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STATE SOVEREIGNTY'S IMPACT ON FEDERAL REGULATION OF MUNICIPAL SECURITIES

INTRODUCTION

In the fall of 1975, New York City announced that unless it received federal aid, it would be bankrupt. Thousands of middle class investors, many of whom were retirees who had placed their savings in municipal securities because of their supposed safety, were threatened with financial disaster. In the wake of this crisis, two bills[1] were proposed which would bring state and municipal bond issuers, long exempted from most provisions of the Securities Act of 1933[2] and the Securities Exchange Act of 1934,[3] under federal control. This Note will discuss the constitutionality of those proposals, as well as the constitutionality of the present securities laws that are applicable to the states. Part I of this Note examines and comments upon the present and proposed regulations. Part II is an analysis of *National League of Cities v. Usery*,[4] which recently narrowed the power of Congress to regulate the states under the commerce clause. In Part III, the principles which are extracted from the discussion of *National League of Cities* will be applied to the present and proposed regulations in order to test their constitutionality.

1. *See Municipal Securities Full Disclosure Act of 1976: Hearings on S. 2969 and S. 2574 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. 3-13 (1976) [hereinafter cited as *1976 Securities Hearings*]. S. 2969 sought to amend the Securities Exchange Act of 1934 to require the preparation of annual reports and distribution statements by issuers of municipal securities. *Id.* at 5. S. 2574 proposed to amend the Securities Act of 1933 to provide for the registration of securities issued by state and local governments. *Id.* at 3.
2. *See* section 3(a)(2), 15 U.S.C. § 77c(a)(2) (1970).
3. *See* section 3(a)(12), 15 U.S.C. § 78c(a)(12) (1970).
4. 426 U.S. 833 (1976).

I. BACKGROUND

A. Current Federal Securities Laws

The Securities Act of 1933[5] and the Securities Exchange Act of 1934[6] are the foundations of federal regulation of the securities industry. Under the 1933 Act, a corporation seeking to issue securities must make complete and accurate disclosure of various facts in not only a registration statement[7] which is filed with the Securities and Exchange Commission (SEC), but also in a prospectus,[8] an exhibit to the registration statement, which must be furnished to securities purchasers before a sale of a security is completed.[9] The information which must be set forth in these two documents includes: (1) the identity of the issuer's directors, underwriters and major shareholders; (2) the remuneration paid the directors and the commissions paid the underwriters for services performed in respect of the sale; (3) a detailed description of the issuer's business; (4) the proposed use of the funds to be acquired from the issue; and (5) certified financial statements for the previous five years.[10] The SEC may review the registration statement to ensure complete disclosure of the required information before which the securities being registered cannot be sold.[11]

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5. 15 U.S.C. §§ 77a-77aa (1970) [hereinafter cited as the 1933 Act or the Securities Act].

6. *Id.* §§ 78a-78hh-1 [hereinafter cited as the 1934 Act or the Securities Exchange Act].

7. Section 5(a) of the Securities Act states that unless a registration statement is in effect as to a security, it shall be unlawful for any person to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security. *Id.* § 77e(a).

8. Under section 2(10) of the Securities Act, the term "prospectus" means any notice, circular, advertisement, letter or communication which offers any security for sale. *Id.* § 77b(10).

9. Section 5(b) mandates that a prospectus meeting the requirements of section 10 of the Securities Act, 15 U.S.C. § 77j (1970), accompany or precede delivery of a security. *Id.* § 77e(b).

10. *See id.* § 77aa; Securities Act Form S-1, *reprinted in* [1977] 2 Fed. Sec. L. Rep. (CCH) ¶ 7121, at 6201.

11. Section 5(c) of the Securities Act makes it unlawful for

> any person to make use of any means or instruments of interstate commerce or the mails to offer to sell or buy any security unless a registration statement has been filed with the Securities and Exchange Commission, and until the effective date of such registration statement.

15 U.S.C. § 77e(c) (1970). Section 8(a) states that

> the effective date of a registration statement shall be the twentieth day after the filing thereof or such earlier date as the SEC may determine, having due regard to the adequacy

The SEC also has the authority, under sections 7 and 10 of the 1933 Act, to require, by rules or regulations, additional disclosure in the registration statement and prospectus of any other information necessary or appropriate for the protection of investors.[12] Section 17(a)[13] of this Act, one of the antifraud provisions,[14] prohibits any person[15] from using the mail or means or instruments of interstate commerce to employ any manipulative or deceptive device, make an untrue statement of a material fact or omit to disclose a material fact necessary in order to assure that statements made, in the light of the circumstances under which they were made, are not misleading[16] to potential purchasers of securities.[17]

The 1934 Act requires certain companies to register and file periodic reports with the SEC which contain extensive financial and other current information concerning their businesses.[18] The Act also contains an antifraud provision which makes it unlawful for any person, through use of "jurisdictional means,"[19] to employ any manipulative or deceptive device, to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made not misleading in connection with the purchase or sale of a security.[20]

> of the information respecting the issuer disclosed in the registration statement.

Id. § 77h(a). However, section 8(b) gives the SEC power to refuse to permit the registration statement to become effective (and, in effect, to prevent the sale of an issue of securities) if it appears that the registration statement is incomplete or inaccurate. *Id.* § 77h(b). The means by which this is accomplished is through the issuance of a "stop order." *See* Note, *Federal Regulation of Municipal Securities*, 60 MINN. L. REV. 567, 568-69 (1976).

12. 15 U.S.C. §§ 77g, 77j(c) (1970).

13. *Id.* § 77q(a).

14. The Securities Act contains another antifraud provision in section 12(2) which is not applicable to any person who offers or sells a security issued by a state or any political subdivision thereof. *Id.* § 77*l*(2). Hence, that provision is not pertinent to this Note.

15. "Person," as defined in Securities Act section 2(2), is broad enough to include not only an individual, but also a corporation, a partnership, a trust, any unincorporated organization, or a government or political subdivision thereof. *Id.* § 77b(2).

16. *Id.* § 77q(a)(2).

17. *See id.* § 77q(a)(1)-(3).

18. Doty, *Application of the Antifraud Provisions of the Federal Securities Laws to Exempt Offerings: Duties of Underwriters and Counsel*, 16 B.C. IND. & COM. L. REV. 393, 405-06 (1975).

19. The term "jurisdictional means" refers to any means or instruments of transportation or communication in interstate commerce or of the mails. The term is used in R. JENNINGS & H. MARSH, SECURITIES REGULATION 1049, 1060 (3d ed. 1972) [hereinafter cited as JENNINGS & MARSH].

20. Rule 10b-5, *Employment of Manipulative and Deceptive Devices*, 17 C.F.R. 240.10b-5

From the investor's standpoint, the most important of the multitude of forms submitted to the SEC is the prospectus. The requirement that companies file this document with the SEC before the distribution of their securities to the public is based upon the belief that a potential investor, armed with the information contained in it, will be able to guage the investment risk of a particular security.[21] The function of the prospectus is not to protect the investor through insulation from risk;[22] instead, it is designed to make available to the investor that information which is required to make an informed investment decision. Assuming that the prospectus does in fact accomplish this function,[23] the investor in municipal securities[24] is denied this protection since

(1977), promulgated under section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b) (1970).

21. JENNINGS & MARSH, *supra* note 19, at 142, 233. When referring to the 1933 Act in a message to Congress on March 29, 1933, President Franklin D. Roosevelt stated:

> Of course, the Federal Government . . . should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound . . . [but] [t]here is . . . an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full . . . information, and that no . . . important element attending the issue shall be concealed from the buying public.

Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

22. JENNINGS & MARSH, *supra* note 19, at 142.

23. There is some doubt as to whether the prospectus does in fact contain such information. *See* Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U.L. REV. 1151 (1970); Sowards, *The Wheat Report and Reform of Federal Securities Regulation*, 23 VAND. L. REV. 495 (1970).

24. The term "municipal securities" means

> securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a state or any political subdivision thereof, or any agency or instrumentality of a state or any political subdivision thereof, or a security which is an industrial development bond the interest of which is excludable from gross income under section 103(a)(1) of the Internal Revenue Code.

15 U.S.C. § 78c(a)(29) (Supp. 1976). Schuda, *Municipal Bonds—The Need for Disclosure*, 78 W. Va. L. Rev. 391 (1976), describes various municipal revenue-raising devices as follows:

> There are many systems of classification of municipal debt . . . . Among these . . . perhaps the most important to the investor is the classification based upon the specific resource used to guarantee repayment. The most often used system is one developed by the Securities Industry Associaton. Under this system there are four types of bonds.
>
> "General obligation" bonds are secured by the issuer's full faith, credit and taxing power. It is the general promise to pay which is the guarantee given to the purchaser. General

issuers of municipal securities have been exempted from the registration and prospectus requirements of the 1933 Act, as well as from the reporting requirements of the 1934 Act.[25]

B. Legislative History of the Exemptions

It was originally intended that municipal securities would be subject to the registration and prospectus requirements of the 1933 Act, but they were exempted for "obvious political reasons."[26] Among the reasons frequently given for the exemption were: (1) a desire for governmental comity;[27] (2) the absence of recurrent abuses in the municipal securities market in 1933;[28] and (3) the existence of "practical" investor protections present in these offerings, inasmuch as the purchasers of municipal securities were regarded as sophisticated and frequently were in-

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> obligation bonds generally require authorization of the taxpayers and may be further limited by a maximum legal tax rate which is set by some higher authority. In this case, the bonds are still general obligation bonds, but are termed "limited tax" bonds.
>
> A second class is the "special tax" bond which is repaid from the proceeds of a particular tax. A part of this class is the "special assessment" bond which is repayable from an assessment against those who benefit from the facilities built with the bond revenues. If special tax bonds are also secured by the full faith, credit and taxing power of the issuer, they are classified as general obligation bonds.
>
> "Revenue" bonds are secured by the proceeds derived from the facilities constructed with the bond issue. Like the previous class, if the full faith, credit and taxing power of the issuer are also pledged, the bonds are termed general obligation bonds.
>
> The fourth class is the "New Housing Authority" bond. They are issued by local public housing authorities and secured by the net rental revenues so, in one sense, they are similar to revenue bonds. However, they are also secured by the full faith of the United States since the Public Housing Authority must make contributions which, together with the local funds, will be sufficient to pay the principal and interest on the bonds.

Id. at 394-95.

25. Securities Act section 3(a)(2) states that the provisions of the Act shall not apply to any security issued or guaranteed by any state or by any political subdivision thereof, or by any public instrumentality of one or more states or territories. 15 U.S.C. § 77c(a)(2) (1970). Likewise, Securities Exchange Act section 3(a)(12) states that the term "exempted security" includes municipal securities. *Id.* § 78c(a)(12).

26. Landis, *supra* note 21, at 39.

27. *1976 Securities Hearings*, *supra* note 1, at 27.

28. *Id.*

stitutions or individuals from the same locality as the issuer.[29] Likewise, the 1934 Act did not exempt issuers of municipal securities from its reporting provisions[30] until, in the final draft of the bill, Congress granted an exemption. It feared, *inter alia*, that federal power to restrict the states' and cities' credit would also be the power to destroy them[31] and that the federal government would possess a dangerous prerogative over the financial affairs of the states if the exemption were not granted.[32]

During Senate hearings on the two Securities Acts, it was argued that the statutes' registration exemptions omitted a class of securities that should have been included.[33] It was also pointed out that "the mere fact that an issue is of municipal bonds [did] not carry with it any sanctity . . . ."[34] Some discussion noted that "many of the municipal securities were worthless" and that a "great many" municipalities had defaulted on their obligations.[35] These arguments were unsuccessful, and both the Securities Act and the Securities Exchange Act were passed with the registration exemptions intact.

C. Applicability and Shortcomings of the Antifraud Provisions

Although municipal securities issuers were exempted from the requirements of filing registration statements and annual reports with the SEC, the antifraud provisions contained in section 17(a)[36] of the Securities Act and in rule 10b-5[37] are applicable to

29. Doty, *supra* note 18, at 396.

30. Note, *Disclosure by Issuers of Municipal Securities: An Analysis of Recent Proposals and a Suggested Approach*, 29 Vand. L. Rev. 1017, 1021 (1976) [hereinafter cited as Note, *Analysis of Recent Proposals*].

31. Note, *Federal Regulation of Municipal Securities*, *supra* note 11, at 570. *See* 6 Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934, Item 22, at 7038 (J. Ellenberger & E. Mahar ed. 1973) (testimony of Archibald B. Roosevelt, President, Roosevelt & Weingold, Inc., Dealers in Municipal Securities, New York, New York) [hereinafter cited as Ellenberger & Mahar].

32. *See* 6 Ellenberger & Mahar, *supra* note 31, Item 22, at 7038, 7042-43 (testimony of George B. Gibbons, President, George B. Gibbons & Co., Inc., Municipal Bond Dealers, New York, New York).

33. 2 *id.*, Item 21, at 65 (testimony of A. H. Carter, President, New York Society of Certified Public Accountants).

34. 6 *id.*, Item 22, at 7042 (testimony of Ferdinand Pecora, counsel to the Senate Committee on Banking and Currency).

