L. REV. 157, 184 (1989). Section 78n(d) provides additional protection to the shareholder by giving the shareholder time to change his mind, preventing the offeror from indefinitely tying up the securities, and insuring that all shareholders are treated equally, regardless of when they decide to accept an offer. Campisi, *supra*, at 185-86. Section 78n(e) is an antifraud provision that protects all parties to the tender offer by prohibiting false statements, fraud, or deceit. Schmid, *supra* note 130, at 1145. Section 78n(f) ensures that all who would be entitled to vote for new directors would be

cases and a significant number of lower court cases. This is one of the two areas of possible preemption discussed in this article where there is guidance from the Supreme Court and one of the two areas, other than payments for order flow, where the courts have engaged in an explicit preemption analysis.

The potential conflict between a state statute and the Williams Act arises when they both regulate the same conduct involving a tender offer.[140] Both the SEC[141] and a number of commentators[142] have argued that the Williams Act pre-

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informed of any election that was to be held at a time other than a regular meeting of shareholders and the candidates therein. Campisi, *supra* at 184.

[140] A state statute and the Williams Act often both cover the regulation of the precommencement waiting periods, administrative hearing provisions, disclosure requirements, duration of withdrawal rights, and the duration of the proration period. *See, e.g.*, Hi-Shear Indus., Inc. v. Neiditz, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,805, at 90,037 (D. Conn. Dec. 16, 1980). Mark A. Sargent, *On the Validity of State Takeover Regulation: State Responses to* MITE *and* Kidwell, 42 OHIO ST. L.J. 689, 695-700 (1981).

[141] *See, e.g.*, Lyman Johnson & David Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862, 1882 (1989) (describing the SEC amicus curiae briefs in cases involving New York, Wisconsin, and Delaware statutes as arguing the state statutes frustrate the purposes of the Williams Act); Bruce L. Silverstein, *Commentary From the Bar: An Analysis of the Constitutional Validity of Delaware's "Business Combination" Statute*, 13 DEL. J. CORP. L. 861, 868 n.31 (1988) (describing the SEC amicus curiae briefs in RP Acquisition Corp. v. Staley Continental, Inc., 686 F. Supp. 476 (D. Del. 1988), and Salant Acquisition Corp. v. Manhattan Indus., 682 F. Supp. 199 (S.D.N.Y. 1988), as challenging the constitutionality of pertinent state statutes with Supremacy Clause and Commerce Clause arguments); Andrew J. Turezyn, *Commentary From the Bar: 1988 Developments in Delaware Corporate Law*, 14 DEL. J. CORP. L. 931, 951 (1989) (describing the SEC position, as presented in amicus curiae brief in *RP Acquisition*, that state statute was unconstitutional because preempted by the Williams Act). The SEC appears to have changed its position as to the preemptive affect of the Williams Act. In its *CTS* amicus curiae brief, the SEC conceded that there was no conflict between the pertinent Indiana statute and the Williams Act that made "it impossible to comply with both statutes." *See* Brief for the Securities and Exchange Commission and the United States as Amici Curiae, at 8-9, CTS Corp. v. Dynamics Corp., 481 U.S. 69 (1987) (Nos. 86-71 & 86-97). In a more startling concession, the SEC then stated that although "the Williams Act was designed to favor neither the takeover bidder nor target management, . . . it does not prohibit states from adopting laws that operate to favor one side or the other, unless those laws *conflict* with the Williams Act or the Commission's regulations promulgated under that Act." *Id.* at 9 (emphasis added). The SEC, however, did argue that the Indiana statute offended the Commerce Clause as a restraint on the transfer of voting rights. *Id.* at 15.

[142] *See, e.g.*, Steven M. Cohen, *State Takeover Statutes Versus Congressional*

empts the field of tender offer regulations, but the Supreme Court has rejected the notion of field preemption, without actually using this phrase.[143] The Supreme Court has applied a two-part preemption test to state takeover laws, holding that preemption occurs only "'where compliance with both federal and state regulation is a physical impossibility'"[144] or "where the state 'law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'"[145] The Supreme Court, however, has neither fully explained the Congressional intent behind the Williams Act nor fully evaluated the likely effects of state takeover statutes.

1. The Early Caselaw

Before the Supreme Court first addressed takeover preemption in *MITE*, the issue arose in a series of lower court cases.[146] The typical pre-*MITE* case involved a suit instigated by the offeror seeking a declaratory judgment that the pertinent state takeover statute was unconstitutional, so that the offeror would not have to attempt to comply with conflicting

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Intent: Preempting the Maze, 5 HOFSTRA L. REV. 857, 859 (1977) (stating that state statutes should be preempted by Williams Act because of conflict); Tyson, *supra* note 62, at 341 (explaining that the Indiana statute, for example, was preempted by the Williams Act because it "upset[] the neutral regulatory balance between the tender offeror and the target management that was struck by Congress when it adopted the Williams Act").

[143] *See* Edgar v. MITE Corp., 457 U.S. 624, 630-31 (1982). After citing section 28(a) for the proposition that "Congress did not explicitly prohibit states from regulating takeovers," the plurality opinion written by Justice White went on to address only possible actual conflict preemption and frustration of congressional purpose preemption. *Id.* at 630-32. In CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987), the Supreme Court moved directly into conflict and frustration preemption analyses after noting that Congress had not explicitly preempted state law. *Id.* at 78-79.

[144] 481 U.S. at 79 (quoting Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 142-43 (1963)).

[145] 481 U.S. at 79 (quoting Hines v. Davidowitz, 312 U.S. 52, 67 (1941)).

[146] *See, e.g.*, MITE Corp. v. Dixon, 633 F.2d 486 (7th Cir. 1980), *aff'd sub nom.* Edgar v. MITE Corp., 457 U.S. 624 (1982); Great W. United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir. 1978), *rev'd sub nom. on other grounds*, Leroy v. Great W. United Corp., 443 U.S. 173 (1979) (reversing on procedural issue); Canadian Pac. Enters. (U.S.) Inc. v. Krouse, 506 F. Supp. 1192 (S.D. Ohio 1981); Wylain, Inc. v. TRE Corp., 412 A.2d 338 (Del. Ch. 1979); Sargent, *supra* note 140 (describing these cases).

federal and state regulations.[147] A smaller number of these early cases were started by target companies seeking injunctions against further violations of the pertinent state statute by the offeror, in the hope of halting the tender offer process.[148]

The first generation state laws that were subjected to these challenges, while quite diverse, shared certain general characteristics.[149] State takeover laws were intended to regulate unfriendly tender offers for the shares of large companies.[150] Requirements included filing of specified information with a state commission some number of days prior to the bid; disclosure similar to that required by the Williams Act (although some state disclosure requirements were more extensive); and provision for the state commission to hold hearings regarding the adequacy of disclosure and the fairness of the offer.[151] Still other aspects of the tender offer process were regulated by the state takeover statutes, including the minimum and maximum offering periods, the withdrawal rights of the tendering shareholders, the imposition of waiting periods, and the duration of the proration period.[152]

These statutes differed in their grounds for state jurisdiction.[153] Most states imposed their state takeover laws on tender offers for corporations that were incorporated within the state, that had their principal place of business in the state, that had a certain percentage of their shareholders that were residents of the state, and/or in which residents of the state owned a certain percentage of the corporation's shares.[154]

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[147] *See, e.g.*, Natomas Co. v. Bryan, 512 F. Supp. 191 (D. Nev. 1981); Tyco Lab., Inc. v. Connelly, 473 F. Supp. 1157 (D. Mass. 1979); Dart Indus. Inc. v. Conrad, 462 F. Supp. 1 (S.D. Ind. 1978).

[148] *See, e.g.*, S-G Sec., Inc. v. Fuqua Inv. Co., 466 F. Supp. 1114 (D. Mass. 1978); Kelly v. Beta-X Corp., 302 N.W.2d 596 (Mich. Ct. App. 1981).

[149] Theodore R. Boehm, *State Interests and Interstate Commerce: A Look at the Theoretical Underpinnings of Takeover Legislation*, 36 WASH. & LEE L. REV. 733, 737 (1979).

[150] Wilner & Landy, *supra* note 130, at 8.

[151] *Id.* at 8-9.

[152] Note, *Securities Law and the Constitution: State Tender Offer Statutes Reconsidered*, 88 YALE L.J. 510, 516 (1979); *The Constitutionality of State Takeover Statutes: A Response to* Great Western, 53 N.Y.U. L. REV. 872, 882-84 (1978) [hereinafter *A Response to* Great Western].

[153] *See, e.g.*, Tyson, *supra* note 62, at 326; *A Response to* Great Western, *supra* note 152, at 881-82.

[154] *See* Tyson, *supra* note 62, at 326-27.

Many states even went so far as to base jurisdiction on the target corporation's (a) having substantial assets and/or its principal place of business within the state or business in the state or (b) being incorporated in the state.[155] No matter what the jurisdictional bases of these state takeover statutes, all had the same objective of protecting local industry from unwanted takeover attempts.[156]

The pre-*MITE* cases rejected arguments, advanced both by parties to these cases and the SEC as amicus curiae, that field preemption should apply.[157] In holding that state takeover statutes were unconstitutional, the courts relied on preemption arising from direct conflict[158] or frustration of Congressional purposes,[159] or on Commerce Clause grounds.[160] The direct

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[155] *See A Response to* Great Western, *supra* note 152, at 881.

[156] *See* Tyson, *supra* note 62, at 327.

[157] *See, e.g.*, Kennecott Corp. v. Smith, 507 F. Supp. 1206, 1216-17 (D.N.J. 1981) (finding neither expressed nor implied preemption of state takeover laws); Canadian Pac. Enters. (U.S.) Inc. v. Krouse, 506 F. Supp. 1192, 1196 (S.D. Ohio 1981) (declaring the court's continued belief that states are not preempted from regulating tender offers); AMCA Int'l. Corp. v. Krouse, 482 F. Supp. 929, 934 (S.D. Ohio 1979) (setting forth the questions necessary to determine whether there is federal preemption of the regulation of tender offers and answering in the negative).

[158] *See, e.g.*, *Krouse*, 506 F. Supp. at 1204 (holding Ohio statute's requirement of announcement 20 days prior to bid preempted by rule 14d-2(b)); Hi-Shear Indus., Inc. v. Neiditz, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,804, at 90,031 (D. Conn. Dec. 16, 1980) (determining that state statute cannot be applied so as to be compatible with federal law); Eure v. Grand Metro. Ltd., [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,694, at 98,648 (finding 30 day state tender offer commencement period and 5 day federal waiting period were in direct conflict); Kelly v. Beta-X Corp., 302 N.W.2d 596, 599 (Mich. Ct. App. 1981) (deciding state waiting period preempted as to corporations governed by the Williams Act). Sargent, *supra* note 140, at 692-95 (describing these cases).

[159] *See, e.g.*, MITE Corp. v. Dixon, 633 F.2d 486, 494 (7th Cir. 1980), *aff'd sub nom.* Edgar v. MITE Corp., 457 U.S. 624 (1982) (deciding state statute hinders the market approach of the Williams Act); Great W. United Corp. v. Kidwell, 577 F.2d 1256, 1279 (5th Cir. 1978), *rev'd on other grounds sub nom.* Leroy v. Great W. United Corp., 443 U.S. 173 (1979) (reversing on procedural issue and finding market approach of Williams Act incompatible with the fiduciary approach of the Idaho statute); *Kennecott*, 507 F. Supp. at 1218-20 (deciding state statute not consistent with the purpose of the Williams Act). Sargent, *supra* note 140, at 693-95 (describing these cases).

[160] *See, e.g.*, Natomas Co. v. Bryan, 512 F. Supp. 191, 193 (D. Nev. 1981) (finding state takeover statute invalid because it may significantly affect trans-

conflict preemption test examined whether it was impossible to comply simultaneously with both the state takeover statute and the Williams Act. The most frequently litigated conflict was the impossibility of complying with rule 14d-2(b)[161] and state pre-announcement periods.[162] Usually only the pre-announcement

actions outside of the state); Dart Indus. Inc. v. Conrad, 462 F. Supp. 1, 13-14 (S.D. Ind. 1978) (finding state statute affects interstate commerce and does not serve any local purpose that would justify its effects).

[161] A public announcement by a bidder through a press release, newspaper advertisement or public statement which includes the information in paragraph (c) of this section with respect to a tender offer in which the consideration consists solely of cash and/or securities exempt from registration under section 3 of the Securities Act of 1933 shall be deemed to constitute the commencement of a tender offer under paragraph (a)(5) of this section. . . .

17 C.F.R. § 240.14d-2(b) (1995). See *supra* text accompanying notes 121-25 for a description of the SEC's adoption of rule 14d-2.

[162] *See, e.g.*, *Kennecott*, 507 F. Supp. at 1222 (1981) (invalidating state provisions that conflict with rule 14d-2(b)); *Natomas*, 512 F. Supp. at 192 (issuing temporary restraining order on the finding that there was direct conflict between state law and rule 14d-2); Canadian Pac. Enters. (U.S.) Inc. v. Krouse, 506 F. Supp. 1192, 1204 (S.D. Ohio 1981) (holding rule 14d-2 preempts state public announcement provision); Crane Co. v. Lam, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,896, at 90,533 (finding it impossible to comply with both rule 14d-2 and state statute); *Hi-Shear*, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,805, at 90,037 (recognizing possible conflict between rule 14d-2 and state law); GM Sub Corp. v. Liggett Group Inc., 415 A.2d 473, 479 (Del. 1980) (recognizing possible conflict between rule 14d-2 and state statute). *See also* National City Lines, Inc. v. LLC Corp., 687 F.2d 1122, 1130-31 (8th Cir. 1982) (finding preemption on, inter alia, conflict between rule 14d-2(b) and Missouri statute in case commenced before, but decided after, *MITE* was decided).

This conflict arose because rule 14d-2 provides for the commencement of the tender offer upon an offeror's meeting state filing and notice requirements, while the typical state statute provided a waiting period, and perhaps an administrative hearing, prior to the commencement of the tender offer. Sargent, *supra* note 140, at 696. The courts held that the SEC intended to preempt state takeover statutes through its adoption of rule 14d-2. *See Canadian Pac.*, 506 F. Supp. at 1203-04 ("We find that the SEC adopted its preemptive rule with deliberate and rationally justifiable purpose to accomplish a permissible regulatory objective.") (footnote omitted); Sargent, *supra* note 140, at 696 (explaining that the SEC recognized that a direct conflict would be created between rule 14d-2 and state takeover statutes, thus setting the stage for preemption). *See also* AMCA Int'l. Corp. v. Krouse, 482 F. Supp. 929, 934 n.4 (S.D. Ohio 1979) (predicting that the SEC's proposed rule 14d-2, which the SEC admitted created direct conflict, would create preemption when effective).

provision of the state statute would be declared constitutionally invalid, leaving the remaining statutory provisions unpreempted.[163]

The conflicting purpose analysis, on the other hand, focused on the Congressional purpose behind the Williams Act. The courts described the Williams Act as taking a "market approach" to the regulation of tender offers.[164] The market approach is neutral, allowing shareholders to make their own decision on whether to tender. State statutes, on the other hand, took a fiduciary approach to the regulation of tender offers, allowing incumbent management and state agencies to replace the shareholders' own judgments. In response to these

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For typical cases finding preemption on other grounds, see Telvest, Inc. v. Bradshaw, 618 F.2d 1029, 1035 (4th Cir. 1980) (finding possible conflict between state hearing provision and the absence of such provision in the Williams Act); Great W. United Corp. v. Kidwell, 439 F. Supp. 420, 436-37 (N.D. Tex. 1977), *aff'd*, 577 F.2d 1256 (5th Cir. 1978), *rev'd on other grounds sub nom.* Leroy v. Great W. United Corp., 443 U.S. 173 (1972) (finding conflict between Williams Act and state's administrative hearing requirement, more detailed information requirement, and exemption from compliance with state statute that was under management control); Kelly v. Beta-X Corp., 302 N.W.2d 596, 598-99 (Mich. Ct. App. 1981) (finding conflict between Williams Act and aspects of state law provision regarding registration requirements). *But see AMCA Int'l Corp.*, 482 F. Supp. at 934-38 (rejecting argument that conflict exists because of state-mandated administrative hearings, fuller disclosure, and extended waiting periods not imposed by Williams Act); Strode v. Esmark, Inc., [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,538, at 97,807 (Ky. Cir. Ct. May 13, 1980), *aff'd in part, rev'd in part sub nom.* Esmark, Inc. v. Strode, 639 S.W.2d 768 (Ky. 1982) (holding in post-*MITE* case that Kentucky Take-Over Act conflicted with Williams Act and evaluating and rejecting argument that conflict exists between Williams Act and more detailed disclosure required by state).

[163] *See, e.g.*, *Kennecott*, 507 F. Supp. at 1222 (invalidating four specific provisions of state law that directly conflicted with rule 14d-2); *Canadian Pac.*, 506 F. Supp. at 1204 (preempting only single provision of the Ohio law); *Beta-X*, 302 N.W.2d at 599-600 (holding registration requirement of state statute invalid but holding anti-fraud provision valid).

[164] *See, e.g.*, MITE Corp. v. Dixon, 633 F.2d 486, 494 (7th Cir. 1980), *aff'd sub nom.* Edgar v. MITE Corp., 457 U.S. 624 (1982) (describing the market approach of the Williams Act as "unfettered choice by well-informed investors"); Great W. United Corp. v. Kidwell, 577 F.2d 1256, 1279 (5th Cir. 1978), *rev'd on other grounds sub nom.* Leroy v. Great W. United Corp., 443 U.S. 173 (1972) (describing market approach of the Williams Act as allowing the shareholder to evaluate the tender offer); *Kennecott*, 507 F. Supp. at 1218 (explaining that the market approach of the Williams Act necessitates that shareholders be allowed to make well-informed decisions).

early takeover cases, some state legislatures changed their takeover statutes. Among these changes were eliminating exemptions given to "friendly" offers, eliminating provisions allowing incumbent management to force an administrative hearing, shortening the waiting periods, accelerating administrative hearings, and amending provisions governing withdrawal and proration periods to make them consistent with federal requirements, or eliminating such provisions.[165]

These forms of preemption analysis from the early takeover cases are found in the later cases in the Supreme Court. Both *MITE* and *CTS* briefly discussed direct conflict preemption, before rejecting it. *MITE* then discussed conflict of purpose preemption, with only a plurality holding that there was preemption of the Illinois statute on this basis. *CTS* focused on the conflict of purpose analysis, holding that there was no preemption of the Indiana statute on this basis.

2. *MITE*

The first Supreme Court opinion to address the tender offer preemption issue was *Edgar v. MITE Corp.*[166] *MITE* was not decided on preemption grounds; therefore, its importance for preemption analysis is unclear.[167] *MITE* involved a declaratory judgment action and injunctive proceeding brought by the offeror in a cash tender offer against enforcement of the Illinois Business Takeover Act (the "Illinois Act"). The Illinois Act was typical of first-generation state takeover statutes.[168]

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[165] *See* Sargent, *supra* note 140, at 716-17.

[166] 457 U.S. 624 (1982).

[167] The *MITE* plurality's preemption argument is a weak precedent because of 1) the misgivings about the analysis expressed by Justices Stevens and Powell; 2) the absence of policy arguments from Justice White to support his position; 3) the absence of explanations by Justice White for his conclusions; and 4) the support of only two other Justices for the analysis. Weiss, *Part I*, *supra* note 139, at 1663.

[168] Among the characteristics the Illinois Act shared with other first-generation state takeover statutes were provisions requiring a 20-day pre-commencement notification and allowing administrative hearings on the fairness of the offer. *See, e.g.*, Evelyn Sroufe & Catherine Gelband, *Business Combination Statutes: A "Meaningful Opportunity" for Success?*, 45 BUS. LAW. 891, 901 (1990); Weiss, *Part I*, *supra* note 139, at 1661.

The Supreme Court began its analysis with the preemption issue. Although this analysis occupies some nine pages of the opinion, it was adopted by only a plurality of the *MITE* Court.[169] Citing to the second sentence of section 28(a),[170] the plurality noted that there was no evidence that Congress intended to "prohibit States from regulating takeovers."[171] Having addressed the issue of Congressional intent, the plurality implicitly rejected the application of field preemption to state takeover laws. The plurality then moved on to discuss possible conflicts between the Williams Act and the Illinois Act. As there was "no contention that it would be impossible to comply with both the provisions of the Williams Act and the more burdensome requirements of the Illinois law,"[172] the plurality narrowed the preemption issue down to "whether the Illinois Act frustrates the objectives of the Williams Act in some substantial way."[173]

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[169] With respect to the preemption issue in *MITE*, Justice White's plurality opinion was joined by only Chief Justice Burger and Justice Blackmun. Justices Powell and Stevens concurred on the Commerce Clause part of *MITE* but disagreed with Justice White's preemption analysis. Justice Powell wrote that "the Williams Act's neutrality policy does not necessarily imply a congressional intent to prohibit state legislation designed to assure - at least in some circumstances - greater protection to interests that include but often are broader than those of incumbent management." *MITE*, 457 U.S. at 646-47 (Powell, J., concurring in part). Justices O'Connor, Marshall, Brennan and Rehnquist did not reach the preemption issue. *See* James F. Pritchard, *The Case for the Constitutionality of State Business Combination Statutes*, 13 DEL. J. CORP. L. 953, 968 (1988) (outlining various portions of the opinions to which the Justices subscribed).

[170] "Nothing in this title 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 title or the rules and regulations thereunder." 15 U.S.C. § 78bb(a) (1994). There has been some dispute about the relevance of this sentence to the preemption debate involving the Williams Act. Some commentators argue that state takeover laws, which did not exist in 1933, are not the type of state regulation that Congress intended to preserve by this sentence. *See supra* text accompanying note 72.

[171] *MITE*, 457 U.S. at 631. The evidence for this Congressional intent was the fact that Congress did not amend the second sentence of section 28(a) when Congress passed the Williams Act, *id.* at 630-31, and that "[t]here is no evidence in the legislative history that Congress was aware of state takeover laws when it enacted the Williams Act," *id.* at 631 n.6.

[172] *Id.* at 631-32.

[173] *Id.* at 632.

The plurality identified protection of investors as the primary Congressional objective. A "major aspect of the effort to protect the investor" was "maintaining the balance between management and the bidder," so that neither was favored.[174] The final step of the plurality's analysis was to examine three provisions of the Illinois Act that the court of appeals below had identified as "upset[ting] the careful balance struck by Congress and which therefore stand as obstacles to the accomplishment and execution of the full purposes and objectives of Congress."[175] The plurality agreed with the court of appeals "in all essential respects."[176]

Even though this position on preemption was reached by a mere plurality, the *MITE* Court found that the Illinois Act was unconstitutional on Commerce Clause grounds.[177] This holding led many states to amend their laws regulating takeovers.[178]

Although control share acquisition statutes were not the only type of state takeover statutes passed after *MITE*, these were

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[174] *Id.* at 633-34.

[175] *Id.* at 634. These three provisions provided that a tender offeror had to make a pre-offer announcement of its intent to make such offer, *id.*; allowed the Secretary of State of Illinois to hold a hearing concerning a tender offer, which hearing had no deadline for completion, *id.* at 637; and allowed the Secretary of State of Illinois "to pass on the substantive fairness of a tender offer," *id.* at 639.

[176] *Id.* at 634. The first provision in the Illinois Act conflicted with Congress' express decision not "to impose a precommencement disclosure requirement." *Id.* at 635. The second provision "frustrate[d] the congressional purpose by introducing extended delay into the tender offer process." *Id.* at 637. The third provision interfered with Congress' intention "for investors to be free to make their own decisions." *Id.* at 639.

[177] *Id.* at 640-46. *See* Campisi, *supra* note 139, at 202-11 (discussing the application of the Commerce Clause to the regulation of the tender offer process). *See generally* Daniel A. Farber, *State Regulation and the Dormant Commerce Clause*, 3 CONST. COMMENTARY 395 (1986) (providing general discussion of the application of the Commerce Clause in the judicial process).

[178] *See* Weiss, *Part I*, *supra* note 139, at 1667 (describing changes in Indiana takeover statute that no longer directly regulated the terms or timing of the tender offer, rather, it denied voting rights to an acquiring company unless a majority of disinterested shareholders granted voting rights). States also responded by applying regulation only to domestic corporations. Tyson, *supra* note 62, at 331. *See generally* Donald C. Langevoort, *The Supreme Court and the Politics of Corporate Takeover: A Comment On CTS Corp. v. Dynamics of America*, 101 HARV. L. REV. 96, 114 (1987) (describing *MITE* as leading to more benign second generation statutes).

the only statutes challenged in published post-*MITE*, pre-*CTS* cases involving state takeover laws. Relying on the *MITE* plurality's analysis, the lower federal courts uniformly held that these statutes were unconstitutional on preemption and/or Commerce Clause grounds.[179] When these statutes were struck down on preemption grounds, the courts focused on the practical effects of these statutes as frustrating Congress's intention in passing the Williams Act.[180] The law seemed so settled that the decision of the Supreme Court in *CTS* came as a great surprise to the securities bar and academic commentators.[181]

3. *CTS*

The most recent Supreme Court decision discussing preemption in the tender offer context, *CTS Corp. v. Dynamics Corp. of America*,[182] involved a typical second generation state takeover law. Decided five years after *MITE*, *CTS* concerned the constitutionality of Indiana's control share acquisition act[183]

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[179] Tyson, *supra* note 62, at 333.

[180] *See, e.g.*, Fleet Aerospace Corp. v. Holderman, 637 F. Supp. 742, 756 (S.D. Ohio 1986), *aff'd*, 796 F.2d 135, 139 (6th Cir. 1986), *vacated*, 481 U.S. 1026 (holding Ohio Control Share Acquisition Act preempted because it delays purchase of tendered shares, favors incumbent management by shareholder vote requirement and prevents individual shareholder from making decision to sell); Gelco Corp. v. Coniston Partners, 652 F. Supp. 829, 843-44 (D. Minn. 1986), *aff'd*, 811 F.2d 414 (8th Cir. 1987) (holding Minnesota Control Share Acquisition Act preempted because individual shareholders deprived "of the right to make independent decisions regarding offers to sell"); Icahn v. Blunt, 612 F. Supp. 1400, 1418-20 (W.D. Mo. 1985) (holding Missouri Control Share Acquisition Statute preempted because it interfered with open market purchases by offeror, removed decision on selling shares from individual shareholder and gave it to other shareholders and management, and favored management); *cf.* Terry v. Yamashita, 643 F. Supp. 161, 166-68 (D. Haw. 1986) (deciding case on Commerce Clause grounds but indicating that Hawaii Control Share Acquisition statute would be preempted because offeror cannot purchase shares without shareholder approval and management can delay shareholder approval because there is no deadline for vote).

[181] *See* Richard A. Booth, *The Promise of State Takeover Statutes*, 86 MICH. L. REV. 1635, 1639 (1988).

[182] 481 U.S. 69 (1987).

[183] IND. CODE § 23-1-42-1 to 1-42-11. (Supp. 1986). The Indiana statute provides, inter alia, that a person who acquires control shares (defined as shares with more than 20%, 33%, or 50% of voting power) may not vote them until a majority of the corporation's disinterested shareholders grants such

(the "Indiana Act") and the degree to which a state corporate statute "may limit or delay"[184] the free exercise of power over corporate affairs by an acquirer after a successful tender offer. Because the *CTS* Court viewed the Indiana Act as a corporate governance statute, the *CTS* Court afforded the Indiana Act different treatment than it would have afforded a state statute exclusively governing the tender offer process. Both the district court and the court of appeals below had found that the Indiana Act was preempted by the Williams Act.[185] The Supreme Court, in making its preemption analysis, noted that "we are not bound by [*MITE*'s] reasoning" on preemption as this reasoning was only that of a plurality.[186] The *CTS* Court characterized the *MITE* plurality's opinion as giving a "broad interpretation of the Williams Act."[187] But the *CTS* Court did not explicitly give a different interpretation as they believed that the Indiana Act "passes muster even under the broad interpretation."[188]

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person voting rights. The corporation has fifty days after the acquirer requests the vote to hold the election. *See CTS*, 481 U.S. at 73-74 (describing relevant portions of the Indiana Act).

[184] *CTS*, 481 U.S. at 85.

[185] Dynamics Corp. of America v. CTS Corp., 637 F. Supp. 389 (N.D. Ill. 1986), *aff'd*, Dynamics Corp. of America v. CTS Corp., 794 F.2d 250 (7th Cir. 1986).

[186] *CTS*, 481 U.S. at 81.

[187] *Id.* Later cases and commentators have contrasted the interpretation of the William Act's objectives given by the *MITE* plurality and the *CTS* Court. *MITE* decided that the Williams Act was intended to strike a balance between the offeror and the target company, while *CTS* followed *Piper's* interpretation that the purpose was to protect investors. *See, e.g.*, Hyde Park Partners, L.P. v. Connolly, 839 F.2d 837, 849-50 (1st Cir. 1988); Veere Inc. v. Firestone Tire & Rubber Co., 685 F. Supp. 1027, 1029-30 (N.D. Ohio 1988); *see also* Weiss, *Part I*, *supra* note 139, at 1679 (pointing out that the *CTS* Court described the purpose of the Williams Act without reliance on any of the legislative history relied upon by the *MITE* Court); Pritchard, *supra* note 169, at 967-76 (explaining that *MITE* used legislative history to say the purpose of the Williams Act was to impose a balance of neutrality between bidders and incumbent management while *CTS* pointed out that Congress did not expressly preempt a traditionally state-occupied field and nothing in the legislative history supports the need to preclude state regulation of the tender offer process in order to support the neutrality purpose of the Williams Act). The earliest case to discuss the purpose of the Williams Act, Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975), described both policies without clearly explaining their relationship. *Id.* at 58-59.

[188] *CTS*, 481 U.S. at 81.

In the first step of its preemption analysis, the *CTS* Court held that, since there was no "explicit indication by Congress of an intent to preempt state law,"[189] it would only consider conflict preemption. The *CTS* Court quickly disposed of the first type of conflict preemption, finding no direct conflict between the Williams Act and the Indiana Act arising out of the provisions in the Indiana Act governing post-tender offer voting rights. The *CTS* Court then narrowed its focus, considering frustration of Congressional purposes as the sole preemption issue.[190]

The Court distinguished the Indiana Act from the Illinois Act. The Illinois Act provided, among other things, for a 20-day precommencement filing period, although the Congress in passing the Williams Act had explicitly rejected such precommencement notice provisions, permitting management "to stymie indefinitely a takeover" through the hearing provisions contained in the Illinois Act.[191] In contrast to the statute in *MITE*, the *CTS* Court observed that the Indiana Act did not directly affect the federally mandated tender offer process and consequently the federal and state statutes could coexist. Indiana's statutory scheme did not prevent an offeror from consummating its offer on the earliest day permitted by the federal regulations promul-

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[189] *Id.* at 78-79. There is no discussion in *CTS* of this point, not even the three sentences present in *MITE*. Edgar v. MITE Corp., 457 U.S. 624, 630-31 (1982).

[190] "Because it is entirely possible for entities to comply with both the Williams Act and the Indiana Act, the state statute can be pre-empted only if it frustrates the purposes of the federal law." *CTS*, 481 U.S. at 79. This is unlike *MITE*, where there was "no contention that it would be impossible to comply with both" the Williams Act and the Illinois Act. *MITE*, 457 U.S. at 631-32; *see also* Brief for Appellees at 23-34, Edgar v. MITE Corp., 457 U.S. 624 (1982) (No. 80-1188). It is not clear from the *CTS* opinion why the *CTS* Court came to this conclusion. Dynamics Corporation of America, the appellee in *CTS*, in its brief to the Supreme Court, did not make an impossibility argument as part of its preemption argument. Brief for Appellee Dynamics Corporation of America at 29-38, CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987) (Nos. 86-71, 86-97) (raising, as grounds for preemption, conflict between the Indiana Act and Williams Act's method for protecting investors and frustration of Williams Act neutrality by Indiana Act). But the *CTS* Court did not qualify its holding on the impossibility point by noting that the argument had not been raised.

[191] *MITE*, 457 U.S. at 637 (quoting MITE Corp. v. Dixon, 633 F.2d 486, 494 (7th Cir. 1980)). *See also CTS*, 481 U.S. at 80-81 (discussing unconstitutional provisions of the Illinois Act).

gated pursuant to the Williams Act.[192] The *CTS* Court also found that the Indiana Act did not impose an "*unreasonable* delay,"[193] and that "it furthers the federal policy of investor protection"[194] because it "allows *shareholders* to valuate the fairness of the offer collectively"[195] and thus was not preempted.

The *CTS* Court also reasoned that the Indiana Act had more to do with traditional state corporate law issues than with the area regulated by the Williams Act and that, if the Williams Act were held to preempt any state law that hindered or delayed the exercise of voting power after a tender offer, "a variety of state corporate laws of hitherto unquestioned validity" would be preempted.[196] Corporations owe their existence to state corporate statutes and "[t]he long-standing prevalence of state regulation in this area suggests that, if Congress had intended to pre-empt all state laws that delay the acquisition of voting control following a tender offer, it would have said so explicitly."[197] The Supreme Court was clearly implying that, prior to holding that Congress had preempted an area of law historically occupied by the states, it would require an explicit

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[192] *CTS*, 481 U.S. at 83.

[193] *Id.* at 85 (quoting *MITE*, 457 U.S. at 639).

[194] *Id.* at 83. Professors Johnson and Millon have explored the implications of "investor protection" in detail, concluding that the *CTS* Court finessed the issue of "the constitutional propriety of deploying state corporation law in a manner harmful to investors" by disregarding "the significant likelihood that shareholders in companies subject to the Indiana statute might, as the ironic price for receiving an apparently central role in takeover decisionmaking, lose opportunities to receive tender offers." Johnson & Millon, *supra* note 138, at 1872-73. At the same time the *CTS* Court seemed "to imply that the *effect* of a statute on shareholder welfare does make a difference and that, constitutionally, a statute significantly precluding the occurrence of takeover bids would run afoul of the Williams Act." *Id.* at 1873.

[195] *CTS*, 481 U.S. 84. Justices White, Blackmun and Stevens dissented, in part because they thought the majority was incorrect in focussing on protection of shareholders as a group. Instead, the dissenting Justices thought that Congress intended the Williams Act to protect individual investors, not the shareholders as a group. *Id.* at 97-98 (White, J., Blackmun, J., Stevens, J., dissenting). Viewed from this perspective, the dissenting Justices thought that the Indiana Act was preempted on "practical" grounds as the Indiana Act "will effectively prevent minority shareholders in some circumstances from selling their stock to a willing tender offeror." *Id.* at 99.

[196] *Id.* at 85.

[197] *Id.* at 86.

statement from Congress articulating precisely such a preemptive intent.[198]

Justice Scalia, in a concurring opinion, went even further by relying on section 28(a) of the Exchange Act and arguing that the Supreme Court should not debate the "purposes" of the Indiana Act. Justice Scalia wrote:

> The Williams Act is governed by the antipre-emption provision of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(a), which provides that nothing it contains "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." Unless it serves no function, that language forecloses pre-emption on the basis of conflicting "purpose" as opposed to conflicting "provision."[199]

Justice Scalia's narrow preemption analysis maintains that a conflict with the specific provisions of a federal statute is the sole constitutional justification under the Exchange Act for preempting a state's takeover statute. Interpreting section 28(a) under this analysis, there would be no room for preemption analysis focussing on frustration of Congress' purpose of the type in which the *MITE* plurality and the *CTS* Court had engaged.[200]

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[198] In a recent case, the Supreme Court noted that "Congress' enactment of a provision defining the preemptive reach of a statute *implies* that matters beyond that reach are not pre-empted." Freightliner Corp. v. Myrich, 115 S. Ct. 1483, 1488 (1985) (quoting Cipollone v. Liggett Group Inc., 505 U.S. 504, 517 (1992)) (emphasis added). "At best, [precedent] supports an inference that an express pre-emption clause forecloses implied preemption; it does not establish a rule." *Id.*

[199] *CTS*, 481 U.S. at 96.

