Corporations

Harmonization, Preemption or Federalism?

By Michael Fransella

Blue Sky laws aren't much fun for a securities lawyer. Often an afterthought, and nearly always an annoyance, they demand extra research and extra blurbs in offering documents, and accomplish little beside extracting a few dollars from the pockets of issuers to state coffers (and of course, to lawyers), and furnishing a further set of tripwires for companies and attorneys picking their way through the SEC minefield. When the SEC proposed defining a "qualified purchaser" under the Securities Act to be equivalent to an "accredited investor" under Regulation D,[1] a move that would result in the preemption of state standards for many private offerings, I suspect most securities lawyers applauded hopefully, except perhaps the ones who specialize in Blue Sky laws. Even those of us otherwise ideologically committed to federalism, devolution, and local control couldn't help but think that preemption would be a good thing, for our clients and for the securities market as a whole. An example, perhaps, of self interest trumping ideology.

More recently, legislation was again introduced in the Financial Services Committee of the House of Representatives that would limit the power of state regulators and attorneys general to impose rules and standards of conduct on the securities industry beyond what is required by federal laws and regulations. That the legislation is supported by the SEC and opposed by the states could not be less surprising. The apparent paradox, to the bill's detractors in the House, the states, and the punditry, is that its proponents are conservative Republicans who in other circumstances have been known to champion such things as "states' rights" and "federalism." In the words of New York Attorney General Eliot Spitzer, "the Federalism of the Republican Party seems to apply when the issue is the rights of the poor, and they want to leave that to the states…but when it comes to using power to help their corporate patrons, they bring it back to Washington."[2] In the face of such criticism, the bill has been postponed and perhaps killed.

Do Spitzer and the other critics have a point? Are Republican lawmakers hypocritically putting aside their principles to further their own interests or those of their friends and supporters? Were those of us who supported federalism in theory, but reacted hopefully to the SEC's proposed preemption of state private offering standards, allowing our own annoyance at having to navigate state laws to blind us to the laws' beneficial effect to society? Since we can't look into hearts to discern motives, a better question is, is it *inherently* inconsistent and hypocritical to support federalism and states' rights in general, but still support the federal preemption of state securities regulation? Can one simultaneously oppose tax harmonization efforts or the establishment of federal corporate law, while supporting the Uniform Commercial Code or federal preemption of state antitrust enforcement? In other words, when federalism, and when harmonization or preemption?

The Point of Federalism

Although traditionally referring simply to a system of split authority between a central government and local governments, particularly the system established by the U.S. Constitution, "federalism," in modern political parlance, is often used to refer to the position that the current split of authority vests too many powers in the federal government and too few in the states, or, even more specifically, to the political philosophy advanced by Michael Greve[3] and others that pathologies of government will be reduced, and beneficial governance made more likely, when governing power is held by a number of competing jurisdictions. Advocates of federalism so defined would hasten to point out that they are not promoting "states' rights" per se, but a system thought to promote liberty and efficiency. In our current context, such an analysis will often lead to the conclusion that some of the powers currently exercised by the federal government should instead be exercised by the states. However, the point is not to protect the sovereignty of states after the manner of John C. Calhoun, but rather to protect the liberty of private actors. Competition among jurisdictions, it is argued, will produce a kind of market force that will compel governments to shape their laws so as to appeal to private actors. When states compete, you win.

On the other hand, there is clearly an economic cost to federalism, particularly, or at least particularly visibly, in the areas of corporate, commercial, and financial law. Even evaluating and choosing a single legal regime from among fifty requires time and resources that could be saved if there were only one, national regime available. And if more than one regime must be complied with, a potentially very large transaction cost is added to economic activity. Businesses that operate nationwide or worldwide are often happy to reduce the cost of compliance through federal preemption of state regulation, perhaps without thought to the likely differences in substantive content. Less frequently, a similar consolidation of regulatory regimes is achieved by harmonization of state laws, rather than by federal preemption, with the UCC being a conspicuous example. It would be hard to find a banker or a frequent secured debtor who would be eager to return to having fifty different regimes regulating secured

transactions or letters of credit. And yet, we might suppose that federalist theory would liken the UCC to a cartel among the states, all agreeing to offer the same product so as to avoid competing. And when suppliers (in this case, of law) form a cartel, consumers seldom come out ahead. Similarly, no merging company wants to comply with fifty antitrust regimes, and no issuer wants to comply with fifty securities commissions.

