

ARE LOCAL GOVERNMENTS LIABLE UNDER RULE 10b-5? TEXTUALISM AND ITS LIMITS

MARGARET V. SACHS*

Whether state and local governments can be sued for damages is a question that cuts across subject-area boundaries. This question, which has long confounded courts in the areas of both antitrust¹ and civil rights² law, now has arisen in a new area: section 10(b)³ of the Securities Exchange Act of 1934⁴ and rule 10b-5.⁵

That this question should emerge under rule 10b-5 is hardly surpris-

* Associate Professor, University of Georgia School of Law. A.B. 1973 Harvard University; J.D. 1977 Harvard Law School. The author wishes to express her appreciation to Lynne L. Dallas, Robert W. Hillman, Alexander M. Meiklejohn, Robert C. Power, and Camilla E. Watson for their helpful comments on earlier drafts of this Article.

1. The Supreme Court has held that local governments may be sued under the antitrust laws. *See City of Lafayette v. Louisiana Power & Light Co.*, 435 U.S. 389 (1978). The local government can avoid liability, however, when it acted pursuant to state policy, thereby entitling it to the antitrust immunity accorded a state acting in its sovereign capacity. *See id.* at 413. *See also City of Columbia v. Omni Outdoor Advertising, Inc.*, 111 S. Ct. 1344, 1356 (1991) (attributing state's immunity to local government); *Town of Hallie v. City of Eau Claire*, 471 U.S. 34, 47 (1985) (same). Moreover, Congress has immunized local governments from liability for damages under the Local Government Antitrust Act of 1984. *See* 15 U.S.C. §§ 34-36 (1988).

2. The Supreme Court has held that local governments may be sued under § 1 of the Civil Rights Act of 1871, 42 U.S.C. § 1983 (1988) [hereinafter § 1983]. *See Monell v. Department of Social Servs.*, 436 U.S. 658, 690 (1978). Local governments can be held liable only for official policies, however, and not simply for the acts of their employees. *See id.* at 690-92. *See also City of Canton v. Harris*, 489 U.S. 378, 388-92 (1989) (addressing circumstances under which inadequate police training can constitute a policy); *Pembaur v. City of Cincinnati*, 475 U.S. 469, 480 (1986) (a policy can be set only by those with final decisionmaking authority).

3. Section 10 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

.....

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1988) [hereinafter § 10(b)].

4. Securities Exchange Act of 1934, 15 U.S.C. §§ 78(a)-(l) (1988) [hereinafter 1934 Act].

5. Rule 10b-5, promulgated by the Securities and Exchange Commission (SEC) in 1942, provides:

ing. Faced with cuts in federal aid, state and local governments⁶ issued twice the volume of securities in 1990 as in 1980.⁷ Fraud litigation involving these securities has been brought against not only brokers, dealers, and other private actors,⁸ but also the governments themselves.⁹ Such litigation against governments is bound to swell. Indeed, a new

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1991) [hereinafter rule 10b-5].

Neither rule 10b-5 nor § 10(b) expressly creates a private right of action. *See supra* notes 3 & 5. Beginning with *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), however, lower federal courts implied a private action for violations of the rule. By 1969, 10 of the 11 United States courts of appeals had done so. *See* 6 LOUIS LOSS, *SECURITIES REGULATION* 3871-73 (2d ed. Supp. 1969) (collecting cases). The Supreme Court first recognized a private right of action under rule 10b-5 in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971). For a discussion of the Supreme Court's rule 10b-5 jurisprudence, see Margaret V. Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96 (1985).

6. Securities are issued by states, by their local governmental units such as cities and towns, and by their instrumentalities such as public utility districts. Collectively, these are known as "municipal securities." *See generally* 15 U.S.C. § 78c(a)(29) (1988); III LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 1159 (3d ed. 1989). This Article focuses solely on the liability of local governments and therefore avoids use of the terms "municipalities" and "municipal securities," which include states and state government securities. The Article refers instead to local governments and local government securities and, when appropriate, to states and state government securities. This Article does not address the liability of the United States under the federal securities laws. *See generally id.* at 1158-59.

7. In 1980, state and local governments issued slightly more than \$76 billion worth of short- and long-term securities. *See* PUBLIC SECURITIES ASS'N, *FUNDAMENTALS OF MUNICIPAL BONDS* 3 (4th ed. 1990). In 1990, the figure was slightly more than \$162 billion. *See Projected Volume Totals for 1991 Compared to Actual 1990 Issuance*, MUN. MARKET DEVS., Feb. 11, 1991, at 2.

8. *See, e.g.*, *Freeman v. Laventhol & Horwath*, 915 F.2d 193, 196 (6th Cir. 1990) (defendants include underwriters, dealers, accountants, and attorneys); *Gorsey v. I.M. Simon & Co.*, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,996, at 95,574 (D. Mass. March 6, 1990) (defendants include underwriters, and corporate officers and directors); *In re New York City Mun. Sec. Litig.*, 507 F. Supp. 169, 172 (S.D.N.Y. 1980) (defendants include underwriters and sellers).

9. *See, e.g.*, *Ross v. Bank South, N.A.*, 837 F.2d 980, 1003 (11th Cir.) (defendants include City of Vestavia Hills), *aff'd on other grounds*, 885 F.2d 723, 728 n.6 (11th Cir. 1989) (en banc) (appeal dismissed as to Vestavia Hills), *cert. denied*, 110 S. Ct. 1924 (1990); *Gorsey*, ¶ 94,996 at 95,577 (defendants include City of South Bend, Indiana); *In re Washington Pub. Power Supply Sys. Sec. Litig.*, 720 F. Supp. 1379, 1395 (D. Ariz. 1989) (approving settlements by, *inter alia*, Seattle, and Richland, Washington).

SEC rule on offerings of state and local government securities mandates that disclosure documents prepared by the issuing government be distributed to investors.¹⁰ In any fraud action involving these documents, the SEC regards the government as the appropriate defendant.¹¹ In addition, many local government issuers are widely thought to be on the verge of default,¹² a fact undoubtedly conducive to rule 10b-5 actions. Finally, issuance of government securities is not essential to governmental liability under rule 10b-5. Claims that governments participated in fraud involving ordinary corporate securities are by no means unknown.¹³

While state governments have avoided liability under rule 10b-5 on the basis of the Eleventh Amendment,¹⁴ local governments have fared less well. Lower federal courts¹⁵ have found rule 10b-5 applicable to New

10. Rule 15c2-12, 17 C.F.R. § 240.15c2-12 (1991) [hereinafter rule 15c2-12]. Rule 15c2-12 became effective on January 1, 1990. See Municipal Securities Disclosure, Securities Exchange Act Release No. 26985, 3 Fed. Sec. L. Rep. (CCH) ¶ 25,098, at 18,190 (June 28, 1989) [hereinafter Municipal Disclosure Release]. Rule 15c2-12 applies to primary offerings of state and local government securities exceeding \$1 million. See rule 15c2-12(a). There are in addition certain limited exemptions. See rule 15c2-12(c). The rule places the burden of distribution on the underwriter. See rule 15c2-12(b)(2). The documents distributed are prepared by the issuing government, however. See rule 15c2-12(b)(1).

11. In its release announcing rule 15c2-12, the SEC stated that “[a]lthough the focus of the Commission’s interpretation was on underwriter practices, issuers are primarily responsible for the content of their disclosure documents and may be held liable under the federal securities laws for misleading disclosure.” Municipal Disclosure Release, *supra* note 10, at 18,199-10 n.84 (cases omitted). The SEC did not address the effect of the Eleventh Amendment on the fraud liability of state issuers. See *infra* note 14 and accompanying text.

12. See, e.g., Constance Mitchell, *Fear of Big Defaults Roils Muni Markets*, WALL ST. J., May 17, 1991, at C1.

13. See, e.g., *In re Citisource, Inc. Sec. Litig.*, 694 F. Supp. 1069, 1072 (S.D.N.Y. 1988) (claim made against New York City).

14. The Eleventh Amendment provides: “The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State.” U.S. CONST. amend. XI. The amendment is read to prevent a citizen from suing his own state in federal court. See *Hans v. Louisiana*, 134 U.S. 1 (1890).

For illustrative cases dismissing state governments as defendants in securities actions on the basis of the Eleventh Amendment, see *Bair v. Krug*, 853 F.2d 672 (9th Cir. 1988); *Charter Oak Fed. Sav. Bank v. Ohio*, 666 F. Supp. 1040 (S.D. Ohio 1987). *But cf.* *Finkielstain v. Seidel*, 857 F.2d 893 (2d Cir. 1988) (Eleventh Amendment inapplicable to state sued in its capacity as receiver rather than in its sovereign capacity); *In re Baldwin-United Corp. Litig.*, [1986-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,951, at 94,655 (S.D.N.Y. June 27, 1986) (Eleventh Amendment inapplicable to state defendants who issued securities but applicable to other state defendants).

15. State courts have been thought to lack jurisdiction over private rule 10b-5 litigation in accordance with the 1934 Act’s exclusive jurisdictional grant in § 27, 15 U.S.C. § 78aa (1988). For the argument that § 27 does not govern private rule 10b-5 actions, see *Margaret V. Sachs, Exclusive*

York City,¹⁶ South Bend, Indiana,¹⁷ Vestavia Hills, Alabama,¹⁸ nine cities in Washington,¹⁹ and five cities in Idaho,²⁰ as well as to numerous local government officials acting in their official capacities.²¹

Determining whether section 10(b) applies to local governments requires analysis of not only the 1934 Act but also the closely related Securities Act of 1933.²² The 1933 Act is principally directed at the initial distribution of securities, while the 1934 Act concentrates on the secondary markets.²³ Despite their different emphases, the two acts employ similar regulatory mechanisms. Each act requires registration of securities²⁴ and each imposes liability for fraud.²⁵ In addition, each act provides an exemption from registration for state and local government securities.²⁶ These registration exemptions, however, are irrelevant to

Federal Jurisdiction for Implied Rule 10b-5 Actions: The Emperor Has No Clothes, 49 OHIO ST. L.J. 559 (1988).

16. See *In re Citisource, Inc. Sec. Litig.*, 694 F. Supp. 1069, 1072-78 (S.D.N.Y. 1988).

17. See *Gorsey v. I.M. Simon & Co.*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,173 (D. Mass. Feb. 23, 1987). See also *Gorsey v. I.M. Simon & Co.*, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,996 (D. Mass. March 6, 1990).

18. See *Ross v. Bank South, N.A.*, 837 F.2d 980, 1003 (11th Cir. 1988), *aff'd on other grounds*, 885 F.2d 723, 728 n.6 (11th Cir. 1989) (en banc) (appeal dismissed as to Vestavia Hills), *cert. denied*, 110 S. Ct. 1924 (1990).

19. See *In re Washington Pub. Power Supply Sys. Sec. Litig.*, 623 F. Supp. 1466, 1476 n.4, 1478-80 (W.D. Wash. 1985), *aff'd on other grounds*, 823 F.2d 1349 (9th Cir. 1987).

20. See *id.*

21. See, e.g., *In re Citisource, Inc. Sec. Litig.*, 694 F. Supp. at 1072-75; *In re Washington Pub. Power Supply Sys. Sec. Litig.*, 623 F. Supp. at 1476 n.4, 1478-80. Suing an official acting in her official capacity is the same as suing the government for which she works. *Kentucky v. Graham*, 473 U.S. 159, 169 (1985); *Monell v. Department of Social Servs.*, 436 U.S. 658, 690 n.55 (1978).

22. Securities Act of 1933, 15 U.S.C. §§ 77(a)-(mm) (1988) [hereinafter 1933 Act]. The legislative history of the 1933 and 1934 Acts is assembled in LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973) [hereinafter LEGISLATIVE HISTORY A] and in FEDERAL SECURITIES LAWS—LEGISLATIVE HISTORY 1933-82 (Federal Bar Ass'n Sec. Law Comm. ed., 1983) [hereinafter LEGISLATIVE HISTORY B].

23. For an overview of the federal securities statutes, see LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 35-39 (2d ed. 1988).

24. The 1933 Act requires registration of all offerings of securities in interstate commerce unless an exemption applies. See 15 U.S.C. § 77e(c) (1988). As originally enacted, the 1934 Act required registration of all securities listed on national securities exchanges in the absence of an applicable exemption. See 15 U.S.C. § 78l(a) (1988). In 1964, Congress extended 1934 Act registration to the over-the-counter markets. See 15 U.S.C. § 78l(g) (1988). Securities registered under the 1934 Act are subject to a periodic reporting requirement. See 15 U.S.C. § 78m (1988).

25. See *infra* notes 27-28 and accompanying text.

26. The 1933 Act lists classes of securities that are exempted from the regulation "[e]xcept as hereinafter expressly provided." 15 U.S.C. § 77c(a) (1988). Included in the list are state and local

section 10(b) and its 1933 Act analog, section 17(a).²⁷ Sections 10(b) and 17(a) apply to fraud involving state and local government securities,²⁸ independent of the question of whether governments themselves are appropriate defendants. Yet section 10(b) is of far greater moment to local governments than is section 17(a), since under section 10(b) and rule 10b-5 a private action is "beyond peradventure,"²⁹ whereas under section 17(a) a private action is now widely rejected.³⁰

There are at present two rationales for applying section 10(b)—which

government securities. See 15 U.S.C. § 77c(a) (2) (1988). The section of the act requiring registration does not countermand the exemption. See 15 U.S.C. § 77e(c) (1988).

