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I. INTRODUCTION

The municipal securities industry, an important segment of the national capital markets, directly affects both the quality of life and the pace of community development throughout the nation. Municipal securities, broadly defined to include all debt securities issued

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or guaranteed by the states and their political subdivisions,[1] are the vehicle by which states, their agencies, and local governments finance both long- and short-term debt requirements. In calendar 1975, for example, the municipal securities industry raised approximately 29.2 billion dollars in long-term issues.[2] In 1973, 8,147 long- and short-term issues raised almost 48 billion dollars,[3] or approximately one-quarter of all direct expenditures of state and local governments for that year.[4] Aid from the federal government for the same year was 39 billion dollars.[5]

The proceeds of municipal securities go not only to highways and other typically governmental projects, but also to housing, hospital, and university construction, pollution control facilities, and industrial development,[6] as well as short-term financing of governmental activities in anticipation of the receipt of tax revenues, federal revenue sharing contributions, and long-term capitalization. These securities, which are unique because of the nature of their issuers and their tax exempt status under existing court decisions and federal tax laws, have contributed substantially to the develop-

1. This Article uses the term "municipal securities" as defined in § 3(a)(29) of the Securities Exchange Act of 1934, *as amended* [hereinafter cited as the 1934 Act], 15 U.S.C.A. § 78c(a)(29) (Supp. 1976) to mean

> securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond (as defined in Section 103(c)(2) of [the Internal Revenue Code of 1954]) the interest on which is excludable from gross income under section 103(a)(1) of [such Code].

INT. REV. CODE OF 1954, § 103(a)(1) appears to be somewhat more expansive in "defining" municipal securities by excluding from gross income the interest on

> the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia.

Yet another definition of municipal securities is set forth in § 3(a)(2) of the Securities Act of 1933 [hereinafter cited as the 1933 Act], *as amended*, 15 U.S.C. § 77c(a)(2) (1970), that exempts from the registration and other provisions of the 1933 Act

> [a]ny security issued or guaranteed . . . by the District of Columbia, or 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.

Although this lack of parallel definitions is disturbing, the disparities generally are not viewed as being destructive of the federal regulatory scheme.

2. THE DAILY BOND BUYER, Jan. 2, 1976, at 1, col. 4.

3. 13 THE BOND BUYER, MUNICIPAL FINANCIAL STATISTICS 7 (June 1975) [hereinafter cited as FINANCIAL STATISTICS].

4. *Id.* at 47.

5. *Id.*

6. S. REP. No. 75, 94th Cong., 1st Sess. 39 (1975) [hereinafter cited as S. REP.]. In 1975, for example, approximately $1.673 billion in pollution control issues and $1.292 billion in hospital and medical care facilities issues were marketed. FINANCIAL STATISTICS, *supra* note 3, at 42-46.

ment of localities across the country.

With the enactment of the Securities Acts Amendments of 1975 (1975 Amendments),[7] brokers, dealers, and banks first became subject to comprehensive federal regulation of their municipal securities activities. The principal impact of this legislation, which substantially amended the Securities Exchange Act of 1934 (1934 Act),[8] upon the municipal securities industry was the establishment of a regulatory framework for transactions in municipal securities. As an integral part of this framework, the 1975 Amendments created the Municipal Securities Rulemaking Board (Board),[9] as an independent, self-regulatory body charged with primary responsibility for developing rules for the municipal securities industry, subject to the general oversight of the Securities and Exchange Commission (Commission). This Article discusses the nature and functioning of the Board and some specific areas of Board activity.

II. 1975 AMENDMENTS

A. *Previous Securities Laws Coverage and Legislative Antecedents*

Prior to enactment of the 1975 Amendments, municipal securities were defined as "exempted securities" under the 1934 Act.[10] As a result of this statutory exclusion, municipal securities were exempt from the reporting requirements of the 1934 Act, and brokers and dealers effecting transactions exclusively in municipal securities, unlike their counterparts engaged in a general securities busi-

7. Pub. L. No. 94-29, 89 Stat. 97 (Dec. 1, 1975) (codified in scattered sections of 15 U.S.C.) [hereinafter cited as 1975 Amendments].

8. 15 U.S.C. §§ 78 *et seq.* (1970).

9. 1934 Act § 15B(b)(1), 15 U.S.C.A. § 78o-4(b)(1) (Supp. 1976), actually directed the Commission to establish the Board. This was accomplished in the fall of 1975. *See* note 33 *infra*.

10. Prior to the 1975 Amendments, § 3(a)(12) of the 1934 Act, 15 U.S.C. § 78c(a)(12) (1970), exempted

> securities which are direct obligations of or obligations guaranteed as to principal or interest by a State or any political subdivision thereof, or by any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States; or any security which is an industrial development bond.

The substance of this language has been incorporated by the 1975 Amendments into the definition of "municipal security" set forth in § 3(a)(29) of the 1934 Act, 15 U.S.C.A. § 78c(a)(29) (Supp. 1976); *see* note 1 *supra*. Section 3(a) (12), 15 U.S.C.A. § 78c(a)(12) (Supp. 1976), now merely defines "exempted securities" to include "municipal securities." Municipal securities are not "exempted securities," however, for all purposes of the 1934 Act, as § 3(a)(12) lists specific provisions that are applicable to municipal securities despite exclusions for "exempted securities." *See, e.g.*, 1934 Act §§ 15(c)(2)-(3) & 15A(f), 15 U.S.C.A. §§ 78o(c)(2)-(3), 78o(3)(f) (Supp. 1976).

ness, were not required to be registered with the Commission[11] and were not subject to the extensive system of regulation for the general securities industry under the 1934 Act. Transactions in municipal securities were not subject to the registration requirements of the Securities Act of 1933, as amended (the 1933 Act),[12] but only to certain of the antifraud provisions of the 1933 and 1934 Acts and the rules and regulations thereunder.[13]

Because municipal securities are traded in over-the-counter markets, securities firms trading only in municipal and other unlisted securities did not become members of national securities exchanges. The rules of the National Association of Securities Dealers, Inc. (the "NASD"), which contain economic incentives to membership, did not apply to transactions in municipal securities.[14] Thus firms that dealt only in municipal securities were not encouraged by

11. Former section 15(a)(1) of the 1934 Act, 15 U.S.C. § 78o(a)(1) (1970), required brokers and dealers effecting transactions in nonexempted securities to register with the Commission. The 1975 Amendments extended this registration requirement to securities firms trading exclusively in municipal securities by providing in § 3(a)(12) of the 1934 Act, 15 U.S.C.A. § 78c(a)(12) (Supp. 1976), that municipal securities are not exempted securities for purposes of § 15. *See* note 10 *supra*. Banks, which are permitted to engage in certain brokerage activities, *see* note 16 *infra*, were not required to register with the Commission prior to tbe 1975 Amendments because they are neither brokers nor dealers, as defined in the 1934 Act. *See* notes 32 & 42 *infra*. Section 15B(a)(1) of the 1934 Act, 15 U.S.C.A. § 78o-4(a)(1) (Supp. 1976), now requires banks that are municipal securities dealers to register with the Commission. *See* text accompanying notes 42 & 43 *infra*.

12. 1933 Act § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1970); *see* note 1 *supra*.

13. Section 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1970), and § 10(b) and former § 15(c)(1) of the 1934 Act, 15 U.S.C. §§ 78j(b), 78o(c)(1) (1970), for example, were and are applicable to transactions in municipal securities. *See* S. REP., *supra* note 6, at 42. Former sections 15(c)(2) & 15(c)(3) of the 1934 Act, 15 U.S.C. §§ 78o(c)(2)-(3) (1970), on the other hand, were inapplicable to transactions in municipal securities prior to the 1975 Amendments.