35. 2 *id.*, Item 21, at 65 (exchange between Senator Reynolds and Mr. Carter, *see* note 33).

36. *See* notes 13-17 *supra* and accompanying text.

37. *See* note 20 *supra* and accompanying text.

them.[38] The effect of these provisions, which prohibit persons engaged in the distribution and sale of securities in interstate commerce from making any untrue statement of a material fact or omitting any material fact "necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading,"[39] is to subject municipal securities issuers to a limited disclosure obligation.[40] Despite such disclosure, there is a substantial gap in the protection afforded investors in municipal securities in comparison with that provided those who invest in corporate securities. First, the disclosures may not be adequate. A municipal issuer may tell a prospective buyer as much or as little as it chooses.[41] Therefore, the municipal securities investor is denied that protection which the federal securities laws were designed to give, that is, the means by which an investor may acquire sufficient information about the issuer before the purchase of a security.[42]

A second shortcoming of the present system of regulation is that it is only applicable retrospectively and thus does not prevent the purchase of a worthless security. Because a nonexempt issuer must file a registration statement with and undergo review of such statement by the SEC before public sale of its securities, it may be prevented from ever marketing its securities. In contrast, an exempt issuer is free to publicly distribute its securities without any SEC review.[43] It is only after the issuer defaults that a purchaser can attempt to recover damages in a suit based upon one or both of the antifraud provisions.[44] These shortcomings were two

38. Section 17(c) of the Securities Act states that the exemption for municipal securities contained in section 3(a)(2), 15 U.S.C. § 77c(a)(2) (1970), shall not apply to the provisions of section 17(a) and (b). 15 U.S.C. § 77q(c) (1970). *See* Doty, *supra* note 18, at 396-98. Section 10(b) of the Securities Exchange Act, by its terms, applies to any security, regardless of whether it is registered on a national securities exchange. 15 U.S.C. § 78j(b) (1970).

39. *See* Securities Act section 17(a)(2) and rule 10b-5(2) promulgated under Securities Exchange Act section 10(b), 15 U.S.C. § 77q(a)(2) (1970); *Employment of Manipulative and Deceptive Devices*, 17 C.F.R. § 240.10b-5 (1977).

40. Note, *Federal Regulation of Municipal Securities*, *supra* note 11, at 574-75.

41. *1976 Securities Hearings*, *supra* note 1, at 25.

42. *See* notes 21-22 and accompanying text.

43. *Cf.* note 11 supra and accompanying text.

44. Typically, a plaintiff will allege violations of both Securities Act section 17(a) and rule 10b-5. The United States Supreme Court has held that a private right of action is available for a violation of rule 10b-5. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971). A private right of action under section 17(a) of the Securities Act has also been upheld by most courts that have ruled on the question. *See* 3 Loss, SECURITY REGULATION 1784-89 (2d ed. 1961).

of the reasons which prompted Congress to reconsider the exemption from registration which municipal securities issuers had historically enjoyed.

D. REEXAMINATION OF THE REGISTRATION EXEMPTION

Senate hearings on legislation to upgrade the quality of information available to potential investors concerning issuers of municipal securities[45] opened with Senator Harrison Williams'[46] statement:

> A year ago there was little reason to reexamine the status of issuers of municipal bonds under the Federal securities laws . . . . The antifraud provisions alone seemed adequate to achieve the necessary disciplines in the offerings of municipal securities.
>
> . . . .
>
> The situation is far different today. The past year has seen turmoil and uncertainty in our municipal securities market.[47]

In fact, the market had been beset by problems long before the year to which Senator Williams referred due to changes in the nature of the investor in municipal securities and the breadth of the municipal securities market. Whereas municipal securities were at one time purchased by sophisticated individuals and institutions,[48] recent investors consist primarily of small unsophisticated individuals,[49] attracted by the tax-free status of the interest

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45. *See 1976 Securities Hearings, supra* note 1, at i.

46. Senator Harrison A. Williams, Jr., from New Jersey, was the Chairman of the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs during the hearings. *Id.* at ii.

47. *1976 Securities Hearings, supra* note 1, at 1.

48. Doty, *supra* note 18, at 396.

49. This was reported by SEC Commissioner John R. Evans at hearings before a House Finance Subcommittee. *See SEC Industry Support House Bill to Regulate Municipal Bond Dealers*, 299 SEC. REG. & L. REP. (BNA) A-6 (April 25, 1975) [hereinafter cited as BNA REPORT]. These "small unsophisticated individuals" have at times fallen prey to certain municipal securities firms that were able to take advantage of their lack of investment sophistication. *Id.* During the early 1970s, some municipal securities dealers who engaged in various fraudulent activities were successfully enjoined by the SEC. *See* SEC v. R.J. Allen & Assoc., 386 F. Supp. 866, 875-78 (S.D. Fla. 1974); SEC v. Charles A Morris & Assoc., Inc., 386 F. Supp. 1327, 1336 (W.D. Tenn. 1973); SEC v. Investors Assoc. of America, Inc., [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93, 644, at 92, 896 (W.D. Tenn. Oct. 26, 1972) (complaint summary). *See also* SEC v. Reclamation Dist. No. 2090, Civil No. 6-76-1231 (N.D. Cal., filed July 27, 1976) (injunctive action). Commissioner Evans remarked that these cases demonstrated that certain new investor

paid on municipal securities.[50] Dramatic changes have occurred in the market itself since the 1930s,[51] including the greatly increased volume of municipal securities issued annually[52] and the fact that municipal securities are now issued in much larger numbers than are corporate securities.[53]

Although important, these changes alone would probably not have led to an immediate reexamination of the registration exemptions granted municipal issuers. The most significant factor leading to the reexamination was the near-default of New York City and the consequent realization that municipal securities were not without risk.[54] "[I]t takes [a] near catastrophe to alert the public and the Congress, and the public through their Congress, to the need for action."[55]

E. The Proposed Reforms

Congress responded to "the near catastrophe" experienced by New York City with two bills,[56] each proposing to establish well defined alternative systems of accounting and standards for disclosure incident to the creation and servicing of the debt of state and local governments.[57] However, the means by which

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protections under the federal securities laws were necessary and appropriate for the protection of municipal securities investors. *See* BNA Report, *supra* at A-6.

50. Note, *Federal Regulation of Municipal Securities*, *supra* note 11, at 567.

51. Note, *Analysis of Recent Proposals*, *supra* note 30, at 1029.

52. In 1933, total expenditures for state and local governments were approximately $7 billion. *1976 Securities Hearings*, *supra* note 1, at 45. In 1976, it was estimated that such expenditures would exceed $200 billion, an increase of more than 2700% in 43 years. *Id.* at 45. There are currently between $25 and $30 billion in long-term municipal securities sold each year, and another $30 billion borrowed short-term. *Id.* at 30.

53. The state and municipal securities market is enormous when compared with the corporate market. In 1975, state and local governments had 8,107 public offerings totaling $58.3 billion. In the same year, corporations marketed 844 public offerings in an aggregate amount of $46.7 billion. *Id.* at 142.

54. Mr. Edwin H. Yeo, III, Undersecretary of the Treasury for Monetary Affairs, opined that perhaps a more significant change in the securities market since 1933 than that of growth was the revelation that municipal securities were not riskless. Investors learned in 1975, when New York City almost defaulted on payment of its outstanding obligations, that theoretical access to the ad valorum taxing power was not an absolute guarantee of timely repayment of municipal obligations. *Id.* at 39.

It took the near-default of New York City to convince the public and its representatives of the need for federal regulation of municipal issuers' accounting practices and disclosure policies. Mr. Yeo stated that the hearings on S. 2969 and S. 2574, *see* note 1 *supra*, would probably not have taken place absent the impressions that the New York City experience made on the American public. *Id.* at 37.

55. *Id.* at 37.

56. *See* note 1 *supra*.

57. *Id.* at 2.

disclosure of financial information to the investor was to be assured were significantly different.

The Eagleton Bill

On October 28, 1975, in the midst of "the throes of the New York City crisis,"[58] Senator Thomas F. Eagleton introduced S. 2574,[59] which would subject a municipal issuer to the same requirements as a corporate issuer. The Eagleton bill would eliminate the exemption from the registration process and reporting requirements which municipal securities issuers had enjoyed under the 1933 and 1934 Acts.[60] Under the bill's provisions, a municipal issuer would be required to file a registration statement with the SEC, which would be empowered to review the statement and to issue a stop order to prevent the proposed sale of municipal securities.[61] The bill would also require the delivery of a prospectus to purchasers and the filing of annual reports concerning the issuer's business and financial status. It would subject the municipal issuer to the full panoply of antifraud provisions contained in the 1933 Act, as well as the defenses thereto.[62]

The "Municipal Securities Full Disclosure Act"

On February 17, 1976, Senator Williams[63] introduced a more limited bill, the "Municipal Securities Full Disclosure Act of 1976."[64] The Williams-Tower bill would amend the Securities Ex-

58. *Id.* at 15.

59. Hereinafter, S. 2574 will also be referred to as the Eagleton Bill.

60. Representative Stephen J. Solarz (Dem., N.Y.) introduced two bills, H.R. 11044, 94th Cong., 1st Sess., 121 CONG. REC. 12020 (1975), and H.R. 11534, 94th. Cong., 2d Sess., 122 CONG. REC. 363 (1976), in the House of Representatives on December 8, 1975, and January 27, 1976, respectively, which also would have brought municipal issuers within the registration and regulatory provisions of the 1933 and 1934 Acts.

61. *See* note 11 *supra*.

62. Senator Eagleton did not attempt to deal with the various sections of the 1933 Act which were inapplicable to municipal issuers as written. For example, who are the directors of a city? *See* sections 6(a) and 11(a)(2), 15 U.S.C. §§ 77f(a), 77k(a)(2) (1970). Could a state official be held civilly liable to an investor because the registration statement contained a false statement? *See* section 11(a), *id.* § 77k(a). To what extent would sovereign immunity serve as a defense to such an action? Moreover, how would the fact that federal courts have exclusive jurisdiction over violations of the 1934 Act, *see* section 27, *id.* § 78aa, relate to the eleventh amendment? At the Senate hearings, Senator Eagleton explained that he "sought a simple, clearcut piece of legislation . . . leaving the detailed rulemaking authority to the SEC . . . ." *1976 Securities Hearings*, *supra* note 1, at 16.

63. Senator Williams' cosponsor was Senator John Tower from Texas. *1976 Securities Hearings*, *supra* note 1, at 5.

64. The bill will hereinafter be referred to as either S. 2969 or the Williams-Tower bill. It was reintroduced in early 1977 and its name changed accordingly.

change Act of 1934 by adding section 13A,[65] which provides for the disclosure of primarily financial information in annual reports and for the distribution of statements prepared by municipal securities issuers under certain circumstances.[66] Recognizing the differences between corporate and municipal issuers, the bill would not remove the 1933 Act's exemption of municipal issuers from the registration and prospectus requirements.[67]

The disclosure requirements of proposed section 13A are considerably more restricted in scope than the analogous requirements in the Securities Exchange Act. The annual report would have to be prepared only by an issuer of municipal securities that had outstanding securities in an amount exceeding fifty million dollars in aggregate principal[68] and would emphasize the disclosure of the issuer's financial status.[69] The requirements of a distribution statement would apply only to an issuer that offers or sells an issue of municipal securities, the aggregate principal amount of which exceeds five million dollars,[70] and would

65. For a description of the provisions of the new section see notes 68-75 *infra*.

66. *See* notes 68 and 70 *infra* for an understanding of the circumstances under which an annual report and/or distribution statement must be prepared by a municipal issuer.

67. *1976 Securities Hearings, supra* note 1, at 19.

68. New section 13A(a)(1) states in part:

> [A]ny issuer of municipal securities which has outstanding during any portion of a fiscal year an aggregate principal amount of municipal securities exceeding $50,000,000 shall prepare for such fiscal year an annual report and reports of events of default . . . .

Id. at 6.

69. New sections 13A(a)(2)(A)-(J) state that the annual report shall contain the following information: a description of the issuer; a description of any legal limitation on the incurrence of indebtedness by the issuer or the issuer's taxing authority; a description of the issuer's debt structure; a description of the nature and extent of other material contingent liabilities or commitments of the issuer; whether any payment of principal or interest on any security of the issuer has been defaulted on, postponed or delayed within the past twenty years; a description of the issuer's tax authority and structure over the past five years; a description of the issuer's major taxpayers; a description of the principal governmental and other services provided or performed by the issuer; a description of the nature and extent of federal or other assistance programs available to the issuer; and financial statements of the issuer for the five previous fiscal years, or for such lesser period as the SEC may prescribe by rule or regulation. *See id.* at 6-8.

In contrast, the annual reports filed by a corporate issuer contain information about its directors, major shareholders, bonus and profit-sharing arrangements, material contracts and other information concerning its business, as well as extensive financial information. *See* Securities Exchange Act sections 12-13, 15 U.S.C. §§ 78*l*-m (1970).

70. Section 13A(b)(1) states in pertinent part:

> Any issuer that offers or sells an issue of municipal securities, the aggregate principal amount of which exceeds $5,000,000 . . . shall, prior to such offer or sale, prepare a distribution statement . . . .

