COMMERCIAL-BANK UNDERWRITING OF MUNICIPAL REVENUE BONDS: A SELF-REGULATORY APPROACH

The Glass-Steagall Act,\(^1\) one of the basic charters of commercial bank power in the United States, specifies those activities in which commercial banks\(^2\) may participate and those in which they may not. Among the activities generally prohibited to commercial banks are the underwriting and dealing in securities\(^3\) other than federal-government bonds and certain municipal securities\(^4\)—specifically, the "general obligations of any State or any political subdivision thereof."\(^5\) This exception to the general prohibition makes no mention of the type of municipal security

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\(^2\) Commercial banks accept deposits and make loans to businesses and individuals. See generally 1 A. H. MICHIE, BANKS AND BANKING 5-12 (1973) [hereinafter cited as MICHIE]. Other banking institutions, such as savings and loan associations, savings banks, and credit unions, provide different services to different markets. See generally 8 MICHIE, supra, at 1-2 nn.1 & 3 (1971). These institutions are chartered under a variety of federal and state laws. See generally 1 MICHIE, supra, at 12-18. State-chartered banks may or may not become members of the federal reserve system. See 12 U.S.C. §§ 321-339 (1976).

\(^3\) The Glass-Steagall Act states:

The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock . . . .


\(^4\) The term "municipal security" will be used hereinafter in its broadest sense to mean all tax-exempt securities issued by state and local governments or their agencies. Municipal securities include both general obligation and revenue bonds. See note 6 infra.

\(^5\) 12 U.S.C. § 24, Seventh (1976) ("The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof . . . . "). See also 12 U.S.C. § 378(a)(1) (1976), which exempts from illegality those securities activities of national- or state-chartered federal reserve member banks which are allowed under 12 U.S.C. § 24 (1976).

It should be noted that these provisions do not prevent those state-chartered banks which are not members of the federal reserve system from engaging in securities activities. As of June 30, 1978 there were 9,077 nonfederal reserve
known as "revenue bonds." In 1968, the District of Columbia Circuit held that the failure of Congress to include revenue bonds among the securities exempted from the Glass-Steagall Act implied that commercial banks were forbidden to underwrite or deal in these securities.

Since that decision both legislators and commentators have debated whether the Glass-Steagall Act should be amended to permit commercial banks to underwrite revenue bonds in addition to general obligation bonds. Several bills have been proposed in Congress to effect such modification of the Act. In congres-

6 Revenue bonds are obligations of state or local governments or governmental agencies such as independent authorities which are backed by revenues from the operation of government projects, such as highways, bridges, electric utilities, housing projects and the like. Often such bonds are issued to raise money for construction of such facilities, the revenue from which is then used to pay off the debt. See L. Moak & A. Hillhouse, Concepts and Practices in Local Government Finance 320 (1975). Revenue bonds are to be contrasted with general obligation bonds, which are backed by the full taxing power of the governmental unit that issues them. Id. 317. Because the latter are secured by the full faith and credit of the issuing government, general obligation bonds are theoretically less risky than revenue bonds, which depend for their redemption on the income stream of a successful project.

Not all facilities constructed from the proceeds of revenue bonds have proved successful. One well-known default, for example, involved the Calumet Skyway Bonds issued by the city of Chicago to construct an expressway. Id. 324. Generally speaking, defaults (i.e., late payment) on revenue bonds have been rare in the postwar period. See Mehle, Bank Underwriting of Municipal Revenue Bonds: Preserving Free and Fair Competition, 26 Syracuse L. Rev. 1117, 1131 (1975). Whether this trend will continue in the face of municipalities' increasing fiscal difficulties is less certain. See text accompanying note 115 infra.


8 Militating against the Port Authority interpretation is the fact that revenue bonds were rarely issued in the 1930's when the Glass-Steagall Act was enacted. See note 14 infra & accompanying text. This suggests that Congress may have simply overlooked revenue bonds when it drafted the exemption clause in 12 U.S.C. § 24, Seventh (1976). Had the legislators been aware of revenue bonds, it is argued, they would have permitted banks to deal in them for the same reason that dealing in general obligation bonds was allowed—to preserve government borrowing sources considered crucial to national recovery. See Mehle, supra note 6, at 1125 n.43.

9 A list of proposed bills and hearings on proposed Glass-Steagall Act amendments up to 1975 can be found in Mehle, supra note 6, at 1118-19 n.7. Since 1975, H.R. 13609, 95th Cong., 2d Sess. (1978), S. 1378, 96th Cong., 1st Sess. (1979); H.R. 1539, 96th Cong., 1st Sess. (1979); and H.R. 4494, 96th Cong., 1st Sess. (1979) have also been introduced. H.R. 1539 was the subject of hearings in the fall of 1979, but no report has been published.
sional hearings,\textsuperscript{10} scholarly\textsuperscript{11} and financial\textsuperscript{12} journals, and occasionally in the general press,\textsuperscript{13} the debate has continued.

The intensity and duration of the debate is attributable, in large measure, to the size of the stakes for the underwriting participants. Although the revenue-bond market was only a small portion of the municipal-securities business at the time the Glass-Steagall Act was passed,\textsuperscript{14} in the past thirty years it has steadily grown. In the first three quarters of 1979, revenue bonds accounted for approximately seventy percent of the new issues of municipal securities.\textsuperscript{16} The passage of Proposition 13 and other state constitutional-debt-limitation provisions is likely to further increase the amount of state and local debt issued as revenue bonds.\textsuperscript{16} All told, the effect of permitting banks to underwrite revenue bonds would be to more than double the volume of securities business available to banks.\textsuperscript{17}


\textsuperscript{12} See, e.g., Two heads are better than Congress, THE ECONOMIST, Dec. 15, 1979, at 66; A British merchant banker looks at America's Glass-Steagall Act, INSTITUTIONAL INVESTOR, June 1979, at 17 (int'l ed.).

\textsuperscript{13} See, e.g., the debate that flared briefly on the New York Times op-ed page after an editorial in favor of bank revenue-bond underwriting was printed. The original editorial can be found at N.Y. Times, May 16, 1979, at 26, col. 1, with letters pro and con at N.Y. Times, May 29, 1979, at 22, col. 4, and N.Y. Times, June 13, 1979, at 24, col. 4. An editorial reaffirming the original editorial was published at N.Y. Times, June 13, 1979, at 24, col. 1, and further letters appeared at N.Y. Times, June 23, 1979, at 20, col. 5, and N.Y. Times, July 25, 1979, at 22, col. 3. See also Banks May Win a Revenue Bond Drive, BUS. WEEK, June 11, 1979, at 31.

\textsuperscript{14} 1974 Hearings, supra note 10, at 215; 1967 Hearings, supra note 10, at 135.

\textsuperscript{15} Out of approximately \$35.353 billion in long-term municipal securities issued from January to October 1979, approximately \$10.453 billion were general obligations and \$24.899 billion were revenue bonds. PUBLIC SECURITIES ASSOCIATION, MUNICIPAL MARKET DEVELOPMENTS, Tables 1, 2A, 2B (Dec. 20, 1979). By contrast, in 1960 \$4.36 billion in general obligations and \$2.07 billion in revenue bonds were issued. JOINT ECON. COMM., 94th Cong., 2d Sess., CHANGING CONDITIONS IN THE MARKET FOR STATE AND LOCAL GOVERNMENT DEBT 6 (Comm. Print 1976) [hereinafter cited as JOINT ECON. COMM].

\textsuperscript{16} For the impact of Proposition 13 and its progeny, see 32 NAT'L TAX J. (Supp. June 1979).

\textsuperscript{17} See note 15 supra.
The debate over commercial-bank participation in the revenue-bond market has been dominated by the larger and more vociferous participants in the municipal-securities marketplace: the commercial bankers, the investment bankers, and the municipal issuers. Very little attention has been devoted to the impact of such activity on those who purchase the securities: the investors. Is the present regulatory machinery adequate to ensure fair transactions? If disclosure requirements are imposed on revenue-bond issuers, can they be enforced? Will the entrance of commercial banks into the revenue-bond market unduly strain existing safeguards? These questions must be faced—before the decision to permit commercial-bank participation in the revenue-bond market is made.

This Comment takes the position that the existing regulatory framework simply will not withstand the entrance of commercial banks into the revenue-bond market. In part I, this framework

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18 Commercial bankers would like to underwrite revenue bonds not only because the market is so large, see notes 14-16 & accompanying text, but also because it is so profitable. Most revenue bond underwritings are conducted as "negotiated transactions" in which negotiations between the issuer and investment banker set the optimum terms for financing. See Joehnk & Kidwell, Comparative Cost Study Favors Competitive Bidding Over Negotiation, Weekly Bond Buyer (P.S.A. Conf. Supp. No. 1), Oct. 8, 1979, at 16. General obligation bond underwriters, on the other hand, are usually selected on the basis of closed, competitive bids. Id. See also S. Rep. No. 75, 94th Cong., 1st Sess. 40, reprinted in [1975] U.S. Code Cong. & Admin. News 179, 217 [hereinafter cited as S. Rep.]; Public Securities Association, Municipal Market Developments Table 5 (Dec. 20, 1979). Empirical analysis suggests that negotiated transactions are more lucrative to underwriters than are competitive underwritings. See Joehnk & Kidwell, supra, at 16-17; Sorensen, The Impact of Underwriting Method and Bidder Competition Upon Corporate Bond Interest Cost, 34 J. Finance 863, 869 (1979).