[200] Justice Scalia's position has found some adherents in the judiciary and the law reviews. *See, e.g.*, Amanda Acquisition Corp. v. Universal Foods Corp., 708 F. Supp. 984, 1003 (E.D. Wis. 1989), *aff'd*, 877 F.2d 496 (7th Cir.), *and cert. denied*, 493 U.S. 955 (1989); Campisi, *supra* note 139, at 201-02, 211-12 (suggesting the Supreme Court adopt Justice Scalia's position so that there is an established standard that is not so subjective). *See generally* Pritchard, *supra* note 169, at 961-62, 966 (describing Justice Scalia's position as mirroring that stated in the brief for the SEC and the United States as amici curiae).

The states responded to the *CTS* decision by modifying existing laws or adopting new ones.[201] Because the Supreme Court upheld the Indiana Act in *CTS*, most states used the Indiana Act as a model for their own legislation.[202] While the control share acquisition statutes, such as the Indiana Act, were constitutional, some states found them to be ineffective.[203] These other states turned to fair price, cash-out, or business combination statutes, or even a combination of such statutes.[204]

4. Post-*CTS* Caselaw

The post-*CTS* cases have split over their interpretation of the Congressional purpose behind the Williams Act. The most restrictive reading of this purpose is found in the Seventh Circuit opinion in *Amanda Acquisitions Corp. v. Universal Food Corp.*[205] The Wisconsin statute in the *Amanda* case (the "Wisconsin Act") was a business combination statute enacted after *CTS* and restricted offers even more than similar statutes such as the one in Delaware.[206]

In a well-reasoned opinion, Judge Easterbrook set forth a three part preemption analysis. First, section 28(a) of the Exchange Act allows securities regulation by states to the extent that it does not conflict with federal law.[207] Second, there is a judicial reluctance to permit federal preemption of subject matters that have traditionally been the province of the states, such as corporate law.[208] Third, the "neutrality" that the Williams Act attempts to promote between the offeror and the target management does not prohibit states from attempting to achieve a different balance, provided that the state regulations do not conflict with the process prescribed by the Williams Act.[209] "To say that Congress wanted to be neutral between bidder and target . . . is not to say that it also forbade the

[201] Sroufe & Gelband, *supra* note 168, at 891; Tyson, *supra* note 62, at 345.
[202] Sroufe & Gelband, *supra* note 168, at 891-92.
[203] Tyson, *supra* note 62, at 347.
[204] *Id.* at 348.
[205] 877 F.2d 496 (7th Cir.), *cert. denied*, 493 U.S. 955 (1989).
[206] *Id.* at 498-99 (summarizing the provisions of the Wisconsin Act).
[207] *Id.* at 502.
[208] *Id.*
[209] *Id.* at 503.

state to favor one of these sides."[210] Rather the Williams Act regulates the "*process* of tender offers" while the state corporate law regulates the "substance."[211]

The Seventh Circuit was engaging in the same type of frustration of purpose preemption analysis carried out by the *MITE* plurality and the *CTS* Court. The *MITE* plurality had stopped its analysis when it held that the purpose of the Williams Act was to "protect the investor," for which end maintaining a balance between the target management and the offeror was a necessary means.[212] The *Amanda* court pushed the analysis one step further by asking whether Congress, in passing the Williams Act, had meant to give "investors a right to be the beneficiary of offers."[213] The Seventh Circuit's answer was that Congress did not intend for investors to have such a right.[214] The *Amanda* court thus could acknowledge that "[i]t is not attractive to put bids on the table for Wisconsin corporations" because of the Wisconsin Act, but could hold that "because Wisconsin leaves the process alone once a bidder appears, its laws may co-exist with the Williams Act."[215]

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[210] *Id.*

[211] *Id.* By "substance" the Seventh Circuit meant the rights that a party may acquire through compliance with the federally mandated "process." For example, federal proxy rules regulate "the process of soliciting proxies" but state laws regulate "the *effect* of investors' votes." *Id.* If Justice Scalia's standard for preemption analysis involving the Exchange Act may be described as the "conflict in provisions" analysis, Judge Easterbrook's narrow view of the proper preemption analysis of the Williams Act of the Seventh Circuit may be termed the "conflict in the process" theory.

[212] *MITE*, 457 U.S. at 633-34. The *CTS* Court had adopted, without affirming, this reading of congressional intent. *See supra* text accompanying notes 194-95. One perceptive commentary has ascribed the failure of the *CTS* Court to address the issues that the *Amanda* court did to the *CTS* Court's misreading of the Indiana Act as "shareholder-empowering" and the *CTS* Court's refusal to acknowledge the real goal of the Indiana Act, protection of "local economic interests at the expense of non-resident shareholders." Johnson & Millon, *supra* note 141, at 1887.

[213] *Amanda*, 877 F.2d at 504.

[214] *Id.* at 503. ("The Williams Act regulates the *process* of tender offers: timing, disclosure, proration if tenders exceed what the bidder is willing to buy, best-price rules.") For a thoughtful and full discussion of these issues, written before the *Amanda* decision was released, see Johnson & Millon, *supra* note 141.

[215] *Amanda*, 877 F.2d at 505. *See generally* Ronald J. Gilson & Bernard S. Black, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 1388 (2d ed. 1995)

In *WLR Foods, Inc. v Tyson Foods, Inc.*,[216] the Court of Appeals for the Fourth Circuit has extended the *Amanda* approach to a statutory scheme in which the likelihood of a successful tender offer is even smaller than under the Wisconsin Act. *WLR Foods* involved a challenge to four Virginia statutes on preemption and Commerce Clause grounds. The four statutes included a control share acquisitions statute, similar to the one in *CTS*, a business combinations statute, similar to the one in *Amanda*, a statute authorizing poison pills and a statute that gave a director the right to rely upon advice rendered by "specified individuals when the director believes in good faith that the information is competent and reliable."[217]

Tyson Foods, the offeror, had argued that these four statutes should be considered as an "integrated unit" that should be judged as a single "scheme." The Fourth Circuit did not rule on this contention, assuming that Tyson Foods' argument was correct.[218] The *WLR Foods* court looked at the congressional purpose behind the Williams Act to see if the Virginia statutes frustrated this purpose. Adopting the approach in *Amanda*, the *WLR Foods* court held that the purpose of the Williams Act was to protect shareholders and that neutrality between the offeror and the target was only a means to achieving this goal;[219] therefore, the Virginia statutes were not preempted. Although the Virginia statutes "may work to give target management an advantage in the tender offer context," this was not the problem with which the Williams Act was concerned.[220]

Interpretations of the congressional intent behind the Williams Act by federal district courts in Delaware are diametrically opposed to the *Amanda* court's interpretation. The Delaware cases have arisen out of the alleged conflict between

("There are hints in *Amanda* that Judge Easterbrook may have hoped to spark new Congressional legislation that would explicitly preempt state anti-takeover statutes."); Honabach & Dennis, *supra* note 72, at 736-42 (analyzing *Amanda* to see what the correspondence was between Judge Easterbrook's opinion and his academic work as a law and economics scholar).

[216] 1995 U.S. App. LEXIS 27173 (4th Cir. Sept. 22, 1995).

[217] *Id.* at *10-13 (describing relevant Virginia statutes).

[218] *Id.* at *11.

[219] *Id.* at *17-18.

[220] *Id.* at *19. The *WLR Foods* court specifically rejected the "meaningful opportunity for success" test first enunciated by the Delaware district court, the main competitor to the *Amanda* approach.

section 203 of the Delaware General Corporation Law,[221] which had been signed into law on February 2, 1988,[222] and the Williams Act. In examining the legislative history of the Williams Act, as interpreted by the *Piper* and *CTS* Courts and the *MITE* plurality, the *BNS* Court came to the conclusion, in its seminal opinion, that the Williams Act stands for "the proposition that the power of the states to regulate tender offers does not extend to complete eradication of hostile offers."[223]

Based on this reading of Congress' intent,[224] the *BNS* court formulated the "meaningful opportunity" test, which provides that "even [State] statutes with substantial deterrent effects on tender offers do not circumvent Williams Act goals, so long as hostile offers which are beneficial to target shareholders have a meaningful opportunity for success."[225] In examining section

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[221] Section 203 of the Delaware General Corporation Law provides that a corporation may not enter into a business combination with an interested stockholder for three years after the stockholder becomes an interested stockholder unless the business combination is approved by the board of directors of the corporation. *See* DEL. CODE ANN. tit. 8, § 203(a) (1994). The section also limits the application of the law to corporations that expressly reject this section in their bylaws or certificate of incorporation, or where shares are not listed on a national securities exchange or held by more than 2,000 stockholders. *See* DEL. CODE ANN. tit. 8, § 203(b) (1994). Such terms as "business combination" are defined within the section. *See* DEL. CODE ANN. tit. 8, § 203(c) (1994).

[222] 66 DEL. LAWS, c.204, § 1 (1988).

[223] BNS, Inc. v. Koppers Co., Inc., 683 F. Supp. 458, 468 (D. Del. 1988).

[224] One Delaware federal district case has been careful to note that the broad interpretation given by the *MITE* plurality to Congress' intent was not necessarily the appropriate Constitutional standard. *See* RP Acquisition Corp. v. Staley Continental, Inc., 686 F. Supp. 476, 481 (D. Del. 1988). As the *Staley Continental* court noted, *CTS* had not "definitively establish[ed] the preemptive effect of the Williams Act's policy of neutrality and the resulting perimeters of state regulation of takeovers. It did not decide, for example, whether a state, in the name of shareholder protection, could bar hostile takeovers without violating the Supremacy Clause." *Id.* Just as the *CTS* Court had not had to address this issue because the Indiana Act had survived the *MITE* plurality's standard, so the *Staley Continental* court could avoid this issue because section 203 also passed the *MITE* plurality's standard. *Id.*

[225] *BNS*, 683 F. Supp. at 469. *Accord Staley Continental*, 686 F. Supp. at 482; City Capital Assoc. L.P. v. Interco, Inc., 696 F. Supp. 1551, 1555 (D. Del. 1988), *aff'd on other grounds*, 860 F.2d 60 (3d Cir. 1988); *cf.* Black & Decker Corp. v. American Standard Inc., 679 F. Supp. 1183, 1191 (D. Del. 1988) (denying motion for preliminary injunction because offeror could gain control of target's board of directors and opt out of section 203).

203, the *BNS* court relied on the fact that an offeror had three available means to escape section 203[226] in holding that "the section will be constitutional notwithstanding its promanagement slant, so long as it does not prevent an appreciable number of hostile bidders from navigating the statutory exceptions."[227] The *BNS* court specifically noted that if further information on the impact of section 203 showed that "on balance [it] harms [shareholders], then at that time reconsideration of the statute's congruence with the Williams Act will be warranted."[228] While some courts outside of Delaware have explicitly rejected the "meaningful opportunity" test,[229] other courts have adopted this test.[230]

Although the *Amanda* court and the Delaware cases did not find that the Wisconsin Act or section 203 was preempted,[231]

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[226] *BNS*, 683 F. Supp. at 470. The three escapes were board approval, tender of 85% of the shares, excluding shares held by officer-directors and certain employee stock ownership plans, or "board approval *and* approval of two-thirds of the nontendering stockholders (again excluding the offeror, but including management)." *Id.* at 470-71.

[227] *Id.* at 470.

[228] *Id.* at 472. The issue of the empirical impact of section 203 and other third generation state takeover statutes has been a focus of post-*BNS* cases that apply the "meaningful opportunity" test. *See, e.g.*, *Staley Continental*, 686 F. Supp. at 482-85 (discussing empirical evidence on probability of hostile offeror's acquiring 85 percent of target's outstanding voting shares); West Point-Pepperell, Inc. v. Farley Inc., 711 F. Supp. 1096, 1103-05 (N.D. Ga. 1989) (discussing empirical evidence on probability of hostile offeror's acquiring 90 percent of target's outstanding voting shares, an exception under Georgia's "business combination" act); *cf.* Topper Acquisition Corp. v. Emhart Corp., 1989 U.S. Dist. LEXIS 9910, at *12 (E.D. Va. Mar. 23, 1989) (refusing to apply "meaningful opportunity" test in preliminary injunction action because "more extensive record" necessary).

[229] *See Amanda*, 877 F.2d at 508-09; *WLR Foods*, 1995 U.S. App. LEXIS 27173, at *19-20. Judge Easterbrook had rejected this "meaningful opportunity" test on the practical ground that the bidder always has options, e.g., a conditional offer, *Amanda*, 877 F.2d at 508, and on the theoretical ground that, even if the practical ground did not exist, the "Commerce Claim does not demand that states leave bidders a 'meaningful opportunity for success'," *id.*

[230] *See, e.g.*, *West Point-Pepperell*, 711 F. Supp. at 1102; *cf. Topper*, 1989 U.S. Dist. LEXIS 9910, at *12 (treating "meaningful opportunity" test as proper one without applying it in preliminary injunction action because "more extensive record" necessary).

[231] *See also* Avon Prod., Inc. v. A/J Partnership, 1990 U.S. Dist. LEXIS 2186, at *14 n.9 (S.D.N.Y. Mar. 1, 1990) (reporting that "[o]ne federal court in this district has already made a preliminary ruling . . . [that] Section 912 of the

a number of cases have found that state takeover statutes were preempted because they frustrated Congress' purpose of protecting shareholders.[232] This methodology of the preemption analysis, with its rejection of field preemption and consideration of only conflict preemption and frustration of purpose preemption, has been clearly established by the Supreme Court. But the lack of a definitive explanation by the Supreme Court of the purpose behind the Williams Act plus a failure by the Supreme Court to fully address the purposes behind state takeover laws has left the caselaw in this area quite confused.[233]

C. Preemption of State Agency Laws Pursuant to Section 20(a) of the Exchange Act

The issue of preemption of state agency principles pursuant to section 20(a) of the Exchange Act[234] is a second area in

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New York Business Corporation Law . . . neither violates the Commerce Clause nor is preempted by the Williams Act"); Veere Inc. v. Firestone Tire & Rubber Co., 685 F. Supp. 1027, 1028-32 (N.D. Ohio 1988) (holding Ohio statute that was "substantially similar to the Indiana Act" in *CTS* except that under Ohio statute shareholders had a fifty days to vote "to authorize or not authorize the outright acquisition" of shares tendered to offeror not preempted because "federal policy of investor protection" furthered by Ohio statute).

[232] Hyde Park Partners, L.P. v. Connolly, 839 F.2d 837, 848-53 (1st Cir. 1988) (holding section of Massachusetts' statute providing that an offeror had to disclose, prior to acquiring five percent of target's shares, its intent to acquire control preempted because Williams Act established specified disclosure procedures for benefit of shareholders); Batus, Inc. v. McKay, 684 F. Supp. 637, 639-40 (D. Nev. 1988) (section of Nevada statute providing that shareholders could only deposit shares in response to a tender offer no more than 60 days after commencement of offer preempted because "objective of neutrality" between offeror and target under Williams Act was substantially frustrated); RTE Corp. v. Mark IV Indus., 1988 U.S. Dist. LEXIS 6609, at *8-9 (E.D. Wis. May 6, 1988), *vacated as moot*, [1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,789 (E.D. Wis. June 22, 1988) (holding Wisconsin business combination statute preempted because it "does not promote investor choice and instead gives to the management a virtual veto power over the outcome of a tender offer contest"); *cf.* Finnegan v. Campeau Corp., 915 F.2d 824, 831-32 (2d Cir. 1990) (holding that Williams Act effected implied repeal of federal antitrust laws because repeal necessary to meet Williams Act "policy of maintaining neutrality among bidders, shareholders and target company management"), *cert. denied*, 499 U.S. 976 (1991).

[233] *See* Johnson & Millon, *supra* note 141, at 1882-86; Weiss, *Part I*, *supra* note 139, at 1678-82 ("One cannot be sure why the Court concluded that [the Indiana Act] 'passes muster.'").

[234] Every person who, directly or indirectly, controls any person liable

which a body of caselaw concerning the preemption of state law has been created. This issue has generated an enormous number of cases and articles. The preemption issue arises because both section 20(a), with its provisions governing "controlling person" liability, and state agency law, with doctrines such as respondeat superior,[235] regulate the same activities.[236] *Commerford v. Olson*[237] is typical of these cases. Audrey L. Commerford sued Miller & Schroeder Municipals, Inc., a municipal bond firm, and her nephew, Ronald O. Olson, a bond salesperson for Miller & Schroeder. Olson had encouraged Commerford to invest in a bond fund, but instead of investing Commerford's money, Olson converted it to his own use.[238]

> under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78(t) (1994).

[235] The agency principles usually employed under the securities laws are based either (1) on a master-servant relationship, in which the issue is whether the servant was acting within the scope of his employment when he did the violative act, or (2) on "apparent authority," in which the issue is whether an agent was acting in what reasonably appeared to a third party to be the authority of the agent.

William H. Kuehnle, *Secondary Liability Under The Federal Securities Laws - Aiding and Abetting Conspiracy, Controlling Person, and Agency: Common-Law Principles and The Statutory Scheme*, 14 J. CORP. L. 313, 367 (1988). A third type of agency exists, "actual authority." In this type of agency, the principal has authorized the agent to do the act. If the act is unlawful, the principal would be liable as a primary, not a secondary, violator. *Id.* at 367 n.273. The first type of secondary liability has been labelled a "status based" liability in contrast to the "authority based" or conduct based liability of the second type. *In re* Atlantic Fin. Management, Inc., 784 F.2d 29, 31-32 (1st Cir. 1986), *cert. denied*, 481 U.S. 1072 (1987). The first type of liability, for scope of employment authority, arises from the status of the primary violator, e.g., as an employee, while the second type, for apparent authority, arises from actions of the principal that lead a third party to believe that the primary violator is the agent of the principal and authorized to take the violative act. Kuehnle, *supra*, at 369.

[236] One commentator has attributed the idea that agency law could be used to establish secondary liability under the securities law to a 1967 amicus curiae brief filed by the SEC. James Duggan, Comment, *The Brooding Omnipresence of the Federal Common Law: The Evisceration of the Controlling Persons Provisions of the Federal Securities Acts*, 50 FORDHAM L. REV. 472, 476 n.23 (1981).

[237] 794 F.2d 1319 (8th Cir. 1986).

[238] *Id.* at 1320-21.

The only issue before the Eighth Circuit was the trial court's refusal to submit to the jury a special verdict form covering the vicarious liability theory of apparent authority that Commerford had requested.[239] Olson asserted that the Eighth Circuit did not have to reach this issue because section 20(a) "preempts recovery under common law agency principles."[240] The Eighth Circuit held that there is no basis for believing that section "20 was intended to narrow the remedies of customers of brokerage houses or to create novel defenses in cases otherwise governed by traditional agency principles,"[241] relying in part on section 28(a) of the Exchange Act.[242]

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[239] Although it is not completely clear from the opinion, this apparent authority presumably covered Olson's federal securities law violations as well as state law violations. *See id.* at 1321.

[240] *Id.* at 1321-22 (footnote omitted).

[241] *Id.* at 1323 (quoting Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir. 1979), *cert. denied*, 449 U.S. 1011 (1980)).

[242] *Id.* Miller & Schroeder had only two connections with Olson's activities: Olson, as Commerford knew, was an employee of Miller & Schroeder and Olson sent one note to Commerford acknowledging receipt of a check in a Miller & Schroeder envelope. All of Commerford's checks were made payable to Olson personally and mailed to him at his home address. In addition, even the acknowledgement note was on "plain memo paper." *Id.* at 1321. In other cases, there have been many more connections between the secondary defendant, usually an employer, and the primary defendant. *See, e.g.*, Richardson v. MacArthur, 451 F.2d 35, 38, 39 n.1 (10th Cir. 1971) (finding company aware of an SEC investigation that stocks might have been improperly sold and had actual knowledge that some of its employees' transactions were in fact violating securities laws but did nothing); Frankel v. Wyllie & Thornhill, Inc., 537 F. Supp. 730, 742 (W.D. Va. 1982) (finding appraisals on bank letterhead, signed by employee in his capacity as vice president, typed by secretary of bank during work hours, referred to as "bank appraisals" by another bank employee); Henricksen v. Henricksen, 640 F.2d 880, 882-84 (7th Cir. 1981) (finding checks received from customer's account went directly to employee at his office address, employer failed to enforce internal compliance rules on a number of matters concerning the account, branch manager waived a required confirmation letter from the customer on the word of the broker that he had just had dinner with the customer, and fellow employee erroneously prepared a report which hid significant losses), *cert. denied*, 454 U.S. 2097 (1987); Kravitz v. Pressmen, Frohlich & Frost, Inc., 447 F. Supp. 203, 208 (D. Mass. 1978) (excessive trading prompted branch manager to send memo questioning activity but no follow-up action was taken).

One commentator has argued that agency theories of liability, see *supra* note 235 and *infra* text accompanying notes 251-52, would not necessarily provide for secondary liability in cases such as *Commerford* if such theories were properly applied. *See* Burns, *supra* note 51, at 1186-87. Mr. Burns maintains that section

As discussed in part II.B, current preemption jurisprudence results in preemption only when (i) there is an express intent to preempt in the federal scheme; (ii) there are conflicting federal and state laws that cannot be complied with simultaneously; or (iii) application of state law frustrates the federal statutory scheme. Simultaneous application of principles of liability pursuant to section 20(a) and state law should not present a situation where preemption is appropriate because section 20(a) contains no express preemptive language; indeed its application is subject to the limitations contained in section 28(a). In addition, the imposition of state agency liability does not prevent the application of section 20(a) liability. In fact, at least with respect to the liability of brokerage firms for acts of brokers, many cases apply both section 20(a) liability standards and state agency liability standards virtually identically, find-

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20(a) controlling person liability has been expanded inappropriately to make brokers responsible for actions of their employees that do not create liability under agency law. *Id.* at 1192-94. Mr. Burns cites to Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991), and Harrison v. Dean Witter Reynolds Inc., 715 F. Supp. 1425 (N.D. Ill. 1989), *aff'd in part, rev'd in part*, 974 F.2d 873 (7th Cir. 1992), *and cert. denied*, 113 S.Ct. 2994 (1993), to support his claim that the courts have expanded section 20(a) by giving no guidance as to what a reasonable system of supervision sufficient to warrant a good faith defense would be in light of the facts in these cases. Burns, *supra* note 51, at 1194. However, Mr. Burns overlooked other cases that do provide this guidance. *See* Zweig v. Hearst Corp., 521 F.2d 1129, 1136 (9th Cir.) (suggesting a variable standard for a good faith defense because a newspaper owner could not be held to same level of knowledge imposed on a broker-dealer), *cert. denied*, 423 U.S. 1025 (1975); Rochez Bros. v. Rhoades, 527 F.2d 880, 891 (3d Cir. 1975) (accepting district court's finding that employer acted in good faith), *cert. denied*, 425 U.S. 993 (1976); Kamen & Co. v. Paul Aschkar & Co., 382 F.2d 689, 697 (9th Cir. 1967) (finding the employer to be a controlling person but not holding employer liable because there was no reason to believe the employer directly or indirectly induced violation), *cert. granted*, 390 U.S. 942, *and cert. dismissed*, 393 U.S. 801 (1968). Mr. Burns also fails to account for cases where a secondary defendant has been found not liable under the provisions of section 20(a) while still liable under the theory of respondeat superior. *See, e.g.*, Bird v. Ferry, 497 F.2d 112 (5th Cir. 1974); Haynes v. Anderson & Strudwick, 508 F. Supp. 1303, 1313 (E.D. Va. 1981). Other commentators think that section 20(a) was meant to cover a situation outside the usual employer-employee relationship; therefore, control person liability remains appropriate even if agency theories do not apply. *See, e.g.*, David S. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 607 (1972).

ing liability under similar factual circumstances. Finally, in the control person context, if the focus is only on the remedy, state law does not limit or frustrate federal law but instead provides a redundant or at best somewhat more expansive liability theory. State statutes which provide additional remedies for fraudulent or other tortious conduct do not, under applicable legal standards, frustrate federal statutes that seek to punish the same conduct.[243] These three factors help explain why virtually all of the cases addressing this issue have concluded that section 20(a) does not preempt state agency law.

Both section 20(a) and state agency law are sources of secondary liability. Primary liability is the result of other provisions of the Exchange Act, usually section 10(b) and rule 10b-5, and state statutory or common law.[244] In each case there are two actors: the primary violator and the secondary violator.[245] The fact that both section 20(a) and state agency law are sources of secondary liability creates a two tier preemption analysis depending on the source of the primary liability. Moving from the broadest to the narrowest preemption, section 20(a) could preempt state agency law by being the sole secondary liability theory for both state law and Exchange Act purposes, when the Exchange Act and state law primary claims arise from the same facts. More narrowly, section 20(a) could preempt state agency law only where the primary liability claim is one under the Exchange Act.[246] Finally, if state agency law survives section 20(a) there is the third preemption-type issue of what agency law should be applied to primary violations under the

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[243] *See* TRIBE, *supra* note 5, § 6-26, at 491.

[244] *See* Kuehnle, *supra* note 235, at 318-320; *see also* Ruder, *supra* note 242, at 600. Other types of common secondary liability for primary violations under the Exchange Act are, as the title of Kuehnle's article indicates, aiding and abetting, Kuehnle, *supra* note 235, at 320-43, and conspiracy, *id.* at 343-48. Neither of these two types of secondary liability involve the preemption issues raised by the possible conflict between control person liability under the federal securities laws and state agency law liability.

[245] "The key distinction between a primary and a secondary violator is that the primary violator does the central act prohibited by the statute or rule while the secondary violator assists or supports the violator's act or is liable for the act through a relationship with the violator." Kuehnle, *supra* note 235, at 318.

[246] The final possibility, that section 20(a) preempts state agency law for primary violations arising under state law, but does not preempt it for a primary violation arising under the Exchange Act, is not logically defensible.

Exchange Act: a federal common law of agency, or the pertinent state common law of agency. The section 20(a) cases do not use an explicit preemption analysis. The cases, however, do provide answers to all three questions, albeit carefully delimited ones in certain federal circuits.

The authors are not aware of any control person case in which the broadest possible type of preemption is raised as an argument. This is not surprising in light of section 28(a) and its preservation of state law rights and remedies.[247]

The second type of preemption has been litigated in an extensive body of caselaw in most federal circuits. The cases have generally applied the same type of strict preemptive analysis enunciated in the tender offer cases, focussing on the Congressional intent behind section 20(a) and the absence of any conflict between federal control person liability and state agency law liability.

The conflict with which the courts have wrestled arises from the concluding clause to section 20(a), which provides for a section 20(a) good faith defense if "the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."[248] The control person, therefore, has a good faith defense against liability if he/she meets two separate requirements,[249] both of which

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[247] *See* Fitzpatrick & Carman, *supra* note 74, at 4 n.21 (explaining that section 28(a) "means . . . that any state law or common law remedy that exists separately [from the federal securities laws] may provide an additional cause of action in a securities matter").

[248] 15 U.S.C. § 78(t) (1994).

[249] First, of course the secondary defendant has to be found to be a control person. Some courts have found control based on the status of the secondary defendant, which an early commentator labelled "control-by-status." Comment, *The Burden of Control: Derivative Liability Under Section 20(a) of the Securities Exchange Act of 1934*, 48 N.Y.U. L. REV. 1019, 1021-22 (1973). Most courts, however, find control only upon a showing of actual control. *Id.* at 1022; J. Christopher York, Comment, *Vicarious Liability of Controlling Persons: Respondeat Superior and the Securities Acts - A Reversible Consensus in the Circuits*, 42 EMORY L.J. 313, 319-21 (1993) (labelling the second theory "control in fact" and reporting that control by status is no longer a favored theory). There are two different tests applied by the courts in determining actual control. The first involves two steps, on each of which the plaintiffs bear the burden of proof.

> [The] plaintiffs must establish, first, that the defendant "actually participated in (*i.e.*, exercised control over) the operation of the corporation in general; then he must prove that the [secondary] defendant possessed the

are under his/her control.[250] There is no similar good faith defense to scope of employment[251] or apparent authority[252] vio-

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power to control the specific transaction or activity upon which the primary violation is predicated, but he need not prove that this later [sic] power was exercised."

Metge v. Baehler, 762 F.2d 621, 630-31 (8th Cir. 1985) (quoting Metge v. Baehler, 577 F. Supp. 810, 817-18 (S.D. Iowa 1984)), *cert. denied*, 474 U.S. 1057 (1986). The second test includes a more restrictive "culpable participant" requirement for a finding of control, which would involve a showing that the secondary defendant participated in or knew of the violative conduct. *See, e.g.*, Rochez Bros. v. Rhoades, 527 F.2d 880, 889-90 (3d Cir. 1975).

If the plaintiff carries its burden of proof, the courts, following the *Metge* test, then require the secondary defendant to carry the burden of proof that it acted in good faith and did not participate in the violative conduct. *Metge*, 762 F.2d at 631. In contrast, in the courts following the *Rochez* test, the plaintiff has the burden of proof that the secondary defendant culpably participated in the violative conduct, *see, e.g.*, Gordon v. Burr, 506 F.2d 1080, 1086 (2d Cir. 1974), which renders a separate good faith defense irrelevant "as a practical matter," Kuehnle, *supra* note 235, at 363-64. Some courts distinguish between the test that is appropriate in the brokerage firm employer/employee relationship, where "good faith is typically determined by examining whether the control person set up and enforced with reasonable diligence sufficient systems of internal supervision and control designed to detect securities violations," with "other contexts," where a "more flexible approach, asking simply whether the control person has taken reasonable measures, in light of the situation, to prevent the securities violation" is appropriate. Donohoe v. Consolidated Operating & Prod. Corp., 30 F.3d 907, 912 (7th Cir. 1994). *See generally* Kuehnle, *supra* note 235, at 356-67 (describing definition of control, culpable participation and good faith defense and criticizing cases requiring plaintiff to prove culpable participation).

[250] *But see* Burns, *supra* note 51, at 1192-94 (criticizing current caselaw as rendering statutory defense meaningless by making a broker's duty of supervision too demanding).

[251] Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1582 (9th Cir. 1990) (en banc) (Hall, J., dissenting) ("In common actions like the present one based upon misrepresentation by employees in connection with the purchase and sale of securities, a broker-dealer will virtually never be able to prove that such a representation was made outside an employee's scope of employment."), *cert. denied*, 499 U.S. 976 (1991). There are potential defenses to scope of employment liability if courts were to take seriously the limitations on the definition of "scope of employment" contained in section 228 of the Restatement (Second) of Agency, which requires some intention by the employee to benefit the employer. Some courts have relied on these potential defenses available to a secondary defendant to argue that "[t]o utilize common law agency principles to determine secondary liability for violations of the securities acts does not expose corporations, employers, and other such potential defendants to strict liability for all acts of their agents or cause them to become insurers of their agent's actions." Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1119 (5th Cir.

lations under state agency law. Whatever ambiguities there may be in construing the parameters of the good faith defense, the legislative history of section 20(a) does make clear that section 20(a) was not intended to make a controlling person an insurer for the actions of its controlled person(s).[253] Section

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1980). As a practical matter, however, most courts, especially when dealing with brokers as secondary defendants, have interpreted scope of employment and apparent authority so broadly that any defenses have been read out of these two agency theories of liability. *See* Kuehnle, *supra* note 235, at 372.

[252] Apparent authority liability requires some action by the secondary defendant, unlike scope of employment liability: there must be a "manifestation" by the secondary defendant that the agent is the secondary defendant's agent. RESTATEMENT (SECOND) OF AGENCY § 8 cmt. a (1958). This difference between the scope of employment and apparent authority doctrines has led some federal circuits to carefully limit their holdings to cover just apparent authority based on the particular facts presented to them. *See infra* note 280. *See generally* Stacy D. Blank, Note, *Section 20(a) or Respondeat Superior?: An Update*, 44 WASH. & LEE L. REV. 919, 933-34 (1987) (interpreting this application of apparent authority as "a judicial determination to adhere to common law recovery and simultaneously retreat from common law strict liability"). What is puzzling about these decisions is that the cases show a greater willingness to find secondary liability in the apparent authority situation than in the scope of employment situation. But apparent authority can be an even broader basis for secondary liability than is scope of employment.

> It is well established that an employer, whose employee acts with apparent authority, may be held liable for the misrepresentations of his employee, even though the employer received no benefit from the employee's actions, even though the employee was acting entirely for his own purposes, and even though the employee was acting against the interests of the principal--indeed, even if the employee acted with the purpose of defrauding the employer.

In re CitiSource, Inc. Sec. Litig., 694 F. Supp. 1069, 1078 (S.D.N.Y. 1988). It is true that it may be more difficult for any particular defendant to make an apparent authority claim. Such a claim is available only to third persons who "believe and have reason to believe that there is [apparent] authority." RESTATEMENT (SECOND) OF AGENCY § 8 cmt. a (1958). This requirement limits apparent authority to face-to-face market transactions and requires the plaintiff to have engaged in some due diligence with respect to the agent's authority. Douglas H. Johnston, Comment, *Vicarious Liability of Controlling Persons Under the Securities Acts*, 11 LOY. L.A. L. REV. 151, 160 (1977). No court, however, discusses the differences between scope of employment and apparent authority in these terms.

[253] *See, e.g.*, *Hollinger*, 914 F.2d at 1575 (determining a broker-dealer not an "insurer" of its representatives); Carpenter v. Harris, Upham & Co., 594 F.2d 388, 294 (4th Cir. 1979) (finding that Congress rejected insurer's liability standard, preferring a fiduciary standard), *cert. denied*, 444 U.S. 868 (1979); Christoffel v. E. F. Hutton & Co., 588 F.2d 665, 668 (9th Cir. 1978).

20(a) was modeled on section 15 of the Securities Act.[254] Both when it was first proposed, and finally passed in 1933, section 15 provided for no defenses to control person liability.[255] However, an amendment a year later provided section 15 with a good faith defense.[256] Section 20(a) contains a similar good faith defense.[257]

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[254] Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k [11] or 77*l* [12] of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77*o* (1994). *See Stock Exchange Practices: Hearings on S. Res. 56 & 97 Before the Senate Banking and Currency Comm.*, 73d Cong., 2d Sess. 6571 (1934).

[255] The original Senate bill "place[d] liability upon a person who acted through another, irrespective of whether a direct agency relationship existed but dependent upon the actual control exercised by the one party over the other." The House bill did not have a corresponding provision. 77 Cong. Rec. 3902 (1933). When originally enacted, section 15 of the Securities Act still did not contain a good faith defense. *See* Securities Act of 1933, ch. 38, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. § 77*o* (1994)). See *supra* note 254 for the text of Section 15, as amended.

[256] The act that contained the Securities Exchange Act of 1934 also amended section 15 of the Securities Act of 1933 by adding the last clause, set forth below, which provides a good faith defense "unless the controlling person has no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (1934).

[257] Although there are differences both in the language describing control and the defenses to controlling person liability in sections 15 and 20(a), courts have treated these sections as identical in their standards for control person liability, *see, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568 n.4 (9th Cir. 1990) ("The standards for liability as a controlling person under § 15 are not materially different for determining controlling person liability under § 20(a)."), *cert. denied*, 499 U.S. 976 (1991); Buhler v. Audio Leasing Corp., 807 F.2d 833, 835 (9th Cir. 1987) (finding that under both sections 15 and 20(a) one must establish the same standard: "1) the defendant had actual power or influence over the alleged controlled person, and 2) the defendant was a culpable participant in the alleged illegal activity"); Paul F. Newton & Co. v. Texas Commerce, 630 F.2d 1111, 1115-16 (5th Cir. 1980) (explaining section 20(a) was patterned after section 15 with the identical purpose); *but see* Randall A. Horstmann, Note, *Liability of Controlling Persons - Common Law and Statutory Theories of Secondary Liability*, 24 DRAKE L. REV. 620, 634-36 (1975) (using

The legislative history is not clear.[258] It can be read to support either the conclusion that section 20(a) was meant to be the exclusive means for finding secondary liability under the Exchange Act,[259] or the opposite conclusion,[260] although the

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statutory language to argue that defense under section 15 should be more difficult to make than defense under section 20(a)); York, *supra* note 249, at 314 (stating section 20(a) of the Exchange Act applies vicarious liability more broadly that section 15 of the Securities Act); Nancy C. Staudt, Note, *'Controlling' Securities Fraud: Proposed Liability Standards for Controlling Persons Under the 1933 and 1934 Securities Acts,* 72 MINN. L. REV. 930, 931 (1988) (explaining difference in standard of liability by pointing out that section 15 of the Securities Act is limited to violations of sections 11 and 12 of that act, while section 20(a) of the Exchange Act applies to violations of any section of that act), and in their standards for a defendant's proving a defense, *see, e.g., Hollinger*, 914 F.2d at 1578 (a defendant has "the same good faith defense available to it under § 15 as it has under § 20(a)"); Staudt, *supra*, at 936 n.29 (explaining that while the defense language of section 20(a) is quite different from that of section 15, courts have held them to proscribe the same standard).