1976 Securities Hearings, supra note 1, at 9.

demand much less extensive information than is required in a prospectus.[71] Furthermore, the distribution statement requirement could be avoided if a state were to establish its own agency to monitor disclosure policies.[72] However, as with the prospectus requirement, it would be necessary for the municipal issuer to make the distribution statements available to municipal securities brokers and dealers for delivery to prospective purchasers of a municipal security.[73]

Two important features of the bill are that the information required by this legislation would not be filed with or automatically reviewed by the SEC[74] and that the annual reports would not be sent to existing securities holders. Instead, the SEC would have the authority either to establish a central repository for the maintenance of the reports and distribution statements or to require municipal securities issuers to maintain the reports and statements at a designated location for public inspection.[75]

S. 2969 contains two clauses that are similar to, but more limited than, sections 7 and 10 of the 1933 Act.[76] Whereas sections

71. Sections 13A(b)(2)(A)-(F) provide that the distribution statement shall contain the following: a description of the offering; a description of the security, including provisions as to security and events of default; a description of any project to be financed from the proceeds of the offering; a description of the intended use of the proceeds of the offering; a statement of counsel's opinion as to the legality of the issuance; and a statement of the availability of the annual reports. *See id.* at 9-10. Compare this with the information which must be disclosed in a prospectus of a corporate issuer as set out in the text accompanying notes 5-25 *supra*.

72. *See* section 13A(c)(1), which states that the distribution statement requirement contained in section 13A(b) shall not apply to an offer or sale of municipal securities, the disclosure with respect to which has been approved, after hearing, as adequate for the protection of investors by a state governmental authority. *1976 Securities Hearings*, *supra* note 1, at 6.

73. Section 13A(f)(2) states that

> [t]he issuer shall make the distribution statement . . . available to municipal securities brokers, municipal securities dealers, and banks acting as agent for delivery to prospective purchasers in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id. at 11-12.

74. *Id.* at 19-20.

75. New section 13A(f)(3) states that

> [t]he [annual] reports and distribution statements . . . shall . . . be maintained by the issuer at a designated location for examination by the public. The [SEC] may also contract to establish a central repository [to] receive and maintain such reports . . . .

Id. at 12.

76. 15 U.S.C. §§ 77g, 77j (1970).

7 and 10 grant broad authority to the SEC to require that the registration statement (and the prospectus) include "such other information . . . as the Commission may be rules or regulations require as being necessary . . . for the protection of investors,"[77] S. 2969 limits somewhat the discretion that the Commission may exercise in promulgating rules governing the type and extent of information which must be provided. New section 13A states that the annual reports and distribution statements shall contain "[s]uch other *similar and specific* information as the Commission may by rule or regulation prescribe as being necessary . . . for the protection of investors."[78] The SEC's authority would probably be confined to the development of rules of disclosure dealing with revenue, expenses and cash flow of a city.[79] Thus, the SEC would be much less likely to require disclosure of information concerning management than it is in private industry.[80]

F. Critique of the Proposed Bills

Both of the proposed bills share three consumer-oriented objectives:[81] (1) the availability to the investor of more accurate information, especially concerning the municipal issuer's financial condition, so the potential purchaser of municipal securities is able to make a truly informed investment decision;[82] (2) the institution of uniform municipal accounting standards and practices so as to facilitate investor comparison of the various municipal securities being issued;[83] and (3) the promotion of confidence in and demand for municipal securities.[84] Yet, there are differences between the two proposed bills in regard to the amount of protection which they would afford municipal securities investors.

By requiring issuers of municipal securities to go through the same registration process as do corporate issuers, the Eagleton bill offers a municipal securities investor the maximum protection

77. *Id.*

78. *See* new sections 13A(a)(4) and 13A(b)(2)(G), *1976 Securities Hearings, supra* note 1, at 8, 10 (emphasis added).

79. SEC Chairman Hills thought that the wording of the proposed amendment was ambiguous, but he believed the SEC's authority would be limited in this way. *Id.* at 25-26.

80. *Id.* at 26.

81. The bills have other objectives, such as the institution of uniform and nationwide municipal accounting standards and practices, which would in turn lead to improved credit ratings and borrowing at lesser interest rates. *Id.* at 2.

82. *Id.* at 43, 129.

83. *Id.* at 31.

84. *Id.* at 2.

afforded an investor under the federal securities laws. Although S. 2574 would not prevent future defaults (nor did the acts of 1933 and 1934 prevent corporate bankruptcies), theoretically, an investor would know the financial situation of a state or municipality before default became a remote possibility.[85] If the Eagleton bill were adopted, the municipal issuer would be forced to disclose accurate and complete financial and other data in the registration statement, and the investor would receive part of this information in a prospectus. It would no longer be the municipal issuer's prerogative to determine how much information to divulge to an investor.

The Williams-Tower bill would accomplish a more limited form of disclosure. Its requirements would only apply to a very restricted number of issuers.[86] It has been estimated that the requirement of filing an annual report would affect only six percent of the approximately 78,000 municipal issuers.[87]

It is more difficult to estimate the impact of the distribution statement requirement on municipal issuers since S. 2969 expressly exempts offers or sales approved by an authorized state agency.[88] Even absent that exemption, only a few issuers of municipal securities would be required to prepare a distribution statement prior to the offer or sale of its securities[89] and make it available for delivery to prospective purchasers.[90]

This distribution statement would include, *inter alia*, a description of the offering, the security, any project to be financed from the proceeds and the intended use of the proceeds of the offering.[91] Compared to the prospectus, which would be required to be distributed to investors under S. 2574, the distribution statement represents a much less extensive disclosure requirement.[92] Moreover, those municipal securities issuers to which the requirement would apply might still be able to avoid altogether the preparation of this distribution statement by obtaining approval of its disclosure from an authorized state governmental

85. *Id.* at 16.
86. *See* text accompanying notes 68 & 70 *supra*.
87. *1976 Securities Hearings, supra* note 1, at 14.
88. *See* note 72 *supra*.
89. *See* note 70 *supra*.
90. *See* note 73 *supra*.
91. *See* note 71 *supra*.
92. *See* text accompanying notes 21-25 *supra*.

agency.[93] That agency need not establish disclosure requirements equivalent to those proposed by S. 2969.[94] There is broad deference to the discretion of any state that assumes the obligation of deciding whether the disclosure is adequate to protect the interest of investors.[95] This exemption "relies very heavily upon the good faith which [the SEC] expect[s] on the part of States to determine that the purposes of the disclosure provision of the proposed legislation have been met."[96]

Regard for the Federalist System

The greatest criticism of the Eagleton bill is that it would intimately involve the federal government in the local revenue-raising affairs of the states and cities[97] in three ways. First, the SEC would be empowered to postpone or prevent a proposed issuance of municipal bonds by a stop order.[98] Second, the decision as to what constitutes sufficient disclosure would be made at the federal as opposed to the state or local level.[99] Third, by requiring municipal issuer compliance with the 1933 and 1934 Acts, S. 2574 would increase the burdens and costs of issuing municipal securities.[100] Although there is disagreement as to how much the increase in costs would be, it has been estimated that the costs of registration alone would be substantial.[101] On the other hand,

93. *See* note 69 *supra* and accompanying text.

94. *1976 Securities Hearings, supra* note 1, at 24.

95. *Id.*

96. *Id.* at 20. This broad deference to the states to establish their own disclosure standards will be, for some, the most troublesome part of the Williams-Tower bill. One witness at the hearings was particularly concerned that in the final analysis the level of disclosure would not improve and that "we would be right back where we started from." *Id.* at 204-05. However, the limited scope of and the circumscribed disclosure requirements of S. 2969 appears to be a compromise between making information available to investors and minimizing the cities' and states' financial burden of compliance. SEC Chairman Roderick A. Hills and Mr. Edwin H. Yeo, III, Undersecretary of the Treasury for Monetary Affairs, were the proponents of this position. *Id.* at 28, 41. *See* text accompanying note 107 *infra.*

97. *Id.* at 33; *see* Note, *Analysis of Recent Proposals, supra* note 30, at 1039.

98. *See* note 11 *supra.*

99. When confronted with the fact that municipal officials would contest his bill, Senator Eagleton acknowledged that the states were adamantly opposed to federal intervention in local financial affairs, perhaps because "no one wants somebody looking over their [*sic*] shoulder." *1976 Securities Hearings, supra* note 1, at 17. By subjecting municipal issuers to the registration and prospectus requirements of the 1933 Act, S. 2574 would produce just that result. The federal government would be "looking over the states' shoulders," prescribing what investors must be told and the manner in which such information must be disseminated.

100. *Id.* at 21, 33, 44.

101. *Id.* at 161.

any additional costs incurred as a result of the registration process and the greater disclosure requirements might be offset by lower interest costs resulting from greater investor confidence in the municipal securities market.[102] The cost of summarizing the information required to be included in the registration statement and prospectus should be nominal,[103] since most municipal issuers already compile most, if not all, of the data.[104] However, as was pointed out at the Senate hearings, any added cost of selling municipal bonds at a time when the fiscal problems of cities are at their peak would still be an unfortunate occurrence.[105]

Testimony at the Senate hearings reflected concern about the amount of federal intervention in the issuance of municipal securities which S. 2574 entailed, leading many witnesses to support the Williams-Tower bill instead.[106] To them, that proposal struck an appropriate balance between disclosure of sufficient information to protect investors and unwarranted federal regulation with its attendant administrative burdens and expenses. In other words, the

> gains [to be derived from subjecting municipal issuers to the registration requirements] must be weighed against the costs, which are both political and economic. By political costs is meant any further dilution of the sovereign areas of State . . . and local governments . . . . By economic costs is meant cost of compliance . . . .[107]

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102. *Id.* at 44.

103. *Id.* at 205.

104. *Id.* at 110, 167, 171.

105. *Id.* at 156.

106. S. 2574 was supported in whole or in part by the following witnesses: SEC Chairman Hills; Mr. Yeo; Harvey Kapnick, chairman and chief executive, Arthur Andersen & Co.; Richard Kezer, president, Dealer Bank Assoc.; Wallace O. Sellers, Merrill, Lynch, Pierce, Fenner & Smith, Inc., chairman, Public Finance Council; Gilman Gunn,, III, senior municipal bond analyst for the Chubb Corp.; and Richard B. Smith, Davis, Polk & Wardwell, New York City. However, some of the witnesses thought even S. 2969 entailed too much federal intervention: Brenton W. Harries, president, Standard & Poor's Corp.; Jackson Phillips, executive vice president, Moody's Investor Services, Inc.; Richard Carver, Mayor, Peoria, Ill., on behalf of the National League of Cities and the U.S. Conference of Mayors; Jim Flaherty, chairman, Allegheny County Board of Commissioners for the National Association of Counties; S. Grady Fullerton, Harris County Auditor, Harris County, Tex., member of the executive board and former president, Municipal Finance Officers Association; and Donald Robinson, Hawkins, Delafield & Wood, New York City. *1976 Securities Hearings, supra* note 1, *passim*.

107. *Id.* at 115.

Underlying the testimony of most of the witnesses was a recognition of the fact that the Eagleton bill raised the constitutional issue of state sovereignty. They realized that the Williams-Tower proposal attempted to avoid the issue by giving states the option of formulating their own disclosure policies.[108] After the close of the Senate hearings on S. 2574 and S. 2969,[109] the question of the constitutionality of federal regulation of certain state activities reached the United States Supreme Court.

II. CONGRESSIONAL POWER TO REGULATE STATE ACTIVITIES

In *National League of Cities v. Usery*,[110] the Court found that federal regulation of the wages and hours of certain state employees was unconstitutional on the ground that the state sovereignty doctrine found in the tenth amendment is an affirmative limitation on Congress' power under the commerce clause.[111] One consequence of *National League of Cities* is that Congress may now have to contend with the issue of the states' power to formulate their own disclosure policies with respect to an issuance of municipal securities and, more broadly, their power to structure their own revenue-raising affairs.[112] Thus, a careful analysis of *National League of Cities* is necessary in order to evaluate any federal provisions governing the issuance of municipal securities.

At issue in *Usery* were provisions of the Fair Labor Standards Act (FLSA)[113] which, *inter alia*, increased minimum wages and maximum hours for employees, including those employed by a "public agency."[114] When Congress originally enacted the FLSA,

108. *Id.* Note also that Chairman Hills emphasized several times in his testimony that S. 2969 did not expand the ultimate responsibility of state and local government. See *id.* at 18-23. Mr. Yeo stated that there was a "fundamental difference" between S. 2574 and S. 2969. *Id.* at 33. The Eagleton bill would be regulatory, while the Williams-Tower bill was not expected to entail such federal involvement in local revenue-raising affairs. *Id.* Mr. Kapnick was sufficiently concerned about the question of state sovereignty to obtain opinions from two law firms to the effect that the federal government had the power under the commerce clause to subject municipal issuers to the registration and reporting requirements of the 1933 and 1934 Acts. *Id.* at 45.

109. The hearings were conducted on February 24, 25 and 26, 1976.

110. 426 U.S. 833 (1976).

111. *Id.* at 852.

112. *See* notes 172-79 *infra* and accompanying text.