The question, then, is what principles can be articulated to determine when the benefits of federalism will be likely to outweigh the costs of federalism (or, to put it the other way around, when the costs of preemption or harmonization will outweigh the benefits of uniformity). The benefit of federalism, remember, is competition. If states do not or are not likely to compete meaningfully, there is little reason to bear the economic cost of duplicative regulatory regimes. This question then becomes, when are states likely to compete meaningfully? Under the same circumstances under which businesses compete: when consumers have a meaningful choice, and when forming or maintaining a cartel is impractical. To determine whether a particular area of corporate or commercial law is better handled by the federal government or by the states, therefore, should involve analyzing whether state regulation would result in meaningful choice for economic actors among regulatory regimes.

Federalism in Securities Law?

Take securities regulation.[4] A securities offering is typically initiated by a single seller, which offers and sells securities to buyers who are numerous and often dispersed. Each state imposes its regulations territorially. If a buyer is located within a state, that state's regulations must be complied with, at least to the extent they are not preempted by the SEC. The buyer or offeree does not have a realistic choice among regimes: few individuals will seriously consider moving their residences to another state to take advantage of a greater range of securities offerings that might be available there as a result of a better regulatory regime. Nor does the seller have a choice: it must comply with the regulations of each state where an offeree resides, or forego that part of the transaction.[5] The only check on state regulators is whatever pressure their constituents exert on them to craft regulations that will increase the number and quality of securities offerings available in their state. Given the infrequency of participation in securities offerings by most affected buyers, and the relatively small and speculative nature of the damage done to any one of them by inefficient regulation, this pressure ranges from negligible to nil. State politicians are likely to get far more mileage from posing as defenders against out-of-state snake oil touts than they could hope to get by opening markets. In this state of affairs, there is little or no incentive for states to compete in a way that would make securities markets more efficient. Moreover, even if there were such an incentive, since offerings would still have to comply with the poor regimes as well as the good ones, the strictest regimes might end up setting the de facto standard. Since there is no significant competition among states, and no reasonable prospect of such competition, it is hardly surprising that those who might normally adhere to federalist principles would favor preemption by the SEC of state securities regulation. One standard is obviously preferable to fifty, other things being equal, and the securities industry will be at least part of the constituency of the SEC, which means that there is reason to think that SEC regulations could be substantively superior to those adopted by most individual states.

To capture the benefits of federalism for securities regulation, issuers would have to have the ability and the incentive to choose among competing regimes. This would require a shift from the territorial application of securities regulations, based on where the "offer" is made or where the offeree is located, to a system in which an issuer could choose the regime that would regulate its offering, or as a second-best solution, to a system in which the law of the issuer's jurisdiction, rather than the jurisdiction of the offeree, applied to the transaction (assuming that issuers could and would organize in or move to a jurisdiction to take advantage of its regulatory regime).[6] Several scholars have in fact proposed giving issuers the power to choose a regulatory regime to govern their offerings. For example, Stephen Choi and Andrew Guzman proposed a mechanism under which participating nations would recognize an issuer's choice of another participating nation's securities laws, or, indeed, of contractual or private regimes,[7] and Roberta Romano has proposed a similar system of competing regulation by states, the SEC, and foreign nations, any one of which could be chosen by issuers.[8]

