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Order Flow Cases: Jurisdiction, Preemption and Securities Laws

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Primary jurisdiction and preemption issues arise in securities class action litigation when alleged violations of state law arise from conduct that is either explicitly or implicitly regulated by the federal securities laws.

These are two distinct theories: one is a matter of administrative law and judicial economy (primary jurisdiction); the other is a matter of constitutional law involving the Supremacy Clause (preemption). To date, there has not been extensive case law involving preemption and the federal securities laws (other than in the blue sky and tender offer areas) and there has been almost no case law on primary jurisdiction and the federal securities laws.

This article discusses these issues in the context of the order flow cases.[1] In the eight ongoing order flow cases pending in state courts in Illinois, Massachusetts, Minnesota and New York, the plaintiffs have challenged the practice of certain broker-dealers that make monetary and non-monetary payments to retail brokers, particularly discount brokers, for the purpose of inducing the retail brokers to send orders to the defendants for execution.[2]

The order flow cases provide a good way to examine the preemption and primary jurisdiction issues because they have begun to generate a body of case law.

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.[3]

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 and then by some regional specialists.[4] The Securities and Exchange Commission believes that some integrated broker-dealer firms may now be paying for order flow. The amount paid per share for an order is relatively small, one or two cents per share, although the aggregate amounts can be high as between 15 percent and 20 percent of the order flow in listed stock is routed pursuant to cash payment arrangements.

Payment for order flow has been the subject of extensive study by the SEC,[5] NASD and other self-regulatory organizations,[6] the Congress[7] and legal and financial academics.[8] A series of alleged problems involving the structure of the securities markets,[9] state agency law and the federal securities laws have been identified by these commentators. The result has been the recent promulgation by the SEC of new disclosure standards for payments for order flow.

The SEC decided to mandate a three tier approach to disclosure.[10] In a companion release[11] to the one promulgating the new rules and amendments, the SEC proposed rules to further broaden the amount of disclosure.

Order Flow Cases

The complaints in the order flow cases primarily have utilized state law causes of action.[12] The plaintiffs, customers of the defendant brokerage firms, have relied on almost identical legal theories alleging breach of the fiduciary duty owed to the plaintiffs, as principal, by the defendant, as agent, and fraud upon the plaintiffs.[13]

The plaintiffs' claim that the defendants have violated a fiduciary relationship has turned on the key issue of whether the plaintiffs consented to payments for order flow made to the defendants.[14] The nature and quality of the disclosure made to the plaintiffs by the defendants are crucial in determining whether consent has been given.[15]

The leading case has been **Dahl v. Charles Schwab & Co.**[16] The trial court's decision to dismiss the complaint in **Dahl** on both preemption and primary jurisdiction grounds has been the basis for the dismissal decision in New York.[17]

Dahl was decided upon defendant's motion for summary judgment. The trial 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.[18]

The trial court noted that the practice of paying for order flow was permissible and lawful under the federal regulatory scheme. Without discussing the legislative intent behind the Exchange Act, the 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.

Having held that Minnesota law was preempted by federal law, the trial court could have stopped its analysis. Instead, it moved on the different theory of primary jurisdiction. Relying on **Gordon v. NYSE,**[19] the trial court held that the practice of paying for order flow is uniquely within the competence of the SEC and, therefore, that the SEC should resolve the underlying issues raised by payments for order flow.

Minnesota's Court of Appeals, the intermediate appellate court, reversed.[20] The three judge panel distinguished the separate issues of preemption and primary jurisdiction more clearly. On the preemption issue, the panel first examined whether there was a specific conflict between either Minnesota's blue sky law[21] or its common law of agency and federal law.[22] Finding that the only federal regulation currently in effect concerning non-commission compensation is found in SEC Rule 10b-10(a)(7)(iii), the panel held that there was no conflict because both state and federal law could be complied with simultaneously.

The court 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.[23]

Without clearly stating what the Congressional purpose might be, the panel reasoned that requiring more disclosure, for which the plaintiffs were arguing, would not affect the operation of the securities market. In fact, the court said such additional disclosure would serve a basic purpose of the federal laws and regulations, namely full, and fair disclosure to purchasers of securities.'[24]

After dealing with the preemption issue, the panel examined the primary jurisdiction question. It noted that the SEC had not yet specifically regulated payments for order flow, which distinguished **Dahl** from the **Gordon** case; therefore, the panel concluded that the doctrine of primary jurisdiction did not apply.[25]

In a footnote, the court specifically stated that its opinion did not reach the effect of the new SEC rules on the preemption issue.[26] Similarly, in its discussion of the primary jurisdiction issue, it 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.[27] Thus, the decision of the Court of Appeals in **Dahl** will not have much precedential value on the preemption and primary jurisdiction issues in any cases that challenge payments for order flow on state law grounds after the effective date of the new SEC rules.[28]

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 concern an agency's expertise and the need to insure that a uniform national regulatory scheme is not unduly interfered with.[29] The fourth factor has to do with the need or insuring a timely resolution of the dispute.[30]

In arguing for the SEC's primary jurisdiction in the payment for order flow cases, the defendants' principal claim has been that the SEC should have primary jurisdiction because of its special expertise in this area. There are at least two problems with this argument.