In contrast to the 1933 Act, the 1934 Act does not contain a comprehensive exemption provision. It does, however, define "exempted securities" to include "municipal securities," 15 U.S.C. § 78c(12)(A)(ii) (1988), a category that includes both state and local government securities. See 15 U.S.C. § 78c(29) (1988). It is therefore necessary to ascertain whether a given section excludes exempted securities. The provisions mandating registration do so expressly. See 15 U.S.C. §§ 78f(a),(g) (1988).

27. Section 17(a) provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (1988) [hereinafter section 17(a)].

28. Section 17(a)'s application to local government securities is clear from § 17(c), which states that "[t]he exemptions provided in section 77c of this title [1933 Act § 3] shall not apply to the provisions of this section." 15 U.S.C. § 77q(c) (1988). The same conclusion follows for § 10(b), which prohibits the use of any "manipulative or deceptive device" in connection with the purchase or sale of "any security" and makes no reference to "exempted securities." For the text of § 10(b), see *supra* note 3.

The other 1933 and 1934 Act fraud provisions do not apply to local government securities. Section 11 of the 1933 Act applies only to offerings of registered securities, 15 U.S.C. § 77k (1988), and local government securities are exempt from registration under the 1933 Act. See *supra* note 26 and accompanying text. Section 18(a) of the 1934 Act, 15 U.S.C. § 78r(2) (1988), applies to fraud in documents filed with the SEC, and the 1934 Act exempts local government securities from registration. See *supra* note 26 and accompanying text. Section 12(2) of the 1933 Act, 15 U.S.C. § 77(l)(2) (1988), by its terms does not apply to securities exempted under § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1988), which includes state and local government securities. Section 9(e) of the 1934 Act, 15 U.S.C. § 78i(e) (1988), expressly does not apply to exempted securities by the terms of §§ 9(a) and (f), 15 U.S.C. §§ 78i(a),(f) (1988).

29. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983).

30. See, e.g., *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 942-43 (7th Cir. 1989); *Newcome v. Esrey*, 862 F.2d 1099, 1101 (4th Cir. 1988) (en banc); *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 784-85 (11th Cir. 1988); *In re Washington Pub. Power Supply Sys. Sec. Litig.*, 823 F.2d 1349, 1354 (9th Cir. 1987) (en banc); *Brannan v. Eisenstein*, 804 F.2d 1041, 1043 n.1 (8th Cir. 1986);

by its terms applies to any "person"³¹—to local governments.³² In the view of the SEC and certain commentators, section 10(b) has applied to local governments since 1934,³³ despite Congress' failure to include governments in the original 1934 Act definition of "person."³⁴ They base their view on the 1933 Act's definition of "person," in which governments were always expressly incorporated.³⁵ Without examining the legislative history,³⁶ they conclude that the discrepancy between the two acts could have no rational explanation and that the omission of governments from the 1934 Act definition should therefore be disregarded.³⁷ Other commentators and a number of lower courts adhere to the very different view that section 10(b) has applied to local governments only since 1975.³⁸ Proponents of this view emphasize the text of the 1934

Landry v. All Am. Assurance Co., 688 F.2d 381, 389 (5th Cir. 1982). *But cf. Ronzani v. Sanofi*, S.A., 899 F.2d 195, 198 (2d Cir. 1990) (leaving question open).

31. For the text of § 10(b), see *supra* note 3.

32. Because rule 10b-5 does not provide its own definition of "person," the statutory definition controls. See 17 C.F.R. § 240.0-1(b) (1991).

33. See SEC Securities Exchange Act Release No. 11,876, [1975-76, Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,333, at 85,826-34 (Nov. 26, 1975) [hereinafter Release No. 11,876] (discussing rule 10b-5's application prior to the then newly enacted 1975 amendments). See also Thomas P. Peacock, *A Review of Municipal Securities and Their Status Under the Federal Securities Laws As Amended by the Securities Acts Amendments of 1975*, 31 BUS. LAW 2037, 2043 (1975); Victor M. Rosenzweig, *Municipal Securities and the Antifraud Provisions of the Federal Securities Laws*, 4 SEC. REG. L.J. 135, 141 (1976); Michael D. Jones, Comment, *Federal Regulation of Municipal Securities: A Constitutional and Statutory Analysis*, 1976 DUKE L.J. 1261, 1265; Note, *Federal Regulation of Municipal Securities: Disclosure Requirements and Dual Sovereignty*, 86 YALE L.J. 919, 927 (1977).

34. Section 3(a)(9) of the 1934 Act originally defined "person" as "an individual, a corporation, a partnership, an association, a joint-stock company, a business trust, or an unincorporated organization." 1934 Act, Ch. 404, 48 Stat. 881, 883, reprinted in 4 LEGISLATIVE HISTORY A, *supra* note 22, item 1 at 883.

35. Section 2(2) of the 1933 Act defined "person" as "an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization, or a government or political subdivision thereof." 1933 Act, Ch. 38, 48 Stat. 74, reprinted in 1 LEGISLATIVE HISTORY A, *supra* note 22, item 1 at 74 (currently codified at 15 U.S.C. § 77b(2) (1988)).

36. Lower federal courts deciding securities cases frequently overlook the legislative history. See, e.g., *Margaret V. Sachs, The International Reach of Rule 10b-5: The Myth of Congressional Silence*, 28 COLUM. J. TRANSNAT'L L. 677, 680 (1990).

37. The SEC does not articulate the basis for its position that § 10(b) always has reached local governments. See Release No. 11,876, *supra* note 33. Commentators who share this view strongly imply that they do so because the 1933 Act always authorized such a reach. See Peacock, *supra* note 33, at 2043; Jones, *supra* note 33, at 1264-65; Robert Dudley Tuke, Note, *Disclosure by Issuers of Municipal Securities: An Analysis of Recent Proposals and a Suggested Approach*, 29 VAND. L. REV. 1017, 1019 n.14 (1976).

38. See Robert W. Doty & John E. Peterson, *The Federal Securities Laws and Transactions in Municipal Securities*, 71 NW. U. L. REV. 283, 294 n.56 (1976); Jon R. Tandler, *Municipal Antifraud Liability Under the Federal Securities Laws Upon Issuance of Tax-Exempt Industrial Development*

Act's 1975 amendments,³⁹ which added to the definition of "person" "a government, or political subdivision, agency, or instrumentality of a government."⁴⁰ Ignoring the legislative history of those amendments, they reason that since section 10(b) embraces any "person" and a "person" has included a government since 1975, section 10(b) has been applicable to local governments since that time.⁴¹

The thesis of this Article is that a local government is an inappropriate rule 10b-5 defendant, regardless of whether it is the issuer of the securities in question or an alleged participant in a scheme involving corporate securities.⁴² The only appropriate rule 10b-5 defendants are private actors.⁴³

Part I demonstrates that legislative history and statutory purpose are essential to resolving the question of section 10(b)'s applicability to local governments, the current arguments in favor of a textual approach to statutory interpretation notwithstanding.⁴⁴ The question implicates two lines of cases in which the Supreme Court for valid reasons has accorded

Bonds, 24 WASH. U. J. URB. & CONTEMP. L. 193, 199 (1983). For illustrative cases, see *In re Citisource, Inc. Sec. Litig.*, 694 F. Supp. at 1072-75; *In re Washington Pub. Power Supply Sys. Sec. Litig.*, 623 F. Supp. at 1478-80.

39. Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified in various sections of 15 U.S.C.) [hereinafter 1975 amendments].

40. *Id.* at 97, reprinted in 2 LEGISLATIVE HISTORY B, *supra* note 22, item 136 at 2257 (currently codified at 15 U.S.C. § 78c(a)(9) (1988)).

41. See cases and commentators cited *supra* note 38.

42. Virtually all of the commentary takes the position that local governments are appropriate rule 10b-5 defendants. See Doty & Peterson, *supra* note 38, at 294 n.56; Ann J. Gellis, *Mandatory Disclosure for Municipal Securities: Issues in Implementation*, 13 J. CORP. L. 65, 67 (1987); Peacock, *supra* note 33, at 2043; Rosenzweig, *supra* note 33, at 141; Joel Seligman, *The Municipal Disclosure Debate*, 9 DEL. J. CORP. L. 647, 650 (1984); Marc I. Steinberg, *Municipal Issuer Liability Under the Federal Securities Laws*, 6 J. CORP. L. 277, 279-80 (1981); Tandler, *supra* note 38, at 199; David L. Butler, Comment, *The Liability of Issuers of Municipal Securities*, 31 BAYLOR L. REV. 551 (1979); June Rose, Note, *Federal Securities Fraud Liability and Municipal Issuers: Implications of National League of Cities v. Usery*, 77 COLUM. L. REV. 1064, 1070 (1977); Jones, *supra* note 33, at 1265; Tuke, *supra* note 37, at 1019; Note, *supra* note 33, at 927. *But cf.* Thomas J. Schwarz, *Municipal Bonds and the Securities Laws: Do Investors Have an Implied Remedy?*, 7 SEC. REG. L.J. 119 (1979) (finding local governments subject to § 10(b) but rejecting an implied right of action on behalf of municipal investors).

43. For illustrative cases in which private actors were named as defendants, see *supra* note 8.

44. For analyses of the textualist movement, see William V. Eskridge, Jr., *The New Textualism*, 37 UCLA L. REV. 621 (1990); Nicholas S. Zeppos, *Legislative History and the Interpretation of Statutes: Toward a Fact-Finding Model of Statutory Interpretation*, 76 VA. L. REV. 1295, 1299-1335 (1990). The chief exponent of this view on the Supreme Court is Justice Scalia. See generally Michael Herz, *Textualism and Taboo: Interpretation and Deference for Justice Scalia*, 12 CARDOZO L. REV. 1663 (1991).

legislative history and purpose a crucial role: federal securities cases and cases involving the liability of local governments under federal statutes.

Part II challenges the view that local governments have been subject to section 10(b) since 1934. Congress deliberately made section 10(b) inapplicable to local governments to avoid the consequent interplay with the contemporaneously enacted municipal bankruptcy statute.⁴⁵ Part II then explains why these consequences nonetheless did not prompt Congress to remove local governments from the definition of "person" under the 1933 Act.

Part III demonstrates the conflict between the text and history of the 1975 amendments. While the text reclassified a government as a "person," the legislative history effectively disclaimed any intent to tamper with governmental liability for fraud. Those courts and commentators who assume that local governments are appropriate rule 10b-5 defendants because they are now "persons" have an obligation to come to terms with this history.

Part IV proposes a reconciliation of the text and history of the 1975 amendments that explains why governments are "persons" on the one hand but retain their immunity from fraud liability on the other. Congress intended the 1975 amendments to regulate professionals dealing in state and local government securities, and the reclassification of governments as "persons" facilitated suits against these professionals. Part IV concludes by considering arguments that run counter to this new interpretation, finding none of them to be persuasive.⁴⁶

I. SECTION 10(b) AND LOCAL GOVERNMENTS: THE IMPORTANCE OF LEGISLATIVE HISTORY AND STATUTORY PURPOSE

The question of section 10(b)'s applicability to local governments implicates two lines of cases: federal securities cases and cases involving the liability of local governments under federal statutes. In each, well-established

45. Provisions for the Emergency Temporary Aid of Insolvent Public Debtors and to Preserve the Assets Thereof and for Other Related Purposes, Act of May 24, 1934, ch. 345, 48 Stat. 798 [hereinafter municipal bankruptcy statute].

46. Were courts to hold local governments immune from liability under rule 10b-5, Congress might well wish to reassess the judgments it made in 1934 and 1975. The thesis of this Article, however, is that this reassessment is for Congress to make on the basis of a thorough legislative study of the problem that balances the interests of investors with those of local governments. Treatment of these policy considerations is beyond the scope of this Article.

lished jurisprudence accords considerable weight to legislative history and purpose in matters of statutory interpretation.

A. *Federal Securities Cases*

Numerous Supreme Court decisions stress that the federal securities laws must be understood in light of their legislative history and purpose. As the Court recently held in *Reves v. Ernst & Young*,⁴⁷ the statutory language "should not be interpreted . . . literally . . . but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts."⁴⁸ Accordingly, the Court has conformed its rulings to legislative history and purpose even when the statutory text alone might suggest a different outcome. The decisions in *United Housing Foundation, Inc. v. Forman*,⁴⁹ *Kern County Land Co. v. Occidental Petroleum Corp.*,⁵⁰ and *SEC v. Capital Gains Research Bureau, Inc.*⁵¹ are illustrative.

In *Forman*, the Court held that stock in a housing cooperative did not constitute a "security" under the 1933 and 1934 Acts. Although the definition of "security" under both acts expressly included stock,⁵² the Court ruled that this was not dispositive: "Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto."⁵³ Since the text set forth no economic criteria by which to identify a security,⁵⁴ the Court

47. 110 S. Ct. 945 (1990).