14. Section 15A(m) of the 1934 Act, 15 U.S.C. § 78o-3(m) (1970) (redesignated § 15A(f) by the 1975 Amendments, 15 U.S.C.A. § 78o-3(f) (Supp. 1976)), provides that nothing in § 15A, dealing with registered securities associations, "shall be construed to apply with respect to any transaction by a broker or dealer in any exempted security." The rules of the NASD were drafted accordingly. *See, e.g.*, NASD Rules of Fair Practice, art. I, § 4; NASD Uniform Practice Code § 1(a). Under art. III, § 25 of the Rules of Fair Practice, NASD members are required to deal with nonmember brokers and dealers on the same terms offered to public customers, thus restricting the resale pricing benefits of the dealer discount or concession to members. Under the 1975 Amendments, municipal securities are no longer exempted securities for most provisions of § 15A. Section 15A(e)(1), 15 U.S.C.A. § 78o-3(e)(1) (Supp. 1976), now authorizes the rules of registered securities associations to provide that dealings by its members with nonmember brokers and dealers (other than bank dealers with respect to transactions in municipal securities) shall be "at the same prices, for the same commissions or fees, and on the same terms and conditions as are by [its members] accorded to the general public." As applied to the municipal securities industry, this would encourage nonmember firms to join the NASD by prohibiting them from participating in underwriting syndicates with member firms and effectively raising the purchase cost to nonmember customers of municipal securities obtained from or through a nonmember firm.

this fact alone to become members of the NASD. Furthermore, integrated corporate and municipal securities firms that were members of the NASD were not subject to regulation by it of their municipal securities activities.[15]

A substantial portion of the municipal securities industry consists of banks, which are authorized to underwrite and otherwise deal in municipal securities that are general obligations of their issuers, as well as unsolicited brokerage activities in securities generally.[16] Banks are subject to regulation by the three federal bank regulatory agencies: the Comptroller of the Currency for national banks, the Board of Governors of the Federal Reserve System (the Federal Reserve) for member state banks and bank holding companies (and their subsidiary banks if neither federally chartered nor insured by the Federal Deposit Insurance Corporation (FDIC)), and the FDIC for all other banks insured by it. Although the overall activities of banks are subject to the scrutiny of these federal bank authorities, there was no focus on municipal securities activities prior to the 1975 Amendments.

The exclusion of municipal securities transactions and professionals from the extensive system of regulation applicable to corporate securities and firms transacting business in such securities reflected congressional recognition that the municipal securities industry had avoided the excesses and abuses of the corporate securities area[17] and that investors in municipal securities generally were more sophisticated and less in need of protection than investors in corporate securities.[18] Because of lower personal income tax rates prevailing at the time and the substantial investment required for most municipal securities, the distribution of municipal securities

15. *See* note 13 *supra*.

16. Glass-Steagall Act of 1933, 12 U.S.C. § 24 (Supp. IV, 1974). As one of many exceptions to the general limitation imposed by the Glass-Steagall Act of 1933 on the ability of national banks to engage in securities transactions as principal, § 24 authorizes dealing in, underwriting, and purchasing for investment any "general obligations of any state or of any political subdivision thereof." Accordingly, national banks may underwrite general obligations securities, but are not permitted to underwrite revenue bonds other than for housing, university, or dormitory purposes (which are exempted under another clause of § 24). Direct placements of municipal and corporate securities, however, do not fall within the general limitation and are permitted.

17. H.R. REP. No. 85, 73d Cong., 1st Sess. 7 (1933) (exemption under the 1933 Act); *Hearings on S.R. 84, S.R. 56 & S.R. 97 Before the Senate Comm. on Banking & Currency*, 73d Cong., 2d Sess. 7037-46 (1934) (need for including municipal securities within coverage of 1934 Act).

18. *See Hearings on S. 1933 & S. 2474 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs*, 93d Cong., 2d Sess. 49-50 (1974) (statement of SEC Commissioner John R. Evans) [hereinafter cited as *1974 Hearings*].

among individuals in the 1930's and for many years thereafter was limited to persons of substantial means for whom the tax-exempt status of these securities' interest income compensated for their relatively modest yields. Banks and fire and casualty insurance companies, the other principal categories of investors in municipal securities, are viewed generally as able to fend for themselves in securities transactions.

With increased personal income tax rates and higher yields on municipal securities in recent years, however, municipal securities have begun to have investment appeal to individuals of less affluence, many unsophisticated in their investment judgment and risking severe financial damage in the event of loss. In 1974, over 60 billion dollars of the 207 billion dollars of municipal securities outstanding were held by "households," a category including individuals, family trusts, and unincorporated businesses.[19] This increased individual investment unfortunately facilitated abuses by a small group in the municipal securities industry. In the course of ensuing antifraud actions brought by the Commission, the egregious misconduct of this minority, concentrating in "boiler room" operations involving the use of high pressure tactics to bilk gullible individuals,[20] drew attention to the limited effectiveness of antifraud rules in protecting investors from dealer misconduct.[21]

Recognizing the integrity of most municipal securities professionals and the efficient functioning of the industry in providing debt financing to issuers and maintaining a secondary market for investors,[22] Congress sought in the 1975 Amendments to provide a sufficient basis of authority for the development of a comprehensive set of industry regulations. Comparing the lack of authority in the Commission and the NASD to prevent undesirable practices by municipal securities professionals with the regulations to which the

19. S. REP., *supra* note 6, at 41-42. Although the percentage of all outstanding municipal securities held by noninstitutional investors has heen declining, the absolute dollar amount has increased dramatically from $30.8 billion in 1960 to $62.3 billion in 1974. *Id.*

20. For an example of the tactics employed by boiler room operators see SEC v. R.J. Allen & Assoc., Inc., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,920 (S.D. Fla. 1974). Injunctive and enforcement proceedings brought by the Commission against registered and unregistered brokers and dealers, although successful in closing down an illegal securities operation by permanent injunction or revocation of registration, necessarily are *ex post facto* actions of less practical benefit to investors than an effective program of fraud prevention. In addition, the lack of recordkeeping requirements for unregistered brokers and dealers prior to the 1975 Amendments meant that the monitoring and evidentiary functions performed by such requirements were not available to the Commission in its antifraud compliance efforts.

21. S. REP., *supra* note 6, at 43.

22. *Id.* at 43-44.

activities of brokers and dealers trading in corporate securities were subject, Congress concluded that "the time has come to revise the [1934] Act to subject municipal securities professionals to essentially the same regulatory scheme that applies to other securities activities."[23]

Specifically, concerning this regulatory scheme for developing a completely new body of substantive industry regulations for a previously unregulated industry—a task not confronted by the Commission, the national securities exchanges, or the NASD—Congress acknowledged again, as in 1934, the inability of government directly to impose effective regulation on a wide scale in the securities context.[24] The Senate Committee on Banking, Housing and Urban Affairs (Senate Committee) stated:

> The Committee believes the historical reasons which persuaded our predecessors to delegate government authority to national securities exchanges and national securities associations remain valid and justify the establishment of a self-regulatory structure for the municipal securities industry. In fact, it is evident from the history of the legislation that support for some type of self-regulatory scheme for the municipal securities industry is widespread. Under the federal securities laws since 1934 and 1938, self-regulation has played and will continue to play an essential role in regulating the corporate securities markets. The bill would simply extend this principle to the municipal securities markets.[25]

B. Nature of the Board as a Self-Regulatory Organization

Consistent with the expressed intent of Congress concerning self-regulation and in the absence of an existing body comprehending and representative of all industry participants, Congress initially considered the establishment of a national association of municipal securities dealers (NAMSD), an independent membership association comparable in status and function to the NASD with respect to broker-dealer activities.[26] This approach, however, met

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23. *Id.* at 43.

24. *Id.* at 22. This necessarily involves a balancing with the potential conflicts between self-regulators' private interests and public duties, a subject reviewed in depth by the Senate Committee with respect to changes effected by the 1975 Amendments in the Commission's authority over self-regulatory organizations. *See id.* at 22-38.

25. *Id.* at 46.

26. *See* S. 2474, 93d Cong., 1st Sess. § 7 (1973). As the Commission commented, authority for the establishment of such an organization under former § 15A of the 1934 Act, 15 U.S.C. § 78o-3 (1970)—as opposed to its creation by the Commission pursuant to a specific legislative directive—could have been accomplished merely by providing that municipal securities are not exempted securities for purposes of § 15A(m), 15 U.S.C. § 78o-3(m) (1970) (redesignated by the 1975 Amendments as § 15A(f), 15 U.S.C.A. § 78o-3(f) (Supp. 1976)). *See 1974 Hearings, supra* note 18, at 79. Section 15A(m) was the provision in the 1934 Act that precluded registered securities associations from adopting rules with respect to munici-

strong objections founded on the necessary participation of commercial banks as members of NAMSD.[27] Banks or separately identifiable departments or divisions of banks that are municipal securities dealers (bank dealers),[28] which like other banks traditionally have been subject to regulation of their activities by the federal bank regulatory agencies, would have become subject to duplicative and potentially inconsistent self-regulatory enforcement as members of NAMSD. On the other hand, failure to regulate the municipal securities activities of bank dealers, it was argued, would have had an adverse effect upon the competitive ability of securities firms with respect to municipal securities. Separate and possibly "unequal" regulation by the bank regulatory agencies could have led to the same distortions in competition.

