Legal Backgrounder

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# STATE-FEDERAL COOPERATION ON SECURITIES ENFORCEMENT ESSENTIAL TO INVESTOR PROTECTION

by

Timothy Hoeffner and Kristin Calabrese

On August 27, 2003, Oklahoma Attorney General Drew Edmondson filed criminal charges against WorldCom, Inc., former CEO Bernard Ebbers, and five additional former employees,[1] alleging fifteen violations of the Oklahoma Securities Act. The institution of this state lawsuit in the face of an ongoing federal investigation of the same conduct by the same parties marks a disturbing trend of state regulators getting in front of federal regulators in attempting to prosecute securities fraud. As explained below, such conduct negatively impacts businesses and investors in national securities markets for the following two reasons: (1) it undermines the equality and clarity of process promoted by national regulation of securities; and (2) it could impede federal investigations. In light of these concerns, although states have a clear right to investigate and prosecute fraud under the federal securities laws, where a lawsuit has national implications, the state investigation and prosecution should be coordinated at the federal level.

***The Importance of Uniform Standards***. A consistent, national set of securities standards protects both businesses and investors from disparate treatment of securities transactions by individual states. Compliance with one set of uniform disclosure requirements benefits companies whose shares are listed on a national exchange by enabling them to avoid the cost and confusion of compliance with requirements of different states that might in some circumstances conflict. Investors also benefit from national securities laws, which, in the words of Securities and Exchange Commission ("SEC") Chairman William Donaldson in a September 14, 2003 speech to the NASAA Annual Conference, allow investors to "rest assured that their state of residence will not determine the volume or quality of information to which they have access or the standards to which their broker is held." In this way, national regulation adds a significant level of equality and clarity to the process of buying and selling securities.

[1]Scott Sullivan, David Myers, Buford Yates, Jr., Betty Vinson and Troy Normand.

**Timothy Hoeffner** is a partner, and **Kristin Calabrese** is an associate, with the law firm Saul Ewing LLP in its Philadelphia office.

Both the legislative and judicial branches have recognized the significance of a national securities market in providing structure and consistency to the issue and sale of securities. The Supreme Court emphasized the importance of nationally-focused securities regulation in *Edgar v. Mite*, 457 U.S. 624 (1982). In this landmark decision, the Court held the Illinois Business Takeover Act unconstitutional under the Commerce Clause based on its direct and indirect regulation of interstate tender offers. *Id*. at 640. In striking down the Act, the Court stated that, "if Illinois may impose such regulations, so may other States; and interstate commerce in securities transactions generated by tender offers would be thoroughly stifled." *Id*. at 642.

In a similar vein, Congress passed the National Securities Markets Improvement Act (NSMIA) of 1996, which created a national system of securities regulation by preempting state regulation of securities that are listed or authorized for listing on the New York Stock Exchange, American Stock Exchange, or the National Market System of the Nasdaq Stock Market. As Representative Thomas J. Bliley, Jr. explained the impetus behind the NSMIA: "In the past, disparate regulatory treatment of [national securities markets] by State laws has unnecessarily hindered the competition that improves the markets for investors. This legislation is designed to provide a level playing field for those markets by eliminating unnecessary State regulation. . . ." H.R. CONF. REP. on H.R. 3005, Nat'l Securities Markets Improvement Act of 1996 (1996).

While the NSMIA preempted state regulation of securities registrations and offerings, it preserved state authority to "investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions." § 102(c)(1). The drafters undoubtedly recognized the strong interest of the states in protecting their businesses and citizens from the effects of fraud. However, while state investigation of securities fraud often serves legitimate interests, difficulties stem from balancing the rights of states to investigate fraud involving companies with nationally-registered securities with the goals of equality and clarity of process sought to be achieved by regulating securities at the national level.

As SEC Chairman Donaldson explained in his NASAA speech, in combating fraud, the SEC should act as rulemaker, and the states as enforcers. A unilateral decision by a state attorney general to bring suit for state criminal charges in a case where a similar investigation is already underway at the federal level wreaks havoc on this model, because the actions of the state in this circumstance could have rulemaking consequences. For example, in approving a settlement of claims by the SEC against WorldCom, the Commission reduced the penalty paid by WorldCom in recognition of the significant remedial measures implemented by WorldCom following the discovery of potential misconduct. *SEC v. WorldCom, Inc*., 273 F. Supp. 2d 431 (S.D.N.Y. 2003). Thus, the Commission is utilizing the proceedings against WorldCom to send a message to the markets that, in considering the appropriate penalties to pursue against a corporation, the Commission will take into consideration remedial measures implemented by a corporation. If Oklahoma imposes its own prosecution and remedies on WorldCom, and these remedies are harsher than the remedies imposed by the federal government — i.e., criminal sanctions — the state action contradicts the federal policy of rewarding corporations that promptly respond to wrongdoing. Therefore, the implications of the state court proceeding would be national in breadth. The uniformity of a national market, and its consequent benefits to businesses and investors, are lost when state investigations of nationally-registered securities are allowed to exist apart from federal standards.