[258] The only official congressional comment on the purpose of the amendment adding the good faith clause to section 15 of the Securities Act is the statement that the amendment was intended to "restrict the scope of the section so as more accurately to carry out its real purpose." 78 Cong. Rec. 8669 (1934) (Memorandum Explanatory of Suggested Amendments to the Securities Act). One active participant in the events leading up to this amendment suggested that the amendment was "intended to make that section applicable only to prevent the use of dummies in order to evade liability." 78 Cong. Rec. 8717 (1934) (Letter from J. Landis, Commissioner of the Federal Trade Commission). Dummies were appointed persons who had no real authority or control but would help corporate directors avoid liability by their position. The dummies took the blame while others exercised actual control. *See* Staudt, *supra* note 257, at 936-37.

The Congressional hearings on sections 11 and 12, the violation of which forms the basis for finding control person liability under the Securities Act, indicate that strict liability was not meant to be imposed. *See* H.R. Rep. No. 85, 73d Cong., 1st Sess. 9-10 (1933). In describing the amendment to the Securities Act, which was designed to parallel the Securities Exchange Act provision, the Explanatory Memorandum stated that "the mere existence of control is not made a basis for liability unless that control is effectively exercised to bring about the action upon which liability is based." 78 Cong. Rec. 8669 (1934) (Memorandum Explanatory of Suggested Amendments to the Securities Act).

[259] Although it is no longer the law in any federal circuit, many cases have held that section 20(a) is the sole source of secondary liability for violations of the Exchange Act. Relying on the legislative history briefly described in *supra* notes 255-58, the argument is that Congress had rejected an insurer's liability under sections 15 and 20(a). In contrast, state agency law doctrines, especially respondeat superior, impose liability based on a relationship rather than conduct and, thus, resemble an insurer's liability. *See infra* note 269 for a sum-

mary of Ninth Circuit cases that for a long time held that section 20(a) was the exclusive means of finding secondary liability under the Exchange Act until overruled by Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991). *Accord* Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967) (holding liability not governed by agency, but by section 20(a)), *cert. denied*, 390 U.S. 951 (1968); Haynes v. Anderson & Strudwick, Inc., 508 F. Supp. 1303, 1312 (E.D. Va. 1981) (uneasily bound to use section 20(a) as the exclusive standard of liability); Gordon v. Burr, 366 F. Supp. 156, 168 (S.D.N.Y. 1973) (holding section 20(a), not respondeat superior, is the appropriate standard), *aff'd in part, rev'd in part on other grounds*, 506 F.2d 1080 (2d Cir. 1974).

See the following law review articles, all of which rely to some extent on the legislative history to argue that section 20(a) should be exclusive: Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 97 (1981) (arguing respondeat superior is negated by the express provisions for secondary liability contained in some sections of the Exchange Act, which are not contained in other sections); Johnston, *supra* note 252, at 170; York, *supra* note 249, at 345 n.311 (arguing the existence of state agency law remedies might provide some evidence that Congress did not intend to create a "duplicative federal remedy"); Shaun P. Kenney, Comment, *The Eighth Circuit and Secondary Liability under the 1933 and 1934 Securities Acts -- Metge v. Baehler*, 19 CREIGHTON L. REV. 887, 931-32 (1986); Comment, *Brokerage Firm's Liability for Salesman's Fraudulent Practices*, 36 FORDHAM L. REV. 94, 102 (1967); Note, *The 'Controlling' Persons Liability of Broker-Dealers for Their Employees' Federal Securities Violations*, 1974 DUKE L.J. 824, 838 (coming to same conclusion as to both sections 15 and 20(a)); Douglas A. Marshall, Comment, *A Comparison of Control Person Liability and Respondeat Superior: Section 20(a) of the Securities and* [sic] *Exchange Act*, 15 CAL. W. L. REV. 153, 171 (1979).

Another group of commentators argues that Congress intended that section 20(a) should supplement existing common law and that, therefore, secondary liability arising from an employer-employee relationship is not even covered by section 20(a). *See, e.g.*, Duggan, *supra* note 236, at 477-78 (coming to the same conclusion as to sections 15 and 20(a)); Ruder, *supra* note 242, at 607 (section 20(a) not designed to govern the usual employment situation); Comment, *Secondary Liability of Controlling Persons under the Securities Acts: Towards an Improved Analysis*, 126 U. PA. L. REV. 1345, 1350 (1978) (coming to the same conclusion as to sections 15 and 20(a)); Comment, *Vicarious Liability for Securities Law Violations: Respondeat Superior and the Controlling Person Sections*, 15 WM. & MARY L. REV. 713, 721-22 (1974) (explaining section 20(a) aimed at relationships other than the typical employer-employee relationship).

This latter reading of section 20(a) relies heavily on Johns Hopkins Univ. v. Hutton, 297 F. Supp. 1165 (D. Md. 1968), *aff'd in part, rev'd in part*, 422 F.2d 1124 (4th Cir. 1970), *and cert. denied*, 416 U.S. 916 (1974). *Johns Hopkins*, in dictum, reasoned that section 15 does not apply "to the employer (brokerage house)-employee relationship." *Id.* at 1211. The employer as a secondary defendant would be liable under only state agency law for violations of the Securities Act. *Id.* at 1213. As the most articulate of these commentators, Mr. Duggan,

overwhelming majority of courts have come to the latter conclusion.[261]

himself points out, later cases apply both state agency law principles and control person provisions simultaneously "without examining the original contention that the former are available because the latter are not." Duggan, *supra* note 236, at 479 n.43. *See generally* Johnston, *supra* note 252, at 164 (criticizing *Johns Hopkins* for being unclear in whether it "meant that the control provisions did not apply in a broker-dealer context, or that they did not apply only to employer-employee relationships between a broker and its representatives").

[260] *See, e.g.*, *In re* Atlantic Fin. Management, 784 F.2d 29, 32-35 (1st Cir. 1986) (section 20(a) does not preclude vicarious liability), *cert. denied*, 481 U.S. 1072 (1987); SEC v. Management Dynamics, 515 F.2d 801, 812 (2d Cir. 1975) (explaining section 20(a) was meant to expand, not restrict, the scope of liability); Fey v. Walston & Co., 493 F.2d 1036, 1052 (7th Cir. 1974) (holding section 20(a) does not restrict the application of common law doctrines.).

See the following law review articles, all of which rely to some extent on the legislative history to argue that section 20(a) should not be exclusive: Burns, *supra* note 51, at 1185, 1199-1206 (suggesting that the control person provision is exclusive to individuals for secondary liability but that respondeat superior applies liability to corporations or partnerships); Fitzpatrick & Carman, *supra* note 73, at 21 (explaining that the purpose of the Exchange Act was to broaden remedies which would not be possible if respondeat superior causes of action were disallowed because of the inclusion of a good faith defense in the control persons provision); Kuehnle, *supra* note 235, at 351 (pointing to the absence of an express provision excluding other secondary liability causes of action); Musewicz, *supra* note 73, at 792; Comment, *The Burden of Control: Derivative Liability under Section 20(a) of the Securities Exchange Act of 1934*, 48 N.Y.U. L. REV. 1019, 1041 (1973); Note, *Rule 10b-5 and Vicarious Liability Based on Respondeat Superior*, 69 CAL. L. REV. 1513, 1524-27 (1981); Patrick W. Foley, Note, *Securities-Vicarious Liability Respondeat Superior Applicable in Case Involving High Fiduciary Duties Despite Controlling Persons Provision of Securities Exchange Act - Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981)*, 12 SETON HALL L. REV. 353, 369 (1982).

[261] *See, e.g.*, Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp. 203 (D. Mass. 1978) (deciding one can be concurrently held liable under section 20(a) and common law doctrines); Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.) (explaining section 20(a) was not intended to narrow traditional agency principles), *cert. denied*, 499 U.S. 1011 (1980); Dougherty v. Mieczkowski, 661 F. Supp. 267 (D. Del. 1987) (finding respondeat superior liability separate from section 20(a) liability); Baker v. Wheat First Sec., 643 F. Supp. 1420 (S.D. W. Va. 1986) (determining common law agency principles still relevant); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980) (deciding common law agency principles remain viable); Kirkland v. E. F. Hutton and Co., 564 F. Supp. 427 (E.D. Mich. 1983) (holding control person provision does not preclude recovery under respondeat superior); Henricksen v. Henricksen, 640 F.2d 880 (7th Cir.) (holding investment firm liable under both section 20(a) and state common law theory of respondeat superior), *cert. denied*, 454 U.S. 1097 (1981); Commerford v. Olson, 794 F.2d

The language of sections 15 and 20(a) has been used to support both conclusions. Some courts and commentators point to the presence of the phrase "agency or otherwise" in section 15 and the word "directly" in section 20(a) as support for the proposition that these sections are the exclusive sources of secondary liability.[262] Other courts and commentators have pointed to the use of the word "person" in both sections, and the fact that an entity such as a corporation can only act through an agent, as evidence of Congressional intent that agency law should survive as a basis for secondary liability.[263]

Subsequent to the decision in *Central Bank of Denver v. First Interstate Bank*,[264] it is questionable whether there remains

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1319 (8th Cir. 1986) (finding section 20(a) not intended to supplement common law respondeat superior); Castleglen, Inc. v. Commonwealth Sav. Ass'n., 689 F. Supp. 1069 (D. Utah 1988) (deciding good faith provision of section 20(a) did not displace common law remedies), *summ. judg. granted on other grounds*, 728 F. Supp. 656 (1989) (Resolution Trust Company successfully asserts defense based on *D'Oench* doctrine), *and aff'd*, 984 F.2d 1571 (10th Cir. 1993).

[262] For sources arguing that the term "agency" supplants common law agency principles, see Johnston, *supra* note 252, at 173; Comment, *Vicarious Liability for Securities Law Violations: Respondeat Superior and the Controlling Person Sections*, 15 WM. & MARY L. REV. 713, 721-22 (1974). For sources arguing that the use of "directly" and "agency" in section 20(a) of the Securities Exchange Act of 1934 and section 15 of the Securities Act of 1933 supplants vicarious liability, see SEC v. Lum's, Inc., 365 F. Supp. 1046, 1063 (S.D.N.Y. 1973); Gordon v. Burr, 366 F. Supp. 156, 168 (S.D.N.Y. 1973) (agreeing with construction in *Lum's*), *aff'd in part, rev'd in part on other grounds*, 506 F.2d 1080 (2d Cir. 1974); Kenneth I. Levin, Comment, *The Controlling Persons Provisions: Conduits of Secondary Liability under Federal Securities Law*, 19 VILL. L. REV. 621, 627 (1974); Note *The 'Controlling Persons' Liability of Broker-Dealers for Their Employees' Federal Securities Violations*, 1974 DUKE L.J. 824, 838; Comment, *Rule 10b-5 and Vicarious Liability Based on Respondeat Superior*, 69 CAL. L. REV. 1513, 1526 (1981).

[263] *See, e.g.*, *In re* Atlantic Fin. Management, 784 F.2d 29, 33-34 (1st Cir. 1986), *cert. denied*, 481 U.S. 1072 (1987); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1118 (5th Cir. 1980); SEC v. Management Dynamics, 515 F.2d 801, 812 (2d Cir. 1975); Burns, *supra* note 51, at 1195-96, 1199-2000; *See* Note, *supra* note 260, at 365.

[264] 114 S. Ct. 1439 (1994). Whether the courts should even get to the preemption-type issue discussed in this part III.C would be controversial to some federal securities law commentators if this issue were posed to them. To these commentators the real issue is whether section 10(b) provides for agency law secondary liability, not whether section 20(a) preempts state agency law doctrine. *See* Fischel, *supra* note 259, at 106-07 (1981) (analyzing language of section 10(b) to support conclusion that respondeat superior is not a theory of liability under Exchange Act); Fitzpatrick & Carman, *supra* note 73, at 26-27

any agency law secondary liability pursuant to the Exchange Act. This decision, however, will have no impact on the continuing viability of section 20(a) liability.

The majority view is held by the United States Courts of Appeals for the Second Circuit,[265] Fifth Circuit,[266] the

(suggesting liability for violations of section 10(b) must be found in substantive provisions of Exchange Act not in common law tort principles); Note, *Rule 10b-5 and Vicarious Liability Based on Respondeat Superior*, 69 CAL. L. REV. 1513, 1523 (1981) (arguing that fact that language and legislative history of section 20(a) do not support preemption position does not answer whether "applying respondeat superior under rule 10b-5 is correct, but only that section 20(a) does not foreclose the possibility of such application"). The authors, however, are not aware of any section 20(a) cases which address these commentators' concerns. *See* Fischel, *supra* note 259, at 94 ("Since courts have uniformly relied upon common law doctrines in imposing secondary liability, no attempt has been made to justify secondary liability by reference to the language of section 10(b), the statutory framework, or relevant legislative history."). These commentators get support from the recent Supreme Court decision of *Central Bank*. See *infra* text accompanying notes 289-90 for a brief discussion of *Central Bank*.

[265] Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir.) (holding broker liable under section 10(b) on respondeat superior principles for employee's misrepresentation of his position with the broker), *cert. denied*, 449 U.S. 1011 (1980); *see also In re* Citisource, Inc., Sec. Litg., 694 F. Supp. 1069, 1077-78 (S.D.N.Y. 1988) (holding, without discussing section 20(a), that municipality can be liable based on scope of employment or apparent authority doctrine for acts of its employees that violate section 10(b) and rule 10b-5). The Second Circuit took a long and convoluted route in arriving at the conclusion that scope of employment principles should apply to brokers.

In early cases the Court of Appeals for the Second Circuit created the impression that section 20(a) preempts respondeat superior. In Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (en banc), the issue was whether Drexel & Co., an investment and brokerage firm, was liable on "grounds of *respondeat superior*" for the actions that allegedly violated section 10(b) and rule 10b-5 of one of its "members" (presumably a partner) or for the actions of one of its outside attorneys, both of whom were on the board of directors of BarChris Construction Company. Lanza v. Drexel & Co., [1970-71 Transfer Binder] Fed. Sec. L. Rep. ¶ 92,826 at 90,106 n.19, (S.D.N.Y. Oct. 9, 1970). The Second Circuit never reached the issue of secondary liability, as it held that neither the member of Drexel nor its attorney had violated the Exchange Act. But in discussing secondary liability, the majority cited with approval Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689 (9th Cir. 1967), discussed *infra* note 269, for the proposition that section 20(a) was the proper section for determining secondary liability. 479 F.2d at 1301. And in the separate concurring and dissenting opinion, the minority mentioned the respondeat superior argument made in the court below but argued for finding Drexel liable under section 20(a). 479 F.2d at 1319-20 (citing Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), discussed *infra* note 268).

A year later, the Second Circuit held that a broker could be "derivatively" liable under section 20(a) for the actions of its employee that violated section 10(b). Gordon v. Burr, 506 F.2d 1080, 1085 (2d Cir. 1974). Although the Second Circuit never explicitly discussed the possible conflict between agency law and section 20(a), the district court below had, concluding "that § 20(a), and not *respondeat superior* is the appropriate standard for determining secondary liability under the Securities Exchange Act." Gordon v. Burr, 366 F. Supp. 156, 168 (S.D.N.Y. 1973), *aff'd in part, rev'd in part on other grounds*, 506 F.2d 1080 (2d Cir. 1974).

Some other courts even interpreted earlier Second Circuit cases as evidence that "the Second Circuit takes the view that section 20(a) . . . is the exclusive way to hold someone secondarily liable." Woodward v. Metro Bank of Dallas, 522 F.2d 84, 94 n.22 (5th Cir. 1975). One early district court opinion from the Second Circuit also read the then scant Second Circuit authority as "suppor[ting] the conclusion that § 20(a), and not *respondeat superior*, is the appropriate standard for liability" for a broker sued by the SEC for injunctive relief for the inside trading activities of an employee that violated section 10(b) and rule 10b-5. SEC v. Lum's, Inc., 365 F. Supp. 1046, 1061-64 (S.D.N.Y. 1973) (Tyler, J.); *accord* Sanders v. Lum's, Inc., [1977-78 Transfer Binder] Fed. Sec. L. Rep. ¶ 96,020 (CCH) (S.D.N.Y. Apr. 15, 1977) (Griesa, J.) (in a related class action, relying on Judge Tyler's opinion in Sec v. Lum's Inc. to hold that broker is not liable under doctrine of respondeat superior); *cf.* Barthe v. Rizzo, 384 F. Supp. 1063, 1068-70 (S.D.N.Y. 1974) (applying only section 20(a), without discussing agency law, to suit under section 10(b) and rule 10b-5 against broker for misrepresentation by employee); Moerman v. Zipco, Inc., 302 F. Supp. 439, 447-48 (E.D.N.Y. 1969), *aff'd*, 422 F.2d 871 (2d Cir.), *and reh'g denied*, 430 F.2d 363 (2d Cir. 1970) (applying only section 20(a), without discussing agency law, to cause of action under rule 10b-5 against directors for actions of corporate president). *But cf.* Moscarelli v. Stamm, 288 F. Supp. 453, 460-61 (E.D.N.Y. 1968) (raising issue, without deciding it, of whether section 20(a) or agency doctrines of scope of employment or apparent authority would provide theory of recovery in section 10(b) and rule 10b-5 action against broker for actions of employees).

In 1975 the Second Circuit directly addressed the preemption issue in SEC v. Management Dynamics, 515 F.2d 801 (2d Cir. 1975). This was an injunctive action brought by the SEC for violations of, among other provisions of the federal securities laws, section 10(b) and rule 10b-5. The Second Circuit held a broker liable on principles of apparent authority for the trading activities of its vice-president in charge of trading on the grounds that "with respect to SEC enforcement actions, § 20(a) was not intended as the sole measure of employer liability." *Id.* at 812. But the Second Circuit was careful to limit its holding:

> We need not decide today whether the entire corpus of agency law is to be imported into the securities acts for all purposes . . . . We stress again, however, that we intimate no view as to other cases which may involve lesser employees, actions for damages, other agency principles, or *respondeat superior*, which may be broader than the apparent authority involved here.

Id. at 813; *accord* SEC v. Geon Indus., 531 F.2d 39, 54 (2d Cir. 1976) (refusing to apply respondeat superior doctrine to a broker in a SEC injunctive action for violations of section 10(b) and rule 10b-5 by a registered representative, in part because of hardship an injunction would impose on broker); *cf.* Touche Ross & Co. v. SEC, 609 F.2d 570, 582 n.21 (2d Cir. 1979) ("It may be argued, for example, that the Commission may not proceed [in a rule 2(e) disciplinary action] against Touche Ross on a theory of *respondeat superior* without first establishing that Congress has delegated such authority and the Commission has through a rulemaking proceeding set standards for such an adjudication, including a definition of 'willful conduct' by organizations."); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 48 n.19 (2d Cir. 1978) (concession by broker that if employee liable it was liable under section 20(a) allowed court "to avoid resolution of the rather thorny controlling person-respondeat superior issue"), *cert. denied*, 439 U.S. 1039 (1978); Plunkett v. Dominick & Dominick, Inc., 414 F. Supp. 885, 889 (D. Conn. 1976) ("Whether the full rigor of the doctrine of *respondeat superior* is appropriate in the context of fraudulent acts of securities salesmen need not be decided at this point. But the doctrine is sufficiently available to permit the claim [for highly speculative trading violating section 10(b)] to survive a motion to discuss."); Edwards & Hanly v. Wells Fargo Securities Clearance Corp., 458 F. Supp. 1110, 1125 (S.D.N.Y. 1978) (avoiding resolution of control person-respondeat superior issue because clearing agent liable under either theory as an aider and abettor), *rev'd on other grounds*, 602 F.2d 478 (2d Cir. 1979) (finding plaintiff knew something was amiss with primary defendant in aider and abettor claim), *and cert. denied*, 444 U.S. 1045 (1980). *But see* SEC v. Cooper, 402 F. Supp. 516, 525 n.31 (S.D.N.Y. 1975) (enjoining broker, in action instituted by SEC upon "agency principles," from violating, inter alia, section 10(b) and rule 10b-5 through actions of its president).

Judge Tyler in *Lum's* also held that a corporation was liable for violations of section 10(b) and rule 10b-5 by its chief executive, who was also a director, for tipping inside information to a broker's employee, who in turn had passed the inside information on to one of his customers. Although the opinion postulates three separate bases for the corporation's liability, without clearly indicating which one is the basis for its decision, the better reading of the case is that the corporation was liable "for what can be deemed the corporate acts of its principal agents." 365 F. Supp. at 1061; *accord* Reeder v. Mastercraft Electronics Corp., 363 F. Supp. 574, 581 (S.D.N.Y. 1973) (holding that issuer corporation is liable, without discussing section 20(a), for violations of, inter alia, section 10(b) and rule 10b-5 through misrepresentation by chairman, who was also the largest shareholder, and by secretary who was also director); *cf.* SEC v. Geon Indus., 381 F. Supp. 1063, 1070 (S.D.N.Y. 1974) (holding, without discussing section 20(a), that corporation liable for violations of, inter alia, section 10(b) and rule 10b-5 by chief executive's tipping), *aff'd on other grounds*, 531 F.2d 39 (2d Cir. 1976).

[266] Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1118-19 (5th Cir. 1980) (holding that a broker can be liable for one of its employee's violations of rule 10b-5 for manipulating stock prices under "common law principles, in particular the doctrine of respondeat superior"); *cf.* Woodward v. Metro Bank of Dallas, 522 F.2d 84, 94 n.22 (5th Cir. 1975) (questioning the position

Seventh Circuit,[267] the Eighth Circuit[268] and the Ninth Cir-

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that section 20(a) "is the exclusive way to hold someone secondarily liable" but not deciding the issue). *But cf.* Bird v. Ferry, 497 F.2d 112, 119 (5th Cir. 1974) (Coleman, J., dissenting) (arguing that claim based on section 20(a) should be dismissed while simultaneously arguing that defendant broker liable under respondeat superior for state law fraud, without discussing preemption issue, committed by employee).

[267] Harrison v. Dean Witter Reynolds, Inc., 715 F. Supp. 1425, 1429 & 1429 n.3 (N.D. Ill. 1989), *aff'd*, 974 F.2d 873, 883-84 (7th Cir. 1992) (holding that broker can be liable under respondeat superior as secondary broker for violations of, inter alia, section 10(b) and rule 10b-5 by employees); Henricksen v. Henricksen, 640 F.2d 880, 887-88 (7th Cir.) (holding that broker liable under common law as secondary defendant under section 10(b) and rule 10b-5 for conversion of customer funds by employee), *cert. denied*, 454 U.S. 1097 (1981); Fey v. Walston & Co., 493 F.2d 1036, 1052 (7th Cir. 1974) (holding that broker liable under doctrine of respondeat superior as secondary defendant for section 10(b) and rule 10b-5 "churning" violations by employee); Denten v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 887 F. Supp. 176, 178-79 (N.D. Ill. 1995) (holding that broker can be liable under apparent authority as secondary defendant under, inter alia, section 10(b) for conversion by employee); *cf.* Sennott v. Rodman & Renshaw, 474 F.2d 32, 37-39 (7th Cir.) (assuming, without discussing section 20(a), that apparent agency would apply to action against broker under section 10(b) and rule 10b-5 for conversion of customer funds by an employee), *cert. denied*, 414 U.S. 926 (1973); Carroll v. First Nat'l Bank of Lincolnwood, 413 F.2d 353, 358 (7th Cir. 1969) (assuming, without discussing section 20(a), that agency law would apply to action against bank for section 10(b) and rule 10b-5 stock price manipulation violation by, among others, executive officers and directors), *cert. denied*, 396 U.S. 1003 (1970); Goodman v. H. Hentz & Co., 265 F. Supp. 440 (N.D. Ill. 1967) (holding that broker can be liable for section 10(b) and rule 10b-5 violations by employee without discussing agency principles).

[268] Commerford v. Olson, 794 F.2d 1319, 1323 (8th Cir. 1986) (holding that a broker can be liable for one of its employee's violations of federal securities laws for conversions of a customer's funds under scope of employment and apparent authority theories); *cf.* Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane, 85 F. Supp. 104, 120-21 (W.D. Ark. 1949) (applying agency law, without discussing preemption issue, to a broker for violation of Exchange Act by one of its correspondent firms). In arriving at this conclusion, the *Commerford* panel discussed an earlier Eighth Circuit case, Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). *Myzel* involved actions under rule 10b-5 brought for misrepresentations made in connection with sales of stock of a closed corporation. There is dicta in *Myzel* that supports the position either that section 20(a) "is [not] governed . . . by principles of agency" or that "a principal is liable [under section 20(a)] for the deceit of his agent committed in the very business he was appointed to carry out." *Id.* at 738. The *Commerford* court's view was that the latter reading was the better one and that, "[i]n any event, *Myzel v. Fields* did not expressly hold that § 20 does or does not supplant common law liability and therefore this issue must still be decided by this

cuit.[269] These courts all have held that there is no preemption by section 20(a)[270] of state agency law liability principles re-

court." *Commerford*, 794 F.2d at 1322 (citation omitted); *see also* Klapmeier v. Telecheck Int'l, Inc., 482 F.2d 247, 256 (8th Cir. 1973) (applying, without discussing agency law, only section 20(a) to secretary/director for violation by corporation of federal securities laws). One pre-*Commerford* commentator predicted that the Eighth Circuit would come to the position that the *Commerford* court did by analogizing the negligence standards in the first part of the control test set forth in Metge v. Baehler, 762 F.2d 621 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986), to the negligence standards of respondeat superior. Kenney, *supra* note 259, at 931.

[269] Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1575-78 (9th Cir. 1990) (en banc) (holding that a broker can be liable under respondeat superior theory for one of its employee's violations of section 10(b) and rule 10b-5 for failure to disclose to its customers an employee's prior fraud conviction), *cert. denied*, 499 U.S. 976 (1991). *Hollinger* is especially noteworthy because, in this case, the Ninth Circuit reversed its longstanding position that section 20(a) supplanted common law liability. *Id.* The *Hollinger* court cited to four of these earlier cases, Buhler v. Audio Leasing Corp., 807 F.2d 833, 835 n.4 (9th Cir. 1987) (involving suit for misrepresentations and omissions of material fact under federal securities laws against broker and one of its sales offices); Christoffel v. E.F. Hutton & Co., 588 F.2d 665, 667 (9th Cir. 1978) (involving suit under federal securities laws against broker laws for conversion of customer's assets by employee); Zweig v. Hearst Corp., 521 F.2d 1129, 1132-33 (9th Cir. 1975) (involving rule 10b-5 suit against newspaper for failure of one of newspaper's columnists to reveal that he owned stock of a company praised in the column), *cert. denied*, 423 U.S. 1025 (1975) ; Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689, 697 (9th Cir. 1967) (involving Exchange Act suit against broker for action of employees in creating artificial market in a worthless stock). To be complete, the *Hollinger* opinion should also have made reference to Hatrock v. Edward D. Jones & Co., 750 F.2d 767, 777 (9th Cir. 1984) (involving federal securities law suit against broker for misrepresentations by employee). *See also* Kersh v. General Council of Assemblies of God, 804 F.2d 546, 550 n.4 (9th Cir. 1986) ("We have clearly taken the position that section 20(a) supplants secondary liability based upon common law agency principles, such as *respondeat superior*."); Smith v. Christie, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,828 (N.D. Cal. Dec. 24, 1980) (holding that section 20(a) "provides the exclusive means by which an employer may be held vicariously liable for acts of its agents or employees. The doctrine of respondeat superior does not apply," in action against broker for violations of, inter alia, section 10(b) and rule 10b-5); Jackson v. Bache & Co., 381 F. Supp. 71, 95 (N.D. Cal. 1974) (holding that broker's liability for employee's violation of rule 10b-5 "governed only by" section 20(a)). *Hollinger* was given a broad interpretation in *In re* Network Equip. Technologies, Inc. Litig., 762 F. Supp. 1359, 1363-66 (N.D. Cal. 1991), which held that respondeat superior can be applied to a secondary defendant that is a corporation and is not restricted to secondary defendants that are broker-dealers.

[270] A similar sort of preemption argument has been raised with respect to

lating to scope of employment, i.e., respondeat superior,[271] when these principles are applied to create secondary liability for violations of the Exchange Act[272] and the secondary defen-

section 15(b)(4)(E) of the Exchange Act in the context of a disciplinary action by the SEC against a broker for misrepresentations by its employees. *See* Armstrong, Jones & Co. v. SEC, 421 F.2d 359, 362 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970). The broker evidently argued that the SEC should not have applied the doctrine of respondeat superior to it. The *Armstrong* court held that "[t]he fact that Congress enacted an additional provision giving the Commission the power to impose a sanction on a broker-dealer for failure to adequately supervise its employees does not limit the Commission's power to discipline a broker-dealer for this employee's acts." *Id.* at 362. The legislative history of section 15(b)(4)(E) is discussed in Ralph C. Ferrara & Diane Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007, 1032-33 (1983). Ferrara & Sanger conclude that the legislative history is ambiguous "as to whether the failure to supervise provisions of subparagraph (E) were intended to supersede the application of respondeat superior." *Id.* at 1033.

[271] The same preemption discussion has occurred with respect to piercing the corporate veil and alter ego liability. *See* Kersh v. General Council of the Assemblies of God, 535 F. Supp. 494, 496 (N.D. Cal. 1982), *aff'd on other grounds*, 804 F.2d 546 (9th Cir. 1986). In *Kersh*, the plaintiffs brought an action under the federal securities laws against a trust fund in which they had deposited moneys. The trust fund was run by a church that was a member of a hierarchy of which defendant was at the top. The defendant argued "that alter ego liability is a form of secondary liability and, as such, is preempted as a basis for federal securities law violations by Section 20(a)." *Id.* at 496. The *Kersh* court noted the then existing "Ninth Circuit rule that liability for federal securities law violations under a theory of *respondeat superior* is precluded by Section 20(a)," but held that alter ego liability is a substitution of parties rather than a strict liability theory as is respondeat superior; therefore, the plaintiffs could attempt to show that defendant was liable on an alter ego theory. *Cf.* Orloff v. Allman, 819 F.2d 904, 908 (9th Cir. 1987) (assuming, without deciding, that *Kersh* was correct on alter ego point; holding that under neither federal nor California law did secondary defendant meet alter ego test); H.B. Holdings Corp. v. Scovill Inc., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,201, at 95,817 (S.D.N.Y. Mar. 23, 1990) (assuming, without deciding, that alter ego doctrine could be used to impose vicarious liability under section 12(2) of the Securities Act on corporation for misrepresentations by employees in connection with private sales of stock by the corporation; holding that secondary defendant did not meet alter ego test), *complaint dismissed sub nom.* Dimplex v. Scovill Inc., 1991 U.S. Dist. LEXIS 11722 (S.D.N.Y. Aug. 22, 1991), *and case reopened*, 1991 U.S. Dist. LEXIS 18032 (S.D.N.Y. Dec. 11, 1991).

[272] A similar, albeit much smaller, body of caselaw has grown up under section 15 of the Securities Act, the analogous section in the Securities Act to section 20(a) of the Exchange Act. *See* Holloway v. Howerdd, 536 F.2d 690, 694-95 (6th Cir. 1976) (holding that broker liable under traditional agency principles

dant is a broker and the primary defendant is the broker's employee.[273]

The majority view finds no evidence that Congress intended to preempt state agency law in enacting section 20(a) and that, when a broker is the party against which secondary liability is asserted, there is no conflict preventing the simultaneous application of state and federal law. There still remains an issue of whether the congressional purpose behind section 20(a)'s good faith defense is frustrated. Many courts justify their conclusion that there is no frustration of purpose conflict between section 20(a) and state agency law by focussing on the special duties imposed upon brokers by the Exchange Act in overseeing their

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for employee violations of section 12(2)); Lewis v. Walston & Co., 487 F.2d 617, 623 (5th Cir. 1973) (holding, without discussing section 15, that broker liable for violation of sections 12(1) and 12(2) of the Securities Act for acts of its employee under scope of employment doctrine); Johns Hopkins Univ. v. Hutton, 422 F.2d 1124, 1130 (4th Cir. 1970), *aff'g* 297 F. Supp. 1165, 1210-13 (D. Md. 1968) (holding that broker liable for violation of section 12(2) of Securities Act for employee acting with apparent authority); VT Investors v. R & D Funding Corp., 733 F. Supp. 823, 827 n.2 (D.N.J. 1990) (noting, in dictum, without discussing section 15, that a claim of liability against an issuing corporation under section 12(2) for misrepresentations by employees under a theory of respondeat superior "would fail as a matter of law" under Third Circuit caselaw); H.B. Holdings Corp. v. Scovill, Inc., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,201, at 95,817 (S.D.N.Y. Mar. 23, 1990) (assuming, without discussing section 15, that respondeat superior doctrine could apply to a corporation under section 12(2) for misrepresentation by employees in connection with private sales of stock by the corporation), *complaint dismissed*, 1991 U.S. Dist. LEXIS 11722 (S.D.N.Y. 1991); Byrley v. Nationwide Life Ins. Co., 640 N.E.2d 187, 196 (Ohio Ct. App. 1994) (citing Holloway v. Howerdd, 536 F.2d 690, 694-95 (6th Cir. 1976), to support holding, without discussing section 15, that a mutual fund can be liable on agency principles under section 12(2) for actions of broker selling mutual fund shares). An early application of agency law to a section 12(2) action is found in Cady v. Murphy, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940). In *Cady*, a broker was held liable for the false representations by its head trader. The *Cady* court did not discuss the basis for its holding or the preemption issue, although the district court did characterize the head trader as the broker's "agent." Murphy v. Cady, 30 F. Supp. 466, 467 (D. Me. 1939). A later case discussed whether this head trader was an employee or a partner of the broker, and reported that the trial transcript had established that the trader was an employee. Johns Hopkins Univ. v. Hutton, 297 F. Supp. 1165, 1210 n.25 (D. Md. 1968), *aff'd in part, rev'd in part*, 422 F.2d 1124 (4th Cir. 1970), *and cert. denied*, 416 U.S. 916 (1974).

[273] The majority view is the one taken by the Federal Securities Code. FEDERAL SECURITIES CODE § 1724(a), § 1724 cmt. (3)(b) (1980).

employees. These duties arise from the fiduciary role played by brokers in representing customers in securities trading.[274] These courts are willing to apply state agency law to impose Exchange Act liability upon secondary defendants in order to further sanction brokers who do not properly supervise their employees.[275]

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[274] *See, e.g.*, Sharp v. Coopers & Lybrand, 649 F.2d 175, 183-84 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1111 (5th Cir. 1980); Plunkett v. Dominick & Dominick, Inc., 414 F. Supp. 885, 889 (D. Conn. 1976). The *Plunkett* court's statement of this policy is particularly eloquent:

> If a cause of action is to be implied for fraudulent activities of securities salesmen, it is appropriate to hold their employers liable unless Congress elects to provide complete or partial insulation. An investor comes to a broker-dealer because the house holds itself out as competent in the handling of investments. The investor obviously understands that he bears the risk that the value of his investment may fluctuate according to the vicissitudes of the market and the acumen of his broker-dealer, but he does not undertake the risk that an agent of the broker-dealer will deal fraudulently with his account. Holding the broker-dealer liable allocates the risk of loss to the entity best able to prevent a loss and most able to sustain the monetary repercussions of the illegal act.

Id.

[275] Although no court phrases its resolution of the preemption issue this way, some courts, motivated by the same policies as in their application of state agency principles, have made it almost impossible for brokers to meet the good faith defense. *See* Burns, *supra* note 51, at 1192-94 (arguing that in cases involving broker secondary defendants, "there has been no case in which a brokerage firm has been able to prove" that its compliance efforts met the good faith test of section 20(a)). Thus, in these cases, there is no practical difference or conflict between section 20(a)'s control person liability and liability under state agency law.

