A CALL FOR ACTION: AN ANALYSIS OF THE IMPENDING REGULATORY CRISIS IN THE MUNICIPAL SECURITIES MARKET

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INTRODUCTION

The current municipal securities market does not resemble its reputation as a “sleepy market.” In 2010, there was nearly $500 billion of municipal securities issued, with an additional $3.35 trillion traded through secondary market

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2. Statistics for 2010 show that there was $433.27 billion in long-term municipal bond issuances and $66.32 billion in short-term municipal note issuances. BOND BUYER, THE BOND BUYER’S 2010 IN STATISTICS 3A (2011) [hereinafter BOND BUYER 2010 STATISTICS], available at
transactions. Due in part to the creation of Build America Bonds, the municipal securities market is as large as it has ever been with nearly $3 trillion in securities outstanding. Moreover, a market once characterized by its simplicity and homogeneity now involves complex variable rate reset securities and sophisticated derivative instruments. Even more startlingly, retail investors now comprise nearly 70% of municipal securities investors.

In addition, the integrity of this market has never been more important. Traditionally, state and local governments have relied on municipal securities as a low-cost capital to implement important public interest projects. In 2010 alone, the market raised over $210 billion for projects related to education, healthcare, and transportation. Increasingly though, state and local governments are relying on these securities to plug budget shortfalls. Consequently, this market is closely intertwined with the ability of state and local governments to satisfy labor costs, and meet long-term healthcare and public pension obligations.

Therefore, considering these developments, it is particularly alarming that industry analysts forecast that the municipal securities market is likely to experience an unprecedented increase in defaults. The most prominent critic has

4. Build America Bonds (“BABs”) were created through the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (codified in scattered sections of the U.S.C.). BABs were taxable municipal bonds in which the federal government provided municipal securities issuers with a “direct interest subsidy or a comparable tax credit.” Bond Buyer 2010 Statistics, supra note 2, at 2A. The program existed for twenty-two months and ended when it was allowed to expire at year’s end in December 2010. Id. For a more detailed description of the program, see id. at 2A, 17A.
8. See infra Part I.
9. Bond Buyer 2010 Statistics, supra note 2, at 3A.
11. See infra Part III.


Meredith Whitney will again garner attention in November 2012 when she is expected to release a book that makes similar arguments regarding the likelihood of defaults in the municipal securities market. See Kevin Roose, *Meredith Whitney Lands Book Deal*, N.Y. TIMES DEALBOOK (Feb. 21, 2012, 6:10 PM), http://dealbook.nytimes.com/2012/02/21/meredith-whitney-lands-book-deal/.


result of the Tower Amendment, a unique regulatory regime has evolved that does not regulate the issuers of municipal securities. Instead, the “backdoor” regime regulates the brokers, dealers, and underwriters who typically interact with the issuers. The question of the adequacy of this regime has taken on additional importance as the Securities and Exchange Commission (“SEC”) has grown increasingly vocal about its desire to repeal the Tower Amendment in order to implement an issuer-based regulatory regime. Moreover, a provision in the recent Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) mandated that the United States Government Accountability Office issue a report in July 2012 advising whether the Tower Amendment should be repealed.

This Article proceeds in five parts. Part I overviews the unique characteristics of municipal securities, in an effort to provide relevant background information on the market’s operations. Part II outlines the existing municipal securities regulatory regime, focusing most closely on the disclosure requirements and the regulatory impediments created by the Tower Amendment. Part III examines the regulatory inadequacies in the municipal securities market and makes the case that these inadequacies are largely the result of sparse regulatory enforcement. Part IV argues, though, that if the existing regulatory regime were enforced in court, then the Tower Amendment would likely render a significant aspect of the current

19. See infra Part II.


One of the most vocal critics of the Tower Amendment is SEC Commissioner Elisse B. Walter. She has pointedly stated:

I believe that the exemptions for municipal securities should be removed . . . and the Tower Amendment should be repealed.

. . . [A]ppropriate legislative change would allow the [SEC] to take important steps to improve the quality and availability of municipal issuer information to investors.

. . . [T]he [SEC] could [then] require that municipal issuers make available to investors offering documents and periodic reports that contain information similar, although not identical, to that required of issuers and offerings of corporate securities.


regulatory regime invalid. Finally, Part V proposes some specific regulatory improvements in response to this Article’s main contention that the existing state of municipal securities regulation is grossly unacceptable.

I. MARKET OVERVIEW

Municipal securities are unique debt instruments issued by state and local government units. Municipal securities operate like a loan because they represent a promise by the issuer to repay investors a stipulated amount of borrowed money, called the principal amount, along with interest according to a fixed schedule. Typically, municipal securities pay the investor predetermined interest-only payments until the security matures, at which point the issuer repays the investor the principal amount. In practice, investors often purchase municipal securities at a market rate price that differs from the security’s principal amount.

This Part provides only a brief overview of the municipal securities market by summarizing three important market idiosyncrasies. First, this Part outlines why issuers and investors participate in this market. Second, this Part characterizes some of the different types of municipal securities. Finally, this Part describes the unique role underwriters and financial advisors play in bringing municipal securities to market.

Municipal securities provide state or local governments with a source of low-


23. Municipal securities can be issued directly by state or local governments, or through related authorities or agencies. Securities Exchange Act of 1934 § 3(a)(29), 15 U.S.C. § 78c(a)(29) (2006 & Supp. IV 2010). Interestingly, municipal securities also include debt issued by “the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States.” 15 U.S.C. § 78c(a)(16) (defining the term “State”); id. §78c(a)(29) (defining municipal securities as “direct obligations of . . . a State”). The critical distinction is that municipal securities do not include debt issued by the United States Treasury and other federal agencies. Compare id. §78c(a)(29) (defining “municipal securities”), with id. § 78c(a)(42) (defining “government securities”).


25. The principal amount is sometimes referred to as the “par value” or “face amount.” MSRB GLOSSARY, supra note 7, Par Value.

26. TEMEL, supra note 7, at 1.

27. FIDELITY INVS., supra note 24. A municipal security matures at the date the principal amount becomes due and payable to the investor. MSRB GLOSSARY, supra note 7, Maturity. A municipal security that includes a redemption provision can become due and payable prior to the maturity date. For a brief overview of redemption provisions, see TEMEL, supra note 7, at 128-30.

28. The market rate price for a municipal security is influenced by interest rate risk and default risk. See THAU, supra note 24, at 25-50. For a discussion of these risks, see infra notes 42, 138 and accompanying text. For a brief overview of how municipal bonds are priced and quoted, see TEMEL, supra note 7, at 21-26.

29. TEMEL, supra note 7, is an excellent book on the municipal securities market.
cost capital because investors typically accept a relatively low rate of return when purchasing these securities. Investors are willing to accept a relatively low rate of return for two primary reasons. First, municipal securities have historically been low-risk investments because governments have reliable revenue sources for repayment. Second, the interest income received from municipal securities is frequently exempt from the investor’s federal and state income tax obligations. The federal income tax exemption applies so long as the security is issued by a state or local government unit to fund a permissible public interest purpose. In addition, most states provide a similar state income tax exemption to in-state investors. These tax exemptions are significant because they distinguish this market from the securities markets in which income is taxable. Thus, these tax exemptions act as a subsidy to municipal securities issuers because investors relieved from an income tax burden will accept a lower rate of return relative to an investment where they would have to pay income tax.


31. “Triple exemption” bonds are exempt from municipal, local income or other special taxes, in addition to being exempt from federal and state income tax. MSRB GLOSSARY, supra note 7, Tax-Exempt Bond.

32. Section 103 of the Internal Revenue Code, which is entitled “Interest on State and local bonds,” provides:

(a) Exclusion
Except as provided in subsection (b), gross income does not include interest on any State or local bond.

(b) Exceptions
Subsection (a) shall not apply to—

(1) Private activity bond . . . .

(2) Arbitrage bond . . . .


A private activity bond exists if the proceeds of a municipal securities issuance are used by one or more private entities. MSRB GLOSSARY, supra note 7, Private Activity Bond; see also I.R.C. § 141 (2006) (outlining the exact conditions for qualifying as a private activity bond). An arbitrage bond exists if a tax-exempt municipal securities issuance creates profit for the issuer because the proceeds are immediately invested in higher earning taxable securities. See MSRB GLOSSARY, supra note 7, Arbitrage; I.R.C. § 148 (2006) (outlining the exact conditions for qualifying as an arbitrage bond). For additional discussion of municipal securities and the federal income tax exemption, see TEMEL, supra note 7, at 210-14.


34. TEMEL, supra note 7, at 27 (“The principal characteristic that has traditionally set municipal securities apart from all other capital market securities is the federal tax exemption.”).

35. A study found Canadian provincial and municipal governments, which must borrow in an exclusively taxable market, are subject to significantly higher borrowing rates relative to their American
some support on both sides of the political aisle to reduce or even eliminate the federal income tax exemption provided to most municipal securities.\textsuperscript{36} Clearly, these proposals would have a significant impact on the municipal securities market because reducing this tax exemption would likely decrease investment and increase issuer borrowing costs.\textsuperscript{37}

Municipal securities can be characterized in many different ways.\textsuperscript{38} This Part examines three of the most significant classifications. First, municipal securities can be issued with different maturities.\textsuperscript{39} A common industry distinction characterizes municipal “notes” as having a maturity of one year or less, and municipal “bonds” as having a maturity greater than one year.\textsuperscript{40} Second, the interest rate used to calculate the investor’s interest payments can be either a predetermined fixed rate or a variable rate that adjusts based on market conditions.\textsuperscript{41} This is a significant factor because fluctuation in interest rates will affect whether a fixed rate municipal bond is more favorable to the issuer or the investor.\textsuperscript{42} Third, the government issuer’s source of repayment can vary. The most basic distinction is between “general obligation bonds” and “revenue bonds.” Repayment on general obligation bonds is made from the issuer’s general tax revenue; thus, repayment is guaranteed only by that issuer’s full faith and credit.\textsuperscript{43} Repayment on revenue bonds is made from and guaranteed only by a specific fund or source.\textsuperscript{44}

Lastly, underwriters and financial advisors play a unique role in bringing municipal securities to market. An underwriter acts as an intermediary between the

\begin{footnotesize}
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\item 37. See Hume & Temple-West, \textit{ supra} note 36.
\item 38. For example, this Part does not discuss that municipal securities can be classified according to maturity structure, issuer, price, rating, or purpose of financing. For an overview of different classifications and characterizations, see MSRB \textsc{ Glossary}, \textit{ supra} note 7, Bond, Note.
\item 39. The “maturity” date is the date when the principal amount of the municipal security becomes due and payable. \textsc{ Temel}, \textit{ supra} note 7, at 248.
\item 40. MSRB \textsc{ Glossary}, \textit{ supra} note 7, Bond, Note. \textit{Bat cf.}, \textsc{ Temel}, \textit{ supra} note 7, at 21, 34 (noting that short-term municipal notes usually have a maturity of thirteen months or less).
\item 41. The term “coupon” is often used to describe a municipal bond’s interest rate because historically a detachable paper coupon evidenced that the investor was owed an interest payment. MSRB \textsc{ Glossary}, \textit{ supra} note 7, Coupon.
\item 42. When interest rates change, a fixed rate investor may be receiving interest payments at a rate below or above where the market would currently pay. This dilemma is called “interest rate risk.” \textit{See Thau}, \textit{ supra} note 24, at 29-36.
\item 43. \textit{See Temel}, \textit{ supra} note 7, at 33. An example of a general obligation bond would be a city that issues a bond and guarantees repayment from its general collection of property taxes.
\item 44. \textit{See id.} An example of a revenue bond would be a transportation agency that issues a bond to build a bridge and guarantees repayment from the bridge’s toll collections.
\end{itemize}
\end{footnotesize}
issuer and investors in an initial offering of securities. Typically, a syndicate of underwriters purchases the securities directly from the issuer and then quickly sells these securities to solicited investors. The issuer pays the underwriter a fee that is determined according to the terms of the particular sale arrangement employed. An underwriter assumes some risk because, in certain circumstances, it can be left owning the issuance’s unsold securities. The municipal securities market is unique in that the underwriters are subject to disclosure regulation.