Support for an amendment allowing banks to underwrite revenue bonds has not come just from bankers. The potential economic benefits to state and local governments from commercial-bank underwriting has attracted the issuers' attention as well. Economic studies have asserted that the effect of opening the revenue bond market to commercial banks would be to increase the number of underwriters competing for the issuer's business and would thereby enable the issuer to bargain for the lowest possible interest cost. See Kessel, A Study of the Effects of Competition in the Tax-exempt Bond Market, 79 J. Pol. Econ. 706 (1971), reprinted in 1974 Hearings, supra note 10, at 276; 1967 Hearings, supra note 10, at 282 (Staff Study Prepared by the Office of the Comptroller of the Currency).

Opponents of commercial bank underwriting—usually investment bankers—challenge these economic arguments. They claim that competitive inequalities would eventually drive many securities firms from the market, thus negating any competitive gain that might initially be realized. See, e.g., 1974 Hearings, supra note 10, at 328 (statement of Nimrod Frazer) & at 378 (statement of Simon Whitney). Recently the SEC has taken up this position on behalf of the securities industry. See, e.g., Bank Revenue Bond Underwriting Could Mean Big Losses For Small Brokerage Firms, SEC Staff Says, [1979] 525 Sec. Reg. & L. Rep. (BNA) A-4; SEC Raises Doubts About Bill to Extend Bond-Underwriting Authority of Banks, Wall St. J., Oct. 18, 1979, at 34, col. 1.

The inequalities in competition between banks and securities firms are discussed in Meble, supra note 6, at 1187-46.
I. Existing Regulation of the Municipal-Securities Market

Until 1975 the purchase and sale of municipal securities were subject only to certain of the antifraud provisions of the federal securities laws. A series of exemptions in the basic securities acts placed these securities outside the disclosure and registration requirements of the Securities Act of 1933 and the broker-dealer regulations of the Securities Exchange Act of 1934. The turbulence in the municipal-securities market caused by the financial collapse of New York City, coupled with an increase in the num-

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19 See notes 141-200 infra & accompanying text.
23 For a sympathetic view of the affair see Shalala & Bellamy, A State Saves a City: The New York Case, 1976 DUKER L.J. 1119. A less sympathetic view is found
ber of "household", as opposed to institutional, investors purchasing municipal bonds, led Congress to enact the Securities Act Amendments of 1975, designed in part "to subject municipal securities professionals to essentially the same regulatory scheme that applies to other securities activities." These new provisions do not go so far as to impose the 1933 Act registration and disclosure requirements on municipal-securities issuers. Congress contented itself with supplementing the existing federal antifraud provisions by extending the registration requirement of section 15 of the 1934 Act to brokers and dealers conducting transactions in municipal securities.

The changes in the 1934 Act did not stop, however, with the extension of broker-dealer regulation to the municipal-securities industry. Recognizing the differences between the corporate- and municipal-securities marketplaces and the absence of a self-regulatory system in the latter, Congress established a new entity, the Municipal Securities Rulemaking Board (MSRB). This new

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24 See S. Rep., supra note 18, at 42, reprinted in [1975] U.S. CODE CONG. & Ad. News at 219-20; Dikeman, supra note 22, at 908. The increase in the number of unsophisticated investors at the time was coupled with an increased number of SEC enforcement actions against abusive trading in municipal securities. See SEC Litigation Rel. Nos. 5583 & 5584 (Oct. 26, 1972); 6005 (Aug. 2, 1973); 6032 (Aug. 22, 1973); 6451 (July 24, 1974); 6575 (Nov. 6, 1974); and 6733 (Feb. 13, 1975), involving seven injunctive actions against 72 defendants.


27 Section 3(a)(2) of the 1933 Act, 15 U.S.C. §77c(a)(2) (1976), still exempts "[a]ny security issued or guaranteed . . . by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of one or more States or territories" from the provisions of the Act. Section 12(2), 15 U.S.C. § 77l(2) (1976) exempts the same class of securities from its express liability provisions.

28 Municipal securities are not exempted from the antifraud provisions of §17 of the 1933 Act, see 15 U.S.C. § 77q(c) (1976); nor are they excluded from the coverage of §10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1976).

29 This was accomplished by amending the definition of "exempted securities" in §3(a)(12) of the 1934 Act, 15 U.S.C. §78c(a)(12) (1976), to exclude municipal securities for purposes of §15, 15 U.S.C. § 78o (1976). In addition, a new §15B(a)(1), 15 U.S.C. §78o-4(a)(1) (1976), was enacted requiring the registration of all "municipal securities dealers," a category designed to reach bank dealers who were not subject to §15 because banks were excluded from the definition of broker-dealers under §3(a)(4)-(5), 15 U.S.C. § 78c(a)(4)-(5) (1976).


31 Section 15B(b)(1) of the 1934 Act, 15 U.S.C. §78o-4(b)(1) (1976). Unlike the National Association of Securities Dealers (NASD), the Board is not
entity was empowered to "adopt rules to effect the purposes of [the 1934 Act] with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers." 32

Responsibility for formulating rules of conduct in municipal-securities transactions is thus lodged in a specialized, unitary body.33 Enforcement of these regulations, however, is not as straightforward. Since the Glass-Steagall Act allows commercial banks to underwrite and deal in the general obligations of state and local governments,34 the municipal-securities marketplace, unlike the corporate-securities marketplace, is populated by members of both the banking and securities industries. These two industries were already subject to separate regulatory systems—the three federal banking agencies35 oversaw the banking community, the Securities and Exchange Commission (SEC) was responsible for the securities community. Imposition of a separate layer of regulation for the municipal-securities market was resisted by both camps.36 Congress therefore scrapped its original plan to give the MSRB both promulgation and enforcement powers37 and instead arranged a compromise whereby the regulations promulgated by the MSRB would be enforced by the banking agencies and the SEC in cooperation with each other.38 The MSRB itself was left with neither inspection nor enforcement powers.

composed of industry participants, but consists of 15 members, five of whom represent municipal securities brokers and dealers other than banks; five of whom represent municipal securities dealers that are banks; and five of whom are public members, including representatives of investors and municipal issuers. Id. For a description of the composition and function of the MSRB, see Dikeman, supra note 22.


33 But see note 69 infra & accompanying text.

34 See notes 1-5 supra & accompanying text.


37 S. 2474, 93d Cong., 1st Sess. § 7 (1973), reprinted in 1974 Hearings, supra note 10, at 25 (proposed § 15B(b)(2)(B)).

Since the rules of the MSRB have existed only a short while, it is too early to draw concrete conclusions about the effectiveness of dividing disciplinary powers. An examination of the intrinsic, structural differences between the banking and securities industries, however, reveals that the dual enforcement scheme—devised to placate both industries—is fraught with difficulties. The SEC, comfortable in its role as securities regulator, approaches the task of municipal-securities regulation with one set of priorities. The banking agencies—so different from the SEC in philosophy and perspective—approach the task with another. The result is an uneven, inefficient enforcement system which may prove inadequate to protect investors' interests if banks are allowed to underwrite municipal-revenue bonds.

II. The Hypothesis: Dual Enforcement as Uneven Enforcement

A. Protecting Depositors and Investors: The Difficulty of Serving Both Masters

Bank and securities regulators have different outlooks and priorities because they represent two very different groups: bank depositors and securities investors. Indeed, the basic objective of the Glass-Steagall Act was to keep these two groups apart and insulate depositors' funds entrusted to the banks from the risks associated with securities transactions. Thus, banks were prohibited from dealing in most securities; the only exceptions—federal-government bonds and municipal general obligations—were less risky and hence were not seen as a threat to the bank depositor.

Today, however, the perils of bank involvement in these so-called "low risk" securities cannot be ignored. For one thing, municipal securities do carry a risk—New York City and Cleveland

40 See notes 43-59 infra & accompanying text.
41 See notes 43-50 infra & accompanying text.
42 Id.
44 See Port Auth. v. Baker, Watts & Co., 392 F.2d 497, 501 (1968) ("Congress' broad purpose in granting eligibility to general obligations of states and political subdivisions was clearly to limit bank underwriting to issues of unquestioned financial integrity.").
made that clear enough.\textsuperscript{46} And those who underwrite or deal in such securities apparently cannot escape liability under the federal antifraud laws. In a recent case growing out of New York City's fiscal turmoil, a federal judge ruled that an implied private right of action was available under section 10(b) of the Securities Exchange Act of 1934\textsuperscript{46} to purchasers of municipal bonds who alleged deceptive practices by a group of underwriters and sellers—including several commercial banks.\textsuperscript{47} Although the merits of the plaintiffs' claims in \textit{In re New York Municipal Securities Litigation}\textsuperscript{43} have not yet been reached, the case does suggest that a finding of liability against a bank-defendant is a real possibility, and could affect the soundness of a bank—if not in fact, at least in the public's perception. Indeed, in other contexts, concern has been expressed that if banks are allowed to enter nonbanking activities, failure of the bank in these activities will be interpreted by the public as failure of the bank itself.\textsuperscript{49}

Such implications may have an important diminishing effect on the zeal with which bank regulators pursue evidence of securities fraud and enforce MSRB rules designed for the protection of investors.\textsuperscript{50} Bank regulators are made to work at cross-purposes when they are asked not only to protect depositors but to help investors pursue banks—and indirectly, their depositors—to recover damages.