First, the defendants must identify why the special expertise of the SEC is needed in these cases. Only if intricate and technical facts are involved would a deferral to the SEC be appropriate.[31] The lack of such facts combined with the traditional expertise of courts in cases involving fraud may explain why primary jurisdiction is rarely raised in most securities fraud cases.[32]

In fact, SEC investigations of violations of the federal securities laws and private civil actions currently proceed simultaneously on a regular basis. It is difficult to square applying the primary jurisdiction argument with the wider implications that this application would have. This is especially so because the SEC's decisions on whether to proceed with an investigation often are based on such factors as staff resources and public policy, which should not determine whether any civil plaintiff or plaintiff class receives a prompt hearing of its complaint.

Second, insofar as the primary jurisdiction doctrine may be stretched to cover situations in which the rule making, rather than the adjudicatory, function of the pertinent regulatory agency is involved, there is no need to defer until the SEC has considered and acted upon the issues involved in payments for order flow. The SEC has already acted in this area.[33]

The doctrine of primary jurisdiction should be applied sparingly with respect to the federal securities laws and the SEC. Especially where the SEC's rule making capacity rather than its adjudicatory capacity is most implicated. A court can always request the SEC to submit an amicus brief, which normally should serve substantially the same purposes as a referral of the initial decision making to the SEC.[34]

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,[35] they ignore that the SEC has complete discretion in deciding whether to take action upon any complaint.[36]

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.**[37] The Court, in an opinion written by Justice Antonin Scalia, carefully delimited the reach of federal preemption.

The Court initially turned to FIRREA as the relevant federal statute and went through a two step analysis. First, it looked for an explicit statutory provision dealing with the issue of displacement of state law and found no such provision. Second, it examined the scope of FIRREA and found it to be a comprehensive and detailed statute. The Court held that it would not create federal common-law to supplement such a statutory scheme. 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 the state law.[38]

As FIRREA was enacted after the FDIC became receiver of the pertinent failed S&L, the Court continued by asking whether assuming the inapplicability of FIRREA[,] this is one of those case in which judicial creation of a special federal rule would be justified.[39] The Court noted that situations in which the creation of such a special federal rule are 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.'[40]

In examining the federal policies or interests identified by the FDIC as supporting such a special federal rule, the Court used language casting doubt on whether the interest in uniformity would ever alone be sufficient to warrant the creation of federal common law. The Court found that, since the FDIC was acting in a unique capacity as a receiver and not as the U.S. government or one of its agents or contractors, [t]here is not even at stake that most generic (and lightly invoked) of alleged federal interests, the interest in uniformity.

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.[41] The desire of the FDIC to eliminate uncertainty in its nationwide litigation did not qualify as a legally cognisable interest in uniformity, sufficient to preempt state law, otherwise we would be awash in federal common-law rules.[42]

Applying the Test

In most areas, the Exchange Act does not explicitly preempt state law. In fact, 28(a) of the Exchange Act preserves state law rights and remedies.[43] In addition, no provision of the Exchange

Act or the rules promulgated thereunder, including 10(b) or 11A, explicitly displaces state law with respect to claims arising as a result of the practice of payments for order flow.

The explicit preemption required pursuant to the **O'Melveny** statutory analysis is, therefore, not currently met. When and if the new SEC rules become effective on Oct. 2, 1995, a stronger argument for preemption will be available to future defendants. The issue will then be whether the new SEC mandated disclosure standards explicitly preempt the state agency law requirements for consent by principals if their agents make profits from transactions conducted on behalf of the principals.

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 duty of agency, which obligates an agent to act exclusively in the principal's best interest.[44]

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. Indeed, one of the options considered and rejected by the SEC was a complete ban upon payments for order flow.[45] Thus, the stage has been set for broker-dealers to argue that, by negative implication, the SEC has approved payments for order flow which are made consistently with its disclosure requirements and that its new rules preempt any state regulation of these payments.

The regulatory scheme under the Exchange Act is the sort of comprehensive and detailed scheme described by the **O'Melveny** Court in the second step of its statutory analysis.[46] Applying **O'Melveny,** state agency law would still survive in the area of payments for order flow because such state law is to be employed to plug holes in otherwise comprehensive federal schemes.