Following the recommendation of the Commission, among others,[29] Congress resolved this problem of regulatory coordination by simplifying the structure and delimiting the powers of the new self-regulatory organization.[30] The resulting body is unique among all independent, self-regulatory organizations in the respects described below.

(1) Nonmembership Organization

First, the Board—unlike the NASD, the stock exchanges, and the proposed NAMSD—is not a voluntary membership organization composed of industry participants that, as the objects of substantive regulation, are subject to the organization's rules by means and because of their membership status. Pursuant to the statutory requirements of the 1975 Amendments,[31] the Board consists of fifteen members, five of whom represent municipal securities brokers and municipal securities dealers[32] other than banks and organizations

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pal and other exempted securities. *See* note 14 *supra*.

27. *See 1974 Hearings, supra* note 18, at 50-53, 218-19.

28. This basically is the definition utilized by the Board in its rule D-8. The term "separately identifiable department or division" of a bank has been defined by the Board pursuant to § 15B(b)(2)(H) of the 1934 Act, 15 U.S.C.A. § 78o-4(b)(2)(H) (Supp. 1976), in its rule G-1. *See* text accompanying notes 88-90 *infra*.

29. *1974 Hearings, supra* note 18, at 52-53, 219-21.

30. The Board is defined to be a "self-regulatory organization" for purposes of rulemaking oversight by the Commission and annual reports by the Commission to Congress. 1934 Act § 3(a)(26).

31. *Id.* § 15B(b)(1), 15 U.S.C.A. § 78o-4(b)(2)(B) (Supp. 1976). Pursuant to § 15B(b)(2)(B)(b), 15 U.S.C.A. § 78c(a)(2)(B) (Supp. 1976) the Board is authorized to increase, but not decrease the number of its members, provided that the whole Board always shall have an odd number of members.

32. Section 3(a)(30) of the 1934 Act, 15 U.S.C.A. § 78c(a)(30) (Supp. 1976), defines the term "municipal securities dealer" to mean:

affiliated with banks; five of whom represent municipal securities dealers that are banks or organizations affiliated with banks; and five of whom are public members, not associated with any broker, dealer, or municipal securities dealer. At least one of the public members must represent investors in municipal securities and another must be representative of issuers of municipal securities. The initial members of the Board, who were appointed by the Commission,[33] will serve two-year terms expiring September 5, 1977. Successor members of the Board are to be nominated and elected pursuant to procedures the Board will adopt in rule form.[34] The Commission will not play a role in the election of successor members except for the purpose of assuring that public members are not associated with a municipal securities professional and that at least one is representative of issuers and one of investors.[35]

Lacking "members" in the sense of the other self-regulatory organizations and therefore unable to finance its operations by means of membership dues and assessments, the Board is authorized and directed by statute to adopt rules requiring municipal securities brokers and municipal securities dealers to pay "such reasonable fees and charges as may be necessary or appropriate to defray the costs and expenses of operating and administering the Board."[36] The Board to date has imposed two charges under this

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any person (including a separately identifiable department or division of a bank) engaged in the business of buying and selling municipal securities for his own account, through a broker or otherwise.

Specific exclusions are provided for persons trading for their own accounts, individually or as fiduciaries, "not as a part of a regular business" and for banks trading in municipal securities only as fiduciaries. Section 3(d) of the 1934 Act, 15 U.S.C. § 78c(d) (1970), provides that issuers of municipal securities and their officers and employees (acting in their official capacities) are not brokers, dealers, or municipal securities dealers "solely by reason of buying, selling, or effecting transactions in the issuer's securities." The definition of "municipal securities dealer" was necessary since banks are excluded specifically from the definitions of "broker" and "dealer" set forth in §§ 3(a)(5) and 3(a)(6) of the Act.

The 1975 Amendments also defined the term "municipal securities broker" to mean "a broker engaged in the business of effecting transactions in municipal securities for the account of others." *Id.* § 3(a)(31). Banks, which frequently act as agent with respect to transactions in municipal securities, are not municipal securities brokers because they are not brokers.

33. In SEC Securities Exchange Act Release No. 11,469 (June 12, 1975), the Commission solicited from the public recommendations of individuals for appointment to the Board. The appointment of the initial members of the Board was announced in SEC Securities Exchange Act Release No. 11,635 (Sept. 5, 1975).

34. 1934 Act § 15B(b)(2)(B), 15 U.S.C.A. § 78o-4(b)(2)(B) (Supp. 1976).

35. *Id.* The Commission is authorized under § 15B(c)(8) of the 1934 Act, 15 U.S.C.A. § 78o-4(c)(8) (Supp. 1976), to discipline or remove members and employees of the Board for willful violations of the 1934 Act, the rules and regulations thereunder, and for abuse of authority.

36. *Id.* § 15B(b)(2)(J), 15 U.S.C.A. § 78o-4(b)(2)(J) (Supp. 1976).

authorization, the first requiring each securities firm effecting transactions in municipal securities and each bank dealer to pay a one-time fee of one hundred dollars,[37] and the second imposing a five cent charge per 1,000 dollar face amount of new issues of municipal securities underwritten or otherwise distributed by or with the assistance of a municipal securities professional acting as principal or agent.[38] As an independent self-regulatory organization, the Board is not deemed to be part of the federal government and receives no federal funding.

The members of the Board have the constituent affiliation traditionally associated with self-regulatory organizations and draw upon their respective areas of expertise and interest in developing rules for the industry. This process embodies the essence of self-regulation: knowledgeable development of transactional and ethical standards of industry conduct by the industry acting in conjunction with interested members of the public.

(2) Regulated Persons and Activities

As noted earlier, prior to the 1975 Amendments, brokers, dealers, and bank dealers were not required to register with the Commission by reason of their transactions in municipal securities.[39] The Commission did not regulate integrated firms (*i.e.* those transacting business in both corporate and municipal securities) specifically with respect to their municipal securities activities. Similarly, the NASD did not regulate its members that were integrated firms with respect to these activities.[40]

The 1975 Amendments extended the registration requirement of section 15 of the 1934 Act to brokers and dealers effecting transactions in municipal securities. This was accomplished by amending the definition of "exempted securities" in section 3(a)(12) of the 1934 Act to exclude municipal securities for purposes of section 15, among others.[41] In addition, section 15B(a)(1) of the 1934 Act now requires the registration with the Commission of all municipal securities dealers (unless already registered as a broker or dealer under section 15), including the option for a bank dealer applicant to

37. MSRB Rule A-12 (1975).

38. MSRB Rule A-13 (1976). This assessment does not apply, however, to short-term issues having a final stated maturity of less than 2 years.

39. *See* note 11 *supra*.

40. 1934 Act § 15A(m) (redesignated as § 15A(f), 15 U.S.C.A. § 78o-3(f) (Supp. 1976); *see* notes 14 & 15 *supra* and accompanying text.

41. *See* notes 10 & 11 *supra*.

register a separately identifiable department or division.[42] Banks that act as agents in effecting transactions in securities, however, are not required to register with the Commission by reason of such "brokerage" activities.[43]

The Board's rulemaking jurisdiction, set forth in section 15B(b)(2) of the 1934 Act, authorizes and directs the Board to "propose and 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."[44] The balance of section 15B(b)(2) refines and strengthens the general grant of authority by identifying in paragraph (C) specific purposes the Board is to consider in adopting rules and setting forth in the remainder of paragraphs (A) through (K) certain subject matter areas in which the Board is directed "as a minimum" to propose and adopt rules.[45]

Among the purposes of the Board's rules set forth in section 15B(b)(2)(C) are preventing fraudulent and manipulative acts and practices, promoting just and equitable principles of trade, fostering industry cooperation, facilitating municipal securities transactions, encouraging the development of a free and open market in municipal securities, and protecting investors and the public interest. The Board's rules are not to be designed to allow unfair discrimination, fix profits, commissions, or prices, impose unnecessary or inappropriate burdens on competition, or regulate matters outside the Board's jurisdiction. Specific areas to be addressed by the Board's rules include standards of professional qualification and operational

42. Unlike the definition of "municipal securities broker" in § 3(a)(31), 15 U.S.C.A. § 78c(a)(31) (Supp. 1976), which establishes a new subgroup within the definition of "broker" contained in § 3(a)(4), 15 U.S.C. § 78c(a)(5) (1970), "municipal securities dealer" creates an entirely new group consisting of both "dealers" and banks, which are neither "brokers" nor "dealers." *See* note 32 *supra*. Although municipal securities dealers are required to register as such by § 15B(a)(1), 15 U.S.C.A. § 78o-4(a)(1) (Supp. 1976), the provision contemplates that municipal securities dealers that are "brokers" or "dealers" and thus registerable under § 15(a) of the 1934 Act, 15 U.S.C.A. § 78o-3(a) (Supp. 1976), will do so. Accordingly, only bank dealers (or their separately identifiable departments and divisions) and "intrastate" dealers that are municipal securities dealers register under § 15B(a) of the 1934 Act, 15 U.S.C.A. § 78o-4(a) (Supp. 1976). Section 15B(a), 15 U.S.C.A. § 78o-3(a) (Supp. 1976), does not impose a registration requirement on municipal securities brokers because they necessarily are "brokers" and thus required to register under § 15(a)—unless they conduct a purely intrastate business, in which case they are not required to register under either section.