\textbf{B. Contrast in Regulatory Philosophies}

Reliance on bank regulators as watchdogs for investors also ignores the longstanding difference in regulatory technique between the bank agencies and the SEC. The premise of most bank regulation is that depositor protection is best served, not by full disclosure of abuses, but by forceful discipline with a minimum of publicity,
so as to preserve public confidence in banks. Direct pressure and supervision by the agency is preferred to the SEC’s practice of investigating publicly, thereby helping investors make informed decisions. This fundamental contrast in regulatory philosophy has been observed by administrators, lawmakers, and commentators.

Recently the Comptroller of the Currency stated his views on a consistent approach to banking regulation:

Historically, the overriding goal of the principal bank regulatory agencies has been the maintenance of economic stability. This goal is addressed through a variety of strategies and functions . . . .

[Most of these] attempt, in one way or another, to minimize the number of individual bank failures and maintain confidence in the banking system. The latter goal is of overriding importance . . . .


See, e.g., the remarks of a former SEC Commissioner:

Bank regulators are primarily responsible to maintain the strength and stability of the banking system . . . . Bank requirements and standards are enforced in a “direct” way out of concern that public knowledge of improper bank activities would cause a loss of confidence by depositors . . . .

The basic thrust of our securities laws and regulations is full and adequate disclosure of all material information . . . as well as the establishment of standards for those who participate in any activities relating to the purchase or sale of securities . . . . When [noncompliance] is found . . . . the Commission takes enforcement action which is disclosed to the public so that both present and prospective investors may have a basis on which to make investment decisions.


Moreover, it seems clear that, relatively speaking, persons in the securities industry offering . . . services are subject to quite detailed regulation but limited direct supervision, while the banking industry, on the other hand, is subject to enormous amounts of direct supervision but very limited external guidance through rules or regulation. While the former system might be criticized by some for “overregulation” of business decisions, the latter system has a more significant disadvantage. Because there is little role for private attorneys general, effective regulation is highly dependent upon on-site visitation and an expensive examining and supervisory staff. When coupled with relatively few regulations, that type of regulatory framework, it seems, leaves the unnecessarily lingering suspicion that bank regulators (or banks) cannot or will not tolerate an outside investigation, that only bank regulators (or banks) are competent to judge appropriate regulatory controls, and that the regulatory process is best carried out with maximum secrecy and minimum public scrutiny.

See also Lehner, In Lance’s Wake: More Disclosure of Bank Affairs, Wall St. J., Oct. 31, 1977, at 16, col. 6 (“Historically, bank regulation has rested on the ‘paternalistic old notion’ that ‘bankers and regulators can solve problems better if bank stockholders and depositors are ignorant.’”) (quoting Professor Roy A. Schotland).
The difference emerged dramatically in the SEC's investigation of the securities activities of banks, undertaken in response to congressional request in 1975. The SEC found particularly distressing the banking agencies' performance in administering consumer-protection regulation pertinent to banks. The agencies, by their own admission, simply did not enforce these regulations aggressively.

Such observations suggest that federal bank agencies are not likely to provide maximum investor protection in the municipal-securities market. They may even thwart the SEC's efforts in this regard. For, although the SEC remains free to enforce the general antifraud provisions of the securities laws against bank dealers directly, it may not investigate or commence any proceedings against a bank for violation of an MSRB rule without first notifying and consulting with the appropriate bank agency "concerning the effect of such proposed action on sound banking practices." It thus seems likely that SEC initiatives may be restrained at this consultation stage in the interest of minimizing harmful publicity. Quiet settlement of the matter might be advised in order to retain public confidence in the target banks, thus leaving investors unaware that securities-law violations may have occurred.

C. Administrative Inefficiencies

The previous two sections have focused on inherent structural and philosophical tensions in the MSRB enforcement scheme, produced when banking and securities activities are mingled in a single entity and securities laws are enforced by bank regulators. This section identifies a series of more minor, pragmatic shortcomings in this complex enforcement scheme which may also cause inefficient or uneven enforcement.

1. Coordination of Inspection

One of the MSRB's basic functions is to specify minimum compliance standards for municipal-securities broker-dealers and

56 Id. 46 (quoting Comptroller General of the U.S., Federal Supervision of State and National Banks, Highlights at 15 (1977)).
57 See note 28 supra.
58 See § 15B(a)(6)(C) of the 1934 Act, 15 U.S.C. §78o-4(c)(6)(C) (1976) ("Nothing in this paragraph shall be construed to impair or limit . . . the power of the Commission . . . to initiate any . . . action pursuant to this chapter . . . .").
to provide for regular examinations to ensure that these minimum standards are being met. In principle, the inspection requirement is straightforward; but, because the inspection duties are distributed among several agencies with their own, different timetables already in place, the frequency of inspection varies from one municipal-securities dealer to another. Brokerage firms subject to the SEC are examined on a random schedule, for example, whereas banks under the jurisdiction of the Federal Reserve Board are inspected only once a year. Other banks will be visited twice a year, and still others on schedules established by state bank examiners. Just implementing the inspection requirement imposed on municipal-securities dealers has, therefore, required careful and complex coordination by the MSRB.

2. Cost of Enforcement

Because inspection and disciplinary actions are carried out by either the SEC or one of the federal banking agencies, the enforcement scheme on which the MSRB depends is itself dependent on federal funding. This is in contrast to the corporate-securities market where a large share of the enforcement costs is borne by the industry participants themselves. Securities dealers pay dues to the National Association of Securities Dealers (NASD), a registered self-regulatory organization which relieves the SEC of many of its enforcement activities. Such a saving cannot accrue to the federal government in the municipal-securities industry so long as commercial banks, already subject to banking-agency regulations, participate in this market. They will inevitably object that membership in the NASD or a similar registered association of municipal-securities dealers would subject them to duplicative regulation.

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60 Section 15B(b)(2)(E) of the 1934 Act, 15 U.S.C. § 78o-4(b)(2)(E) (1976), specifically directs the MSRB to "specify the minimum scope and frequency of examinations."
61 See generally § 17(b) of the 1934 Act, 15 U.S.C. § 78q(b) (1976), under which the SEC conducts inspections.
65 See Wallison, supra note 39, at 312-14.
67 See note 36 supra & accompanying text.
Moreover, the banking agencies themselves have “continually opposed the regulation of banks through quasi-governmental, self-regulatory associations.”68 Indeed, so long as banking agencies have a role in enforcing rules in the municipal-securities market, the cost of expanding investor protection will likely be borne by the federal government, partly through appropriations to those banking agencies.

3. Potential SEC Interference with Rulemaking

Although enforcement difficulties predominate, the promulgation of rules governing the municipal-securities industry can also be a source of controversy. Ultimate say concerning the rules of the MSRB is vested in the SEC. The Commission is authorized to disapprove, add to, or delete from an MSRB rule.69 Yet exercise of this prerogative could produce considerable friction if the SEC uses this power to override an action taken by the MSRB that reflects the views of its banking-community representatives.70 By granting such authority, Congress clearly intended the SEC to have the power to override the MSRB in unusual circumstances; but it is questionable whether this power can ever be effectively exercised when the law requires that enforcement of such rules be a cooperative effort between the SEC and the banking agencies.71 Ultimately, one is left with a recurrent impression: the ability of the SEC to react swiftly to undesirable practices in the municipal-securities industry is significantly hampered by the participation of commercial banks as dealers and the awkward regulatory structure which their presence has spawned.

The dual enforcement scheme described in this part of the Comment leads not only to philosophical conflicts and administrative inefficiencies. The scheme, and its intrinsic structural weaknesses, also impede regulation of the most egregious practices in the securities marketplace: trading abuses by the dealer or underwriter, and fraud by the issuer. These two areas will be discussed below.

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70 For a description of the composition of the MSRB, see note 31 supra.

71 See note 38 supra & accompanying text.
III. Regulating the Municipal-Securities Marketplace: Implications of Bank Underwriting

A. Policing Trading Abuses

A banking institution engaged in underwriting a security occupies two potentially conflicting roles. At the same time, it may be both a seller and a purchaser. In particular, banks that underwrite municipal bonds can also purchase the bonds they underwrite, both for their own investment portfolios and for private trust funds in their fiduciary capacity. Current MSRB regulations are inadequate to guard against the risk that, in their role as underwriters, banking institutions will "dump" slow-moving securities on their trust funds and on correspondent banks or, alternatively, corner the supply of "hot" issues for their own investment portfolio and favored customers. If banks are allowed to underwrite revenue as well as general-obligation bonds, the resulting increase in the volume of municipal securities handled by bank underwriters will dramatically increase the potential for such self-dealing abuses. Thus, the problem must be addressed now, before commercial-bank entry into the revenue-bond market.