In addition, municipal securities issuers often employ a financial advisor to provide counseling services in structuring the securities issuance. In theory, the financial advisor should provide trusted counseling because, unlike the underwriter, the financial advisor is not directly exposed to the issuance’s financial risks and rewards. The financial advisor’s expertise might include analyzing the issuer’s


46. This type of underwriting arrangement is called a “firm-commitment underwriting.” For a description of different underwriting arrangements, see Hazen, supra note 45, § 2.1[2], at 68-71.

47. Generally, there are two types of sale arrangements in the municipal securities market. Temel, supra note 7, at 7. In a “competitive sale” the issuer determines the terms of the issuance in advance and then selects the underwriter that bids for the job promising to get the lowest interest rate. Id. In a “negotiated sale” the issuer selects the underwriter, and then together they determine the terms of the issuance. Id. A negotiated sale is often used where gauging investors’ interest is more difficult because the security being issued is more complex or risky. Id. at 64.

48. Whether a particular underwriter might be left owning the issuance’s unsold securities depends upon the type of underwriting arrangement that is employed. See Hazen, supra note 45, § 2.1[2], at 68-71.

49. For a discussion of the regulatory demands placed upon underwriters in the municipal securities market, see infra Part II. Generally, a municipal securities underwriter incurs continuing regulatory obligations that exist until the security’s maturity; whereas, the regulatory obligations of most corporate securities underwriters relate almost entirely to the initial offering. See infra Part II.

50. A financial advisory relationship exists “when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to a [municipal securities issuance].” MSRB Activities of Fin. Advisors, Mun. Sec. Rulemaking Bd. Rule G-23(b) (2011). Some commentators suggest “[s]ignificantly more and more issuers of municipal bonds use the services of financial advisors during the bond issuance process.” Kenneth N. Daniels & Jayaraman Vijayakumar, The Role and Impact of Financial Advisors in the Market for Municipal Bonds, 30 J. Fin. Servs. Res. 43, 43 (2006).

51. Some commentators strongly suggest that financial advisors help municipal securities issuers achieve more favorable financial terms in their issuance of securities. Id. at 44-45 (“Our results show that using financial advisors results in significantly lower . . . underwriter [fees] for revenue issues. . . . Our results also show that using financial advisors reduces underwriter [fees] significantly for revenue and [general
financing needs, advising the issuer on its overall financing plan, or even assisting the issuer in the selection of the underwriter.\textsuperscript{52} Many financial institutions provide both underwriting services and financial advisory services.\textsuperscript{53} However, there has been a regulatory effort to curtail issuances in which the same financial institution acts as underwriter and financial advisor.\textsuperscript{54} Unfortunately, despite these efforts, there continues to be concerns that issuances exist in which there is a conflict of interest between these distinct roles.\textsuperscript{55} The recent passage of the Dodd-Frank Act should significantly impact the relationship between the financial advisor and issuer by imposing a fiduciary duty on the financial advisor.\textsuperscript{56} As a result, the role of the financial advisor should be of increasing importance in the municipal securities market.

This Part provides only a basic overview of the municipal securities market’s unique characteristics, but this overview is sufficient for understanding the rest of this Article.

\section*{II. REGULATORY REGIME}

The municipal securities regulatory regime is unquestionably unique. Since issuers are comprised almost entirely of nonfederal governments, there has been strong resistance to federal regulation. As a result, the regulatory regime has evolved slowly and typically only in response to significant investor setbacks.\textsuperscript{57} An obstacle to enacting municipal securities regulation is the Tower Amendment.\textsuperscript{58} Enacted in 1975, this statutory provision broadly restricts securities regulators from

\textsuperscript{52} TEMEL, supra note 7, at 11. Other important services provided by the financial advisor include working with the rating agencies and credit enhancers. \textit{Id}. The rating agencies provide evaluations of the credit quality of municipal securities. MSRB GLOSSARY, supra note 7, Ratings. Ratings are intended to measure the probability of the issuer’s timely repayment to investors. \textit{Id}. Ratings are often assigned upon issuance and are periodically reviewed. \textit{Id}. Credit enhancers are third parties that help increase the credit quality of a municipal securities issuance. MSRB GLOSSARY, supra note 7, Credit Enhancement. This includes providing bond insurance, bank letters of credit, or government related guarantees. \textit{Id}.

\textsuperscript{53} In 2010, these financial institutions were market leaders in various municipal securities categories for both underwriting and financial advisory services: RBC Capital Markets (All Issues), Goldman Sachs (Transportation Bonds), Barclays Capital (Electric Power Bonds), Piper Jaffray & Co. (Small Issues), Raymond James (Housing Bonds). See BOND BUYER 2010 STATISTICS, supra note 2, at 9A, 11A, 12A, 15A; MSRB GLOSSARY, supra note 7, Senior Manager.


\textsuperscript{56} See infra p. 20 and accompanying notes.

\textsuperscript{57} Regulation in the municipal securities market is widely criticized for being developed only in response to a market crisis. See, e.g., Theresa A. Gabaldon, \textit{Financial Federalism and the Short, Happy Life of Municipal Securities Regulation}, 34 J. CORP. L. 739, 742 (2009) (“[M]unicipal securities regulation is a tale of call and response between municipal financial fiasco and federal regulation reaction.”).

implementing “issuer-based regulation” in the municipal securities market.\(^{59}\) Consequently, the regulatory regime involves primarily “backdoor” regulation.\(^{60}\)

This term describes regulation that is not imposed directly on the issuer of the security, but is instead imposed indirectly through the “backdoor” against the brokers, dealers, and underwriters that interact with the issuer of the security.\(^{61}\) This “backdoor” regulatory approach has led to an assortment of regulators having jurisdiction in the municipal securities market. Regulators in the municipal securities market include the SEC,\(^{62}\) the Municipal Securities Rulemaking Board (“MSRB”),\(^{63}\) the Financial Industry Regulatory Authority (“FINRA”),\(^{64}\) and various bank regulating agencies.\(^{65}\)

\(^{59}\) “Issuer-based regulation” refers to a regulatory regime akin to corporate securities regulation where most issuers are responsible for registering securities and producing timely disclosure. For a brief overview of the corporate securities disclosure regime, see COFFEE, JR. & SALE, supra note 7, at 93–95.

\(^{60}\) The phrase “backdoor” regulation is commonly used in the securities industry. See, e.g., id. at 16-17.

\(^{61}\) Broker, dealer, and broker-dealer are the most general terms for persons or firms acting as intermediaries in securities transactions. A broker is a person or firm engaged in the business of buying and selling securities for others. E.g., Securities Exchange Act of 1934 § 3(a)(4), 15 U.S.C. § 78c(a)(4) (2006) (defining broker). A dealer is a person or firm engaged in the business of buying and selling securities through their own account. E.g., 15 U.S.C. § 78c(a)(5) (defining dealer). A broker-dealer is typically a firm that is engaged in both these activities. MSRB GLOSSARY, supra note 7, Broker-Dealer. An underwriter is a specific type of dealer or broker-dealer. See TiMEl, supra note 7, at 256. An underwriter acts as an intermediary between the issuer and investors in an initial offering of securities. See supra p. 8 and accompanying notes. In that process, the underwriter purchases the securities from the issuer through its “own account” and then sells the securities to solicited investors. See supra p. 8 and accompanying notes.


\(^{63}\) The MSRB is a “self-regulatory organization” that helps develop regulations and set standards for securities firms and banks involved in underwriting, trading, and selling municipal securities. TiMEl, supra note 7, at 18. The MSRB’s history and its role in municipal securities regulation is detailed at infra pp. 12-21 and accompanying notes.


\(^{65}\) The bank regulating agencies involved in enforcing municipal securities regulation include the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Comptroller of Currency, and the Office of Thrift Supervision. E.g., Tesia Nicole Stanley, Narrowing the Disclosure Gap: Is EMMA EDGAR
Originally, the Securities Act of 1933 (“1933 Act”) and the Securities Exchange Act of 1934 (“1934 Act”) limited municipal securities regulation to the SEC’s enforcement of a few antifraud statutes.66 Since the enactment of the 1933 Act and 1934 Act, municipal securities issuers have been exempted from the issuer registration requirements placed upon most other securities.67 However, municipal securities issuers have always been subject to the antifraud provisions outlined at section 17 of the 1933 Act.68 Interestingly, many courts and commentators conclude municipal securities issuers were not subject to the antifraud provisions outlined at section 10 of the 1934 Act prior to 1975.69

66. Section 17 of the 1933 Act and section 10 of the 1934 Act are the antifraud statutes that pertain to municipal securities issuers. Although sections 11 and 12 of the 1933 Act are also antifraud statutes, these sections are not applicable in the municipal securities market because these sections apply only to registered securities that trade on national securities exchanges. See 15 U.S.C. §§ 77k-77i (2006).


68. Section 17 of the 1933 Act, 15 U.S.C. § 77q (2006), relates to fraud in the “offer or sale of any securities.” The SEC often uses sections 17(a)(2) and 17(a)(3) when it brings an enforcement action against a municipal securities issuer. See, e.g., New Jersey, Securities Act Release No. 9135, 2010 WL 3260860 (Aug. 18, 2010). Interestingly, sections 17(a)(2) and (a)(3) require mental culpability akin to negligent fraud, while section 17(a)(1) requires mental culpability akin to intentional fraud. See Aaron v. SEC, 446 U.S. 680, 695-97, 701-02 (1980). Municipal securities issuers are subject to the antifraud provisions at section 17 because section 17 applies to “persons” and section 2(a)(2) of the 1933 Act, 15 U.S.C. § 77b(a)(2) (2006), includes “government or political subdivisions thereof” in the definition of “persons.”