What Spitzer and other critics miss or choose to ignore is that federalism is not about restraining private actors, but rather about restraining governments. To the extent that we want to be paternalistic, and believe that the market will not provide the protections that offerees need, then the question is whether allotting such regulation to the states rather than to the federal government will provide some benefit that can justify the economic cost, both in wasted governmental resources and in compliance costs, of having fifty such different regimes. Of course, an argument can be made that, even discounting competition among states, government that is closer to its constituents will be more responsive and better aware of their particular desires and tolerances, and will therefore produce better results than the federal government, or that experimentation by states, letting fifty flowers bloom as it were, will produce at least some very good regimes that can then be adopted more widely. But given the experience of how state regulators operate, and the reasons, discussed above, to be skeptical of the potential for any effective electoral check on regulatory excess at the state level, it's hard to fault congressional Republicans for concluding that preemption by the SEC of Spitzer and his colleagues would be a good thing.

When Federalism?

The classic example of an area in which competitive federalism can work is taxation. To the extent that individuals and businesses are able to move themselves or their economic activity from one jurisdiction to another in response to differing levels of taxation, states (and nations) are forced to compete for tax revenue by lowering taxes, just as businesses compete for revenue by lowering prices. Crucially, each individual, transaction or stream of income is most often taxed by only one jurisdiction at a time, and taxes can be such a substantial factor that the benefits of switching jurisdictions based on taxation will often outweigh the costs of switching. These same competition-promoting factors also serve to inhibit the ability of regimes to form a cartel, although, like businesses, many of them would like nothing better than to do so.[9] In fact, shifting taxing authority and spending responsibility from the states to the federal government is equivalent to the formation of a cartel: a single "supplier" of services and tax policy replaces competing suppliers, and like a cartel or monopoly is insulated from the discipline of the market.

The benefits of federalism for improving taxation policy can be enhanced by reforms that base taxation on factors that can be easily changed or manipulated by the subjects of taxation. For example, as Greve has pointed out,[10] allowing states to tax internet sales based on the location of the seller would be far superior to a system in which such sales were instead taxed based on the location of the buyer, since sellers will typically have far greater incentive and ability to change jurisdictions than will buyers. It's true that, for businesses that operate nationally or globally, a proliferation of taxing regimes will increase compliance costs. But any likelihood of real competition among states with respect to tax policy would result in any such costs being dwarfed by the benefits of the lower tax burden that devolution of taxing and spending authority would provide.

Similarly, corporate law, and contract law in general, provide an example of federalism that has been, on balance, successful. Because an entity can choose its jurisdiction of organization and have that choice respected by most other jurisdictions, there is real competition among states and foreign governments to produce corporate law and corporate forms that will be attractive to incorporators or to existing entities looking to reincorporate. The way Delaware markets its corporate law, and the way the Delaware Division of Corporations interacts with its "customers," for example, is far closer to what we typically expect from a private firm than to what we expect from a bureaucracy. As a result, corporate law is shaped to appeal to those who are subject to it.[11] Similarly, because most jurisdictions will recognize a choice of law by sophisticated parties to govern a contractual relationship, cross-border transactions can take advantage of a known commodity like New York or English law and limit their inquiry into other local laws to the question of whether their choice of law will be observed, passing over substantive contract law entirely. Because a jurisdiction does not necessarily benefit directly from having parties choose to be governed by its contract law, the incentive for states to improve contract law is not as great as the incentive to improve tax or corporate law. Even so, since there is no appreciable benefit to having only a single contract law, the benefit of experimentation alone, even without competition, should be enough to justify leaving contract law to the states.

When Harmonization or Preemption?