74 The correspondent banking system between so-called "city banks" and "country banks" is described in Staff of House Comm. on Banking and Currency, 88th Cong., 2d Sess., A Report on the Correspondent Banking System (Subcomm. Print 1964). See also M. Stigum, The Money Market: Myth, Reality and Practice (1978). In return for "country banks" placing deposit balances with them, major banks offer their correspondent banks such services as check clearing, loan participations, lines of credit, and investment advice. Opportunity probably exists for city banks to condition extension of credit or services to a correspondent upon securities purchases by such correspondent. See Mehl, supra note 6, at 1145, 1153.

75 The Senate Committee Report for the Securities Act Amendments of 1975 recognized this potential:

The economic power accruing to banks by virtue of their role as major consumers as well as underwriters of new issue municipals . . . permit[s] banks to be underwriter distributors of new issues of municipal bonds and at the same time and in the same new issue give their own investment portfolio the prerogatives and priorities of public institutional orders.


76 See notes 15-17 supra & accompanying text.
1. Current Investor Protection

The problem of self-dealing by bank underwriters has typically been cast as a problem of unfair competitive advantage. From the perspective of the securities-firm underwriter, a bank's own investment account, trust funds, and correspondent banking network constitute captive markets for the municipal bonds it underwrites. The existence of such captive markets allows a bank to underbid securities firms, confident in the knowledge that, if necessary, it can deal the securities off to these captives.

The temptations that such captives represent to bank underwriters, however, have their counterparts in securities firms as well. In recent years there has been a substantial growth in mutual funds and municipal-bond unit trusts that invest in tax-exempt securities, and which may be under the direct or indirect control of a securities firm. While these investors do not purchase as large a share of the overall municipal-securities market as do commercial banks, the existence of captive or controlled funds is nevertheless common to both bank and nonbank dealers. The real concern should be with protection of investors from the abusive use of controlled funds.

Such abuse falls into two categories. First, controlled funds could be used as a dumping ground for slow securities that are not selling well in the public market. Using the bank's own portfolio

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77 See Hopewell & Kaufman, Commercial Bank Bidding on Municipal Revenue Bonds: New Evidence, 32 J. Finance 1647, 1648 (1977); Meble, supra note 6, at 1142.

78 Knowing the existence of demand for a given security at a given price is crucial to competitive bidding. See Meble, supra note 6, at 1142. See also note 18 supra.

79 From November 1978 to November 1979 the total assets of mutual funds that trade solely in municipal bonds increased from $2.749 billion to $3.415 billion. Investment Company Institute, Trends in Mutual Fund Activities Table 3 (Nov. 1979).


81 The $700 million increase in mutual fund investment in state and local government securities is quite small compared to the $33 billion increase in similar investments by commercial banks. Compare Investment Company Institute, Trends in Mutual Fund Activities Table 3 (Nov. 1979), with Federal Reserve Board of Governors, Flow of Funds Statement 17 (May 9, 1979).

82 See Meble, supra note 6, at 1143-44. This problem was severe in the years before the Glass-Steagall Act was enacted. See W.N. Peach, The Security Affili-
to rescue mispriced underwritings might be against the interests of the bank's shareholders; likewise, dealing such bonds to the trust department threatens unfairness to beneficiaries.

A second, converse abuse is the favoring of controlled funds to the detriment of customers with no connection to the underwriter. An underwriter might favor its own portfolio when an attractive issue is involved; indeed, it might engage in speculation by "withholding" a "hot" issue in an intermediate account to await an expected rise in the market price after the underwriting period. Alternatively, a municipal-securities underwriter might discriminate unfairly among investors by offering price discounts to favored customers without affecting the price at which the bonds are offered to the general public. Such practices were recently exposed in the corporate-securities market by the "Papilsky" hearings conducted by the SEC. The corporate-security industry's self-regulatory body, the NASD, responded to such evidence of withholding and discriminatory dealing by amending its Rules of Fair Practice to check the abuses; but these rules are inapplicable to transactions in municipal securities.

ATIES OF NATIONAL BANKS 116, 131 (1941), reprinted in 58 JOHNS HOPKINS U. STUD. HIST. POL. SCI. at 554, 569 (1940).

Note that the price of a bond issuance is fixed by the underwriting syndicate before the distribution commences. A mispriced issue cannot be "moved" simply by lowering the price until the syndicate breaks.

83 See Mehle, supra note 6, at 1143.

84 Although statutes and common law prevent banks as trustees from profiting through the sale of securities to their trust accounts, a trust department may purchase from the bank's underwriting account if the trust instrument so permits. See Mehle, supra note 6, at 1144-45.

85 Id. 1143 n.116. At the time the author wrote in 1975, the MSRB had just been created and he predicted that "withholding" would likely be an outlawed practice under any rules promulgated pursuant to new legislation to regulate the municipal security industry." Id. Moreover, the drafters of the Securities Act Amendments of 1975 were aware of the potential problem. See S. Rep., supra note 18, at 49, reprinted in [1975] U.S. CODE CONG. & AD. NEWS at 227. However, no MSRB Rule promulgated to date has directly outlawed withholding. For an examination of the steps the Board has taken, see note 101 infra.

86 These methods include overtrading in "swap transactions" (accepting old bonds in payment for new bonds at less than the par value of the new issue) and free provision of services such as investment research. See Sec. Act Rel. No. 34-15807, 44 Fed. Reg. 28,574, 28,575 (1979).


88 For example, the NASD Rules of Fair Practice prohibit insider purchases of "hot securities," NASD MANUAL (CCH) ¶2168; require setting forth the public offering price, id. ¶2157; and require that all securities "swapped" for newly issued securities be traded at "fair market value," id. ¶2158.

The risk of unfair practices in the municipal-securities market is hardly foreclosed by the rules so far promulgated by the MSRB.\textsuperscript{90} When the underwriting is done by a brokerage firm, the inadequacy of the MSRB rules may be harmless because overlapping regulations are promulgated and enforced by the SEC. When, however, the underwriting of a municipal bond is done by a bank, the safeguards are considerably reduced. Such unequal regulation results not only in unequal competition between bank and nonbank dealers, but also in inconsistent protection of investors.

a. Safeguards Applicable to Securities-Firm Underwriters

Unfair sales by securities-firm underwriters to their affiliated investment companies are prevented by strict regulation of the purchaser by the SEC under the Investment Company Act of 1940.\textsuperscript{91} Section 10(f)\textsuperscript{92} of the Act specifically regulates transactions between investment companies and affiliated underwriters during the underwriting period,\textsuperscript{93} while section 17 \textsuperscript{94} regulates transactions generally between such affiliated parties. Regulations promulgated under section 10(f) require that investment companies affiliated with underwriters can only purchase new issues from the underwriters at terms which are equivalent to those offered to the general public.\textsuperscript{95} Section 17 sets similar limitations on such transactions after the underwriting period.\textsuperscript{96} The reporting requirements imposed by the Investment Company Act and enforced by the SEC\textsuperscript{97} make close scrutiny of such transactions possible.

b. Safeguards Applicable to Bank Underwriters

When municipal bonds are underwritten by banks, the transaction is not directly subject to the SEC.\textsuperscript{98} Thus, any purchases which the bank makes from itself as underwriter are regulated only

\textsuperscript{90} See notes 99-107 infra & accompanying text.
\textsuperscript{91} 15 U.S.C. §§ 80a-1 to 80a-52 (1976).

\textsuperscript{93} Congress flatly prohibited such transactions in § 10(f), but delegated authority to the SEC to make such exceptions as it finds appropriate. Hence, the SEC has promulgated rule 10f-3, 17 C.F.R. § 270.10f-3 (1979), which allows such purchases under suitable conditions. The SEC recently amended rule 10f-3 to include municipal securities. Inv. Co. Act Rel. No. 10736, 44 Fed. Reg. 36,152 (1979).

\textsuperscript{95} 17 C.F.R. § 270.10f-3 (1979).
\textsuperscript{96} 15 U.S.C. § 80a-17(a), (d) (1976).
\textsuperscript{97} 17 C.F.R. § 270.10f-3(h) (1979).

\textsuperscript{98} The "appropriate regulatory agency" for bank securities activities is defined in section 3(a)(34) of the 1934 Act, 15 U.S.C. § 78c(34) (1976).
to the extent provided by the MSRB. Section 15B(b)(2)(K) of the 1934 Act\(^9\) gives the MSRB power to regulate transactions between municipal-securities underwriters and affiliated investment portfolios. To date, the rules promulgated under this section have done nothing to prevent portfolio purchases.\(^{100}\) The primary duty imposed has been disclosure by each underwriter to the underwriting syndicate when it is investing for its account. This rule was designed to ensure equal access to information and fair distribution of issues among the syndicate members.\(^{101}\) The MSRB powers are limited, moreover, to the underwriting period.\(^{102}\) Thus, even if portfolio purchases from a bank’s own underwriting account were flatly prohibited, this limitation would allow the MSRB rules to be easily evaded.\(^{103}\) No provision with the broad post-underwriting-period coverage of section 17 of the Investment Company Act is provided to the MSRB in section 15B.\(^{104}\) As a result, the MSRB


\(^{100}\) Significantly, unlike § 10(f) of the Investment Company Act, see notes 92, 95 supra & accompanying text, § 15B(b)(2)(K) of the 1934 Act does not authorize the MSRB to prohibit portfolio purchases altogether. Congress feared that to forbid banks from purchasing the municipal bonds they underwrote would make it too difficult for municipalities to find alternative buyers. See S. Rep., supra note 18, at 49, reprinted in [1975] U.S. CODE CONG. & AD. NEWS at 227.

