[Washington University Law Review](https://openscholarship.wustl.edu/law_lawreview)

[Volume 81](https://openscholarship.wustl.edu/law_lawreview/vol81)
[Issue 2 *After the Sarbanes-Oxley Act: The Future of the Mandatory Disclosure System*](https://openscholarship.wustl.edu/law_lawreview/vol81/iss2)

January 2003

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Stephen M. Cutler
Securities and Exchange Commission

Recommended Citation

Stephen M. Cutler, *Remarks of Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission*, 81 WASH. U. L. Q. 545 (2003).
Available at: https://openscholarship.wustl.edu/law_lawreview/vol81/iss2/9

REMARKS OF STEPHEN M. CUTLER, DIRECTOR

DIVISION OF ENFORCEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION

AT THE F. HODGE O'NEAL CORPORATE AND SECURITIES LAW SYMPOSIUM

WASHINGTON UNIVERSITY SCHOOL OF LAW

February 21, 2003

Good afternoon. It's a pleasure to be here. The description of this panel suggests numerous tempting topics, but I thought I would use my time to address one that for me has left the realm of the theoretical and entered the very real world of my daily life as head of the SEC's enforcement program. Specifically, I'd like to share with you my views, and they are only my views and not those of the Commission or its staff, on the appropriate roles and responsibilities of the federal government and the states in the regulation of our securities markets.

It's an issue that has received a lot of attention as of late. Indeed, at the Senate Banking Committee hearing held last week to consider his nomination as SEC Chairman, Bill Donaldson was asked by a member of the Committee for his thoughts on this subject. Chairman Donaldson observed that "one of the great strengths of our market system is that it is a national market system and has not been Balkanized."

During the last 12 months, the overlapping responsibilities of federal and state securities agencies have been vividly illustrated by the joint investigations of research analyst practices undertaken by the SEC, the self-regulatory organizations, and the states. On December 20 of last year, the Commission, along with the NASD, New York Stock Exchange, New York Attorney General Eliot Spitzer, and other state regulators, announced a settlement-in-principle with the nation's top investment firms to address issues of conflict of interest between investment banking and research analyst activities at major brokerage firms. The "global settlement," if finalized, would address firm (but not individual) liability.

The announcement of the global settlement was preceded by the New York Attorney General's action against Merrill Lynch, and then an extensive joint investigation among the SEC, the self-regulatory organizations, and the states. Although this process has by no means come to a close—indeed, until the Commission authorizes the global settlement-in-principle, not even that aspect of the matter will be final—I view this effort as having been instructive for regulators as well as beneficial to investors.

The investigation of research analyst practices has been a singular one not only for the breadth and importance of the issues being examined, but for the number of different regulators who have actively participated. Perhaps for these reasons, it has been, and continues to be, particularly effective at highlighting important questions concerning the roles of the SEC and state agencies in effecting change in the securities markets. As I've grappled with these questions, it has occurred to me that there may exist certain common principles discernible from the history of the securities laws that should guide federal and state securities regulators alike. After all, we are all public servants doing our best to give life to the dual regulatory system that Congress created. Moreover, keeping our eyes firmly on these principles might, in fact, guide us more effectively in dealing with issues of state/federal cooperation than would any bright-line rules we might struggle to articulate. Today's forum provides me an opportunity to explore these principles in a deliberate fashion.

Indeed, in preparing for this panel, I've found that pursuit of a fairly limited number of central principles animated the lawmakers who created, and subsequently revised, the dual regulatory system in which we operate. With that in mind, I'd like to use my time, first, to identify and discuss these historically important goals, and then to consider the implications of these priorities for contemporary federal/state cooperation in the securities regulation arena.

A BRIEF SURVEY OF THE HISTORY OF THE SECURITIES LAWS

Policy makers have been debating the roles of the federal and state governments in protecting investors since before the 1933 and 1934 Acts and the creation of the SEC. Decades before the first federal securities law was adopted, states had begun to implement the so-called blue sky laws. These statutes were enacted in response to the ever-increasing prevalence of overvalued, speculative, and fraudulent securities.[1] Such legislation was very popular, and between 1911, when Kansas adopted the first blue sky law, and 1933, when the first federal securities statute was adopted, all states, except Nevada, implemented such laws.[2]

Despite this blanket of state regulation, by the 1930s there was widespread demand for the federal government to assume a role in policing the markets. According to a Department of Commerce Report, "notwithstanding . . . protective state laws, there has never been a period in history when the public has been so grossly mulcted of accumulated savings by shrewd and conscienceless 'securities' manipulators, as during recent years."[3]