The regulatory regime was comprised entirely of antifraud provisions until the Securities Acts Amendments of 1975 was enacted in response to New York City’s near municipal bond default. This legislation enacted several significant municipal securities related amendments to the 1934 Act. First, municipal securities issuers were clearly made subject to the antifraud provisions codified at section 10 of the 1934 Act. This was important because it also made municipal securities issuers subject to the SEC’s most extensive antifraud regulation, Rule 10b-5. Second, the MSRB was established as a “self-regulatory organization.” The MSRB’s mission is “to protect investors, issuers of municipal securities and entities whose credit stands behind municipal securities, and public pension plans.” However, the MSRB is disadvantaged in serving its mission for three primary reasons. First, the MSRB was originally authorized to adopt regulations only applicable to brokers, dealers, and underwriters. Second, the SEC must approve any regulations proposed by the MSRB. Third, the MSRB has no enforcement authority and must rely on the SEC, FINRA, and the various bank regulating agencies to enforce its regulations.

of Temporary Rule 23a-1(T), Exchange Act Release No. 11,876, 8 SEC Docket 541 (Nov. 26, 1975) (“Rule 10b-5, which has always applied to all transactions in municipal securities . . . will continue to do so.”).


73. In 1942, the SEC promulgated Rule 10b-5 pursuant to authority in section 10(b) of the 1934 Act. Prohibition of Fraud by Any Person in Connection with the Purchase or Sale of Securities, 7 Fed. Reg. 3804 (May 22, 1942) (codified at 17 C.F.R. § 240.10b-5 (2011)).

74. Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 15B, 89 Stat. 97, 131 (codified as amended at 15 U.S.C. § 78o-4 (2006)). A “self-regulatory organization” is a regulatory entity that specializes in overseeing a particular market. COFFEE, JR. & SALE, supra note 7, at 63. These entities are funded by fees assessed on that industry. Id. They are also generally controlled by industry personal although the SEC retains ultimate authority. Id. The MSRB and FINRA are examples of self-regulatory organizations. For further discussion of self-regulatory organizations, see id. at 63-66.


76. Originally, the MSRB was only authorized to propose regulations applicable to “transactions in municipal securities effected by brokers, dealers, and municipal securities dealers.” Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 15B(b)(2), 89 Stat. 97, 132 (current version at 15 U.S.C. § 78o-4(b)(2) (Supp. IV 2010)). However, the Dodd-Frank Act expanded the MSRB’s authority by permitting the MSRB to propose regulations that are applicable to financial advisors. See infra p. 20 and accompanying notes.


78. Section 15B(c) of the 1934 Act, 15 U.S.C. § 78o-4(c) (2006 & Supp. IV 2010), provides no
The Securities Acts Amendments of 1975 also placed an additional statutory restriction on municipal securities regulators through the enactment of the Tower Amendment.\footnote{See SEC 1993 MUNICIPAL SECURITIES REPORT, supra note 65, at 7; Enforcement of MSRB Rules, Mun. Sec. Rulemaking Bd., http://www.msrb.org/Municipal-Bond-Market/How-the-Market-is-Regulated/Enforcement-of-MSRB-Rules.aspx (last visited Oct. 3, 2011). This view is widely-accepted in the industry. See, e.g., TEMEL, supra note 7, at 220. Nonetheless, the Dodd-Frank Act expanded the MSRB’s authority by permitting it to “provide guidance and assistance” in enforcing compliance with regulations proposed by the MSRB. See infra note 122 and accompanying text.} To fully understand the effect of the Tower Amendment, it is important to first understand what regulatory regime could be possible without it. Even though municipal securities have been exempted from the issuer registration requirements outlined in the 1933 Act and 1934 Act, in theory a similar issuer-based regulatory regime could be enacted in the municipal securities market pursuant to the SEC’s broad antifraud authority.\footnote{For a more detailed analysis of whether without the Tower Amendment an issuer-based regulatory regime could be enacted pursuant to the SEC’s antifraud authority, see Robert W. Doty & John E. Petersen, The Federal Securities Laws and Transactions in Municipal Securities, 71 NW. U. L. REV. 283, 301-02 (1976) (emphasizing that the antifraud provisions are “vague and their boundaries are uncertain”). Although this analysis concludes that the SEC would likely lack the authority “to promulgate municipal securities disclosure forms or filing requirements,” id. at 301, this analysis precedes Supreme Court jurisprudence favoring judicial deference to administrative agencies, see, e.g., Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984). The SEC has recently suggested that the municipal securities exemptions from the issuer registration requirements in the 1933 Act and 1934 Act would prevent it from enacting an issuer-based regulatory regime even if the Tower Amendment was repealed. See GAO MUNICIPAL SECURITIES REPORT, supra note 21, at 23-24. However, this recent suggestion is a shift from previous SEC commentary regarding whether repealing the Tower Amendment could lead to issuer-based regulation. See supra note 20.} But, the Tower Amendment curtails this possibility by imposing additional regulatory restrictions on the SEC and MSRB. Commentary from the SEC indicates that the Tower Amendment was enacted to address “intergovernmental comity,” which concerns the constitutional dual-sovereignty issues associated with federal interference into state and local governments.\footnote{The Tower Amendment contains two provisions that expressly restrict federal regulation in the municipal securities market.\footnote{See supra note 69, at app. A at 11 n.33. Section 15B(d)(2) was added to the Securities Acts Amendments of 1975 because of an amendment cosponsored by Senator John Tower. 121 CONG. REC. 10735-36 (1975); Doty & Petersen, supra note 80, at 345-47. On the other hand, section 15B(d)(1) was the result of a “rapidly secured agreement.” 121 CONG. REC. 10722 (1975) (showing that section 15B(d)(1) was included in the initial proposal that would later be enacted as the Securities Acts Amendments of 1975); Doty & Petersen, supra note 80, at 345 (explaining that the SEC and MSRB are each adamant that the MSRB has no enforcement authority and must rely on the SEC, FINRA, and the various bank regulating agencies to enforce its rules. See SEC 1993 MUNICIPAL SECURITIES REPORT, supra note 65, at 7; Enforcement of MSRB Rules, Mun. Sec. Rulemaking Bd., http://www.msrb.org/Municipal-Bond-Market/How-the-Market-is-Regulated/Enforcement-of-MSRB-Rules.aspx (last visited Oct. 3, 2011). This view is widely-accepted in the industry. See, e.g., TEMEL, supra note 7, at 220. Nonetheless, the Dodd-Frank Act expanded the MSRB’s authority by permitting it to “provide guidance and assistance” in enforcing compliance with regulations proposed by the MSRB. See infra note 122 and accompanying text.} This Article relies on two important
distinctions between these two provisions. The first provision, codified at section 15B(d)(1) of the 1934 Act, places limitations on both the SEC and MSRB, and restricts municipal securities regulation in primary market issuances. It states:

Neither the Commission nor the Board is authorized under this chapter, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.83

The second provision, codified at section 15B(d)(2) of the 1934 Act, places limitations on only the MSRB and restricts municipal securities regulation in secondary market transactions. It states:

The Board is not authorized under this chapter to require any issuer of municipal securities, directly or indirectly through a municipal securities broker, municipal securities dealer, municipal advisor, or otherwise, to furnish to the Board or to a purchaser or a prospective purchaser of such securities any application, report, documents, or information with respect to such issuer: Provided, however, that the Board may require municipal securities brokers and municipal securities dealers or municipal advisors to furnish to the Board or purchasers or prospective purchasers of municipal securities applications, reports, documents, and information with respect to the issuer thereof which is generally available from a source other than such issuer. Nothing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this chapter.84

Interestingly, there is no legislative history that specifically addresses the SEC’s exclusion from the second provision.85

The two distinctions between the Tower Amendment’s two provisions have led to a “backdoor” regulation of municipal securities that operates differently in the primary market compared to the secondary market.86 This Part chronologically discusses the development of this “backdoor” regulation. The SEC justifies this compromised style of regulation by relying on antifraud provisions in the 1934 Act, including section 15(c)(2) which forbids brokers and dealers from engaging in fraudulent, deceptive, or manipulative practices.87

85. Laughman, supra note 69, at 1196. However, for some detailed insight into the legislative history of the Securities Acts Amendment of 1975, see Doty & Petersen, supra note 80, at 343-48.
86. The primary market is the market where new issues of municipal securities are initially sold by issuers to investors typically with an underwriter acting as an intermediary. MSRB GLOSSARY, supra note 7, Primary Market, New Issue Municipal Securities; see also supra p. 8. The secondary market is the continuing market for securities that have already been issued in the primary market. TEMEL, supra note 7, at 254; MSRB GLOSSARY, supra note 7, Secondary Market. For additional discussion of how the Tower Amendment’s first provision pertains to primary market issuances, see infra pp. 30-31 and accompanying notes.
87. Municipal securities “backdoor” regulation is currently applied through Rules 15c2-12 and G-32. See infra pp. 15-18 and accompanying notes. The SEC justifies Rule 15c2-12 by relying on section 15(c)(2) of the 1934 Act, 15 U.S.C. § 78o(c)(2) (Supp. IV 2010) (forbidding brokers, dealers, and municipal securities
In 1989, the SEC adopted “backdoor” regulation in the primary market by promulgating Rule 15c2-12.\textsuperscript{88} This enactment was in response to Washington Public Power Supply System’s default on $2.25 billion of municipal bonds.\textsuperscript{89} Essentially, the original rule simply required that underwriters in most municipal securities issuances “obtain and review” the issuer’s “official statement” and distribute that official statement to any potential customer upon request.\textsuperscript{90} The official statement is intended to replicate the prospectus that is used in most corporate issuances,\textsuperscript{91} but Rule 15c2-12 grants the underwriter and issuer significant discretion to decide the official statement’s contents and disclosures.\textsuperscript{92} Thus, many commentators argue Rule 15c2-12 requires only “voluntary disclosure.”\textsuperscript{93} Nonetheless, the SEC interpretive release that accompanied the adoption of the rule emphasized that the underwriter must have a “reasonable basis” to believe the truthfulness, completeness, and accuracy of the key representations contained in the official statement.\textsuperscript{94}

In 1990, the SEC increased primary market regulation by approving MSRB Rule G-36, which originally required underwriters to submit “copies” of the official statements they obtained through Rule 15c2-12 to either the MSRB or its designee.\textsuperscript{95} The MSRB proposed this rule because it was concerned that Rule 15c2-12 disclosure was not widely disseminated since it was available only upon dealers from engaging in fraudulent, deceptive, or manipulative practices). See Municipal Securities Disclosure, 54 Fed. Reg. 28,799, 28,800 (July 10, 1989) (codified at 17 C.F.R. § 240.15c2-12 (2011)). The SEC justifies Rule G-32 by relying on section 15B(b)(2)(C) of the 1934 Act, 15 U.S.C. § 78o-4(b)(2)(C) (Supp. IV 2010) (permitting the MSRB to propose regulations that are designed to prevent fraudulent and manipulative acts). See Order Approving Proposed Rule Change Relating to the Delivery of Official Statements and Recordkeeping, 55 Fed. Reg. 23,333, 23,336 (June 7, 1990). Rule G-32 was first adopted as Rule G-36. See infra note 99 and accompanying text.