\(^{101}\) The MSRB has adopted Rule C-11 as its primary response to this congressional mandate. See [1978] 469 SEC. REG. & L. REP. (BNA) at E-1 to E-3. The thrust of the regulations is to increase the amount of information disclosed by underwriters in a syndicate to the syndicate manager. The syndicate manager, in turn, is obligated to ensure that all members of the syndicate have access to the information that is provided to him. For example, each underwriter must reveal the type and sometimes the identity of the portfolio for which it is placing a purchase order.

The rationale appears to be that by increasing the scope of information available to syndicate managers and members, other municipal securities professionals and the investing public will also obtain such information and be able to act upon it. Whether such exchange of information within the syndicate is sufficient to prevent speculative practices by underwriters is debatable; and it certainly does not address the problem of “swapping” or other methods by which underwriters benefit favored customers. See note 87 supra & accompanying text.

For an indication that commercial banks resisted earlier efforts to extend rule C-11 disclosure, see PSA Reverses Position on G-11, WEEKLY BOND BUYER, July 3, 1978, at 1, col. 2; [1978] 437 SEC. REG. & L. REP. (BNA) at F-2.

\(^{102}\) Section 15B(b)(2)(K) of the 1934 Act, 15 U.S.C. § 78o-4(b)(2)(K) (1976), explicitly limits the scope of any “terms and conditions” set by the MSRB to portfolio purchases made “during the underwriting period.”

\(^{103}\) See Mehle, supra note 6, at 1151. The author suggests that such a prohibition would still leave bank portfolios free to purchase from other underwriters in the syndicate during the offering period. The opportunity for speculation in a hot issue would thus remain unaffected; conversely, a “bail out” could also be arranged.

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is unable to prevent banks as underwriters from using their own portfolios or trust funds to bail themselves out of a slow-moving security. No attention is paid to the potential for overreaching in transactions with correspondent banks.\textsuperscript{105} No rules equivalent to the NASD's Rules of Fair Practice exist to police discriminatory treatment of favored purchasers\textsuperscript{106} or prevent the withholding of issues for purposes of speculation.\textsuperscript{107}

The contrasts between the MSRB regulations and the Investment Company Act point to the lack of consistency in Congress's attitude towards the municipal-securities market. The latter statute reflects the typically tough federal stance on conflicts-of-interests in securities transactions.\textsuperscript{108} Yet when Congress noted the potential conflict in banks serving as both underwriters and purchasers of bonds, the usual concern with market fairness and safety was then balanced against a perception that the existing large volume of bank purchases of municipal bonds was critical to the ability of local governments to raise funds and thus could not be overly constricted.\textsuperscript{109}

The potential for abuse described above exists, of course, because banks that underwrite general-obligation bonds are subject to different standards of conduct than are securities houses participating in the same market. If the Glass-Steagall Act is amended to permit bank underwriting of revenue bonds, the resulting increase

\textsuperscript{105} See note 74 supra.

\textsuperscript{106} See, e.g., Proposed Amendment to Art. III, § 24, of the Rules of Fair Practice of the NASD, Sec. Act Rel. No. 15020, 43 Fed. Reg. 35,447 (1978); and Proposed New § 36 of Art. III and Interpretation Thereof, Rules of Fair Practice, id. 35,448, which together would regulate the practices of institutional purchasers during underwritings. See also notes 86-87 supra & accompanying text.

\textsuperscript{107} The Board of Governors of the NASD adopted an interpretation of that organization's Rules of Fair Practice, Art. III, § 1, to prohibit "withholding" in the corporate securities market. See NASD Manual (CCH) ¶ 2151.

\textsuperscript{108} Indeed, in the very same year the MSRB was established, Congress did not hesitate to separate so-called "money-management" and brokerage functions in the corporate-securities area, when evidence disclosed that a broker might manage the stock portfolios of his clients so that his volume of transactions—and hence his commissions—were increased. See S. Rep., supra note 18, at 60, 63, 64, reprinted in [1975] U.S. Code Cong. & Ad. News at 238-39, 242.

Section 11(a) of the 1934 Act, 15 U.S.C. § 78k(a) (1976) was amended in 1975 to prohibit stock exchange members from trading for their own accounts or for accounts they managed except under limited circumstances. The strange story of the birth of § 11(a) is told in H. Bines, The Law of Investment Management ¶ 10.02 (1978).

The prohibitions against combining brokerage and money management in § 11(a) only apply to transactions conducted on a stock exchange floor or using the NASD's Automated Quotations System (NASDAQ), see Art. XVI, NASD By-Laws, NASD Manual (CCH) §§ 1651-1654. Hence, they do not apply to municipal securities.

\textsuperscript{109} See note 100 supra & accompanying text.
in bank-underwritten municipal bonds would have a direct and immediate effect on the ability of this bifurcated regulatory system to successfully control trading abuses.

An increase in bank participation in the municipal-securities market would have long-range effects as well. Specifically, the presence of banks as revenue-bond underwriters would—given the present regulatory system—hinder potential imposition of disclosure and registration requirements on the municipal-securities issuer and underwriter. It is to this more far-reaching and speculative issue that we now turn.

B. Imposing Disclosure Requirements

In 1975 Congress stopped short of imposing registration and disclosure requirements on issuers of municipal securities. The current reluctance to impose these requirements is attributable partly to doubts over the constitutionality of direct federal intrusion into local fiscal affairs, and partly to a fear that the cost of such requirements would be prohibitive to state and local governments and would exceed the likely benefits to investors. A number of


The eleventh amendment of the U.S. Constitution poses a second constitutional difficulty, since it may bar private damage actions against state governments. See Colum. Note, supra, at 1080-81 (Congress retains the power to establish basis for waiver in the future by expressly providing for private causes of action for damages against state governmental issuers); but see Yale Note, supra, at 928-29 n.36.

Private remedies against municipal governments are not affected by the eleventh amendment, and indeed, the recent decisions in Owen v. City of Independence, 48 U.S.L.W. 4389 (U.S. April 15, 1980) and in Monell v. Department of Social Servs., 436 U.S. 658 (1978), clearly demonstrate a willingness to impose liability on a municipality.

112 See generally Doty, SEC Urged to Consider Damage of Due Diligence Requirements to Market, Daily Bond Buyer, Oct. 5, 1977, reprinted in Practising
commentators, however, suggest that a regimen of disclosure require-
ments could be designed to pass constitutional muster; and the
financial crises in New York City and Cleveland suggest that
investors may indeed be jeopardized by lack of information. The
municipal issuers themselves have voluntarily attempted to improve
disclosure, and legislation has been introduced in Congress since
1975 to impose disclosure requirements. Thus, though the prob-
lems of implementing disclosure requirements are speculative, the
issue is far from settled, and it is important to consider the effect
that commercial-bank expansion into the revenue-bond market
would have on the question.

At a time when the bulk of municipal bonds were general
obligations, the need for disclosure was mitigated by the risk-free
nature of the bonds and the fact that the information needed to
estimate their quality—such as debt per capita, the mil rate, and
the general wealth of the community—is generally public knowl-
dge. However, with the dramatic increase in issuance of revenue
bonds, the security of which depends on the success of a particular
project, disclosure requirements have become more appropriate.
These bonds may present risks similar to those of corporate bonds,

LAW INSTITUTE, MUNICIPAL BONDS at 81 (1978); Doty & Petersen, The Federal
Securities Laws and Transactions in Municipal Securities, 71 Nw. U. L. Rev. 283
(1976).

113 See COLUM. Note, YALE Note, and N.Y.U. Note, supra note 111.
114 See note 23 supra.
115 In spite of Cleveland's default, the last five years have been a relatively
stable time in municipal finance. See Levin, State and Local Government Fiscal
Position in 1978, 58 Survey Current Bus. No. 12, at 19 (Dec. 1978). There are
signs, however, that the good times may be over. Another Drag on the Economy,
Bus. Week, Oct. 1, 1979, at 44.
116 See, e.g., the allegation of damages by investors who purchased New York
City bonds just before the city's near financial collapse. In re New York Municipal
See note 47 supra.
117 The Municipal Finance Officers Association (MFOA) has led the way
toward voluntary disclosure. See MFOA, Disclosure Guidelines For Offerings
Of Securities By State And Local Governments (1976); MFOA Guidelines
For Use By State And Local Governments In The Preparation Of Annual
Disclosure Documents And Other Current Disclosures (1976). A sympathetic
view of the current state of disclosure in the municipal-securities market can be
found in Doty, Municipal Disclosure—Recent Developments, 11 Urb. Law. v
(1979).
118 See, e.g., S. 2339, 95th Cong., 1st Sess. (1977); S. 3323, 95th Cong., 2d
119 YALE Note, supra note 111, at 941.
120 See notes 14-15 supra & accompanying text.
121 See note 6 supra; STANDARD & POOR'S MUNICIPAL BOND RATING CRITERIA,
reprinted in Municipal Bonds Rating Regulation: Hearings Before the Subcomm.
on Consumer Protection and Finance of the House Comm. on Interstate and
Foreign Commerce on H.R. 675, 94th Cong., 2d Sess. 34 (1976); YALE Note, supra
and the information needed to assess the credit risk is generally less public.