113. 29 U.S.C. §§ 201-219 (1970), *as amended by* Fair Labor Standards Amendments of 1974, Pub. L. No. 93-259, § 6, 88 Stat. 58.

114. Fair Labor Standards Act section 3(d), 29 U.S.C. § 203(d) (1970), was amended in pertinent part to read: " 'Employer' includes any person acting directly or indirectly in the interest of an employer in relation to an employee and *includes a public agency*

it exempted from its coverage employees of individual states and their political subdivisions.[115] In 1966, Congress withdrew the states' exemption from the operation of the FLSA with respect to employees of state hospitals, institutions and schools.[116] Such congressional action was sustained in *Maryland v. Wirtz*.[117] In 1974, Congress again amended the FLSA[118] to include employees

. . . ." 29 U.S.C. § 203(d) (Supp. IV 1974) (invalidated by National League of Cities v. Usery, 426 U.S. 833 (1976) (emphasis added)). Section 3(e)(2), 29 U.S.C. § 203(e)(2) (1970), was amended in relevant part to read:

> In the case of an individual employed by a public agency, such term means—
>
> (c) any individual employed by a State, political subdivision of a State, or an interstate governmental agency, other than such an individual—
>
> (i) who is not subject to the civil service laws of the State, political subdivision, or agency which employs him; and
>
> (ii) who—
>
> (I) holds a public elective office of that State, political subdivision, or agency,
>
> (II) is selected by the holder of such office to be a member of his personal staff,
>
> (III) is appointed by such officeholder to serve on a policymaking level, or
>
> (IV) who is an immediate advisor to such officeholder, with respect to the constitutional or legal powers of his office.

29 U.S.C. § 203(e)(2) (Supp. IV 1974) (invalidated by *National League of Cities*).

115. As originally enacted, section 3(d) of the FLSA stated in relevant part: "Employer . . . shall not include . . . any State or political subdivision of a State . . . ." Fair Labor Standards Act of 1938, ch. 676, § 3(d), 52 Stat. 1060 (current version at 29 U.S.C. § 203(d) (1964)).

116. Fair Labor Standards Amendments of 1966, Pub. L. No. 89-601, § 102(a)-(b), 80 Stat. 830 (amending 29 U.S.C. §§ 203(d), 203(r) (1964) (invalidated by National League of Cities v. Usery, 426 U.S. 833 (1976)).

117. 392 U.S. 183 (1968), *overruled*, National League of Cities v. Usery, 426 U.S. 833 (1976). Congressional control of the states under the commerce power reached its peak in *Wirtz*. In *Wirtz*, the states protested the application of the Fair Labor Standards Act, 29 U.S.C. § 201-219 (1964), *as amended by* Fair Labor Standards Amendments of 1966, Pub. L. No. 89-601, tit. 1, §§ 101-103, 80 Stat. 830 (invalidated by *National League of Cities*), to state-operated schools and hospitals. They argued that extension of the enterprise concept—which established coverage of the FLSA so long as an employee is employed in a business where at least one employee is directly engaged in interstate commerce or the production of goods for interstate commerce, 29 U.S.C. § 203(s) (1970)—to include state-operated facilities was an unconstitutional interference with sovereign state activities. 392 U.S. at 187. Relying on United States v. California, 297 U.S. 175 (1936), the *Wirtz* Court rejected any argument that the states should be treated differently from individuals with respect to the commerce power. 392 U.S. at 196-97. *See* note 124 *infra*. The *Wirtz* test for determining the extent of congressional power under the commerce clause was simple: as long as a federal enactment was a regulation of commerce with a rational basis, it was constitutionally valid. 392 U.S. at 194-95.

118. Fair Labor Standards Amendments of 1974, Pub. L. No. 93-259, § 6, 88 Stat. 58 (amending 29 U.S.C. § 203 (1970) (invalidated by *National League of Cities v. Usery*).

of any public agency, thereby almost completely abolishing the states' exemption from the minimum wage and maximum hour requirements.[119] Various cities and states challenged the 1974 amendments in *National League of Cities v. Brennan*.[120] A three-judge district court, relying on *Maryland v. Wirtz*, upheld the constitutionality of the 1974 amendments as a valid exercise of congressional power under the commerce clause but expressed concern about the "far-reaching implications of *Wirtz*."[121] On appeal, the Supreme Court reversed the district court's decision, expressly overruled *Wirtz* and established state sovereignty as an affirmative constitutional limitation on the commerce power.[122]

A. The Court's and the Concurring Opinions.

Justice Rehnquist, writing for the Court, stated the general principle that "the States as States stand on a quite different footing than an individual or a corporation when challenging the exercise of Congress' power to regulate commerce."[123] The

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119. Executive, administrative or professional personnel and individuals holding public office or serving such an officeholder remained exempt from FLSA coverage. *See* note 114 *supra*.

120. 406 F. Supp. 826 (D.D.C. 1974), *prob. juris. noted sub nom.* National League of Cities v. Usery, 420 U.S. 206 (1975), *rev'd*, 426 U.S. 833 (1976).

121. 406 F. Supp. at 838.

122. 426 U.S. 833, 852, 855, 856 (1976).

123. *Id.* at 854. This is consistent with the theory asserted in the dissenting opinions by Justice Douglas in New York v. United States, 326 U.S. 571 (1945), and in Maryland v. Wirtz, 392 U.S. 183 (1969), *overruled*, National League of Cities v. Usery, 426 U.S. 833 (1976), and by Justice Rehnquist's dissent in Fry v. United States, 421 U.S. 542 (1975), that the state sovereignty doctrine found present in the tenth amendment places an affirmative limitation on an otherwise valid exercise of Congress' power.

The theory first appeared in Justice Douglas' dissent in New York v. United States, 326 U.S. 572 (1945). For Douglas, the tenth amendment, in reserving certain powers to the states, guaranteed the states a certain independence and placed them on a different plane from private citizens. *Id.* at 593-96. Douglas asserted the same principles in his dissent in Maryland v. Wirtz, 392 U.S. 183 (1968), *overruled*, National League of Cities v. Usery, 426 U.S. 833 (1976). The 1966 amendments to the Fair Labor Standards Act were a "serious invasion of states' sovereignty protected by the Tenth Amendment . . . [and] not consistent with our constitutional federalism." 392 U.S. at 201. The very existence of the states was threatened by the Court's affirmance of the enterprise concept as applied to state-operated facilities. Since a state itself was an enterprise affecting interstate commerce, it would be completely subject to congressional control under the commerce power unless the "constitutional principles of federalism" raised some limit. *Id.* Regarding the essential governmental functions test, Douglas called upon the Court to "draw the 'constitutional line between the State as government and State as trader . . . ,' " *id.* at 205, and advocated that in doing so, the Court be guided by the principles set forth in the taxing power cases, particularly Justice Stone's concurring opinion in New York v. United States, 326 U.S. 571, 586-90 (1946)

Court's former reasoning that the states were on an equal footing with private individuals in relation to the commerce power was

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(limitation on federal taxing power based on the notion of state sovereignty). For further discussion of *New York v. United States* see note 149 *infra*. *But see* note 148 *infra*.

In Fry v. United States, 421 U.S. 542 (1975), Justice Rehnquist adopted Justice Douglas' affirmative constitutional right theory. In a dissenting opinion directed as much to *Wirtz* as to *Fry*, Rehnquist asserted the same principles that are found in his opinion in *National League of Cities v. Usery*. First, the Court in United States v. California, 297 U.S. 175 (1936), was wrong when it stated that the states are on an equal footing with individuals vis-à-vis the commerce power. 421 U.S. at 552. Second, there is no distinction between the commerce and the taxing power; therefore, if the states were immune from Congress' power to tax, they should also be immune from Congress' power to regulate them pursuant to the commerce clause. *See id.* at 553-54. Third, the operation of schools, hospitals and similar facilities involved in *Wirtz* is an activity sufficiently allied with traditional state functions so that wages of state employees of such facilities should be beyond the scope of the commerce power. *Id.* at 588. Relying on these principles, Rehnquist stated that he would hold that the wage controls imposed on state employees by the Economic Stabilization Act of 1970, 12 U.S.C. § 1904 (Supp. I 1971) (expired 1975), were beyond Congress' power under the commerce clause. *Id.* In a footnote, he suggested that the proprietary governmental distinction might prove a useful tool in drawing the line on Congress' power under the commerce clause. *Id.* at 558 n.2. He also recognized, as he did later in *National League of Cities*, that the permissible scope of congressional regulation under the war power or that under section 5 of the fourteenth amendment may be greater than that under the commerce power, so that Congress could infringe state sovereignty when acting under those powers in a manner that would not be permitted when it was acting pursuant to the commerce power. *Id.* at 558-59. *See* note 131 *infra*.

The Douglas-Rehnquist view of federalism and the tenth amendment represents one of two positions espoused since the Constitution was written; it has historically been labeled Madisonian or Jeffersonian. This view maintains that there are two conditions which must be satisfied in order to sustain the constitutionality of a congressional act. First, the legislation must be enacted pursuant to a delegated power. Second, the exercise of that power must not encroach on any of the powers reserved to the states. Perhaps the greatest exaltation of the Madisonian view appeared in Hammer v. Dagenhart, 274 U.S. 251 (1918), *overruled*, United States v. Darby, 312 U.S. 116 (1940), wherein the Court expressed the following:

> In interpreting the Constitution it must never be forgotten that the Nation is made up of States to which are entrusted the powers of local government. And to them and to the people the powers not expressly delegated to the National Government are reserved. The power of the States to regulate their purely internal affairs by such laws as seem wise to the local authority is inherent and has never been surrendered to the general government. To sustain this (child labor protection) statute would not be in our judgment a recognition of the lawful exertion of congressional authority over interstate commerce, but would sanction an invasion by the federal power of the control of a matter purely local in its character . . . .

274 U.S. at 275-76 (per Day, J.) (regulation held not within scope of commerce power) (citations omitted).

The other position, traditionally denominated as Hamiltonian, conceives of the constitutional validity of federal legislation as turning on whether the congressional ac-

simply wrong.[124] Rehnquist did not dispute that the challenged FLSA amendments came within the scope of the commerce power but declared that there was an "express"[125] limitation on that power found in the tenth amendment which imposed defi-

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tion was taken pursuant to some delegated authority, regardless of the effects that action may have on powers reserved to the states. *See* notes 143-45 *infra* and accompanying text. Both views have prevailed at various times during the nation's history. From the ratification of the Constitution until the 1830s, the Court subscribed to the Hamiltonian view. From the mid-1830s to 1936, the Court adhered to the Madisonian view. Since 1936, at least until *National League of Cities* was decided, the Hamiltonian view once again predominated over the Madisonian view in the resolution of federalism issues before the Court. For a discussion of the various views of the tenth amendment see E. CORWIN, THE TWILIGHT OF THE SUPREME COURT 1-51 (1934); C. HAINES, THE ROLE OF THE SUPREME COURT IN AMERICAN GOVERNMENT AND POLITICS: 1789-1835, *passim* (1944); C. HAINES & F. SHERWOOD, THE ROLE OF THE SUPREME COURT IN AMERICAN GOVERNMENT AND POLITICS: 1835-1864, at 1-26, 193-244 (1957); Castro, *The Doctrinal Development of the Tenth Amendment*, 51 W. VA. L.Q. 227 (1949); Cowen, *What is Left of the Tenth Amendment*, 39 N.C.L. REV. 154 (1961). For a general discussion of state sovereignty in preconstitutional American history see Murphy, *State Sovereignty Prior to the Constitution*, 29 MISS. L. J. 115 (1958).

124. 426 U.S. at 854-55. Thus, the reasoning, but not the result, in United States v. California, 297 U.S. 175 (1936), is overruled. In *California*, the state of California sought to be exempted from the federal Safety Appliance Act, section 2, 45 U.S.C. § 2 (1893), and section 6, ch. 87, 29 Stat. 85 (1896) (current version at 45 U.S.C. § 6 (1970)), in the operation of its state-owned railroad on the ground that it was engaged in performing a public function in its sovereign capacity. The Court differentiated between the commerce and taxing powers, rejecting the analogy to the immunity of state instrumentalities from federal taxation. 297 U.S. at 184. It reasoned that since both state and federal governments can tax, the nature of the power required "that it be so construed as to allow each government reasonable scope" for the exercise of that power. *Id.* But there was no such limitation on the commerce power. *Id.* at 184-85. In relation to that power, *California* held that the states were on the same footing as private individuals. *See id.* at 185-86. In *National League of Cities*, Justice Rehnquist labeled the differentiation as erroneous "dicta." 426 U.S. at 854-55 & n.18.

125. 426 U.S. at 842. However, omission of the word "expressly" from the text of the tenth amendment is highly significant and was sharply debated at the constitutional convention. Under article II of the Articles of Confederation, the federal government was limited to exercising only those powers expressly delegated to it. Due to the weakness of the government formed under the Articles of Confederation, the meaning of article II was never fully developed. But in the new Constitution, the necessary and proper clause, U.S. CONST. art. I, § 8, cl. 18, the supremacy clause, U.S. CONST. art. VI, cl. 2, and omission of the word "expressly" from the tenth amendment were cumulative indications of a shift in favor of a greatly strengthened central government possessed of implied as well as express powers. *See* Cowen, *supra* note 123, at 156-57. Therefore, when Rehnquist stated that the tenth amendment is an "express" limitation on the commerce power, he may have read a word into that amendment which had been intentionally omitted by its drafters.

