Are Local Governments Liable Under Rule 10b-5? Textualism and Its Limits

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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 antitrust and civil rights law, now has arisen in a new area: section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5.

That this question should emerge under rule 10b-5 is hardly surpris-
ing. Faced with cuts in federal aid, state and local governments issued twice the volume of securities in 1990 as in 1980. Fraud litigation involving these securities has been brought against not only brokers, dealers, and other private actors, but also the governments themselves. Such litigation against governments is bound to swell. Indeed, a new

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


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.


SEC rule on offerings of state and local government securities mandates that disclosure documents prepared by the issuing government be distributed to investors. In any fraud action involving these documents, the SEC regards the government as the appropriate defendant. In addition, many local government issuers are widely thought to be on the verge of default, 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.

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


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.


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).


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, South Bend, Indiana, Vestavia Hills, Alabama, nine cities in Washington, and five cities in Idaho, as well as to numerous local government officials acting in their official capacities.

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. The 1933 Act is principally directed at the initial distribution of securities, while the 1934 Act concentrates on the secondary markets. Despite their different emphases, the two acts employ similar regulatory mechanisms. Each act requires registration of securities and each imposes liability for fraud. In addition, each act provides an exemption from registration for state and local government securities. These registration exemptions, however, are irrelevant to


20. See id.


23. For an overview of the federal securities statutes, see LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 35-39 (2d ed. 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). Sections 10(b) and 17(a) apply to fraud involving state and local government securities, 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," whereas under section 17(a) a private action is now widely rejected.

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


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.


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"—to local governments. In the view of the SEC and certain commentators, section 10(b) has applied to local governments since 1934, despite Congress' failure to include governments in the original 1934 Act definition of "person." They base their view on the 1933 Act's definition of "person," in which governments were always expressly incorporated. Without examining the legislative history, 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. 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. Proponents of this view emphasize the text of the 1934 Act.

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).


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)).


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 Pescock, 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).


Act's 1975 amendments, which added to the definition of "person" "a government, or political subdivision, agency, or instrumentality of a government." 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.

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

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. The question implicates two lines of cases in which the Supreme Court for valid reasons has accorded


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.


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

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. 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 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.

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-estab-
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*, 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." 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*, *Kern County Land Co. v. Occidental Petroleum Corp.*, and *SEC v. Capital Gains Research Bureau, Inc.* 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, 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." Since the text set forth no economic criteria by which to identify a security, 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 SEG 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).
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," 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." Guided by this "touchstone," the Court concluded that Congress did not intend the statutory protections to apply to the housing cooperative in question.

In Kern, the Court held that a transaction arguably falling within the common-sense meaning of "sale" nonetheless was not a "sale" under the 1934 Act provision prohibiting short-swing profits. Eschewing a literal reading of the text, the Court sought guidance from the underlying statutory purpose. 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."

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

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.
61. See Kern County Land Co., 411 U.S. at 593-95.
62. Id. at 594 (footnote omitted).
64. Capital Gains Research Bureau, Inc., 375 U.S. at 185.
65. Id. at 186-201. 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

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\(^{67}\) 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).


\(^{73}\) 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. 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" and a transaction "not involving any public offering," 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. The federal securities laws were enacted as emergency legislation at a time of national crisis. 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. They provided comprehensive and undoubtedly influen-

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.
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.

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

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 depolitization 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, 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 antitrust and civil rights 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., the Court focused principally on policy considerations underlying the antitrust laws that might warrant immunity for local governments despite the textual support for liability. In

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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.


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 Zeppos, 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, PIs. 2-2C, HUGH L. SOWARDS, FEDERAL SECURITIES ACT OF 1933—PRIMARY SOURCE MATERIAL; 11A, PIs. 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.