43. *See* note 32 *supra*.

44. It was unnecessary for the section to refer to "transactions . . . effected by brokers, municipal securities brokers, dealers, and municipal securities dealers" because all municipal securities brokers are defined to be brokers. 1934 Act § 3(a)(31), 15 U.S.C.A. § 78c(a)(31) (Supp. 1976); *see* notes 32 & 42 *supra*.

45. The adoption of rules in one subject area, arbitration, was left to the Board's discretion pursuant to § 15B(b)(2)(D), 15 U.S.C.A. § 78o-4(b)(2)(D) (Supp. 1976).

capability, scope and frequency of periodic compliance examinations, form and content of quotations, recordkeeping requirements, definition of "separately identifiable department or division" of a bank dealer for purposes of registration of a part of a bank dealer rather than the whole bank,[46] terms and conditions of sales of new issues to municipal securities investment portfolios, administration and financing of the Board, and procedures for the nomination and election of successor members of the Board.

To understand the unique nature of the Board's rulemaking jurisdiction, section 15B(b)(2) of the 1934 Act must be read together with the statutory authority of the national securities exchanges and the NASD to adopt rules applicable to their members. The grant of authority to the Board "with respect to transactions in municipal securities" by brokers, dealers, and bank dealers then must be interpreted in light of the specific purposes and subject matter areas set forth in sections 15B(b)(2)(A) through (K). In other words, the self-regulatory functions of the Board as expressed in section 15B of the 1934 Act cannot be construed without identifying the regulatory vacuum Congress intended the Board to fill.

Prior to the 1975 Amendments, the rulemaking jurisdiction of the national securities exchanges, and to a lesser extent the NASD, was subject to some controversy. In their capacity as membership bodies—disregarding for the moment the exercise of delegated governmental power—exchanges prior to the 1934 Act arguably had the consensual authority customarily granted such bodies to prescribe regulations with respect to the relationship between the exchange and its members, including membership in the exchange, and the members' relationships with each other. Since exchanges provided facilities of economic benefit to their members, authority also existed to prescribe regulations governing the facilities and their use by the members.

With the enactment of the 1934 Act came the acknowledgment that exchanges are affected with a public interest. As a condition to delegating governmental powers to exchanges, however, former section 6 of the 1934 Act imposed a registration requirement for exchanges that required rules of the exchanges to provide for disciplinary sanctions against members for conduct "inconsistent with just and equitable principles of trade."[47] Former section 6 did not state that exchanges must define just and equitable principles of trade or limit their ability to do so. In former section 19(b) of the

46. *See* text accompanying notes 88-90 *infra*.

47. Act of June 6, 1934, ch. 404, § 6(b), 48 Stat. 886.

1934 Act,[48] the Commission was authorized "to alter or supplement the rules" of a registered exchange relating to trading in listed securities, financial responsibility requirements for members, and "similar matters" concerning transactions utilizing the exchange's facilities, thus recognizing implicitly an exchange's authority to adopt rules in these areas.

As noted by the Senate Committee in 1975, however, it was not clear whether or to what extent these specific provisions defined the limits of an exchange's rulemaking jurisdiction,[49] especially in view of former section 6(c), which provided that nothing in the 1934 Act

> shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with [the 1934 Act] and the rules and regulations thereunder and the applicable laws of the State in which it is located.[50]

Thus it was understood that national securities exchanges as self-regulatory organizations were supposed to be responsible for listing securities, regulating facilities provided, regulating the use of facilities and the manner of effecting transactions by means of an exchange's facilities, financial responsibility of members, and defining just and equitable principles of trade to be followed by members with each other and with their customers, at least with respect to listed securities. The extent, if any, to which exchanges could or should regulate the conduct of their members with respect to unlisted securities and activities unrelated to securities remained uncertain.

With the addition of section 15A by the Maloney Act in 1938,[51] the 1934 Act authorized the registration of national securities associations and the delegation of certain governmental powers incident to the contemplated self-regulatory role they were expected to perform. The NASD, the only organization registered under section 15A, did not offer its members the use of any facilities comparable to the auction markets maintained by the exchanges.[52] Accordingly, the rulemaking jurisdiction for registered securities associations, rather than adopting the format of former sections 6 and 19(b) of the 1934 Act, was stated in terms of purposes and standards.[53] Apart from minimum rule requirements relating to the membership form

48. *Id.* § 19(b), 48 Stat. 899.

49. S. REP., *supra* note 6, at 26-27.

50. Act of June 6, 1934, ch. 404, § 6(c), 48 Stat. 886.

51. Act of June 25, 1938, ch. 677, § 1, 52 Stat. 1070.

52. *See, e.g.*, note 14 *supra* and accompanying text.

53. S. REP., *supra* note 6, at 27; *see* 1934 Act §§ 15A(b)(8), (12), 15 U.S.C. §§ 78o-3(b)(8), (12) (1970).

or organization, the form and content of quotations, and optional economic incentives to membership, former section 15A(b)(8) provided the basis of the NASD's rulemaking jurisdiction by requiring that

> the rules of the association [be] designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market; and not [be] designed to permit unfair discrimination between customers, or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges.[54]

The scope of the NASD's application of its rulemaking jurisdiction has depended upon two major considerations. First, under former section 15A(b)(3) of the 1934 Act, only brokers and dealers effecting or inducing transactions in securities "otherwise than on a national securities exchange" could become members. In other words, eligibility for membership depended, with minor exceptions, upon participation in over-the-counter markets. The almost universal concept of membership in a registered securities association[55] stands in contrast with the concept of membership in exchanges.[56] Consistent with the retention and expansion of the membership concept, section 15A required the adoption of qualification rules[57] and disciplinary procedures for violation of the association's rules by its members.[58] Rules relating to members' relationships with each other and with their customers were grounded within the statutory purposes and standards referred to in former section 15A(b)(8).

Secondly, the only explicit reference to the types of securities an association's rules were to address with respect to transactions effected by its members was in former section 15A(b)(12), which required the adoption of "provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange." The only explicit limitation on this

54. Act of June 25, 1938, ch. 677, § 7, 52 Stat. 1070.

55. Except, of course, for the provisions of former § 15A(b)(3) of the 1934 Act, 15 U.S.C. § 78o-3(b)(3) (1970), which authorized discrimination on the bases of geographical location and type of business done, membership in a registered securities association was and is universally available to all brokers and dealers meeting statutory requirements and the association's qualification rules. Banks, however, are ineligible for membership in a registered securities association. 1934 Act §§ 15A(b)(3), (g)(1), 15 U.S.C.A. §§ 78o-3(b), (g)(1) (Supp. 1976).

56. *See* S. REP., *supra* note 6, at 23-24.

57. Act of June 25, 1938, ch. 677, § 1, 52 Stat. 1070 (former § 15A(b)(5).

58. *Id.* (former §§ 15A(b)(9), (10)).

broad area of rulemaking jurisdiction was in former section 15A(m), which excluded municipal and other exempted securities. Obviously, registered securities associations were intended to do more than just establish qualification standards for their members and regulate in a general manner the relationships among members and between members and their customers. Similarly, although former section 15A did not expressly preclude registered securities associations from regulating their members' transactions in listed securities on exchanges, the Maloney Act—while not focusing in detail on potential jurisdictional conflicts—presumably did not intend to duplicate the exchange's function in this regard.