Before the tenth amendment was adopted, motions to amend it to include the word "expressly" were defeated three times. Krash, *A More Perfect Union; The Constitutional World of William Winslow Crosskey*, 21 U. CHI. L. REV. 1, 15 & n.56 (1953). For a discussion of the debate regarding whether to include the word "expressly" in the tenth amendment see Feller, *The Tenth Amendment Retires*, 27 A.B.A.J. 223 (1941).

nite restrictions upon the authority of Congress to regulate the activities of the states as states.[126] He stated that

> there are attributes of sovereignty attaching to every state government which may not be impaired by Congress, not because Congress may lack an affirmative grant of legislative authority to reach the matter, but because the Constitution prohibits it from exercising the authority in that manner.[127]

Analyzing the FLSA amendments within this new constitutional framework, the Court's opinion stated without supportive reasoning[128] that one "undoubted" attribute of state sovereignty is the state's power to determine the wages, working hours and overtime compensation[129] of those persons employed to carry

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126. 426 U.S. at 845. Justice Rehnquist found authority for this statement in a footnote in Fry v. United States, 421 U.S. 542, 547 n.7 (1975), and in a statement taken out of context from the majority opinion in *Maryland v. Wirtz* that the Court has "ample power to prevent . . . 'the utter destruction of the State as a sovereign political entity.' " 392 U.S. at 196 (footnote omitted). In *Fry*, the Supreme Court upheld the application of the Economic Stabilization Act of 1970, 12 U.S.C. § 1904 (Supp. 1971) (expired 1975), to state employees. 421 U.S. at 548. Rather than merely finding a rational basis for the wage and price controls instituted by the Act, the Court upheld the regulations by balancing their intrusiveness into state sovereignty against the need for effective federal action, *id.* at 548, a standard that is more restrictive of the commerce power than the rational basis test used in *Wirtz*. More importantly, for the first time since United States v. Darby, 312 U.S. 100 (1941), had relegated the tenth amendment to the status of a mere truism, *id.* at 124, the Court acknowledged that the tenth amendment has some constitutional meaning. The *Fry* Court stated that the tenth amendment "expressly declares the Constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system." 421 U.S. at 547 n.7. *But see* note 125 *supra*. Although to some extent the *Fry* footnote revitalizes the tenth amendment as a meaningful constitutional principle, it does not stand for the proposition that the tenth amendment is an affirmative constitutional right. Furthermore, for Rehnquist to cite *Wirtz* in support of his view of state sovereignty when that case expressly declined to adopt such a view, 392 U.S. at 198-99, is particularly disturbing. It would have been more intellectually honest had Rehnquist stated that the Court was retreating from its former position on federalism questions rather than attempting to demonstrate that his constitutional position on federalism was consistent with the position taken in recent cases.

127. 426 U.S. at 845.

128. Since the entire analysis in *National League of Cities* is premised on an interference with state sovereignty, Rehnquist's failure to express the reasoning underlying his assertion that wage determinations are a sovereign function is a major weakness in the opinion which makes the turnabout in the Court's approach to federalism issues even more difficult to accept.

129. The amendments to the Fair Labor Standards Act required that the states pay their employees at premium rates whenever their work exceeded a specified number of hours in a given period. Furthermore, premium compensation for overtime worked was to be paid in cash only, rather than compensatory time off, unless the compensatory

out "governmental functions."[130] The threshold question in *National League of Cities*, then, was "whether these determinations were functions essential to 'the separate and independent existence' " of the states.[131] Justice Rehnquist determined that they were, holding that "insofar as the challenged amendments operate[d] to directly displace the States' freedom to structure integral operations in the areas of traditional governmental functions, they [we]re not within the authority granted Congress by Art. 1, § 8, cl. 3."[132] Direct displacement would occur when a

time was taken in the same pay period. *See* Fair Labor Standards Amendments of 1974, Pub. L. No. 93-259, § 6(c)(1)(A), 88 Stat. 60 (1974) (invalidated by *National League of Cities*).

130. 426 U.S. at 845.

131. *Id.*

132. *Id.* at 852. It is important to bear in mind that *National League of Cities* applies only to exercises of the commerce power. The Court's opinion stated:

> We express no view as to whether different results might obtain if Congress seeks to affect integral operations of state governments by exercising authority granted it under other sections of the Constitution such as the spending power, Art. I, §8, cl. 1 [the taxing power] or §5 of the Fourteenth Amendment.

Id. at 852 n.17. Since the taxing power cases are the source of much of the reasoning in *National League of Cities*, it seems likely that Congress would be limited in its exercise of that power. *See id.* at 843, *citing* New York v. United States, 326 U.S. 572, 587-88 (1946) (per Stone, C.J.).

However, Congress' power under section 5 of the fourteenth amendment is not limited by the decision in *National League of Cities*. In an opinion by Justice Rehnquist rendered just four days after *National League of Cities*, Fitzpatrick v. Bitzer, 427 U.S. 445 (1976), the Court again distinguished Congress' power under section 5 from its power under the commerce clause. In *Bitzer*, males employed by the State of Connecticut sought an award of back pay, alleging that certain provisions of Connecticut's retirement plan discriminated against them because of their sex, thus violating Title VII of the Civil Rights Act of 1964. Connecticut raised the issue of state sovereignty in the context of the eleventh amendment, asserting that the eleventh amendment barred the back pay award. The Court sustained the award, stating that the principle of state sovereignty was constitutionally limited by section 5 of the fourteenth amendment. *Id.* at 456; *see also* Fry v. United States, 421 U.S. 542, 559 (per Rehnquist, J.) (dissenting) (fourteenth and fifteenth amendments may empower Congress to impose significant restrictions on state choices).

Similarly, a number of lower federal courts have consistently denied claims that *National League of Cities* was a defense to wage regulations codified in the Equal Pay Act, 29 U.S.C. § 206 (1970), for any one or a combination of reasons, including: (1) the Equal Pay provisions of the FLSA can be sustained under section 5 of the fourteenth amendment; (2) discrimination is not an attribute of sovereignty; (3) intrusion into state affairs under the Equal Pay Act was minimal and, on balance, the federal interest in preventing discrimination outweighed the state interest in sovereignty; and (4) the scope of *National League of Cities* applied only to the wage and hour provisions of the FLSA, not to the Equal Pay provisions. Virtually all of the cases construed *National League of Cities* strictly. *See* Usery v. Allegheny County Inst. Dist., 544 F.2d 148 (3d Cir. 1976) (prohibition of sex discrimination in employment enacted under fourteenth amendment, hence not limited by *National League of Cities*); Usery v. Edward J. Meyer

federal enactment had overriden state policies regarding the structure of the governmental activities, thereby impairing the states' ability to function effectively within a federal system.[133] The cost of compliance,[134] although not the dispositive factor, was an important element in finding the amendments unconstitutional. The practical effect of the substantial costs imposed by the amendments was to force the states to allocate funds in a manner which they claimed would cause them to limit or abandon pro-

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Memorial Hosp., 428 F. Supp. 1368 (W.D.N.Y. 1977) (Equal Pay provision sustained as an exercise of fourteenth amendment power); Brown v. County of Santa Barbara, 427 F. Supp. 112 (C.D. Cal. 1977) (motion to dismiss denied); Usery v. Bettendorf Community School Dist., 423 F. Supp. 637 (S.D. Iowa 1976) (minimal intrusion; Equal Pay Act cases decided in the same way as Title VII cases, which *Bitner* held were outside the scope of *National League of Cities'* restraints); Usery v. Dallas Independent School Dist., 421 F. Supp. 116 (N.D. Tex. 1976) (employment discrimination on basis of sex not a legitimate state interest and not a function essential to separate and independent existence of the states); Christensen v. Iowa, 417 F. Supp. 423 (N.D. Iowa 1976) (discrimination based on sex not a "fundamental employment decision," nor an "attribute of sovereignty"); Usery v. Fort Madison School Dist., [1976-1977] 79 Lab. Cas. (CCH) ¶ 33,419 (S.D. Iowa Sept. 1, 1976) (motion to dismiss denied); Usery v. Charleston County School Dist., [1976-1977] 79 Lab. Cas. (CCH) ¶ 33,431 (D.S.C. Aug. 25, 1976)(motion to dismiss denied). Similar results have been reached in challenges to the Age Discrimination Act, 29 U.S.C. §§ 621-634 (Supp. V 1975). *See* Aaron v. Davis, 424 F. Supp. 1234 (E.D. Ark. 1976) (no significant interference); Usery v. Board of Educ., 421 F. Supp. 718 (C.D. Utah 1976).

Additionally, it should also be noted that Justice Rehnquist specifically excepted the war power from the *National League of Cities* holding. 426 U.S. at 855 n.18. Even had he not, it seems clear that exercises of the war power would not be subject to the limitation of Congress' power articulated in *National League of Cities* because exercises of the war power would fall within the exceptions to those limitations. *See* notes 168-69 *infra* and accompanying text.

133. Justice Rehnquist stated the basis of *National League of Cities* as follows:

> [T]he dispositive factor is that Congress has attempted to exercise its Commerce Clause authority to prescribe minimum wages and maximum hours to be paid by the States in their capacities as sovereign governments. In so doing, Congress has sought to wield its power in a fashion that would impair the States' "ability to function effectively within a federal system."

Id. at 852.

134. One county in Tennessee alleged that the amendments would increase its cost in providing police and fire protection by $938,000 per year without increasing the extent of service or current salary levels. *Id.* at 846. A city in Missouri estimated that its budget for fire protection would probably be doubled. *Id.* The State of Arizona anticipated increased costs of $2,500,000 in its essential state services. *Id.* California estimated increases of between $8,000,000 and $16,000,000. Id. There was, however, some dispute as to whether the alleged increase in costs would in fact occur. According to the Secretary of Labor, the states' cost allegations were exaggerated and based on misinterpretations of the challenged amendments. *Id.* at 874 n.12 (per Brennan, J.) (dissenting).

grams they had previously decided were essential to the well-being of their citizens.[135]

Justice Rehnquist distinguished *National League of Cities* from *Fry v. United States*,[136] an earlier case which had sustained Congress' power to impose a national wage freeze applicable to the states as well as private employers as part of the Economic Stabilization Ace of 1970 (ESA),[137] on the grounds that the ESA was a temporary enactment occasioned by a serious national problem which could be forestalled only by collective national action.[138] Rehnquist further noted that the ESA had displaced no state choices and had reduced, rather than increased, the pressures on state budgets.[139]

In a separate concurring opinion, Justice Blackmun stated that he was "not untroubled" by the possible implications of the Court's opinion.[140] However, he believed that opinion represented a balancing approach which did not outlaw federal power where the federal interest was greater than that of the states and when national uniformity of action was essential.[141]

B. Justice Brennan's Dissent

In a lengthy dissent,[142] Justice Brennan vigorously attacked virtually every aspect of the Court's opinion, asserting that effective restraint on Congress' power vis-à-vis the states must be a

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135. For example, the states alleged that the increased costs would force them to curtail or abandon programs in areas of affirmative action and law enforcement training. *Id.* at 847. Justice Rehnquist stated that the amendments would also effectively prohibit the states from hiring the marginally employable, since they could not afford to hire such persons at the federally prescribed minimum wage. *Id.* at 848.

136. 421 U.S. 542 (1975).

137. 12 U.S.C. § 1904 (Supp. I 1971) (expired 1975).

138. 426 U.S. at 853.

139. *Id.* In his dissenting opinion, Justice Brennan challenged Justice Rehnquist's statement that the ESA had displaced no state choices, pointing out the absurdity of the suggestion that there was a constitutionally significant distinction between curbs against increasing wages and curbs against paying wages lower than the federally prescribed minimum. The importance of Justice Rehnquist's treatment of *Fry* is discussed at notes 168, 169 & 171 *infra* and accompanying text.

140. 426 U.S. at 856.

141. Justice Blackmun gave as an example the area of environmental protection. *Id.* The importance of this concurring opinion is discussed at notes 170-71 *infra* and accompanying text.

142. Justices Marshall and White joined in dissent. Justice Stevens delivered a separate dissenting opinion. 426 U.S. at 880.

product of the political, rather than the judicial, process.[143] In Justice Brennan's view, the Court's involvement in federal-state balance-of-powers questions ended once the Court found that Congress was regulating "commerce" and that the regulation was a necessary and proper exercise of the commerce power.[144] He interpreted the tenth amendment to mean merely that the federal government may not exercise a power not delegated to it.[145] A reasonable exercise of the commerce power was to be restrained only when it infringes individual rights guaranteed by the first, fifth and sixth amendments.[146]

Justice Brennan's dissent observed further that the crucial test adopted by the *National League of Cities* Court for finding a "protectible sovereignty interest,"[147] that is, whether an essential state governmental activity was impaired, had been rejected by the Court thirty years earlier because it depended on the differentiation between essential and nonessential governmental function.[148] The dichotomy had been discarded as "having proved to

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143. *Id.* at 857-58, *quoting* Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 197 (1824), *and* Wickard v. Filburn, 317 U.S. 111, 120 (1942). Legislative protection of state sovereignty is based on the following theory: since Congress consists of representatives elected from the states, when a decision is made regarding the extent of federal intervention in state affairs, the states themselves are making that decision. Should the states feel that proposed legislation would invade their sovereignty, they would not enact it into law. *See* Wickard v. Filburn, 317 U.S. 111 (1942); Wechsler, *The Political Safeguard of Federalism: The Role of the States in the Composition and Selection of the National Government*, 54 COLUM. L. REV. 543 (1954). *But see* New York v. United States, 326 U.S. 572, 594 (1946) (per Douglas, J.) (dissenting).