48. *Id.* at 950. (footnote omitted) (interpreting the term "any note"). The Supreme Court has announced its eschewal of literalism in securities cases many times. Thus, for example, in *Randall v. Loftsgaarden*, 478 U.S. 647 (1986), it held that "if the language of a provision of the securities laws is sufficiently clear in its context and *not at odds with the legislative history*, it is unnecessary to examine the additional considerations of 'policy' . . . that may have influenced the lawmakers in their formulation of the statute." *Id.* at 656 (quoting *Aaron v. SEC*, 446 U.S. 680, 695 (1980) (emphasis added)). See also *SEC v. Sloan*, 436 U.S. 103, 122-23 (1978) (pointing to absence of legislative history that would countermand statutory language); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977) (same).

49. 421 U.S. 837 (1975).

50. 411 U.S. 582 (1973).

51. 375 U.S. 180 (1963).

52. See § 2(1) of the 1933 Act, 15 U.S.C. § 77b(1) (1988); § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10) (1988).

53. *Forman*, 421 U.S. at 849. The Court also noted that "a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers." *Id.* (quoting *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892)).

54. *Id.* at 847.

drew on the "the background of [the statutory] purpose,"⁵⁵ finding pivotal "the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."⁵⁶ Guided by this "touchstone,"⁵⁷ the Court concluded that Congress did not intend the statutory protections to apply to the housing cooperative in question.⁵⁸

In *Kern*, the Court held that a transaction arguably falling within the common-sense meaning of "sale"⁵⁹ nonetheless was not a "sale" under the 1934 Act provision prohibiting short-swing profits.⁶⁰ Eschewing a literal reading of the text, the Court sought guidance from the underlying statutory purpose.⁶¹ The Court concluded that the provision prohibited transactions that "may serve as a vehicle for the evil which Congress sought to prevent—the realization of short-swing profits based upon access to inside information."⁶²

In *Capital Gains*, the Court held that conduct could constitute "fraud or deceit" under section 206 of the Investment Advisers Act⁶³ even absent a showing of scienter. Acknowledging that scienter is a necessary element of fraud and deceit "in their technical sense,"⁶⁴ the Court nonetheless ruled a lack of scienter not dispositive. What mattered was the "history and purpose of the Investment Advisers Act,"⁶⁵ which, the Court concluded, did not support a scienter requirement.⁶⁶

55. *Id.* at 849.

56. *Id.* at 852.

57. *Id.*

58. *Id.* at 859. Similarly, in *Marine Bank v. Weaver*, 455 U.S. 551 (1982), the Supreme Court did not quarrel with the lower court's conclusion that the agreement in question was literally "a certificate of interest or participation in a profit-sharing agreement," a phrase included in the definition of a security. 15 U.S.C. §§ 77b(1), 78c(a)(10) (1988). The Court nonetheless reversed the lower court and held that the agreement was not a security. *See* 455 U.S. at 559-60.

59. At issue in *Kern* were sales by a defeated tender offeror (Occidental) of the stock of the target company (Old Kern), which had merged into a third company (Tenneco). The merger agreement entitled Occidental to exchange its shares of Old Kern for shares of Tenneco. Occidental entered into an agreement with Tenneco that conferred an option to purchase Occidental's Tenneco shares obtained pursuant to the merger agreement. Tenneco subsequently exercised this option. *See Kern County Land Co.*, 411 U.S. at 584-91.

60. Section 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1988).

61. *See Kern County Land Co.*, 411 U.S. at 593-95.

62. *Id.* at 594 (footnote omitted).

63. Investment Advisers Act § 206, 15 U.S.C. § 80b-6 (1988).

64. *Capital Gains Research Bureau, Inc.*, 375 U.S. at 185.

65. *Id.* at 186. The discussion of this history and purpose occupies 15 pages. *See id.* at 186-201.

66. *Id.* at 200-01. For illustrative additional cases relying on legislative history and statutory

Three factors have led the Court to rely heavily on legislative history and purpose in these cases. First, it is essentially impossible to focus exclusively on the text when the text itself directs otherwise.⁶⁷ Key terms in the federal securities laws—such as “security,”⁶⁸ “issuer,”⁶⁹ “underwriter,”⁷⁰ and “prospectus,”⁷¹—apply “unless the context otherwise requires.”⁷² While at a minimum “context” embraces the text of the specific provision in question,⁷³ the Supreme Court and commentators have construed it to reach further and to encompass the facts of the transaction in question,⁷⁴ the purpose of the provision in question,⁷⁵ and

purpose, see *Pinter v. Dahl*, 486 U.S. 622, 645 n.22 (1988) (finding support for interpretation of § 12 of the 1933 Act in Congress’ rejection of a proposed amendment); *Basic, Inc. v. Levinson*, 485 U.S. 224, 245 (1988) (finding interpretation of reliance requirement supported by 1934 Act policy); *Randall v. Loftsgaarden*, 478 U.S. 647, 663-64 (1986) (looking to congressional purpose to determine meaning of “actual damages” in § 28(a) of the 1934 Act); *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 315-17 (1985) (denial of the *in pari delicto* defense in the case would further policies important to Congress); *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 11-12 (1985) (using legislative history and statutory purpose to interpret § 14(e) of the 1934 Act); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201-06, 214 n.33 (1976) (relying on legislative history to establish scienter requirement under § 10(b)); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 732, 737-49 (1975) (relying on legislative history and statutory policy to uphold purchaser-seller requirement under § 10(b)); *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 11-12 (1971) (using legislative history and statutory purpose to determine scope of § 10(b)).

67. Some constitutional scholars make the analogous point that the framers intended that their original intent be disregarded. See Robert C. Power, *The Textualist*, 84 Nw. U. L. Rev. 711, 733 & n.138 (1990) (book review) (collecting authorities).

68. See § 2(1) of the 1933 Act, 15 U.S.C. § 77b(1) (1988); § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10) (1988).

69. See § 2(4) of the 1933 Act, 15 U.S.C. § 77b(4) (1988); § 3(a)(8) of the 1934 Act, 15 U.S.C. § 78c(a)(8) (1988).

70. See § 2(11) of the 1933 Act, 15 U.S.C. § 77b(11) (1988).

71. See § 2(10) of the 1933 Act, 15 U.S.C. § 77b(10) (1988).

72. The 1933 Act prefaces its definition provisions with the language: “when used in this subchapter, unless the context otherwise requires.” See 15 U.S.C. § 77b (1988). The 1934 Act prefaces its definitions the same way, substituting “chapter” for “subchapter.” See 15 U.S.C. § 78c(a) (1988).

73. See *SEC v. National Sec., Inc.*, 393 U.S. 453, 466 (1969) (construing the phrase “unless the context otherwise requires” to mean that “Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws”); II LOSS & SELIGMAN, *supra* note 6, at 873; Mark I. Steinberg & William E. Kaulbach, *The Supreme Court and the Definition of “Security”: The “Context” Clause, “Investment Contract” Analysis, and Their Ramifications*, 40 VAND. L. REV. 489, 504 (1987).

74. See, e.g., *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 687 (1985) (noting that “the context of the transaction involved here—the sale of stock in a corporation—is typical of the kind of context to which the Acts normally apply”); *Marine Bank v. Weaver*, 455 U.S. 551, 560 n.11 (1982) (whether an instrument is a security turns on “the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole”); II LOSS & SELIGMAN, *supra* note 6, at 874 (finding support in legislative history and Supreme Court precedent for examining the factual context). But see Steinberg & Kaulbach, *supra* note 73, at 504 (finding no support in the legislative

the wider legal context of other federal statutes.⁷⁶ Construed in these ways, the "context" clause renders the definitions of key terms inoperable without consideration of factors outside the text of the statute. In addition, the text omits altogether definitions of other crucial terms such as "seller"⁷⁷ and a transaction "not involving any public offering,"⁷⁸ necessarily diverting attention to other sources.

Second, legislative history is a particularly dependable guide when the circumstances of enactment reduce the likelihood that members of Congress are functioning simply as mouthpieces for special interest groups.⁷⁹ The federal securities laws were enacted as emergency legislation at a time of national crisis.⁸⁰ History and logic suggest that legislators were unusually attentive to the national interest and that their pronouncements tended to reflect their own policy choices.

Third, the value of legislative history is inevitably a function of the abilities of the drafters and proponents of the legislation. The drafters of the federal securities laws were highly atypical, consisting mainly of a cadre of extraordinarily able lawyers recruited by (then Professor) Felix Frankfurter.⁸¹ They provided comprehensive and undoubtedly influen-

history for examining the factual context, but acknowledging Supreme Court precedent to this effect).

75. See, e.g., *National Sec. Inc.*, 393 U.S. at 467. See also Steinberg & Kaulbach, *supra* note 73, at 507.

76. See *Marine Bank*, 455 U.S. at 557-59 (consideration of federal banking laws); *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 569-70 (1979) (consideration of ERISA); Steinberg & Kaulbach, *supra* note 73, at 507.

77. Sellers of securities are subject to liability under § 12 of the 1933 Act. See 15 U.S.C. § 77I (1988). As the Supreme Court has noted, however, "the Securities Act nowhere delineates who may be regarded as a statutory seller." *Pinter v. Dahl*, 486 U.S. 622, 642 (1988).

78. This is the language of § 4(2) of the 1933 Act, 15 U.S.C. § 77d (1988), popularly known as the private-offering exemption. As the Supreme Court has noted, the 1933 Act does not set forth the boundaries of this exemption. See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 122 (1953).

79. Some scholars argue that the text of a statute constitutes a deal struck between Congress and special interest groups. If legislative history is taken into account, these scholars contend, the special interest groups in question may get a deal better than that for which they and Congress bargained. See Zeppos, *supra* note 44, at 1304-05 (discussing the problem and collecting authorities).

80. For a discussion of the historical context of enactment, see I LOSS & SELIGMAN, *supra* note 6, at 168-71.

81. These drafters were Benjamin Cohen, Thomas Corcoran, and James Landis. See James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 34 (1959). See also 77 CONG. REC. 2916, reprinted in 1 LEGISLATIVE HISTORY A, *supra* note 22, item 7 at 2916 (Rep. Rayburn) (listing drafters of 1933 Act as including Cohen, Landis, and Felix Frankfurter); "Stock Exchange Regulation," *Hearings on H.R. 7852 and H.R. 8720 Before the House Interstate and Foreign Commerce Comm.*, 73d Cong., 2d Sess. (1934) [hereinafter 1934 Act House

tial testimony throughout the hearings,⁸² and the Supreme Court has quoted and parsed their statements⁸³ in apparent disregard of the fact that they did not hold elective office.⁸⁴

Thus, legislative history in federal securities cases is important because of the nature of the statutory text, the high caliber of the drafters who testified at the hearings, and the depoliticization of the enactment process that resulted from the economic crisis of the early 1930s. One final factor provides additional reinforcement: the legislative history is easily accessible in multiple competing compilations,⁸⁵ powerful evidence in itself of the history's significance.

B. *The Liability of Local Governments Under Federal Statutes*

The Supreme Court has already confronted the issue of local government liability under the antitrust⁸⁶ and civil rights⁸⁷ laws. Like the securities decisions, antitrust and civil rights decisions accord legislative history an important role, even in the face of seemingly clear statutory language. Exemplifying this approach is the leading decision under each statute holding local governments subject to suit. In *City of Lafayette v. Louisiana Light & Power Co.*,⁸⁸ the Court focused principally on policy considerations underlying the antitrust laws that might warrant immunity for local governments despite the textual support for liability.⁸⁹ In

Hearings], reprinted in 8 LEGISLATIVE HISTORY A, *supra* note 22, item 23 at 83 (statement of Thomas Corcoran) (listing drafters of the 1934 Act as including Landis, Corcoran, and Cohen).

82. See, e.g., *infra* notes 149, 154, 169, 171 and accompanying text.

83. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202-03 (1976) (relying on statements of Thomas Corcoran); *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 246-49 (1976) (same).

84. Some scholars who reject legislative history as a guide to statutory interpretation argue that committee reports are written by congressional staff rather than by members of Congress. See Zepos, *supra* note 44, at 1311-13 (discussing the argument and noting that the same can be said for the text of the bill).

85. See *supra* note 22. See also 11, Pts. 2-2C, HUGH L. SOWARDS, FEDERAL SECURITIES ACT OF 1933—PRIMARY SOURCE MATERIAL; 11A, Pts. 2-2F, EDWARD N. GADSBY, FEDERAL SECURITIES EXCHANGE ACT OF 1934—PRIMARY SOURCE MATERIAL.

86. For illustrative cases, see *supra* note 1.

87. For illustrative cases, see *supra* note 2.

88. 435 U.S. 389 (1978).

89. The *Lafayette* Court made plain early in its opinion that statutory language was not alone dispositive: "the conclusion that the antitrust laws are not to be construed . . . to subject cities to liability . . . must rest on the impact of some overriding public policy which negates the construction of coverage." *Id.* at 397. For a discussion of the textual support for liability, see *id.* at 394-95. See also *infra* note 217.