Without exploring in detail the areas in which the jurisdictions of the exchanges and the NASD overlapped prior to the 1975 Amendments and the addition of section 17(d)(1)(B), which authorizes the Commission to allocate rulemaking authority among self-regulatory organizations that share jurisdiction under the 1934 Act,[59] each type of organization was authorized generally to adopt standards of conduct and qualifications for its members, based upon their participation in a particular market, as well as transactions effected by their members in these markets and with customers. Neither of these two classes of self-regulatory organizations, however, regulated transactions in the separate municipal securities markets or the professional qualifications and business standards of securities firms participating in these markets as such. Bank dealers were not subject to any self-regulatory organization with respect to their transactions in municipal securities.

Congress in enacting the 1975 Amendments revised certain aspects of the system of self-regulation maintained by the exchanges and the NASD. Although most of these changes are not siguificant for purposes of this discussion, the manner in which the rulemaking jurisdiction of the exchanges and the NASD was restated is pertinent to understanding section 15B(b)(2) of the 1934 Act. Although the Board is not a membership organization and need not qualify for registration with the Commission to receive its delegated governmental powers, it is under an affirmative obligation to adopt certain types of rules, which substantially parallel the revised minimum

59. The Commission has adopted Rule 17d-1, which relates to examination duties of self-regulatory organizations with respect to their members' compliance with applicable financial responsibility rules, and proposed Rule 17d-2, which would permit self-regulatory organizations to submit allocation plans covering other regulatory functions to the Commission for approval. SEC Exchange Act Release No. 12352 (April 20, 1976).

rule requirements for registration under sections 6 and 15A of the 1934 Act.

Addressing the substantial changes effected by the 1975 Amendments in former sections 6 and 19(b) of the 1934 Act, which are not indicated in the legislative history as reflecting a change in the substantive content of the exchanges' and the NASD's rulemaking jurisdiction, the Senate Committee expressed its belief "that the statutory pattern governing the scope of the NASD's authority is sound."[60] In addition, the Senate Committee noted that:

> Under the [1975 Amendments] the scope of the rule-making authority and responsibility of all self-regulatory organizations would be defined in terms of purposes and standards rather than subject matters. The purposes to be served by self-regulatory rules would be expressed affirmatively and negatively (what the rules must be, and what they may not be, designed to accomplish) . . . .[61]

Apart from separate provisions relating directly to the membership form of organization, and, in the case of the NASD, form and content of quotations, the statutory bases for the exchanges' and the NASD's rulemaking jurisdiction over the standards and conduct of their members, as well as market regulation of the substance and form of transactions effected by their members, are set forth in the new and almost identical sections 6(b)(5) and 15A(b)(6) of the 1934 Act in terms of purposes and standards. The only explicit limitation upon these grants of authority also is set forth in these two sections: that the rules adopted "not [be] designed . . . to regulate by virtue of any authority conferred by [the 1934 Act] matters not related to the purposes of [the 1934 Act] or the administration of the [self-regulatory organization]."[62] This limitation was added, according to the Senate Committee, to assure that "the diversification of securities firms [would] not automatically extend the jurisdiction of the self-regulatory agencies."[63]

Comparing the provisions of section 15B(b)(2) of the 1934 Act with the new sections 6(b) and 15A(b), it is clear that section 15B(b)(2)(C) parallels and is based upon the "purposes and standards" grants of rulemaking jurisdiction to the exchanges and the NASD under the 1934 Act. The other paragraphs of section 15B(b)(2), which set forth minimum subject matter areas for the Board to consider, have counterparts in the separate minimum rule conditions set forth in sections 6 and 15A of the 1934 Act, accommo-

60. S. REP., *supra* note 6, at 27.
61. *Id.*
62. *Id.* at 28.
63. *Id.* at 47.

date the nonmembership form of the Board, or address specific questions in the municipal securities markets, such as purchases of new issues by municipal securities investment portfolios. Section 15B(b)(2)(C) contains the operative language that authorizes the Board to adopt the bulk of its regulations concerning the municipal securities markets and participants. It would appear from the similarity of section 15B(b)(2)(C) to sections 6(b)(5) and 15A(b)(6) that the type, nature, and scope of the Board's rulemaking jurisdiction are to be comparable to the jurisdiction of the exchanges and the NASD.

What, then, is the function of the statement in section 15B(b)(2) that "[t]he Board shall . . . 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"? It should be noted that this language does not read "adopt rules with respect to transactions." This interpretation would be inconsistent with the understanding developed concerning the meaning of the "purposes and standards" set forth in section 15B(b)(2)(C), as well as other paragraphs of section 15B(b)(2), such as paragraph (A) concerning professional qualifications, that clearly are not transactional in nature. Also, this interpretation effectively would preclude the Board from regulating municipal securities professionals as such except to the extent specifically authorized in other paragraphs of section 15B(b)(2) and contradict the Senate Committee's stated intent that the Board "have primary rulemaking authority with respect to the activities of municipal securities dealers and transactions in municipal securities."[62]

Read properly, it would appear that the quoted language from section 15B(b)(2) does not restrict the Board's jurisdiction to transactions themselves, but indicates the markets in which the Board is intended to develop a system of regulation, as well as the capacities in which the Board is to regulate market participants. Like sections 6(b)(5) and 15A(b)(6), section 15B(b)(2)(C) also provides that the Board's rules not be desigued "to regulate . . . matters not related to the purposes of [the 1934 Act]," which apparently was intended to preclude regulation of non-securities activities of regulated persons.[64] As this limitation alone would have duplicated the existing market jurisdiction of the exchanges and the NASD over listed and over-the-counter nonexempted securities with respect to their members that also are municipal securities professionals, a

64. *See* text accompanying notes 62 & 63 *supra*.

further definition of the purposes of the 1934 Act the Board was intended to promote—"with respect to transactions in municipal securities"—was needed. In addition, the references to municipal securities brokers and municipal securities dealers in the minimum subject matter areas of sections 15B(b)(2)(A) through (K) must be read in light of the broader reference to "brokers, dealers, and municipal securities dealers" in the general statement of section 15B(b)(2). Section 15B(c)(1), for example, prohibits the use of any facilities of interstate commerce by brokers, dealers, or municipal securities dealers "to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the Board." This underscores the Board's authority to address rules not only to sole municipal securities brokers and municipal securities dealers, but also to brokers and dealers whose level of activity in municipal securities would appear insufficient to make them municipal securities brokers or municipal securities dealers.

Clearly, the applicability of a Board rule to a broker, dealer, or municipal securities dealer depends upon the existence of a nexus between the rule and a transaction in municipal securities, the terms of the rule, and the capacity in which the person or firm to which the rule is sought to be applied is acting. Because of the broad rulemaking jurisdiction of the Board, it has attempted to exercise circumspection in delimiting the intended scope of application of its rules by referring only to municipal securities brokers and municipal securities dealers when appropriate in view of the Board's statutory purposes and imposing substantive and procedural requirements that are compatible with existing regulations of other self-regulatory organizations to which some municipal securities professionals are subject.

(3) Enforcement of Board Rules

Unlike the national securities exchanges and the NASD, the Board has neither inspection nor enforcement powers with respect to its rules. The NASD is directed by section 19(g)(1)(B) of the 1934 Act, "absent reasonable justification or excuse," to enforce compliance with Board rules by its members and their associated persons.[65] In addition, the Commission's power to impose disciplinary sanctions on and revoke the registration of brokers, dealers, municipal

65. 15 U.S.C.A. § 78f(g)(1)(B) (Supp. 1976). National securities exchanges, unlike the NASD, are not under a specific duty to enforce compliance with Board rules by their members. 15 U.S.C.A. § 78f(g)(1)(A) (Supp. 1976).

securities dealers, and their associated persons has been strengthened generally and now includes violation of Board rules as a basis for revocation under sections 15(b)(4) and 15B(c)(2) of the 1934 Act.