144. 426 U.S. at 861.

145. *Id.* at 862.

146. *Id.* at 858. *See* Leary v. United States, 395 U.S. 6 (1969) (due process clause contained in fifth amendment); United States v. Jackson, 390 U.S. 570 (1968) (right to trial by jury contained in sixth amendment); Mabee v. White Plains Publishing Co., 327 U.S. 178 (1946) (first amendment).

While Justice Rehnquist never stated in *National League of Cities* that the tenth amendment should be equated with the constitutional protections of individual rights embodied in the first eight amendments, it is inferable from his characterization of the tenth amendment as containing an "express declaration" of the "limits upon the authority of Congress to regulate the activities of States as States by means of the commerce power," *id.* at 842. *See also id.* at 841, where Rehnquist also refers to the *Leary* and *Jackson* cases as constitutional barriers to an otherwise valid exercise of the commerce clause.

147. The phrase "protectible sovereignty interest" will be used throughout the remainder of this Note to designate a situation in which both the subject matter and the manner of federal regulation of a state are prima facie impermissible according to the "guidelines" set forth in *National League of Cities*. *See*. See text accompanying note 155 *infra*.

148. 426 U.S. at 864-65, *citing* Case v. Bowles, 327 U.S. 92, 101 & n.7 (1946). In *Bowles*, the Price Administrator of the Emergency Price Control Act (EPCA) sought an injunction barring the completion of a sale of school-land timber by the State of

be unworkable" in measuring Congress' power to tax.[149] A state sovereignty limitation on the commerce power, continued Justice Brennan, constituted nothing more than an "awkward" judicial

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Washington to the highest bidder at a public auction. The sale price agreed upon exceeded the ceiling price fixed by the Price Administrator pursuant to authority granted by the EPCA. The State of Washington argued that the EPCA could not be constitutionally applied to this sale since it was entered into "for the purpose of gaining revenue to carry out an essential governmental function—the education of its citizens." 327 U.S. at 101. The Court's opinion, authored by Justice Black, declared that the constitutional validity of the application of the war power under which the EPCA was enacted did not depend on whether state functions are "essential" to state government. *Id.*

> The use of the same criterion in measuring the constitutional power to tax has proved to be unworkable, and we reject it as a guide in the field here involved . . . .
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> . . . .
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> To construe the Constitution as preventing [the power to make war] would be to read it as a self-defeating charter. It has never been so interpreted. Since the decision in *McCulloch v. Maryland*, it has seldom if ever been doubted that Congress has power in order to attain a legitimate end—that is, to accomplish the full purpose of a granted authority—to use all appropriate means plainly adapted to that end, unless inconsistent with other parts of the Constitution. And we have said, that *the Tenth Amendment "does not operate as a limitation upon the powers, express or implied, delegated to the national government."*

Id. at 101-02 (footnotes and citations omitted)(emphasis added). In footnote 7, the Court expressly mentioned "the several opinions" of *New York v. United States* to demonstrate the unworkability of the essential governmental function test. *Id.* at 101 n.7. Furthermore, the Court cited *United States v. Darby* and *United States v. California*, two cases sustaining Congress' exercise of the commerce power, in support of its statement that the tenth amendment does not limit the operation of an express or implied power delegated to national the governmental. *Id.* at 102 n.8. *See also* California v. United States, 320 U.S. 577 (1944), where the Court stated:

> Finally, it is too late in the day to question the power of Congress under the Commerce Clause to regulate such an essential part of interstate and foreign trade as the activities and instrumentalities which were here authorized to be regulated . . . *whether they be the activities and instrumentalities of private persons or of public agencies.*

Id. at 586 (federal regulation of storage rates at state-owned wharfs)(emphasis added).

149. *Id.* at 865, *citing* Case v. Bowles, 327 U.S. 92, 101 & n.7 (1946). The federal power to tax is delegated in article I, § 3, cl. 1 of the Constitution. Clashes between the federal and state taxing powers resulted in federal immunity from state taxation on the ground that the state's power to tax the federal government threatened the sovereignty and independence of that government. McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819) (sustaining the constitutionality of the Bank of the United States and holding unconstitutional Maryland's tax on the operations of the Bank). This reasoning was later turned around to establish state immunity from federal taxation. Collector v. Day, 78 U.S. (11 Wall.) 113 (1870), *overruled on other grounds*, Graves v. New York *ex. rel.* O'Keefe, 306 U.S. 466 (1939).

However, activities performed by the state, or on its behalf, which were not "essential to the maintenance of a state government," Helvering v. Gerhardt, 304 U.S. 405,

"extension of the doctrine of state immunity from federal taxation."[150]

To Justice Brennan, the Court's opinion cast serious doubt on Congress' continuing ability under the commerce clause to im-

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417 (1938), could be taxed. Thus, when a state engaged in a business of a private or proprietary nature such as the sale of alcohol, Ohio v. Helvering, 292 U.S. 360 (1934), or the operation of a railroad, Helvering v..Powers, 293 U.S. 214 (1934), or charged for admission to sports events in a state university stadium, Allen v. Regents of Univ. System, 304 U.S. 439 (1938), the immunity was lost, even if the state undertook the activity for a public purpose. *Id.* at 452-53.

The Court was unable to establish any clear criteria for defining which state activities constituted "essential governmental functions." The results of the tax immunity cases were not always consistent, *compare* Helvering v. Powers, 293 U.S. 214 (1934) (salary of a publicly appointed manager of a state-operated railway was subject to federal taxation), *with* Brush v. Commissioner, 300 U.S. 352 (1936) (salary of the chief engineer of New York City's municipally owned water supply was not subject to federal taxation), and rejection of the essential governmental functions test was advocated. *See, e.g.*, Helvering v. Gerhardt, 304 U.S. 405 (1938) (per Black, J.) (concurring).

The test was discarded in New York v. United States, 326 U.S. 572 (1946), in which six members of an eight member court held that a federal tax assessed against the State of New York on mineral waters taken from a state-operated spring was constitutional. Six members of the court also upheld state sovereignty as a limitation upon the federal taxing power. The result of the case is confusing because the six justices who sustained the tax were not the same six who upheld sovereignty as a limitation on the taxing power.

Justice Frankfurter delivered the judgment of the Court in which only Justice Rutledge joined. Frankfurter stated that the federal power to tax state activities could be restrained only if the tax discriminated against the states, that is, if the federal government taxed activities which could not be performed by private individuals. *Id.* at 575-76. Thus, Frankfurter acknowledged that there are

> State activities and State-owned property that partake of uniqueness from the point of view of intergovernmental relations. These inherently constitute a class by themselves. Only a State can own a Statehouse; only a State can get income by taxing. These could not be included for purposes of federal taxation in any abstract category of taxpayers without taxing the State as State.

Id. at 582-83.

In an opinion written by Justice Stone, four members of the Court concurred in the result reached by Frankfurter but disagreed with his reasoning. Justice Stone pointed out that if the limitation on federal taxation enunciated by Justice Frankfurter was a truly nondiscriminatory standard, then the statehouse and the revenues raised by state taxes would be just as subject to federal taxation as the real property and income of private individuals. *Id.* at 586-87. For Stone, the limitation on the federal taxing power articulated by Frankfurter was in fact based on the notion of sovereignty. *Id.* at 588. Stone upheld the federal tax on New York's mineral water operation because that operation was not a sovereign function. *See id.* at 590. Justice Douglas, joined by Justice Black, dissented. Douglas took the position that the sovereign powers of the states should be immune from federal taxation, and that the mineral water bottling operation was an exercise of New York's sovereign powers. *Id.* at 591.

150. Since the Court acknowledged that Congress had acted pursuant to the commerce power, it may be argued that the "essential governmental function" limitation did not apply. Comparisons between the commerce power and the federal taxing

plement national policy in employer-employee relationships. He opined that an unrestrained state sovereignity doctrine could operate as an absolute prohibition against congressional regulation of wages and hours of states whenever such regulation was an exercise of the commerce power.[151] Moreover, there was nothing in *National League of Cities* that precluded the states from engaging in businesses competing with the private sector, thereby removing employees of those enterprises from the reach of federal regulation enacted under the commerce clause.[152] In sum, Justice Brennan declared that the majority opinion signaled the abandonment of the formerly unchallenged principle that Congress could completely displace decisions of the states to the full extent of the commerce clause,[153] thereby repudiating an unbroken line of precedent extending over fifty years.[154]

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power were rejected from the outset. *See* Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1 (1824). The commerce power of the federal government has been held superior to the sovereign power of the states to provide for the welfare or necessities of its inhabitants. *See* Sanitary Dist. of Chicago v. United States, 266 U.S. 405 (1925) (sustaining an injunction which prohibited the Sanitary District of Chicago from diverting waters from Lake Michigan for sewage purposes in excess of amounts allowed by the Secretary of War). Even a tax on a state which would otherwise be unconstitutional as a violation of the state immunity from federal taxation was found constitutional as an exercise of the commerce power. Board of Trustees v. United States, 289 U.S. 48 (1933) (upholding import tax imposed by Congress on scientific apparatus imported by the University of Illinois on the ground that it was a valid exercise of Congress' power to regulate foreign commerce). Moreover, the analogy between state immunity from federal taxation and state sovereignty as a limitation on the commerce power was expressly rejected in United States v. California, 297 U.S. 175 (1936). *See* note 124 *supra* and accompanying text.

151. Justice Brennan reasoned that since the Court had disclaimed any reliance on the cost of compliance in reaching its holding, 426 U.S. at 846, and had furnished no reasoning to support its bold assertion that wage and hour determinations were "undoubted attribute[s] of state sovereignty," *id.* at 845, the Court would be capable of invalidating any federal regulation under the commerce clause dealing with the "States' abilities to structure employer-employee relationships." *Id.* at 875.

152. *Id.* at 872-73. Justice Brennan cited Justice Frankfurter's opinion in New York v. United States, 326 U.S. 572 (1946), wherein Frankfurter pointed out that "by engaging in the railroad business a State cannot withdraw the railroad from the power of the federal government to regulate commerce." *Id.* at 582, *citing* United States v. California, 297 U.S. 175 (1936).

153. *See* 426 U.S. at 862-63 (*citing* United States v. Darby, 312 U.S. 100, 124 (1941)), 871 (*citing Bowles, United States v. California and Wirtz*).

154. *Id.* at 867. *See* Sperry v. Florida *ex rel.* Florida Bar, 873 U.S. 379 (1963); California v. Taylor, 353 U.S. 553 (1957); Oklahoma v. United States Civil Serv. Comm'n, 330 U.S. 127 (1947); Case v. Bowles, 327 U.S. 92 (1946); Fernandez v. Wiener, 326 U.S. 340 (1945); California v. United States, 320 U.S. 577 (1944); Oklahoma *ex rel.* Phillips v. Atkinson Co., 313 U.S. 508 (1941); Board of Trustees v. United States, 289 U.S. 48 (1933); United States v. Sprague, 282 U.S. 716 (1931); Sanitary Dist. of Chicago v. United States, 226 U.S. 405 (1925). It is true that *National League of Cities* overruled the reasoning which had prevailed since *Sanitary Dist. of Chicago v. United States*. However, the

C. ANALYSIS OF THE APPLICABILITY OF *National League of Cities*: FINDING A "PROTECTIBLE SOVEREIGNTY INTEREST"

The holding in *National League of Cities* indicated that a determination of whether state sovereignty will be protected involves a two-step process. First, it must be decided that the subject of the regulation involves an essential or traditional governmental function. If so, it must further be determined whether the manner of regulation is impermissible, *i.e.*, whether the regulation's operation impairs a state's freedom to make policy choices regarding that function. If a state can show that these two factors are present, it will have established a "protectible sovereignty interest."[155] A determination that the manner of regulation is impermissible is a question of fact to be answered by examining the challenged legislation. However, a determination that an activity is an essential governmental function remains a thorny problem.

Historically, the Court has been unable to give meaningful definition to the phrase essential or traditional governmental function.[156] In attempting to provide concrete examples, Justice Rehnquist cited the following: fire prevention, police protection, sanitation and public health services, and furnishing parks.[157] He noted, however, that these activities did not establish "an exhaustive catalogue of the numerous line and support activities" which he considers to be traditional operations of state and local governments.[158] Aside from those few comments, the Court offered no guidance for determining whether a state governmental activity is traditional. Due to the lack of a definition of this key concept, it will be difficult, if not impossible, for Congress to decide if a proposed regulation of state activities is a valid exercise of the commerce power. The Court's failure to delineate the boundaries

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cases in which the results were overruled may be few. Many of those cases are distinguishable on the ground that the power being exercised was not the power over interstate commerce, Case v. Bowles, 327 U.S. 92 (1946) (war power), Board of Trustees v. United States, 289 U.S. 48 (1933) (foreign commerce), or the activity being regulated was not a traditional governmental function, California v. Taylor, 353 U.S. 557 (1957); California v. United States, 320 U.S. 577 (1944).