Monell v. Department of Social Services,⁹⁰ the Court upheld the liability of local governments under section 1983 entirely on the basis of legislative history and statutory policy.⁹¹ Moreover, in later decisions refining the contours of local government liability under the antitrust and civil rights laws, the Court continues to base its analysis on considerations of history and purpose rather than confining itself to the statutory text.⁹²

The Court's approach in these cases may at least in part be the result of factors peculiar to the antitrust and civil rights laws.⁹³ Two additional factors are, however, probably also at work in cases involving local government liability under federal statutes.

The first is the principle of federalism, which provides that the federal government will not encroach unnecessarily on state governments in the course of safeguarding federal interests.⁹⁴ To be sure, local governments do not possess the sovereignty of states under the Constitution.⁹⁵ Yet local and state governments are not always fully segregable, since local governments implement state policy.⁹⁶ Thus, as a means of avoiding federal-state conflicts, the Court does not rest with a textual analysis of the federal statute at issue, but asks whether legislative history and policy confirm that regulation of local governments was intended.

The second factor involves practicalities. As the Court has acknowledged, albeit in the limited context of punitive damages, a money judgment can create financial hardship for a local government, with its citizenry the ultimate victims.⁹⁷ Before subjecting local governments and their citizens to this hazard, the Court has determined whether legislative history and policy reflect a clear congressional choice in favor of regulation.⁹⁸ The Court no doubt will be similarly protective of local govern-

90. 436 U.S. 658 (1978).

91. *See id.* at 665-89.

92. *See, e.g.,* Pembaur v. City of Cincinnati, 475 U.S. 469, 480-81 (1986) (§ 1983); Jefferson County Pharmaceutical Ass'n v. Abbott Lab., 460 U.S. 150, 157-62 (1983) (antitrust); Owen v. City of Independence, 445 U.S. 622, 638 (1980) (§ 1983).

93. *See, e.g.,* Arthur Stock, Note, *Justice Scalia's Use of Sources in Statutory and Constitutional Interpretation: How Congress Always Loses*, 1990 DUKE L.J. 160, 168 & n.35 (legislative history carries special significance when a statute is so old that the meaning of words in the text may have shifted over time).

94. *See* Younger v. Harris, 401 U.S. 37, 44 (1971).

95. *See, e.g.,* Town of Hallie v. City of Eau Claire, 471 U.S. 34, 38 (1985).

96. *See, e.g.,* City of Columbia v. Omni Outdoor Advertising, Inc., 111 S. Ct. 1344, 1349 (1991).

97. *See* City of Newport v. Fact Concerts, Inc., 453 U.S. 247, 270 (1981).

98. *See id.* at 267.

ments even when only compensatory damages are at issue. Such protectiveness would appear to represent the will of Congress, which in the area of antitrust has granted local governments immunity from actions not only for treble damages, but for any and all damages.⁹⁹

In short, in both the federal securities cases and cases involving the liability of local governments under federal statutes, the Supreme Court has found nontextual sources essential to its analysis. The question of section 10(b)'s applicability to local governments partakes of both lines of cases. The necessity for considering legislative history and purpose thus is doubly compelling.

II. SECTION 10(b) AND LOCAL GOVERNMENTS IN 1934: A NEW PERSPECTIVE

Determining whether section 10(b) applies to local governments requires analysis of both the 1933 and 1934 Acts. Some brief background concerning the two acts as they stood in 1934 is therefore in order.

The 1933 Act was principally directed at initial offerings of securities.¹⁰⁰ It required registration of such offerings through the filing of a detailed disclosure document known as a registration statement.¹⁰¹ Certain categories of securities—including securities issued by state and local governments—were exempt from the registration requirement¹⁰² on the theory that their relative safety made such regulation unnecessary.¹⁰³ Exempted securities were not thought to be absolutely safe, however, and hence they fell within the ambit of section 17(a),¹⁰⁴ an anti-fraud prohibition enforceable by the government.¹⁰⁵ Moreover, a section 17(a) defendant could be any "person,"¹⁰⁶ a term defined by the 1933 Act to include a government.¹⁰⁷ In contrast to section 17(a), the private fraud remedy under section 12(2) expressly excluded from its purview state and local government securities.¹⁰⁸ This exclusion may have reflected an intent to

99. See Local Government Antitrust Act of 1984, 15 U.S.C. §§ 34-36 (1988).

100. See *supra* note 23 and accompanying text.

101. See *supra* note 24 and accompanying text.

102. See *supra* note 26 and accompanying text.

103. See *infra* notes 133-38 and accompanying text.

104. See *supra* note 28 and accompanying text.

105. For the text of § 17(a), see *supra* note 27.

106. See *id.*

107. See *supra* note 35 and accompanying text. In 1933, the constitutionality of subsuming local governments under § 17(a) was far from clear. See *infra* note 182.

108. See *supra* note 28 and accompanying text.

shield local governments from the negligence-based private actions authorized by section 12(2),¹⁰⁹ or, conceivably, from all private actions.¹¹⁰

The 1934 Act focused on the secondary markets.¹¹¹ Like the 1933 Act, the 1934 Act contained a registration requirement¹¹² and fraud prohibitions.¹¹³ Issuers with securities traded on a national securities exchange were required to register the security and to file periodic reports thereafter.¹¹⁴ Among the securities exempted from this requirement were those issued by state and local governments.¹¹⁵ Like the 1933 Act, the 1934 Act contained no private express fraud remedy applicable to state and local government securities.¹¹⁶ Such securities were, however, fully subject to section 10(b),¹¹⁷ the general anti-fraud provision, which, in tandem with rule 10b-5 promulgated thereunder in 1942, authorized government actions expressly¹¹⁸ and private actions by implication.¹¹⁹ Local governments did not appear to be appropriate section 10(b) defendants, however. While section 10(b) applied to any "person,"¹²⁰ the term "person" was not defined to include a government under the 1934 Act as originally enacted.¹²¹

The SEC and certain commentators nonetheless maintain that section 10(b) has applied to local governments since 1934,¹²² apparently in reliance upon the inclusion of governments in the definition of "person" under the 1933 Act.¹²³ Believing this discrepancy in definitions could have no rational explanation, they conclude that the omission of governments from the 1934 Act definition¹²⁴ should be disregarded.¹²⁵

Such a position is flatly contradicted by the legislative history, which

109. See Steinberg, *supra* note 42, at 280 n.15.

110. None of the express private remedies for fraud under the 1933 and 1934 Acts applies to local government securities. See *supra* note 28.

111. See *supra* note 23 and accompanying text.

112. See *supra* note 24 and accompanying text.

113. See *supra* notes 28-29 and accompanying text.

114. See *supra* note 24 and accompanying text.

115. See *supra* note 26 and accompanying text.

116. See *supra* note 28 and accompanying text.

117. See *id.*

118. For the text of § 10(b) and rule 10b-5, see *supra* notes 3 and 5 respectively.

119. See *supra* note 29 and accompanying text.

120. For the text of § 10(b), see *supra* note 3.

121. See *supra* note 34 and accompanying text.

122. See *supra* note 33 and accompanying text.

123. See *supra* note 35 and accompanying text.

124. See *supra* note 34 and accompanying text.

125. See *supra* note 37 and accompanying text.

makes clear that local governments fall outside the scope of section 10(b). To appreciate this point, it is necessary to examine (a) the history of the definition of "person" under the 1933 and 1934 Acts; (b) the history of the exemptions for state and local government securities under both Acts; and (c) the consequences for section 10(b).

A. *The Definition of "Person"*

There is considerable evidence that Congress fully intended to exclude governments from the 1934 Act's definition of "person." The issue of whether a government was a "person" under the 1933 Act, and hence subject to section 17(a), had been the subject of considerable dispute. A government was a "person" in the version of the 1933 Act passed by the House,¹²⁶ but not in the version passed by the Senate.¹²⁷ A House-Senate conference resolved the matter, with the House view prevailing.¹²⁸ Thus, whether governments should be deemed statutory "persons" was, by 1934, already ground well travelled. A clear textual departure in 1934 from this much-debated 1933 choice was almost certainly no accident.

Further evidence of congressional intent to exclude local governments emerges upon placing the issue in its larger context. Whether a government is a "person" subject to a fraud provision is simply one aspect of a subject to which Congress in 1933 and 1934 devoted considerable attention: fraud involving securities of state and local governments. The same 1933 Act joint conference that deemed a government a "person" also made the private remedy under section 12(2) inapplicable to fraud involving state and local government securities, regardless of whether the defendant was a government.¹²⁹ And under the 1934 Act, the section 9(e) and 18(a) private remedies likewise did not apply to fraud involving state or local government securities.¹³⁰ Given the attention Congress paid to fraud involving these securities, it seems highly unlikely that the 1934 Act's definition of "person" would have excluded government issuers fortuitously.

126. See H.R. 5480, 73d Cong., 1st Sess. (1933), reprinted in 3 LEGISLATIVE HISTORY A, *supra* note 22, item 26 at 2.

127. See *id.*, item 27 at 40.

128. See H.R. CONF. REP. NO. 152, 73d Cong., 1st Sess. (1933), reprinted in 2 LEGISLATIVE HISTORY A, *supra* note 22, item 19 at 2.

129. *Id.* at 26-27.

130. See *supra* note 28 and accompanying text.

B. *The Exemptions for State and Local Government Securities*

As adopted, both the 1933 and 1934 Acts exempted state and local government securities from their respective registration provisions.¹³¹ Yet in considering the 1934 Act, Congress thought seriously about rejecting an exemption for such securities, the 1933 Act precedent notwithstanding.¹³² This near break in 1934 from the pattern of 1933 illuminates the actual break between the acts that did occur regarding the definition of "person." It is thus necessary to turn to the reasons state and local government securities were exempted from registration under the 1933 Act and to the subsequent events that placed the analogous 1934 Act exemption in jeopardy.

1. *The 1933 Act*

The legislative history provides two bases for exempting state and local government securities. First was lack of necessity. According to the House Report, the 1933 Act sought only to "prevent recurrences of demonstrated abuses,"¹³³ providing exemptions where "there is no practical need for [the 1933 Act's] application or where the public benefits are too remote."¹³⁴ With Senator Reynolds the only announced dissenter in Congress,¹³⁵ the consensus in 1933 was that state and local government securities were relatively safe,¹³⁶ rarely the subject of fraud,¹³⁷ and owned

131. See *supra* note 26 and accompanying text.

132. See *infra* notes 151-55, 168-69 and accompanying text.

133. H.R. REP. NO. 85, 73d Cong., 1st Sess. (1933), reprinted in 2 LEGISLATIVE HISTORY A, *supra* note 22, item 18 at 7.

134. *Id.* at 5.

135. Arguing against the exemption, Senator Reynolds suggested that local governments faced serious financial problems. "Securities Act": *Hearings on S. 875 Before the Senate Banking & Currency Comm.*, 73d Cong., 1st Sess. (1933) [hereinafter 1933 Act Senate Hearings], reprinted in 2 LEGISLATIVE HISTORY A, *supra* note 22, item 21 at 65. A witness questioned by Senator Reynolds appeared to share that view. See *id.* (statement of Col. A.H. Carter, President of the New York State Society of Certified Public Accountants).

136. See *supra* note 134 and accompanying text. See also "Federal Securities Act": *Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. (1933) [hereinafter 1933 Act House Hearings], reprinted in 2 LEGISLATIVE HISTORY A, *supra* note 22, item 20 at 29 (statement of Huston Thompson, former FTC Commissioner); *Hearing Before the House Comm. on the Judiciary on H.R. 1670, H.R. 3083, H.R. 4311, H.R. 5267, and H.R. 5009*, 73d Cong., 1st Sess. 25 (statement of Rep. Wilcox) [hereinafter House Municipal Bankruptcy Hearing].

137. See *supra* note 133 and accompanying text. See also 1933 Act Senate Hearings, *supra* note 135, reprinted in 2 LEGISLATIVE HISTORY A, *supra* note 22, item 21 at 232-33 (statement of M.H. MacLean, bank vice president).

primarily by sophisticated investors.¹³⁸

The second basis involved a constitutional doctrine that enjoyed its heyday in the early 1930s: state and local government immunity from federal taxation.¹³⁹ The Supreme Court had inferred a constitutional mandate to provide state and local governments with insulation from federal intrusion.¹⁴⁰ The 1933 Act House Report explicitly linked this doctrine and the registration exemption for state and local government securities:

The line drawn . . . corresponds generally with the line drawn by the courts as to what obligations of States, their units and instrumentalities created by them, are exempted from Federal taxation. By such a delineation, any constitutional difficulties that might arise with reference to the inclusion of State and municipal obligations are avoided.¹⁴¹

Given the Supreme Court's decisions applying the immunity doctrine in the tax area, it was distinctly possible that the Court also would strike down a federal registration requirement for state and local government securities. Indeed, the Court had invalidated federal taxation in situations in which the effect on the state or local government was hypothetical at best.¹⁴² For instance, a state judge's salary was held immune from federal taxation,¹⁴³ as were the proceeds private individuals received

138. Contemporaneous congressional statements of this point can be found in the legislative history of the municipal bankruptcy statute. See House Municipal Bankruptcy Hearing, *supra* note 136, at 25 (statement of Rep. Wilcox); 77 CONG. REC. 5471 (1933) (statement of Rep. Foss). See also Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 94th Cong., 2d Sess. 27 (1976) (statement of SEC chairman Roderick M. Hills) (commenting on the historical reasons for the exemption for state and local government securities).