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,\(^9\) 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-

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

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),\textsuperscript{109} or, conceivably, from all private actions.\textsuperscript{110}

The 1934 Act focused on the secondary markets.\textsuperscript{111} Like the 1933 Act, the 1934 Act contained a registration requirement\textsuperscript{112} and fraud prohibitions.\textsuperscript{113} Issuers with securities traded on a national securities exchange were required to register the security and to file periodic reports thereafter.\textsuperscript{114} Among the securities exempted from this requirement were those issued by state and local governments.\textsuperscript{115} Like the 1933 Act, the 1934 Act contained no private express fraud remedy applicable to state and local government securities.\textsuperscript{116} Such securities were, however, fully subject to section 10(b),\textsuperscript{117} the general anti-fraud provision, which, in tandem with rule 10b-5 promulgated thereunder in 1942, authorized government actions expressly\textsuperscript{118} and private actions by implication.\textsuperscript{119} Local governments did not appear to be appropriate section 10(b) defendants, however. While section 10(b) applied to any “person,”\textsuperscript{120} the term “person” was not defined to include a government under the 1934 Act as originally enacted.\textsuperscript{121}

The SEC and certain commentators nonetheless maintain that section 10(b) has applied to local governments since 1934,\textsuperscript{122} apparently in reliance upon the inclusion of governments in the definition of “person” under the 1933 Act.\textsuperscript{123} Believing this discrepancy in definitions could have no rational explanation, they conclude that the omission of governments from the 1934 Act definition\textsuperscript{124} should be disregarded.\textsuperscript{125}

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

\textsuperscript{109} See Steinberg, supra note 42, at 280 n.15.
\textsuperscript{110} None of the express private remedies for fraud under the 1933 and 1934 Acts applies to local government securities. See supra note 28.
\textsuperscript{111} See supra note 23 and accompanying text.
\textsuperscript{112} See supra note 24 and accompanying text.
\textsuperscript{113} See supra notes 28-29 and accompanying text.
\textsuperscript{114} See supra note 24 and accompanying text.
\textsuperscript{115} See supra note 26 and accompanying text.
\textsuperscript{116} See supra note 28 and accompanying text.
\textsuperscript{117} See supra note 29 and accompanying text.
\textsuperscript{118} For the text of § 10(b) and rule 10b-5, see supra notes 3 and 5 respectively.
\textsuperscript{119} See supra note 29 and accompanying text.
\textsuperscript{120} For the text of § 10(b), see supra note 3.
\textsuperscript{121} See supra note 34 and accompanying text.
\textsuperscript{122} See supra note 33 and accompanying text.
\textsuperscript{123} See supra note 35 and accompanying text.
\textsuperscript{124} See supra note 34 and accompanying text.
\textsuperscript{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, but not in the version passed by the Senate. A House-Senate conference resolved the matter, with the House view prevailing. 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. 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. 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.

127. See id., item 27 at 40.
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.
134. Id. at 5.
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).

http://openscholarship.wustl.edu/law_lawreview/vol70/iss1/2
primarily by sophisticated investors.\textsuperscript{138}

The second basis involved a constitutional doctrine that enjoyed its heyday in the early 1930s: state and local government immunity from federal taxation.\textsuperscript{139} The Supreme Court had inferred a constitutional mandate to provide state and local governments with insulation from federal intrusion.\textsuperscript{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.\textsuperscript{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.\textsuperscript{142} For instance, a state judge's salary was held immune from federal taxation,\textsuperscript{143} as were the proceeds private individuals received

\textsuperscript{138} Contemporaneous congressional statements of this point can be found in the legislative history of the municipal bankruptcy statute. \textit{See} House Municipal Bankruptcy Hearing, \textit{supra} note 136, at 25 (statement of Rep. Wilcox); 77 CONG. REC. 5471 (1933) (statement of Rep. Foss). \textit{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. \textit{See generally} III \textsc{Loss} \& \textsc{Seligman}, \textit{supra} note 6, at 1162-73.