89. Hamilton, supra note 71, at 1022. For a brief history of this default, see MOODY’S DEFAULT REPORT, supra note 30, at 17-18.


91. MSRB GLOSSARY, supra note 7, Official Statement (defining the official statement as “functionally equivalent” to the prospectus that is used in most corporate securities issuances).

92. E.g., TEMEL, supra note 7, at 66 (“There is no list of mandatory information that must be included in the official statement.”).

93. See, e.g., Lisa M. Fairchild & Nan S. Ellis, Municipal Bond Disclosure: Remaining Inadequacies of Mandatory Disclosure Under Rule 15c2-12, 23 J. CORP. L. 439, 461 (1998) (“Because the parties control the content of the official statement and secondary disclosures, any disclosures are, in effect, voluntary.”). For an analysis of the different accounting standards used in municipal securities disclosure, see infra p. 18 and accompanying notes.

94. Municipal Securities Disclosure, Exchange Act Release No. 26,985, 43 SEC Docket 1880, 1887, 1899 (June 28, 1989). In one of the few municipal securities cases to be litigated in court, the United States Court of Appeals for the Ninth Circuit held that the industry standard of care is one factor to consider in determining whether the underwriter satisfied the “reasonable prudence” standard. SEC v. Dain Rauscher, Inc., 254 F.3d 852, 854 (9th Cir. 2001). However, the court stressed that the industry standard of care is not the “determinative factor.” Id.

request. In addition, the MSRB was concerned that Rule 15c2-12 did not allow investors in the secondary market the ability to reliably and regularly obtain official statements. In 1991, the MSRB was permitted to establish the Municipal Securities Information Library as a central electronic repository for the official statements it collected pursuant to Rule G-36. In May 2009, the SEC approved the MSRB’s consolidation of Rule G-36 into Rule G-32, and approved the MSRB’s official replacement of the Municipal Securities Information Library with the Electronic Municipal Market Access system (“EMMA”).

In 1994, the SEC extended Rule 15c2-12 “backdoor” regulation into the secondary market. Again, this expansion was enacted in response to market events. This time, the bankruptcy and default of Orange County, California precipitated the changes. As a result, Rule 15c2-12 now also generally prohibits an underwriter from participating in an issuance unless the underwriter initially obtains a written agreement or contract requiring the issuer or “obligated person” to disclose continuing financial information. These continuing disclosure requirements include what amounts to an annual official statement and notice of specified financial events. The SEC has recently amended and clarified the

96. Id.
97. Id.
99. MSRB Disclosures in Connection with Primary Offerings, Mun. Sec. Rulemaking Bd. Rule G-32 (2011). The former Rule G-32 generally required brokers and dealers selling a recently issued municipal security to deliver to the customer the official statement. Notice of Filing of Proposed Rule Change Relating to the Establishment of a Primary Market Disclosure Service and Trade Price Transparency Service of the Electronic Municipal Market Access System and Amendments to MSRB Rules G-32 and G-36, 74 Fed. Reg. 15,190, 15,190 (Apr. 2, 2009). Similarly, the former MSRB Rule G-36 required dealers acting as an underwriter in a municipal securities issuance to submit the official statement to the MSRB or its designee. Id. at 15,191. This Article analyzes the legal validity of Rules 15c2-12 and G-32 by determining whether these regulations could be enforced in court considering the first provision of the Tower Amendment. See infra Part IV.
103. SEC Municipal Securities Disclosure Rule, 17 C.F.R. § 240.15c2-12(f)(10) (2011) (“[O]bligated person means any person, including an issuer of municipal securities, who is . . . generally . . . committed by contract or other arrangement to support payment . . . on the municipal securities to be sold in the Offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities).”) (emphasis omitted); see also Securities Exchange Act of 1934 § 15B(e)(10), 15 U.S.C. § 78o-4(e)(10) (Supp. IV 2010) (providing a similar definition of “obligated person”).
104. 17 C.F.R. § 240.15c2-12(b)(5)(i).
105. Id. Notice of a specified financial event must be filed “in a timely manner not in excess of ten business days after the occurrence of the event.” Id. § 240.15c2-12(b)(5)(i)(C). Examples of financial events include principal and interest payment delinquencies, non-payment related defaults, adverse opinions on the tax status of the security, bond calls, and rating changes. Id.
specified financial events that must be disclosed. Originally, the SEC designated entities called nationally recognized municipal securities information repositories (“NRMSIRs”) and state information depositories (“SIDs”) as the filing recipients of continuing disclosure. In December 2008, however, the SEC adopted amendments to Rule 15c2-12 officially designating EMMA as the central repository for continuing disclosure.

The existing municipal securities “backdoor” regulatory regime includes two peculiarities of particular importance. First, the issuer’s initial and continuing financial disclosure is not required to be provided according to a uniform accounting standard because the SEC remains adamant that it lacks the authority to mandate standardized disclosure practices in the municipal securities market. Thus, most municipal securities issuers provide financial disclosure according to voluntary industry standards or according to their mandated state or local standard. This current practice is problematic, of course, because some standards


108. The SEC indicates that the only states operating SIDs are Texas, Michigan and Ohio. Sources of Municipal Securities Information, U.S. Sec. & Exch. Comm’n, http://www.sec.gov/answers/nrmsir.htm (last modified Jan., 26 2011). For an overview of state municipal securities disclosure laws, see Fairchild & Ellis, supra note 93, at 454-56.

109. Municipal Securities Disclosure, 59 Fed. Reg. 59,590, 59,594 (Nov. 17, 1994) (codified at 17 C.F.R. pt. 240) (“For purposes of the amendments, documents will be considered to be publicly available if they have been submitted to each NRMSIR and to the appropriate state information depository . . . .”).


112. The Government Finance Officers Association (“GFOA”) and the Governmental Accounting Standards Board (“GASB”) have each put forward industry standards for municipal securities disclosure. See, e.g., TEMEL, supra note 7, at 216. GASB has established “generally accepted accounting principles” that are used by many municipal securities issuers. SEC 2007 MUNICIPAL SECURITIES WHITE PAPER, supra note 82, at 7. However, some states require accounting standards that differ significantly from GASB. Id. at 8. It is estimated that about 20,000 of the more than 50,000 total municipal securities issuers use an accounting standard that does not conform to GASB’s generally accepted accounting standards. Id. at 7-8. For an overview of how GFOA disclosure standards differ with corporate disclosure requirements, see SEC 1993 MUNICIPAL SECURITIES REPORT, supra note 65, at app. C.
are more transparent.\textsuperscript{113} As a result, it can be difficult for an investor or analyst to conduct an accurate and efficient comparison between municipal securities of different issuers.\textsuperscript{114}

Second, Rules 15c2-12 and G-32 do not expressly provide a noncompliance remedy. As a result, it is uncertain whether a private cause of action exists for the failure to comply with Rules 15c2-12 and G-32.\textsuperscript{115} The SEC, FINRA, and the various bank regulating agencies have several available remedies for enforcing noncompliance even though Rules 15c2-12 and G-32 do not expressly provide a noncompliance remedy.\textsuperscript{116} Collectively, this means that municipal securities investors are largely reliant on the regulators to compel disclosure.

Finally, two recent developments in the municipal securities market deserve additional attention. First, the MSRB’s recent creation of EMMA is significant because it provides a free, online, centralized repository for both initial and

\textsuperscript{113} For example, Texas recently enacted a law requiring that the state not use a GASB accounting standard that requires governments to report the accrued costs of health care and employment benefits. SEC 2007 \textit{MUNICIPAL SECURITIES WHITE PAPER}, supra note 82, at 8 n.33. Thus, pursuant to state law, this questionable accounting practice will likely be incorporated into the financial statements that Texas discloses when issuing municipal securities.

\textsuperscript{114} See id. at 8.

\textsuperscript{115} Several federal district courts have held that there is no private cause of action to enforce the MSRB rules. See \textit{Prager v. FMS Bonds, Inc.}, No. 09-80775-CIV, 2010 WL 2950065, at *7 (S.D. Fla. July 26, 2010) (holding that there is no private cause of action to enforce MSRB rules); \textit{Charter House, Inc. v. First Tenn. Bank, N.A.}, 693 F. Supp. 593, 597-98 (M.D. Tenn. 1988) (holding that there is no private cause of action to enforce MSRB Rule G-19); \textit{Redstone v. Goldman, Sachs & Co.}, 583 F. Supp. 74, 77 (D. Mass. 1984) (holding that there is no private cause of action to enforce MSRB Rules G-17 and G-19). Nonetheless, a litigant could rely on analogous Supreme Court jurisprudence to argue that an “implied” remedy exists permitting private enforcement actions against brokers, dealers, and underwriters for noncompliance with Rules 15c2-12 and G-32. For example, the Supreme Court has held that an implied private cause of action exists to enforce compliance with section 10(b) of the 1934 Act and Rule 10b-5. See \textit{Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.}, 552 U.S. 148, 164-66 (2008); Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971). However, after a few early decisions upheld an implied private cause of action under section 17(a) of the 1933 Act, the more recent cases have generally rejected an implied private cause of action under section 17(a). \textit{Coffee, Jr. & Sale}, supra note 7, at 929. At least one commentator argues that the judicial and legislative trend in federal securities law favors permitting fewer private causes of action. \textit{Gabaldon}, supra note 57, at 768.