The wisdom of exempting state and local government securities from registration has since been subject to serious challenge. See generally III LOSS & SELIGMAN, *supra* note 6, at 1162-73.

139. The seminal decision was *Collector v. Day*, 78 U.S. (11 Wall.) 113 (1870). A number of cases involving this doctrine were decided on the eve of the 1933 Act's enactment. See, e.g., *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393 (1932); *Indian Motorcycle Co. v. United States*, 283 U.S. 570 (1931); *National Life Ins. Co. v. United States*, 277 U.S. 508 (1928). In 1939, the Court sharply curtailed the doctrine. See *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466 (1939) (overruling *Collector v. Day*). For a general review of the doctrine and its decline, see *Massachusetts v. United States*, 435 U.S. 444, 453-60 (1978).

140. See *Day*, 78 U.S. (11 Wall.) at 125-26. The doctrine was thought to follow from the Constitution's recognition of states as indispensable units of the federal system. See *id.* See also *Massachusetts v. United States*, 435 U.S. at 455. The doctrine protected local governments as well on the theory that such governments "are representatives of the States and exercise some of their powers." *Indian Motorcycle Co.*, 283 U.S. at 577. Cf. *Ambrosini v. United States*, 187 U.S. 1, 7-8 (1902).

141. H.R. REP. NO. 85, 73d Cong., 1st Sess., reprinted in 2 LEGISLATIVE HISTORY A, *supra* note 22, item 18 at 14.

142. See *Indian Motorcycle Co.*, 283 U.S. at 580 (Stone, J., dissenting).

143. *Day*, 78 U.S. (11 Wall.) at 124.

from selling a motorcycle to a city for official use¹⁴⁴ and from selling minerals produced from state-owned land to a third party.¹⁴⁵ These decisions did not turn on the magnitude of anticipated harm to state or local governments: "Where the principle applies it is not affected by the amount of the particular tax or the extent of the resulting interference, but is absolute."¹⁴⁶

Thus, the 1933 Act's exemption from registration for state and local government securities had both practical and theoretical underpinnings. These securities were viewed as relatively safe investments not requiring the safeguard of registration, and mandatory registration was seen as arguably unconstitutional.¹⁴⁷

2. *The 1934 Act*

Paralleling the 1933 Act, the 1934 Act exempted state and local government securities from its registration requirements.¹⁴⁸ Justifications for this exemption included the possible unconstitutionality of requiring state and local governments to register their securities¹⁴⁹ as well as the difficulties that such a registration requirement would create for tiny governmental units such as villages and school districts.¹⁵⁰ Yet Congress

144. *Indian Motorcycle Co.*, 283 U.S. at 570. *Cf.* *Panhandle Oil Co. v. Mississippi ex rel. Knox*, 277 U.S. 218 (1928) (invalidating state tax on a corporation's sale of gasoline to the United States government).

145. *See* *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393 (1932). *Cf.* *Gillespie v. Oklahoma*, 257 U.S. 501 (1922) (invalidating state tax on income generated from federal land). *But cf.* *Group No. 1 Oil Corp. v. Bass*, 283 U.S. 279 (1931) (upholding federal taxation of income derived from property that buyer purchased from the federal government).

146. *Indian Motorcycle Co.*, 283 U.S. at 575.

147. *Cf.* *Landis*, *supra* note 81, at 39 (exemption for state and local government securities came about for unspecified but "obvious political reasons").

148. *See supra* note 26 and accompanying text.

149. *See, e.g.*, 1934 Act House Hearings, *supra* note 81, reprinted in 9 LEGISLATIVE HISTORY A, *supra* note 22, item 23 at 898 (statement of drafter James Landis) (describing the constitutional question as "awfully difficult"); *id.* at 822 (statement of Rep. Pettengill) (noting that "with all of the constitutional questions that are involved in this bill, we have got one over the power of Congress to place any burden upon a State in the marketing of its bonds").

150. *See, e.g.*, "Stock Exchange Practices": *Hearings Before the Senate Banking and Currency Comm. on S. Res. 84 (72d Cong.), S. Res. 56, and S. Res. 97 (73d Cong.)*, 73d Cong. [hereinafter 1934 Act Senate Hearings], reprinted in 6 LEGISLATIVE HISTORY A, *supra* note 22, item 22 at 7042 (statement of George B. Gibbons, municipal securities dealer). *See also id.* at 6840 (statement of Frank Shaughnessy, president of the San Francisco Stock Exchange); *id.* at 6991 (statement of Eugene E. Thompson, president of Associated Stock Exchanges); 1934 Act House Hearings, *supra* note 81, reprinted in 9 LEGISLATIVE HISTORY A, *supra* note 22, item 23 at 535 (statement of Fredric H. Johnson, president of the San Francisco Curb Exchange).

Another justification offered for the exemption was that, in its absence, state and local govern-

seriously considered ignoring these justifications—as well as the precedent of the 1933 Act—and requiring registration of these securities.¹⁵¹

What put the exemption at risk was that state and local government securities had lost the aura of safety and stability on which their 1933 Act exemption had in large measure been based. While only one member of Congress had openly questioned their safety in connection with the 1933 Act,¹⁵² the number of doubters had swelled by 1934. For example, Senator Fletcher, chairman of the Senate Committee considering the 1934 Act, observed that some state and local government securities were “not worth a dime on the dollar.”¹⁵³ Drafter Thomas Corcoran commented that such securities were “running very unevenly.”¹⁵⁴ Additionally, Senator Gore showed concern in questioning a dealer: “Is there any way that you could vest this administrative agency with the power to forewarn prospective purchasers that the bond of a certain town is a bad investment? Is there any red light at all? . . . Is there any form of protection or warning that can be afforded?”¹⁵⁵

This change in attitude originated with Congress' contemporaneous consideration of a municipal bankruptcy statute that addressed the finan-

ments would incur greater expenses in marketing their securities. *See, e.g.*, 1934 Act Senate Hearings, *supra*, reprinted in 7 LEGISLATIVE HISTORY A, *supra* note 22, item 22 at 7526 (statement of Eugene E. Thompson, president of the Associated Stock Exchanges).

151. Early 1934 Act bills contained no exemption for state and local government securities. *See* H.R. 7852, 73d Cong., 2d Sess., reprinted in 10 LEGISLATIVE HISTORY A, *supra* note 22, item 24 at 6-7 (bill introduced Feb. 10, 1934) (defining the term “security” to exclude United States securities, thereby exempting them from the entire statute, but providing no such exemption for state and local government securities); H.R. 7855, 73d Cong., 2d Sess., reprinted in 10 LEGISLATIVE HISTORY A, *supra* note 22, item 25 at 6-7 (bill introduced Feb. 10, 1934) (same); S. 2693, 73d Cong., 2d Sess., reprinted in 11 LEGISLATIVE HISTORY A, *supra* note 22, item 34 at 6-7 (bill introduced Feb. 9, 1934) (same); H.R. 8720, 73d Cong., 2d Sess., reprinted in 10 LEGISLATIVE HISTORY A, *supra* note 22, item 28 at 8-9 (bill introduced March 19, 1934) (defining “exempted securities” to include United States securities but not state or local government securities).

152. *See supra* note 135 and accompanying text.

153. 1934 Act House Hearings, *supra* note 81, reprinted in 9 LEGISLATIVE HISTORY A, *supra* note 22, item 23 at 821.

154. *Id.* at 685.

155. 1934 Act Senate Hearings, *supra* note 150, reprinted in 7 LEGISLATIVE HISTORY A, *supra* note 22, item 22 at 7450. Similarly, the Assistant Secretary of the Treasury warned that some state and local government issuers “had better correct their practices.” 1934 Act House Hearings, *supra* note 81, reprinted in 9 LEGISLATIVE HISTORY A, *supra* note 22, item 23 at 721 (statement of Tom K. Smith). A Federal Trade Commission official lamented the “many misfortunes to investors in municipal securities.” *See id.* at 866 (statement of Robert E. Healy). And the Senate Committee counsel observed that “the mere fact that an issue is of municipal bonds does not carry with it any sanctity, so far as its soundness or secureness is concerned.” 1934 Act Senate Hearings, *supra* note 150, reprinted in 6 LEGISLATIVE HISTORY A, *supra* note 22, item 22 at 7042.

cial crisis faced by local governments across the United States. By January 30, 1934, 2019 local governments had defaulted on payments of interest or principal.¹⁵⁶ Congress feared that without federal intervention these governments soon would be unable to provide even basic fire and police protection.¹⁵⁷ Thus, two weeks before enacting the 1934 Act,¹⁵⁸ it passed a municipal bankruptcy statute that allowed a local government¹⁵⁹ that is "insolvent or unable to meet its debts"¹⁶⁰ to obtain federal bankruptcy court approval to readjust its debts to creditors,¹⁶¹ including holders of government securities,¹⁶² consistent with its ability to pay.¹⁶³ While the statute required that a majority of the creditors approve the readjustment,¹⁶⁴ it did not require the local government to disclose information to creditors that would assist them in deciding

156. See 78 CONG. REC. 7641 (1934) (statement of Sen. Neely). On November 24, 1933, the number of such local governments was 1650. See *id.*

157. See S. REP. NO. 407, 73d Cong., 2d Sess. 2 (1934).

158. Congress enacted the 1934 Act on June 6, 1934. See 1934 Act, ch. 404, 48 Stat. 881. Congress enacted the municipal bankruptcy statute on May 24, 1934. See municipal bankruptcy statute, ch. 345, 48 Stat. 798.

159. The municipal bankruptcy statute applied to "[a]ny municipality or other political subdivision of any State, including (but not hereby limiting the generality of the foregoing) any county, city, borough, village, parish, town, or township, unincorporated tax or special assessment district, and any school, drainage, irrigation, reclamation, levee, sewer, or paving, sanitary, port, improvement, or other districts." Ch. 345, § 80(a), 48 Stat. 798.

160. *Id.*

161. "Creditors" was defined to "include . . . all holders of claims, debts, securities, liens or other interests of whatever character against the [local government] or its property or revenues, including claims under executory contracts and for future rent, . . . and all holders of judgments rendered against such [local government] but excepting claims for salaries and wages for officers and employees of the [local government]." Ch. 345, § 80(b), 48 Stat. 798, 799.

162. "Securities" was defined to "include bonds, notes, and other evidences of indebtedness, either secured or unsecured, and certificates of beneficial interests in property." *Id.*

163. The municipal bankruptcy statute provided:

[a] plan of readjustment . . . (1) shall include provisions modifying or altering the rights of creditors generally, or any class of them, secured or unsecured, either through the issuance of new securities of any character or otherwise; and (2) may contain such other provisions and agreements, not inconsistent with this chapter, as the parties may desire.

Id.

164. Creditors were required to give their approval at two points. First, the bankruptcy court had to receive a proposed plan of readjustment that had been accepted by creditors holding at least 51% of the claims (at least 31% for drainage, irrigation, reclamation, and levee districts). Ch. 345, § 80(a), 48 Stat. 798, 799. Second, once the judge had approved the plan, confirmation required acceptance by creditors holding 66% of the allowed claims. Ch. 345, § 80(d), 48 Stat. 798, 801. The language setting forth the 66% requirement also appears to impose a 75% requirement, the application of which is not clear. See *id.* Moreover, acceptance was not required for any creditor or class of creditors neither affected nor compensated in full by the plan. See *id.*

whether to approve.¹⁶⁵ In addition, a plan that the court and a majority of creditors approved bound every creditor, whether approving or disapproving.¹⁶⁶ No doubt for these reasons, the statute was described as “a loophole in the legal background of municipal securities.”¹⁶⁷

Proponents of the 1934 Act explicitly invoked the municipal bankruptcy statute to explain their reluctance to exempt state and local government securities from the registration requirement. Thus, Senator Fletcher noted that the need for the municipal bankruptcy statute called the exemption from registration into question:

Do you think it would be wise to have a blanket exemption [for local government securities], when there has been passed through the House a municipal bankruptcy act and I think probably passed the Senate, for us to say in this bill that we would exempt every municipal bond from the provisions of [this] bill?

. . . If they were all in good shape, they wouldn't be asking for this bankruptcy Act, would they?

. . . I wish they were all in such shape that we could exempt them, every one of them, from this bill.¹⁶⁸

And drafter Thomas Corcoran made the same connection between bankruptcy and an exemption for state and local government securities: “The fact that the Senate has already passed a municipal bankruptcy bill, and there is now pending before your House a municipal bankruptcy bill, argues that you can no longer put all municipals in the same exempted grade as [United States] government bonds.”¹⁶⁹

Thus, despite its ultimate enactment of an exemption for state and local government securities, the Congress that enacted the 1934 Act regarded these securities with skepticism. Behind the skepticism lay cold, hard reality: local governments were in financial distress and were lobby-

165. This subject was addressed only to the extent that the bankruptcy judge was given discretion to require the local government to “open its books, records, and files to the inspection of any creditor . . . during reasonable business hours.” Ch. 345, § 80(c)(7), 48 Stat. 798, 800.