\textsuperscript{140} \textit{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. \textit{See id.} \textit{See also Massachusetts}, 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." \textit{Indian Motorcycle Co.}, 283 U.S. at 577. \textit{Cf.} \textit{Ambrosini v. United States}, 187 U.S. 1, 7-8 (1902).

\textsuperscript{141} H.R. REP. NO. 85, 73d Cong., 1st Sess., \textit{reprinted in} 2 \textsc{Legislative History A}, \textit{supra} note 22, item 18 at 14.

\textsuperscript{142} \textit{See Indian Motorcycle Co.}, 283 U.S. at 580 (Stone, J., dissenting).

\textsuperscript{143} \textit{Day}, 78 U.S. (11 Wall.) at 124.
from selling a motorcycle to a city for official use and from selling minerals produced from state-owned land to a third party. 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."

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.

2. The 1934 Act

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


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.\textsuperscript{156} Congress feared that without federal intervention these governments soon would be unable to provide even basic fire and police protection.\textsuperscript{157} Thus, two weeks before enacting the 1934 Act,\textsuperscript{158} it passed a municipal bankruptcy statute that allowed a local government\textsuperscript{159} that is "insolvent or unable to meet its debts"\textsuperscript{160} to obtain federal bankruptcy court approval to readjust its debts to creditors,\textsuperscript{161} including holders of government securities,\textsuperscript{162} consistent with its ability to pay.\textsuperscript{163} While the statute required that a majority of the creditors approve the readjustment,\textsuperscript{164} it did not require the local government to disclose information to creditors that would assist them in deciding

\begin{footnotesize}
\begin{enumerate}
\item[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.
\item[158.] Congress enacted the 1934 Act on June 6, 1934. See 1934 Act, ch. 404, 48 Stat. 881.
\item[159.] Congress enacted the municipal bankruptcy statute on May 24, 1934. See municipal bankruptcy statute, ch. 345, 48 Stat. 798.
\item[160.] 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.
\item[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.
\item[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.
\item[163.] The municipal bankruptcy statute provided:
\begin{quote}
[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.
\end{quote}
\textit{Id.}
\item[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 \textit{id.} Moreover, acceptance was not required for any creditor or class of creditors neither affected nor compensated in full by the plan. See \textit{id.}
\end{enumerate}
\end{footnotesize}
whether to approve. In addition, a plan that the court and a majority of creditors approved bound every creditor, whether approving or disapproving. No doubt for these reasons, the statute was described as "a loophole in the legal background of municipal securities."

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.

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."

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-

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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.


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").
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. 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.

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. 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.

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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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{177} Moreover, the municipal bankruptcy statute itself threatened local sovereignty to the extent it accorded the federal bankruptcy courts authority over local governments.\textsuperscript{178} Congress recognized that the municipal bankruptcy statute was vulnerable on this basis,\textsuperscript{179} a suspicion that two years later proved prescient.\textsuperscript{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.\textsuperscript{181} Congress may have sought to compensate for the im-

\textsuperscript{175} See generally S. REP. No. 407, 73d Cong., 2d Sess. 1-2 (1934).
\textsuperscript{176} See supra note 173 and accompanying text.
\textsuperscript{177} See supra notes 139-41, 149 and accompanying text.
\textsuperscript{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).
\textsuperscript{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).
\textsuperscript{180} See supra note 178.
\textsuperscript{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
impact 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. Moreover, after its extensive consideration of the definition of "person" in 1933, 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.


In 1975, in the course of the "most substantial and significant revision of this country's Federal securities laws since . . . 1934," 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. Moreover, after its extensive consideration of the definition of "person" in 1933, 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.

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.

gress revisited the issue of the regulation of state and local government securities. Testimony in congressional hearings reported abuses by brokers and dealers in these securities, who were largely unregulated by the 1934 Act. The 1975 amendments required these professionals not only to register with the SEC but also to abide by rules promulgated by the newly created Municipal Securities Rulemaking Board. While leaving untouched the registration exemptions for state and local government securities, 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." This revision attracted attention. Although supported by the Senate, it was not incorporated in the bill that originally passed the House. A conference committee resolved the conflict by choosing the Senate version, which both houses then adopted.