Compliance with Board rules by bank dealers and their associated persons is enforceable by both the Commission and the appropriate bank regulatory agency.[66] Rules of the Commission applicable to municipal securities dealers and transactions in municipal securities, like comparable rules of the Board, are also enforceable by the three federal bank regulatory agencies.[67] Whether the ultimate sanction is revocation of registration as a municipal securities dealer under section 15B of the 1934 Act or termination of insured status under section 8 of the Federal Deposit Insurance Act,[68] the appropriate bank regulatory agency or the Commission, whichever is initiating investigative or enforcement activities, is obligated to notify the other and to consult with it concerning not only the feasibility and desirability of coordination with the other agency, but also the effect of its proposed activities on sound banking practices (if the Commission is the initiating body)[69] and investor protection (if a bank regulatory agency is the initiating body).[70]

To aid municipal securities professionals in complying with the Board's rules and to assist the Commission, the three federal bank regulatory agencies, and the NASD in applying uniform inspection and enforcement criteria, the Board by rule has provided for advisory opinions and interpretations of its rules.[71] These opinions and interpretations, which are rendered at the request of any interested person, represent the Board's intent in adopting the rules discussed and do not address the meaning of statutory definitions or the applicability of substantive or procedural requirements of the 1934 Act to individuals or firms.[72]

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66. Section 3(a)(34)(A) of the 1934 Act, 15 U.S.C.A. § 78c(a)(34)(A) (Supp. 1976), defines the "appropriate regulatory agency" with respect to municipal securities dealers. All municipal securities dealers other than bank dealers are suhject to oversight or direct regulation by the Commission. The appropriate regulatory agency for each type of banking institution is the federal bank regulatory agency responsible for regulating its ordinary banking activities. *See* text following note 16 *supra*.

67. 1934 Act § 15B(c)(5), 15 U.S.C.A. § 78o-4(c)(5) (Supp. 1976).

68. 12 U.S.C. § 1818 (1970), *as amended*, (Supp. IV, 1974).

69. 1934 Act § 15B(c)(6)(A)(ii), 15 U.S.C.A. § 78o-4(c)(6)(A)(ii) (Supp. 1976).

70. 1934 Act § 15B(c)(6)(B)(ii), 15 U.S.C.A. § 78o-4(c)(6)(B) (ii) (Supp. 1976).

71. MSRB Rule A-8(b) (1975).

72. *See, e.g.*, MSRB Interpretation G-1:75:1 (Nov. 17, 1975).

III. Rulemaking Relationships

A. *Adoption and Effectiveness of Board Rules*

Section 15B(b)(2) of the 1934 Act authorizes the Board to propose and adopt rules within its rulemaking jurisdiction. Moreover, the Board is directed to adopt rules concerning the specified subject matter areas set forth in paragraphs (A) through (K) of section 15B(b)(2). This, however, is but the beginning of the rulemaking process. Any change, addition, or deletion adopted by the Board relating to its rules is a "proposed rule change," as defined by section 19(b)(1) of the 1934 Act, and like proposed rule changes adopted by national securities exchanges and the NASD, is subject to approval by the Commission under section 19(b). In addition, the Board is required to file a copy of each of its proposed rule changes with the three federal bank regulatory agencies.[73]

Approval by the Commission, which generally is required prior to effectiveness,[74] requires a finding by the Commission that the proposed rule change "is consistent with the requirements of [the 1934 Act] and the rules and regulations thereunder applicable to" the Board.[75] If the Commission contemplates disapproving the proposed rule change, it must commence proceedings giving notice of the contemplated grounds for disapproval and affording an opportunity for hearing.[76] At the conclusion of the proceedings, the Commission by order must approve or disapprove the entire proposed rule change; it is not authorized to revise or rework the Board's proposed rule changes under section 19(b).

The Commission also is afforded the opportunity by section 19(c) of the 1934 Act to initiate rulemaking by abrogating, adding to, or deleting from the Board's rules. In contrast to the summary abrogation provisions of section 19(b)(3)(C), the Commission may act under section 19(c) only by giving notice to the Board, publish-

73. 1934 Act § 17(c)(1), 15 U.S.C.A. § 78q(c)(1) (Supp. 1976).

74. Under § 19(b)(3)(A) of the 1934 Act, 15 U.S.C.A. § 78s(b)(3)(A) (Supp. 1976), rules relating to the Board's internal administration and its fees and assessments become effective on filing with the Commission. The Commission, however, may abrogate these automatically effective rules summarily within 60 days of their filing and require the Board to resubmit them in accordance with prior approval procedures. *Id.* § 19(b)(3)(C), 15 U.S.C.A. § 78s(b)(3)(C) (Supp. 1976). Rules not falling within the provisions of § 19(b)(3)(A) may be made effective summarily by the Commission "if it appears . . . that such action is necessary for the protection of investors, the maintenance of fair and orderly markets, or the safeguarding of securities or funds," but also are subject to summary abrogation by the Commission. *Id.* §§ 19(b)(3)(B), (C), 15 U.S.C.A. §§ 78s(b)(3)(B), (C) (Supp. 1976).

75. *Id.* § 19(b)(2), 15 U.S.C.A. § 78s(b)(2) (Supp. 1976).

76. *Id.* § 19(b)(2)(B), 15 U.S.C.A. § 78s(b)(2)(B) (Supp. 1976).

ing notice of its proposed action in the *Federal Register* (including the text of the proposed rule to be amended, adopted, or abrogated and a statement of the Commission's reasons therefor), and giving interested persons an opportunity to make oral presentations on the record and present written submissions. The standard against which the Commission's rulemaking activities under section 19(c) are measured is whether the action is necessary or appropriate to the fair administration of the Board, the conformity of the Board's rules with the requirements of the 1934 Act and applicable rules and regulations, or otherwise in furtherance of the purposes of the 1934 Act with respect to transactions in municipal securities.[77] In areas of substantive rulemaking, this standard for Commission initiative —necessary or appropriate to conform the Board's rules to applicable requirements—is similar to the criteria for Commission approval of the Board's proposed rule changes.

The difference arises by implication in the contemplated timing of the Commission's exercise of its powers under section 19(c). The legislative history of the 1975 Amendments demonstrates a clear reaffirmation of Congress' intent to utilize the self-regulatory mechanism with respect to the municipal securities industry.[78] Indeed, the following statement made by the Senate Committee emphasizes this point:

> The Committee believes that the Board has ample authority to deal with the problems of the municipal securities industry. The Board is intended to be the primary medium for regulation of the municipal securities industry and should be afforded ample opportunity to develop responsible rules for the industry.[79]

Turning to a comparison of the two standards, the Commission is *directed* to approve proposed rule changes of the Board if "consistent" with applicable statutory and regulatory requirements,[80] but merely is *authorized* to initiate substantive rulemaking activities for the regulation of the municipal securities industry if "necessary or appropriate" to conform the Board's rules to applicable statutory and regulatory requirements.[81] It would appear that this latter authority principally addresses two situations: inaction by the Board in regulating a particular aspect of the municipal securities industry, *i.e.* failure to adopt rules relating to identified subject matter areas under sections 15B(b)(2)(A) through (K), or a substantial

77. *Id.* § 19(c), 15 U.S.C.A. § 78s(c) (Supp. 1976).
78. *See* text accompanying note 24 *supra*.
79. S. REP., *supra* note 6, at 48.
80. 1934 Act § 19(b)(2), 15 U.S.C.A. § 78s(b)(2) (Supp. 1976).
81. *Id.* § 19(c) at 15 U.S.C.A. § 78s(c) (Supp. 1976).

change in knowledge, or market circumstances rendering a Board rule previously approved by the Commission no longer "consistent" with applicable requirements under the 1934 Act.[82] Although section 19(c) does not by its terms impose a time limitation or deference provision, preemptive exercise of this rulemaking authority by the Commission in either case would be inconsistent with the application of the principle of self-regulation envisioned by the 1975 Amendments and the express language of the Senate Committee. Thus, while the Commission clearly is afforded the ultimate say concerning rules of the Board, the 1975 Amendments assume a substantial measure of discretion in the Commission's exercise of these powers.

B. Concurrent Jurisdiction with Other Rulemaking Bodies

The unique rulemaking jurisdiction of the Board—extending beyond a membership base to any broker or dealer effecting transactions in municipal securities, regardless of the firm's membership in the NASD or one or more national securities exchanges—raises interesting concerns for the indirect effects of the exercise of the Board's rulemaking powers in areas of legitimate concern to other self-regulatory organizations. Similarly, as noted below,[83] the Commission has direct rulemaking authority over specified types of general securities transactions and professionals that overlaps certain portions of the Board's rulemaking authority.