The third step in the **O'Melveny** analysis, whether there is a significant conflict between federal policy or interest and the use of state law, should not be determinative in any future payment for order flow cases. The brokerage industry does have grounds for making a stronger argument on the uniformity issue than the FDIC made in **O'Melveny** because the SEC is a federal agency and has a mandate to establish a national market system.

But this argument suffers from at least two major problems. First, this third step was applied in **O'Melveny** only because the pertinent federal statute did not apply to the defendant's actions, which will not be the situation in any such future cases.

Second, it is hard to identify the overriding federal interest that applying state agency law to payments for order flow will frustrate. In several cases, potential conflicts between the federal securities laws and state agency law have been raised and the courts have rejected the preemption argument.[47]

Conclusion

The doctrine of primary jurisdiction has minimal application to the payment for order flow cases. The SEC already has studied the issue of payments for order flow in great detail and provided its written conclusions. Insofar as additional guidance from the SEC would be useful, the courts should seek amicus briefs from the agency.

The brokerage industry will have a strong preemption argument once the new SEC rules are effective; however, in the post-**O'Melveny** environment, where clear evidence in a statutory or regulatory scheme of Congressional intent to preempt is necessary, the industry would be wise to seek a clearer statement of the SEC's intent to preempt state laws and its reasons therefore.

The industry still has such an opportunity with respect to the companion release.[48] If it does not get 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 have only itself to blame if additional payment for order flow cases are brought.

End Notes

1. There have been several recent class actions involving other areas of the federal securities laws in which these preemption and primary jurisdiction issues also have arisen including **Rosenfeld v. Bear Stearns & Co.,** No. 110812-93 (Sup.Ct. N.Y. County filed Aug. 13, 1993), and **In re: NASDAQ Market-Makers Antitrust Litigation,** No. 94 Civ. 3996 (SDNY filed Dec. 16, 1994).

2. Rachel S. Witmer, Investors' Actions Against Brokers Seek Return of Cash Paid for Order Flow, 26 **Sec. Reg. & Law Rep.** 590 (April 22, 1994); Steve Bailey, Investor Suits Hit Payments to Brokers by Market Makers, **Boston Globe,** Sept. 29, 1994, at 37. 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).

3. Release No. 34-33,026, 58 Fed. Reg. 52,934, 52,935-36 (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.

4. Id. at 52,936.

5. See, e.g., Division of Market Regulation, SEC, Market 2000: An Examination of Current Equity Market Developments 22, 23 (1994); 58 Fed. Reg. 52,934; Release No. 34-30,920, 57 Fed. Reg. 32,592, 32,596 (1992) (requesting comments from interested parties on many issues involving the equity market, including payments for order flow).

6. See, e.g., Inducements for Order Flow, A Report to the Board of Governors National Association of Securities Dealers Inc. (1991); Brandon Becker, Christine A. Sakach and 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 Midwest Stock Exchange activities).

7. Hearings on Inducements for Order Flow Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce (May 13, 1993).

8. See, e.g., Note, supra note 2 (citing to legal and financial academic articles as well as independently discussing issues); John C. Coffee Jr., Brokers and Bribery, **NYLJ,** Sept. 27, 1990, at 5 (pioneering article on payments for order flow).

9. This article does not discuss these structural issues, although they have been influential in motivating SEC studies that have led to the regulatory initiatives mentioned at the text accompanying infra notes 10 and 11. See 58 Fed. Reg. at 52,939.

10. Broker-dealers will be required to provide certain information at the time an account is opened, annually thereafter, and on the transaction confirmation. 59 Fed. Reg. at 55,006. The effective date for the new rules has been delayed from April 3, 1995 to Oct. 2, 1995. Release No. 34-35, 473, 60 Fed. Reg. 14,366, 14,367 (1995).

11. Release No. 34-34,903, 59 Fed. Reg. 55,014 (1994).

12. See, e.g., Complaint Class Action, **Guice v. Charles Schwab & Co.,** No. 94-100875 (Sup.Ct. N.Y. County filed Jan. 7, 1994).

13. In each complaint, there have been causes of action arising out of these theories unique to the pertinent state. See, e.g., Complaint, supra note 12, at 8-9 (causes of action under New York Penal Code 180.05 and General Business Law 352-c, the former dealing with commercial bribery and the latter with fraud).

14. Secondary sources discussing the state law agency problem cite to 388 of the Restatement (Second) of Agency, 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. See, e.g., Note, supra note 2, at 1684 n.68; Coffee, supra note 8, at 6.