166. Ch. 345, § 80(f), 48 Stat. 798, 802.

167. *Amendment of Bankruptcy Laws—Bankruptcy of Municipalities: Hearings on S. 1868 and H.R. 5950 Before a Subcomm. of the Senate Judiciary Comm.*, 73d Cong., 2d Sess. 112 (1934) (statement of Harry B. Wade, League For the Preservation of Municipal Credit) [hereinafter Senate Municipal Bankruptcy Hearing].

168. 1934 Act House Hearings, *supra* note 81, reprinted in 9 LEGISLATIVE HISTORY A, *supra* note 22, item 23 at 820-21.

169. *Id.* at 685. See also 1934 Act Senate Hearings, *supra* note 150, reprinted in 7 LEGISLATIVE HISTORY A, *supra* note 22, item 22 at 7414 (committee counsel Pecora) (asking witness arguing for an exemption for state and local government securities whether this should be “[w]ithout regard as to whether any issues are in default or not”).

ing successfully for passage of a municipal bankruptcy statute.¹⁷⁰

C. The Consequences for Section 10(b)

The municipal bankruptcy statute also provides the explanation for why governments were not included as “persons” subject to section 10(b) of the 1934 Act. Had it been applicable to local governments, section 10(b) would have interacted frequently with the municipal bankruptcy statute, since local governments at or near default would be particularly prone to charges of misleading investors concerning their finances.¹⁷¹ This in turn would have triggered a number of consequences Congress wished to avoid—consequences that evidently outweighed the investor protection that application of section 10(b) to local governments would have provided.¹⁷²

First, section 10(b) would increase the likelihood of default for those local governments that were already financially unstable. The reason for this has to do with the nature of section 10(b), which is not a fraud prohibition as such but rather a grant of authority to the SEC to promulgate anti-fraud rules.¹⁷³ Since the character of these as yet unspawned rules was unknown in 1934, so too were the compliance costs that the rules would impose on local governments. These costs were probably viewed with concern, especially in combination with the other threat to financial stability that section 10(b) presented to local governments on the verge of default: court orders under section 10(b) that would directly or indirectly interfere with governmental income or assets.¹⁷⁴

170. See 77 CONG. REC. 5474 (1933) (statement of Rep. Kurtz) (acknowledging that the pressure for the municipal bankruptcy statute came not from investors but from local governments); 78 CONG. REC. 7652-53 (1934) (statement of Sen. Vandenberg) (describing cities supporting the municipal bankruptcy statute). See also *supra* note 168 and accompanying text. *But cf.* S. REP. NO. 407, 73d Cong., 2d Sess. 2 (1934) (asserting that the Senate Judiciary Committee is “convinced” that most creditors of local governments favor enactment of the municipal bankruptcy statute).

171. *Cf.* 1934 Act House Hearings, *supra* note 81, reprinted in 9 LEGISLATIVE HISTORY A, *supra* note 22, item 23 at 897 (statement of drafter James Landis) (noting that “[u]nquestionably there are salesmen who trade in municipal securities . . . and will not tell the purchasers that they are in default”).

172. With respect to the municipal bankruptcy statute as well, the welfare of local governments appeared to loom larger for Congress than did the welfare of investors. See *supra* notes 165-67 and accompanying text.

173. For the text of § 10(b), see *supra* note 3. See also Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385 (1990) (showing that § 10(b) was intended to vest more authority in the SEC than is today assumed).

174. Such orders were, on the other hand, expressly prohibited under the municipal bankruptcy statute “unless the plan of readjustment so provides.” Ch. 345, § 80(c) (11), 48 Stat. 798, 801.

Second, section 10(b) might thwart the speedy financial recovery of local governments that the municipal bankruptcy statute was intended to promote.¹⁷⁵ Recovery would be delayed or prevented if local governments were required to expend resources complying with administrative rules or court orders.

Third, section 10(b) would have raised constitutional problems that the municipal bankruptcy statute would only have aggravated. Section 10(b)'s constitutional vulnerability was rooted in its delegation of power to an administrative agency.¹⁷⁶ Extended to include authority over local governments, such power would have been at least as great a threat to local sovereignty as the registration requirement for local government securities that Congress had rejected as probably unconstitutional.¹⁷⁷ Moreover, the municipal bankruptcy statute itself threatened local sovereignty to the extent it accorded the federal bankruptcy courts authority over local governments.¹⁷⁸ Congress recognized that the municipal bankruptcy statute was vulnerable on this basis,¹⁷⁹ a suspicion that two years later proved prescient.¹⁸⁰ Thus in 1934 Congress must have been aware that, as applied to local governments, section 10(b) and the municipal bankruptcy statute had parallel constitutional weaknesses such that the odds were good that one or both would be struck down in any case in which both were implicated.

Finally, section 10(b) would have imposed compliance costs on solvent local governments, whose ability to market securities was widely thought to be imperiled by the very existence of a statute that authorized municipal bankruptcy.¹⁸¹ Congress may have sought to compensate for the im-

175. See generally S. REP. NO. 407, 73d Cong., 2d Sess. 1-2 (1934).

176. See *supra* note 173 and accompanying text.

177. See *supra* notes 139-41, 149 and accompanying text.

178. In a five to four decision, the Supreme Court declared the municipal bankruptcy statute unconstitutional on this very basis in 1936. See *Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U.S. 513 (1936). Congress then enacted an essentially identical statute, Act of Aug. 16, 1937, Pub. L. No. 302, 50 Stat. 653, which the Supreme Court thereafter upheld. See *United States v. Bekins*, 304 U.S. 27 (1938).

179. Representative Wilcox, a sponsor of the municipal bankruptcy statute, frequently addressed this point. See, e.g., House Municipal Bankruptcy Hearing, *supra* note 136, at 23-24 (defending the statute's constitutionality); Senate Municipal Bankruptcy Hearing, *supra* note 167, at 145 (same). Moreover, the Senate Report captioned a section as follows: "THIS BILL DOES NOT EXTEND THE FEDERAL JURISDICTION OVER THE STATES OR OVER ANY OF THEIR SUBDIVISIONS." S. REP. NO. 407, 73d Cong., 2d Sess. 2 (1934).

180. See *supra* note 178.

181. See, e.g., 78 CONG. REC. 7662 (1934) (statement of Sen. Vandenberg); 77 CONG. REC. 5730 (1933) (statement of Sen. Reed); 77 CONG. REC. 5485-86 (1933) (statement of Rep. Hastings). See

pect of the municipal bankruptcy statute by shielding all local governments from the reach of section 10(b).

In sum, if applicable to local governments, section 10(b) would have generated numerous undesirable effects. It would have threatened the financial stability of local governments near default, while delaying the recovery of those that had defaulted already. Additionally, section 10(b) might well have been declared unconstitutional as applied to local governments, particularly if the municipal bankruptcy statute were also involved.

Congress did not display indifference to these effects by failing to reconsider the reach of section 17(a) of the 1933 Act in light of the poor financial condition of local governments that surfaced in 1934. Instead, Congress no doubt understood section 17(a) to pose significantly less of a threat to local sovereignty than did section 10(b). Indeed, section 17(a) simply prohibited fraud, and did not, as did section 10(b), vest an administrative agency with wide discretion.¹⁸² Moreover, after its extensive consideration of the definition of "person" in 1933,¹⁸³ legislators may have been unwilling to treat the matter as an open question the very next year.

In short, Congress acted reasonably as well as deliberately in excluding local governments from the reach of section 10(b). If there is any basis for applying section 10(b) to local governments, it must lie with the 1975 amendments.

III. THE CONFLICT BETWEEN THE TEXT AND HISTORY OF THE 1975 AMENDMENTS

In 1975, in the course of the "most substantial and significant revision of this country's Federal securities laws since . . . 1934,"¹⁸⁴ Con-

also 1934 Act House Hearings, *supra* note 81, reprinted in 9 LEGISLATIVE HISTORY A, *supra* note 22, item 23 at 823 (statement of Rep. Pettengill) (expressing his opposition to the municipal bankruptcy statute on this basis). *But cf.* 78 CONG. REC. 7742-43 (1934) (statement of Sen. Robinson) (arguing that there would be no harm to solvent local governments in the long run).

182. For the text of § 17(a), see *supra* note 27. Whether the application of § 17(a) to local governments would have withstood constitutional challenge in the 1930s is nonetheless an open question. *Cf.* *Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U.S. 513 (1936) (holding the municipal bankruptcy statute unconstitutional on the basis of numerous cited authorities). Today, in the wake of *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), the application of § 17(a) to local governments would appear to be free from constitutional difficulty.

183. See *supra* notes 126-28 and accompanying text.

184. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 384-385 (1983) (quoting *Securities Acts*

gress revisited the issue of the regulation of state and local government securities.¹⁸⁵ Testimony in congressional hearings reported abuses by brokers and dealers in these securities,¹⁸⁶ who were largely unregulated by the 1934 Act.¹⁸⁷ The 1975 amendments required these professionals not only to register with the SEC¹⁸⁸ but also to abide by rules promulgated by the newly created Municipal Securities Rulemaking Board.¹⁸⁹ While leaving untouched the registration exemptions for state and local government securities,¹⁹⁰ the 1975 amendments changed the statutory status of the governments themselves by adding to the definition of "person" a "government, or political subdivision, agency, or instrument of a government."¹⁹¹ This revision attracted attention. Although supported by the Senate,¹⁹² it was not incorporated in the bill that originally passed the House.¹⁹³ A conference committee resolved the conflict by choosing the Senate version, which both houses then adopted.¹⁹⁴

According to a number of lower federal courts and commentators, local governments became appropriate rule 10b-5 defendants once Congress revised the 1934 Act's definition of "person."¹⁹⁵ In their view, the

Amendments of 1975: Hearings on S. 249 before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 94th Cong., 1st Sess. 1 (1975)).

185. Other topics addressed by Congress in 1975 included the national market system, the national system for clearance and settlement of securities transactions, and self-regulatory organizations. See generally Donald M. Harrison, Note, *Legislation: Securities Acts Amendments of 1975*, 29 OKLA. L. REV. 462 (1976).

186. See S. REP. NO. 75, 94th Cong., 1st Sess. 43 (1975) [hereinafter 1975 Senate Report], reprinted in 3 LEGISLATIVE HISTORY B, *supra* note 22, item 158 at 2717.

187. These brokers and dealers were, however, potential § 10(b) and rule 10b-5 defendants prior to 1975. For pre-1975 cases against brokers and dealers, see *infra* notes 224-28 and accompanying text.

188. Brokers and dealers in state and local government securities were designated "municipal securities dealers." 15 U.S.C. § 78c(a)(30) (1988). As such, they were required to register with the SEC. See 15 U.S.C. § 78o-4(a) (1) (1988).

189. See 15 U.S.C. § 78o-4(b) (2) (1988). See generally Roswell C. Dikeman, *Municipal Securities Rulemaking Board: A New Concept of Self-Regulation*, 29 VAND. L. REV. 903 (1976).

190. For a description of these exemptions, see *supra* note 26 and accompanying text.

191. Section 3(a)(9) of the 1934 Act now provides that "the term 'person' means a natural person, company, government, or political subdivision, agency, or instrumentality of a government." 15 U.S.C. § 78c(a)(9) (1988). Prior to 1975, governments were not "persons" under the 1934 Act. See *supra* note 34 and accompanying text.

192. See 121 CONG. REC. 10,711 (1975), reprinted in 3 LEGISLATIVE HISTORY B, *supra* note 22, item 159 at 2928.

193. See 121 CONG. REC. 11,748 (1975), reprinted in 3 LEGISLATIVE HISTORY B, *supra* note 22, item 160 at 2983.

194. See H.R. CONF. REP. NO. 229, 94th Cong., 1st Sess. (1975), reprinted in 3 LEGISLATIVE HISTORY B, *supra* note 22, item 162 at 3041.

195. See *supra* note 38 and accompanying text.

legislative history need not be considered because of the straightforward statutory language: section 10(b) and rule 10b-5 apply to any "person" and a "person" now includes a government.¹⁹⁶

This textual approach has serious flaws. It ignores the importance of legislative history to analyses of the federal securities laws and the liability of local governments under federal statutes,¹⁹⁷ and it produces a result squarely at odds with Congress' intent. Indeed, the legislative history of the 1975 amendments is altogether inconsistent with the creation of liability for local governments. In the words of the Senate Report: "The bill assures that access of state and local governments to the capital markets will not be regulated in ways *not now permitted* under the fraud provisions of the federal securities laws."¹⁹⁸ This pronouncement appeared in a section entitled "REGULATION OF MUNICIPAL SECURITIES PROFESSIONALS—NOT ISSUERS."¹⁹⁹

Further evidence of Congress' choice not to regulate local governments lies in its efforts to assure those governments that regulation would not occur accidentally. The anxiety of local governments in this regard was of sufficient magnitude to warrant mention in the Senate Report: "While conceding that nothing in the legislation contemplates direct regulation of issuers or the registration of their securities, municipal issuers have nevertheless expressed concern over the possibility of indirect requirements. . . ."²⁰⁰ The anxiety apparently also struck Congress as reasonable under the circumstances, prompting the addition of two provisions to the 1934 Act: sections 3(d)²⁰¹ and 15B(d).²⁰² Section 3(d) was designed to prevent regulation of a state or local government that traded in its own securities.²⁰³ Section 15B(d) was intended to insure

196. See *supra* notes 39-41 and accompanying text.

197. In federal securities cases, the legislative history from the 1930s is important because of the nature of the statutory text, the high caliber of the drafters who testified at the hearings, and the depoliticization of the enactment process that resulted from the economic crisis of the early 1930s. See *supra* notes 67-85 and accompanying text. Clearly the first factor supports the importance of the history of the 1975 amendments as well, since those amendments merely plugged holes in an already well-established statutory design. The history of the 1975 amendments is likewise important for all the reasons that legislative history is central to analysis of the liability of local governments under federal statutes. See *supra* notes 86-99 and accompanying text.