In light of the allocation of self-regulatory obligations to the Board under the 1975 Amendments, failure of the other self-

82. S. REP., *supra* note 6, at 50. It is noteworthy that approval of a Board rule under § 19(b)(2) necessarily entails an affirmative finding by the Commission that the proposed rule change is within the powers of the Board and is consistent with any other applicable requirements under the 1934 Act. *See id.* at 28. Amendment by the Commission of previously approved Board rules should be distinguished from amendment of other rules of the Board in effect. Thus, rules effective on filing under § 19(b)(3)(A) do not relate to new, substantive regulation of the industry and are subject to summary abrogation by the Commission under § 19(b)(3)(C) and resubmission by the Board under the prior approval procedure of § 19(b)(2). Rules summarily made effective by the Commission under § 19(b)(2)(B) entail at least an informal determination by the Commission that they are "necessary" for one of the three stated reasons—*i.e.* purposes of the 1934 Act—and are subject to summary abrogation by the Commission under § 19(b)(3)(C) and resubmission for approval under § 19(b)(2). As it would appear that recourse to the Commission's powers under § 19(c) would be inappropriate at a time when summary abrogation under § 19(b)(3)(C) is available to invoke the prior approval procedure of § 19(b)(2), rules effective under § 19(b)(3) and no longer subject to summary abrogation thereunder should be viewed as standing on the same basis as rules approved under § 19(b)(2) for purposes of the Commission's exercise of its § 19(c) powers.

83. *See* part III.B(2), *infra*.

regulatory organizations and the Commission to acknowledge and accommodate the rulemaking jurisdiction of the Board might tend to undermine the Board's ability to function as the primary rulemaker for the municipal securities industry, a result conflicting with Congress' apparent intent. The Board, on the other hand, also needs to be attuned to the effect of its rules upon persons regulated by other bodies—the exchanges, the NASD, and the bank regulatory organizations.

(1) Other Self-Regulatory Organizations

Under section 15B(b)(2) of the 1934 Act, the Board is directed to adopt rules relating to just and equitable principles of trade, standards of professional qualification and operational capability, and form and content of quotations. Under section 15A of the 1934 Act, the NASD is accorded rulemaking authority over its members for similar matters,[84] but not with respect to municipal securities.[85] Although the possibility of a direct conflict between NASD rules and rules of the Board seems extremely remote, indirect effects upon NASD members may occur merely by reason of the Board's establishing additional rules relating to municipal securities. Thus, an NASD member firm that is a municipal securities broker or municipal securities dealer may be required to meet two sets of standards of operational capability. The Board is aware that its rules in this area may have an impact on the internal structure and organization of the member firm and has attempted to devise its rules on professional qualifications and operational capability to avoid this result. Nevertheless, the Board is under a duty to use its collective expertise in proposing and adopting rules that in its judgment serve the purposes of the 1934 Act with respect to municipal securities. This requires a balancing of the Board's statutory purposes and standards, which do not address specifically the maintenance of the existing structure of integrated firms that participate

84. *See* 1934 Act §§ 15A(b)(6), (11), (g)(3), 15 U.S.C.A. §§ 78o-3(b)(6), (11), (g)(3) (Supp. 1976).

85. Although § 3(a)(12) of the 1934 Act, 15 U.S.C. § 78c(a)(12) (1970), provides that municipal securities are not deemed to be exempted securities for purposes of § 15A generally, §§ 15A(b)(6), (11), (g)(2), 15 U.S.C.A. § 78o-3(h)(6), (11), (g)(2) (Supp. 1976), are expressly excluded. The reference to § 15A(g)(2) apparently is a printer's error and § 15A(g)(3) was intended. Section 15A(f), 15 U.S.C.A. § 78o-3(f) (Supp. 1976), provides that § 15A shall not "be construed to apply with respect to any transaction by a broker or dealer in any exempted security." Accordingly, the NASD's rulemaking powers under §§ 15A(b)(6), (11) & (g)(3) are viewed as being inapplicable to transactions in municipal securities.

in the municipal securities markets, and an evaluation of the feasibility of alternative methods of furthering these purposes.

(2) The Commission

The persons and firms to which the Board's rules may be made applicable are (with the minor exception of intrastate municipal securities brokers) subject to registration with the Commission as brokers or dealers under section 15 or as municipal securities dealers under section 15B of the 1934 Act. Under sections 10(b), 15(b)(7), 15(c)(1), 15(c)(2), and 17(a) of the 1934 Act, the Commission has rulemaking jurisdiction over matters that are also covered by the Board's rulemaking jurisdiction under section 15B(b)(2) of the 1934 Act. Under section 15(b)(7), for example, the Commission is authorized to adopt standards of professional qualification and operational capability for registered brokers and dealers, which would not include bank dealers. The Board, on the other hand, is directed by section 15B(b)(2)(A) to adopt standards of professional qualification and operational capability for municipal securities brokers and municipal securities dealers, many of which are registered as brokers or dealers with the Commission.

The Board's rules in this area—unlike the Commission's under section 15(b)(7), which relates to brokers and dealers generally—must take into consideration not only unique elements of transactions in municipal securities, but also the status of bank dealers. In addition, the import of the principle of equal regulation, which played a substantial role in the creation of the Board and the definition of its rulemaking authority, under the 1975 Amendments, is competitive equality between securities firms and banks as participants in the municipal securities industry.[86] It would appear appropriate, therefore, for the Commission to exercise judicious discretion in initiating rulemaking activities under its separate authority in areas that might tend to derogate from the Board's ability to assure uniform regulation of the municipal securities industry under section 15B of the 1934 Act.

IV. Activities of the Board

Effective self-regulation of the municipal securities industry, like any other industry, requires that industry expertise be incorpo-

86. As noted by Commissioner John R. Evans in his testimony before the Subcommittee on Securities of the Senate Committee, "[i]f the advantage of unequal regulation were added to the existing economic advantages of banks in the municipal field, nonbank dealers might well find it even more difficult to survive." *1974 Hearings, supra* note 18, at 51.

rated into the rulemaking process. Because the Board lacks the membership base of the other self-regulatory organizations from which to elect its rulemakers,[87] the statutory qualifications of Board members, by requiring that members be "associated with" their constituencies, assure this active, constituent participation. In this way the Board is able to take continuous stock of industry conditions and needs by the direct involvement of its industry members. Public representatives similarly bring a fresh awareness of issuer, investor, and public concerns to the Board. In addition, the Board has obtained direct industry involvement by publishing proposed rules in exposure draft form for comment prior to adoption by the Board and filing with the Commission.

Since its first meeting on September 16, 1975, the Board has been actively engaged in two principal endeavors: proposing and adopting rules under section 15B(b)(2) and performing a consultative and analytical function with respect to issues affecting the municipal securities industry. These include various Commission proposals with respect to its regulatory activities and the issues of disclosure and issuer and underwriter liability that have arisen since enactment of the 1975 Amendments.

A. Rulemaking—Present and Future

Due to the time interval between the writing of this Article and its publication, a detailed review of the status of the Board's rulemaking activities almost necessarily would be outdated. Accordingly, the following listing is provided to show the areas in which the Board has adopted rules or anticipates making rule proposals in the near future and the approximate order of priority in which the Board will address these areas. Subjects marked with one asterisk are covered by rules in effect, published for comment, or presently filed with the Commission; subjects marked with two asterisks were under consideration and active discussion by the Board as of the end of May 1976.

* Administrative rules, including fees and assessments
* Definitional rules
* Definition of separately identifiable department or division of a bank
* Standards of professional qualification
* Recordkeeping requirements
* Information concerning associated persons 0.087
* Sales during the underwriting period

87. *See* part II.B.(1) *supra*.

* Interdealer transactions, including:
  Settlement dates
  Confirmations
  Delivery of securities
  Payment
  Reclamations and rejections
  Close-out procedures
* Quotations relating to municipal securities
* Reports of sales or purchases
* Form and content of customer confirmations
** Discretionary accounts
** Fair prices and commissions
** Charges for services performed
** Recommendations to customers
** Concessions
** Periodic compliance examinations
  Use of information obtained in a fiduciary capacity
  Payments designed to influence market prices
  Advertising
  Disclosure of participation or interest in distributions
  Supervision of activities and personnel
  Customers' securities and funds
  Disclosure of financial condition
  Transactions for personnel of another dealer
  Gifts and gratuities
  Short sales of municipal securities
  Stabilizing
  Prevention of manipulative acts and practices
  Credit transactions and terms
  Financial reporting forms
  Arbitration
  Procedures for nomination and election of Board members

The Board may direct its attention to other matters not comprehended within the foregoing list.

The Board's rule adopting a definition of "separately identifiable department or division of a bank" for purposes of section 3(a)(30) of the 1934 Act underscores the types of industry practices best brought out through the self-regulatory process. The function of the term is to permit the registration of the municipal securities dealer function of a bank dealer rather than requiring the registration of the entire legal entity of which the dealer function is a part.[88]

88. A comparable provision in § 15(b)(2)(B), 15 U.S.C.A. § 78o(b)(2)(B) (Supp. 1976), permits the registration of a separately identifiable department or division of broker or dealer in certain circumstances.