\textsuperscript{116} Section 15(b)(4) of the 1934 Act, 15 U.S.C. § 78o(b)(4) (2006), empowers the SEC to bring enforcement actions against brokers, dealers, and underwriters for willful violations of the 1934 Act, regulations promulgated pursuant to the 1934 Act, or any regulations proposed by the MSRB. The remedies available to the SEC for such violations include censuring, suspending, or limiting the violator’s activities. \textit{Id.} Also, Section 21B of the 1934 Act, 15 U.S.C. § 78u-2 (2006), authorizes the SEC to demand monetary penalties for such violations and section 21C of the 1934 Act, 15 U.S.C. § 78u-3 (2006), provides the SEC general authority to order that any securities violation “cease and desist.” In addition, section 15A(b)(7) of the 1934 Act, 15 U.S.C. § 78o-3(b)(7) (2006), empowers FINRA to bring enforcement actions against brokers, dealers, and underwriters for violations of the 1934 Act, regulations promulgated pursuant to the 1934 Act, as well as any regulation proposed by the MSRB or FINRA. The remedies available to FINRA for such violations by brokers, dealers, and underwriters include expulsion, suspension, censure, limiting the violator’s activities, or “any other fitting sanction.” \textit{Id.} Lastly, section 15B(c)(5) of the 1934 Act, 15 U.S.C. § 78o-4(c)(5) (2006), empowers the various bank regulating agencies to bring enforcement actions against “dealer banks” for violations of the municipal securities provisions in the 1934 Act, municipal securities regulations promulgated pursuant to the 1934 Act, or any regulations proposed by the MSRB. The remedies available to the various bank regulating agencies for such violations by “dealer banks” include censuring, suspending, or limiting the violator’s activities. \textit{See id.; Securities Exchange Act of 1934 § 15B(c)(2), 15 U.S.C. § 78o-4(c)(2) (2006).}
continuing municipal securities disclosure. 117 EMMA has received praise because municipal securities disclosure was previously difficult to obtain.118 EMMA is intended to replicate EDGAR, which is the SEC’s successful online repository for corporate securities disclosure.119

Second, the recent enactment of the Dodd-Frank Act120 affects the municipal securities regulatory regime in three important ways.121 First, the Dodd-Frank Act expands the MSRB’s authority by permitting it to “provide guidance and assistance” in enforcing compliance with its proposed regulations.122 Second, the Dodd-Frank Act imposes a fiduciary duty on “municipal advisors”123 and authorizes the MSRB to propose regulations that affect these advisors.124 This is a significant development because municipal advisors include the financial advisors in a municipal securities issuance.125 Finally, commentators argue that the Dodd-Frank Act requires that municipal securities swaps be disclosed, but that municipal securities are likely exempted from the swap registration requirements and other

118. See Andrew Ackerman, Changing of the Guard, BOND BUYER, Dec. 19, 2008, http://www.bondbuyer.com/issues/117_242/297645-1.html. Previously, free primary market disclosure was only available to visitors to the MSRB’s facility in Alexandria, Virginia. Stanley, supra note 65, at 105. Alternatively, primary market and secondary market disclosure could be obtained through fee subscription services from the MSIL and NRMSIRs. Id.; Ackerman, supra. Municipal securities market participants criticized the NRMSIRs for the “inconsistent manner in which the repositories collected and displayed disclosure documents.” Stanley, supra note 65, at 107-08.
mandates on asset-backed securities. Surprisingly, the Dodd-Frank Act relies heavily on rulemaking, which has largely not yet been promulgated, particularly with respect to the municipal securities market. As a result, its affect on the municipal securities market often lacks clarity. This is fitting because overall the municipal securities regulatory regime is unique and contains many uncertainties.

III. REGULATORY INADEQUACIES

In theory, the municipal securities market is a regulated market. However, the Tower Amendment acts to restrict much of the available oversight to the “backdoor” regulation of brokers, dealers, and underwriters. This framework begs the question of whether this regulatory regime is adequate. This Part outlines the basic principles underpinning federal securities regulation and then applies these principles to the municipal securities market to determine if the “backdoor” regulatory regime is adequate. This Part concludes that regulatory inadequacies exist in the municipal securities market largely as a result of sparse regulatory enforcement.

Federal securities regulation is grounded in the related principles of investor protection and disclosure. These principles relate to the unique nature of a “security.” The theory is that investors deserve increased protection in the securities markets because the investment they are purchasing often cannot be physically inspected. Therefore, to help protect investors, the existing securities regulation framework often mandates the disclosure of important information because this should permit investors to make more informed investment decisions.

In addition, some argue the disclosure must be required because

126. NAT’L ASS’N OF BOND LAWYERS, supra note 121, at 4-5. A swap is a speculative contractual arrangement where the issuer and a counterparty simultaneously sell each other counteracting securities for the purpose of altering the issuer’s cash flows. Hildreth & Zorn, supra note 6, at 135; MSRB GLOSSARY, supra note 7, Swap. In the municipal securities market, the counterparty is often the underwriter and the swap is typically offered to the issuer to help hedge against interest rate risk. MSRB GLOSSARY, supra note 7, Interest Rate Swap Contract. For a practical explanation of how swaps generally operate, see COFFEE, JR. & SALE, supra note 7, at 24.


128. Id.

129. See supra Part II.

130. See COFFEE, JR. & SALE, supra note 7, at 2-5; Macchiarola, supra note 22, at 44 (“[Federal securities legislation] embraced a disclosure-based system of regulation and represented an attempt to minimize the financial risks that an investor faces when investing on the basis of imperfect or insufficient information.”).

131. See supra note 22.

132. COFFEE, JR. & SALE, supra note 7, at 4-5.

133. Id. at 5. Disclosure in the securities markets relates to the principle that securities regulation not be overly paternalistic. See id. at 4. Thus, this principle permits an investor to purchase high-risk securities so long as that investor is provided the appropriate disclosure to make an informed investment decision. Id. This principle is critical because the securities markets rely on investors having divergent views, whereby investors receive financial reward for efficiently investing their capital.
otherwise negative information would not be routinely disclosed.\textsuperscript{134} Frequently, the disclosure is required in a standardized format because the value of securities can only be derived through comparison to similar securities.\textsuperscript{135} Finally, history shows that there is a close relationship between the securities markets and the health of the national economy.\textsuperscript{136} Thus, the principles of investor protection and disclosure also serve a general public policy purpose by helping instill integrity in the securities markets.\textsuperscript{137}

The regulatory environment in the municipal securities market provides inadequate investor protection and disclosure. This Part discusses the related inadequacies in investor protection and disclosure, and then makes the case that these inadequacies largely exist because there has been sparse regulatory enforcement.

Current data suggest increased default risk\textsuperscript{138} is a reasonable investor protection concern in the municipal securities market. Admittedly though, municipal securities have a stellar credit history, which would otherwise suggest adequate investor protection exists.\textsuperscript{139} For example, only fifty-four Moody’s-rated municipal bonds have defaulted since 1970\textsuperscript{140} and no state has defaulted on a municipal securities obligation since Arkansas during the Great Depression.\textsuperscript{141} However, these are not typical economic times and the recent United States credit downgrade indicates that even the unthinkable is now possible.\textsuperscript{142} Current data overwhelmingly suggest that state and local issuers face unprecedented levels of short-term and long-term fiscal stress. This implies increased investor protection concerns exist in the municipal securities market because investors are increasingly
subject to default risk. Overall, state issuers are currently facing short-term annual expenditures that are outpacing annual revenues. Moreover, the states have long-term fiscal stress from sizable yet growing public pension and healthcare obligations. It is conceivable that the states could quickly correct their short-term fiscal imbalances, but the states would likely have to reduce revenue transfers to local governments to do so. The budgetary impact on local governments from declining state transfers will be magnified because local governments are only now starting to experience the decline in property tax revenue. In addition, many local governments are exposed to the same long-term public pension and health care obligations as state governments. Some commentators respond that


145. C O NG. B UDGET O FFICE, F ISCAL S TRESS F ACED B Y L OCAL G OVERNMENTS 1 (2010), available at http://www.cbo.gov/fpdocs/120xx/doc12005/12-09-Municipalities_Brief.pdf (“Collectively, local governments derive nearly one-third of their revenues from state aid, about one-quarter from property taxes, one-tenth from sales and other taxes, and most of the remainder from fees and miscellaneous revenues; only 4 percent represents direct aid from the federal government.”).


147. A report by the Congressional Budget Office stated: “The ability of some local governments to decrease spending is sometimes limited by federal and state requirements, particularly laws that require local governments to pay for a portion of the costs of certain services. For example, more than half of the states require local governments to contribute a share of the costs of the state’s Medicaid program. Many states also restrict the way local governments deliver services – regardless of the local government’s fiscal situation. For example, many states cover local employees under their pension plans and restrict the extent to which local governments can reduce their contributions to the plans when revenues fall.” C O NG. B UDGET O FFICE, supra note 145, at 5.
repayment on municipal securities debt currently comprises only a small portion of state and local budgets. Even if this is true, the fiscal pressures felt by state and local governments is long-term stress in addition to short-term stress. Thus, increased investor protection concerns will persist in the municipal securities market because the default risk is not easily or quickly correctable.

Regardless, industry reports and commentary indicate that investor protection and disclosure problems clearly exist in the municipal securities market as a result of pervasive noncompliance with continuing disclosure requirements. Two recent industry reports make three important findings. First, more than one-third of recent municipal securities issuers failed to comply with the Rule 15c2-12 continuing disclosure requirements. Second, investors were more likely to pay above the principal amount for a distressed municipal bond in the secondary market if that bond was missing continuing disclosure. Finally, even if continuing disclosure is provided, it is most often “stale” because on average the required continuing disclosure is filed over 200 days after the issuer’s fiscal year end. Surprisingly, the SEC has publicly acknowledged most of these findings. In
addition, other commentators and publications have recently highlighted similar findings. Collectively, this shows that investor protection and disclosure problems clearly exist within the municipal securities market even if the default risk is not immediate.

Sparse regulatory enforcement in the municipal securities market has largely led to the existing regulatory regime providing inadequate investor protection and disclosure. The sparse regulatory enforcement is evidenced by the low number of enforcement actions and the SEC’s disparate treatment of regulatory noncompliance in the municipal securities market relative to the corporate securities market.

The enforcement of disclosure compliance in the municipal securities market has been limited to basically a few SEC antifraud actions against municipal securities issuers and a couple regulatory enforcement actions by FINRA done annually against brokers, dealers, and underwriters. Shockingly, the SEC and the various bank regulating agencies have rarely ever enforced disclosure compliance against a broker, dealer, or underwriter using Rule 15c2-12, Rule G-32, or the


This is problematic because FINRA was created to self-police brokers and dealers, not to be the primary regulator in the municipal securities market. See supra note 64.
A Call for Action

former Rule G-36. Furthermore, no municipal securities regulator has ever enforced these regulations in court. Such few enforcement actions suggest that the municipal securities market has not historically been a regulatory priority. Consider the SEC’s much-celebrated settlement with the State of New Jersey in 2010. This antifraud action was hardly the result of an in-depth investigation. The fraudulent nondisclosure started in 2001 and seemingly ended in 2007 as a result of a New York Times’ special report.

In addition, the SEC’s disparate treatment of regulatory noncompliance in the municipal securities market evidences the sparse regulatory enforcement in this market. SEC data provided in the figure below shows the depth of the SEC’s neglect.

This disparate treatment is difficult to rationalize. The SEC has the authority to enforce compliance in both markets, and while there is more trading activity in

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<th>Total Issuer Reporting and Disclosure Enforcement Actions</th>
<th>2005</th>
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<tr>
<td>Total Municipal Offering Enforcement Actions</td>
<td>4</td>
<td>8</td>
<td>5</td>
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This data accurately reflects the disparate treatment because the SEC has recorded all its municipal securities related enforcement actions in the “municipal offering” category. Consequently, the “issuer reporting and disclosure” category includes only enforcement actions in the corporate securities markets.