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***Interference with Federal Investigations***. A major concern of those involved in the current federal investigation of WorldCom and its executives is that separate proceedings, or even the threat of separate criminal proceedings, by state governments will impede cooperation with the federal investigation of these parties based on the same transactions. For example, SEC Chairman Donaldson had the following harsh words for Attorney General Edmondson:

> The failure of the Oklahoma attorney general to inform federal officials, who had been actively investigating the WorldCom fraud, runs the risk of undermining the federal prosecutions — raising the possibility that those most deserving of prosecution could slip through the net — and without any meaningful incremental benefit to investors. . . . It is my hope that the Oklahoma Attorney General's actions will not jeopardize the criminal cases being prosecuted by the U.S. Attorney's Office or our ongoing investigations.

Speech to NASAA Annual Conference, Sept. 14, 2003.

Without cooperation by key WorldCom employees, it is difficult for any government, federal or state, to build a case against senior officers of the company or to punish those most deserving of prosecution. WorldCom has to-date been cooperating with investigators, and ex-executives David Myers, Buford Yates, Jr., Betty Vinson and Troy Normand have pled guilty to federal charges and are assisting the federal investigation. Each of these individuals is named as a defendant in the Oklahoma prosecution. Cooperation with federal authorities is often agreed to in exchange for promised or expected leniency. Where the possibility of a criminal trial in a separate state lawsuit remains despite a reduction in federal charges, there is less incentive to cooperate with federal investigators. As David Schertler, a lawyer for Mr. Yates, is quoted as saying:

> There are a lot of cases like this now and there are going to be more and every time a person is thinking about cooperation and assisting, he has to wonder about one or 50 states. . . . This will have a chilling effect on their willingness to enter into cooperation agreements.

Mark Hamblett, *Comey is "Disappointed" Over WorldCom Charges; Implies Oklahoma Action Could Hinder His Investigation*, N. Y. LAW JOURNAL, Aug. 28, 2003, at 1.

A further concern of federal investigators is that state lawsuits may compromise a federal investigation by sacrificing thoroughness for speed. For example, in the course of a typical investigation, it is a slow process to obtain cooperation from lower level employees, and then to work up within the organization to obtain the cooperation of more senior employees who are more likely to be in a position to provide evidence concerning the possible participation in misconduct of senior officers. If the Oklahoma criminal case proceeds against Bernard Ebbers before the government is able to obtain the cooperation of more senior individuals within WorldCom who could testify in support of the prosecution, the state may not be in a position to present the strongest case possible against Mr. Ebbers. Defendants in any subsequent federal criminal prosecution will then benefit from the preview of the witnesses' testimony afforded by the state prosecution. As a result, the effectiveness of potential witnesses in the federal case could be impaired by their testimony in the Oklahoma proceeding. Also, the state prosecution, regardless of the outcome, forces the federal prosecutors to satisfy the requirements of the Justice Department's "Petite Policy"

before seeking to prosecute an individual who has already been tried in state court. *See* U.S. Attorney's Manual § 9-2.031.

In addition to creating procedural hazards, federal-state in-fighting undermines public confidence in the investigation and prosecution of securities fraud. In the words of Chairman Donaldson, "If it appears that each of us cares more about getting there first than getting it right, the public will question the fairness and integrity of our processes – and that's something none of us can afford."

State regulators who go forward with proceedings without coordinating with the federal regulators also create the appearance that their actions are politically motivated. Many state prosecutions are brought by elected officials who are inspired to play to their constituencies. By bringing an action in a high profile securities case, it is easy for the state official to use the case as a political tool to demonstrate that he or she is seeking to protect the local constituents. In contrast, the focus of the SEC is to protect and remedy harm to investors, regardless of the location of these investors or the name of the offending company. Therefore, when investigations are coordinated at the national level by the SEC, the interests of investors, businesses, the securities industry and the public at large are less likely to be manipulated for political gain.

***Conclusion: Coordination Between State and Federal Governments is Key to Success***. Without a cooperative effort, both federal and state investigations are undermined. The need for investor protection is therefore better met by one nationally-organized investigation, with assistance from the states, than by multiple lawsuits that undermine the likelihood of conviction. What does coordination between state and federal governments entail? It means that while states may protect investors through vigorous enforcement of their securities laws, "when states initiate actions that would have a 'rulemaking consequence,' then a state has 'an obligation to go to the SEC to get the SEC involved to ensure that there is uniformity in the capital markets."[2] Chairman Donaldson has noted that active participation at both the state and federal levels worked to positive effect in recent cases, and in the last two years, the SEC has publicly recognized the assistance of fourteen states in twenty different enforcement actions. A notable example is the coordinated investigation of securities analysts, which involved the SEC, NASD and New York State Attorney General's office. Therefore, a balance between state and federal involvement in investigations can and has been achieved in recent prosecutions.

The WorldCom investigation would benefit from a similar cooperative effort. If, indeed, Attorney General Edmondson believes Oklahoma state action can advance the interest of combating securities fraud by providing resources that the federal government cannot, his best option is to assist and join forces with the federal investigation. Indeed, according to an October 29, 2003 article in the *Wall Street Journal*, Mr. Edmondson has now acknowledged the need to coordinate the WorldCom cases to serve the "best interest of justice." However, the failure to coordinate investigations prior to indictment could still create a problem if Mr. Ebbers or other criminal defendants seek a "speedy trial" and force the Oklahoma case to proceed before the government is fully prepared to present its case. State regulators should take note of the WorldCom case and in the future seek to better coordinate with federal regulators.

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[2]This language was originally used by New York Attorney General Elliot Spitzer in a June 2003 program before the SEC Historical Society. SEC Chairman Donaldson quoted Spitzer in his September 14, 2003 speech before the NASAA Annual Conference.

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