Legal Opinion Letter

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MUNICIPAL DERIVATIVES CASE PITS SECURITIES VS. ANTITRUST

by
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Attorneys for a class of state and local governments recently filed a sweeping antitrust complaint alleging pervasive abuse of the financial instruments used to raise money for major public works projects. In *Fairfax County, Virginia, et al. v. Wachovia Bank, N.A., et al.*, No. 1:08-cv-00432 (D.D.C.), plaintiffs allege that the defendant Wall Street banks and brokerage houses colluded to fix prices, allocate customers, and rig bids in the market for municipal derivatives. Long before the plaintiffs reach the requested jury trial, however, they will need to overcome a substantial obstacle to their claims: the antitrust doctrine of implied repeal. As most recently interpreted by the Supreme Court – in the 2007 case of *Credit Suisse v. Billing*[1] – the doctrine readily ousts antitrust enforcement in the presence of other, potentially conflicting federal regulation, and appears to be given particularly broad effect in the securities context.

The financial instruments at issue can be quite complicated, and require some preliminary explanation. In order to raise money for large, long term construction projects – such as roads, bridges, and stadiums – state and local governments often issue municipal bonds. Municipal derivatives, in contrast, are tax-exempt vehicles that government entities use to invest the proceeds of bond offerings while waiting to spend them for their given purpose. Government entities purchase municipal derivatives from investment banks or brokers, most often through a competitive bidding or auction process.

According to the *Fairfax County* complaint, the 36 named defendants – in addition to unnamed others – colluded to subvert the bidding process, with the goal of suppressing the interest rates paid on municipal derivatives. The complaint alleges that collusive conduct was pervasive throughout the $400 billion municipal derivatives market, and was facilitated and reinforced by the "interconnected" nature of the industry. The specific practices alleged include: the submission of "courtesy" bids to create the appearance of competition; the sharing of profits from winning bids with losing bidders; exchanges of deliberately losing bids for future winning bids; as well as the payment of kickbacks to brokers. The complaint also alleges more complicated conduct, such as "yield burning" – the practice of charging a bond-issuing government entity a higher fee to conceal the fact that tax-exempt bond proceeds have been invested in derivatives whose yield exceeds that of the bonds themselves by an impermissible amount.

[1] 127 S. Ct. 2383 (2007).

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All of which begins to sound, at a high level of generality, suspiciously like the Supreme Court's *Credit Suisse* case. In *Credit Suisse*, plaintiffs alleged a similarly sweeping antitrust conspiracy, though in the market for IPO underwriting services rather than for municipal derivatives. As in the *Fairfax County* complaint, plaintiffs asserted that the inherent interconnectedness of the industry – as exemplified by such practices as syndicate formation and joint "road shows" – facilitated collusive conduct, ranging from commission overcharges to more arcane practices, such as "tying" (conditioning the purchase of IPO shares on the purchase of less desirable securities) and "laddering" (conditioning the purchase of IPO shares on a agreement to make additional, future purchases at escalating prices).

Although sensitive to the fact that both the antitrust laws and the securities laws advance important policy objectives – a point highlighted by dueling Antitrust Division and SEC *amicus* briefs at the appellate level – the Supreme Court came down squarely on the side of the securities laws. In doing so, the Court gave a particularly broad construction to the doctrine of implied repeal, which holds that conduct already covered by more specific federal regulation is exempted from antitrust enforcement. Although the Court had previously held that only a "plain repugnancy" between the two conflicting regulatory regimes would effect an implied repeal of the antitrust laws – a standard many courts interpreted as being limited to situations in which the two regimes pull in completely opposite directions – the *Credit Suisse* majority adopted a more lenient standard of "clear incompatibility." Pursuant to this standard, a mere "risk" or "threat" that enforcement of both the securities and antitrust laws will impose conflicting obligations on the defendant is enough to preclude so-called "pile-on" antitrust claims.

Application of this standard alone, of course, is not a surefire predictor of the ultimate outcome of the *Fairfax County* case. Plaintiffs will almost certainly attempt to avoid a finding of "clear incompatibility" by arguing that municipal derivatives are not themselves securities, and are therefore beyond the SEC's jurisdiction. This argument is equally unlikely to end the debate, however, as SEC Rule 10b-5 gives the Commission broad authority to investigate fraud "in connection with" the purchase or sale of any security[2] – in this case, the underlying municipal bonds. This analysis is bolstered by actions of the SEC itself, which recently issued "Wells notices" – a Commission letter advising the recipient of potential civil charges – to a number of the *Fairfax County* defendants.[3]

Consequently, the implied repeal analysis will likely involve careful consideration of the reasoning underlying the Supreme Court's *Credit Suisse* opinion – a factor which seems to favor the defendants. The majority expressed great skepticism regarding the efficacy of dual antitrust and securities enforcement, noting that evidence tending to show unlawful antitrust activity and lawful securities activity may be difficult to distinguish, for both judges and juries. The Court also held that the specter of antitrust enforcement could potentially chill essential economic conduct – such as the capital formation process, of which IPOs are a critical component – and that implied repeals should therefore be found wherever necessary to shield such "heartland" securities activities. The Court's concerns in this regard are not wholly unwarranted, as demonstrated by a February incident in which a misunderstanding regarding Antitrust Division comments on the lawfulness of relationships between futures exchanges and their clearing operations caused shares of the parent companies of both Nymex and the Chicago Mercantile Exchange to plunge 18%.[4]

Are the processes by which municipalities raise money for public works as central to the enterprise of securities regulation as IPO underwriting services? Maybe or maybe not. Perhaps – sticking with the Supreme Court's geographic metaphors – the district court will conclude that municipal derivatives are more of a peripheral, Eastern Seaboard or Pacific Northwest-type concern than a "heartland" securities issue. One way or the other, however, the looming implied repeal issue at the heart of the *Fairfax County* case will soon compel it to decide.

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[2]17 C.F.R. § 240.10b-5.

[3]Tony Cooke, *B of A Receives Wells Notice in Municipal Bond Investigation*, WALL ST. J., Feb. 28, 2008.

[4]Judith Burns and Jed Horowitz, *Antitrust Concerns Draw Fire*, WALL ST. J., Feb. 8, 2008.

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