See supra note 116.
corporate securities relative to municipal securities,\textsuperscript{164} being delisted from a trading exchange provides an additional incentive for most corporate issuers to comply.\textsuperscript{165}\textsuperscript{7}

Collectively, industry data coupled with recent reports and commentary indicate that municipal securities investors are not receiving adequate protection and disclosure. Sparse regulatory enforcement seems to be a significant contributor to the relaxed regulatory environment that is grossly unacceptable.

IV. LEGAL UNCERTAINTIES

All indications suggest that the SEC and FINRA intend to get more aggressive in enforcing the municipal securities “backdoor” regulatory regime.\textsuperscript{166} However, a

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\item 165. The municipal securities market trades almost entirely “over-the-counter” through broker-dealers and inter-dealer transactions. MSRB Glossary, supra note 7, Over-The-Counter Market (OTC). Conversely, the corporate securities markets include the heavy trading volume from the corporate securities listed on the national securities exchanges. See COFFEY, JR. & SALE, supra note 7, at 30-35. Corporate securities listed on the national securities exchanges face possible delisting if they become delinquent in their SEC disclosure filings. KEVIN C. SMITH, WHAT LATE SEC FILERS NEED TO KNOW (2005), available at http://www.chadbourne.com/files/Publication/8c793188-13cd-4b5c-8894-981185b4d15a/Presentation/PublicAttachment/2a46a74c-d333-46a4-991e-9a3bc2c378f0/WhatLateSECFilersNeedtoKnow_BloomLaw102005.pdf.
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significant impediment to regulators is the legal uncertainty surrounding this regime. This uncertainty exists largely because Rule 15c2-12, Rule G-32, and the former Rule G-36 have never been litigated in court. An increase in enforcement actions would strengthen the likelihood a litigant invokes these regulations in court. Considering that the Tower Amendment places broad limitations on the SEC and MSRB, a significant yet unlitigated issue is the legal validity of Rules 15c2-12 and G-32.

Legal commentators, industry participants, and even regulatory officials have long questioned the legal validity of the municipal securities “backdoor” regulatory regime. In particular, the 1994 expansion of Rule 15c2-12 sparked strong criticism that the SEC’s implementation of continuing disclosure requirements against brokers, dealers, and underwriters crossed the line that the Tower Amendment drew and was therefore legally invalid. The legal arguments attacking the validity of the continuing disclosure requirements are plausible; however, this Article highlights the legal uncertainty in regulating primary market issuances. This Article emphasizes this argument because this is the stronger argument for invalidating “backdoor” regulation since the Tower Amendment is significantly more restrictive towards primary market regulation relative to secondary market regulation.

Specifically, this Article argues that the *Chevron* test renders the primary market regulation outlined in Rules 15c2-12 and G-32 invalid because these regulations operate in tandem to create primary market regulation that the Tower Amendment expressly prohibits. Section A outlines this argument that the regulations are invalid pursuant to the *Chevron* test, and then Section B rebuts the SEC’s arguments defending these regulations in light of the Tower Amendment.

A. Primary Market Regulation, Tower Amendment, and *Chevron*

167. See supra pp. 25-26 and accompanying notes.
168. See Laughman, supra note 69, at 1200 (concluding that the SEC’s expansion of Rule 15c2-12 in 1994 was “a result not intended by Congress . . . .”); Kiernan, Jr., supra note 67, at 708 (“The argument that SEC Rule 15c2-12 and [former] MSRB Rule G-36 are invalid because of the Tower Amendment is not frivolous.”); Lynn Hume, SEC’s New Muni Initiative, BOND BUYER, Mar. 6, 2007, http://www.bondbuyer.com/news/-266335-1.html (quote from former SEC Chairman Christopher Cox) (“As you know there’s been concern that Rule 15c2-12, as it exists, might encroach on the Tower Amendment already.”); SEC Disclosure Rules Can Be Legally Challenged, Some Say, BOND BUYER, Apr. 17, 1995, http://www.bondbuyer.com/news/-47429-1.html (quoting several bond lawyers that argue the 1994 expansion of Rule 15c2-12 could be invalid because of the Tower Amendment). For an overview of the municipal securities “backdoor” regulatory regime, see supra Part II.
170. For a discussion of how the Tower Amendment limits the SEC and MSRB in primary market regulation, see supra pp. 14-15 and infra pp. 30-31.
The Tower Amendment contains plain language that broadly limits the regulation of municipal securities issuances. Applying the *Chevron* test, this Article finds that the primary market regulation outlined in Rules 15c2-12 and G-32 is contrary to the Tower Amendment and therefore these regulations would likely be invalidated by a court.

Courts often apply the *Chevron* test if litigation invokes judicial review of whether a regulation conforms to an agency’s enabling statute. Courts will apply the *Chevron* test when two elements are established. First, the court must be reviewing an agency’s regulatory “construction” of its enabling statute. Second, that agency’s “construction” must carry the “force of law.” Therefore, if a municipal securities regulator sought to enforce Rules 15c2-12 or G-32 in court, then the application of the *Chevron* test should determine whether the primary market regulation outlined in these rules is legally valid. The first element would be established because this litigation would rely on judicial review of whether Rules 15c2-12 and G-32 are lawfully constructed pursuant to the 1934 Act. Rules 15c2-12 and G-32 were promulgated by the SEC pursuant to provisions in the 1934 Act; therefore, the enabling statute in this litigation would be the 1934 Act. The Tower Amendment must be considered in this review because it is codified in the 1934 Act. The second element would be established because the SEC promulgated Rules 15c2-12 and G-32 through notice and comment rulemaking, which satisfies the “force of law” requirement.

If the *Chevron* test controls, then courts apply a two-part inquiry to determine whether the regulations are lawfully constructed pursuant to the agency’s enabling statute. First, the court analyzes whether Congress has directly spoken to the “precise question at issue.” If Congress has unambiguously spoken to the issue and its intent is clear, then Congress’s statute should invalidate the agency’s conflicting regulation thereby ending the *Chevron* test inquiry. However, if Congress has not unambiguously spoken to the precise question at issue, then the

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171. A regulation that is invalid pursuant to the *Chevron* test cannot be enforced in court because “[t]he judiciary is the final authority on issues of statutory construction and must reject administrative constructions which are contrary to clear congressional intent.” *Chevron*, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843 n.9 (1984).


175. *See supra* note 87.


177. *See supra* notes 88, 99 and accompanying text.


179. *Chevron*, 467 U.S. at 842 (“When a court reviews an agency’s construction of the statute that it administers, it is confronted with two questions.”).

180. *Id.* at 842.

181. *Id.* at 842-43.
inquiry should continue with the court next determining whether Congress “explicitly left a gap for the agency to fill.”\textsuperscript{182} If so, then the regulation is upheld under this second inquiry unless the regulation is “arbitrary, capricious, or manifestly contrary to the statute.”\textsuperscript{183} The \textit{Chevron} test embodies the principle of judicial deference to agency regulations;\textsuperscript{184} hence, the test is often referred to as “\textit{Chevron} deference.”\textsuperscript{185}

The primary market regulation outlined in Rules 15c2-12 and G-32 could be legally invalid under the first inquiry of the \textit{Chevron} test because the Tower Amendment speaks to the “precise question at issue” by expressly prohibiting the SEC and MSRB from requiring filings obtained from the issuer prior to a primary market issuance. The Tower Amendment’s first provision pertains to primary market issuances and it states:

Neither the Commission nor the Board is authorized under this title, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.\textsuperscript{186}

The terms “Commission” and “Board” are, respectively, shorthand for the SEC and MSRB.\textsuperscript{187} Moreover, the phrase “purchaser or prospective purchaser of securities from the issuer” matches the statutory definition of an underwriter.\textsuperscript{188} Also, the phrase “prior to the sale” could reasonably be construed as applying the provision’s limitation to the primary market time period.\textsuperscript{189} Finally, the terms

\textsuperscript{182} Id. at 843-44.

\textsuperscript{183} Household Credit Serv., Inc. v. Pfennig, 541 U.S. 232, 239 (2004); \textit{Chevron}, 467 U.S. at 843-44. Some courts and commentators appropriately articulate the \textit{Chevron} test’s second inquiry with a slight variation, which states “if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency’s answer is based on a permissible construction of the statute.” \textit{Chevron}, 467 U.S. at 843. Here, this is not the appropriate standard to apply because Congress has clearly not been silent or ambiguous towards municipal securities regulation since Congress enacted the Tower Amendment in 1975. Regardless, most commentators distill the \textit{Chevron} test’s second inquiry to be whether the agency’s regulation is “reasonable” no matter how the standard is specifically articulated. \textit{See Stephen G. Breyer ET AL., ADMINISTRATIVE LAW AND REGULATORY POLICY 328 (6th ed. 2006).}

\textsuperscript{184} \textit{Chevron}, 467 U.S. at 844 (“We have long recognized that considerable weight should be accorded to an executive department’s construction of a statutory scheme it is entrusted to administer, and the principle of deference to administrative interpretations.”).

\textsuperscript{185} The term “\textit{Chevron} deference” is frequently used when articulating the \textit{Chevron} test. \textit{See generally Karneitz, supra} note 172.


\textsuperscript{188} 15 U.S.C. § 78c(a)(20) (defining “underwriter” as having the same meaning as in the Investment Advisors Act of 1940); Investment Advisors Act of 1940 § 202(a)(20), 15 U.S.C. § 80b-2(a)(20) (2006) (“Underwriter” means any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking . . . .”). Even the SEC acknowledges that the phrase “purchaser or prospective purchaser of securities from the issuer” is referring to underwriters. SEC 2007 MUNICIPAL SECURITIES WHITE PAPER, supra note 82, at 3 n.12.

\textsuperscript{189} The phrase “prior to the sale” is not rigidly defined by the 1934 Act. \textit{See} Securities Exchange Act of
“application,” “report,” or “document” could reasonably be construed to include the official statement even though the 1934 Act does not specifically define these terms. Therefore, a reasonable interpretation is that the Tower Amendment’s first provision expressly prohibits the SEC and MSRB from requiring an underwriter to file with the SEC or MSRB an official statement obtained from the issuer prior to a primary market issuance.

Consequently, the Tower Amendment’s first provision likely invalidates the primary market regulation outlined in Rules 15c2-12 and G-32 because these regulations operate in tandem to require that an underwriter file with the MSRB an official statement obtained from the issuer prior to a primary market issuance. First, Rule 15c2-12 requires that the underwriter “obtain and review an official statement” from the issuer prior to the issuance of municipal securities. Second, Rule G-32 states that “the underwriter of a primary offering of municipal securities shall submit the official statement for such offering to [MSRB’s] EMMA . . . no later than the closing date.” The “closing date” is the date of the primary market issuance. Therefore, these regulations could conflict with the Tower Amendment’s first provision.