155. *See* note 147 *supra*.

156. *See* note 149 *supra*.

157. 426 U.S. at 851. Justice Rehnquist characterized these as "typical of those [activities] performed by state and local governments in discharging their dual functions of administering the public law and furnishing public services." *Id.* Such a description merely serves to highlight the defects of the traditional governmental functions approach. For instance, why is it not a public service for a state to operate a railway? *See* note 124 *supra*.

158. 426 U.S. at 851 n.16.

of *National League of Cities'* limitations on the operation of the commerce clause is a major flaw in the opinion.

The opinion is also unclear as to whether the power to determine wages, hours and overtime pay provisions of all state employees, regardless of their function, is an attribute of state sovereignty, and hence constitutionally protectible, or whether the constitutional protection extends to wage determinations of only those state employees engaged in traditional governmental activities.[159] For two reasons, it is believed that the latter is the construction that was intended. First, Justice Rehnquist limited his examination of the impact of the amendments to employees engaged in "traditional activities," specifically those involved in police and fire protection. Second, a broader reading of the class of affected employees would end virtually all congressional control of wage and hour determinations of state employees under the commerce clause.[160] It seems unlikely that the Court intended such a far reaching result. Thus, despite careless and imprecise language, it appears that the opinion does not apply to state employees engaged in nontraditional activities.

National League of Cities is further complicated by Justice Rehnquist's statement that the 1974 amendments were unconstitutional to the extent that they operated to "directly displace" the states' freedom to structure integral operations in areas of traditional governmental functions.[161] Nowhere is "direct dis-

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159. The problem arises because of Justice Rehnquist's careless use of language. For the most part, he speaks about interference with "governmental activities." For example, he states that one undoubted attribute of state sovereignty is the states' power to determine the wages of those employed to carry out "their governmental functions," 426 U.S. at 845; that the Fair Labor Standards Act would result in forced relinquishment of important "governmental activities," *id.* at 847; that the Act displaced state policies regarding the manner of delivering "those governmental services," *id.*, which their citizens require. However, at another point, Justice Rehnquist commented that the amendments were impermissible because they supplanted state policy choices as to how to "structure pay scales in state employment." *Id.* at 848. Thus, it is unclear whether the wage determinations of all state employees are protected from federal interference, or whether only wage determinations of employees engaged in "governmental activities" are protected.

Further, the word "governmental" itself is ambiguous. It is not at all clear from the text whether Justice Rehnquist intended that term to include only traditional or essential functions of a government. Any operation undertaken by a government can be a "governmental" activity simply because it is performed by a government. *See also* note 152 *supra* and accompanying text. If Justice Rehnquist was trying to reinstate the formerly accepted distinction between proprietary and nonproprietary activities, he should have given a clear definition of the term "governmental."

160. *See* Justice Brennan's reasoning recited at note 151 *supra*.

161. 426 U.S. at 852.

placement" explained. Direct displacement could occur if federal legislation impaired any state activity, thereby interfering with a state's freedom to choose how to structure its traditional governmental services.[162] Or, it could occur if the legislation were directed at traditional governmental functions only, and such legislation interfered with a state's freedom to choose how to structure those functions. The latter interpretation seems correct, since on its facts, *National League of Cities* is limited to wage determinations of employees engaged in "traditional governmental activities" as an attribute of state sovereignty.[163] Moreover, a broader reading would render the commerce power impotent as applied to the states.[164]

Balancing of Competing Interests

Under *National League of Cities*, a federal regulation is not necessarily unconstitutional even though it interferes with a "protectible sovereignty interest."[165] The Court suggested that in making a final determination of constitutionality, the federal interest will be weighed against the protectible state sovereignty interest. However, it is unclear as to how great that federal interest must be. *National League of Cities* may be construed as holding that state sovereignty interests are to be subordinated to federal regulation only when Congress passes a "temporary enactment tailored to combat a national emergency."[166] Presumably, such legislation would be constitutionally justified by the mere existence of such an emergency. In such a situation, federal interests would predominate over any state sovereignty interests which may be infringed by reason of the legislation's operation. However, if the Court intended that a national emergency be the only condition

162. The effect on the structuring of traditional governmental functions would probably be through the budget. To the extent that the federal government imposes costly regulations on a state in its exercise of a nonessential function, it is removing from the legislature's control funds which might otherwise be allocated to traditional governmental activities. Thus, the state's freedom to structure those traditional activities would be affected.

163. If Justice Rehnquist intended the wage determinations of all governmental employees to be included in the sovereign power of the states, then the first construction of the holding must prevail.

164. Virtually every federal regulation of state activities under the commerce clause would have some impact on a state's budget, thus interfering with its freedom to structure traditional governmental functions.

165. *See* note 151 *supra*.

166. 426 U.S. at 853. However, it must be admitted that Justice Rehnquist's distinguishing of *Fry* may be limited solely to the factors of no displacement of state policies and no burden on state budgets. *See* text accompanying note 139 *supra*.

which could override a protectible sovereignty interest, it failed to give adequate recognition to important federal concerns which do not rise to the level of an emergency or problems that are federal in scope which, if left unattended, may become emergencies. It hardly seems likely that *National League of Cities* means that congressional action is foreclosed when it intrudes into state governmental affairs *until* a problem develops into a national emergency. Further, Justice Rehnquist's description of what constitutes a "national emergency"—"an extremely serious problem which endanger[s] the well-being of all the component parts of our federal system and which only collective action by the National Government might forestall'[167]—is not commensurate with the usual connotation of the term.

Defining national emergency as an "extremely serious problem . . . which might [be] forestall[ed]" raises an alternative approach which those joining with Justice Rehnquist are likely to follow. Under this reading, *National League of Cities* entails a "silent balancing."[168] If a national interest were sufficiently serious so as to require unified national action in order to protect or foster it, then the federal legislation seeking to effectuate that interest

167. 426 U.S. at 853.

168. Justice Rehnquist did not articulate any balancing test in his opinion, but such a balancing test may be inferred from the manner in which he reaffirms and distinguishes *Fry*. *See* notes 138-39 *supra* and accompanying text. Further support for this reading may be found in Justice Blackmun's statement that he believed the Court had adopted a balancing approach. 426 U.S. at 856. The fact that the Court seemed to equate the tenth amendment with the fifth and sixth, *see* note 146 *supra*, as an "affirmative" constitutional bar to the operation of the commerce power also suggests that Justice Rehnquist viewed the tenth amendment as a constitutional right vested in the states whose importance limited the commerce power. The phrase is derived from Justice Brennan's characterization of the Court's apparent treatment preserving *Fry*. *Id.* at 879-80.

It appears that Justice Rehnquist and those who joined in the Court's opinion (Justices Stewart, Powell and Chief Justice Burger) will apply a strict scrutiny analysis to decide conflicts between state sovereignty and the commerce power in a fashion analogous to that employed to protect individual liberties secured by the first eight amendments. *See* Fitzpatrick v. Bitzer, 427 U.S. 445 (1976), discussed at note 132 *supra*, wherein the Court found that state sovereignty would be subordinated only in order to achieve compelling national interests. *See also* note 169 *infra* and accompanying text. Justice Rehnquist could have found authority for this approach in the famous *Carolene Products* footnote which marked the beginning of strict scrutiny analysis: "There may be a narrower scope of operation of the presumption when legislation appears on its face to be within the specific prohibition of the Constitution, such as those of the first *ten* Amendments . . . ." United States v. Carolene Prods. Co., 304 U.S. 144, 152 n.4 (1938) (emphasis added). For a discussion of various balancing techniques to federalism issues see Comment, *An Affirmative Constitutional Right: The Tenth Amendment and Resolution of Federalism Conflicts*, 13 SAN DIEGO L. REV. 876 (1976).

would outweigh the interference with a protectible sovereignty interest.[169]

In his concurring opinion, Justice Blackmun also advocated a balancing approach. His understanding of Justice Rehnquist's opinion was that *National League of Cities* did not "outlaw federal power . . . where the federal interest is demonstrably greater and state facility compliance with federal standards would be essential."[170] Unlike the Rehnquist approach, which would require a showing of a serious national problem before engaging in a balancing of the competing interests, once a protectible sovereignty interest had been established, Justice Blackmun would balance federal interests against state interests in every case. Thus, the Blackmun test is a much less severe restraint on the commerce power than the "serious national problem" standard of Justice Rehnquist's "silent" balancing approach.

Summary

Despite the criticisms that can be leveled at *National League of Cities*, it is now controlling in the area of federal-state relations. Hence, in order to test the constitutionality of federal regulation of the state activities, the Court's methodology must be applied. First, a prima facie showing must be made that the regulation interferes with a protectible state sovereignty interest. Such a prima facie showing involves an affirmative answer to two questions: (1) is there a regulation of a traditional governmental function; and (2) does the enactment being scrutinized displace the states' freedom to structure that traditional function? Second, if a protectible sovereignty interest is found, national interest must be examined. As discussed, the opinions of both Justice Rehnquist and Justice Blackmun will balance federal interest against the states' interest in sovereignty. In the analysis of the constitutionality of the present and proposed federal regulations of municipal securities which follows, both Justice Rehnquist's "silent" balancing standard and Justice Blackmun's "greater federal interest" standard will be applied.[171]

169. Implicit in Justice Rehnquist's "silent" balancing approach is a "least restrictive alternatives" test. This is inferable from the requirement that federal regulation is permissible *only* where "collective national action" can forestall the problem. 426 U.S. at 853.

170. *Id.* at 856.

171. It appears that the outcome using Justice Blackmun's standard will be determinative because of the way the justices are split in *National League of Cities*. That is, four justices favor a strong state sovereignty limitation which will impede federal regu-

III. CONSTITUTIONALITY OF THE PRESENT AND PROPOSED FEDERAL REGULATION OF MUNICIPAL SECURITIES

As a result of *National League of Cities*, the constitutionality of the continuing applicability of the current anti-fraud provisions to municipal issuers,[172] as well as the constitutional validity of the Eagleton and Williams-Towers proposals, is subject to doubt. The threshold question is whether the regulation of municipal securities implicates a traditional governmental function.[173] The unique nature of the power to issue municipal securities makes its categorization difficult. The Supreme Court has held that a tax on interest paid on municipal bonds is unconstitutional because the issuance of municipal bonds is an exercise of the power to borrow money.[174] Further, the Court has repeatedly stated that the

lation of state activities in all but a few instances in which the national interests are clearly paramount, four justices view the limitation as constitutionally inappropriate and Justice Blackmun will cast the "swing" vote depending on the importance of the federal interests involved as compared with the state sovereignty interests.

172. *See* notes 13-20 *supra* and accompanying text.

173. As discussed at note 132 *supra*, *National League of Cities* only applies to exercises of the commerce power. However, few would seriously contend that the interstate sale of municipal securities is not a proper subject of regulation under the commerce clause. Lower federal courts have repeatedly affirmed the enactment of the federal securities laws as a valid exercise of the commerce power. *See* Wright v. S.E.C., 112 F.2d 89 (2d Cir. 1940); Bogy v. United States, 96 F.2d 734 (6th Cir. 1938), *cert. denied*, 305 U.S. 608 (1938); S.E.C. v. Crude Oil Corp., 93 F.2d 844 (7th Cir. 1937); S.E.C. v. Bailey, 41 F. Supp. 647 (S.D. Fla. 1941); S.E.C. v. Payne, 35 F. Supp. 873 (S.D.N.Y. 1940); S.E.C. v. Torr, 15 F. Supp. 315 (S.D.N.Y. 1936), *rev'd on other grounds*, 87 F.2d 446 (2d Cir. 1937). Moreover, the Supreme Court has consistently declined to pass on the issue. Petitions for certiorari raising the constitutionality of the Securities Act of 1933 and the Securities and Exchange Act of 1934 have been denied. Smolowe v. Delendo Corp., 320 U.S. 751 (1943); Ryan v. Newfield, 302 U.S. 729 (1938); Coplin v. United States, 301 U.S. 703 (1937). Therefore, the regulation of municipal securities may be assumed to represent a constitutionally valid exercise of the commerce power, *see* Stern, *The Commerce Clause and the National Economy, 1933-1946 (Part Two)*, 59 HARV. L. REV. 883, 926 (1946), and the principles of *National League of Cities* apply.