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." 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)).


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.


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.


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.\textsuperscript{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,\textsuperscript{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 \textit{not now permitted} under the fraud provisions of the federal securities laws." \textsuperscript{198} This pronouncement appeared in a section entitled "\textsc{Regulation of Municipal Securities Professionals—Not Issuers.}"\textsuperscript{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. . . ." \textsuperscript{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)\textsuperscript{201} and 15B(d).\textsuperscript{202} Section 3(d) was designed to prevent regulation of a state or local government that traded in its own securities.\textsuperscript{203} Section 15B(d) was intended to insure

\begin{itemize}
\item \textsuperscript{196} See supra notes 39-41 and accompanying text.
\item \textsuperscript{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.
\item \textsuperscript{198} 1975 Senate Report, supra note 186, reprinted in \textit{3 Legislative History B}, supra note 22, item 158 at 2719 (emphasis added).
\item \textsuperscript{199} Id. at 2718.
\item \textsuperscript{200} Id.
\item \textsuperscript{201} Section 3(d), 15 U.S.C. § 78c(d) (1988) [hereinafter § 3(d)].
\item \textsuperscript{202} Section 15B(d), 15 U.S.C. § 78o-4(d) (1988) [hereinafter § 15B(d)].
\item \textsuperscript{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.\textsuperscript{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."\textsuperscript{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.\textsuperscript{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.\textsuperscript{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

\begin{itemize}
\item 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).
\item 204. Section 15(B)(d) provides:
\begin{enumerate}
\item 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.
\item 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. . . .
\end{enumerate}
\item 205. 121 CONG. REC. 10,736 (1975), reprinted in 3 LEGISLATIVE HISTORY B, supra note 22, item 159 at 2953.
\item 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.
\item 207. See supra notes 47-85 and accompanying text.
\end{itemize}
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*, 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. The *Monroe* Court also held, however, that local governments were not "persons" subject to liability under section 1983. 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. 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. From this the Court inferred an intent to reject local government liability in all circumstances, notwithstanding a definition of "person" in the contemporary Dictionary Act that militated in favor of liability. *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.

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

214. Id. at 191.
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. 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, thereby supplying the conspiracy with its necessary second partici-
 Likewise, as a "person" a government could be cited as the uncharged principal perpetrator of the violation that the professional aided and abetted. In this way, the government would supply the aiding and abetting charge with the necessary primary violation. Congress would have regarded the foregoing strategy 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. First, in most of the cases, the professionals were charged either with conspiracy to violate rule 10b-5 or with aiding and abetting the rule 10b-5 violations of others. Second, in most of them, local governments or local government officials

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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).


were either named as defendants\(^{227}\) 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.\(^{231}\)

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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 governement 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. 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. 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.

Courts have long struggled to reconcile these competing considerations. In Gebardi v. United States, the Supreme Court tilted in favor of safeguarding the excluded person’s statutory immunity from liability. Gebardi involved the conviction under the Mann Act 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. 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.” 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. The Court reversed not only her conviction

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).
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).


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 con-
federate—though uncharged—was himself excluded from the underlying
substantive offense for reasons of statutory policy. Hence under the
1934 Act as originally enacted, a local government, excluded from sec-
tion 10(b) for reasons of policy, was an inappropriate uncharged con-
spirator 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 un-
charged confederate would have improved immeasurably if Congress re-
classified 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 securi-
ties 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, 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 con-
spirators 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 securi-
ties cases. It does not follow, however, that in 1975 Congress in-
tended 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 be-
because they 'constitute interrelated components of the federal regulatory scheme governing transac-
tions in securities.'" Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477, 484-85

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.