This is accomplished by defining the term "municipal securities dealer" to include only the dealer function of a bank dealer if this function can be isolated and properly described in accordance with the Board's definition of "separately identifiable department or division."[89] Structuring a rule to define this term obviously requires a particularized knowledge of the internal organization of bank dealers and an awareness of the various types of activities conducted by banks incident to their dealer activities in municipal securities.

The rule commences by assuming a hypothetical business unit, one that "conducts all of the activities of the bank relating to the conduct of business as a municipal securities dealer."[90] This language ordinarily would be sufficient to permit the exclusion of investment activities of the bank, if truly independent of the dealer function, but it would not identify the other activities that must be within the registered unit. In other words, it is insufficient as a definition of the activities conducted as a municipal securities dealer. Accordingly, the rule lists municipal securities dealer activities, all of which must be within the registered unit if engaged in by the bank dealer. These activities include: the underwriting, trading, and selling of municipal securities; processing and clearance functions; research, analysis, and preparation of literature; and maintenance of records. Since adoption of this rule, the Board has proposed adding financial advisory and consultant services to the list of dealer activities to recognize the integral role many bank dealers perform in advising issuers of municipal securities concerning proposed new issues and communicating with prospective investors.

The definition also needs to acknowledge variations in the organizational structures of bank dealers and their dealer activities. It is not uncommon, for example, for a bank to separate its clearing activities from its trading and underwriting activities, either geographically or organizationally. Similarly, research is often conducted by a separate unit, even though it is integral to the bank's ability to underwrite general obligations securities.

Accordingly, the Board's rule is designed to permit organizational and even geographical separation of the subgroups performing dealer activities. This, however, raises additional considerations that are addressed in the rule. Because registration is but one element of the regulation of bank dealers, the definition also must be designed to facilitate inspection and enforcement functions with

89. 1934 Act § 3(a)(30), 15 U.S.C.A. § 78c(a)(30) (Supp. 1976).
90. MSRB Rule G-1 (1975).

respect to the registered unit. This is accomplished by imposing two conditions: first, the registered unit and its employees must be supervised with respect to the day-to-day conduct of its municipal securities dealer activities by one or more officers designated by the board of directors of the bank for this purpose. Secondly, the records of all the subgroups comprising the registered bank unit must be maintained separately from the unregistered portion of the bank or be separately extractable from general bank records, and all such dealer records must be maintained in a manner designed or otherwise sufficiently accessible to permit independent examination of the registered bank unit. These two conditions have the effect, among others, of defining lines of responsibility within the bank's general organizational structure that relate directly to the registered unit.

Without examining in detail the substance of the Board's other rulemaking activities, it should be noted that active industry participation in the Board's development of rules concerning inter-dealer transactions and professional qualifications, combined with the knowledge and background of the members of the Board, have enabled the Board to adopt rules in these areas with greater speed and certainty than likely would have been possible outside the self-regulatory framework. Direct industry involvement has been assured by the Board's procedure of publishing its proposed rules in exposure draft form for comment prior to adoption by the Board and filing with the Commission.

B. Disclosure and Liability

At hearings held in February of this year by the Subcommittee on Securities of the Senate Committee, testimony was presented by government officials, industry participants, and investors concerning the need for federal legislation in the area of municipal securities disclosure and liability in connection with underwritings. Congressional interest in these areas led to the introduction of two bills: S. 2574, introduced by Senator Thomas Eagleton, and S. 2969, cosponsored by Senators Harrison Williams and John Tower. S. 2574 would subject municipal securities to the registration requirements of the 1933 Act and their issuers to the reporting requirements of the 1934 Act. S. 2969 would require issuers, based upon minimum dollar requirements of issue size and amount of securities outstanding, to prepare disclosure documents (called distribution statements in the bill) and annual reports containing statutorily prescribed information. Preparation of the required disclosure documents would be

a condition to the issuer's sale of its securities to underwriters.

The Board presented a detailed, written statement of comments and recommendations on the two bills to the Subcommittee. Noting that the Board is precluded by the terms of the Tower Amendment[91] from requiring issuers, directly or indirectly, to make disclosures with respect to the issuance of their securities, the Board proposed that Congress provide for an independent committee representative of issuers, underwriters, and investors to develop voluntary disclosure guidelines for all new issues of municipal securities. These guidelines would be effective unless disapproved by the Commission as being inconsistent with the public interest. The voluntary approach recommended by the Board would be consonant, in the Board's view, with the powers and prerogatives accorded states under the Constitution and would be enforced by demands of the marketplace.

In addition, the Board recommended the enactment of a statutory clarification of the respective duties and responsibilities of all participants engaged in the process of distributing new issues of municipal securities. Under existing law, only implied causes of action arising under the antifraud provisions of the 1933 and 1934 Acts are available to investors in municipal securities. Recognizing constitutional questions concerning the applicability of implied causes of action to issuers of municipal securities that are states[92] and the undesirability of relegating the participants' duties and liabilities to subsequent definition by the courts, the Board suggested the creation of two express civil liability provisions.

Modeled on section 11 of the 1933 Act, the first provision would subject issuers of municipal securities and, within prescribed limits, underwriters and accountants and other experts to suit for damages in connection with material misstatements in or omissions from disclosure documents produced by the issuer in connection with its distribution. Defenses would be established to reflect the practical ability of each category of distribution participant, including the

91. 1934 Act § 15B(d), 15 U.S.C.A. § 78o-4(d) (Supp. 1976). This provision also precludes the Commission and the Board from requiring, directly or indirectly, an issuer of municipal securities to file information with the Commission or the Board "in connection with the issuance, sale, or distribution of [municipal] securities" prior to the sale of the securities by the issuer. *Id.* § 15B(d)(1), 15 U.S.C.A. § 78o-4(d)(1) (Supp. 1976).

92. *See* Edelman v. Jordan, 415 U.S. 651 (1974); *cf.* National League of Cities v. Usery, 44 U.S.L.W., 4974 (U.S. June 24, 1976), *rev'g* National League of Cities v. Brennan, Civ. No. 74-1812 (D.D.C. 1974); Nowak, *The Scope of Congressional Power To Create Causes of Action Against State Governments and the History of the Eleventh and Fourteenth Amendments*, 75 COLUM. L. REV. 1413 (1975).

issuer, to ascertain the completeness and accuracy of the information in question. The defense afforded underwriters of municipal securities would reflect their inability in a competitive bid situation to perform a due diligence function comparable to that performed by corporate underwriters, which participate in far fewer distributions in the course of a year and receive substantially higher underwriting profits for these services.[93] The second provision contemplated by the Board would subject all participants in the distribution process to civil damages for active fraud or gross negligence in connection with a material misstatement or omission.

Finally, the Board suggested that it would be consistent with federal legislation establishing a mechanism for the development of disclosure guidelines to authorize the Board to adopt rules relating to the distribution of municipal securities disclosure documents by brokers, dealers, and municipal securities dealers.

Since the date of the Board's statement on disclosure, the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*[94] has clarified the scope of liability under section 10(b) of the 1934 Act and Rule 10b-5. In *Hochfelder*, a private damages suit against an accounting firm, the Court interpreted section 10(b) of the 1934 Act to authorize the Commission to adopt rules prohibiting intentionally, but not merely negligently, fraudulent conduct. The Court reserved for future consideration the questions whether civil liability for damages may be premised upon reckless behavior and whether scienter is a necessary element of an injunctive proceeding based on section 10(b).[95]

V. CONCLUSIONS

The year 1975 brought great changes to the municipal securities industry: municipal securities professionals became subject as such for the first time to registration with the Commission, and the industry saw the Board established as its self-regulator. The Board, with its unique mandate and relationship to other regulatory bodies, was created to systematize and facilitate transactions in municipal securities and to regulate the business standards of municipal securities professionals for the benefit of the industry, issuers, and the public.

93. This defense would relate to information an issuer might be required to disclose that originates with another governmental organization not within the control of the issuer, *e.g.*, demographic information published by the Bureau of the Census.

94. BNA SEC. REG. & L. REP. No. 346, I-1 (March 31, 1976).

95. *Id.* at I-3 n.12.

Consistent with congressional recognition of the importance of the municipal securities markets, the Board has endeavored to fulfill its obligations as a self-regulatory organization as effectively as possible. With the adoption of rules and rule proposals as well as other Board activities affecting the industry, the Board has made a start in developing an appropriate legal and ethical framework in which the municipal securities industry can continue to grow and to meet the needs and expectations of both issuers and investors.