Like securities regulation in its current form, other areas of business law in which federal preemption or harmonization of state laws appears desirable from the standpoint of governance and economic efficiency[12] tend to be characterized by a lack of realistic choice among regimes on the part of regulated entities. For example, if each state is going to have a mandatory standard for validity and perfection of security interests that it applies to debtors and/or collateral within its borders, better that each state have the same standard, as in the case of Article 9 of the UCC, than that there be fifty different standards, as in the case of priorities in real estate. Moreover, because such laws govern intercreditor disputes in addition to creditor/debtor issues, there is no practical way for the involved parties to choose a law. In such a case, the best solution is likely to be a single standard, arrived at either through harmonization of state laws, as with the UCC, or through federal preemption.[13]

Regulation of industries that operate in a national market, such as telecommunications regulation, much of antitrust, or energy, provide another instance in which regulation by local jurisdictions would tend to be cumulative, rather than competitive, because such regulation is based on operation within the jurisdiction of the regulator, rather than on the choice or home jurisdiction of the regulated entity. Indeed, the securities industry can be considered as part of this category. This cumulative regulation is why proponents of deregulation and smaller government often support transfers of authority to regulatory agencies such as the FCC or FTC at the expense of state regulators.

Conclusion

The reason that Spitzer's criticism is poorly founded, then, is that federalism is a means, and not an end. The end is regulation that is more efficient and less burdensome to economic actors, and less detrimental to liberty. If devolution were good at all times and places, then presumably we would not have a federal government at all. Unless you are a bureaucrat or politician in one or the other, there is little reason to support the states against the federal government, or the federal government against the states, in all circumstances: both are tools to be used to keep the other in check and perform the tasks for which they are best suited. Because it happens that the states are best positioned to tax and spend on social programs, while the federal government is best positioned to provide any mandatory regulation of securities offerings, the contrast cited by Spitzer as an example of hy-

pocrisy is in fact consistent with the principle of free enterprise and small government. This point is poorly understood by the public at large, and appears to be poorly understood even by many of the very politicians who practice it but seem incapable of explaining the apparent contradiction, and are therefore forced to retreat from a beneficial reform. If they are to avoid being painted as latter-day Calhouns at best and corrupt hypocrites at worst, it would be well for leaders who preach federalism to understand it.

Footnotes

[1] Proposed Rule: Defining the Term "Qualified Purchaser" Under the Securities Act of 1933, Release No. 33-8041,17 C.F.R. pt. 230 (Dec. 19, 2001).

[2] *As quoted in* E.J. Dionne Jr., *Defending States' Rights—Except on Wall Street*, Wash. Post, July 22, 2003, at A17.

[3] *E.g.*, Michael S. Greve, Real Federalism: Why it Matters, How it Can Happen (1999).

[4] …Please! *Cf.* Henny Youngman, Take My Wife, Please!: Henny Youngman's Giant Book of Jokes (1998).

[5] The latter response can be seen on an international level in the frequent offerings that are made available to investors virtually everywhere except the United States by firms that don't want to expend the resources necessary to comply with U.S. securities regulation. The SEC's reputation at home as a lax regulator is not shared abroad.

[6] Ironically, effective federalism will often require harmonization of choice-of-law rules across competing jurisdictions.

[7] Stephen J. Choi and Andrew Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. Cal. L. Rev. 903 (1998).

[8] Roberta Romano, The Advantages of Competitive Federalism for Securities Regulation (2002).

[9] *See, e.g.*, Organisation for Economic Co-operation and Development, Harmful Tax Competition: An Emerging Global Issue (1998).

[10] Michael Greve, *Yes, Tax the Net*, Weekly Standard, May 15, 2000.

[11] That is, to those who have control over the entities organized under such law. How to deal with the agency costs inherent in dispersed ownership of such entities, and the resultant possibility that corporate law is serving the interests of managers rather than shareholders, is an important but distinguishable issue; the point here is that it is the preferences of the regulated, and not of the regulators, that are being served.

[12] Whether federal preemption complies with Constitutional limitations on the federal government's powers, although undoubtedly an important question, is beyond this article's scope.

[13] This analysis would arguably not apply to purely contractual portions of the UCC, such as Article 2 (Sales). Contracting parties are capable of choosing the law to apply to a sales transaction, and federalism would presumably provide at least the benefit of experimentation and natural selection, if not competition. However, to the extent that contract law is default law that applies only when an alternative governing law has not been chosen, a uniform default law will reduce costs, which may offset the benefit of experimentation.