This is not to say that Congress questioned the commitment of the states to investor protection. Instead, lawmakers attributed the shortcomings of state-only enforcement to securities fraudsters' ability to operate in the more lightly (or un-) regulated states or by conducting sales on an interstate basis. Thus, two important goals of the federal legislation were to provide uniform standards for offering securities to the public[4] and to eliminate the ability of scammers to "tak[e] advantage of State boundaries."[5]

While there were occasional nods toward the need to avoid too many, or inconsistent, regulations, the single-minded preoccupation of lawmakers appears to have been protecting investors and preventing fraud. Indeed, the 1933 and 1934 Acts included explicit provisions preserving existing state authority to regulate intr*a*state activities. In sum, Congress' apparent intent at this early stage was to "supplement and strengthen" the existing state regimes,[6] rather than replace them with a single federal regime.

While in 1933, lawmakers thought of federal standards as essential to

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1. Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 353-60 (1991); Joel Seligman, *The Historical Need for A Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 19 (1983).

2. *Hearing on the Federal Securities Act: A Study of the Economic and Legal Aspects of the Proposed Federal Securities Act (submitted for the record by the Department of Commerce)*, 73d Cong. 93-94 (1933) [hereinafter "Economic Study"].

3. *Id.*

4. It is worth noting that the desire for—and recognition of the importance of—national uniformity in securities laws did not first arise from adoption of the federal securities laws. In fact, the first significant effort to achieve a more uniform approach to securities regulation occurred several years earlier, in 1929, with the development of the Uniform Sale of Securities Act by the National Conference of Commissioners on Uniform State Laws. This model state statute was adopted by only seven states. Dennis C. Hensley, *The Development of a Revised Uniform Securities Act*, 40 BUS. LAW. 721, 722 (1985).

5. Economic Study, *supra* note 2, at 101.

6. *Id.*

achieving investor protection, decades later, Congress came to view federal standards as the key to a new priority—efficiency. Congress' first clear articulation of this new priority was in 1980, when it adopted the Small Business Investment Incentive Act, adding Section 19(c) to the Securities Act. Section 19(c) (now Section 19(d)) mandated greater federal/state cooperation in order to, among other things, maximize uniformity in federal and state standards and minimize "interference" with capital formation.[7] Like the 1933 and 1934 Acts, however, it explicitly preserved existing state authority.[8]

By 1996, Congress was moved to address the more practical difficulties arising from the patchwork quilt of state regulation.[9] In the National Securities Markets Improvement Act ("NSMIA"), in contrast to the prior federal securities laws, Congress explicitly pre-empted vast areas of state regulation.[10] The Conference Committee that approved NSMIA explained in its joint statement: "[T]he system of dual Federal and state securities regulation has resulted in a degree of duplicative and unnecessary regulation . . . that, in many instances, is redundant, costly, and ineffective."[11] In short, Congress could hardly have been clearer in articulating its intent that our dual regulatory system promote efficiency and competitiveness whenever possible. Congress worried that our dual system of regulation had become *dueling* systems, burdening capital formation, job creation, and commercial innovation.

At the same time, the drafters of NSMIA were careful to explain that while eliminating regulatory burdens, the Act "preserve[ed] important investor protections by reallocating responsibility over the regulation of the nation's securities markets in a more logical fashion between the Federal

7. Securities Uniformity; Annual Conference on Uniformity of Securities Laws, Securities Act Release No. 8072, at 1-2, 77 SEC Docket 716 (Mar. 20, 2002).

8. *See* 15 U.S.C. §§ 77s(d)(1)-(d)(6).

9. The effort to encourage nationwide uniformity through creation of a model state securities law had been renewed in 1947. During that period, no two blue sky laws were identical, and the 47 statutes altogether contained a whopping 2,800 exemptions. Hensley, *supra* note 4, at 721. Nine years later, in 1956, a model act was approved by the relevant drafting bodies. *Id.* The Uniform Standards Act of 1956, or variations thereon, subsequently was adopted in 39 jurisdictions. The Uniform Securities Act was revised in 1985, but adopted in that form by only a few states. It was again redrafted in 2002. JOEL SELIGMAN, THE NEW UNIFORM SECURITIES ACT 1 (2002). These dogged, long-running (and thus far fruitless) efforts to develop a consensus model-act evidence the value legal experts have placed on attaining greater uniformity in securities regulation.

10. Kevin A. Jones, *The National Securities Markets Improvement Act of 1996: A New Model for Efficient Capital Formation*, 53 ARK. L. REV. 153, 154 (2000).