The courts have tended to treat agency problems involving corporate officers differently from those involving lower level employees. Although an entity such as a corporation or partnership can only act through its executive officers, *see* Charles R.P. Keating et al., 2 FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 266, 437 (1990 ed.) [hereinafter FLETCHER], or general partners, *see* Scott Rowley, 1 THE MODERN LAW OF PARTNERSHIP §§ 136, 286 (1916), the actions of officers and partners should be analyzed under normal agency principles. *See* FLETCHER, *supra*, § 437; Uniform Partnership Act § 9 (1914); Rowley, *supra*, § 508. Many courts, however, are much more ready to find the secondary defendant liable when the primary defendant is a corporate officer. These courts often do not discuss agency law and use language implying that, when such an individual violates the Exchange Act, the entity has violated the Exchange Act as a primary violator not as a secondary violator. See cases from the First and Third Circuits discussed *infra* notes 280-81 and the Second Circuit discussed *supra* note 265 for illustrations of this approach. This is another

Most of the cases discussed in this part III.C involve private actions under the Exchange Act. Where the SEC is involved, either in seeking an injunction or in a disciplinary proceeding, the same preemption issues arise. The SEC historically has taken the position that agency principles can supplement section 20(a).[276] The few decisions in this area show that courts are more hesitant in applying agency principles, especially in

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concept that has its genesis in the fertile collective mind of the SEC. Duggan, *supra* note 236, at 477 n.26 (stating that in a 1967 amicus curiae brief, the SEC argued "that, because a corporation or partnership can only act through its agents, the acts of agents in violation of the antifraud provisions are the acts of their principals"). *But cf.* Pippenger v. McQuik's Oilube, Inc., 854 F. Supp. 1411, 1420-25 (S.D. Ind. 1994) (treating actions of executive officers of secondary defendant as a respondeat superior issue). One commentator tries to justify this approach by attributing the resulting liability for the secondary defendants in such cases to ratification by the secondary defendant of its agent's actions. Carol M. Lynch, Note, *Rule 10b-5 - The Equivalent Scope of Liability Under Respondeat Superior and Section 20(a) - Imposing a Benefit Requirement on Apparent Authority*, 35 VAND. L. REV. 1383, 1411-12 (1982) (citing to RESTATEMENT (SECOND) OF AGENCY §§ 82-104 (1958)). The problem with this argument is that many of the cases do not involve any action by the corporation that is separate from the primary defendant's action and that could be considered ratification by the corporation under the Restatement's standards. *See, e.g.*, A. J. White & Co. v. SEC, 556 F.2d 619 (1st Cir. 1977) (finding president to have aided and abetted the corporation's violations, which violations arose solely from the president's knowledge of fraudulent loans and underwriting of other loans), *cert. denied*, 434 U.S. 969 (1977); Holmes v. Bateson, 583 F.2d 542 (1st Cir. 1978) (holding corporation liable because it was found to have negotiated the fraudulent purchase of stock through its employees and to have benefitted from the transaction); SEC v. Lum's Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973) (holding corporation liable because responsible for managing the behavior of the chief operating officer who leaked information that was later conveyed by a third person to an investor); Reeder v. Mastercraft Electronics Corp., 363 F. Supp. 574 (S.D.N.Y. 1973) (stating simply that "the liability of the corporation is coextensive with that of" the chairman of the board of directors and largest stockholder and secretary and director of the corporation, who manipulated price of a stock by spreading false and misleading information). *See generally* Burns, *supra* note 51, at 1195-96 (describing two problems arising from the intersection of a corporation's artificial existence and section 20(a): "First, a corporation cannot, in any real sense, 'control' its executives. Second, a circularity problem arises when courts attempt to apply the statutory defenses to corporate entities.").

[276] *See generally* Kuehnle, *supra* note 235, at 374-76 (discussing SEC enforcement actions); Ferrara & Sanger, *supra* note 270, at 1029-35 (discussing SEC administrative actions under section 15(b) of the Exchange Act); Fitzpatrick & Carman, *supra* note 73, at 28-36 (discussing application of respondeat superior in SEC injunctive actions and administrative proceeding).

injunctive proceedings brought by the SEC, than they are in private actions.[277] This hesitancy may be due to the differing natures of the injunctive relief sought by the SEC and the monetary damages sought by private plaintiffs.[278]

In three federal circuits, there is no definitive statement of the pertinent Court of Appeals' view, and only district court authority that explicitly follows the majority view.[279] The

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[277] *See* Kuehnle, *supra* note 235, at 374-76; SEC v. Washington County Util. Dist., 676 F.2d 218 (6th Cir. 1982) (hesitant to grant injunction until magnitude of the violation by the secondary violator determined); SEC v. Geon Indus., 531 F.2d 39, 54-55 (2d Cir. 1976) (stating that the consequences of an injunction could be great; therefore, the imposition of agency liability has a higher threshold than in other situations); SEC v. Coffey, 493 F.2d 1304, 1318 (6th Cir. 1974) (SEC may not rely on section 20(a) in an injunctive enforcement action), *cert. denied*, 420 U.S. 908 (1975).

[278] Kuehnle, *supra* note 235, at 375-76. The effectiveness of administrative and injunctive remedies has to be judged by their ability "to prevent and deter misconduct." *Id.* at 375. Where a secondary defendant carries the burden of showing that "it diligently employed high standards to protect against misconduct," *id.* at 376, an administrative or injunctive remedy may not accomplish its purpose. "The SEC in using its discretion in administrative proceedings, and the courts in applying equity considerations, apparently have followed this principle without specific articulation of it." *Id.*

[279] In the Sixth Circuit, the only Court of Appeals' decisions deal with section 15(6)(5)(E) of the Exchange Act, *see* Armstrong, Jones & Co. v. SEC, 421 F.2d 359, 362 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970), or Section 15 of the Securities Act, *see* Holloway v. Howerdd, 536 F.2d 690, 694-95 (6th Cir. 1976), and their respective preemptive effects on state agency law. Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427 (E.D. Mich. 1983), read *Holloway* as holding that recovery under the Exchange Act is permitted against a secondary defendant on the doctrine of respondeat superior. 564 F. Supp. at 447; *accord* SEC v. Charles A. Morris & Assoc., 386 F. Supp. 1327, 1335 (W.D. Tenn. 1973) (citing *Armstrong*, in SEC injunctive action, for proposition that broker can be liable under respondeat superior for violations of, inter alia, section 10(b) and rule 10b-5 by employees). *Contra* SEC v. Washington County Util. Dist., 676 F.2d 218, 224 n.11 (6th Cir. 1982) (interpreting *Coffey*, in another SEC injunctive action, as a case where SEC "attempted to hold [defendant] liable on basis of *respondeat superior*. We refused to impose liability on that theory."); SEC v. Coffey, 493 F.2d 1304, 1315 (6th Cir. 1974) (holding, in SEC injunctive action, that corporate officials could not be "liable for any securities law violations by a subordinate" because to hold otherwise "would, *sub silentio*, repeal the protections contained in . . . section 20"), *cert. denied*, 420 U.S. 908 (1975). *Kirkland* does not cite to either *Coffey* or *Washington* nor does *Holloway* make reference to *Coffey*. Finally, neither *Coffey* or *Washington* discuss either *Armstrong* or *Holloway*. As with so many of the section 20(a) cases, *Kirkland* involved a claim against a broker's employee for violating, inter alia, section 10(b) of the Exchange Act.

Court of Appeals for the First Circuit[280] has been careful to

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In the Tenth Circuit, Castleglen, Inc. v. Commonwealth Sav. Ass'n, 689 F. Supp. 1069, 1071-72 (D. Utah 1988), held that section 28(a) does not preclude "liability under a common law respondeat superior theory." *Id.* at 1070, 1073. In arriving at this holding, the *Castleglen* court concluded that, in determining "the effect of section 20(a) on respondeat superior liability . . . [,] there is no direct Tenth Circuit authority on point." *Id.* Castleglen discussed Kerbs v. Fall River Indus., 502 F.2d 731 (10th Cir. 1974), noting that different circuits have come to different conclusions on whether *Kerbs* addressed the survival of respondeat superior in light of section 20(a). *Id.* at 1071. Without discussing section 20(a), the *Kerbs* court had held that a corporation could be secondarily liable under an apparent authority theory for the violations by its president of section 10(b) and rule 10b-5, 502 F.2d at 740; *see also* Richardson v. MacArthur, 451 F.2d 35, 41-42 (10th Cir. 1971) (reasoning that "[l]iability under § 20(a) is not restricted by principles of agency or conspiracy," without discussing preemption issue, and then holding that corporation liable under section 20(a) for employee's violations of, inter alia, section 10(b) and rule 10b-5); Reyos v. United States, 431 F.2d 1337, 1346-47 (10th Cir. 1970) (holding, without discussing section 20(a), that bank liable for actions of employees when employees that violated rule 10b-5 were "apparently acting within their authority").

In the Eleventh Circuit, Estate of Pidcock v. Sunnyland America, Inc., 726 F. Supp. 1322, 1339-40 (S.D. Ga.), *modified on other grounds*, 1989 U.S. Dist. LEXIS 6354 (S.D. Ga. 1989), held that a corporation could be liable on state agency law principles for misrepresentations by a corporate officer made in connection with stock purchase by the corporation from a shareholder. The *Pidcock* court relied on decisions from the Fifth Circuit, the circuit out of which the Eleventh Circuit was created. *Id.* at 1339, 1339 n.17. *See also* Bonner v. City of Prichard, 661 F.2d 1206, 1207 (11th Cir. 1981) (holding, in a non-securities law case, that decisions of the Fifth Circuit, "as that court existed on September 30, 1981, handed down by that court prior to the close of business on that date, shall be binding as precedent in the Eleventh Circuit").

[280] *See In re* Atlantic Fin. Management, 784 F.2d 29 (1st Cir. 1986). In an opinion written by then Judge Breyer, the First Circuit held that a corporation could be liable under the common law doctrine of apparent authority for the misrepresentations of the corporation's chairman. *Id.* at 35; *cf.* Holmes v. Bateson, 583 F.2d 542, 560 (1st Cir. 1978) (supporting principle "that a corporation is liable for the acts and omissions of its agents, officers, and employees acting under the corporate manner" in a confusing discussion of secondary liability of corporation for section 10(b) and rule 10(b)(5) violations by executive officers who were also shareholders); A.J. White & Co. v. SEC, 556 F.2d 619, 624 (1st Cir. 1977) (holding, in reviewing SEC disciplinary action against broker-dealer for violating antifraud extension of credit and prospectus delivery provisions of securities acts, that a broker-dealer "can act only through its agents, and is accountable for the actions of its responsible officers"), *cert. denied*, 434 U.S. 969 (1977). These misrepresentations were violations of section 10(b) and rule 10b-5 that occurred in connection with sales of the corporation's stock. *Id.* at 30. The First Circuit limited the holding to the particular facts before it ("a corporation" and "misrepresentations of an important corporate

confine its holdings to the facts presented to it and to the doctrine of apparent authority, indicating a disinclination to expansively apply agency principles to the Exchange Act. The Court of Appeals for the Third Circuit follows the majority position on agency law, but it has hedged its holdings with restrictive language showing a marked disinclination to reading too much of agency law into the Exchange Act.[281] Finally, the law in the

officer") and the single common law doctrine of apparent authority. "We state this conclusion narrowly, however, for reasons that, by now should be apparent." *Id.* at 35; *accord* Verrecchia v. Paine, Webber, Jackson & Curtis, 563 F. Supp. 360, 364-65 (D. P.R. 1982) (holding broker could be liable for violations of section 10(b) and rule 10b-5 by employee under apparent authority doctrine, noting that liability under respondeat superior extends further). *But see* Fed. Sav. & Loan Ins. v. Shearson-American Express, 658 F. Supp. 1331, 1343 (D. P.R. 1987) (holding that broker can be liable on respondeat superior for violations by employee of federal securities laws); Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp. 203, 214 (D. Mass. 1978) (holding broker liable under respondeat superior for churning by an employee that violated, inter alia, section 10(b)); *cf.* Adams v. Hyannis Harborview, Inc., 838 F. Supp. 676, 692-94 (D. Mass. 1993) (holding bank liable under respondeat superior for actions of employee that violated state blue sky law, even though blue sky law contained provision similar to section 15 of the Securities Act). First, common law principles should be applied to the Exchange Act only to "the extent to which their adoption is consistent with the statute's language and furthers its purpose." *Atlantic*, 784 F.2d at 35. Second, section 20(a), "in an appropriate context (perhaps involving the use of 'dummies')," could help determine the meaning of common law agency concepts. *Id.* at 35.

[281] *See* Sharp v. Coopers & Lybrand, 649 F.2d 175, 181 n.5, 182-83, 184-85 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); Rochez Bros. v. Rhoades, 527 F.2d 880, 886 (3d Cir. 1975). *Sharp* involved an action under section 10(b) and rule 10b-5 against an accounting firm for a tax opinion written by one of its employees. This tax opinion was used by an oil drilling limited partnership in its sales program for limited partnership interests. The district court upheld the jury verdict that the accounting firm was liable under both respondeat superior and section 20(a). Sharp v. Coopers & Lybrand, 457 F. Supp. 879, 891, 895 (E.D. Pa. 1978). In affirming the district court's decision, the Third Circuit contrasted the "simple garden variety master-servant relationship" with that present in *Sharp*, where the accounting firm "perform[ed] a valuable service in evaluating, synthesizing, and explicating complex financial date" that were "designed to influence the investing public." 649 F.2d at 184; *accord* Dougherty v. Mieczkowski, 661 F. Supp. 267, 279 (D. Del. 1987) (broker as secondary defendant); Walsh v. Butcher & Sherrerd, 452 F. Supp. 80, 85-86 (E.D. Pa. 1978) (broker as secondary defendant). Repeatedly emphasizing the limited application of its holding, and explicitly noting that "as a panel of this court we are not authorized to overrule the decision of a prior panel," *Sharp*, 649 F.2d at 181 n.5, the Third Circuit justified its holding by arguing that, as a practical matter, accounting firms had to be judged by a legal standard that would

motivate the firms to properly supervise their employees. Otherwise a firm that could attempt to avoid liability "by constructing a 'Chinese wall' between its employees and partners, allowing only the former to draft opinion letters." *Id.* at 184. *But see* Fitzpatrick & Carman, *supra* note 73, at 25 (criticizing this argument because such conduct by a secondary defendant would not meet the good faith defense of section 20(a), the alternate available ground for liability). In the Third Circuit's view, the imposition of "an absolute duty on the part of the firm . . . to supervise employees closely" was the only way to insure that the investing public was properly protected. *Sharp*, 649 F.2d at 184. *But see* Fitzpatrick & Carman, *supra* note 73, at 7-8, 11-12, 22 (criticizing *Sharp* and arguing that Supreme Court decisions make justifying respondeat superior based on general references to remedial purposes of Exchange Act inappropriate). The tax opinion was signed by a firm partner in the name of the firm. *Sharp*, 457 F. Supp. at 883. Based on these facts, the SEC argued in an amicus curiae brief that the accounting firm could have been held liable as a primary defendant rather than a secondary defendant "because the accounting firm's name was on the opinion letter and, thus, it held itself out to the public as responsible for the contents." Lynch, *supra* note 275, at 1407 n.134. See the cases discussed *supra* note 275 for the application of this primary liability concept to corporations. *See also* Straub v. Vaisman & Co., 540 F.2d 591, 596 (3d Cir. 1976) (holding, in an opinion whose clarity and reasoning leaves something to be desired, corporation liable for its "active participation" in violations of, inter alia, section 10(b) and rule 10b-5 when president, who was also sole stockholder, participated in violations). Such a holding would have been, however, as much a misreading of partnership law as the equivalent approach with corporate employees is of corporate law. Although apparent or actual authority may, as a factual matter, be more easily found when the actions of a general partner are at issue rather than those of a corporate employee, the same agency principles of actual and apparent authority should be applied in both situations. *See* Uniform Partnership Act § 9 (1914).

Before *Sharp*, the Third Circuit's decision in *Rochez Bros.* had been read to establish that the Third Circuit viewed section 20(a) as preempting state agency law principles. *Rochez* involved a rule 10b-5 suit, Rochez Bros. v. Rhoades, 353 F. Supp. 795, 796 (W.D. Pa. 1973), brought by the seller of shares in a closed corporation for actions by the buyer, the president and director of the corporation. *Id.* at 799-800. Although the Third Circuit could have found, on the facts, that respondeat superior would not have applied, it went on to analyze the applicability of respondeat superior. The *Rochez* court held "that agency principles - *respondeat superior* - are not applicable to determine secondary liability in a securities violation case." 527 F.2d at 886. In arriving at this holding, the *Rochez* court noted that:

> We are not faced with the type of relationship that prevails in the broker-dealer cases where a stringent duty to supervise employees does exist. This duty is imposed to protect the investing public and make brokers aware of the special responsibility they owe to their customers. We find no reason to impose this same duty in a situation like the one presently before us where the parties were dealing for themselves and for their own accounts.

Court of Appeals for the Fourth Circuit[282] is unclear, although the preemption issue has been addressed.

The majority position is consistent with current preemption jurisprudence. There is no explicit provision in section 20(a) dealing with the displacement of state agency law, and section 28(a) precludes field preemption. Accordingly, as application of

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Id.; *accord* Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 778-79 (3d Cir. 1976) (holding that two corporations could not be liable on "ordinary agency principles" for alleged violations of, inter alia, section 10(b), for actions on a third corporation's board of an individual who was an executive officer and director, respectively, of the secondary defendants); Thomas v. Duralite Co., 524 F.2d 577, 586 (3d Cir. 1975) (relying on *Rochez* in similar factual situation). *See generally* Ferrara & Sanger, *supra* note 270, at 1020 (characterizing the Third Circuit's position on the preemption issue as "novel, intermediate"); Musewicz, *supra* note 73, at 763-65 (perceptive analysis of Third Circuit cases).

[282] The leading Exchange Act case in the Fourth Circuit, Carras v. Burns, 516 F.2d 251 (4th Cir. 1975), held that a broker could be liable under "familiar principles of an employer's vicarious liability" for churning violations by an employee that violated section 10(b) and rule 10b-5. *Id.* at 259 (citing Johns Hopkins University v. Hutton, 422 F.2d 1124, 1130 (4th Cir. 1970), a case involving section 12(2) of the Securities Act); *accord* American Gen. Ins. Co. v. Equitable Gen. Corp., 493 F. Supp. 721, 747-48 (E.D. Va. 1980) (finding corporation that repurchased its shares could be secondarily liable under section 10(b) and rule 10b-5 for the actions of its officers or employees). Four years later, a different panel of the Fourth Circuit applied only sections 20(a) and 15 and not state agency law principles to a suit under the Exchange Act and the Securities Act against a broker for sales of unregistered securities by one of its employees. Carpenter v. Harris, Upham & Co., 594 F.2d 388, 394-95 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); *see also* Hunt v. Miller, 908 F.2d 1210, 1214, 1216 n.14 (4th Cir. 1990) (applying respondeat superior only to pendent state common law claims in action against broker for violations of, inter alia, section 10(b) and rule 10b-5 by employee).

Although the *Carpenter* court did not explain why it did not apply state agency law, one district court in the Fourth Circuit has read *Carpenter* as having "overruled [*Johns Hopkins* and *Carras*] *sub silentio*." Haynes v. Anderson & Strudwick, Inc., 508 F. Supp. 1303, 1311 (E.D. Va. 1981). The *Haynes* court concluded that "[t]he inescapable implication from *Carpenter* is that § 20(a) is the exclusive standard of liability for a broker-dealer." *Id.* at 1312. This reading of the caselaw by the *Haynes* court has been criticized in two other district court opinions in the Fourth Circuit. Baker v. Wheat First Sec., 643 F. Supp. 1421, 1426-27 (S.D. W. Va. 1986) (broker as secondary defendant); Frankel v. Wyllie & Thornhill, Inc., 537 F. Supp. 730, 740-42 (W.D. Va. 1982) (bank as secondary defendant for appraisal by employee of real estate securing bonds). The Court of Appeals for the Fourth Circuit itself has not spoken to this split among the district courts.

state agency principles does not interfere with enforcement of section 20(a), state law remedies should not be preempted.

Having concluded that section 20(a) does not preempt state agency law does not answer the separate but related issue of whether secondary liability is part of the section 10(b) liability scheme.[283] This is the question to which *Central Bank of Denver v. First Interstate Bank*[284] is addressed. In fact, a preemption analysis of section 20(a) may become irrelevant because of this case and the approach to section 10(b) that it espouses.[285] *Central Bank* involved the issue of "whether private civil liability under § 10(b) extends as well to those who do not engage in the manipulative or deceptive practice but who aid and abet the violation."[286] Relying primarily on the language of section 10(b), which does not mention aiding and abetting, the Supreme Court held "that a private plaintiff may not maintain an aiding and abetting suit under § 10(b)."[287] The Supreme Court explicitly rejected the argument that Congress in enacting the Exchange Act had intended to incorporate the "deeply rooted background of aiding and abetting tort liability" into private causes of action under the Exchange Act.[288]

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[283] There is, also, the further issue of whether secondary liability is part of the liability scheme under other sections of the Exchange Act such as section 9.

[284] 114 S. Ct. 1439 (1994).

[285] The petitioner in *Central Bank* argued that aiding and abetting liability under section 10(b) was unavailable because section 20(a) was the only provision within the Exchange Act that provides for secondary liability. Brief for Petitioner at 25-27, Central Bank of Denver v. First Interstate Bank of Denver, No. 92-854 (Sup. Ct. filed July 30, 1993). This argument could have been a springboard for the Supreme Court to discuss the preemptive effects of section 20(a) but the Supreme Court did not take the dive.

[286] *Central Bank*, 114 S. Ct. at 1443.

[287] *Id.* at 1455. The leading academic proponent of the position that the Supreme Court took has been Professor Daniel R. Fischel, whose article, at *supra* note 259, was cited several times in *Central Bank*, 114 S. Ct. at 1444, 1452. In his discussion of respondeat superior, Professor Fischel, however, focused on the legislative history of section 20(a), Fischel, *supra* note 259, at 98-99, as well as the language of section 10(b), *id.* at 94-96. His conclusion was that "[t]hose courts which have held employees strictly liable under a respondeat superior theory as a matter of federal law . . . have acted contrary to the legislative intent of Congress." *Id.* at 99. The existence of this section 20(a) legislative history helps distinguish the section 20(a) cases from *Central Bank* and should allow alert plaintiffs to keep state agency law principles alive until the Supreme Court finally hears a case directly on point.

[288] *Central Bank*, 114 S. Ct. at 1451-52. See Edward Brodsky, *Aiding and*

In light of the fact that agency liability is another type of secondary liability not mentioned in section 10(b), a strong *Central Bank*-type argument is available to future secondary defendants sued under state agency law for Exchange Act causes of action, rather than under section 20(a).[289] A *Central Bank*-type analysis might never get as far as the legislative history of section 20(a) and the potential conflict between the good faith defense and state agency law. A recasting of the issue to focus on what remedies section 10(b) provides could make preemption analysis irrelevant in this context because section 10(b) could be found to not implicate agency principles. Instead of becoming an issue of preemption, the issue could become one of implied causes of action.[290] In a sense such a recasting of the issue would be circular. The central issue

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Abetting Claims Under Rule 10b-5, N.Y. L.J., June 14, 1995, at 3, for a discussion of the post-*Central Bank* decisions. Mr. Brodsky argues that some courts have attempted to circumvent *Central Bank* by finding primary liability under section 10(b) on suspect grounds. *Id.* at 4. *See generally* Edward Brodsky, *After "Central Bank": Litigating Claims for Secondary Liability*, N.Y. L.J., Nov. 11, 1995, at 3; John F.X. Peloso & Stuart M. Arnoff, *The Impact of "Central Bank of Denver" on the SEC*, N.Y. L.J., Oct. 19, 1995, at 3 (both discussing further case developments in the lower federal courts in applying *Central Bank*).

[289] *See Central Bank*, 114 S. Ct. at 1460 n.12 (Stevens, J., dissenting) ("[M]any courts, concluding that § 20(a)'s 'controlling person' provisions . . . are not the exclusive source of secondary liability under the Exchange Act, have imposed liability in § 10(b) actions based upon *respondeat superior* and other common-law agency principles. . . . These decisions likewise appear unlikely to survive the Court's decision.") (citations omitted). *But cf.* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (without discussing agency law, treating actions of employees as those of employer); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 154 (1972) (holding, without any discussion, that "[t]he liability of the bank [the secondary defendant], of course, is coextensive with that of" the primary defendants, officers of the bank, for violations of section 10(b) and rule 10b-5); Denten v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 887 F. Supp. 176 (N.D. Ill. 1995) (post-*Central Bank* control person case in which defendant evidently did not raise this issue).

[290] *See* York, *supra* note 249, at 353-56. Mr. York predicts that:

> The Supreme Court's trend of restricting the scope of liability under the securities laws and its continuing emphasis on statutory language suggests that a nonstatutory cause of action imputing vicarious liability to employers based on agency principles will not survive review. The Court is likely to extend the *Hochfelder* scienter requirement to the conduct of employers and to specifically exclude respondeat superior as a source of secondary liability.

Id. at 356.

would remain Congressional intent, but the focus would shift from section 20(a) (preemption) to section 10(b) (implied causes of action).

The majority view that section 20(a) does not preempt state agency law does not resolve the issue of whether federal or state agency law applies. Only one control person case, when applying agency law principles, has engaged in any discussion of whether a federal common law of agency should be applied.[291] Some courts have applied federal agency law[292] while other courts have applied state law.[293] Relying on re-

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[291] *Orloff*, 819 F.2d at 909. In discussing whether to apply state or federal corporate alter ego common law in a federal securities case, the Ninth Circuit reasoned that, in order "[t]o decide, the court must determine, as a matter of law, whether the federal interest at stake requires a uniform national alter ego rule and whether application of a state rule would frustrate specific objectives of federal law." *Id.* The Ninth Circuit did not have to decide this issue because the defendant could not have been liable under either standard. *Id.* The authors have found no other cases that have expressly dealt with the conflict between applying federal or state law, although several have skirted around the issue. *See* Denten v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 887 F. Supp. 176, 179 n.4 (N.D. Ill. 1995) ("Determining vicarious liability for the plaintiff's state law claims is governed by Illinois law whereas vicarious liability for plaintiff's federal claim would *presumably* be governed by federal principles. This court [as did the parties] will rely on federal and state cases interchangeably since there is no discernible distinction on this legal issue.") (emphasis added); Adams v. Hyannis Harborview Inc., 838 F. Supp. 676 (D. Mass. 1993) (discussing whether Massachusetts blue sky "controlling person" law coexists with a presumably federal standard of respondeat superior); Thomas v. Duralite Co. Inc., 386 F. Supp. 698 (D.N.J. 1974) (pointing out that a state common law claim brought in a federal court must be considered in light of state law), *aff'd in part, rev'd in part on other grounds*, 524 F.2d 577 (3d Cir. 1975), *and aff'd*, 559 F.2d 1209 (3d Cir. 1977) (mem.); Carras v. Burns, 516 F.2d 251 (4th Cir. 1975) (holding that it is not necessary to decide if a federal policy should control court's decision of whether to allow punitive damages for a pendent state claim).

[292] *See, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990) (categorizing common law theory of respondeat superior as a federal claim), *cert. denied*, 499 U.S. 976 (1991); Carras v. Burns, 516 F.2d 251 (4th Cir. 1975) (speaking of respondeat superior separately from discussion of state common law claims); Pippenger v. McQuik's Oilube, Inc., 854 F. Supp. 1411 (S.D. Ind. 1994) (discussing respondeat superior under section entitled "Federal Securities Fraud Claim" rather than section dealing with state fraud claims); Baker v. Wheat First Sec., 643 F. Supp. 1420 (S.D. W. Va. 1986) (discussing respondeat superior liability in section entitled "Federal Securities Law Claims").

[293] *See, e.g.*, Commerford v. Olson, 794 F.2d 1319 (8th Cir. 1986) (using Minnesota's apparent authority standard for imposing vicarious liability); Hatrock v. Edward D. Jones & Co., 750 F.2d 767 (9th Cir. 1984) (using Idaho

cent Supreme Court precedent described in part II.B, state agency law should be applied.[294] The fact that the courts have not explicitly considered this third type of preemption issue is not surprising in light of the fact that there has been "little analysis of the boundaries of courts' power to make federal common law" by either the courts or commentators.[295] The

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common law to find company liable for punitive damages for acts of its employee); Kerbs v. Fall River Indus., Inc., 502 F.2d 731 (10th Cir. 1974) (although there was no existing explicit state law standard, the federal court was convinced that Utah courts would impose the same standard of agency law); SEC v. First Sec. Co. of Chicago, 463 F.2d 981 (7th Cir. 1972) (although there was no existing explicit state law standard, the federal court was convinced that Illinois courts would impose Restatement standard of apparent authority), *cert. denied*, 409 U.S. 880 (1972).

[294] Only one commentator on the control person cases has addressed this issue, although he did not have to resolve it because he concluded that sections 15 and 20(a) should be the exclusive means for secondary liability under the Securities Act and the Exchange Act. Duggan, *supra* note 236, at 481-88.

Professor Gabaldon has explored this issue in general with respect to the federal securities laws, with special attention to recent Supreme Court cases, most of which are not discussed in this article. *See* Gabaldon, *supra* note 41, at 184-202. Where "state law applies on its own terms to answer a question," Professor Gabaldon would have the courts engage in the "standard preemption analysis." *Id.* at 207-08. *But see* Johnson, *supra* note 41, at 884 ("Neither the Constitution nor statute require the federal courts to resort to state law to fill gaps in a federal statute."). A similar issue arises under state blue sky laws, where the issue becomes whether federal securities law concepts should be borrowed to construe blue sky statutory provisions that are similar to those in the federal securities laws. *See* Martin C. McWilliams, Jr., *Thoughts on Borrowing Federal Securities Jurisprudence Under the Uniform Securities Act*, 38 S.C. L. REV. 243, 275 (1987) (concluding that consideration must be given to "function and purpose" of relevant state and federal securities provisions before looking to federal law for guidance and that such guidance is not always appropriate).

[295] Martha A. Field, *Sources of Law: The Scope of Federal Common Law*, 99 HARV. L. REV. 883, 886, 886 n.14 (1986); Gabaldon, *supra* note 41, at 157-58.

Professor Gabaldon's summary of the caselaw in the federal securities area is an apt one. She writes that these cases are part of

> a tradition of seeming randomness in which the court sometimes has implicitly invoked state law as the federal rule of decision, sometimes has viewed various state precedents as somewhat interesting but distinctly noncompelling and sometimes has seized on state law not as a model of any sort but rather as a reason to curtail conflicting interpretations of federal law.
>
> The Supreme Court has not acted alone. The lower federal courts also have played a part in creating the "now you see it, now you don't" atmosphere surrounding the use of state law in answering (or creating) federal

usual test that is applied is a two part one derived from the Supreme Court's decision in *United States v. Kimbell Foods, Inc.*[296]

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securities questions. It is fairly obvious, however, that the true nature of these conflicts is unrecognized at any level.

Gabaldon, *supra* 41, at 157-58 (footnotes omitted).

Issues of coordinating federal and state law also arise in the area of implied rights of action under the federal securities laws, an area not addressed by this article. The seminal case is Burks v. Lasker, 441 U.S. 471 (1979), which involved the issue of whether state or federal law would apply to determine whether disinterested directors could terminate a derivative suit brought under the Investment Company and Investment Advisers Acts of 1940. Although the *Burks* Court assumed that the derivative action was implied by the two acts and that, therefore, "state law does not operate of its own force," the *Burks* Court was very solicitous of existing state corporation law. *Id.* at 476-78. Without using the word preemption, the *Burks* Court engaged in a preemption-type of analysis. Only if state law was inconsistent with "'the federal policy underlying the cause of action,'" should state law be displaced. *Id.* at 479 (quoting Johnson v. Ry. Express Agency, 421 U.S. 454, 465 (1975)). *See generally* Alison G. Anderson, *The Meaning of Federalism: Interpreting the Securities Exchange Act of 1934*, 70 VA. L. REV. 813, 827-28, 858 (1984) (criticizing *Burks* and similar Supreme Court cases for invoking federalism concerns that "confuse and obscure discussion of the major substantive policy choices"); Edmund W. Kitch, *A Federal Vision of the Securities Laws*, 70 VA. L. REV. 857, 868 (1984) (critiquing Professor Anderson's article and concluding that "[a]s a simple matter of sensible allocation of power and coherent administration, it makes sense to limit national rules to areas such as the securities markets, which are the subject of comprehensive federal legislation, and leave to the states the development of the law governing internal relations within corporations"); Thomas L. Hazen, *Corporate Chartering and the Securities Markets: Shareholder Suffrage, Corporate Responsibility and Managerial Accountability*, 1978 WIS. L. REV. 391, 437 (1978) (suggesting that federal oversight most appropriate for areas where actors are investors and state oversight most appropriate for areas where actors are shareholders); David L. Ratner, *Federal and State Roles in the Regulation of Insider Trading*, 31 BUS. LAW. 947, 963 (1976) ("My basic suggestion is to contract the boundaries of federal jurisdiction to encompass only those corporations in which there is some public trading market, and to leave to state law and state courts the essentially person-to-person dealings in closely held corporations.").

[296] 440 U.S. 715 (1979). The first part of the test, "whether the issue before [the court] is properly subject to the exercise of federal power," Field, *supra* note 295, at 886, is easily met, with the result that there has been a great expansion of federal common law. *See* Mary K. Hoefer, *Formulating a Federal Rule of Decision in Commercial Transactions after Kimbell*, 66 IOWA L. REV. 391, 399-403 (1981) (federal common law, which may be an adopted state law, applies after looking at the federal function factor, which is an easily-met test); *cf. Orloff*, 819 F.2d at 909 (citing *Kimbell Foods* for the proposition that there

In conclusion, most federal circuits have demonstrated a reluctance to find state agency principles preempted pursuant to section 20(a) of the Exchange Act insofar as these state agency principles are applied to violations of the Exchange Act. The issue of whether state or federal law should be applied in defining the applicable agency principles has not been directly addressed by the courts but should be resolved against the application of federal common law pursuant to *O'Melveny* principles.

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can be a federal common law of corporate alter ego liability). Many published control person cases do not have to reach the issue of whether to apply federal or state agency law because they deal only with the preemption issue. In such cases, the actual application of the pertinent law to the facts is not yet procedurally relevant. *See, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1578 (9th Cir. 1990) (liability of corporation under both section 20(a) and respondeat superior to be determined on remand), *cert. denied*, 499 U.S. 976 (1991); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1119 (5th Cir. 1980) (finding on appeal that common law agency applicable with section 20(a) but remanded for factual finding if primary defendant acted within scope of employment); Castleglen, Inc. v. Commonwealth Sav. Ass'n., 689 F. Supp. 1069, 1073 (D. Utah 1988) (holding section 20(a) does not preempt agency principles but no decision made as to whether secondary defendant liable), *summ. judg. granted*, 728 F. Supp. 656 (1989); Federal Sav. Loan Ins. v. Shearson - American Express, 658 F. Supp. 1331, 1340 (D. P.R. 1987) (denying motion to dismiss, court found that liability possible under respondeat superior and section 20(a) but left the actual determination of the case to be made at trial); Dougherty v. Mieczkowski, 661 F. Supp. 267, 281 (D. Del. 1987) (on motion to compel arbitration, the court found that section 20(a) and respondeat superior are separate causes of action and granted motion to compel arbitration on state claims while holding motion to compel arbitration in abeyance as to federal claims); Baker v. Wheat First Sec., 643 F. Supp. 1420, 1434 (S.D. W. Va. 1986) (deciding on cross motions for summary judgment, that respondeat superior was not preempted, therefore denying summary judgment on this count); Kirkland v. E. F. Hutton & Co., 564 F. Supp. 427, 447 (E.D. Mich. 1983) (finding on motion for partial summary judgment, that section 20(a) and respondeat superior applied but remanded for determination of whether good faith was proven by the control person); Commerford v. Olson, 794 F.2d 1319, 1324 (8th Cir. 1986) (holding that plaintiff was entitled to instructions on apparent authority liability but left determination of whether defendant liable under that theory for remand); Moscarelli v. Stamm, 288 F. Supp. 453, 460 (E.D.N.Y. 1968) (recognizing on motion to dismiss that liability possible under section 20(a) and the common law but left the factual determination to be made at trial). The recent analysis set forth in *O'Melveny* and described in part II.B makes clear that creation of a federal law of agency to supplement the remedies available under the Exchange Act is inescapable.