198. 1975 Senate Report, *supra* note 186, reprinted in 3 LEGISLATIVE HISTORY B, *supra* note 22, item 158 at 2719 (emphasis added).

199. *Id.* at 2718.

200. *Id.*

201. Section 3(d), 15 U.S.C. § 78c(d) (1988) [hereinafter § 3(d)].

202. Section 15B(d), 15 U.S.C. § 78o-4(d) (1988) [hereinafter § 15B(d)].

203. Section 3(d) provides: "No issuer of municipal securities or officer or employee thereof

that state or local government issuers were not subject to the newly created Municipal Securities Rulemaking Board.²⁰⁴ As Senator Williams, a sponsor of section 15B(d), explained on the floor, the section "would simply clarify . . . that the bill is not intended to tamper in any way with prerogatives of State and local governments in their sale of securities."²⁰⁵

Congress' attempt to purge the 1975 amendments of even indirect regulatory effects on local governments is incompatible with an intent to subject these governments to the daunting prospect of private litigation under section 10(b) and rule 10b-5.²⁰⁶ It strains credulity to suppose that Congress would precipitate a change of this nature without comment while simultaneously insisting that the legislation did not affect local governments even indirectly.

Proponents of a textual approach might respond that Congress reasonably could have assumed that as newly minted statutory "persons," local governments automatically would become subject to section 10(b) and hence any legislative history to the contrary should not be taken at face value. Indeed, how was Congress to know that legislative history was crucial? Most of the Supreme Court's securities decisions emphasizing legislative history's importance were not on the books at the time Congress enacted the 1975 amendments.²⁰⁷ Nor did those books contain the Court's 1978 antitrust and civil rights decisions on the liability of local governments in which the legislative history was accorded great

acting in the course of his official duties as such shall be deemed to be a 'broker,' 'dealer,' or 'municipal securities dealer' solely by reason of buying, selling, or effecting transactions in the issuer's securities." 15 U.S.C. § 78c(d) (1988).

204. Section 15(B)(d) provides:

- (1) Neither the Commission nor the Board is authorized under this chapter, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.
- (2) The Board is not authorized under this chapter to require any issuer of municipal securities, directly or indirectly through a municipal securities broker or municipal securities dealer or otherwise, to furnish to the Board or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer. . . .

15 U.S.C. § 78o-4(d) (1988).

205. 121 CONG. REC. 10,736 (1975), *reprinted in* 3 LEGISLATIVE HISTORY B, *supra* note 22, item 159 at 2953.

206. If § 10(b) and rule 10b-5 were not applicable, local governments would face virtually no threat of private securities fraud litigation. *See supra* notes 28-30 and accompanying text.

207. *See supra* notes 47-85 and accompanying text.

weight.²⁰⁸

But Congress in fact did know that legislative history was crucial. The importance of legislative history to local government liability had been established in 1961 in *Monroe v. Pape*,²⁰⁹ one of the landmark civil rights decisions of the twentieth century. The Supreme Court's interpretation of section 1983 in *Monroe* made possible most of the litigation under that statute of the last thirty years.²¹⁰ The *Monroe* Court also held, however, that local governments were not "persons" subject to liability under section 1983.²¹¹ This holding was not based on statutory language, which simply imposed liability on any "person"—a term not otherwise defined—who acted "under color of" state law.²¹² Instead, the Court rejected local government liability entirely on the basis of the legislative history, despite the fact that nothing in the legislative history was directly on point. The evidence that persuaded the Court was largely inferential. Congress had rejected the Sherman Amendment, which would have made cities liable for specified acts of violence.²¹³ From this the Court inferred an intent to reject local government liability in all circumstances,²¹⁴ notwithstanding a definition of "person" in the contemporaneous Dictionary Act²¹⁵ that militated in favor of liability.²¹⁶ *Monroe* thus showed that local government liability under federal statutes must be based on clear evidence of congressional intent, gathered from both textual and nontextual sources.²¹⁷

208. See *supra* notes 88-92 and accompanying text.

209. 365 U.S. 167 (1961).

210. In *Monroe*, the Court held that § 1983 encompassed both official government actions and the unauthorized actions of individual state defendants that violated state law. See *id.* at 183-87. See generally ERWIN CHERMERINSKY, FEDERAL JURISDICTION § 8.3 (1989).

211. *Monroe*, 365 U.S. at 187-91. In *Monell v. Department of Social Services*, 436 U.S. 658 (1978), the Court reversed the holding of *Monroe* that rejected local government liability under § 1983.

212. Section 1983 provides:

Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

42 U.S.C. § 1983 (1988).

213. *Monroe*, 365 U.S. at 188-90.

214. *Id.* at 191.

215. Act of Feb. 25, 1871, § 2, 16 Stat. 431.

216. *Monroe*, 365 U.S. at 190-91.

217. The teaching of *Monroe* was confirmed by lower court antitrust cases on the books at the time Congress considered the 1975 amendments. Various factors suggested strongly that local gov-

The text and the history of the 1975 amendments, then, seem very much at odds. The text, considered alone, appears to authorize fraud actions against local governments: a government is deemed a "person" and any "person" is subject to section 10(b). The legislative history runs counter to this interpretation, however, by stressing that the fraud liability of local governments was to remain unchanged. Hence the question arises whether text and history can be reconciled or whether a choice must be made between them.

IV. SECTION 10(b) AND LOCAL GOVERNMENTS AFTER THE 1975 AMENDMENTS: A NEW PERSPECTIVE

This Article proposes a reconciliation of the text and history of the 1975 amendments, attempting to explain why Congress would choose both to redefine "person" to include a government but not to make local governments liable under section 10(b) and rule 10b-5. Together, these choices furthered the central purpose of the 1975 amendments: the regulation of professionals dealing in state and local government securities.²¹⁸ The reclassification of governments as "persons" provided a firmer foundation for claims against these professionals. As a "person," a government could be cited as the professional's uncharged conspirator,²¹⁹ thereby supplying the conspiracy with its necessary second partici-

ernments were appropriate defendants under the Sherman Act, 15 U.S.C. §§ 1-7 (1988). The statutory text created a cause of action against any "person," see 15 U.S.C. § 1 (1988), and "person" was defined in highly general terms that easily could have encompassed local governments. See 15 U.S.C. § 7 (1988). An earlier Supreme Court decision had held a city to be a "person" under the antitrust laws and for that reason a proper antitrust plaintiff. See *Chattanooga Foundry & Pipe Works v. City of Atlanta*, 203 U.S. 390, 396 (1906). Nonetheless, at the time Congress considered the 1975 amendments, lower courts divided over how to harmonize the liability of local governments with the antitrust immunity of states. See Ellen J. Tchorni, Note, *Antitrust Law and Municipal Corporations: Are Municipalities Exempt from Sherman Act Coverage Under the Parker Doctrine?*, 65 GEO. L.J. 1547, 1561-75 (1977) (collecting the lower courts' various approaches). Underlying this division was broad agreement that local government antitrust liability could not be accepted or rejected solely on the basis of statutory language. *Id.* at 1561-75. These lower court decisions made it clear that for federal statutory liability to attach to local governments, Congress would have to do more than adopt a broad definition of "person."

218. See *supra* notes 186-89 and accompanying text.

219. For discussions of conspiracy under the federal securities laws, see William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws—Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common Law Principles and the Statutory Scheme*, 14 J. CORP. L. 313, 343-48 (1988); David S. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 620-45 (1972).

pant.²²⁰ Likewise, as a "person" a government could be cited as the uncharged principal perpetrator of the violation that the professional aided and abetted.²²¹ In this way, the government would supply the aiding and abetting charge with the necessary primary violation.²²² Congress would have regarded the foregoing strategy²²³ as obvious and worthwhile in light of (1) the then existing rule 10b-5 cases involving professionals in local government securities, as well as (2) the difficulty in citing a government as an uncharged conspirator or primary violator if a government were not a 1934 Act "person."

A. Pre-1975 Rule 10b-5 Caselaw

In considering the regulation of professionals who dealt in local government securities, Congress would have found noteworthy two aspects of the eleven reported federal cases then on the books in which such professionals had been charged with fraud.²²⁴ First, in most of the cases, the professionals were charged either with conspiracy to violate rule 10b-5²²⁵ or with aiding and abetting the rule 10b-5 violations of others.²²⁶ Second, in most of them, local governments or local government officials

220. For the proposition that a conspiracy requires two participants, see *Morrison v. California*, 291 U.S. 82, 92 (1934). See also 18 U.S.C. § 371 (1988) (two-person requirement under federal conspiracy statute).

221. For discussions of aiding and abetting under the federal securities laws, see Alan R. Bromberg & Lewis D. Lowenfels, *Aiding & Abetting Securities Fraud: A Critical Examination*, 52 ALB. L. REV. 637 (1988); Kuenhle, *supra* note 219, at 320-43; Ruder, *supra* note 219, at 620-45.

222. For the proposition that an aiding and abetting charge requires a primary violation by a separate party, see Bromberg & Lowenfels, *supra* note 221, at 662, 668-70. See also Kuenhle, *supra* note 219, at 322.

223. The strategy probably embraced state governments as well. As long as the state government was not subject to liability, it arguably could be named as an uncharged conspirator or as an uncharged primary violator consistent with the Eleventh Amendment. Cf. *Dennis v. Sparks*, 449 U.S. 24 (1980) (allowing a state official to be named as an uncharged conspirator under § 1983).

224. See *SEC v. Senex Corp.*, 399 F. Supp. 497 (E.D. Ky. 1975), *aff'd*, 534 F.2d 1240 (6th Cir. 1976); *SEC v. R.J. Allen & Assocs., Inc.*, 386 F. Supp. 866 (S.D. Fla. 1974); *SEC v. Charles A. Morris & Assocs., Inc.*, 386 F. Supp. 1327 (W.D. Tenn. 1973); *Shapiro v. Schwamm*, 279 F. Supp. 798 (S.D.N.Y. 1968); *International Ladies' Garment Workers' Union v. Shields & Co.*, 209 F. Supp. 145 (S.D.N.Y. 1962); *Texas Continental Life Ins. Co. v. Bankers Bond Co.*, 187 F. Supp. 14 (W.D. Ky. 1960), *rev'd sub nom. Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962); *Thiele v. Shields*, 131 F. Supp. 416 (S.D.N.Y. 1955); *Connecticut Mut. Life Ins. Co. v. Shields*, 131 F. Supp. 363 (S.D.N.Y. 1954); *Greenwich Sav. Bank v. Shields*, 131 F. Supp. 368 (S.D.N.Y. 1955); *Baron v. Shields*, 131 F. Supp. 370 (S.D.N.Y. 1954); *Citizens' Casualty Co. v. Shields*, [1954 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,683 (S.D.N.Y. Nov. 9, 1954).

225. See *Shapiro*, 279 F. Supp. at 800; *Texas Continental Life Ins. Co.*, 187 F. Supp. at 24; *Thiele*, 131 F. Supp. at 418; *Greenwich Sav. Bank*, 131 F. Supp. at 369; *Citizens Casualty Co.*, [1954 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,683 at 92,057.

were either named as defendants²²⁷ or if not, were otherwise implicated in the transactions.²²⁸

B. Conspiracy and Aiding and Abetting

Under the 1934 Act as originally enacted, there was serious difficulty in charging a securities professional with conspiring with or aiding and abetting a government to violate rule 10b-5. The difficulty resulted from the fact that while a professional was a statutory "person" with the legal capacity to commit a substantive 1934 Act violation, a government was not.²²⁹ Thus, the conspiracy or aiding and abetting charge against the professional might fail on the ground that his government confederate was not a "person" recognized by the 1934 Act.

To be sure, as a general rule, two people can be convicted of conspiracy if only one of them has the legal capacity to commit the underlying substantive offense. Thus, in *United States v. Holte*,²³⁰ the Supreme Court approved the conviction of a government employee and a private party for conspiring to commit a substantive offense that only the government employee had the legal capacity to commit.²³¹ Application of

226. See *Senex Corp.*, 399 F. Supp. at 507; *R.J. Allen & Assocs., Inc.*, 386 F. Supp. at 877; *Charles A. Morris & Assocs.*, 386 F. Supp. at 1335.