11. Joint Explanatory Statement of the Committee of Conference, Conference Report—National Securities Markets Improvement Act of 1996, HR 3005, H.R. CONF. REP. NO. 104-864 (1996).

government and the states."[12] Specifically, under the legislation, the states were to "continue to exercise their police power to prevent fraud and broker-dealer sales practice abuses," but abstain from regulation of "the securities registration and offering process."[13] Moreover, Congress was explicit that the prohibitions on state authority "applied both to direct and indirect State action."[14] That is, states were not to use the regulatory authority they retained to exercise the sort of authority that had been preempted.

LESSONS OF THE LEGISLATIVE HISTORY OF THE SECURITIES LAWS

Let me pause here to summarize what I believe is evident from even this brief discussion of the history of the securities laws. First, aggressively protecting investors and instilling in them confidence in the fairness of our markets is critical to Congress' vision of oversight of our capital markets. Second, especially in recent years, Congress has likewise emphasized the goals of efficiency and competitiveness in our capital markets, and has concluded that uniformity in regulation is a pre-requisite to achieving these goals. Third, Congress continues to believe in the efficacy of a dual regulatory system in which both federal and state agencies serve specific, valuable functions.

In my view, these broad principles can provide helpful guidance to federal and state securities regulators as we carry out our separate and overlapping duties. Indeed, these general principles can have very specific implications in practice. I'll use the remainder of my time to discuss these implications.

APPLYING THE LESSONS TO FEDERAL/STATE COOPERATION

First, there is no question in my mind that the imperative to achieve consistent regulation of the U.S. securities markets, and of the vast majority of domestic securities offerings, regardless of locale, dictates the need for a single, dominant regulator. Coordinated efforts to achieve uniformity among the states, and between the states as a group and the federal system, have fallen short, even after decades of trying. In adopting NSMIA, Congress expressed its intent to "further advance the development of <u>national</u> securities markets" by establishing the SEC as "the exclusive regulator of national

12. *Id.*
13. *Id.*
14. National Securities Markets Improvement Act of 1996, H.R. REP. NO. 104-622, at 30 (1996) [hereinafter "House Report"].

offerings of securities."[15] In a global economy, in which U.S. competitors are taking dramatic steps to integrate their markets and eliminate barriers, a national market is more important than ever.

Moreover, the SEC is able to bring to its consideration of matters affecting our markets a broader perspective—one informed by national economic and international policy developments—than can any one state. Accordingly, when confronted with circumstances requiring cooperation or coordination, federal and state securities regulators should keep Congress' command firmly in mind. Our *mutual* goal should be to avoid re-balkanizing (to paraphrase Chairman Donaldson) the securities markets, and effectively, undoing the work Congress has done. We, as public servants and policy makers, should ask ourselves how the actions we contemplate taking as federal or state actors would promote or detract from Congress' vision of a truly national market system.

This is not meant to suggest, however, that I believe the states should be relegated to the backseat of our regulatory system. Let me be clear: state securities agencies have played—and should continue to play—a significant role in making our securities markets the most respected and trusted in the world. The more resources—federal and state—we can bring to the cause of maintaining this status, the better off we are. By working together, state and federal regulators can help to ensure that our markets remain the envy of the world.

That brings me to the next or second guiding principle. It is clear that protecting investors from fraud must always remain central to our missions. The *primary* goal of the lawmakers who drafted and adopted the first federal securities statutes was, undoubtedly, investor protection. They were coming to the aid of the many "investors [who] were induced to exchange hard-earned savings of a lifetime for 'securities' which were not worth the paper on which they were engraved or printed."[16] According to the legislative record the members took pains to create, Congress was moved to action by "[r]ecent disclosures in financial circles [that shook] public confidence to its very foundations.'"[17] Perhaps not coincidentally, these concerns have a surprisingly contemporary sound to them.

The Congress that considered NSMIA some 60 years later was not so single-minded, but still unquestionably viewed protection of investors as a high priority. Although the legislation focused on the need to streamline the dual securities regulatory system, the exhortations to enhance

15. House Report, *supra* note 14, at 16.
16. Economic Study, *supra* note 2, at 92.
17. *Id.*

competitiveness and efficiency consistently were qualified by the need to preserve aggressive and vigorous investor protection mechanisms.

Thus, lawmakers made clear that the legislation "preserved the authority of the states to protect investors through application of state antifraud laws . . . [and] to exercise their police power to prevent fraud and broker-dealer sales practice abuses."[18] The state enforcement agencies were characterized as the "local cop[s] on the beat" who were best positioned to quickly detect and address the needs of individual investors.[19] And, of course, the states have proven themselves highly effective in investigating and charging those who defraud their residents, and continue to be committed to doing so.[20]

This alignment of congressional intent and state regulators' agendas suggests another or third principle that should inform the judgments of securities regulators. We should expect state agencies—and respect the right of state agencies—to pursue fraudulent conduct within their jurisdictions. State regulators are an important part of the arsenal needed to combat securities law misconduct. The SEC will never have resources sufficient to investigate every allegation of fraud, particularly those affecting a small number of geographically-concentrated investors. Active state enforcement programs can only benefit such investors.