D. Preemption of Damage Claims in Pendent State Causes of Action

A more traditional preemption issue is posed by the limitation upon damages contained in section 28(a). As well as preserving state law rights and remedies, section 28(a) provides, in the second clause of its first sentence, that "no person permitted to maintain a suit for damages under the provisions of [the Exchange Act] shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of."[297] Relying on this language, the courts have had no difficulty in holding that remedies such as punitive damages[298] and damages for mental distress[299] are not allowed for violations of section 10(b) and rule 10b-5.[300] This language is also used to ensure that a plaintiff may not recover actual damages twice, once for Exchange Act claims and once for state law claims.[301]

When a section 10(b) claim is plead together with a state fraud claim, the issue becomes whether section 28(a) limits the state law damage remedy that is available[302] for the pendent

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[297] 15 U.S.C. § 78bb(a) (1994).

[298] *See, e.g.*, Green v. Wolf Corp., 406 F.2d 291, 303 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969). *See generally* Note, *Section 28(a) of the Securities Exchange Act: Punitive Damages and Pendent State Claims*, 46 U. COLO. L. REV. 59, 70-71 (1974) (discussing possible rationales that the courts may have relied upon in coming to this conclusion). When this issue was first litigated, some courts took the position that the phrase "under the provisions of this chapter" in the second clause referred only to express remedies in the Exchange Act and not to implied remedies such as those under section 10(b) and rule 10b-5. *See* deHaas v. Empire Petroleum Co., 435 F.2d 1223, 1230 (10th Cir. 1970) (discussing this position before concluding that punitive damages not allowed in private action under rule 10b-5).

[299] *See, e.g.*, Greitzer v. United States Nat'l Bank, 326 F. Supp. 762, 766 (S.D. Cal. 1971) (holding that damages for mental distress not recoverable under either the Securities Act or the Exchange Act).

[300] In order to avoid inconsistent results under the Securities Act and the Exchange Act, the courts have extended this limitation to violations of section 17(a) of the Securities Act although there is no comparable language in the Securities Act to that in the second clause of section 28(a). *See, e.g.*, Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1286 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). *But see* Nagel v. Prescott & Co., [1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,524 (N.D. Ohio 1964) (holding punitive damages available under Securities Act because lack of such comparable language).

[301] *See, e.g.*, Young v. Taylor, 466 F.2d 1329, 1338 (10th Cir. 1972).

[302] Gilbert v. Bagley, 492 F. Supp. 714, 742 (M.D.N.C. 1980) ("The defen-

state law claim. Usually the issue arises in connection with claims for punitive damages for the pendent state law claim, although it has also been discussed in connection with claims for damages for mental distress. The language of the second clause of section 28(a) "may be construed as limiting the possible recovery to anyone '*permitted* to maintain' an action under the [Exchange] Act even if that plaintiff is prosecuting a different cause of action."[303] By focussing on the word "permitted," defendants have contended that a plaintiff suing upon a set of facts that would support both a state law claim and an Exchange Act claim may not recover punitive damages in either action because the facts "permitted" suit under the Exchange Act.

In contrast, the argument against preemption of state law remedies providing for other than actual damages focuses on the language of the first clause of the first sentence of section 28(a), which preserves "rights and remedies," and from the limitation of the second clause to "suit[s] for damages under the *provisions* of this chapter" (emphasis added). The majority view is that suit under state law is not a suit under the "provisions" of the Exchange Act and, therefore, preemption does not apply.[304] Stated simply, the limitation upon non-actual damages

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dants interpret § 28(a) as preserving common law and statutory remedies while limiting recovery thereunder to actual damages.").

[303] *Gilbert*, 492 F. Supp. at 743 (noting also that this argument would "preclude a prayer for punitive damages in state court action, e.g., common law fraud, unless the plaintiff could prove a negative, i.e., that he could not maintain an action under the [Exchange] Act"); Laurence D. Rubin, *Punitive Damages in Implied Civil Actions Under the Federal Securities Laws: The Need for Flexibility*, 17 UCLA L. REV. 1280, 1287 n.33 (1970) (criticizing the results if this interpretation were to be applied); *see also* Nunes v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 609 F. Supp. 1055, 1060 (D. Md. 1985) (rejecting same argument as raised in *Gilbert*). A more limited preemption possibility exists. Recovery for punitive damages for state law claims might only be barred by section 28(a) when such claims are pendent claims but not when such claims are brought only in state court. *See* Note, *supra* note 298, at 71 (rejecting this argument because of problems arising from encouraging plaintiffs to split their causes of action into two suits).

[304] *See, e.g.*, Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 445 (N.D. Cal. 1968) (explaining phrase "actual damages" does not limit recovery in state causes of action that permit punitive damages), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); deHaas v. Empire Petroleum Co., 435 F.2d 1223, 1230 (10th Cir. 1970) (discussing this argument but relying on policy considerations because this argument not clearly addressed by the Exchange Act); John

in the Exchange Act was not intended to limit remedies available under state law for claims arising in securities actions.

The minority view that preemption applies is found in four district court cases in the Seventh Circuit: three from the Northern District of Illinois, two from the early 1970s, and one from the mid-1980s;[305] and one 1960s case from the Eastern District of Wisconsin.[306] These cases held that plaintiffs who have sued under section 10(b) and rule 10b-5 could not recover

Huffaker, *The Reappearance of Punitive Damages in Private Actions for Securities Fraud*, 5 TEX. TECH. L. REV. 111, 132 (1973); William Vincent Walker, *Punitive Damages for Securities Regulation*, 8 HOUS. L. REV. 137, 143-44 (1970-71); Mark M. Weintraub, *Comment - The Availability of Variant State Remedies for Pendent State Fraud Claims Actionable Under the Federal Securities Acts*, 47 S. CAL. L. REV. 1213, 1218-19 (1974).

[305] Etshokin v. Texasgulf, Inc., 612 F. Supp. 1220, 1234 (N.D. Ill. 1985) (citing Schaefer v. First National Bank of Lincolnwood); Schaefer v. First National Bank of Lincolnwood, 326 F. Supp. 1186, 1193 (N.D. Ill. 1970) (holding section 28(a) has not saved common law damages rules permitting recovery in excess of actual damages), *appeal dismissed*, 465 F.2d 234 (7th Cir. 1972); *cf.* Cant v. A.G. Becker & Co., [1971-72 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,347, at 91,874-75 (N.D. Ill. Dec. 20, 1971) (stating, in dictum, plaintiff should not be permitted to obtain punitive damages indirectly through common law claim when he/she cannot obtain them directly under the Exchange Act or pertinent state statute). *Schaefer* applied this principle also to violations of the registration requirements under the Securities Act.

[306] Kohler v. Kohler Co., 208 F. Supp. 808, 825 (E.D. Wis. 1962), *aff'd on other grounds*, 319 F.2d 634 (7th Cir. 1963). The discussion of damages is technically dictum in *Kohler* because the district court had already determined that there had been no violation of Wisconsin law by the defendant for nondisclosure. *Id.*

punitive damages for pendent state law fraud claims.[307] None of these cases provides a persuasive preemption argument.

There is no dispositive opinion from the Seventh Circuit on the damages preemption issue. Nonetheless, every other case to consider this issue has held that state punitive damages remedies are available for pendent state law claims.[308] It is

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[307] One other case has been cited by defendants in some cases to support preemption, Kerby v. Commodity Resources, Inc., 395 F. Supp. 786, 790 (D. Colo. 1975). The *Kerby* court dismissed pendent state law claims including, inter alia, one for common law fraud. The plaintiff sought punitive damages and attorney's fees for these pendent state law claims and the *Kerby* court, after noting the restrictions on recovery under rule 10b-5 for either punitive damages or attorney's fees, gave as one of its reasons for dismissing the pendent state claims that

> [t]hese limitations on the federal securities law claim may well be the motivating reason for these type of joinder of claims made in this complaint and which has become typical in this kind of litigation. *Such an apparent attempt to expand the scope of the remedy* is a reason to reject these pendent claims in recognition of the limited role of the federal law and the federal courts.

Id. (emphasis added); *accord* Technology Exchange Corp. v. Grant County State Bank, 646 F. Supp. 179, 184 (D. Colo. 1986) (citing *Kerby* to support dismissal of pendent state claims because, inter alia, "assertion of these state claims tends to expand improperly the scope and remedies provided under federal securities laws"); Anastasi v. American Petroleum, Inc., 1984 WL 3248, at *2 (D. Colo. Dec. 24, 1984) (citing *Kerby* to support dismissal of pendent state claims because, inter alia, "[a]ssertion of such claims in the context of this suit only serves to expand improperly the coverage and remedies provided under federal securities law").

The defendants in Gilbert v. Bagley, 492 F. Supp. 714 (M.D.N.C. 1980), relied on *Kerby*. The *Gilbert* court read the *Kerby* court's ruling as "predicated upon the court's discretion rather than a finding of preemption." *Id.* at 743. The *Gilbert* court could also have cited a Tenth Circuit case, Young v. Taylor, 466 F.2d 1329 (10th Cir. 1972), that allowed the recovery of punitive damages for pendent state law claims. *Id.* at 1337. The Tenth Circuit is, of course, the *Kerby* court's circuit.

[308] Organized by federal circuits, these cases are:

FIRST CIRCUIT: Holmes v. Bateson, 434 F. Supp. 1365, 1389 (D. R.I. 1977) (holding, in dictum, that punitive damages are available for state fraud and breach of fiduciary duty claims), *aff'd in part, rev'd in part on other grounds*, 583 F.2d 542 (1st Cir. 1978);

SECOND CIRCUIT: Flaks v. Koegel, 504 F.2d 702, 706 (2d Cir. 1974) (allowing punitive damages for state law fraud and deceit claim); Faller Group, Inc. v. Jaffe, 564 F. Supp. 1177, 1185-86 (S.D.N.Y. 1983) (allowing punitive damages for state fraud claims without discussing preemption issue); Salvino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1244-45 (S.D.N.Y. 1981) (allowing punitive damages for state fraud claim without discussing preemption issue); *In re*

Caesar's Palace Securities Litig., 360 F. Supp. 366, 393-94 (S.D.N.Y. 1973) (punitive damages for state law fraud claim); American Bank & Tr. Co. v. Barad Shaff Sec. Corp., 335 F. Supp. 1276 (S.D.N.Y. 1972) (questioning, but not answering, whether punitive damages are recoverable under state claim); Gann v. Bernzomatic Corp., 262 F. Supp. 301, 304 (S.D.N.Y. 1966) (punitive damages for state law fraud and deceit claim);

FOURTH CIRCUIT: Walker v. Action Industries, Inc., 802 F.2d 703 (4th Cir. 1986) (suggesting punitive damages would have been recoverable if state law claim proven), *cert. denied*, 479 U.S. 1065 (1987); Baker v. Wheat First Sec., 643 F. Supp. 1420 (S.D. W. Va. 1986) (allowing punitive damages for common law claim); Nunes v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 609 F. Supp. 1055, 1060 (D. Md. 1985) (holding punitive damages available for state law fraud, breach of fiduciary duty, negligence, and breach of contract claims); Gilbert v. Bagley, 492 F. Supp. 714, 743 (M.D.N.C. 1980) (finding punitive damages for state law claims); Goodman v. Poland, 395 F. Supp. 660, 686 (D. Md. 1975) (finding punitive damages for state law fraud or deceit claims);

FIFTH CIRCUIT: Miley v. Oppenheimer & Co., 637 F.2d 318, 330 (5th Cir. 1981) (finding punitive damages for state law breach of fiduciary duty claim); Coffee v. Permian Corp., 474 F.2d 1040, 1044 (5th Cir.) (claiming, in dictum, that punitive damages available for state law violation), *cert. denied*, 412 U.S. 920 (1973); Stowell v. Ted S. Finkel Inv. Serv. Inc., 489 F. Supp. 1209, 1215-16 (S.D. Fla. 1980) (allowing punitive damages for state law claim; decided when Florida was still part of Fifth Circuit prior to the creation of the Eleventh Circuit), *aff'd on other grounds*, 641 F.2d 323 (5th Cir. 1981);

SIXTH CIRCUIT: Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427, 446 (E.D. Mich. 1983) (holding, in dictum, that punitive damages are available for state fraud claims); Emmens v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 532 F. Supp. 480, 485 (S.D. Ohio 1982) (allowing punitive or exemplary damages for state fraud and infliction of mental distress claims); Ohio v. Crofters, 525 F. Supp. 1133, 1141 (S.D. Ohio 1981) (allowing punitive damages for state fraud claim);

SEVENTH CIRCUIT: Hunt v. Miller, 908 F.2d 1210, 1216 (4th Cir. 1990) (allowing punitive damages for state fraud claim without discussing preemption issue); Halling v. Hobert & Svoboda, Inc., 720 F. Supp. 743, 746 (E.D. Wis. 1989) (holding, in dictum, that punitive damages are available for state law claims); Darling & Co. v. Klouman, 87 F.R.D. 756, 759 (N.D. Ill. 1980) (allowing punitive damages for state law fraud claim); Burkhart v. Allson Realty Trust, 363 F. Supp. 1286, 1291 (N.D. Ill. 1973) (criticizing two Illinois district court cases that held preemption applied; allowing punitive damages for state fraud and deceit claims);

EIGHTH CIRCUIT: Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1223 n.20 (8th Cir. 1990) (allowing punitive damages for state law fraud and breach of fiduciary duty claims); Grogan v. Garner, 806 F.2d 829, 838 (8th Cir. 1986) (allowing punitive damages for state law fraud claim); Nye v. Blyth Eastman Dillon & Co., 588 F.2d 1189, 1200 (8th Cir. 1978) (holding, in dictum, that punitive damages available for state fraud claim); Ryan v. Foster & Marshall, Inc., 556 F.2d 460, 464 (9th Cir. 1977) (finding punitive damages for state law claims); St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner

therefore well settled that the second clause of section 28(a) does not preempt such damage claims. Nothing in the legislative history of the second clause of section 28(a) would lead to a different conclusion.[309] This conclusion is also consistent with the preemption analysis described in part II.B.[310]

& Smith, Inc., 412 F. Supp. 45, 61 (E.D. Mo. 1976) (allowing punitive damages for state fraud and breach of fiduciary duty claims), *rev'd on other grounds*, 562 F.2d 1040 (8th Cir. 1977), *and cert. denied*, 435 U.S. 925 (1978); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 445 (N.D. Cal. 1968) (holding, in dictum, that exemplary damages are available for state law claims);

NINTH CIRCUIT: Hall v. Security Planning Serv., Inc., 462 F. Supp. 1058 (D. Ariz. 1978) (allowing punitive damages for state fraud claim);

TENTH CIRCUIT: Young v. Taylor, 466 F.2d 1329 (10th Cir. 1972) (allowing punitive damages for state claim);

ELEVENTH CIRCUIT: Stowell v. Ted S. Finkel Inv. Serv. Inc., 489 F. Supp. 1209, 1215-16 (S.D. Fla. 1980) (allowing punitive damages for state law claim; decided when Florida was still part of Fifth Circuit prior to the creation of the Eleventh Circuit), *aff'd on other grounds*, 641 F.2d 323 (5th Cir. 1981).

The Ninth Circuit has read the punitive damage cases summarized in this footnote as standing "for the broader proposition that remedies for pendent state law claims have not been circumscribed by the Federal Securities Acts." *Ryan*, 556 F.2d at 464. Using this broader proposition, the Ninth Circuit held that damages for mental suffering under state common law claims are not preempted by the second clause of section 28(a). *Id.*; *accord Emmons*, 532 F. Supp. at 485; *cf.* Greitzer v. United States Nat'l Bank, 326 F. Supp. 762, 766 (S.D. Cal. 1971) (raising issue of preemption of state mental distress damages but not deciding because such damages not recoverable in this case).

[309] The only reference to the second clause in the House report is unhelpful, stating only that while section 28(a) reserves "remedies existing outside of those provided in the act" it "limits the total amount recoverable to the amount of actual damages." H.R. Rep. No. 1383, 73 Cong., 2d Sess. 7709 (1934). The original Senate version did not contain any clause that limited the amount recoverable. *See* S. 3420, 73d Cong., 2d Sess. (1934). The limiting clause, however, was agreed to by both the House and Senate in the final, passed bill. *See* Securities Exchange Act of 1934, ch. 404, Title I, 48 Stat. 903 (1934). Some commentators have argued that the absence of an express prohibition against punitive damages means they are available. *See, e.g.*, Marc Kapustin, *The Availability of Punitive Damages for Express and Implied Causes of Action Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 43 TEMP. L.Q. 140, 140 (1970). One possible reading of Congress' intent is that the second clause of section 28(a) is meant "solely to prevent 'double recovery' by plaintiffs bringing separate actions for state common-law fraud and for violations of federal law." deHaas v. Empire Petroleum Co., 435 F.2d 1223, 1230 (10th Cir. 1971) (mentioning this argument but noting that legislative history of section 28(a) is not clear and, therefore, relying on policy arguments).

[310] Although the preemption analysis described in part II.B is not a policy based analysis, commentators applying policy based arguments have come to

IV. PRIMARY JURISDICTION AND THE EXCHANGE ACT

Primary jurisdiction normally is a judicial doctrine involving principles of judicial economy, which, under limited circumstances, vests the initial substantive resolution of a technically complex matter with the administrative agency charged with interpreting or enforcing the law or regulatory scheme at issue.[311] Primary jurisdiction often rests with an administrative agency if such agency has superior expertise in resolving disputes in that area. In making the determination of whether to allocate the initial decision-making to a court or an administrative agency, courts consider at least four factors. Three of these factors have to do with an agency's expertise and the need to insure that a uniform national regulatory scheme is not unduly interfered with,[312] while the fourth factor relates to insuring a timely resolution of the dispute.[313] Primary jurisdiction generally has little application in the securities context because (i) courts have extensive experience in analyzing the facts and legal issues raised in securities cases; (ii) securities cases do not typically raise technically complicated factual issues which are beyond the competence of the courts; and (iii) most securities cases are intensely fact based and therefore the resolution of such a case does not typically raise concerns with respect to the uniform application of law as the decisions can typically be distinguished on a factual basis. In this regard, it is when a

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the same conclusion. Richard D. Gamblin & Paul H. Stephenson III, Comment, *Punitive Damages and the Federal Securities Act: Recovery Via Pendent Jurisdiction*, 47 MISS. L.J. 743, 762-63 (1976); Huffaker, *supra* note 304, at 133-34. One policy argument against allowing recovery of punitive damages for pendent state claims is the increased risk of forum shopping. *See* Robert B. Hirsch & Jack L. Lewis, *Punitive Damage Awards Under the Federal Securities Act*, 47 NOTRE DAME L. REV. 72, 87 (1971).

[311] *See* National Comm. Ass'n v. American Tel. & Tel. Co., 46 F.3d 220 (2d Cir. 1995) (citing Far East Conference v. United States, 342 U.S. 570, 574 (1952)).

[312] 2 DAVIS & PIERCE, *supra* note 1, § 14.1 ("In making such determinations, courts consider several factors, including (1) the extent to which the agency's specialized expertise makes it a preferable forum for resolving the issue, (2) the need for uniform resolution of the issue, and (3) the potential that judicial resolution of the issue will have an adverse impact on the agency's performance of its regulatory responsibilities.").

[313] *Id.* The first three factors are balanced against the chance of undue delay if the doctrine of primary jurisdiction is applied.

uniform securities industry practice (such as payment for order flow) is challenged, and thus the possibility of non-uniform decisions resulting in industry confusion exists, that the primary jurisdiction issue arises.

The issue of primary jurisdiction has been periodically raised in federal securities cases but it has rarely been the issue upon which a decision is based.[314] The coordination of federal antitrust and securities laws has been one area where defendants have argued for the application of primary jurisdiction.[315] The concurring opinion of Chief Judge Swygert in *Thill Sec. Corp. v. NYSE*[316] is the progenitor of this focus on primary jurisdiction.[317] *Thill* arose from a class action challenging the prohibition imposed by the New York Stock Exchange ("NYSE") on the sharing of commission income by NYSE members with nonmembers.[318] The district court first looked at section 19(b) of

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[314] For reported cases involving the federal securities laws where the doctrine of primary jurisdiction has been raised but no determination as to its applicability has been made, see, e.g., Eisen v. Carlisle & Jacquelin, 479 F.2d 1005, 1013 (2d Cir. 1973) (involving antitrust class action involving commissions for odd-lot purchases and sales); Schenker v. Meridian Inv. & Dev. Corp., [1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,612 (S.D.N.Y. Aug. 28, 1972) (involving derivative action by shareholder of an investment company); Kinzler v. NYSE, 53 F.R.D. 75, 77 (S.D.N.Y. 1971) (involving antitrust class action arising from NYSE sanctioned freeze on transfer of registered representatives from Goodbody & Co., a broker, to other brokers); Reinisch v. NYSE, 52 F.R.D. 561, 563 (S.D.N.Y. 1971) (antitrust class action involving fixed commission rates).

[315] For background on these anti-trust issues, see William F. Baxter, *NYSE Fixed Commission Rates: A Private Cartel Goes Public*, 22 STAN. L. REV. 675 (1970); Robert A. Bicks, *Antitrust and the New York Stock Exchange*, 21 BUS. LAW. 129 (1965); Note, *Antitrust Laws and the Securities Exchanges*, 66 NW. U. L. REV. 100 (1971).

[316] 433 F.2d 264, 275-77 (7th Cir. 1970).

[317] Commentators had raised the issue of the application of primary jurisdiction before Chief Judge Swygert's concurrence. *See, e.g.*, Baxter, *supra* note 315, at 683-91; Bicks, *supra* note 315, at 153-54. Although Professor Baxter's article was cited in Judge Swygert's concurrence, *Thill*, 433 F.2d at 276-77, a reading of the article does not yield exactly what Professor Baxter expected the SEC to determine. The closest seems to be his suggestion that "[s]ome institution ought to examine the merits of the question whether fixed commissions are socially and economically desirable-whether an exception from antitrust principles is required in order to advance some alternative goal of equal or greater importance." Baxter, *supra* note 315, at 691. Professor Baxter never explained why he believed that the SEC rather than the courts should get the first crack at this issue.

[318] Thill Sec. Corp. v. NYSE, [1969 Transfer Binder] Trade Cas. (CCH)

the Exchange Act.[319] This section authorized "registered national securities exchanges to adopt rules in respect of 'fixing of reasonable rates of commission' subject to review and revision by" the SEC.[320] The district court held that a prohibition against commission sharing was a method of "fixing reasonable rates of commission."[321] Relying on the SEC's supervision, the district court held that the federal antitrust laws did not apply to the prohibition.[322]

In arriving at this holding, the district court relied on *Silver v. NYSE*[323] as it had been interpreted by *Kaplan v. Lehman Bros.*[324] *Silver* involved an antitrust challenge by an over-the-counter broker-dealer to a NYSE decision ordering NYSE members to cut off private wire service to the non-NYSE member broker-dealer.[325] The Supreme Court first enunciated the principle that the antitrust exemption was available "only if necessary to make the Securities Exchange Act work, and then only

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¶ 72,911, at 87,468 (E.D. Wis. Aug. 26, 1969).

[319] The Securities Acts Amendments of 1976 completely rewrote section 19, eliminating the language relied on by the *Thill* court. Pub. L. 94-29, § 16, 89 Stat. 146 (codified at 15 U.S.C. § 78s (1994)). The change was intended to reflect "the adoption of Rule 19b-3 prohibiting exchanges from fixing rates of commission charged by their members. . . ." S. Rep. No. 75, 94th Cong., 1st Sess. 2 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 180-81; *see also* Brokers, Dealers or Members of Exchanges, Prohibition Against Fixing of Commission Rates, Exchange Act Release No. 34-11,203, 39 Fed. Reg. 38, 396 (Oct. 24, 1974) (adopting rule 19b-3). In 1988, the SEC rescinded rule 19b-3, having determined that it was unnecessary because "the activities proscribed by Rule 19b-3 are prohibited to the same extent by section 6 of the [Exchange] Act." Rescission of Rules Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-26,180, 53 Fed. Reg. 41,205, 41,206 (Oct. 14, 1994).

[320] *Thill*, 433 F.2d at 269.

[321] *Thill*, [1969 Transfer Binder] Trade Case (CCH) ¶ 72,911 at 87,469.

[322] *Id.* at 87,470-71.

[323] 373 U.S. 341 (1963).

[324] 250 F. Supp. 562 (N.D. Ill. 1966), *aff'd*, 371 F.2d 409 (7th Cir. 1967).

[325] Although other antitrust issues, as well as tort issues, had been raised below, e.g., Silver v. NYSE, 196 F. Supp. 209, 210-11 (S.D.N.Y. 1961), the only issue appealed to the Supreme Court concerned "the collective refusal to continue private wire connections," *Silver*, 373 U.S. at 347. These private wire connection were direct telephone lines that allowed the plaintiff to communicate with NYSE members by "simply . . . flipping a switch." *Silver*, 196 F. Supp. at 212.

to the minimum extent necessary,"[326] repeating the principle four pages later.[327]

The *Silver* Court then examined the SEC's supervision of the NYSE's rules concerning private wire services, finding that the SEC could approve or disapprove any rule but that it had no "jurisdiction to review particular instances of enforcement of exchange rules."[328] The Supreme Court placed great weight on this fact, stating twice in the *Silver* opinion that a "different case . . . would be presented" if there were such review.[329]

Making what the dissent described as a detour into "due process concepts of notice, confrontation, and hearing,"[330] the majority held that "no justification can be offered for self-regulation conducted without provision for some method of telling a protesting member why a rule is being invoked so as to harm him and allowing him to reply in explanation of his position."[331] The Supreme Court's decision focused on the failure of the NYSE to have afforded basic due process to the affected broker; thus, there was no need for the *Silver* Court to examine whether the challenged NYSE action was consistent with the limited antitrust exemption.

Kaplan v. Lehman Bros.,[332] which was decided three years after *Silver*, involved an antitrust challenge to fixed commission rates. The Seventh Circuit, in a short opinion, held that the fixing of commission rates was immune from antitrust challenge. The *Kaplan* court cited the statement in *Silver* that "[r]epeal [of the antitrust laws] is to be regarded as implied only as necessary to make the Securities Exchange Act work."[333] But the Seventh Circuit gave no clear indication of how it had moved from this general principle to its holding.[334]

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[326] *Silver*, 373 U.S. at 357.

[327] *Id.* at 361 ("[E]xchange self-regulation is to be regarded as justified in response to antitrust charges only to the extent necessary to protect the achievement of the aims of the Securities Exchange Act.").

[328] *Id.* at 357.

[329] *Id.* at 358 n.12, 360.

[330] *Id.* at 368 (Stewart, J., dissenting).

[331] *Id.* at 361.

[332] 371 F.2d 409 (7th Cir. 1967).

[333] *Id.* at 411 (quoting Silver v. NYSE, 373 U.S. 341, 357 (1963)).

[334] The district court opinion is more illuminating, although it rests on two separate grounds. First, the district court noted that the plaintiffs in *Kaplan* were only challenging fixed commission rates as illegal *per se* under the

Distinguishing *Kaplan* on its facts,[335] the Seventh Circuit reversed the district court in *Thill*. In interpreting *Silver*, the *Thill* panel, as had the *Kaplan* panel, focused on the statement in *Silver*[336] that "[r]epeal [of the antitrust laws] is to be regarded as implied only as necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary."[337] As this issue, and other factual issues raised by the plaintiff, had not been addressed by the district court, the *Thill* panel remanded the case for further proceedings.[338]

Chief Judge Swygert's concurrence suggested that the district court would have to consider "whether the doctrine of primary jurisdiction requires that the anti-competitive aspects of an exchange rule be considered in the first instance by the SEC."[339] That Chief Judge Swygert raised the issue of pri-

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Sherman Act. Kaplan v. Lehman Bros., 250 F. Supp. 562, 564 (N.D. Ill. 1966). As the *Silver* Court had rejected such a *per se* argument, the district court reasoned that "the holding in *Silver* . . . is a complete bar to" plaintiff's claim. *Id.* at 565. Having applied *Silver* in this fashion, the district court could have stopped. Instead, it went on to justify its decision on the alternative ground that "the SEC exercises a general and continuing power to change, alter or supplement the rules of the Exchange fixing the rates of commission." *Id.* at 566.

[335] *Thill*, 433 F.2d at 270.

[336] *Id.* at 269.

[337] *Silver*, 373 U.S. at 357.

[338] *Thill*, 433 F.2d at 273-74. At least one judge thought that the NYSE would have a difficult time proving that the prohibition on commission sharing was necessary to the operation of the Exchange Act. *Silver*, 373 U.S. at 373. Although this statement occurred in the majority opinion by Judge Campbell, the concurring opinion of Chief Judge Swygert, although it praised Judge Campbell's approach, found complicated antitrust issues implicated in *Thill*, 433 F.2d at 275 (Swygert, C.J., concurring), which is a position inconsistent with doubt expressed by Judge Campbell.

[339] *Id.* at 275 (Swygert, C.J., concurring). Chief Judge Swygert went so far as to even specify some of the questions concerning primary jurisdiction that should be considered below when deciding whether to apply the doctrine:

> (1) whether and to what extent the SEC is empowered to consider antitrust laws and policy in fulfilling its duty of review of exchange self-regulation; (2) whether an aggrieved party may initiate SEC review of exchange rules under the provisions of the Securities Exchange Act or the Administrative Procedure Act; (3) whether and to what extent SEC expertise would be useful in resolving, in the first instance, the question of whether a given rule is necessary to make the Securities Act work; and (4) whether the anticompetitive aims of the Sherman Act can be achieved without subjecting the exchanges to treble damage suits which necessarily

mary jurisdiction makes perfect sense based on the majority's interpretation of *Silver*. If the impact of the NYSE's prohibition on commission sharing upon the functioning of the Exchange Act was the central issue under *Silver*, input from the SEC would certainly have been useful to a court.[340]

In *Gordon v. NYSE*,[341] the Second Circuit took a totally different approach from the Seventh Circuit's to a similar antitrust issue arising from a challenge under the Sherman Act to, among other issues, the fixing of commission rates by the NYSE. These rates, in turn, were subject to SEC review.[342] The *Gordon* court considered the legislative history behind section 19(b), concluding that Congress had delegated the power to the SEC to determine whether the setting of commission rates by exchanges met the *Silver* test,[343] i.e., was it "necessary to make the Securities Exchange Act work."[344] This delegation had led to "wide-reaching and systematic" regulation by the SEC of commission rates,[345] which regulation would be disrupted if the courts subjected the exchanges to standards

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> result if the doctrine of primary jurisdiction is unavailable to the defendant in this case.

Id. at 277 (Swygert, C.J., concurring).

[340] *See* Bicks, *supra* note 315, at 153 ("The sole inquiry which Congress intended is whether such minimum rates are 'reasonable' and do in operation serve Exchange Act goals. And this determination the Congress charged the SEC to make."). *But see* Note, *supra* note 315, at 114 (suggesting rejection of primary jurisdiction in *Thill* litigation because SEC does not have authority to apply appropriate antitrust standards and remedies). Two years later the district court in the remand held

> that the laws governing the functions of the Securities and Exchange Commission are [not] so pervasive and comprehensive as to require referral to the Commission under the doctrine of primary jurisdiction [of] the issue of whether the defendant's rules and conduct complained of are necessary to make the Securities Exchange Act of 1934 work.

Thill Sec. Corp., [1972 Transfer Binder] Trade Cas. (CCH) ¶ 73,903 (E.D. Wis. Mar. 13, 1972). Seven years later, the district court, relying on Gordon v. NYSE, 422 U.S. 659 (1975), decided in favor of the NYSE. Thill Sec. Corp. v. NYSE, 473 F. Supp. 1364 (E.D. Wis. 1979), *aff'd*, 633 F.2d 65 (7th Cir. 1980).

[341] 498 F.2d 1303 (2d Cir. 1974).

[342] The *Gordon* court noted that, relying on *Silver*, it might well have been justified in stopping its analysis based on the "existence of SEC review power" over the pertinent NYSE rules. *Id.* at 1305.

[343] *Id.* at 1306.

[344] Silver v. NYSE, 373 U.S. 341, 357 (1963).

[345] *Gordon*, 498 F.2d at 1308.

different from those adopted by the SEC.[346] The *Gordon* court was careful to explicitly note that its holding was not based on the primary jurisdiction of the SEC but, rather, on its interpretation of the powers granted by the Exchange Act to the SEC.[347] In addition, the *Gordon* court sought to distinguish the 1970 *Thill* decision on its facts but acknowledged that the holding in *Gordon* was "inconsistent" with that in *Thill*.[348]

This conflict between the circuits[349] set the stage for the Supreme Court's grant of certiorari in *Gordon*.[350] The Supreme Court was petitioned solely on the issue of whether "fixed commission rates are beyond the reach of the antitrust

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[346] *Id.* at 1307.

[347] *Id.* at 1309 n.8. The district court in *Gordon* made a similar point. Gordon v. NYSE, 366 F. Supp. 1261, 1267 (S.D.N.Y. 1973) ("We must add, if it is not already clear, that if *Thill* is to be read as holding that an anti-trust court has concurrent jurisdiction with the SEC over *all* potentially anti-competitive practices and rules, we disagree.").

[348] *Id.* at 1310.

[349] For cases adopting the *Thill* approach, see, e.g., Harwell v. Growth Programs, Inc., 451 F.2d 240, 247 (5th Cir. 1971) (citing *Thill* in rejecting argument that close supervision of NASD by SEC is enough to establish antitrust immunity for NASD rules); Fedrickson v. Merrill Lynch, Pierce, Fenner & Smith Inc., 389 F. Supp. 1151, 1157 (N.D. Ill. 1974) (citing *Thill* and refusing to follow *Gordon* in rejecting argument the SEC has exclusive jurisdiction over antitrust claims involving minimum commission rates); Zuckerman v. Yount, 362 F. Supp. 858, 863 (N.D. Ill. 1973) (citing *Thill* in rejecting argument that an implied repeal of antitrust laws with respect to Midwest Stock Exchange membership rules had occurred).

For cases adopting the *Gordon* approach, see, e.g., Abbott Sec. Corp. v. NYSE, 384 F. Supp. 668, 670 (D.D.C. 1974) (citing *Gordon* in holding that ban on "give-ups" by NYSE immune from anti-trust challenge), *aff'd*, 569 F.2d 159 (D.C. Cir. 1977) (mem.); Jacobi v. Bache & Co., Inc., 377 F. Supp. 86, 92 (S.D.N.Y. 1974) (exercising court's concurrent jurisdiction over anti-trust controversy involving NYSE rules on compensation of registered representations because SEC had disclaimed primary responsibility); *In re* Mutual Fund Sales Antitrust Litig., 374 F. Supp. 95, 111 n.53, 111 n.54, 113 n.59, 114 (D.D.C. 1973) (distinguishing *Harwell* and citing *Gordon* in holding that section 22 of Investment Company Act displaces antitrust laws in "the narrow area of distribution and sale of mutual fund sales" and rejecting application of primary jurisdiction).