227. See *International Ladies' Garment Workers' Union v. Shields & Co.*, 209 F. Supp. 145 (S.D.N.Y. 1962) (defendants include chairman of Bellevue, Nebraska Bridge Commission); *Thiele v. Shields*, 131 F. Supp. 416 (S.D.N.Y. 1955) (same); *Greenwich Sav. Bank v. Shields*, 131 F. Supp. 368 (S.D.N.Y. 1955) (same); *Connecticut Mut. Life Ins. Co. v. Shields*, 131 F. Supp. 363 (S.D.N.Y. 1954) (same); *Citizens Casualty Co. v. Shields*, [1954 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,683 (S.D.N.Y. Nov. 9, 1954) (same); *Baron v. Shields*, 131 F. Supp. 370 (S.D.N.Y. 1954) (defendants include Bellevue, Nebraska Bridge Commission and its members). None of these cases indicated that the local government official acted in other than his official capacity. In his official capacity, a local government official is indistinguishable from the local government itself. See *supra* note 21 and accompanying text.

No challenge was made in these cases to the naming of local governments and local government officials as defendants. For a discussion of this issue, see *infra* notes 249-52 and accompanying text.

228. See *Texas Continental Life Ins. Co. v. Bankers Bond Co.*, 187 F. Supp. 14 (W.D. Ky. 1960) (implicating West Beuchel, Ky.), *rev'd on other grounds sub nom.* *Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962). See also *SEC v. Senex Corp.*, 399 F. Supp. 497 (E.D. Ky. 1975) (implicating Covington, Ky.), *aff'd*, 534 F.2d 1240 (6th Cir. 1976). The City of Covington later was named as a defendant in a separate action growing out of the same transaction. See *Brown v. City of Covington*, 805 F.2d 1266 (6th Cir. 1986).

229. See *supra* note 34 and accompanying text.

230. 236 U.S. 140 (1915).

231. *Id.* at 145. See also *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 224, 225 n.59 (1940) (reaffirming the general rule); *United States v. Rabinowich*, 238 U.S. 78, 86 (1915) (upholding charge that bankrupts and nonbankrupts conspired to violate a bankruptcy act provision pertaining only to bankrupts). Cf. *United States v. Giordano*, 489 F.2d 327, 330 (2d Cir. 1973) (a depositor can

the general rule assumes, however, that no affirmative statutory policy prevents the offense in question from subsuming in an appropriate case those not government employees. When Congress excludes a particular class of persons from a provision for policy reasons, the general rule gives way. In such a case, the member of the excluded class is immune from liability not only for the substantive offense, but also for conspiracy to commit that offense.²³² Moreover, in all likelihood she cannot be cited as an uncharged conspirator or as an uncharged primary violator to provide a foundation for the liability of another.²³³ While citing her in these ways would facilitate statutory enforcement, it would to some extent undermine her immunity, since her guilt or innocence would be a focus of the trial even though she was not actually charged.²³⁴

Courts have long struggled to reconcile these competing considerations. In *Gebardi v. United States*,²³⁵ the Supreme Court tilted in favor of safeguarding the excluded person's statutory immunity from liability. *Gebardi* involved the conviction under the Mann Act²³⁶ of a man and a woman for conspiracy to transport the woman across state lines for purposes of prostitution. Under the Mann Act, the man, but not the woman, had the legal capacity to commit the substantive offense.²³⁷ Observing that the woman had been excluded from the statute for policy reasons, the Court concluded: "It would contravene that policy to hold that the very passage of the Mann Act effected a withdrawal by the conspiracy statute of that immunity which the Mann Act itself confers."²³⁸ Accordingly, the Court held not only that the woman was herself immune from a charge of conspiracy to violate the Mann Act, but also that she could not be cited as the man's conspirator for purposes of sustaining his conspiracy conviction.²³⁹ The Court reversed not only her conviction

be liable for aiding and abetting a violation by a bank officer that only the bank officer has the legal capacity to commit).

232. See *infra* notes 235-40 and accompanying text.

233. See *infra* notes 239-43, 245 and accompanying text. But cf. *supra* note 244.

234. Cf. *Sparks v. Duval County Ranch Co.*, 604 F.2d 976, 986 (5th Cir. 1979) (en banc) (Coleman, Ainsworth, Roney, and Hill, JJ., dissenting) (noting that when a judge, immune from liability, is named as an uncharged conspirator under § 1983, his behavior is on trial even if he is not actually named as a defendant), *aff'd sub nom. Dennis v. Sparks*, 449 U.S. 24 (1980).

235. 287 U.S. 112 (1932).

236. Mann Act, 18 U.S.C. §§ 2421-2424 (1988) [hereinafter Mann Act].

237. See *Gebardi*, 287 U.S. at 118.

238. *Id.* at 123.

239. *Id.* It is true, of course, that in *Gebardi* the woman was a member of the class that the Mann Act was designed to protect. See *id.* at 116. Yet courts have applied the principle of this case more broadly. Thus, in *United States v. Blondek*, 741 F. Supp. 116 (N.D. Tex. 1990), *aff'd sub*

tion, but his as well.²⁴⁰

A variant of this issue arose repeatedly under section 1983 prior to enactment of the 1975 amendments to the 1934 Act. The Supreme Court regarded section 1983 as inapplicable to states both because Congress so intended²⁴¹ and because the Eleventh Amendment so required.²⁴² But could the state (or its official acting in his official capacity) nonetheless be cited as the uncharged conspirator of a private individual? If so, the state would both give the conspiracy its necessary second participant and also satisfy section 1983's "under color of state law" requirement.²⁴³ In 1975, the Supreme Court's resolution of the issue lay five years in the future,²⁴⁴ and in line with *Gebardi*, lower courts adopted the view that a state or state official could not be treated as a private individual's uncharged conspirator.²⁴⁵

In short, in 1975, a claim of conspiracy or aiding and abetting a viola-

nom. United States v. Castle, 925 F.2d 831 (5th Cir. 1991), the court observed that "[n]othing in *Gebardi* indicates that only 'protected' persons are exempted from conspiracy charges." *Id.* at 118. Accordingly, the court held that foreign officials could not be charged with conspiracy to violate the Foreign Corrupt Practices Act because they had been omitted from that Act's substantive provisions for policy reasons. *See id.* at 120. Similarly, in United States v. Nasser, 476 F.2d 1111 (7th Cir. 1973), the court relied on *Gebardi* to overturn convictions of a former government lawyer and his client for conspiracy to violate a federal conflict-of-interest statute that applied only to the lawyer. The court rejected the argument that *Gebardi* did not apply because the client had "culpable intent" and was therefore not among those the statute was intended to protect. *See id.* at 1120.

240. *Gebardi*, 287 U.S. at 123. *See also* *Nasser*, 476 F.2d at 1120 (rejecting conspiracy convictions of lawyer and client because, for reasons of statutory policy, client was not covered by the underlying substantive offense); *Nigro v. United States*, 117 F.2d 624, 629 (8th Cir. 1941) (rejecting conspiracy between purchaser and seller of narcotics because purchaser was excluded from the underlying substantive offense for policy reasons). *Cf.* *Aldinger v. Howard*, 427 U.S. 1, 17-18 (1976) (county, excluded from liability under § 1983 for policy reasons, could not be brought into federal court pursuant to pendent-party jurisdiction); *United States v. Amen*, 831 F.2d 373, 381-82 (2d Cir. 1987) (rejecting conviction for aiding and abetting because defendant had been excluded for policy reasons from the Comprehensive Drug Abuse Prevention & Control Act), *cert. denied*, 485 U.S. 1021 (1988).

241. Since, in the wake of *Monroe v. Pape*, 365 U.S. 167 (1961), local governments were not "persons" under § 1983, it followed *a fortiori* that states were not "persons" either. *See* *Fitzpatrick v. Bitzer*, 427 U.S. 445, 452 (1976). The Supreme Court has recently held that states and state officials acting in their official capacities are not "persons" under § 1983. *See* *Will v. Michigan Dept. Of State Police*, 491 U.S. 58, 62-71 (1989).

242. *See, e.g.*, *Edelman v. Jordan*, 415 U.S. 651, 663 (1974).

243. For the text of § 1983, *see supra* note 212. For a discussion of the "under color of state law" requirement, *see* CHEMERINSKY, *supra* note 210, § 8.3.

244. In *Dennis v. Sparks*, 449 U.S. 24 (1980), the Court upheld the conviction of a private individual for conspiring with an uncharged state official to violate § 1983.

245. *See, e.g.*, *Waits v. McGowan*, 516 F.2d 203, 205 (3d Cir. 1975); *Sykes v. California*, 497 F.2d 197, 202 (9th Cir. 1974); *Guedry v. Ford*, 431 F.2d 660, 664 (5th Cir. 1970).

tion of federal law was vulnerable to dismissal when the defendant's confederate—though uncharged—was himself excluded from the underlying substantive offense for reasons of statutory policy.²⁴⁶ Hence under the 1934 Act as originally enacted, a local government, excluded from section 10(b) for reasons of policy,²⁴⁷ was an inappropriate uncharged conspirator of a securities professional as well as an inappropriate uncharged perpetrator of the primary violation that the professional allegedly aided and abetted. Yet prospects for treating the local government as an uncharged confederate would have improved immeasurably if Congress reclassified the government as a "person," even if the government's immunity remained intact. By turning governments into "persons," the 1975 amendments accomplished precisely that result.

C. *Counter Arguments*

Three arguments run counter to the conclusion that local governments are subject to section 10(b) only to the extent that they may be cited as uncharged conspirators and uncharged primary violators: (1) because local governments sometimes were defendants in pre-1975 federal securities cases, their reclassification as "persons" may have been intended to provide a foundation for governmental liability; (2) in the interests of harmony between the 1933 and 1934 Acts,²⁴⁸ local governments should have the same status under section 10(b) as under section 17(a); and (3) had Congress intended local governments to be cited as uncharged conspirators and uncharged primary violators, it would have said so expressly.

1. *Local Government Defendants in Pre-1975 Caselaw*

Local governments sometimes were defendants in pre-1975 federal securities cases.²⁴⁹ It does not follow, however, that in 1975 Congress intended to provide a foundation for their liability. None of the pre-1975 actions against a local government appears to have advanced beyond the

246. The claim also would be at risk today. See *supra* note 239 and accompanying text. *But cf. supra* note 244.

247. See *supra* notes 148-50 and accompanying text.

248. It is sometimes said that "the 1933 and 1934 Acts should be construed harmoniously because they 'constitute interrelated components of the federal regulatory scheme governing transactions in securities.'" *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 484-85 (1989) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976)).

249. See *supra* note 227 and accompanying text.

preliminary motion stage,²⁵⁰ and in none did the opinion consider the argument that local governments were inappropriate defendants.²⁵¹ These cases, therefore, did not seriously invite Congress to consider subjecting local governments to liability under section 10(b) and rule 10b-5. In any event, the Senate Report on the 1975 amendments states categorically that the fraud liability of local governments would remain unchanged.²⁵²

2. *Harmony Between the 1933 and 1934 Acts*

Subjecting local governments to liability under section 10(b) and rule 10b-5 would not promote harmony between the 1933 and 1934 Acts. To be sure, as "persons" under the 1933 Act, local governments are subject to liability under section 17(a), because nothing in the legislative history contradicts the statutory language. Yet if local governments were also made subject to section 10(b) and rule 10b-5, a substantial discrepancy between the two acts would result: the 1934 Act would allow private fraud actions against local governments, whereas the 1933 Act would not. Indeed, while there is no doubt about the existence of a private action under section 10(b) and rule 10b-5,²⁵³ a private action under section 17(a) is now widely rejected.²⁵⁴ Thus, it is specious to argue that giving uniform effect to the two definitions of "person" would produce harmony between the 1933 and 1934 Acts.

3. *Congress's Silence Concerning Conspiracy*

Finally, it is certainly true that the legislative history of the 1975 amendments contains no outright statement authorizing the citing of local governments as uncharged conspirators and uncharged primary violators. Yet it would have been entirely reasonable for Congress to suppose that the reclassification of governments as "persons" automatically would permit them to be cited in this fashion. Moreover, explicitness also may have been politically inexpedient. Local governments appear to have lobbied hard in Congress to avoid even indirect regulation under the 1975 amendments.²⁵⁵ Although treatment as uncharged con-

250. *See id.*

251. *See id.*

252. *See supra* notes 198-99 and accompanying text.

253. *See supra* note 29 and accompanying text.

254. *See supra* note 30 and accompanying text.

255. *See supra* notes 200-05 and accompanying text.

spirators and uncharged primary violators was not regulation as such, it was not something about which local governments would in all likelihood have waxed enthusiastic.

CONCLUSION

Local governments are immune from liability under section 10(b) and rule 10b-5. In 1934, local governments were not among those "persons" to whom section 10(b) applied. This exclusion was intentional, designed to prevent interaction between section 10(b) and the contemporaneously enacted municipal bankruptcy statute. When Congress amended the 1934 Act in 1975, local governments remained immune from fraud liability, notwithstanding their reclassification as "persons." Congress intended the 1975 amendments to regulate professionals dealing in state and local government securities, and thus reclassified governments as "persons" merely to facilitate suits against these professionals.

A textual approach has obvious merits and is often an appropriate method of statutory construction in some areas of the law. In the areas of federal securities regulation and local government liability under federal statutes, however, it produces results at odds with congressional intent. Only by adopting a comprehensive and historical approach in these areas can the courts accomplish the results that Congress has chosen.