If revenue bonds continue to be underwritten solely by general securities houses, the problems of implementing disclosure requirements, should they be mandated, will be manageable. The SEC machinery—already working in the corporate-securities market—could easily be modified to suit the revenue bond market. If, on the other hand, commercial banks are permitted to underwrite and deal in revenue bonds, familiar problems would arise. First, the current regulatory scheme, which divides enforcement responsibilities between the SEC and the banking agencies, would enable investors to receive different information, depending on whether the underwriter is a bank or a securities firm and so reports directly to a banking agency or the SEC. Such uneven enforcement could occur if the agency's sole responsibility was to check and investigate registration statements; but the disparity is even more likely to develop if the appropriate enforcement staff is informally consulted in the drafting of registration statements and thereby influences their content.

A second, even more serious problem would result if disclosure requirements were imposed in the municipal-securities area. Such requirements would undoubtedly raise the standard of care and

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122 See notes 131-33 infra & accompanying text.
123 See notes 43-71 supra & accompanying text.
124 Such inequality of investor protection has been sharply criticized in another context where bank and brokerage firm activities overlap. See Lybecker, supra note 54, at 1011-12:

It seems clear, moreover, that it is no longer legally sufficient or appropriate to defer conclusively to the historical serendipity of whatever type of regulation a particular financial institution is used to receiving; rather, the reconciling standard or focus . . . must be the investor protections which ought to exist, whoever is offering the investment management service.

125 The disclosure requirements for corporate securities are laid out simply in Schedule A of the 1933 Act, 15 U.S.C. § 77aa (1976). One facet of the process, not widely known outside of the securities bar, however, is the degree to which informal communications between the filers of registration statements and the SEC enforcement staff are relied upon to facilitate composition of the registration statement. See C. SCHNEIDER, J. MANTE & R. KANT, GOING PUBLIC: PRACTICE, PROCEDURE AND CONSEQUENCES 18 (1979). It is difficult to conceive that registration procedures developed by two separate agencies would result in identical disclosure on both sides, given the extent to which informal communications play a role in the current process.
hence the liabilities imposed on banks in their role as municipal-
securities underwriters.\textsuperscript{128} Under rule 10b-5, banks are held ac-
countable for disclosure of any material information that they have
pertaining to an issuer of government bonds.\textsuperscript{127} But since liability
under the rule requires proof of scienter,\textsuperscript{128} bank underwriters
will not be liable for information not in their possession—which
may be considerable, given that municipal issuers are not legally
bound to disclose.\textsuperscript{129} The contrast with laws compelling disclosure
in the corporate-securities market is striking. The corporate issuer
is compelled to submit detailed information to both the SEC and its
purchasers,\textsuperscript{130} with penalties attached if material errors or omissions
occur in its statements.\textsuperscript{131} Compliance is enforced, in part by
direct SEC inspection of the registration materials, but also by the
threat of private suits. Underwriters play a crucial role in this
disclosure process: they may be sued by purchasers for failure to
correct a material misstatement or omission,\textsuperscript{132} and simple ignorance
is not a defense. Rather, the underwriter is charged with exercis-
ing “due diligence” and may avoid liability only after showing
that a “reasonable investigation” was made and failed to uncover
the error.\textsuperscript{133}

\textsuperscript{128} Indeed, it is the fear of liabilities similar to those imposed on corporate
underwriters that is foremost in the minds of those opposing registration requirements
for municipal securities. See Doty, supra note 112, at 83-84; R. Doty, The
Municipal Securities Full Disclosure Act of 1977—Analysis of Provisions and
Arguments 5 (Feb. 20, 1978) (bulletin of the Municipal Finance Officers Ass’n).

\textsuperscript{127} In re New York Municipal Securities Litigation, [Current] Fed. Sec. L.

\textsuperscript{128} Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

\textsuperscript{129} Section 3(a)(2) of the 1933 Act, 15 U.S.C. § 77c(a)(2) (1976);

\textsuperscript{130} Sections 6-8, 10 of the 1933 Act, 15 U.S.C. §§ 77f-77h, 77j (1976).


\textsuperscript{133} Section 11(b)(3) of the 1933 Act, 15 U.S.C. § 77k(b)(3) (1976). See
1, 189 (1969).

One court has stated the role of the underwriter in the disclosure process in the
following terms: “[U]nderwriters . . . are supposed to assume an opposing posture
with respect to management. The average investor probably assumes that some
issuers will lie, but he probably has somewhat more confidence in the average level of
morality of an underwriter who has established a reputation for fair dealing.” Feit
Similarly, one commentator concluded that

[o]nly the underwriter and the accountant are free to assume an adverse
role, have little incentive to accept the risk of liability, and possess the
facilities and competence to undertake an independent investigation.
The municipal-securities investor would thus receive considerably more protection if disclosure requirements patterned after those in the 1933 Act were applied to municipal bonds. However, to increase the standard of care and hence the liabilities imposed on municipal-securities bank underwriters—without isolating their operations and funds from the bank as a whole—may stir depositors' concern over the safety of their funds. Once again, the conflict-of-interest between the investor and the bank depositor may lead to inadequate protection of both interests. Complications like these, caused by bank underwriting and its present regulation, will significantly hamper the movement for disclosure by municipal issuers. The system must be changed now, before bank entry into the revenue bond market and before disclosure requirements are imposed.

IV. CONGRESSIONAL OPTIONS

Extension of commercial-bank underwriting to revenue bonds would increase the pressures for transactions by bank dealers to be scrutinized as closely as any other securities activity. There are three ways in which the need for stricter regulation could be met. Much of the potential abuse would be removed if Congress prohibited banks from making portfolio purchases from their own underwriting accounts. This has been a typical feature of bills proposing that banks be allowed to underwrite revenue bonds. However, not only would such a flat prohibition be susceptible to evasion, it would also run counter to the entire thrust of previous congressional securities legislation. Congress has traditionally preferred to delegate rulemaking authority to administrative agencies and industry organizations in the securities area. These bodies are capable of adopting regulations much more finely tuned to the complexities of the marketplace than any "rigid proscriptions imposed" by outside legislators.

Comment, BarChris: Due Diligence Refined, 68 COLUM. L. REV. 1411, 1421 (1968) (footnote omitted).

135 See note 103 supra.
Congress followed this strategy when it delegated rulemaking authority to the MSRB. This suggests an obvious second means of increasing investor protection in this field: namely, the MSRB could devise tougher, more comprehensive rules comparable to those imposed by the Investment Company Act or the NASD. However, so long as inspection and enforcement powers remain bifurcated and partly lodged in the banking agencies, the analysis in Part II casts doubt on whether the goals of maximum investor protection could actually be achieved thereby.

This leaves the third and most promising alternative. Since it is the mingling of banking and underwriting activities which creates the difficulties of inspection and enforcement, the most direct method for alleviating the difficulties would be to isolate the municipal-securities underwriting activities of banks in separate subsidiaries or affiliates and to subject these affiliates, along with brokerage-firm underwriters of municipal bonds, to a unified system of enforcement modeled after current corporate-securities regulation.

A. A Proposal: Securities Affiliates Within Banks

In drafting the Securities Act Amendments of 1975, Congress appreciated the value of separating underwriting activity from the other functions within a bank, but the drafters ultimately took only a limited step in that direction. The amendments provide that a bank may establish a "separately identifiable department or division" in which to carry on its municipal-securities activities. If such a separately identifiable department or division is established, it rather than the entire bank registers as a municipal-securities dealer. Such an arrangement does not, however, provide

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139 See notes 91-97 supra & accompanying text.

140 See notes 106-07 supra & accompanying text.


142 Registration with the SEC under the 1934 Act follows a complex scheme. Section 3(a)(5), 15 U.S.C. § 78c(a)(5) (1976), exempts banks from the definition of broker-dealer (presumably because the Glass-Steagall Act prohibits banks from securities activities). Hence banks do not have to register as broker-dealers under § 15(a) of the 1934 Act, 15 U.S.C. § 78o (1976). The definition of "municipal securities dealer" in § 3(a)(30), 15 U.S.C. § 78c(a)(30) (1976), excludes banks unless the bank is dealing in municipal securities but is not doing so through a separately identifiable department or division (as defined by MSRB rule G-1).
sufficient separation for purposes of effectively policing unfair underwriting practices. In the first place, the definition of "separately identifiable department or division" allows personnel from a variety of bank departments to belong to the separate division and does not require that they confine themselves to municipal-securities matters. The chief merit of the "separate department" is that it is required to maintain separately accessible records pertaining to its municipal-securities transactions so as to facilitate regulatory inspection. However, the failure to isolate the funds involved in the underwriting activity subjects depositors' funds to the risk of liabilities incurred by the bank as underwriter. Under such circumstances, bank agencies will likely prefer their traditional policy of quiet supervision and intervention in the interests of depositor protection to the SEC's customary policy of making investigations public. Concern for public confidence in the banks is legitimate since, absent a more identifiable separation, losses in the bank's municipal-securities activities may weaken public confidence in the bank as a whole.