[350] Gordon v. NYSE, 422 U.S. 659 (1975). *Gordon* is the case that Dahl v. Charles Schwab & Co. Inc., 524 N.W.2d 742 (Minn. Ct. App. 1994), *review granted*, C1-94-1040, 1995 Minn. LEXIS 127 (Minn. Feb. 14, 1995), the leading payment for order flow case, has focused on in deciding whether to apply the doctrine of primary jurisdiction to the payment for order flow cases. *Id.* at 747 (distinguishing the facts of its case from those in *Gordon*).

laws."[351] The Supreme Court first examined the legislative history behind section 19(b)(9) of the Exchange Act, which authorized the SEC to regulate, by rule or order, "the fixing of reasonable rates of commissions, interest, listing, and other charges." The Supreme Court determined that Congress had given the SEC permission to fix commission rates.[352]

The Supreme Court then turned to the history of the SEC's exercise of its supervisory power over commission rates, finding that as early as 1958 "the SEC thoroughly exercised its supervisory powers."[353] In addition, the Supreme Court examined the activities of the various congressional committees that had also considered the issue of commission rates. The Supreme Court concluded that "[t]he committees of the Congress, while recently expressing some dissatisfaction with the progress of the SEC in implementing competitive rates, have generally been content to allow the SEC to proceed without new legislation."[354] Carefully limiting its holding to the specific issue before it,[355] the Supreme Court further concluded that "[i]mplied repeal of the antitrust laws is, in fact, necessary to make the Exchange Act work as it was intended; failure to imply repeal would render nugatory the legislative provision for regulatory agency supervision of exchange commission rates."[356]

In arriving at this conclusion, the Supreme Court considered, and rejected, the application of the doctrine of primary jurisdiction.[357] The *Gordon* Court saw that there were two different issues. One was "a *factual* question as to whether fixed commission rates are actually necessary to the operation of the ex-

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[351] *Gordon*, 422 U.S. at 663.

[352] *Id.* at 659, 681-82.

[353] *Id.* at 668.

[354] *Id.* at 682.

[355] "[W]hether the Exchange Act amounts to pervasive legislation ousting the antitrust acts is not a question before us." *Id.* at 689.

[356] *Id.* at 691.

[357] *Id.* at 686. As a practical matter there was no need for a deferral to the SEC under the doctrine of primary jurisdiction as the SEC had participated as an amicus curiae in both the *Thill* litigation after the initial decision by the Seventh Circuit, *see* Thill Sec. Corp. v. NYSE, 57 F.R.D. 133, 135 (E.D. Wis. 1972), and the *Gordon* litigation, *see* Gordon v. NYSE, 498 F.2d 1303, 1304 (2d Cir. 1974). The SEC continued to act as amicus curiae in post-*Gordon* cases in which the meaning of the anti-trust exemption set forth in *Gordon* was an issue. *See, e.g.*, Shumate & Co. v. NYSE, 486 F. Supp. 1333, 1334 (N.D. Tex. 1980) (involving a case where the SEC both filed a brief and argued).

changes as contemplated under the Securities Exchange Act,"[358] the type of issue to which the doctrine of primary jurisdiction is often applied. Although the *Gordon* Court did not label it this way, this is a reformulation of the *Silver* principle upon which the *Thill* court had relied. The *Gordon* Court never reached this factual issue because it dealt with the legal issue first. This legal issue was "whether antitrust immunity, as a matter of law, must be implied in order to permit the Exchange Act to function as envisioned by the Congress."[359] As the answer was "yes," there was no need to address the factual issue.

Although the Supreme Court's language is anything but clear, the authors understand *Gordon* to be a statutory interpretation case, not a case involving application of the doctrine of primary jurisdiction. The judicial analysis did not involve such traditional primary jurisdiction factors as efficiency, superior agency knowledge, and the need for uniformity. Instead, it addressed squarely the issue of congressional intent as to the breadth of the Exchange Act and its interaction with the federal antitrust laws.[360]

In addition to the antitrust cases that culminated in *Gordon*, a number of cases have dealt with primary jurisdiction in the context of NYSE listing rules. *Cavanagh Communities Corp. v. NYSE* is typical of these cases.[361] The issue in *Cavanagh* was whether the NYSE or the SEC should initially decide whether the plaintiff's shares should be delisted from the NYSE.[362]

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[358] *Gordon*, 422 U.S. at 688 (emphasis added).

[359] *Id.*

[360] One distinguished constitutional law treatise treats *Gordon* as a preemption case, TRIBE, *supra* note 5, § 6-26, at 494 n.91, while one distinguished administrative law treatise treats *Gordon* as a primary jurisdiction case, 2 DAVIS & PIERCE, *supra* note 1, § 14.5. Judge Duffy's words in *Cavanagh*, when considering whether to apply either the theory of primary jurisdiction or that of implied repeal (based on *Gordon*), are particularly *apropos* here: "The Supreme Court has tacitly acknowledged the broad overlap between these two doctrines. Jurisprudential theories should be recognized for what they are: shorthand verbalizations of common sense. The debate over which nomenclature should be employed can only lead to a possible victory of form over substance." Cavanagh Communities Corp. v. NYSE, 422 F. Supp. 382, 385 (S.D.N.Y. 1976).

[361] *Cavanagh*, 422 F. Supp. 382.

[362] The standards for delisting promulgated by the NYSE were incorporated by regulation "as a basis for delisting by the SEC." In addition, these rules were explicitly subject (by the Exchange Act) to modification by the SEC. Under internal NYSE procedures, the NYSE would first hold an evidentiary hearing. If

The NYSE had appealed from a decision of the bankruptcy court granting the plaintiff an injunction to prevent the delisting of its shares. The district court held that "[t]he statutory authority of the SEC over listing and delisting of securities on an exchange is pervasive and comprehensive" and vacated the order of the bankruptcy court granting the injunction.[363] The authors believe that cases such as *Cavanagh* really involve issues of exhaustion of administrative remedies.[364]

The limited application of primary jurisdiction in the caselaw is not surprising in light of the SEC's historical policy of assisting the courts in private securities litigation by acting as amicus curiae. The SEC has taken an active role in many areas of securities law, including the preemptive impact of the Williams Act on state takeover laws[365] and the application of agency law principles to control person liability.[366] The SEC historically has intervened primarily in appellate litigation,[367] al-

this hearing was adverse to the issuer, the NYSE could then apply to the SEC to delist the issuer's shares. The SEC had a number of options when reviewing the NYSE application. It could "postpone delisting, impose conditions on delisting, order a hearing, or grant the application." *Id.* If the SEC did order delisting, the Court of Appeals could review this decision. *Id.* This regulatory and statutory regime remains substantially unchanged today.

[363] *Id.* at 386; *accord* Winkleman v. NYSE, 445 F.2d 786 (3d Cir. 1971); Costello v. NYSE, [1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,060 (S.D.N.Y. Mar. 17, 1975); *cf.* Blank v. NYSE, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,536, at 97,796 (S.D.N.Y. June 16, 1980) (holding that SEC has "exclusive primary jurisdiction" over alleged violations of NYSE rules). In many primary jurisdiction cases, the court does not refuse to exercise jurisdiction; rather, it defers a decision until the administrative agency has acted. 2 DAVIS & PIERCE, *supra* note 1, § 14.1. In *Cavanagh*, the district court refused to exercise jurisdiction because, by statute, the exclusive review of a delisting decision by the SEC was vested in the Court of Appeals. 422 F. Supp. at 386 n.*.

[364] *See* First Jersey Sec., Inc. v. Bergen, 605 F.2d 690, 696 (3d Cir. 1979), *cert. denied*, 444 U.S. 1074 (1980) (requiring exhaustion of administrative remedies where disciplinary proceedings had been commenced by the National Association of Securities Dealers); Faragalli v. NYSE, No. 92-3791, 1992 U.S. Dist. LEXIS 13,193, at *6-8 (E.D. Pa. Aug. 31, 1992) (requiring exhaustion of administrative remedies where disciplinary proceedings had been commenced by the NYSE); Fontaine v. SEC, 259 F. Supp. 880, 887 (D. P.R. 1966) (applying primary jurisdiction in action seeking an injunction against SEC proceeding involving revocation of broker-dealer's registration after first determining that exhaustion of remedies applied).

[365] *See supra* note 141.

[366] *See supra* note 236.

[367] *See* David S. Ruder, *The Development of Legal Doctrine Through Amicus*

though it has recently articulated a policy of intervening more often in trial litigation. In several cases in which primary jurisdiction has been raised, the active role that the SEC has taken has led the court to hold that application of primary jurisdiction was unnecessary as a practical matter.[368]

The SEC has recently decided that it will become even more active as an amicus curiae and also seek a role in discovery in private securities law class actions.[369] SEC Litigation Release No. 14,411 (the "Litigation Release")[370] sets forth the SEC's current amicus curiae policy as follows:

> The new Litigation Analysis Unit will expand the Commission's amicus participation at the trial court level in selected cases. The Commission believes that it is important to participate at the trial court level because many of the current concerns regarding abuses in securities litigation relate to the dynamics of the trial court process itself, rather than substantive law issues decided at the appellate level.[371]

Participation: The SEC Experience, 1989 WIS. L. REV. 1167, 1176 (1989). The development of federal securities law through such an informal process raises the "format" concerns that Professor Grundfest has discussed in connection with his proposal that the SEC "disimply" private rule 10b-5 actions. *See* Grundfest, *supra* note 56, at 983-84.

[368] *See, e.g.*, Fredrickson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 389 F. Supp. 1151, 1158 (N.D. Ill. 1974) (holding, in antitrust case challenging fixed commissions, that application of primary jurisdiction unnecessary because SEC's position on fixed commission rates was clear); *cf.* Harwell v. Growth Programs, Inc., 315 F. Supp. 1184, 1190 (W.D. Tex. 1970) (refusing to apply exhaustion of remedies because, inter alia, of the SEC's approval of the questioned rule "in an amicus brief filed with this Court"); Standard Fruit & Steamship Co. v. Midwest Stock Exchange, 178 F. Supp. 669, 677 (N.D. Ill. 1959) (refusing to apply exhaustion of remedies doctrine because, inter alia, of the SEC's "briefs and participation in the hearings in this case").

[369] An address by Arthur Levitt, Chairman of the SEC, was the first public notice that the SEC was considering these two steps. *See* Arthur Levitt, Chairman of the SEC, Private Litigation Under the Federal Securities Laws, Address Before the Securities Regulation Institute, The University of California, San Diego 7 (Jan. 26, 1995). Chairman Levitt was responding to the current controversy over "private securities litigation and the role that it plays in the vital process of capital formation." *Id.* at 1.

[370] Litigation Analysis Unit Established, Litigation Release No. 14,411 (Feb. 14, 1995), 58 SEC Docket 2357 (1995).

[371] *Id.* at 2358.

The Litigation Release further sets forth the SEC's intention to provide amicus curiae participation at the trial court level, even in "motions to dismiss or for summary judgment." The Litigation Release encourages the courts to bring appropriate cases to the SEC's attention.[372] In light of the SEC's express policy to provide legal analysis when called upon or when it is deemed appropriate, it is difficult to understand the role of the primary jurisdiction doctrine in the securities context.[373]

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[372] The SEC's Litigation Analysis Unit has also become involved in providing assistance to courts in "the use of focused, limited discovery to determine at an early stage whether private securities class actions have sufficient merit to proceed." Office of the General Counsel, SEC, A Proposal for Focused, Limited Discovery Leading to Early Disposition of Securities Class Actions in Appropriate Circumstances 1 (Aug. 11, 1995). This is an experimental program that, as of August 1995, had analyzed thirteen cases. *Id.* at 1, 3 n.2.

[373] Of course, there is the possibility that the SEC will not respond to all such requests because of such factors as resources and public policy. Insofar as that possibility exists, it does not argue for the application of primary jurisdiction. The same factors play a role in the SEC's decisions on whether to proceed with an investigation and these factors should not determine whether any civil plaintiff or plaintiff class receives a prompt hearing of its complaint.

A more theoretical argument against primary jurisdiction can also be made. Both the SEC and private litigants have the right to enforce many provisions of the federal securities laws. Applying primary jurisdiction to a matter in which the SEC has already or may in the future assert enforcement jurisdiction raises a serious conflict of interest in that the SEC is likely to draw the same legal conclusions in the civil litigation it has been asked to address that it has already drawn in its enforcement capacity. As the SEC may favor vigorous, expansive legal interpretations in its enforcement role in certain areas and less expansive interpretations in other areas, its judgment in its adjudicatory role under the primary jurisdiction doctrine may be suspect. Stated simply, referring legal conclusions under the primary jurisdiction doctrine to an agency with direct enforcement power may raise conflict of interest issues.

This conflict of interest issue goes beyond complaints made in the past that the SEC has aided one side over another in private litigation. *See, e.g.*, Carl L. Shipley, *The SEC's Amicus Curiae Aid to Plaintiffs in Mutual Fund Litigation*, 52 A.B.A. J. 337, 340 (1966) (criticizing the SEC for encouraging private litigants through amicus curiae participation). But the SEC's response to the conflict of interest issue would presumably mirror the response made by former Chairman Ruder to the encouragement complaint:

> The question is whether the SEC should support a claim in litigation by one private party against another private party. The answer to this question is that the Commission has a legitimate interest both in issues that may affect its own enforcement powers and in assuring that private actions are available to compensate investors and compel compliance with the securities laws.

V. PAYMENTS FOR ORDER FLOW

The practice of paying for order flow started in the over-the-counter market with payments made by market makers, i.e., dealers in OTC securities, to their regional correspondent brokerage firms. Market maker firms later began to make payments for order flow to other retail brokers until the practice of paying for order flow became common in the OTC market.[374] While payment for order flow in the OTC market has a long-standing history, it is only in the past seven years that it has spread to listed securities, starting with payments by third market makers[375] and then by some regional specialists.[376] The SEC believes that some integrated broker-dealer firms may now be paying for order flow.[377] The amount of cash paid per share for an order is relatively small, one or two cents per share, although the aggregate amounts can be quite high as "between 15% and 20% of the order flow in listed stock is routed pursuant to cash payment arrangements."[378] Mayer &

Ruder, *supra* note 367, at 1169 (footnotes omitted).

[374] Payment for Order Flow, Exchange Act Release No. 34-33,026, 58 Fed. Reg. 52,934, 52,935-36 (Oct. 13, 1993). "Because of their lack of retail networks, wholesale firms[, in contrast to the integrated broker-dealers,] often are dependent on their ties to other broker-dealer firms for order flow." *Id.* at 52,936 n.15. One study traces these practices back to the 1960s. Inducements for Order Flow, A Report to the Board of Governors, National Association of Securities Dealers, Inc. 36 (1991) [hereinafter Ruder Report].

[375] The "third market" is the securities industry's term for OTC trading of exchange listed securities. MARKET 2000, *supra* note 7, at II-10. These listed securities tend to be the 400 most active NYSE stocks and a handful of Amex stocks. Third market makers have been competing by providing automated execution systems for small orders, paying for order flow and not charging any fees or commissions. They have been quite successful. "In 1989, the third market garnered 3.2% of reported NYSE volume and five percent of the reported trading; in 1993 this percentage had increased to 7.4% of reported NYSE volume and 9.3% of the reported trades." *Id.* at II-11. See *id.* at II-1 to -23 for a description of the current markets for securities in the United States. *See generally* Michael J. Simon & Robert L.D. Colby, *The National Market System for Over-the-Counter Stocks*, 55 GEO. WASH. L. REV. 17 (1986) (describing the development of the OTC market).

[376] 58 Fed. Reg. at 52,936.

[377] *Id.*

[378] *Id.* In 1992, the average daily number of shares traded on the NYSE was 202,266,000 shares. New York Stock Exchange, Inc., FACT BOOK FOR THE YEAR 1992 83 (1993). At one cent per share, payments for fifteen percent of the

Schweitzer Inc., the market maker subsidiary of Charles Schwab Corp., first announced that it would no longer pay for order flow[379] and then withdrew the new policy when other brokers indicated that they would no longer send it orders.[380] This is a particularly ironic development as its brokerage affiliate, Charles Schwab & Co., is the primary target of the payment for order flow cases described in part VII.

As the practice of paying for order flow has grown, the trading volume of listed securities done on the primary exchanges has declined. For example, from 1978 to 1992 the percentage of consolidated tape trades in NYSE stocks executed by the NYSE dropped from 85.99% to 65.17%, while the percentage executed

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daily average order flow of NYSE listed shares alone would total approximately $303,400 per day. It should be noted that the SEC figures on the percentage of order flow in listed securities for which there are payments for order flow are only estimates. 58 Fed. Reg. at 52,936. In addition, evidently more is paid for unlisted than for listed stocks. *Id.* at 52,936 n.16. One prominent third market maker, Bernard L. Madoff Investment Securities, has estimated that it paid approximately $10 million in 1992 for order flow. *Hearings on Inducements for Order Flow Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 103d Cong., 1st Sess. 409 (1993) [hereinafter *May 1993 Hearings*]. At the same time, this firm did approximately ten percent of the transaction volume and seven percent of the share volume on the NYSE. *Id.* at 410. One newspaper article, in guessing at the amount derived from internalization of order flow, a practice that the SEC believes may be equivalent to payments for order flow, *see* 58 Fed. Reg. at 52,939 n.38, gave a figure of $500 million annually. William Power, *'In-House' Trades Can Be Costly for Small Investors*, WALL ST. J., Dec. 20, 1994, at C1. This figure, of course, includes the entire dealer spread that is being captured, not just the amount that a third party dealer would pay to capture this amount of business.

[379] William Power, *Schwab Plans to End Order-Flow Payments*, WALL ST. J., Oct. 10, 1995, at C1. This article reports that Mayer & Schweitzer "says it processes about 8% of Nasdaq's overall daily volume." *Id.* Mayer & Schweitzer hoped that a new automated trading service, which Mayer & Schweitzer claims will give its customers superior pricing, would attract business to offset that lost by ceasing payment for order flow. *Schwab to End Order Flow Payments, Start Trading Service for NASDAQ Stocks*, 27 SEC. REG. & L. REP. 1671 (Oct. 20, 1995). When the original announcement was made, one Schwab official reported that he believed that this announcement was the "death knell" for the practice of payment for order flow. *Id.* (interview with Ronald W. Readmond, a Charles Schwab Corp. vice chairman). What action, if any, that Charles Schwab is planning with respect to its receipt of payments for order flow, the subject of the payment for order flow cases, is not reported in these articles.

[380] *Schwab Ends Plan to Halt Payments for Order Flow*, 27 SEC. REG. & LAW REP. 1958 (1995).

by the regional exchanges and NASDAQ climbed from 11.55% to 24.22% and 2.39% to 10.57%, respectively.[381]

No study demonstrates how important a factor payments for order flow have been in this migration of trading off exchanges. It is worth noting, however, that the NYSE, the American Stock Exchange ("Amex"), the Chicago Stock Exchange ("CHX;" formerly the Midwest Stock Exchange ("MSE")), and the Specialist Association are all proponents of bans on cash payments for order flow, at least with respect to exchange listed securities.[382] Other regional exchanges have taken no position on whether cash payments for order flow should be banned.[383] The National Association of Securities Dealers ("NASD"), however, has supported payments for order flow by arguing that this practice increases competition, encourages innovations in order processing, and reduces costs for customers.[384]

A major controversy has developed over what practices should be included within the definition of payments for order flow. As discussed in part VI, the SEC has taken a very expansive position, requiring disclosure of a long laundry list of practices. In the SEC's view, these monetary and non-monetary inducements are "economically equivalent" because (a) "non-cash

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[381] MARKET 2000, *supra* note 7, at Ex. 18. See *supra* note 378 for a description of the inroads of third market makers on trading in exchange listed shares.

[382] Letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Jonathan G. Katz, Secretary, SEC (Dec. 9, 1993) [hereinafter NYSE Letter]; Letter from Jules L. Winters, Chief Operating Officer, Amex, to Jonathan G. Katz, Secretary, SEC (Dec. 21, 1993) [hereinafter Amex Letter]; MSE, Petition to the Securities and Exchange Commission for Issuance and Amendment of Rules of General Application (May 18, 1990) (petition to amend rules 10b-10 and 11Aa3-1 and adopt a new rule 11Ac1-4 "to eliminate the harmful effects of the growing practice of market makers making cash payments to brokers for their customer order flow in *exchange traded* securities") (emphasis added) [hereinafter MSE Petition]; Letter from David E. Humphreville, Executive Administrator, the Specialist Association, to Jonathan G. Katz, Secretary, SEC (Dec. 17, 1993) [hereinafter Specialist Letter].

[383] Letter from Leopold Korins, Chairman and Chief Executive Officer, the Pacific Exchange, to Jonathan G. Katz, Secretary, SEC (Dec. 9, 1993); Letter from John I. Fitzgerald, Executive Vice President, Legal Affairs and Trading Services, Boston Stock Exchange, to Jonathan G. Katz, Secretary, SEC (Dec. 10, 1993); Letter from William W. Uchimoto, General Counsel, Philadelphia Stock Exchange, to Margaret H. McFarland, Deputy Secretary, SEC (Dec. 10, 1993).

[384] Letter from Richard Ketchum, Executive Vice President and Chief Operating Officer, NASD, to Jonathan G. Katz, Secretary, SEC (Dec. 3, 1993) [hereinafter NASD Letter].

renumeration is as likely to influence the broker's order routing decision as cash . . . [; and (b)] as is the case with monetary payments, the customer is unlikely to be aware of many of these practices."[385] In contrast, certain commentators on the new disclosure rules have argued that the main danger in payments for order flow arises from "[p]ayments of cash or anything else of ascertainable value (such as commercially available goods or services)."[386]

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[385] Payment for Order Flow, Exchange Act Release No. 34-34,902, 59 Fed. Reg. 55,006, 55,008 (Nov. 2, 1994). The source of this expansive position can be found in the Ruder Report which identified ten external inducements and three internal or indirect inducements for order flow. The external inducements consisted of "[c]ash payments for order flow;" "[r]eciprocal order-routing arrangements;" "[r]eciprocal order-routing arrangements involving derivative products;" "[r]outing order flow to exchanges that offer discounts, credits, and free services;" "[r]outing order flow to exchanges that offer to accommodate and adjust trading errors of the broker-dealer;" "[r]outing orders to specialist brokers that are owned by the broker-dealer or related entity, or sharing in the profit of a specialist unit;" "[b]rokers directing order flow to specialists in return for specialist proprietary order flow;" "[r]outing order flow to exchange specialists or floor brokers that are working on a monthly retainer, rather than on a volume service charge;" "[r]eductions in clearing charges for introducing brokers that also use the clearing firm's execution services;" and "[d]irection of order flow in return for participation as an inducement in public offerings." Ruder Report, *supra* note 374, at 15-20. The external inducements consisted of "[i]nternalization of order flow by multiservice broker-dealers as principal," "[c]learing firms with stock loan operations sharing interest payments with large correspondents responsible for directing order flow to the firm" and "[e]xecuting firms paying soft dollars in return for dedicated order flow." *Id.* at 20-22. By creating such an inclusive listing, the Ruder Report was able to argue that cash payments "are not substantially different from other inducements for order flow." *Id.* at 2. As cash payments are similar to other inducements, all such inducements should be regulated by the same means as cash payments. *Id.* at 32. The Ruder Report, thus, provided a means to direct some of the criticism of order flow away from the more controversial and easy to understand cash payments to less controversial and more hard to understand areas and to implicitly promote a disclosure, rather than a prohibitory, solution. *See* Joel Seligman, *Another Unspecial Study: The SEC's Market 2000 Report and Competitive Developments in the United States Capital Markets*, 50 BUS. LAW. 485, 520, 520 n.137 (1995).

[386] Specialist Letter, *supra* note 382, at 13-14. In part the objection to an expansive definition reflects an evaluation of what these commentators think actually influences brokers and a fear that too much information would be supplied to customers, thus rendering the disclosure more confusing than enlightening. *Id.* Not surprisingly, the exchanges have been particularly resistant to the idea that rebates of exchange fees and charges and exchange fee and charge reductions should be treated as types of payments for order flow. 59

Payment for order flow has been the subject of extensive study by the SEC,[387] NASD and other self-regulatory organizations,[388] the Congress,[389] and legal and financial academics.[390] A series of alleged problems involving the structure

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Fed. Reg. at 55,008.

[387] MARKET 2000, *supra* note 7, at 22, 23 (1994); 58 Fed. Reg. 52,934, *supra* note 374; U.S. Equity Market Structure Study, Exchange Act Release No. 34-30,920, 57 Fed. Reg. 32,592, 32,596 (July 22, 1992) (requesting comments from interested parties on many issues involving the equity market, including payments for order flow); Penny Stock Disclosure Rules, Exchange Act Release No. 34-29,093, 56 Fed. Reg. 19,165, 19,184 n.151 (April 25, 1991) (raising issue of whether disclosure of payments for order flow should be made in connection with disclosure of compensation of broker-dealer engaged in agency transaction in a penny stock but postponing action in light of regulatory initiatives described in part VI). On July 24, 1989, the SEC also sponsored a Roundtable on Commission Dollar and Payment for Order Flow Practices. 58 Fed. Reg. at 52,935. A transcript and summary of this Roundtable circulated in the securities industry. *See* Letter from Andrew M. Klein, Schiff Hardin & Waite, to Jonathan G. Katz, Secretary, SEC, at 2 n.2 (July 5, 1990) [hereinafter Schiff Hardin Letter]. All of the SEC's study has still left the basic facts of payments for order flow unclear. "Because the Commission is unable to determine the number of broker-dealers accepting payment for order flow and the extent to which they accept payment for order flow, it is unable to reasonably quantify the impact that the proposed rules would have on small broker-dealers." Initial Regulatory Flexibility Analysis, Rule 11Ac1-3 and Amendments to Rule 10b-10.

[388] *See, e.g.*, Ruder Report, *supra* note 382. *See generally* Brandon Becker, Christine A. Sakach & Tonya Noonan Herring, *Broker-Dealer Order Execution Duties, in Securities Portfolio Executions, Transaction-Based Compensation, and Soft Dollar Practices 1991* PLI Corp. Law & Prac. Handbook Series No. 744 (1991) (describing NASD and MSE activities). In 1984, the NASD established a committee to study payment for order flow. This committee "concluded that, at the least, confirmation disclosure of payment for order flow is required." 58 Fed. Reg. at 52,935 n.3. On April 30, 1985, the NASD issued Notice to Members 85-32. This Notice discussed the disclosure of "remuneration" mandated by rule 10b-10 and concluded that "payments received by a retail firm from a market maker in return for their directing order flow to the market maker should be considered additional compensation received in connection with each transaction [under rule 10b-10]." NASD, Notice to Members 85-32, at 1-2 (Apr. 30, 1985). Notice 85-32 also reiterated the NASD's requirement that member firms "obtain the best execution of trades subject to" payment for order flow arrangements while noting that NASD examinations had not revealed any problems with best execution arising from payments for order flow. *Id.* at 2. This empirical conclusion as to best execution was not supported with any published facts, although this conclusion is regularly reiterated by the NASD. *See, e.g.*, Ruder Report, *supra* note 382, at 27.

[389] *May 1993 Hearings*, *supra* note 378.

[390] *See, e.g.*, Note, *supra* note 7 (citing to legal and financial academic

of the securities markets,[391] state agency law, and the federal securities laws[392] have been identified by these commentators.[393] The result of all this study has been the recent

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articles as well as independently discussing issues); John C. Coffee Jr., *Brokers and Bribery*, N.Y. L.J., Sept. 27, 1990, at 5 (pioneering article on payments for order flow). Professor Coffee's analysis of payments for order flow was foreshadowed in the Schiff Hardin Letter, *see supra* note 387, which the authors highly recommend to anyone analyzing the state law issues raised by payments for order flow.

[391] This article does not discuss these structural issues, although they have been influential in motivating SEC studies that have led to the regulatory initiatives described at the in part VI. *See* 58 Fed. Reg. at 52,939. The SEC summarized these structural issues by asking if:

> payment for order flow (1) has an effect on pricing efficiency in the markets; (2) is inconsistent with the goal of fair competition set forth in Section 11A of the Act; (3) reduces market maker quote competition for orders; and (4) improperly diverts customer orders to automated execution systems where they cannot be executed without the participation of a dealer.

Id. See generally, Note, *supra* note 7, at 1680-83 (describing these structural problems as the erosion of the exchanges' liquidity, perhaps encouraging volatility, and of their price discovery functions, the widening of spreads, the oligopolistic concentration of market-makers and brokers, and the lessening of public confidence in the markets); Coffee, *supra* note 390.

[392] Except insofar as these potential federal securities law violations relate to state law, for example the duty of best execution, this article does not discuss these problems. See Note, *supra* note 7, at 1685-88 and Coffee, *supra* note 390, at 6, both discussing fiduciary norms under the federal securities laws, and 58 Fed. Reg. at 52,937-38 and 59 Fed. Reg. at 55,007 n.15, both discussing a broker's duty of best execution under the federal securities laws.

[393] The types of structural issues raised by payments for order flow are also implicated in other securities trading practices including preferencing and soft-dollar practices. With regard to the latter, the SEC is now considering requiring enhanced disclosure by investment advisers to their customers. Disclosure by Investment Advisers Regarding Soft Dollar Practices, Exchange Act Release No. 34-35,375, 60 Fed. Reg. 9,750 (Feb. 21, 1995). *See generally* Seligman, *supra* note 385, at 520-24 (discussing similar best execution concerns raised by soft dollars and payments for order flow and suggesting that disclosure alone may not be adequate to address these concerns). These proposed rules have been put "on hold" because of the large number of negative comments on these proposed rules and the failure of institutional investors to comment at all. *Proposed Soft Dollar Rule Will Not Be Pursued, SEC Official Says*, 27 SEC. REG. & L. REP. at 1670 (Oct. 20, 1995); *Clarification*, 27 SEC. REG. & L. REP. at 1712 (Oct. 27, 1995). Preferencing has been implemented on an experimental basis by the Cincinnati Stock Exchange (the "CSE") and the Boston Stock Exchange (the "BSE"). In general, preferencing allows certain dealers to give priority to their own customers' orders thereby internalizing their own order flow. MARKET 2000,

supra note 7, at II-9. *See generally* Susan Antilla, *Why More Stock Exchanges? Brokers See a Way to Profit*, N.Y. TIMES, May 16, 1995, at D12; Power, *supra* note 378 (both discussing economic benefits of internalizing order flow). Although SEC approval for both of these programs expired on May 18, 1995, the SEC evidently has not yet taken final action. *See* Antilla, *supra*.

Although the structural issues involved in preferencing have to do with such things as whether best execution is adversely affected by such programs and not with payments for order flow per se, it should be noted that the two functioning preferencing programs have banned payments for order flow. These bans were instituted in response to concerns expressed by the SEC. Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment to Proposed Rule Change of the Cincinnati Stock Exchange, Inc., Relating to the Preferencing of Public Agency Market and Marketable Limit Orders by Approved Dealers and Other Proprietary Members, Exchange Act Release No. 34-28,866, 56 Fed. Reg. 5,854 (Feb. 7, 1991); Self-Regulatory Organizations; Boston Stock Exchange, Inc.; Notice of Filing of Amendments Nos. 1, 2, and 3 to a Proposed Rule Change Relating to the Competing Specialists Pilot Program, Exchange Act. Release No. 34,33,089, 58 Fed. Reg. 58,205, 58,206 (Oct. 22, 1993)

The CSE first proposed preferencing in 1990. Self-Regulatory Organization: Filing of Proposed Rule Change by the Cincinnati Stock Exchange Relating to the Preferencing of Public Agency Market and Marketable Limit Orders by Approved Dealers and Other Proprietary Members, Exchange Act Release No. 34-27,910, 55 Fed. Reg. 15,311 (Apr. 17, 1990). The SEC has approved a number of extensions to the original six month CSE pilot period, but has not taken final action to approve preferencing without any time limit. *See* Exchange Act Release No. 34-28868, 56 Fed. Reg. at 5,855 (six month trial period); Exchange Act. Release No. 34-29,524, 56 Fed. Reg. 38,160 (Aug. 5, 1991) (extending pilot period for an additional six months); Exchange Act Release No. 34-30,353, 57 Fed. Reg. 5,918 (Feb. 7, 1992) (extending pilot program for an additional six months); Exchange Act Release No. 34-31,011, 57 Fed. Reg. 38,704 (Aug. 7, 1992) (extending pilot period for an additional nine months and increasing the "limit on the number of issues any one dealer may preference from 250 to 350"); Exchange Act Release No. 34-32,168, 58 Fed. Reg. 22,006 (Apr. 26, 1993) (extending pilot period for an additional year); Exchange Act Release No. 34-32,280, 58 Fed. Reg. 28,424 (May 7, 1993) (extending pilot period for an additional year); Exchange Act Release No. 34-33,975, 59 Fed. Reg. 23,243, 23,244 n.5 (Apr. 28, 1994) (extending pilot period for ninety days while SEC considers CSE request to modify the preferencing program by expanding the number of preference securities beyond 350 and lifting the ban on payment for order flow); Exchange Act Release No. 34-34,258, 59 Fed. Reg. 33,992, 33,993 (June 24, 1994) (extending pilot program to date of expiration of the BSE's preferencing program so that the SEC can "consolidate its future review of the preferencing programs of the various exchanges"); Exchange Act Release No. 34-34,493, 59 Fed. Reg. 41,531 (Aug. 5, 1994) (approving amendments to preferencing program and extending it until May 18, 1995).

In 1993, the BSE proposed a competing specialists program, *see* Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by Boston

promulgation by the SEC of new disclosure standards for payments for order flow.[394]

Stock Exchange, Exchange Act Release No. 34-32,549, 58 Fed. Reg. 36,229 (June 29, 1993), that had the effect of allowing its dealers to internalize order flow, *see* Exchange Act Release No. 34,078, 59 Fed. Reg. 27,082, 27,084-86 (May 18, 1994). The SEC approved the competing specialists program for a one year period. *Id.* at 27,087.

The Chicago Stock Exchange has proposed the creation of a new national securities exchange under the Exchange Act that would allow preferencing. Self-Regulatory Organizations; Notice of Filing of Application for Registration as a National Securities Exchange by the United States Stock Exchange, Inc. and Amendment No. 1 Thereto, Exchanged Act Release No. 34-35,709, 60 Fed. Reg. 26,752 (May 11, 1995). Despite the precedents set by the CSE and BSE preferencing and competing specialists programs with respect to bans on payments for order flow, the application, as amended, for the United States Stock Exchange makes no mention of payments for order flow. *See* United States Stock Exchange, Inc., Form 1, Application for Registration as a National Securities Exchange (Mar. 23, 1995).

[394] The two most important events leading up to the SEC's recent rulemaking were a filing, dated April 18, 1990, by the NASD with the SEC in which the NASD proposed an amendment to section 12 of its Rules of Fair Practice that would require enhanced disclosure of payment for order flow to customers. Self-Regulatory Organizations; Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Disclosure of Payment for Order Flow Practices on Customer Confirmations, Exchange Act Release No. 34-28,020, 55 Fed. Reg. 21,284 (May 23, 1990), and the MSE Petition, *supra* note 382. The NASD proposed rule initially provided that the following disclosure would be made with respect to payments for order flow: "[t]he firm may receive remuneration for directing orders to a particular broker or dealer, through which your transaction is executed. Such remuneration is considered compensation to us and the source and amount of any compensation will be disclosed upon request." 55 Fed. Reg. at 21,284. This disclosure was to be "in bold typeface, in a prominent location on each customer confirmation" of a transaction subject to payment for order flow. *Id.* Finally, in both its Notice to Members 90-11 (which put the proposed rule to a vote by NASD members) and in its filing of the proposed rule with the SEC, the NASD reminded members of "the importance of obtaining the best execution of trades subject to these [payment for order flow] arrangements." *Id.* This proposal represented a change from the prior NASD position, which had been to abolish section 12 in its entirety because rule 10b-10 by going "beyond" the confirmation requirements of section 12 "superseded" section 12. NASD, Notice to Members 86-9 (Feb. 7, 1986), *reprinted in* 1986 NASD LEXIS 434, at *128. This proposed deletion was never made, although it was reproposed in Notice to Members 89-20 (Feb. 17, 1989), *reprinted in* 1989 NASD LEXIS 24, at *133 ("The Board of Governors recommends that section 12 be deleted because the confirmation requirements of SEC Rule 10b-10 more than adequately cover the provisions of this section.").