Moreover, a visible and aggressive *state* enforcement machine may motivate *federal* regulators, like me, to respond more quickly to potential securities-related misconduct. Of course, if we in the federal government want to be the dominant securities enforcement authority, we must be vigilant in protecting the investing public. And I think I can safely say that Chairman Donaldson, as well as the Commission and its staff, are single-minded in our determination to do just that.

Such competition among regulators, to be the first on the scene, if tempered by the other principles I've identified, will help ensure that investors' needs are addressed promptly. As public servants, we must admit to ourselves, however, the possibility that a contest to be the most *responsive* regulator could too easily become a contest to be the most *popular* but most *irresponsible* regulator. This in turn can have untold costs—to investors, to issuers, to financial institutions, to the capital markets, to the justice system, and, ultimately, to our credibility as regulators. Federal and state securities agencies must bear this in mind at all times and exercise our judgment and

18. H.R. REP. NO. 104-864, at 40.

19. *See* NASAA President Christine Bruenn's Speech to Annual Conference of the North American Securities Administrators Association, Philadelphia, PA (Oct. 1, 2002), *at* http://www.nasaa.org/nasaa/Files/File_Uploads/Bruennspeech.37528-49824.doc.

20. *Id.*

discretion accordingly. As Supreme Court Justice Robert H. Jackson eloquently cautioned in a speech he made as Attorney General: "While the prosecutor at his best is one of the most beneficent forces in our society, when he acts from malice or other base motives, he is one of the worst."[21]

In sum, as federal regulators, we must acknowledge the value of the states' enforcement firepower, and, in return, prevail upon our state counterparts to recognize that when a state enforcement matter implicates a competing federal regulatory interest, consultation and cooperation with the Commission may be critical.

That brings me to the fourth and *final* guiding principle: adherence to Congress' particular vision of what our dual regulatory system should be. As I've already discussed, lawmakers were quite explicit that those areas of regulation reserved to the federal system should be immune not just from the direct exercise of state authority, but also from the indirect exercise of such authority. In my view, this command creates important considerations for the exercise of state enforcement authority. Let me explain.

As an enforcement lawyer, I am quite familiar with the complaint, often raised by defendants or respondents, and even by an occasional SEC Commissioner, that a proposed settlement amounts to rulemaking by enforcement. While I'm confident that we hear that argument far more often than warranted, it points up that an enforcement proceeding can, in fact, realign an industry standard. That is, when faced with the risks and costs of litigating an enforcement action, some parties may agree in settlement to change or restrict their future conduct in significant and far-reaching ways. So what does this have to do with NSMIA and dual regulation?

Consider that, though varying in their breadth, state securities fraud statutes are commonly enforceable through criminal sanctions and civil remedies that, for regulated entities, can be as extreme as the loss of a license. As has been vividly demonstrated, in some circumstances, the prospect of being charged with fraud, even *civilly*, creates very high stakes for securities-industry participants—indeed, so high, that state regulators may find themselves in a position to dictate dramatic changes in conduct to settling parties. In short, they will have the leverage to effect rule changes through enforcement. Why is this a particular problem in the context of the dual regulatory system? It's a problem because Congress clearly intended, when it adopted NSMIA, that the *federal* government, not the states, establish the rules and policies governing the securities markets, and that it

21. Robert H. Jackson, Attorney General of the United States, The Federal Prosecutor: Address at The Second Annual Conference of United States Attorneys (Apr. 1, 1940).

do so on a national, rather than piecemeal, basis. Moreover, Congress specifically warned that the states should not rely on their residual power to set regulatory standards for the national markets. As state and federal regulators navigate the waters of our dual regulatory system, this congressional command should guide our decisions. Otherwise, we may destroy the balance Congress struck in its effort to strengthen and streamline our national market system.

CONCLUSION

The question of the appropriate roles of the federal and state governments in our dual securities regulatory system has arisen continually for 70 years, and it's not likely to go away anytime soon. Although some may question the value of legislative history generally, on this subject I believe it can provide federal and state securities regulators with a useful roadmap. The lawmakers who created the dual regulatory system, and those who have maintained it, clearly expressed the belief that regulatory uniformity imposed at the national level, coupled with aggressive and overlapping enforcement authority would best foster fair and efficient markets. And frankly, it's hard to argue with their results to date. But with today's increasingly complex and international securities markets, we need to proceed carefully. As we exercise the discretion with which Congress entrusted us, it is important that both federal and state securities regulators bear in mind the balance Congress sought to strike.