A requirement that banks isolate their municipal-securities activities in a separately capitalized affiliate rather than a separate "department" as defined above would afford several advantages. It would allow the traditional full-disclosure policy of securities regulation to be applied to the activities and finances of the affiliate without calling into question the soundness of the rest of the bank.

Note 141 supra. If the bank is using a separately identifiable department or division, only that unit need register as a municipal securities dealer with the SEC under §15B(a), 15 U.S.C. §78o-4(a) (1976). Otherwise, the entire bank must register. See 17 C.F.R. §240.15Ba2-1(a) (1979) ("An application for registration pursuant to Section 15B(a) of the Act, of a municipal securities dealer which is a bank... or a separately identifiable department or division of a bank (as defined by the [MSRB]), shall be filed with the Commission... ").

The SEC has taken the position that a subsidiary of a bank or bank holding company which is not, itself, a bank or separately identifiable department within a bank must register with the SEC as a broker-dealer under §3(a)(4)-(5) of the 1934 Act, 15 U.S.C. §78c(a)(4)-(5) (1976) and §15(a) of the 1934 Act, 15 U.S.C. §78o (1976). Sec. Act Rel. No. 11742, 40 Fed. Reg. 49,772, 49,774 (1975). The consequence of such status is that the "appropriate regulatory agency" for inspecting the subsidiary becomes the SEC rather than the banking agencies. This result may act as an incentive for banks not to conduct existing municipal securities activities through subsidiaries.

Note 143 MSRB rule 4(a), 40 Fed. Reg. 49,420 (1975). See Wallison, supra note 39, at 324-25 n.145. The rule requires that certain officers be identified as responsible for the day-to-day conduct of the bank's municipal-securities affairs, but their activities, too, are not restricted to such affairs. See PRACTISING LAW INSTITUTE, BANKS AND THE SECURITIES LAWS 600-01 (1976).


Note 145 See notes 51-54 supra & accompanying text.
and raising depositors' fears over the safety of their funds. Indeed, since they would not conduct any banking activity, separately-operated securities affiliates of commercial banks could be treated as full-fledged broker-dealers and regulated as such, without fear of subjecting them to duplicative or inconsistent banking regulation.

The primary justification for the existing bifurcated enforcement scheme, with all its shortcomings, would no longer apply. A homogeneous municipal-securities industry would result, which could be directly policed by the MSRB, the SEC, or a new self-regulatory organization of municipal-securities dealers, modeled after the NASD in the corporate securities field. In this way, investors in municipal bonds could be afforded maximum, uniform protection from deceptive practices and from overreaching by underwriters who are tempted to speculate in hot issues or use "captive" markets such as trust funds or correspondent banks as dumping grounds for slow-moving issues. Purchases during the underwriting period made by a bank's affiliate for the bank's own portfolio, favored customers, or potentially captive markets, would not have to be flatly prohibited, but could simply be scrutinized for fairness to the same extent that transactions between brokerage firms and their affiliated mutual funds are now inspected.

The affiliate structure will have much the same prophylactic effect as the "walls" currently erected between lending and trust departments within banks to restrict the flow of nonpublic information which might be illegally used in investment decisions. In addition, isolation of underwriting activities from the bank would avert the concern that aggressive regulation of such activity might too severely undermine public confidence in the bank as a whole. The identity of a separate affiliate is less likely than a "separate department or division" to be confused with that of the entire bank.

146 See note 49 supra & accompanying text.
147 See note 36 supra & accompanying text.
148 See notes 193-200 infra.
149 See notes 74-75 and 82-85 supra & accompanying text.
150 See notes 91-97 supra & accompanying text.
153 See notes 48-49 supra & accompanying text.
B. The History of the Securities Affiliate

The use of securities affiliates by banks is not novel. Before the major reforms in financial regulation imposed by Congress in the midst of the Great Depression, securities affiliates of national banks were quite common. When the crash came, securities affiliates were blamed for a great deal of the speculation and chicanery in the financial markets and were explicitly banned by the Glass-Steagall Act. Senator Glass reserved some of his choicest rhetoric to excoriate these affiliates.

In the decade after the crash the definitive work of scholarship on securities affiliates was produced by W.N. Peach. Peach described four classes of abuse perpetrated by securities affiliates of national banks: (1) fraud, deceit, and manipulation in the underwriting of securities; (2) manipulation of the stock of the parent bank; (3) insider trading; and (4) “dumping” securities in the bank investment accounts and, conversely, underwriting securities of corporations to enable the bank to get out of bad loans.

Peach himself indicated that the first three types of abuse could be and were attacked by the Securities Act of 1933 and the Securities Exchange Act of 1934. The fourth class of abuse, however, was one which he felt was endemic to the combination of investment and commercial banking. Peach’s concerns were echoed by the Supreme Court in Investment Co. Institute v. Camp, which held that a national bank could not operate a collective investment fund which was, in the Court’s eyes, indistinguishable from a mutual fund.

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157 See, e.g., 75 Cong. Rec. 9887 (1933) (remarks of Sen. Glass) (“[O]ne of the greatest contributions to the unprecedented disaster which has caused this almost incurable depression was made by . . . bank affiliates. . . . They were organized to evade the law. That is the very purpose of their existence . . . .”).


There are many who feel that the concerns expressed above on the merits of merging commercial banking and investment banking services are overstated. However, the breadth of this issue need not be addressed in considering the question of municipal-revenue-bond underwriting. Since Congress found that it was permissible for banks to underwrite general obligation bonds, it is difficult to argue that the concerns expressed above are as serious in the municipal-securities as in the corporate-securities market. Furthermore, assuming Congress provided the general-obligation exception so as not to burden the state and local governments in their efforts to raise funds, the recent growth in the revenue-bond area suggests that continued adherence to a literal reading of this exception may once again burden the financing of local government.

In addition, there are numerous safeguards built into today's structure of banking and securities laws which will prevent the abuses of the pre-Depression days. These safeguards, such as the rules against bank-insider misconduct, restrictions on loans between banks and affiliates, minimum capital requirements and the panoply of regulations regarding transactions between underwriters and investment funds contained in the Investment Company Act are sufficient to forestall recurrence of the abuses of the 20's. This is particularly true in the municipal-securities market, which, because of its dearth of secondary trading, is not as susceptible to these problems in the first place.

Finally, the question of the use of securities affiliates per se must be addressed. It has been argued that the use of affiliates for bank conduct of any non-banking business is unwise. At least one commentator has suggested that if the bank and the affiliate have different sets of stockholders, or if the bank and the affiliate have

164 See notes 3-8 supra & accompanying text.
different ratios of debt to equity (that is, different leverage), the bank's management will be tempted to take unnecessary risks.\textsuperscript{171}

The regulatory scheme outlined below addresses these problems by applying strict regulations to transactions between banks and affiliates. Indeed, it is difficult to see how some of the possible abuses could be policed otherwise than by separating the banking and securities operations. By isolating bank activities into securities affiliates it will be possible to apply the full range of safeguards noted above to the municipal-securities activities of commercial banks. Under current proposals, which do not require that affiliates be used to conduct securities activities, the same set of safeguards will be far more difficult, if not impossible, to enforce.

C. A Legislative Proposal

The proposed creation of bank-owned securities affiliates, together with the structural realignment of municipal-securities regulation made possible by such affiliates, can only be achieved by amending both the existing securities and banking laws. The various legislative steps required will be outlined in this section. The net effect of these modifications is that primary jurisdiction over the underwriting activities of commercial banks would be ceded by the federal banking agencies to securities regulators in one form or another.

Before outlining this proposal, however, it is necessary to meet the objection that Congress could take a "wait-and-see" approach to the extension of bank underwriting—that is, allow the underwriting of revenue bonds and see if the MSRB machinery already in place is capable of meeting problems as they arise. It is submitted, however, that it will be more difficult to separate banking and underwriting activities once the latter have been allowed to expand

\textsuperscript{171} See, e.g., Edwards, supra note 154, at 286.

A survey of empirical work on the additional risks experienced by bank holding companies entering nonbanking activities through affiliates was conducted by the Staff of the Federal Reserve Board in 1978. \textit{Federal Reserve Board Staff Compendium of Papers, The Bank Holding Company Movement to 1978} (1978) [hereinafter cited as \textit{Compendium}]. These studies are inconclusive but suggest that diversification through affiliates may reduce overall bank holding company risks. These studies do not, however, address the question whether the nonbanking activity will be riskier if done through affiliates rather than directly within the bank. Rose, \textit{The Effect of the Bank Holding Company Movement on Bank Safety and Soundness}, in \textit{Compendium}, supra 133, 154. Studies of banking affiliates of bank holding companies do show that these affiliates are somewhat more highly leveraged than their independent counterparts, but this pattern may vary from area to area. \textit{Id.} 149. The term "bank holding company" is defined in note 173 infra.
in together.172 Indeed, the slow pace at which bank holding companies 173 have divested certain nonbanking operations, as required by the Bank Holding Company Act Amendments of 1970,174 suggests that isolation of bank underwriting functions should be required as a prophylactic measure before banks enter the revenue-bond market.