In response to discussions with the SEC and a review of the comment letters, the NASD amended this proposed rule. The amended rule read: "[t]he firm

VI. THE NEW PAYMENT FOR ORDER FLOW RULES

Although the focus of this article is not on the specifics of these new disclosure standards, it is important to understand their general content in order to appreciate the preemption and primary jurisdiction arguments made in the payment for order flow cases.[395] After extensively studying the problems and

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receives renumeration for directing orders to particular broker/dealers or market centers for execution. Such remuneration is considered compensation to the firm, and the source and amount of any compensation received by the firm in connection with your transaction will be disclosed upon request." Self-Regulatory Organizations; Notice of Amendment to Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Disclosure of Payment for Order Flow Arrangements on Customer Confirmations, Exchange Act Release No. 34-28,774, 56 Fed. Reg. 2573, 2574 (Jan. 23, 1991) (emphasis added). The main change was to delete the word "may" before the word "receives." This was done to reflect rule 10b-10's requirement that a broker affirmatively disclose payments for order flow. *Id.* Since then the NASD has submitted to the SEC an amendment to its Rules of Fair Practice that would require annual disclosure concerning payments for order flow. NASD, Form 19b-4, Proposed Rule Change by NASD, File No. SR - NASD - 93 - 53 (Sept. 30, 1993). The SEC never released the NASD proposal for annual disclosure for public comment, although reference is made to the proposal in the SEC releases dealing with payments for order flow. *E.g.*, 58 Fed. Reg. at 52,937 n.21. This proposal is similar to the new rules just adopted by the SEC except that NASD did not provide for any quantification of payments for order flow. *Id.* Neither of these proposed amendments has become effective and the NASD has stated that it "anticipates amending or withdrawing the proposed NASD rules once the Commission has taken action so that the NASD's disclosure requirements will not conflict with SEC requirements." NASD Letter, *supra* note 384, at 5 n.4.

The MSE Petition, submitted in response to the NASD proposed rule, MSE Petition, *supra* note 378, at 3, sought to require broker-dealers to pass on to their customers cash payments for order flow with respect to listed securities. In other words, the new rules proposed by the MSE would not have prohibited payments for order flow. "What it does prohibit is a broker-dealer retaining these payments for its own benefit." *Id.* at 10. In addition, the MSE proposed additional disclosure with respect to payments for order flow. *Id.* at 10-12. The MSE Petition was never published by the SEC although it is summarized in Becker, Sakach and Herring, *supra* note 388, at 299-302. The MSE Petition was withdrawn on October 29, 1991. 58 Fed. Reg. at 52,935. The MSE's position on cash payments for order flow was explored at length in an eleven page letter from John G. Weithers, Chairman of MSE, to Jonathan G. Katz, Secretary, SEC, dated February 13, 1990, which was an exhibit to the MSE Petition.

[395] The preemption arguments that have been made in the payment for order flow cases all revolve, to a certain degree, around the new rules. Rules, adopted pursuant to Congressional delegation to an agency, can have the same preemptive effect as congressional statutes. *See supra* text accompanying notes

benefits associated with payments for order flow, the SEC decided to mandate a three tier approach to disclosure. As of October 2, 1995, the effective date of the adoption of rule 11Ac1-3 and the amendments to rule 10b-10 under the Exchange Act,[396] broker-dealers will be required to provide certain information "at the time an account is opened, annually thereafter, and on the transaction confirmation."[397] This information, for the opening of a new account and the annual update, shall include

> (1) The broker's or dealer's policies regarding receipt of payment for order flow . . . , including a statement as to whether any payment for order flow is received for routing customer orders and a detailed description of the nature of the compensation received; and
>
> (2) The broker's or dealer's policies for determining where to route customer orders that are the subject of payment for order flow . . . absent specific instructions from customers, including a description of the extent to which orders can be executed at prices superior to the best bid or best offer. . . .[398]

16-21.

[396] The effective date for the new rules was delayed from April 3, 1995 to October 2, 1995. Payment for Order Flow, Confirmation of Transactions, Exchange Act Release No. 34-35,473, 60 Fed. Reg. 14,366, 14,367 (March 17, 1995). The SEC extended the effective date because of a concern with whether the changes could be implemented quickly, particularly in light of demands by broker-dealers made by the transition to three day settlement mandated by the SEC in Securities Transactions Settlement, Exchange Act Release No. 34-33,023, 58 Fed. Reg. 52,891 (Oct. 13, 1993), which was effective June 7, 1995. The SEC is currently considering granting additional time to broker-dealers to "fix their systems" so that they can properly disclose SuperDot credit (a type of payment for order flow) that they receive from the NYSE. *Wall Street Firms Negotiating with SEC for Time to Comply with Payment for Order Flow Rules*, 27 SEC. REG. & L. REP. 1648 (Oct. 13, 1995). In addition, the SEC had, on the same day as adopting the new rules, proposed amendments to the new rules, which could require changes to any disclosure arrangement with respect to payments for order flow; the SEC concluded that "[i]t would enhance efficiency and reduce costs if broker-dealers could make systems changes at one time rather than potentially be required to make changes twice to implement payment for order flow requirements." 60 Fed. Reg. at 14,367. These amendments to the new rules are discussed *infra* text accompanying notes 402-06.

[397] 59 Fed. Reg. at 55,007.

[398] *Id.* at 55,012.

The transaction confirmation shall include "a statement whether payment for order flow is received by the broker or dealer for transactions in such securities and that the source and nature of the compensation received in connection with the particular transaction will be furnished upon written request of the customer."[399] The required disclosure is both more frequent and more detailed than what is currently required by the SEC,[400] although it is less detailed than the proposed rule

[399] *Id.* The two other important substantive provisions of the new rule are the definitions of (a) the securities subject to the disclosure obligations, *id.* at 55,007 ("any subject security as defined in § 240.11Ac1-2 or a security authorized for quotation on an automated interdealer quotation system that has the characteristics set forth in Section 17B of the Act"), and (b) payment for order flow, which includes both monetary and non-cash inducements, *id.* at 55,008.

[400] Rule 10b-10(a)(7)(iii), 17 C.F.R. § 240.10b-10(a)(7)(iii) (1995). This rule provided that a broker must send, with certain limited exceptions, written notification to a client disclosing "whether any other renumeration has been or will be received and that the source and amount of such other renumeration will be furnished upon written request of such customer." No specific reference to payments for order flow was required by this rule. The NASD also has certain requirements that it has imposed upon its membership or that it has proposed for the SEC's approval. *See supra* note 394. Rule 10b-10 was adopted in 1977. 42 Fed. Reg. at 25,318. Rule 15c1-4, which was adopted in 1937, was the predecessor to rule 10b-10. Exchange Act Release No. 34-1,330, 2 Fed. Reg. 1,389 (Aug. 10, 1937); *see also* Exchange Act Release No. 34-1,763, *reprinted in* 1938 W.L. 6227 (S.E.C.) (June 28, 1938) (renumbering rule MC4 as X-15c1-4). A failure by a broker-dealer to disclose certain information to a customer, including "[t]he source and amount of any commission or other renumeration received or to be received by [the broker-dealer] in connection with the transaction," was defined in rule 15c1-4 as "manipulative, deceptive, or other fraudulent device or contrivance." 2 Fed. Reg. at 1,390. Rule 15c1-4 was limited to OTC trading as it was adopted to define a phrase in section 15(c)(1) of the Exchange Act, which covers only trading "otherwise than on a national securities exchange." 15 U.S.C. § 78o(c)(1) (1994).

Subsequent amendments to rule 15c1-4 exempted certain federal defense securities from the rule's requirements, Exchange Act Release No. 34-3,131, *reprinted in* 1942 SEC LEXIS 443 (Jan. 21, 1942); eased certain of its requirements for "certain purchases of securities issued by any open-end investment company registered under the Investment Company Act of 1940," Confirmation Requirements for the Sale of Redeemable Registered Investment Company Securities to Certain Persons, Exchange Act Release No. 34-11,025, 39 Fed. Reg. 35,343 (Oct. 1, 1974); and extended the confirmation requirements to municipal securities dealers, Regulation of Municipal Securities Professionals and Transactions in Municipal Securities, Exchange Act Release No. 34-12,468, 41 Fed. Reg. 22,820 (June 7, 1976). *See also* Distributions of Variable Annuities by Insurance Companies: Broker-Dealer Registration and Regulation Problems Under the

Exchange Act of 1934, Exchange Act Release No. 34-8,389, 33 Fed. Reg. 13,005, (Sept. 13, 1968) (interpretative release clarifying application of rule 15c1-4 to variable annuity interests offered and sold by life insurance companies). In addition, the SEC proposed, Exemption of Certain Variable Life Insurance Contracts and Their Issuers from Federal Securities Laws, Securities Act No. 33-5,234, 37 Fed. Reg. 5,510 (March 16, 1972), and then rejected exempting variable life insurance from the disclosure requirements of rule 15c1-4; Securities Act Release No. 5,360, at *8-9, *reprinted in* 1973 SEC LEXIS 3,258 (Jan. 31, 1973); Securities Act Release No. 5,361, *reprinted in* 1973 SEC LEXIS 3,259 (Jan. 31, 1973).

In 1976 the SEC proposed rescinding rule 15c1-4 and replacing it with rule 10b-10, in large part to ensure that confirmation delivery requirements should apply to "all broker-dealers regardless of the market in which transactions are effected." Securities Confirmations, Proposed Rules Regarding Transactions, Exchange Act Release No. 34-12,806, 41 Fed. Reg. 41,432 (Sept. 22, 1976). The proposed rule 10b-10(a)(3)(i)(A) required disclosure of the source and amount of any renumeration received by the broker-dealer in connection with any transaction in which the broker-dealer exercised "investment discretion" on behalf of its customs. *Id.* at 41,434. In response to comments stating that there were practical administrative difficulties in reporting such renumeration information, the SEC deleted this requirement in the final rule. Securities Confirmations, Exchange Act Release No. 34-13,508, 42 Fed. Reg. 25,318, 25,321-22 (May 17, 1977).

It is possible to draw two contradictory conclusions from this rulemaking history. The first conclusion is that the SEC explicitly rejected a renumeration reporting requirement that would have covered most payments for order flow. But this conclusion is undermined by the fact that there is no discussion by the SEC of payments for order flow in either the proposing or the final release for rule 10b-10, which is not surprising because payment for order flow was not yet the widespread and controversial practice it has become. *See supra* text accompanying notes 375-76.

Charles Schwab & Co., in its brief to the Minnesota Supreme Court, has argued that the SEC made an indirect reference to payments for order flow in the release proposing rule 10b-10. Appellant's Brief at 27, Dahl v. Charles Schwab & Co., No. C1-94-1040 (Minn. Sup. Ct. filed Mar. 16, 1995) [hereinafter *Dahl* Appellant's Brief]. In the proposing release, the SEC discussed requiring disclosure by a dealer in principal transactions of "the amount and source of any special renumeration paid or to be paid to him in connection with a particular transaction. That clause would relate to situations where payments were made to the dealer to induce transactions in securities." Securities Confirmations: Proposed Rules Regarding Transactions, 41 Fed. Reg. 41,432, 41,433 (Sept. 22, 1976). The *Dahl* Appellant's Brief, however, fails to note that the SEC was describing payments made to a principal and not payments made to an agent, the latter being the type of transactions about which the plaintiffs in the payment for order flow cases have brought suit, and that even these principal disclosure provisions were dropped from the final rule. Securities Confirmations, Exchange Act Release No. 34-13,508, 42 Fed. Reg. 25,318, 25,322 (May 17, 1977). Finally, the SEC cited United States v. Light, 394 F.2d 908 (2d Cir.

1968), as an example of "the circumstances intended to be covered by this [principal] disclosure requirement." 41 Fed. Reg. at 41,433 n.13. *Light* involved a stock manipulation scheme in which stock, whose price had been artificially inflated by fake financial statements, was sold to the public by dealers that received kickbacks from the issuers of the stock. *Light*, 394 F.2d at 910. Whatever else payments for order flow may be, they are not payments outside of the normal course of business such as kickbacks in the furtherance of a scheme of stock manipulation.

The SEC reconsidered the issue of requiring additional disclosure by dealers when they were acting as principals, Securities Confirmations: Proposed Rulemaking, Securities Act Release No. 13,661, 42 Fed. Reg. 33,348, 33,349-50 (June 30, 1977), only to withdraw the proposed rules, Securities Confirmations, Exchange Act Release No. 34-15,219, 43 Fed. Reg. 47,495, 47,501 (Oct. 16, 1978). In a comment that is a precursor of its approach in the payment for order flow cases, the SEC noted, in its release proposing this principal disclosure, that such disclosure would not necessarily "act as an effective further deterrent to behavior that may otherwise be illegal" under "the federal securities laws or other statutes." 42 Fed. Reg. at 33,349-50. Ultimately, the SEC did adopt additional disclosure requirements for dealers when they are acting as principals. Confirmation Disclosure for Reported Securities, Exchange Act Release No. 34-22,387, 50 Fed. Reg. 37,648 (Sept. 17, 1985).

Nothing in the subsequent history of rule 10b-10 sheds any additional light on the SEC's intentions with respect to the possible preemptive effect of rule 10b-10. *See* Securities Confirmations, Exchange Act Release No. 34-14,942, 43 Fed. Reg. 30,270 (July 14, 1978) (delaying effective date of paragraph (a) of the rule until December 18, 1978); Securities Confirmations, Exchange Act Release No. 34-15,219, 43 Fed. Reg. 47,495 (Oct. 16, 1978) (rescinding rule 15c1-4 effective December 18, 1978 and amending rule 10b-10 to deal with disclosure of odd-lot differential, mark-ups, and mark-downs in "riskless" principal transactions; market maker status; and the timing of confirmations of certain transactions in securities issued by investment companies); Securities Confirmations, Proposed Rulemaking, Exchange Act Release No. 34-15,220, 43 Fed. Reg. 47,538 (Oct. 16, 1978) (proposing extension of disclosure with respect to "riskless" principal transactions in nonmunicipal debt securities and municipal securities); Securities Confirmations, Exchange Act Release No. 34-18,987, 47 Fed. Reg. 37,919 (Aug. 27, 1982) (withdrawing Exchange Act Release No. 34-15,220); Securities Confirmations, Exchange Act Release No. 34-18,988, 47 Fed. Reg. 37,920 (Aug. 27, 1982) (proposing a limited exception from rule 10b-10 for certain "account management plans" offered by broker-dealers and additional disclosure by broker-dealers of the yield of debt securities purchased or sold by customers); Securities Confirmations, Exchange Act Release No. 34-19,687, 48 Fed. Reg. 17,583 (April 25, 1983) (adopting amendments of the type proposed in Exchange Act Release No. 34-18,988); Confirmation Disclosure for Reported Securities, Exchange Act Release No. 34-21,708, 50 Fed. Reg. 5,766 (Feb. 12, 1985) (proposing enhanced disclosure for principal transactions in reported securities); Confirmation Disclosure for Reported Securities, Exchange Act Release No. 34-22,397, 50 Fed. Reg. 37,648 (Sept. 17, 1985) (adopting amendments of the type proposed in Exchange Act Release No. 34-21,708); Confirmation of Securities Trans-

would have required.[401] Finally, in a companion release[402] to

actions, Exchange Act Release No. 34-26,169, 53 Fed. Reg. 40,721 (Oct. 18, 1988) (technical amendment); Confirmation of Transactions, Exchange Act Release 34-33,743, 59 Fed. Reg. 12,787 (Mar. 17, 1994) (proposing (a) disclosure of mark-ups and mark-downs for riskless principal transactions in debt securities; fact that a debt security is unrated; mark-ups and mark-downs in NASDAQ and exchange-listed securities; and fact that broker-dealer not a member of the Securities Investor Protection Corporation and (b) modification of disclosure requirements with respect to certain collateralized debt securities); Confirmation of Transactions, Exchange Act Release No. 34-34,962, 59 Fed. Reg. 59,612 (Nov. 17, 1994) (adopting amendments of the type proposed in Exchange Act Release No. 34-33,743). See *infra* note 406 for a discussion of the introductory note added to rule 10b-10 by Exchange Act Release No. 34-34,962.

[401] In its proposed rulemaking, the SEC provided for amendments to rule 10b-10 and a new rule 11Ac1-3, as did the final rules. But the proposed rules covered only national market securities, as such term is defined in rule 11Aa2–1. Proposed Rules 10b-10(a)(7)(iii)(A) & 11Ac1-3, 58 Fed. Reg. at 52,942, 52,943. The final rules also cover securities traded in the OTC market by including any "security authorized for quotation on an automated interdesk system that has the characteristics set forth in Section 17B of the [Securities Exchange] Act [of 1934]." Rules 10b-10(a)(7)(iii) & 11Ac1-3, 59 Fed. Reg. at 55,012, 55,013. The proposed rules had provided for disclosure of the amount of "any monetary payment, discount, rebate or reduction of a fee received in connection with a transaction in a national market system security." Proposed Rule 10b-10(a)(7)(iii)(B), 58 Fed. Reg. at 52,942. This requirement was dropped from the final rules, although the SEC is still contemplating additional disclosure of the amounts of payments for order flow. *See infra* text accompanying notes 403-04. Both the proposed rules and the final notes contain expansive definitions of "payment for order flow," although the final rules' definition was clarified to make clear that "the definition of payment for order flow includes discounts, rebates, credits or other fee arrangements only to the extent that such discounts exceed the fee charged. In addition, the SEC has clarified that payment for order flow received from a registered securities association is also subject to the disclosure rules." 59 Fed. Reg. at 55,008 n.24. The proposed initial and subsequent annual disclosure had provided for information on "[t]he aggregate amount of monetary payments, discounts, rebates or reduction in fees received . . . on an annual basis." by the broker-dealer. Proposed Rule 11Ac1–3(a)(2), 58 Fed. Reg. at 52,943. The final rules deleted this amount requirement, instead requiring the broker-dealer to disclose its "policies for determining where to route customer orders that are the subject of payment for order flow . . . absent specific instructions from customers, including a description of the extent to which orders can be executed at prices superior to the best bid or best offer." Rule 11Ac1-3(a)(2), 59 Fed. Reg. at 50,013. As with disclosure about the amount of payments for order flow on trade confirmations, the SEC is still considering further disclosure requirements with respect to such amounts in the initial and annual disclosures. *See infra* text accompanying notes 403-04.

[402] Internalized/Affiliate Practices, Payment for Order Flow and Order Routing Practices, Exchange Act Release No. 34-34,903, 59 Fed. Reg. 55,014

the one promulgating the new rules and amendments (the "Companion Release"), the SEC proposed rules to (a) further broaden the amount of disclosure with respect to (i) payments for order flow, in particular disclosure of the amount of such payments,[403] and (ii) order routing practices generally, in particular the internalization of orders or the routing of orders to an affiliated broker-dealer;[404] and (b) eliminate the requirement that such disclosure be given only where payment for order flow is involved.[405] In addition, the SEC requested comments on expanding the new rule 11Ac1-3 to encompass exchange-traded options.[406]

VII. THE PAYMENT FOR ORDER FLOW CASES

The complaints in the payment for order flow cases have primarily relied on state law causes of action.[407] The plain-

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(Nov. 2, 1994).

[403] The Companion Release bifurcates payment for order flow into two new defined terms: "monetary payment for order flow" and "non-monetary payment for order flow." 59 Fed. Reg. at 55,015. The disclosure of payments with respect to non-monetary payment for order flow relies on estimates, rather than actual amounts, because "precision may not be possible" with respect to such payments." *Id.*

[404] 59 Fed. Reg. at 55,016-017. See Power, *supra* notes 378-79, for a description of current internalization practices.

[405] *Id.* at 55,017.

[406] *Id.* The SEC considered making the amended rules effective simultaneously with the new rules on April 3, 1995, but decided to instead delay the effective date of the new rules. *Id.* While it was considering rules covering payments for order flow, the SEC also proposed several other amendments to rule 10b-10 that were meant to increase disclosure to customers. 59 Fed. Reg. 12,767 (1994) (proposed Mar. 17, 1994). As finally adopted, these rules "require broker-dealers to disclose (1) mark-ups in connection with transactions in certain NASDAQ and regional exchange-listed securities; (2) if they are not members of the Securities Investor Protection Corporation . . .; (3) information relevant to certain types of collateralized debt instruments; and (4) if a debt security has not been rated by a nationally recognized statistical rating organization." 59 Fed. Reg. 59,612-13 (1994).

[407] *See, e.g.*, Complaint Class Action, Guice v. Charles Schwab & Co., No. 94-100875 (N.Y. Sup. Ct. N.Y. County filed Jan. 7, 1994) [hereinafter *Guice* Complaint], *dismissed*, No. 94-100875, slip op. (N.Y. Sup. Ct. N.Y. County Oct. 4, 1994) [hereinafter *Guice* slip op.], *rev'd*, 630 N.Y.S.2d 317 (N.Y. App. Div. 1995). The seventh and final cause of action in the *Guice* Complaint involves an alleged failure by the defendant in obtaining "the best possible execution" of the plaintiffs' transactions. *Id.* at 10. This probably is a reference to a broker's duty

tiffs, customers of the defendant brokerage firms, have relied in all of these cases on almost identical legal theories alleging breach of the fiduciary duty owed to the plaintiffs, as principal, by the defendant broker-dealers, as agent, and fraud upon the plaintiffs.[408] The plaintiffs' claim that the defendants have

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under the federal securities laws of best execution. See *infra* text accompanying notes 438-39 for a discussion of best execution. No disclosure claims under section 10b or any other section of the federal securities laws have been made in the payment for order flow cases. This may reflect a judgment by the plaintiffs' attorneys to avoid clouding their cases with arguments by the defendants that rule 10b-10 "prescribes all the necessary disclosure relevant to a customer's securities transaction." 59 Fed. Reg. 59,612, 59,615 (1994). See *id.* at 59,615 n.42 for cases raising this argument.

The SEC's position is that rule 10b-10 "is not intended as a safe harbor from disclosure obligations imposed by the general antifraud provisions of the federal securities laws." *Id.* at 59,615 (footnote omitted); *see also* 52 Fed. Reg. 15,575, 15,576 n.7 (1987) (arguing that rule 10b-5 imposes an obligation to disclose excessive mark-ups to customers beyond rule 10b-10's disclosure requirements). The SEC articulated this position when it first adopted rule 10b-10. 42 Fed. Reg. 25,318, 25,320 n.28 (1977) ("The rule does not attempt to set forth all possible categories of material information to be disclosed by broker-dealers in connection with a *particular* transaction in securities. Rule 10b-10 only mandates the disclosure of information which can *generally* be expected to be material. Of course, *in particular circumstances*, additional information may be material and disclosure may be required.") (emphasis added). In order to make "explicit" its "longstanding position," the SEC has added a preliminary note to rule 10b-10 setting forth this position. 59 Fed. Reg. 59,612, 59,615, 59,620 (1994). It should be noted, that while the SEC's position by using language such as "particular" and "generally" does not foreclose the argument that in the ordinary renumeration situation, which a payment for order flow would be, no disclosure beyond that mandated by rule 10b-10 is required, the caselaw is not favorable to this argument. *See, e.g.*, Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 835 F.2d 1031, 1035-36 (3d Cir. 1987) (rejecting argument that compliance with rule 10b-10 shields defendant from liability under rule 10b-5 because defendant failed to show any intention by SEC to reach such a result); Krome v. Merrill Lynch & Co., 637 F. Supp. 910, 915-16 (S.D.N.Y. 1986) (rejecting claim that compliance with rule 10b-10 acts as a "'safe harbor'" against liability under any provisions of the securities laws). *But cf.* Leboce, S.A. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 709 F.2d 605, 606-08 (9th Cir. 1983) (failing to reach argument that federal securities law preempted state law on disclosure issue because no state law violation); Shivangi v. Dean Witter Reynolds, Inc., 107 F.R.D. 313, 321-22 (S.D. Miss. 1985) (relying on *Leboce* to hold that common law does not impose greater duty of disclosure than does rule 10b-10).

[408] In each complaint, there have been causes of action arising out of these theories unique to the pertinent state, often including state criminal statutes prohibiting commercial bribery. *See, e.g.*, *Guice* Complaint, *supra* note 407, at 8-9 (causes of action under New York Penal Code section 180.05 and General

violated a fiduciary relationship has turned on the key issue of whether the plaintiffs consented to payments for order flow made to the defendants.[409] The nature and quality of the dis-

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Business Law Article 23-a, section 352-c, the former dealing with commercial bribery and the latter with fraud). These state commercial bribery laws can be interpreted to be codifications of the state agency law principles discussed *infra* note 409. Schiff Hardin Letter, *supra* note 387, at 7-11. *See generally* D.E. Ytreberg, Annotation, *Validity and Construction of Statutes Punishing Commercial Bribery*, 1 A.L.R. 3d 1350 (1965) (discussing validity and construction of state and federal statutes punishing commercial bribery).

[409] Secondary sources discussing the state law agency problems cite to section 388 of the RESTATEMENT (SECOND) OF AGENCY (1957), which provides that: "*Unless otherwise agreed*, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal." (emphasis added). *See, e.g.*, Note, *supra* note 7, at 1684 n.68; Coffee, *supra* note 390, at 6. One of the puzzling aspects of the complaints made in the payment for order flow cases, and in the academic commentary on this area, is the focus on section 388. In fact, section 388 is just one specific application of the general fiduciary duty of loyalty under state law: "*Unless otherwise agreed*, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency." RESTATEMENT (SECOND) OF AGENCY § 387 (1957) (emphasis added). In addition an agent has a specific duty to obtain the most advantageous terms for his or her principal: "*Unless otherwise agreed*, an agent employed to buy or to sell is subject to a duty to the principal, within the limits set by the principal's directions, to be loyal to the principal's interests and to use reasonable care to obtain terms which best satisfy the manifested purposes of the principal." RESTATEMENT (SECOND) OF AGENCY § 424 (1957) (emphasis added). These two state law duties underlie the concept of best execution. *See* MARKET 2000, *supra* note 7, at V-1 to -2 (discussing common law agency principles and best execution).

The NASD has attempted to quell these agency law concerns by shifting the focus of the debate concerning payments for order flow away from the payments to the order flow itself. In the NASD's view, what is being paid for is the "aggregated flow" of orders and not any individual order. Letter from Frank J. Wilson, Executive Vice President and General Counsel, NASD, to Jonathan G. Katz, Secretary, SEC (Aug. 31, 1990) at 4 [hereinafter Wilson Letter]; *see also* Ruder Report, *supra* note 374, at 25-26 ("In the Committee's view, the value in order flow is derived from the aggregation of small orders, and the benefits that accrue from aggregation cannot be translated after the fact to attach to each individual order."). This flow "is created by the broker," Wilson Letter, *supra*, at 4, and, therefore, by implication, is the property of the broker and not of the customers whose individual orders make up this flow. Not surprisingly, this also is the position of the defendants in the payment for order flow cases. *See, e.g.*, *Dahl* Appellant's Brief, *supra* note 400, at 10. Professor Coffee has criticized this argument in light of certain California cases involving frequency discounts for advertisements, where the courts have held that these discounts belonged to the advertiser and not its advertising agency. John C. Coffee, Jr.,

closure made to the plaintiffs by the defendants are crucial in determining whether consent has been given.[410]

The leading case has been *Dahl v. Charles Schwab & Co.*[411] The decision by the district court, Minnesota's trial court, to dismiss the complaint in *Dahl* on both preemption and primary jurisdiction grounds has been the basis for the dismissal decisions by trial courts in New York and Illinois.[412]

Order-Flow Payments Get New Scrutiny, NAT'L L.J., July 19, 1993 [hereinafter Coffee Part I], at 16, 18. *See generally* Note, *supra* note 7, at 1685 (describing and criticizing other possible broker defenses: payments for order flow are an industry wide custom; brokers have complied with rule 10b-10's disclosure requirements; and agents only have to disclose material information to principals).

In addition, the Ruder Report recommended that best execution for small orders should be defined by the NASD as "execution at the best published bid or offer." Ruder Report, *supra* note 374, at 29. The NASD has not acted on this recommendation, which in theory would have the effect of defining away the problem. Not surprisingly, this definitional proposal has come in for vigorous attack, especially from the various stock exchanges. *See, e.g.*, NYSE Letter, *supra* note 382, at 13-15; Amex Letter, *supra* note 382, at 2-5.

[410] In the payment for order flow cases, this will become a discussion of the adequacy of the disclosure on confirmation slips sent by the defendants to the plaintiffs, which disclosure is mandated by rule 10b-10(a)(7)(iii) and section 12 of the NASD Rules of Fair Practice, when and if the merits of the agency issues are reached. *See generally* Dahl v. Charles Schwab & Co., 524 N.W.2d 742, 744 n.1 (Minn. Ct. App. 1994), *review granted*, No. C1-94-1040, 1995 Minn. LEXIS 127 (Minn. Feb. 14, 1995) (describing the limited disclosure given by Schwab on its confirmation slips).

> We believe that, under most if not all circumstances, customers would not be deemed, under applicable law, to have constructive knowledge of . . . payments [for order flow] or to have given implied consent to receipt of such payments by their brokers simply as a consequence of having received a confirmation that includes [disclosure that the brokers 'may receive renumeration for directing orders to a particular broker or dealer, through which your transaction is executed' and that 'the source and amount of any compensation will be disclosed upon request'] and failing thereafter to object to the transaction.

Schiff Hardin Letter, *supra* note 387, at 13 (quoting Securities Exchange Act Release No. 34-28020 (May 15, 1990)). Nor is it necessarily relevant to analysis of the agency law issues whether the principal "suffered any loss or discernible harm in connection with the transaction." *Id.* at 7.

[411] Dahl v. Charles Schwab & Co., Nos. 93-16272, 93-16360, 93-16383, slip op. (Minn. Dist. Ct. April 7, 1994) [hereinafter *Dahl* slip op.], *rev'd*, 524 N.W.2d 742 (Minn. Ct. App. 1994), *and review granted*, No. C1-94-1040, 1995 Minn. LEXIS 127 (Minn. Feb. 14, 1995).

[412] *See* Guice v. Schwab, No. 94,100875, slip op., at 5-6 (N.Y. Sup. Ct. N.Y. County Oct. 4, 1994) (relying on the same cases as the *Dahl* trial court and specifically citing and quoting from the *Dahl* trial court's decision to support

Dahl was decided upon defendant's motion for summary judgment. The district court granted this motion, dismissing the plaintiffs' complaint in all respects, because "[i]t is the opinion of this Court that the application of state law to the practices in question here, [sic] would violate the Supremacy Clause of the United States Constitution."[413] The district court noted that the practice of paying for order flow was "permissible and lawful under the federal regulatory scheme."[414] Without discussing the legislative intent behind the Exchange Act, the district court reasoned that prohibiting the payment for order flow under Minnesota law "would frustrate the objectives of Congress as set forth in" the Exchange Act.[415]

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dismissal of the *Guice* action), *rev'd*, 630 N.Y.S.2d 317 (N.Y. App. Div. 1995); Evangelist v. Fidelity Brokerages Services, Inc., No. 111050/94, slip op. at 4, 6-7 (N.Y. Sup. Ct. N.Y. County Jan. 12, 1995) [hereinafter *Evangelist* slip op.] (relying on *Dahl* trial court's reasoning and rejecting opinion of Minnesota Court of Appeals in *Dahl*); Orman v. Charles Schwab & Co., No. 93 CH 7365, slip op. (Ill. Cir. Ct. June 2, 1994) [hereinafter *Orman* slip op.] (granting, in a one sentence order, defendant's motion to dismiss because "this court [has] determined that plaintiff's claims are preempted by federal law and [has] adopted the opinion of the District Court of Hennepin County, Minnesota in that complaint styled Dahl v. Charles Schwab & Company"). The plaintiffs in *Orman* have filed notices of appeals. *Dahl* Appellant's Brief at 22-23, *supra* note 400.

[413] *Dahl* slip op., *supra* note 411, at 4.

[414] *Id.* at 3.

[415] *Id.* at 5. The plaintiffs in Dahl might have done better at the trial court level if the district court had read their carefully crafted complaint more closely. One of the remedies sought was an injunction against payments for order flow. Class Action Complaint at 9, Dahl v. Charles Schwab & Co., No. 93-16383 (Minn. Dist. Ct. filed Sept. 21, 1993) [hereinafter *Dahl* Complaint]; *see also Guice* Complaint, *supra* note 407, at 11 (demanding judgement "[e]njoining Schwab from continuing to receive payments and other inducements from market makers for the execution of orders for its customers"); Complaint at 5, Rubenstein v. Quick & Reilly Inc., No. 94 CH 1446, (Ill. Cir. Ct. filed Feb. 14, 1994) (seeking an "injunction halting the practices complained of."). But the *Dahl* plaintiffs were careful to seek such an injunction only if payments for order flow were made "without the customer's knowledge and consent." *Dahl* Complaint, *supra*, at 9. (The *Guice* Complaint contained no such limiting language in its request for an injunction.) The plaintiffs sought to avoid the argument that they sought to ban payments for order flow. But the trial court in *Dahl* saw the preemption issue in exactly these terms: "To the extent that the order flow payments are permissible under Federal regulations yet could be prohibited under the laws of Minnesota, a conflict exists." *Id.* The Minnesota Court of Appeals recharacterized the plaintiffs' complaints: "A review of appellants' complaints reveals that appellants do not suggest that order flow pay-

Having held that Minnesota law was preempted by federal law, the district court could have stopped its analysis. Instead, it moved seamlessly from preemption to the very different theory of primary jurisdiction. Relying on *Gordon v. NYSE*,[416] the district court held that the practice of paying for order flow is "uniquely within the competence of the SEC"[417] and, therefore, that the SEC should resolve the "underlying issues" raised by payments for order flow.[418]

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ments themselves are illegal under Minnesota law or that they should be prohibited." *Dahl*, 524 N.W.2d at 746. By recharacterizing the complaints in this way, the Court of Appeals created one support for its holding that applying Minnesota law to payments for order flow would not frustrate the congressional purpose. *Id.* There is another type of conflict that could have been raised by Schwab. The SEC had considered requiring the pass through of payments for order flow to customers, 59 Fed. Reg. 55,010-11 (1994), but rejected this approach because it was "not the appropriate regulatory response at this time," *id.*; *see also* Braunstein v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., N.Y. L.J., June 22, 1995 (N.Y. Sup. Ct. N.Y. County June 22, 1995) at 30 [hereinafter *Braunstein* slip op.] (distinguishing *Dahl* based on this SEC response from situation in *Braunstein* where "the SEC's action has been more limited"). If this argument had been raised, the response of the Minnesota Court of Appeals probably would have been similar to the one it made with respect to the prohibition argument: the *Dahl* Complaint seeks pass through payments only for past undisclosed, and unconsented to, payments for order flow. Proper disclosure to, and consent from, its customers would allow a broker to keep any payments for order flow in the future.

Insofar as in any particular case the plaintiffs seek to prohibit the practice of payments for order flow or to require the pass through of future payments for order flow to customers, the defendant in such case has a stronger argument that the SEC has preempted such remedies. *See Evangelist* slip op., *supra* note 412, at 4 (distinguishing *Dahl* on basis that plaintiffs in *Evangelist* sought to ban payments for order flow; held that preemption applied); *Braunstein* slip op., *supra*, at 29 (distinguishing *Guice* and *Dahl*, inter alia, on ground that plaintiffs sought to prohibit payments for order flow). The SEC explicitly considered such a prohibition and such a pass through and rejected them because "these approaches are not the appropriate regulatory response at this time." 59 Fed. Reg. 55,010-11 (1994). The SEC has taken this position in the face of proposals that the practice be banned. *See, e.g.*, NYSE Letter, *supra* note 382, at 1-4; Amex Letter, *supra* note 382, at 2; *Order Flow Payments, Preferencing Harm Investors, Dingell Contends*, 27 SEC. REG. & LAW REP. at 842 (June 2, 1995) (reporting that Representative John Dingell, ranking minority member of the House Commerce Committee, had written on May 23, 1995, to the SEC asking it to justify its failure to ban payments for order flow).

[416] Gordon v. NYSE, 422 U.S. 659 (1975). See *supra* text accompanying notes 341-60 for a discussion of *Gordon*.

[417] *Dahl* slip op., *supra* note 411, at 6.