The legal obstacle in invalidating these regulations is that the analysis must rely on the collective effect of Rules 15c2-12 and G-32 to find a conflict with the Tower Amendment. The SEC has carefully tailored both regulations so that if each is considered individually, then the primary market regulation survives such scrutiny. Rule 15c2-12’s requirement that the underwriter “obtain and review” the official statement is not necessarily in conflict with the Tower Amendment because the regulation does not by itself mandate a filing with the SEC or MSRB. Moreover, Rule G-32’s requirement that the underwriter file the official statement with MSRB’s EMMA is not necessarily in conflict with the Tower Amendment because the regulation does not by itself mandate that the issuer provide an official statement to the underwriter.

However, this Article finds that this legal obstacle can be overcome for two reasons. This Article highlights these two specific reasons, and then outlines the Supreme Court’s emphasis on plain language and congressional intent when applying the Chevron test. Collectively, these arguments support invalidating the primary market regulation outlined in Rules 15c2-12 and G-32.

1934 § 3(a)(14), 15 U.S.C. § 78c(a)(14) (2006) (“The terms ‘sale’ and ‘sell’ each include any contract to sell or otherwise dispose of.”). The primary market is the market where new issues of municipal securities are initially sold by issuers to investors typically with an underwriter acting as an intermediary. MSRB Glossary, supra note 7, Primary Market, New Issue Municipal Securities; see also supra p. 8.

190. This is a reasonable interpretation because Rule 15c2-12 defines “final official statement” as a “document or set of documents prepared by an issuer of municipal securities or its representatives . . . .” SEC Municipal Securities Disclosure Rule, 17 C.F.R. § 240.15c2-12(f)(3) (2011) (emphasis added).

191. 17 C.F.R. § 240.15c2-12(b)(1) (“Prior to the time the Participating Underwriter bids for, purchases, offers, or sells municipal securities in an Offering, the Participating Underwriter shall obtain and review an official statement that an issuer of such securities deems final as of its date . . . .”).


193. Mun. Sec. Rulemaking Bd. Rule G-32(d)(ii) (“The term ‘closing date’ shall mean the date of first delivery by the issuer to or through the underwriter of municipal securities sold in a primary offering.”); see also Temel, supra note 7, at 242.
The *Chevron* test can invalidate two regulations that operate in tandem to conflict with an enabling statute if those regulations were promulgated by the same agency and “constructed” from the same enabling statute.\(^\text{194}\) Here, the SEC promulgated Rules 15c-12 and G-32 as effective “constructions” of the 1934 Act.\(^\text{195}\) Rule 15c2-12 was initially proposed and promulgated by the SEC.\(^\text{196}\) Rule G-32 was initially proposed by the MSRB,\(^\text{197}\) but the regulation only became law because the SEC promulgated the regulation through its rulemaking process. The 1934 Act recognizes that the MSRB may “propose and adopt” regulations, but that these regulations will only “take effect” if approved by the SEC.\(^\text{198}\) This distinction is important because the *Chevron* test is applied to regulations that carry the “force of law”\(^\text{199}\) and Rule G-32 only assumed the “force of law” after the SEC promulgated it through notice and comment rulemaking. Therefore, it is the SEC that truly “constructed” Rule G-32 pursuant to the 1934 Act even though the text of the Tower Amendment distinguishes between SEC and MSRB regulations. Thus, the *Chevron* test can be applied considering whether the collective effect of these regulations conflicts with the 1934 Act’s Tower Amendment because both regulations were promulgated by the SEC pursuant to the 1934 Act.

In addition, in the past, the Supreme Court has applied the *Chevron* test to invalidate multiple regulations that conflict with an enabling statute if the text of those regulations indicates that they were intended to operate in tandem.\(^\text{200}\) Here, the text of Rules 15c2-12 and G-32 indicates that they were intended to operate in tandem. Rule 15c2-12 requires the underwriter to contract with the issuer to receive “copies of a final official statement in sufficient quantity to comply with ... the rules of the [MSRB].”\(^\text{201}\) This is an explicit textual reference to Rule G-32, which requires the underwriter to submit the official statement to MSRB’s EMMA prior to the primary market issuance. Moreover, Rule G-32 explains that its filing requirement shall not apply “[i]f an official statement will not be prepared for a primary offering of municipal securities exempt from ... Rule 15c2-12.”\(^\text{202}\) Thus, this text makes Rules 15c2-12 and G-32 operate in tandem because the provision is

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194. *Chevron* states specifically that it applies to an agency’s “construction of the statute which it administers.” *Chevron*, 467 U.S. at 842.

195. See supra note 87.

196. See supra pp. 15-16 and accompanying notes.

197. See supra pp. 16-17 and accompanying notes.


199. See supra note 174 and accompanying text.

200. See Sullivan v. Zebley, 493 U.S. 521, 524-26, 541 (1990) (holding that a test for determining qualification for Social Security Income that was enacted through multiple regulatory provisions operating in tandem is invalid pursuant to the *Chevron* test); Bd. of Governors of Fed. Reserve Sys. v. Dimension Fin. Corp., 474 U.S. 361, 368 (1986) (holding that regulatory provisions operating in tandem to alter the definition of “bank” to conflict with the statutory definition of “bank” are invalid).


exempting Rule G-32’s filing requirement for those issuances already exempt from Rule 15c2-12’s “obtain and review” requirement. Therefore, the text in Rules 15c2-12 and G-32 indicates that these regulations were intended to operate in tandem. As a result, the Chevron test can be applied to invalidate the primary market regulation outlined in Rules 15c2-12 and G-32.

The Supreme Court’s emphasis on plain language and congressional intent in the application of the Chevron test also supports invalidating the primary market regulation outlined in Rules 15c2-12 and G-32. Supreme Court case law overwhelmingly stresses that Chevron deference is only owed to agency regulations that are consistent with the enabling statute’s plain language. Here, the Tower Amendment’s plain language expresses a broad limitation that a court could reasonably conclude forbids the primary market regulation outlined in Rules 15c2-12 and G-32. Moreover, Supreme Court case law also stresses that Chevron deference is not owed to regulations that are inconsistent with congressional intent. Clearly, the collective effect of Rules 15c2-12 and G-32 violates the Tower Amendment’s congressional intent as articulated in the Senate floor debate:

With respect to the authority of the [MSRB], the [Tower Amendment] would simply clarify the position the Committee articulated in its report, namely that the bill is not intended to tamper in any way with prerogatives of State and local governments in their sale of securities. The [Tower Amendment] thus states that the [MSRB] may not impose on issuers, directly or indirectly, disclosure requirements. Surely there can be no argument with that result.

Thus, the Tower Amendment’s plain language and congressional intent support invalidating the primary market regulation outlined in Rules 15c2-12 and G-32.

Finally, it should be acknowledged that this statutory conflict has existed since 1990. Rule 15c2-12 was promulgated to regulate primary market issuances in 1989

203. See generally Karnezis, supra note 172, § 12 (listing numerous Supreme Court cases that stress Chevron deference is only owed to agency regulations that are consistent with the enabling statute’s plain language).

204. See supra pp. 30-31 and accompanying notes.

205. See generally Karnezis, supra note 172, § 13 (listing numerous Supreme Court cases that stress Chevron deference is not owed to regulations that are inconsistent with congressional intent).

206. 121 CONG. REC. 10,736 (1975) (statement of Sen. Harrison Williams, Jr.). Senator Williams also stated that “the [Tower Amendment] would make clear that the [MSRB] created by the bill would not have authority to require State and local governments to make disclosures about their operations.” Id. At 10,737 (emphasis added).

Regardless, the Tower Amendment’s congressional intent conflicts with the primary market disclosure that is required by Rules 15c2-12 and G-32 operating in tandem. For additional analysis of the Tower Amendment’s congressional intent, see Kiernan, Jr., supra note 67, at 707 (arguing that Rule 15c2-12 and the former Rule G-36 are contrary to the “spirit of the Tower Amendment” because the regulations require “precisely what the Tower Amendment aimed to prevent”) (emphasis added).
and the filing requirement in Rule G-32 was first promulgated by the SEC as Rule G-36 in 1990. However, the longstanding nature of this conflict should not influence whether a court finds that these regulations are legally valid. The Supreme Court has held that longstanding regulations are not entitled to *Chevron* deference if the regulations conflict with the plain language of the statute. Also, practitioners should not be dissuaded by this longstanding conflict. Collectively, there has been little motivation to challenge this primary market regulatory regime because there has been sparse regulatory enforcement and investors have been subject to relatively few defaults. Of course, these motivations could change quickly if there is an increase in enforcement actions or an increase in defaults.

Overall, the Tower Amendment’s first provision expresses broad limitations that a court could reasonably conclude invalidates the primary market regulation outlined in Rules 15c2-12 and G-32.

**B. SEC’s Arguments**

This Section rebuts the SEC’s arguments defending Rules 15c2-12 and G-32 in light of the Tower Amendment. This Section outlines each SEC argument independently, and then analyzes the persuasiveness of each argument. This Section finds that a court is unlikely to be swayed by the SEC’s arguments defending Rules 15c2-12 and G-32.

The SEC’s argument in defense of the primary market regulation outlined in Rule 15c2-12 is as follows:

While Congress limited the power of the MSRB to require that disclosure documents be provided to investors, it was careful to preserve and expand the

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207. *See supra* pp. 15-16 and accompanying notes.

208. *See, e.g.*, Brown v. Gardner, 513 U.S. 115, 122 (1994) (“A regulation’s age is no antidote to clear inconsistency with a statute, and the fact, again, that [the regulation] flies against the plain language of the statutory text exempts courts from any obligation to defer to it.”); Pub. Emp. Ret. Sys. of Ohio v. Betts, 492 U.S. 158, 171 (1989) (“But, of course, no [Chevron] deference is due to agency interpretations at odds with the plain language of the statute itself. Even contemporaneous and longstanding agency interpretations must fall to the extent they conflict with statutory language.”). *But cf.* Commodity Futures Trading Comm’n v. Schor, 478 U.S. 833, 846 (1986) (“It is well established that when Congress revisits a statute giving rise to a longstanding administrative interpretation without pertinent change, the congressional failure to revise or repeal the agency’s interpretation is persuasive evidence that the interpretation is the one intended by Congress.”) (internal quotations omitted).


210. Municipal securities investors have had little motivation to litigate against issuers or underwriters over the disclosure regulations because investors have generally always received their principal and interest payments since there have been relatively few defaults in the municipal securities market to date. *See generally Moody’s Default Report*, *supra* note 30 (outlining that only fifty-four Moody’s-rated municipal bonds have defaulted since 1970).