1. Municipal-Securities Affiliates and Banking Laws

The use of bank-owned affiliates to perform nonbanking functions permitted to commercial banks under the federal banking laws is well-established. During the 1960's banks and banking agencies undertook a policy of expansion of banking activities into a variety of fields including insurance, data processing, courier services and travel agencies.175 By the 1970's these activities were frequently carried on within a bank-holding-company corporate structure,176 using separate subsidiaries to conduct the nonbanking activities.177

172 In antitrust litigation courts frequently issue "hold separate" orders in order to maintain the separate corporate existence of an acquired firm where the acquisition is challenged under the antitrust laws. See, e.g., FTC v. PepsiCo., 477 F.2d 24 (2d Cir. 1973); FTC v. Exxon Corp., [1979-2] TRADE CAS. § 62,763 (D.D.C. July 28, 1979); United States v. United Technologies Corp., 466 F. Supp. 196 (N.D.N.Y. 1979); United States v. Black & Decker Mfg. Co., 430 F. Supp. 729 (D. Md. 1976). The value of such orders is to facilitate the eventual divestiture should one be required. Divestiture would be more difficult after the corporations have mingled assets.


176 See note 173 supra.

The expansion of banking activities undertaken by banks and banking agencies encountered some resistance in the courts. With regard to securities activities, a recent decision by the District of Columbia Circuit has reiterated the difficulties that banks face when they attempt to organize affiliates or holding-company subsidiaries to conduct securities-related business. The court found in the federal banking laws three distinct bars to banks entering the securities business. Section 21 of the Glass-Steagall Act prohibits any single entity from engaging in both investment- and commercial-banking activities subject to the exception for general obligation bonds; section 20 of the same Act prohibits ownership or control of securities affiliates by banks; section 4(a) of the Bank Holding Company Act prohibits bank holding companies from owning subsidiaries engaged in securities activities.

It is thus recommended that section 20 of the Glass-Steagall Act and section 4(a) of the Bank Holding Company Act be amended to allow banking institutions to own affiliates engaged in municipal-securities underwriting. Such underwriting must be confined to affiliates so the exception in Section 21 of the Glass-Steagall Act, permitting banks themselves to deal in general obligation bonds, should be repealed. Additionally, the prohibitions on interlocking directorates between banks and securities firms must be made subject to a municipal-securities exception.

The resurrection of the securities affiliate will be successful, of course, only if strict limitations on credit and other transactions between the bank and its affiliate are enforced. Bank regulatory agencies would retain an important role in this area. Section 23A of the Federal Reserve Act limits credit from a bank to any single affiliate to less than ten percent of the bank's capital and limits credit to all affiliates to less than twenty percent of the bank capital. Furthermore, all such loans must be collateralized at between 110% and 120% of their face value. If bank underwriting

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178 Id. (collecting cases).
180 Id. 1012-13.
182 See note 5 supra.
187 Id.
activity is expanded and conducted through affiliates, these loan restrictions would form a basic component of regulatory policy and must be rigidly enforced.

2. Municipal-Securities Affiliates and Securities Laws

Parallel modifications would need to be made in the relevant securities laws affecting municipal bonds. Only affiliates of banks would be permitted to register as municipal-securities dealers under section 15B(a) of the 1934 Act, 188 and the permission for banks to establish "separately identifiable department[s] or division[s]" for underwriting purposes 189 would be repealed.

By restricting the affiliates' business to securities transactions, the relevance of federal banking regulations to their activity is reduced and the problem of duplicative or inconsistent regulation, which prompted Congress to deny the MSRB enforcement powers, 190 is removed. Because separately capitalized and operated underwriting affiliates of commercial banks can be treated as full-fledged municipal-securities dealers and regulated by securities specialists inclined to a philosophy of full disclosure, 191 it would no longer be necessary to separate the enforcement of municipal-securities regulation from its promulgation. Section 15B could therefore be amended to impose strict post-underwriting period discipline comparable to that provided by the Investment Company Act. 192

Congress need not, however, impose such regulations directly; nor, indeed, is this advisable. Market ethics are best adopted by individuals actually engaged in or familiar with the business, rather than by Congress. The greater homogeneity of underwriting participants which would result from isolating bank underwriting in securities affiliates would allow Congress to delegate regulatory authority over the municipal-bond market in one of several ways.

Initially, it might seem most expedient to simply leave the MSRB in place and grant it uniform enforcement powers over all municipal-securities dealers. However, to elevate the MSRB to the

190 See note 36 supra & accompanying text.
191 Federal banking authorities would continue to police loan transactions and other management relations between the bank and its affiliate to ensure that the separation of capital and operation is actual in fact. See notes 186-87 supra & accompanying text.
192 See notes 91-97 supra & accompanying text.
status of an independent enforcement agency would require government funding. As currently structured, the MSRB is an independent, though nonmembership, self-regulatory organization and not part of the federal government. It therefore receives no federal funding, but is authorized to impose reasonable fees on municipal-securities brokers and dealers in order to defray its costs. The expense of converting the MSRB into a new federally-funded agency is bound to encounter political resistance. Alternatively, the existing separation of promulgation and enforcement could continue, but all enforcement powers could be vested in the SEC, rather than shared awkwardly with the banking agencies.

In the corporate-securities market, however, no such full reliance is placed on the SEC, because its resources are limited. Rather, the industry has relied on self-regulation through the NASD, its own voluntary organization. This association is composed of industry participants that adhere to the organization's rules in part because of the economic benefits and services which membership status confers. Conceivably, the NASD could be expanded to include municipal-securities dealers. However, the differing characteristics of the municipal-securities and corporate-securities markets would mean that not only the regulations but also the services required by the municipal-bond dealers would differ from those now imposed and provided by NASD. It is

193 See note 31 supra.


It should be noted that self-regulation in the corporate securities area is also performed by the national securities exchanges. See, e.g., §§ 6, 19 of the 1934 Act, 15 U.S.C. §§ 78f, 78s (1976). However, because municipal securities are traded in over-the-counter markets, S. Rep., supra note 18, at 40-41, reprinted in [1975] U.S. CODE CONG. & A. News at 218, brokerage firms or bank securities affiliates trading only in municipal securities cannot be reached by exchange rules.

196 This would require partial repeal of § 15A(f), 15 U.S.C. § 78o-3(f) (1976), precluding registered securities associations from adapting rules with respect to municipal securities.

197 See note 30 supra.

198 The municipal-securities market is characterized by a relatively small secondary trading volume and a relatively high percentage of institutional investors. See note 30 supra & accompanying text. Such a market does not require the complex trading and quotation system or minimum capital requirements that constitute much of self-regulation in the corporate-securities area. See, e.g., New York Stock Exchange rules 60-79, 325-28, NEW YORK STOCK EXCHANGE GUIDE (CCH) §§ 2060-2079A, 2325-2328; NASD By-Laws Arts. VII, XVI and Rules of
likely, therefore, that the NASD would have to set up a separate branch for municipal-securities affairs in any event. Thus, a more effective alternative is to establish a national association of municipal-securities dealers (NAMSD), comparable in status and function to the NASD, to deal directly with undesirable practices by their peers. Such an association was contemplated by the original drafters of the Securities Act Amendments of 1975, but the idea was ultimately dropped in favor of the nonmembership, nonenforcement-oriented MSRB. That compromise satisfied the commercial bankers who claimed that membership in an NASD-type organization would subject them to duplicative regulation. If commercial bank underwriters are split off from the rest of the bank's personnel and functions, however, their activity will be only indirectly affected by banking regulations and this objection to membership in a self-regulatory organization registered under the SEC will no longer have merit.

CONCLUSION

This Comment has attempted to contribute to the debate over commercial-bank entry into the municipal-revenue-bond market by examining the proposal from the standpoint of investor protection. The bulk of commentary and analysis has failed to consider the impact that such an extension of bank securities activity would have on the quality of market regulation now and in the future. The benefits that may result from increased bank activity in this area can only be achieved by isolating these activities into securities affiliates, which would function exclusively as full-fledged municipal-securities dealers and thus could be regulated as such, without deference to the banking agencies. This Comment has attempted to outline the regulatory system that could be established to oversee this new municipal-securities marketplace.

Fair Practice Art. III, NASD Manual (CCH) ¶¶ 1501-1505, 1651-1654, 2151-2184. It is noteworthy that in other securities markets, such as the federal-government bond market, where steps have recently been taken toward self-regulation, there has nonetheless been no attempt to integrate with the NASD. See, e.g., GNMA Dealers' Efforts at Self-Regulation, [1979] 513 SEC. REG. & L. REP. (BNA) A-9.

This, like the expansion of the NASD, could be authorized by providing that municipal securities are not exempted securities for purposes of § 15A(f) of the 1934 Act, 15 U.S.C. § 78o-3(f) (1976).

See Dikeman, supra note 22, at 909-10.