[418] *Id.* at 5. It is possible to read the district court's opinion in *Dahl* as

On appeal, the Court of Appeals, Minnesota's intermediate appellate court, reversed the district court.[419] The three judge panel distinguished the separate issues of preemption and primary jurisdiction more clearly. On the preemption issue, the Court of Appeals first examined whether there was a specific conflict between either Minnesota's blue sky law[420] or Minnesota's common law of agency and federal law.[421] Finding that the "only federal regulation currently in effect concerning non-commission compensation is found in SEC Rule 10b-10(a)(7)(iii)," the Court of Appeals held that there was no conflict because both state and federal law could be complied with simultaneously,[422] i.e., any state law mandating *additional* disclosure to satisfy its agency law requirements could be complied with in a manner which did not conflict with federal law.

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dealing with only preemption and not primary jurisdiction. Although the district court's discussion of *Gordon* discusses traditional primary jurisdiction concepts such as the SEC's "specialized expertise in studying and ultimately controlling the regulatory rate structure," *id.* at 6, the district court never uses the phrase "primary jurisdiction" anywhere in its opinion. The district court ends its opinion by referring to the danger of "conflicting rules regarding" payments for order flow and that this danger "is precisely the reason for the existence of the Supremacy Clause. Accordingly, defendant's motion for summary judgment is granted and plaintiffs' complaints are, in all respects, dismissed." *Id.* at 8. This language implies that the only basis for the district court's decision was preemption. *See also Guice* slip op., *supra* note 407, at 4-8 (dismissing plaintiff's complaint because of the Supremacy Clause); *Orman* slip op., *supra* note 412 (dismissing plaintiff's action because "plaintiff's claims are preempted by federal law").

The plaintiff-appellants in *Dahl* raised this possible confusion between preemption and primary jurisdiction, *see* Respondent's Brief at 20, Dahl v. Charles Schwab & Co., No. Cl-94-1040 (Minn. Ct. App. filed July 18, 1994) [hereinafter *Dahl* Respondent's Brief], but the Minnesota Court of Appeals choose to treat the district court's decision as covering both legal doctrines, *Dahl*, 524 N.W.2d at 744 ("The district court granted Schwab summary judgment, concluding that appellants' claims are preempted by federal securities law and that the Securities and Exchange Commission has primary jurisdiction over the issues.").

[419] Dahl v. Charles Schwab & Co., 524 N.W.2d 742 (Minn. Ct. App. 1994). The reversal in *Dahl* also helped lead to the reversal in *Guice*. *See* Guice v. Charles Schwab & Co., 630 N.Y.S.2d 317 (N.Y. App. Div. 1995). The Appellate Division prefaced its short opinion by noting "that the Minnesota case cited by the [trial] court has been reversed on appeal" and then summarizing the Minnesota Court of Appeals' reasoning in *Guice*. *Id.*

[420] MINN. STAT. § 80A.06(5) (1992).

[421] *Dahl*, 524 N.W.2d at 744.

[422] *Id.* at 745-46.

Continuing with its preemption analysis, the Court of Appeals then examined the defendant's assertion that there was "an actual conflict between the state and federal schemes because to give effect to Minnesota statutory and common law would be an obstacle to the accomplishment and execution of the full purpose and objectives of Congress."[423] Without clearly stating what the Congressional purpose might be, the Court of Appeals reasoned that requiring more disclosure, for which the plaintiffs were arguing, would not affect the operation of the securities market. In fact, in the view of the Court of Appeals, such additional disclosure would "serve a basic purpose of the federal laws and regulations,"[424] namely "'full and fair disclosure to purchasers of securities.'"[425]

After dealing with the preemption issue,[426] the Court of

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[423] *Id.* at 746.

[424] *Id.*

[425] *Id.* at 747 (quoting El Khadem v. Equity Sec. Corp., 494 F.2d 1224, 1227 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974)). The *Dahl* court did not consider the possible application of the third branch of preemption analysis, field preemption. *See supra* note 11. The field preemption argument that the defendant could make is the same one made by the petitioner manufacturer in Freightliner Corp. v. Myrick, 115 S. Ct. 1483 (1995). In *Freightliner*, the petitioner argued that "the failure of federal officials 'affirmatively to exercise their full authority takes on the character of a ruling that no such regulation is appropriate or approved pursuant to the policy of the statute.'" *Id.* at 1487 (quoting Ray v. Atlantic Richfield Co., 435 U.S. 151, 178 (1978), which in turn was quoting Bethlehem Steel Co. v. New York State Labor Relations Bd., 330 U.S. 767, 774 (1947)). One of the probable reasons that the *Dahl* court did not deal with the field preemption argument is that the defendant did not raise this argument before the court. *See Dahl* Respondent's Brief, *supra* note 418, at 10-19 (discussing in detail only conflict preemption and preemption arising from frustration of Congress' objectives). Even if the defendant had raised this argument, it is unlikely that this argument would have overcome the test announced in *Freightliner*: A lack of federal regulation does not preclude state regulation unless "Congress intended to centralize all authority over the regulated area in one decision-maker: the Federal Government." 115 S. Ct. at 1487.

[426] Two federal district courts in Louisiana and one in Maryland have come to substantially the same conclusions in additional payment for order flow cases as has the Minnesota Court of Appeals. *See* Gilman v. Wheat, First Sec., Inc., No. JFM-95-1245, 1995 U.S. Dist. LEXIS 11085 (D. Md. July 31, 1995) (discussing only preemption); Thomas v. Charles Schwab & Co., No. 95-0307, 1995 U.S. Dist. LEXIS 12007 (W.D. La. July 12, 1995) (discussing only preemption); Dumont v. Charles Schwab & Co., No. 95-0606, 1995 U.S. Dist. LEXIS 5992 (E.D. La. May 3, 1995). In *Dumont*, which is typical of these three cases, Schwab sought to have the case removed from the Louisiana civil district court

Appeals examined the primary jurisdiction issue. The Court of Appeals noted that the SEC had not yet specifically regulated payments for order flow, other than requiring disclosure. This lack of SEC regulation distinguished *Dahl* from the *Gordon* case; therefore, the Court of Appeals concluded that the doctrine of primary jurisdiction did not apply.[427]

In a footnote, the Court of Appeals specifically stated that its opinion did not reach the effect of the new SEC rules on the preemption issue.[428] Similarly, in its discussion of the primary jurisdiction issue, the Court of Appeals relied on the fact that "[w]hile the SEC will impose regulation of order flow payments in the future, the fact remains that there are now no specific regulations."[429] Thus, in any cases that, after the effective date of the new SEC rules,[430] challenge payments for order

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to the federal district court. The plaintiff moved to remand on the ground, inter alia, that there was no federal question implicated in *Dumont*. In ordering that the case be remanded, the *Dumont* court held that preemption would not apply on reasoning that parallels that of the Minnesota Court of Appeals in *Dahl*. The plaintiff did "not seek injunctive relief to prohibit the practice of order flow payments nor does plaintiff claim that the practice is impermissible or in violation of Louisiana Law." *Id.* at *4. In addition "compliance with both federal regulations and the stricter Louisiana standard of care is not impossible. Moreover, since greater disclosure could benefit the investor, the application of Louisiana law may indeed serve the basic purpose of federal laws and regulations." *Id.* at *11. *Dumont* is the only one of these cases in which any mention is made of the primary jurisdiction issue, and even there it is only a passing mention. *Id.* at *6. This is surprising because presumably the primary jurisdiction issue was raised in all three cases and, if it was raised, the courts would have had to address it in deciding whether a federal question existed.

[427] *Dahl*, 524 N.W.2d at 747. *Gordon* is discussed at *supra* text accompanying notes 341-60. On its face, the plaintiffs in the payment for order flow cases could make a stronger primary jurisdiction argument if they focused on best execution. A determination of whether best execution has been achieved depends upon a close study of the securities markets. *See* MARKET 2000, *supra* note 7, at V-3 to -15. This examination of markets is closer to an area in which the technical expertise of the SEC would be relevant than the consideration of whether payments for order flow are for the account of the principal, an area where technical expertise seems irrelevant. The authors, as described at the *infra* text accompanying notes 438-43, believe that emphasizing best execution would not make for a stronger primary jurisdiction argument than the current emphasis on what the plaintiffs characterize as bribery.

[428] *Dahl*, 524 N.W.2d at 745 n.3.

[429] *Id.* at 747.

[430] One of the curious aspects of the payment for order flow cases is that it took so long for the plaintiffs' class action bar to commence these actions

flow on state law grounds,[431] the decision of the Court of Ap-

around the United States. The first payment for order flow case was filed on August 12, 1993, Witmer, *supra* note 7, but the first publicly available in-depth analyses of the state law issues were available three years earlier, *see* Schiff Hardin Letter, *supra* note 387; Coffee, *supra* note 390. In addition, there were other articles in the press describing payments for order flow and giving varying degrees of detail about the potential legal issues. *See, e.g.*, John C. Coffee, Jr., *A Break or a Bribe? Undisclosed Rebates Benefit Brokers, Not Clients*, BARRON'S, Sept. 17, 1990, at 18; Barbara Franklin, *Stock Inquiry Looks at Fees for 'Steering:' 'Order Flow' Payments to Brokers Questioned*, N.Y. L.J., Aug. 16, 1990, at 1; Floyd Norris, *Cutting 'Rebates' on O-T-C Trades*, N.Y. TIMES, Dec. 8, 1989, at D6; Jane Sasseen, *Dirty Little Secret*, FORBES, June 17, 1985, at 203; *see also* Simon & Colby, *supra* note 375, at 96-98 (describing the practice of paying for order flow and discussing disclosure and conflict of interest issues). The first case was filed less than a month after Professor Coffee reiterated his opposition to payments for order flow in two excellent articles in the National Law Journal, both of which are essential reading for anyone interested in the legal and market issues raised by payments for order flow. Coffee Part I, *supra* note 409; John C. Coffee Jr., *Will Reform Alter Order-Flow Payments?*, NAT'L L.J., July 26, 1993, at 16.

Perhaps the fact that the plaintiffs' bar did not respond more quickly is not so surprising in light of a comment letter the SEC received in response to the proposed rules, which had been published in the Federal Register on October 13, 1993. 58 Fed. Reg. 52,934-42 (proposed Oct. 13, 1993). The commentator, a NASD market maker and CHX specialist, reported that "[a]s a consequence of the Commission's request for comment, it was a signal to many broker/dealers who previously did not request payment, that they were clearly missing an opportunity to increase their bottom line with a practice that the Commission was going to sanction." Letter from Caroline B. Austin, President & CEO, Dempsey & Company, to Jonathan A. Katz, Secretary, SEC (Jan. 28, 1994). Some of the hesitation in asking for payments for order flow may have been due to concerns with the legality of the practice, *see* Schiff Hardin Letter, *supra* note 387, at 17 (commenting that fair competition among brokers and dealers may be impeded because some brokers and dealers may not pay for order flow out of concerns about the legality of the practice), which the SEC's rulemaking may have helped assuage.

[431] *Dahl* and the other payment for order flow cases are already having an impact in other securities class actions. In *Braunstein*, *supra* note 415, at 29, the plaintiffs brought an action challenging Merrill Lynch's failure to pay interest on customer free credit balances. In response to Merrill Lynch's motion to dismiss on, inter alia, preemption and primary jurisdiction grounds, the *Braunstein* court distinguished the payment for order flow cases. In *Dahl*, *Guice*, and *Evangelist*, the plaintiffs sought to ban payments for order flow and/or to obtain these payments for themselves. The SEC had considered and rejected both possibilities and, therefore, conflict preemption existed in the *Braunstein* court's view in all three payment for order flow cases. *Id.* In contrast, the SEC on a number of occasions had addressed the issue of interest on free credit balances and had explicitly stated that this was a business matter

peals in *Dahl* may not have much precedential value on the preemption and primary jurisdiction issues.

As this article discusses in part VII.B, the new SEC rules, once they become effective, will strengthen the preemption argument. But in the absence of a specific preemption statement and in light of the preface to rule 10b-10, which suggests an intent not to preempt state law,[432] the courts are likely to continue to find no preemption or primary jurisdiction. On September 12, 1995, the Minnesota Supreme Court heard oral arguments on the appeal from the Court of Appeals' decision, and a decision is pending.

A. Primary Jurisdiction and the Payment for Order Flow Cases

The primary jurisdiction argument is a weak one in the context of the payment for order flow cases. In making their argument for the SEC's primary jurisdiction in the payment for order flow cases, the defendants' principal argument in *Dahl* has been that the SEC should have primary jurisdiction because of its special expertise in this area. The sole case involving the SEC which the defendants cite and discuss is *Gordon v. NYSE*.[433] The defendants have cited no additional cases involving this area of securities regulation or the federal securities laws generally.[434] In addition to the weakness of *Gordon*

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for the broker-dealer and customer to deal with and not a regulatory matter. *Id.* As the *Braunstein* plaintiffs did not challenge the fact that Merrill Lynch used customers' free credit balances but only the lack of interest, there was no conflict with SEC regulation and, thus, no preemption. *Id.*

[432] *See supra* note 407.

[433] *See, e.g., Dahl* Appellant's Brief, *supra* note 400, at 36-37. See *supra* text accompanying notes 341-60 for a discussion of *Gordon*.

[434] The defendants cite to cases from an analogous area of law because the issue of the SEC's primary jurisdiction over payments for order flow has never been specifically addressed by a court. The cited cases all involve either adjudicatory procedures or non-discretionary investigations in the commodity industry. *See, e.g., Dahl* Appellant's Brief, *supra* note 400, at 37 n.13 (citing Furry v. First Nat'l Monetary Corp., 686 F. Supp. 156 (E.D. Mich. 1986); Chicago Mercantile Exch. v. Deaktor, 414 U.S. 113 (1973); Ricci v. Chicago Mercantile Exch., 409 U.S. 289, *reh'g denied*, 410 U.S. 960 (1973)); Defendant's Memorandum of Law in Support of its Motion to Dismiss or to Stay at 17 n.8, Guice v. Charles Schwab & Co., No. 94-100875 (N.Y. Sup. Ct. N.Y. County filed Mar. 22, 1994) [hereinafter *Guice* Defendant's Memorandum] (citing same three cases). In *Ricci*,

as precedent for the defendant's position on primary jurisdiction and the lack of additional precedent for this position, there are at least two other substantive problems with this argument.

First, the defendants must identify why the special expertise of the SEC is needed in these cases, which they never do.[435] Only if "intricate and technical facts" are involved would a deferral to the SEC be appropriate.[436] Here the dispositive le-

for example, the issues of the Commodity Exchange Commission's discretion to institute proceedings and the complainant's right to intervene were part of the reason that four Justices dissented. *See* 409 U.S. at 310-11 (Marshall, J., dissenting) ("At the outset, it should be noted that the Commodity Exchange Act fails to provide petitioner with a means by which he can require the Commodity Exchange Commission or the Secretary of Agriculture to consider his case."). The majority, however, interpreted the CEA regulations as requiring the CEC to investigate complaints and to act upon them. *Id.* at 304-05 n.14; *see also* Rosado v. Wyman, 397 U.S. 397, 406 (1970) (concluding that primary jurisdiction doctrine is not applicable where plaintiffs could not trigger, or participate in, administrative review of state action reducing welfare benefits). The majority in *Ricci* was relying on 17 C.F.R. § 0.53(c), which has been superseded. 409 U.S. at 296-97 n.9. *See* 41 Fed. Reg. 2,508-22 (1976).

In a number of cases in which the primary jurisdiction of the SEC has been raised, the application of the doctrine has turned, in part, on whether there was a procedure for the plaintiff to seek a remedy from the SEC. *See* Goldstein v. Groesbeck, 142 F.2d 422, 427 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944) (denying SEC's primary jurisdiction under Public Utility Holding Company Act over a shareholder's derivative suit because the act provided no administrative remedy); Standard Fruit & S.S. Co. v. Midwest Stock Exch., 178 F. Supp. 669, 676 (N.D. Ill. 1959) (holding that both exhaustion of remedies and primary jurisdiction doctrines "assume[] the existence of a remedy for the wrong charged within the administrative system"); Cogan v. Johnston, 162 F. Supp. 907, 909 (S.D.N.Y. 1958) (in private action alleging violations of Investment Company Act by an unregistered investment company, holding that primary jurisdiction does not apply because SEC "has no power to deal administratively with [such] violations"); *cf.* D&S Investments, Inc. v. Mouer, 521 S.W.2d 118, 120 (Tex. Ct. App. 1975) (holding that Texas Securities Commission has primary jurisdiction over whether transactions constituted a security under Texas law; plaintiff could have requested a hearing on this issue, which request must be granted). *See generally* Thill Sec. Corp. v. NYSE, 433 F.2d 264, 277 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971) (Swygert, C.J., concurring) (stating that one factor in considering application of primary jurisdiction is "whether an aggrieved party may initiate SEC review of exchange rules under the provisions of the Securities Exchange Act or the Administrative Procedure Act").

[435] The defendants raise the policy arguments underlying the primary jurisdiction doctrine without ever identifying exactly what it is that they want the SEC to decide. *See, e.g.*, *Dahl* Appellant's Brief, *supra* note 400, at 32-38; Appellant's Reply Brief at 17-22, Dahl v. Charles Schwab & Co., No. C1-94-1040 (Minn. Sup. Ct. filed May 8, 1995) [hereinafter *Dahl* Appellant's Reply Brief].

[436] Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216,

gal issue is whether the defendant's disclosure is sufficient to imply customer consent to the receipt by the defendant of payment for order flow. No macro-economic policy analysis or extensive knowledge of securities trading is necessary to resolve this issue. The lack of the need for such technical analysis in most securities cases, combined with the traditional expertise of courts in cases involving disclosure issues and fraud, accounts for the fact that primary jurisdiction is rarely raised in most securities fraud cases.[437] In fact, SEC investigations of violations of the federal securities laws currently proceed simultaneously with private civil actions on a regular basis without any primary jurisdiction issue being raised.

It is difficult to square applying the primary jurisdiction argument in the payment for order flow cases with the wider implications that this application would have in general securities cases involving claims of fraudulent activity under state law. Instead, to the extent courts need legal guidance in these areas, they should rely upon the amicus curiae and litigation analysis process recently announced by the SEC.

The defendants in the payment for order flow cases could have made a stronger argument for applying primary jurisdiction by emphasizing that part of the plaintiffs' case that deals with the duty of best execution, and the fiduciary prohibition against an agent (the broker) from taking benefits belonging to the principal (the customer).[438] The duty of best execution is grounded in the common law of agency. To determine what constitutes best execution requires an intimate knowledge of

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236 (6th Cir. 1980) (discussing *Ricci*, 409 U.S. 289 (1973), and *Deaktor*, 414 U.S. 113 (1973), and refusing to apply primary jurisdiction doctrine to fraud action under Commodities Exchange Act), *aff'd on other grounds*, 456 U.S. 353 (1982).

[437] *See generally* Richard M. Travis, Comment, *Primary Jurisdiction: A General Theory and Its Application to the Securities Exchange Act*, 63 CAL. L. REV. 926, 980 (1975) ("In summary, there might be a place for the Ricci technique in the 10b-5 area, but it should be used sparingly.").

[438] See *supra* note 409 for a discussion of these related but separate duties. The briefs by the defendants in the payment for order flow cases do not distinguish these two duties. *See, e.g.*, *Guice* Defendant's Memorandum, *supra* note 434, at 5, 13-18 (describing the plaintiffs' complaint as asserting "claims under New York State Law for breach of fiduciary duty, commercial bribery, fraud, breach of contract, conversion, and self-dealing" and discussing primary jurisdiction without ever describing the intricate and technical facts for which the SEC's expertise is needed).

the securities markets, the economics of trading, and how trades are executed.[439] This argument could have been bolstered by citation to the various economic studies which have analyzed and debated whether payment for order flow reduces or increases execution costs.[440] These studies reflect the complexity of determining whether payment for order flow results in better execution.

The SEC has particular expertise in examining the economics of executions in the securities markets. In contrast, courts have extensive expertise in determining the proper agency law disclosure standards.[441] Having said the foregoing, the authors do not believe that a focus on best execution would ultimately strengthen the argument for primary jurisdiction. Courts regularly decide complicated economic issues, relying on expert testimony to the extent that it is necessary.[442] Unlike the rate

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[439] For example, in discussing best execution and automated order routing systems, the SEC has distinguished the markets for NASDAQ and exchange listed shares, primarily on the possibilities for price improvement implicit in the differences between a dealer based and an order based market. In addition, the SEC mentioned the following criteria as bearing on order routing decisions and, therefore, on whether best execution has been achieved: quotes, "speed of execution, market fees, and affiliations with specialists or market makers." MARKET 2000, *supra* note 7, at V-3 to -5.

[440] *See generally* Note, *supra* note 7, at 1679-80 (1994) (summarizing empirical studies).

[441] In all fairness, the argument in favor of the SEC's primary jurisdiction makes more policy sense than legal sense. It can be legitimately argued that the payment for order flow issues have been debated within the securities industry among legal and economic experts for years without specific guidance from federal regulators except for the minimal disclosure standards set forth in rule 10b-10. As a policy matter, the industry deserved, or should have demanded, definitive guidance on operative policies for payment for order flow by the SEC together with a clear indication of preemption of potentially conflicting or expansive state common law doctrines and statutory provisions.

[442] Similar fiduciary duty issues to those involved in the payment for order flow cases were raised in a series of federal "give-up" cases in the 1970s. *See, e.g.*, Arthur Lipper Corp. v. SEC, 547 F.2d 171 (2d Cir.), *reh'g denied*, 551 F.2d 915 (2d Cir. 1976), *and cert. denied*, 434 U.S. 1009 (1978); Fogel v. Chestnutt, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976); Moses v. Burgin, 445 F.2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971); *see also*, *In re* Thomson & McKinnon, 43 SEC 785, 787-88 (1981) (finding registrant interposed broker-dealers between itself and market-makers in order "to reciprocate for listed business referred to it by such broker-dealers and to reward such broker-dealers for furnishing services;" registrant disciplined by SEC for failure to get best price for customers). These cases all involved give-ups of fixed commissions

making cases out of which the doctrine of primary jurisdiction evolved,[443] the issues that a court would examine in a best

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by brokers in connection with securities transactions by mutual funds. This practice developed into split fixed commissions, historically charged by the NYSE and other exchanges, between the fund managers and the executing brokers. Fund managers came to rely "on a few executing brokers who were then instructed to 'give-up' a portion of their commissions, sometimes as much as 75%, to another broker whom the fund manager wished to reward." *Fogel*, 533 F.2d at 735. When the SEC released a study that critically discussed give-ups, a "large number of derivative stockholders actions [were] brought on behalf of mutual funds against investment advisers, distributors [of mutual fund shares], and directors of both." *Id.* at 734 (footnote omitted). In these cases, the plaintiffs claimed that the fund managers were under a duty "to recapture brokerage commissions for the benefit of the fund." *Id.* In some cases this fiduciary duty was predicated on both the Investment Company Act of 1940, a federal statute, and state common law, *e.g.*, *Moses*, 316 F. Supp. at 34-35, and in some cases solely on the Investment Company Act of 1940, *e.g.*, Fogel v. Chestnutt, 383 F. Supp. 914, 915 (S.D.N.Y. 1974), *rev'd*, 533 F.2d 731 (2d Cir. 1975), *and cert. denied*, 429 U.S. 824 (1976).

The history of the SEC study of give-ups was as long and tangled as that involving payments for order flow, and the policy implications of give-ups for the securities markets were certainly serious. *See generally Fogel*, 533 F.2d at 734-37, 739-44 (summarizing the SEC's actions commencing in 1963 and ending in 1975); MARKET 2000, *supra* note 7, at V-10 (describing reciprocal and give-up practices). But the courts in the give-up cases were not hesitant about applying their traditional skills to determine whether the defendants had violated their fiduciary duties. This lack of hesitation is even more striking because among the issues that the courts had to decide was the highly technical one of whether recapture was even legal as it might have infringed certain rules of certain stock exchanges. *See, e.g.*, *Fogel*, 533 F.2d at 752-55. The published cases do not contain any indication that the defendants in the give-up cases urged the doctrine of primary jurisdiction upon the courts or that the courts independently considered this doctrine.

[443] A good illustration of this statement is found in the 1907 Supreme Court case from which the doctrine of primary jurisdiction evolved, Texas & Pac. Ry. Co. v. Abilene Cotton Oil Co., 204 U.S. 426 (1907). In *Texas & Pac. Ry.*, the issue was whether a court or the Interstate Commerce Commission (the "ICC") should first consider whether certain freight rates were reasonable or discriminatory or constituted undue preferences. *Id.* at 430-31. The Supreme Court noted that the pertinent federal statute required the ICC to ensure that "uniformity and equality of rates is observed" and that "if, without previous action by the Commission, power might be exerted by courts and juries generally to determine the reasonableness of an established rate, it would follow that unless all courts reached an identical conclusion a uniform standard of rates in the future would be impossible." *Id.* at 440-41. The Supreme Court therefore held that the plaintiff had to "*primarily* invoke redress through the Interstate Commerce Commission, which body alone is vested with power *originally* to entertain proceedings for the alteration of an established schedule, because the rates

execution case are not primarily economic, but instead arise from basic state law agency principles, which a court is better equipped to address than is the SEC.

Moreover, with respect to payment for order flow, the SEC has already addressed itself to this area, fully discussing the history of this practice and its views on it, and may be called upon in its amicus curiae capacity to further enunciate its position.[444]

The authors conclude that the doctrine of primary jurisdiction should be applied sparingly with respect to the federal securities laws and the SEC. Primary jurisdiction is most appropriately applied where there are agency adjudicatory procedures designed to resolve the issues involved, such as in the ICC context. This conclusion finds significant support in the fact that the SEC can submit an amicus curiae brief, which normally should serve substantially the same purpose as a referral of the initial decision making to the SEC.[445]

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fixed therein are unreasonable." *Id.* at 448 (emphasis added).

[444] *See* parts IV and V; *cf.* 2 DAVIS & PIERCE, *supra* note 1, at 284-85 ("Similarly, a court need not invoke primary jurisdiction to obtain an agency's resolution of a jurisdictional question if the agency has already expressed its views in some definitive manner.").

[445] The SEC has been closely following the payment for order flow cases. 59 Fed. Reg. at 55,007 n.10 (citing to the pending litigation concerning payments for order flow). Insofar as the defendants also have argued in the various order flow cases that the plaintiffs can make a customer complaint to the SEC or the pertinent self-regulatory organizations "which could lead to the commencement of a regulatory enforcement proceeding," Defendant's Reply Memorandum in Support of Its Motion to Dismiss or Stay at 6 n.2, Guice v. Charles Schwab & Co., No. 94-100875 (N.Y. Sup. Ct. N.Y. County filed Apr. 21, 1994), they ignore that the SEC has complete discretion in deciding whether to take action upon any complaint. *See also* Appellant's Reply Brief at 18 n.9, Dahl v. Charles Schwab & Co., No. C1-94-1040 (Minn. Sup. Ct. 1995 filed Dec. 13, 1994); Gordon v. SEC, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,628 (N.D. Ga. Aug. 21, 1980) (relying upon sections 77t(a) of the Securities Act of 1933 and 78u(a) of the Securities Exchange Act of 1934 to hold that "the SEC's decision to refrain from conducting an investigation is not subject to judicial review"), *aff'd*, 645 F.2d 70 (5th Cir.), *and cert. denied*, 454 U.S. 1033 (1981), *and reh'g denied*, 454 U.S. 1116 (1982).

B. Application of the Supreme Court's Recently Enunciated Preemption Test to the Payment for Order Flow Cases

As discussed in part III.A, section 28 has been amended several times by Congress to add three explicit preemption provisions to the Exchange Act. Applying the *Freightliner/Cipollone* presumption against implied preemption, it is unlikely that any court would hold that the new SEC rules preempt state law as it applies to payments for order flow. This conclusion is particularly true with respect to any field preemption arguments. Under the *Freightliner/Cipollone* analysis, the securities industry may raise the issue of conflict preemption arising out of either the impossibility of complying with both federal and state law or frustration of congressional purpose by state law, but under the analysis described in this part VIII.B, such a conflict analysis is unlikely to be successful.

In most areas, the Exchange Act does not explicitly preempt state law. In fact, section 28(a) of the Exchange Act preserves state law rights and remedies.[446] In addition, no provision of the Exchange Act, including sections 10(b) or 11A, or the rules promulgated thereunder, explicitly displaces state law with respect to claims arising as a result of the practice of payments for order flow. The explicit preemption test set forth by the current Supreme Court is, therefore, not currently met. With the effectiveness of the new SEC rules on October 2, 1995, a stronger argument for preemption is now available to future defendants. The issue will then become whether the new SEC mandated disclosure standards explicitly preempt the state agency law requirements for consent by principals in instances where their agents either make profits from transactions conducted on behalf of the principals or fail to obtain best execution of their orders. The prefatory language to rule 10b-10 should preclude any such preemption.

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[446] In and of itself, such a savings clause is not sufficient to satisfy the third step of the *O'Melveny* analysis, which deals with direct conflicts between federal policy and state law, with respect to any particular provision of the federal securities law, and the allegedly conflicting provision of state law. In other words, the federal policy must still be described and then examined in light of the pertinent state law. *See supra* text accompanying notes 50-61, 68-93 for a further discussion of section 28(a) and these issues.

In adopting the new rules, the SEC discussed "a broker-dealer's fiduciary duty to seek to obtain the best execution for its customer," noting that this duty derived in part from "the common law agency duty of loyalty, which obligates an agent to act exclusively in the principal's best interest."[447] In the SEC's view, the mere fact that payments were made for order flow was not determinative of whether the duty of best execution was met.[448] Indeed, one of the options considered and rejected by the SEC was a complete ban upon payments for order flow.[449] Thus, broker-dealers could argue that, by negative implication, the SEC has approved payments for order flow that are made consistently with the SEC's disclosure requirements and that the SEC's new rules preempt any state regulation of these payments. The preamble to rule 10b-10, and cases such as *Cipollone*,[450] should remind us that this argument, which is unlikely to succeed, may be stronger in the area of preempting separate state disclosure requirements than in the area of implying consent under state agency law to the actual receipt of payments for order flow.

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[447] 59 Fed. Reg. 55,006, 55,009 n.28. The SEC also discussed the belief of "some opponents of the practice of payment for order flow . . . that acceptance and retention of payments by brokers from market makers constitute a breach of duty not permitted under agency common law," citing RESTATEMENT (SECOND) OF AGENCY § 388 (1957). In discussing the import of its new disclosure rules for payments for order flow, the SEC noted that "[d]isclosure of payment for order flow, moreover, could help inform customers and negate the concern that customers are unable to evaluate whether they receive inferior executions due to undisclosed rebates." *Id.*

[448] *Id.*

[449] *Id.* at 55,011.

[450] Cipollone v. Liggett Group, Inc., 112 S. Ct. 2608, 2619 (1992) (construing federal statute, which required certain warnings on packages with respect to the hazards of smoking, to preempt state laws "mandating particular cautionary statements and [to] not preempt state law damages actions") (footnote omitted). A separate question will be presented, of course, by whether compliance with the new federal disclosure standards suffices to support the conclusion under a particular state's law that a customer has consented to a broker taking payments for order flow. Indeed, the SEC substantively discussed issues of state law in connection with the adoption of the payment for order flow rules. *See supra* notes 447-49.

VIII. CONCLUSION

The doctrine of primary jurisdiction has minimal application to the payment for order flow cases. The SEC has already studied the issue of payments for order flow in great detail and provided its written conclusions concerning these practices. Insofar as additional guidance from the SEC would be useful to the courts in resolving the legal issues raised by these cases, the courts should, consistent with the SEC's recently announced policy, seek amicus curiae briefs from the SEC. In light of this policy and the judiciary's experience with interpretation of the federal securities laws, primary jurisdiction should be a doctrine which has little or no application to the securities industry.

The brokerage industry has a new preemption argument now that the new SEC rules are effective; however, in the post-*Freightliner/O'Melveny* environment, where clear evidence in a statutory or regulatory scheme of congressional intent to preempt is necessary, the industry would have been wise to seek a clearer statement of the SEC's intent to preempt state laws and

its reasons for so doing.[451] Instead the industry is left with a contrary statement of intent in the rule 10b-10 preamble.

The industry may have another opportunity with respect to the Companion Release. If it is unable to successfully lobby for a clear statement of the SEC's intent into the final version of the Companion Release, thereby creating an unambiguous "legislative" history, the brokerage industry will be forced to continue its battle in the payment for order flow cases pursuant to the statutory and common law of the state jurisdictions in which such cases arise.[452]

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[451] When the SEC has wanted to preempt state law through a regulatory initiative, it has made its intentions clear. *See supra* text accompanying notes 121-24. This article does not address the issue of what provisions in the Exchange Act and/or the Securities Act the SEC could rely on as granting it the power to preempt the area of payments for order flow. Without a congressional grant of power to the SEC, any preemptive action by the SEC would be subject to being vacated by a court. *See, e.g.*, Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990). *See generally* Joel Seligman, *Equal Protection in* Shareholder Voting Rights: The One Common Share, One Vote Controversy, 54 GEO. WASH. L. REV. 687, 714-19 (1986) (advocating, in pre-*Business Roundtable* article, probable existence of SEC's authority to promulgate rule of type rejected by the *Business Roundtable* court); George W. Dent, Jr., *Dual Class Capitalization: A Reply to Professor Seligman*, 54 GEO. WASH. L. REV. 725, 735-36 (1986) (rejecting Professor Seligman's argument because, inter alia, SEC does not have authority to preempt state corporate laws). Two possible statutory sources of authority would be sections 10(b) and 11A(a) of the Exchange Act. In light of the SEC's willingness to directly confront preemption issues in the past, its coyness over the preemptive effect of its new payment for order flow rules is puzzling. Perhaps this coyness arises from the potential political controversy surrounding payments for order flow. *Compare Order Flow Payments, Preferencing Harm Investors, Dingell Contends*, 27 SEC. REG. & LAW REP. 842 (1995) (Representative John Dingell, ranking Democratic member of the House Commerce Committee, advocates a SEC ban on payments for order flow) *with Lawmakers Urge Disclosure Solution to Payment for Order Flow Questions*, 27 SEC. REG. & LAW REP. 1194 (1995) (Representative Thomas Biley, Republican Chairman of the House Commerce Committee, and Representative Jack Fields, Republican Chairman of the Subcommittee on Telecommunications and Finance, advocate disclosure, not banning, as the appropriate SEC response to payments for order flow).

[452] Even such a statement of intent would not resolve the preemption issue with respect to practices that were not consistent with the new federal scheme. If the SEC attempted to immunize past practices with respect to payments for order flow, *cf.* 59 Fed. Reg. 67,358, 67,359 (Dec. 29, 1994) (retroactively to June 6, 1934, exempting from registration requirements under the Exchange Act persons acting as brokers or dealers with respect to certain categories of over-the-counter derivative instruments), novel preemption and administrative law

The lesson of the payment for order flow cases is thus clear. Absent a clear intent to establish preemptive federal standards for the securities industry, the industry will continue to face a multiplicity of state law claims, in various inhospitable jurisdictions. Until recently, the securities industry has faced an uphill battle as Congress and the SEC have each, to date, clearly made a judgment not to preempt state law in virtually all areas of securities law. This decision is based in part on federalism concerns and may also reflect the notion that more potential claims means more efficient securities' policing. This decision, however, not to preempt is not without consequences, which include extensive state litigation even when there has been compliance with the Exchange Act.

This inhospitable attitude toward a uniform preemptive federal standard may be changing. This is evidenced by the recently promulgated Fields bill[453] and Chairman Arthur Levitt's recent efforts to better "coordinate" state and federal securities laws.[454] This changing climate provides the securities industry with a unique chance to seek congressionally mandated preemptive standards for the national securities market system, which standards could be created by either direct congressional action or a congressional requirement that the SEC adopt such preemptive standards.

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issues would be raised, *cf.* New York City Employees' Retirement System v. SEC, 45 F.3d 7, 13-14 (2d Cir. 1995) (holding that the SEC may modify a no-action position without complying with the Administrative Procedures Act even when an existing SEC rule is changed).

[453] See *supra* text accompanying notes 115-20 for a discussion of the Fields bill.

[454] See *supra* note 116 for a description of Chairman Levitt's recent speech on the topic.