211. *See supra* Part III (discussing the need for more municipal securities enforcement actions and the likelihood of an increase in municipal securities defaults).
authority of the Commission under section 15(c)(2) of the [1934] Act. Section 15B(d)(2) expressly indicates that “[n]othing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this title.” Thus, although section 15B(d)(1) prevents the Commission from requiring that municipal issuers file reports or documents prior to the issuance of securities in the same fashion as corporate securities, Congress expanded the Commission’s authority to adopt rules reasonably designed to prevent fraud, so long as the rules did not require documents to be filed with the Commission. The Commission believes that Rule 15c2-12 is consistent with its Congressional mandate to adopt rules reasonably designed to prevent fraud in the federal securities markets.²¹²

This argument is unpersuasive for two main reasons. First, it relies on a clause in section 15B(d)(2) of the 1934 Act (the Tower Amendment’s second provision) to justify the primary market regulation outlined in section 15B(d)(1) (the Tower Amendment’s first provision). A court could reasonably conclude that the clause, “nothing in this paragraph shall be construed to impair or limit the power of the [SEC] under any provision of this title,” is only a limitation affecting the “paragraph” defined as section 15B(d)(2). This is the more likely interpretation because section 15B(d)(2) is noteworthy for mysteriously not applying to the SEC;²¹³ therefore, it would seem relevant to clarify that nothing in section 15B(d)(2) should be applied to limit the SEC’s other powers as provided elsewhere in the 1934 Act. Second, while the SEC is correct to assert its authority in section 15(c)(2),²¹⁴ this provision cannot be applied in a manner that renders meaningless all other provisions within the 1934 Act.²¹⁵ Thus, while the SEC can generally promulgate rules designed to prevent fraud by brokers and dealers pursuant to section 15(c)(2), it cannot, in that process, violate other specific statutory restrictions on its authority such as the Tower Amendment. Finally, it also noteworthy that the SEC’s argument does not acknowledge the Tower Amendment’s broad limitation on “indirect” regulation, which is the plain language that most specifically conflicts with the primary market regulation outlined in Rule 15c2-12. Overall, this argument is plausible, but unlikely to sway a court.

The SEC’s argument in defense of the primary market filing requirement now outlined in Rule G-32 is as follows:

Rule 15c2-12 was a lawfully promulgated Commission rule that addresses regulatory concerns pertaining to the obligations of underwriters to obtain [official statements] and provide them to the public pursuant to a Commission rule, it would strain the language of the Tower Amendment to suggest that that provision prevents the MSRB from promulgating a separate rule requiring underwriters to make a copy of the [official statements] available to the Board. Rule G-36 imposes no additional

²¹³ See supra p. 15 and note 85.
²¹⁴ See supra p. 15 and note 87.
²¹⁵ TRW Inc. v. Andrews, 534 U.S. 19, 31 (2001) (“It is a cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.”) (internal quotation marks omitted) (quoting Duncan v. Walker, 533 U.S. 167, 174 (2001)).
requirement, directly or indirectly, on issuers. Thus, the Commission believes that rule G-36 is not in conflict with the delicate balance Congress sought to achieve in section 15B between the need to grant the Board authority to carry out the important investor protection objectives of the Act and the concerns over comity among various levels of government.216

This argument is unpersuasive for three main reasons. First, this argument ignores the plain language in the Tower Amendment that outlines that the SEC and MSRB cannot require that an underwriter file with the MSRB an official statement obtained from the issuer prior to a primary market issuance.217 Thus, there is a “strain on the language of the Tower Amendment” when the SEC adopts an MSRB regulation requiring that such a filing be made with the MSRB. Second, this argument relies on a very peculiar definition of “indirectly.” A court would likely conclude that requiring the issuer’s underwriter to file the official statement does indirectly impose additional requirements on the issuer, particularly when Rule 15c2-12 requires that the underwriter “obtain and review” that official statement from the issuer. Finally, the argument essentially states that no additional requirement is created by mandating that a “copy” of the official statement be filed. A more reasonable argument is that an additional requirement is created when an additional filing is mandated, regardless of whether that filing must be an original document or a copy. Overall, this argument is unlikely to sway a court.

The SEC has a recent history of promulgating regulations that go beyond its statutory authority.218 This Section finds that the SEC has likely again gone beyond its authority. A strong argument exists that the primary market regulation outlined in Rules 15c2-12 and G-32 conflicts with the Tower Amendment’s broad limitations. Therefore, if these regulations were enforced in court, then it is likely that a court would invalidate these regulations pursuant to the Chevron test.

V. CONCLUSIONS AND RECOMMENDATIONS

The relaxed regulatory environment in the municipal securities market must be reevaluated because the market no longer resembles its reputation as a “sleepy market.” An impending regulatory crisis exists in the municipal securities market for several related reasons. Investors face growing default risk as state and local governments face increasing financial stresses.219 Also, there is inadequate financial disclosure largely as a result of sparse regulatory enforcement.220 Moreover, if the existing regulatory regime were to be enforced in court, then judicial review would likely render the primary market disclosure requirements

217. See supra Part IV.A.
219. See supra pp. 22-24 and accompanying notes.
220. See supra pp. 24-27 and accompanying notes.
invalid. Collectively, these concerns largely incriminate the Tower Amendment. This Article proposes two recommendations to help begin correcting the unacceptable existing state of municipal securities regulation.

First, regulators must increase their focus on the municipal securities market. Unequivocally, regulators must start meaningfully enforcing compliance with Rules 15c2-12 and G-32. In addition, regulators must be more active in using their broad antifraud authority. The investor protection and disclosure principles underpinning securities regulation lend support to increasing regulatory enforcement considering that the municipal securities market now involves more issuances and trading, larger retail investor participation, and greater use of complex and sophisticated instruments. Moreover, the municipal securities market exists to implement important public interest projects; therefore, maintaining market integrity should be of the utmost importance.

There have been recent developments that demonstrate that regulators are increasing their focus on municipal securities. The creation of EMMA as a free, online, centralized repository for obtaining municipal securities disclosure is a positive development for investors. Also, the SEC’s investigation into public pension disclosures shows that the SEC is taking notice. Lastly, the Dodd-Frank Act’s amendment to the 1934 Act that allows the MSRB to be more active in municipal securities enforcement will perhaps be a long-term improvement in municipal securities regulation. However, the immediacy of this regulatory crisis demands that more attention be paid. In addition, the existing legal uncertainties surrounding primary market enforcement complicates matters.

Therefore, secondly, Congress should improve the statutory authority for municipal securities regulatory enforcement so that primary market disclosure can be lawfully compelled by regulators. The necessary reforms to primary market disclosure could even be accomplished by maintaining the “backdoor” regulatory framework, but the Tower Amendment’s first provision codified at section 15B(d)(1) of the 1934 Act must be revised. Thus, a successful revision would make clear that the SEC and MSRB can require an underwriter to file with MSRB’s EMMA an official statement obtained from the issuer prior to a primary market issuance. This revision could be accomplished by simply deleting one reference to the MSRB. A revised section 15B(d)(1) would state:

See supra Part IV.

See supra pp. 24-27 and accompanying notes (outlining the rampant noncompliance with disclosure requirements and the sparse regulatory enforcement that exists in the municipal securities market).

See supra pp. 11-12 and accompanying notes (outlining the SEC’s broad antifraud authority).

See supra pp. 21-22 and accompanying notes.

See supra pp. 1-2 and accompanying notes.

See supra p. 2 and accompanying notes.

See supra p. 19 and accompanying notes.

See supra note 166.

See supra p. 20 and note 122.

See supra Part IV (outlining an argument that primary market municipal securities disclosure cannot currently be compelled in court because the Chevron test would render the regulations invalid and unenforceable). The SEC did not include this in its most recent recommendations for improving municipal securities disclosure. See SEC 2012 MUNICIPAL SECURITIES REPORT, supra note 20, at 134-39.
Neither the Commission nor the Board is authorized under this title, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission [delete: or the Board] prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.

Alternatively, affirmative language could replace the existing section 15B(d)(1) to make this proposed revision unambiguous. This statutory revision would state:

The SEC and MSRB may, by rule or regulation, require any issuer of municipal securities indirectly through a purchaser or prospective purchase of securities from the issuer, to file with the MSRB prior to the sale of such securities by the issuer any official statement in connection with the issuance, sale, or distribution of such securities.

Either of these revisions would provide the necessary reform and avoid the contentious issue of whether the Tower Amendment should be fully repealed.231

These recommendations should be welcomed by all participants in the municipal securities market. Recently, investors have withdrawn funds from the municipal securities market even though defaults have not increased to the alarming levels predicted by the market critics.233 Increased enforcement efforts could bolster investor confidence and help lower borrowing rates for issuers.234 Brokers, dealers, and underwriters never welcome increased enforcement, but they should prefer this option to other proposed alternatives.235 For example, repealing the Tower Amendment and implementing issuer-based regulation could easily affect their profits by decreasing the market’s issuing and trading activity. Broker, dealers, and underwriters might respond to increased enforcement with increased fees, but these fee increases would likely cost issuers less than the increased costs associated with issuer-based regulation.236

Unfortunately, these recommendations will likely not be realized in the current

231. See Andrew Ackerman, SEC Looks to Target Tower Amendment, BOND BUYER, May 13, 2009, http://www.bondbuyer.com/issues/118_91/-303354-1.html (discussing the opposition to repealing the Tower Amendment); Joe Mysak, U.S. Muni Issuers Prepare to Debate Tower Amendment, BLOOMBERG (May 2, 2007, 2:35 AM), http://www.bloomberg.com/apps/news?pid=newsarchive&refer=bondheads&sid=aMm1dddQjwoI (outlining why some market participants oppose repealing the Tower Amendment).


234. Id. (“Because of the panic selling, small investors . . . got hit the hardest, unless of course you count the nation’s taxpayers who are now forced to pay higher interest rates when the cities and states they live in need [to] issue debt.”).

235. SEC Commissioner Elisse B. Walter has proposed implementing issuer-based regulation in the municipal securities market. See supra note 20.

236. Issuer-based regulation would likely increase an issuer’s regulatory costs because it would impose new expenses on the issuer. It is likely that increased expenses would stem from new accounting mandates and additional legal burdens. It is likely that there would then be fewer issuances as a result of these increased costs. Over time there would then be less trading activity because there would be fewer municipal securities outstanding. Brokers, dealers, and underwriters make profits by charging fees on issuances and trades.
political climate. In the meantime, we can only hope that our government will heed to this “call for action” and help curtail an impending regulatory crisis that seems but a matter of time.

Moreover, the current political gridlock provides little hope that meaningful federal legislation can be enacted. See, e.g., Tim Reid, Analysis: U.S. May be Entering Age of Political Deadlock, REUTERS (July 28, 2011, 10:45 AM), http://www.reuters.com/article/2011/07/28/us-usa-debt-gridlock-idUSTRE76R43U20110728.