174. Pollack v. Farmers Loan & Trust Co., 157 U.S. 429 (1891). Although never overruled, there is dispute as to whether *Pollack* is still good law. *See* Comment, *Intergovernmental Tax Immunities: An Analysis and Suggested Approach to the Doctrine and Its Application to State and Municipal Bond Interest*, 15 VILL. L. REV. 414 (1970) (*Pollack* no longer controlling); Comment, *Tax-Exempt State and Local Bonds: Form of Intergovernmental Immunity and Form of Intergovernmental Obligation*, 21 DE PAUL L. REV. 757 (1972) (*Pollack* still good law). A number of commentators believe the municipal bond immunity is no longer constitutionally mandated. *See* Gardner, *Tax Immune Bonds*, 8 GEO. WASH. L. REV. 1200 (1940); Martori & Bliss, *Taxation of Municipal Bond Interest—"Interesting Speculation" and One Step Forward*, 44 NOTRE DAME LAW. 191 (1968); Powell, *The Remnant of Intergovernmental Tax Immunities*, 58 HARV. L. REV. 757 (1945); Comment, *Constitutionality of the Tax Exempt Status of Municipal Bonds*, 18 S.D.L. REV. 221 (1973).

Finally, certain municipal bonds are not presently exempt from federal taxation. These are arbitrage bonds and most industrial development bonds. However, industrial

power to borrow money is "an essential governmental operation."[175]

On the other hand, when borrowing money, a state enters the interstate market. Unlike providing services such as police or fire protection, schools and hospitals, the state's exercise of this traditional function is a "proprietary" act.[176] Like any private business, it is a borrower seeking creditors; but unlike private businesses, its credit is backed by the power to tax.[177]

On final analysis, the states' power to borrow should be found a protectible attribute of sovereignty under *National League of Cities*. It is a power which the states have traditionally exercised since the earliest days of the nation and which the court has protected from federal intervention. Congress, in hearings on both the present and proposed regulations of municipal securities, was acutely aware that restriction of the states' power to borrow would place a burden on their sovereignty.[178] Finally, the borrowing power is one which the states have exercised in order to raise revenues to provide those services that citizens require and expect from their state government. Regulation of the power to borrow could interfere with the provision of those services, thereby threatening state "functions essential to separate and independent existence."[179]

A. The Antifraud Provisions

Presently, the extent of federal regulation of municipal securities is embodied in the antifraud provisions of the securities acts. The sole requirement which the antifraud provisions imposes upon the states is that they disclose all material information to a municipal securities investor and employ no manipulative or deceptive device in connection with the offer or sale of a secu-

development bonds issued for certain activities, such as city services, convention centers, residential rental property and pollution control, are exempt from federal taxation. I.R.C. § 103(c)(4). Exempt industrial revenue bonds raise revenues for activities which could be defined as essential state activities.

175. Ashton v. Cameron County W.I. Dist. No. One, 298 U.S. 513 (1936); Wilcuts v. Bunn, 282 U.S. 216 (1931); Pollack v. Farmers Loan & Trust Co., 157 U.S. 429 (1891); Mercantile Bank v. United States, 121 U.S. 138 (1886).

176. *See* note 159 *supra*.

177. Certain bonds are not backed by the power to tax. They are not within the scope of this Note's analysis.

178. *See* notes 106-08 *supra* and accompanying text; *see also* notes 31-32 *supra* and accompanying text.

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

rity.[180] The SEC has the power to enforce these provisions by bringing an action to enjoin further sale of the securities.[181] In the exercise of its power to issue securities, a state must make fundamental decisions as to when to issue securities, where, to whom, in what form and at what rate of interest. When the SEC enjoins further sale, it interferes with the states' decisions as to how and when their securities will be issued. Thus, the effect of the regulation is to empower the federal government to displace these fundamental decisions, and a protectible sovereignty interest arises under *National League of Cities*.

A determination that there has been an infringement of the state's interest in their sovereignty does not mean the enactment is unconstitutional. For the antifraud provisions to be unconstitutional under *National League of Cities*, it must also be shown that on balance, national interest in the protection of investors is outweighed by the states' interest in securing their sovereign authority.[182] Under the Rehnquist silent balancing approach, an "extremely serious problem" which only collective national action might forestall would outweigh the state's interest in sovereignty.

Although the New York City crisis shook investor confidence in the municipal bond market[183] and the federal interest in preserving this important component of our national economy is great,[184] an emergency situation has not developed. At the Senate hearings on the two proposed bills, one witness stated that "the impact of the problem of New York City [had not] in fact upset the market to the extent that the vast majority of the cities in the United States had found themselves unable to sell bonds at a reasonable rate.[185] Therefore, *National League of Cities* Court would probably not find such an extremely serious situation in the municipal securities market as to justify the extent of federal regulation which the present antifraud provisions entail.

Even if the *National League of Cities* Court were to determine that there was an extremely serious situation, collective action by the national government is not the only means of maintaining the integrity of the municipal securities market. The states could be

180. *See* notes 13-20 *supra* and accompanying text.
181. *See* note 11 *supra*.
182. *See* notes 165-70 *supra* and accompanying text.
183. *See 1976 Securities Hearings*, *supra* note 1, at 114.
184. *See id*. at 45.
185. *Id*. at 157.

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encouraged to enact their own disclosure regulations.[186] Inasmuch as such alternative means are available, the antifraud provisions would not satisfy the "collective action" component of the "serious problem" standard and thus would be held unconstitutional. The practical effect of this conclusion would be to leave the great national interest in a stable municipal securities market in the hands of the states to diligently require adequate disclosure by their issuers. Perhaps one, or a few, states would abdicate the responsibility of ensuring adequate disclosure by their issuers in order to cut the cost of distributing municipal securities. It was precisely because the states advanced their individual interests at the expense of the nation as a whole that the commerce clause was originally created.[187] Thus, a finding that these measures are unconstitutional is clearly unacceptable.

Since the municipal securities market is such a large component of the national economy, the federal interest in protecting that market is great. For Justice Blackmun, the potentially disastrous consequences of the collapse of this market, although not amounting to a national emergency, would indicate that the federal interest in protecting it outweighs the states' interest in their sovereignty. Furthermore, state compliance with the antifraud provisions is essential; if only a handful of states refused to comply, the market would be seriously threatened. Therefore, under Justice Blackmun's "greater federal interest" test, the antifraud provisions would be found constitutional. Because he would find the present regulations constitutional, Blackmun would join with the four justices who dissented in *National League of Cities* in upholding the constitutionality of the antifraud provisions if that issue came before the court. Thus, their constitutionality would probably be sustained while the present court sits.

B. The Eagleton Bill

Since it has been determined that the regulation of the issuance of municipal securities is a regulation of a traditional gov-

186. S. 2969 stresses this principle. The goal is commonly effectuated through conditional federal grants to the states.

187. Although the commerce power was an addition to the Constitution, it was one "which few oppose and from which no apprehensions are entertained." The Federalist No. 45 (J. Madison), at 329 (Harvard University Press 1961). The commerce power was probably not intended to be used to accomplish the variety of congressional objectives of general government for which it is used today. Rather, it was in the nature of a "negative and preventive provision" to end that prevalent abuse of power under which the importing states taxed the nonimporting states. 3 M. Farrand, Records of the Federal Convention 478 (rev. ed. 1966).

ernmental function, the first important inquiry here is whether this particular proposal interferes with the decisionmaking capacity of the states in regard to an issuance of municipal securities.

By equating the municipal securities issuer with the corporate issuer and eliminating all distinctions between the two in application of the federal securities laws, S. 2574 runs afoul of a major premise of *National League of Cities*—in the context of regulation under the commerce clause, states are different than individual businesses. In requiring the filing of a registration statement with, and review of it by, the SEC, the Commission would have the authority to refuse to permit the municipal issuer to distribute its securities to the public under section 8(b) of the Securities Act.[188] Under these circumstances, the states would be denied the unfettered right to decide whether to sell securities. The decision whether securities were to be sold would become a federal one, thus impermissibly interfering with the sovereign borrowing power. Further, if this interference were to prevent a distribution of bonds, the proceeds of which were to be used to build a school or a sewage treatment plant, the ability of the governmental unit to finance one of those fundamental services "which governments are created to provide"[189] would be destroyed.

The fiscal impact of the Eagleton bill might also interfere with the states' decisionmaking powers. *National League of Cities* indicated that where costs of compliance cause essential government programs to be abandoned or curtailed, interference with state decisionmaking resulted. Although not dispositive, this was one factor in finding the 1974 FLSA amendments unconstitutional. Under S. 2574, the costs of compliance with the 1933 Act could be substantial.[190] If forced to comply, a state might curtail a program and instead apply funds set aside to the payment of the registration fees. *National League of Cities* indicated that this would be an impermissible interference with the states' freedom to structure that program. As discussed above,[191] a serious national problem necessitating collective action does not presently exist in the municipal securities market, and there are alternative means of action which are less intrusive. Therefore, S.2574 would be found unconstitutional using Justice Rehnquist's balancing standard.

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188. *See* note 11 *supra*.

189. *See National League of Cities v. Usery*, 426 U.S. 833, 851 (1976); *see also* note 135 *supra* and accompanying text.

190. *See* notes 100-05 *supra* and accompanying text.

191. *See* notes 182-85 *supra* and accompanying text.

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Justice Blackmun would find that although the federal interest is great, state compliance with this proposed federal regulation is not essential to the protection of that interest. The problems of inadequate disclosure could be solved without subjecting states and municipalities to the registrations requirement of the 1933 Act, which were designed specifically for corporate issuers. For instance, application of the antifraud provisions and the enactment of the Williams-Tower proposal are ways of dealing with the problem in a manner that is less of an interference with state sovereignty. Therefore, it is likely that Justice Blackmun would join those subscribing to Justice Rehnquist's opinion to form a majority finding the Eagleton bill unconstitutional.

C. THE WILLIAMS-TOWER PROPOSAL

Unlike the Eagleton proposal, the manner of regulation embodied in the Williams-Tower bill would not be impermissible under *National League of Cities* because none of its provisions would interfere with the state decisionmaking process. The Williams-Tower bill would give the states the option of avoiding the distribution statement requirement altogether by setting up their own agencies to pass on the adequacy of their municipalities' disclosure policies. Even if a state chose not to take advantage of the exemption, thereby compelling compliance with the distribution statement requirement by certain of its municipalities, federal intervention would still be kept to a minimum since this document is not filed with, nor reviewed by, the SEC. Most importantly, the Commission would have no power to issue a stop order to prevent the distribution of any municipal securities.

The most troublesome provision of S. 2969, even though it is only applicable to a small minority of issuers, is the universal requirement of the filing of an annual report. The annual report requirement is, however, merely an administrative burden. The requirement does not impose an impermissible regulation because it in no way directly impairs the states' ability to carry out distributions they have chosen to issue.

Finally, the costs of compliance with the Williams-Tower proposal would not be so great as to force a state to abandon or curtail services it traditionally provides. Costs of administering

the plan are estimated to be considerably less than the cost of registration required under the Eagleton bill.[192]

CONCLUSION

The drastic changes that have occurred in the municipal securities market since the enactment of the 1933 and 1934 Acts have made present municipal bond issuer regulations insufficient. Testimony from diverse interest groups at the Senate hearings concerning the proposed plans demonstrated the need and support for some federal action. One proposed alternative, the Eagleton bill, would treat states no differently from private issuers. As discussed, it is extremely doubtful that the Eagleton bill would be constitutionally sustained by the present Court.

Even if the Eagleton bill were held to be constitutional, it hardly pays due respect to the federalist system. By allowing the states to formulate their own disclosure policies, the Williams-Tower proposal achieves federal goals without undue interference with the state prerogatives regarding disclosure policies. The states have issued their securities largely outside the framework of the federal securities laws for forty-three years. Instead of now subjecting them to the full panoply of these statutes, it would be wiser in terms of political and economic costs to take a more moderate and federalist position.

The Williams-Towers proposal would encourage policies underlying federalism, *i.e.*, self-government and diversity.[193] Self-government would be furthered by giving states the opportunity to devise their own standards of disclosure and to implement those standards as they see fit. Deference to state regulation encourages the federalist policy of diversity and experimentation. While S. 2969 would induce the states to meet the federal need for investor protection in the municipal securities market, it simultaneously would encourage states to devise policies which meet the unique needs of its municipalities. The states might share their results with each other and may develop new concepts by which to regulate disclosure by private issuers. As one witness at the Senate hearings commented:

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192. This is due to the fact that less information would be required to be filed, the filing would be at the state level, and many issues would not have to be registered.

193. *See* G. GUNTHER & N. DOWLING, CASES AND MATERIALS ON CONSTITUTIONAL LAW 200 (8th ed. 1970).

> [I]t should be borne in mind that State governments have often shown the federal government the way; after all, several states built turnpikes, the forerunners of our Interstate system, with some operations beginning as much as 18 years before the Federal Interstate system legislation was worked out.[194]

Primarily because S. 2969 would force the issue, the level of disclosure would also improve if left up to the states. The states are adamantly opposed to federal regulation. The Williams-Towers bill provides states with an opportunity to assert their sovereign powers in the area of municipal bond disclosure;[195] only failure to act would invoke federal regulation. The states can hardly complain of interference with their sovereignty should they ignore the opportunity S.2969 would provide for its exercise.

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194. *1976 Securities Hearings, supra* note 1, at 114.

195. SEC Chairman Hills commented that S. 2969 would not affect the sovereignty of state and local governments at all. Rather, S. 2969

> helps [to] clarify the responsibility of local and State government. In our judgment, the proposed legislation does not expand or contract the ultimate responsiblity of State and local government under the 1933 and responsibilities, for the exercise of their duties in this area.

Id. at 23.