15. In the other flow cases, this becomes 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). See **Dahl v. Charles Schwab & Co.,** No. Cl-94-1040, 1994 Minn. App. LEXIS 1237, at *3, 9 (Ct.App. Dec. 7, 1994).

16. **Dahl v. Charles Schwab & Co.,** Nos. 93-16272, 93-16360, 93-16383, slip op (Minn. Dist. Ct. April 7, 1994), rev'd, No. Cl-94-1040, 1994 (Minn. App. LEXIS 1237 (Ct.App. Dec. 7, 1994).

17. See **Guice v. Schwab,** No. 94,100875 at 5-6 (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 dismissal of the **Guice** action). The plaintiffs in **Guice** have filed an appeal.

18. **Dahl v. Charles Schwab & Co.,** Nos. 93-16272, 93-16360, 93-16383, slip op. at 4 (Minn. Dist. Ct. April 7, 1994).

19. 422 U.S. 659 (1975).

20. **Dahl,** supra note 16.

21. Minn. Stat. 80A.06 (5) (1992).

22. **Dahl,** supra note 16, at 8-9.

23. Id. at 10.

24. Id. (quoting **El Khadem v. Equity Sec. Corp.,** 494 F2d 1224, 1227 (9th Cir.), cert. denied, 419 U.S. 900 (1974)).

25. Id. at 12.

26. Id. at 7 n.3.

27. Id. at 12.

28. **Dahl** has been appealed by the defendant.

29. Kenneth Culp Davis & Richard J. Pierce Jr. II, **Administrative Law Treatise.** (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.).

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

31. Cf. **Curran v. Merrill Lynch, Pierce, Fenner & Smith Inc.,** 622 F2d 216, 236 (6th Cir. 1980) (discussing **Ricci** and **Deaktor** and refusing to apply primary jurisdiction doctrine to fraud action under Commodities Exchange Act), aff'd on other grounds, 456 U.S. 353 (1982).

32. 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).

33. See text accompanying supra notes 3-5 and infra notes 44-45; cf. Davis & Pierce, supra note 29, 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.).

34. The SEC has been closely following the payment for order flow cases. 59 Fed. Reg. at 5 n.10 (citing to the pending litigation concerning payments for order flow).

35. Defendant's Reply Memorandum in Support of Its Motion to Dismiss or Stay, **Guice v. Charles Schwab & Co.,** No. 94-100875, at 6 n.2 (Sup.Ct. N.Y. County April 21, 1994).

36. See **Gordon v. SEC,** 1980 Fed. Sec. L. Rep. (CCH) 97,628 (N.D. Ga. Aug. 21, 1980) ([T]he SEC's decision to refrain from conducting an investigation is not subject to judicial review.), aff'd, 645 F2d 70 (5th Cir.), cert. denied, 340 U.S. 1033 (1981), reh'g denied, 454 U.S. 116 (1982).

37. 114 S.Ct. 2048 (1994).

38. 114 S.Ct. at 2054. In effect, the 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 Lawrence H. Tribe, **American Constitutional Law** 497-501 (2d ed. 1988). 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.

39. 114 S.Ct. at 2055.

40. Id. (quoting **Wheeldin v. Wheeler,** 373 U.S. 647, 651 (1963), and **Wallis v. Pan American Petroleum Corp.,** 384 U.S. 63, 68 (1966)) (citations omitted).

41. Id. at 2055 (citation omitted).

42. 114 S.Ct. at 2055.

43. The plaintiffs in the order flow cases rely upon 28(a) of the Exchange Act, which provides that [t]he 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 15 USC 78bb(a) (1988). In and of itself, such a savings clause does not answer the preemption issue as to any particular provision of the federal securities law and the allegedly conflicting provision of state law in the third step of the **O'Melveny** analysis, which deals with direct conflicts between federal policy and state law. See Note, Pre-emption as a Preferential Ground: A New Canon of Construction, 12 **Stan. L. Rev.** 208, 211-15 (1959).

44. 59 Fed. Reg. at 55,009 n.28. The SEC went so far as to discuss 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. 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.

45. Id. at 55,011.

46. The fact that this is a regulatory scheme rather than a statutory one should not affect the analysis. Cf. Tribe, supra, note 38, at 498 n.11.

47. See, e.g., **Commerford v. Olson,** 794 F2d 1319, 1322-23 (8th Cir. 1986) (holding that section 20 of the Exchange Act, providing for controlling person liability, does not preempt state agency law). But see **Hatrock v. Edward D. Jones & Co.,** 750 F2d 767, 777 (9th Cir. 1984) (holding that controlling person liability under 20 supplants liability understate common law of respondeat superior).

48. Supra note 11.