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Why the SEC Says it Can't Fight a Challenge to a Pay-To-Play Rule.

WASHINGTON — The Securities and Exchange Commission is arguing it can't fight a lawsuit challenging a revised rule to curb municipal securities pay-to-play activity because the fiscal 2016 appropriations act prohibits it from spending money on any rules governing political contributions.

The Sixth Circuit Court of Appeals in Cincinnati, where the suit is pending, has responded by halting proceedings until it can issue an order on the SEC's motion for dismissal of the suit. The SEC is arguing that the restrictions, along with federal statutes, prevent the three state Republican parties from challenging it over the latest revisions of the Municipal Securities Rulemaking Board Rule's G-37 on political contributions.

Under the changes to Rule G-37, municipal advisors, similarly to dealers, will be barred from engaging in municipal advisory business with an issuer for two years if the firm, one of its professionals, or political action committee controlled by either the firm or an associated professional, makes significant contributions to an issuer official who can influence the award of municipal advisory business.

The revised rule contains a de minimis provision like the original rule. It would allow a municipal finance professional (MFP) or a municipal advisor professional (MAP) to give a contribution of up to $250 per election to any candidate for whom he or she can vote without triggering the two-year ban.

The Tennessee Republican Party, Georgia Republican Party, and New York Republican State Committee claim Rule G-37 is unconstitutional because its political contribution language forces municipal advisor and dealer employees to choose between doing their jobs and exercising their right to support political candidates. The state parties also argue that Congress did not empower the SEC or MSRB to regulate political contributions and instead made such regulation the exclusive jurisdiction of Congress and the Federal Election Commission.

In bringing their suit against the SEC and MSRB, the three state GOP groups relied on a provision of the Securities Exchange Act of 1934 that allows for appeals court review of a "final order" of the commission, according to the SEC lawyers. The parties also cited sections of the Administrative Procedure Act (APA) that would allow for court review of the MSRB rule if it can be proved that an SEC "agency action" took place.

The SEC's motion to dismiss the suit argues that there was neither a "final order" from the commission nor any "agency action" leading up to the rule's approval.

The Dodd-Frank Act states the SEC has 45 days after the date a proposed MSRB rule is published to approve, disapprove, or decide to take more time to decide on the rule. If the commission does none of those, the rule is deemed approved at the end of the 45-day period.

SEC lawyers said the commission, after publishing the proposed changes, did not take further action on the rule because of the restrictions in the fiscal 2016 appropriations act. The act prohibited the

SEC from using any funds to “finalize, issue, or implement any rule, regulation, or order regarding the disclosure of political contributions, contributions to tax exempt organizations, or dues paid to trade associations.”

But under Dodd-Frank, the SEC’s inaction meant the revised rule was subsequently deemed approved 45 days after the commission published it. It is scheduled to take effect on Aug. 17.

“The commission did not approve or disapprove the proposed rule change, nor did it institute proceedings to determine whether to disapprove it, within the relevant time frame,” said the SEC lawyers. “The commission did not issue an order regarding the amendments to Rule G-37 and it did not publish any further notice regarding the rule.”

The commission never met the definition of “agency action” as laid out in the APA, according to the commission’s lawyers. The act defines agency action to include “the whole or a part of an agency rule, order, license, sanction, relief, or the equivalent denial thereof, or failure to act.”

“Except for ‘a failure to act’ … each ‘agency action’ requires an affirmative and discrete act ‘of an agency,'” the SEC lawyers argue, something that did not happen during the course of approval.

The lawyers defended against the possible applicability of the “failure to act” portion by pointing to three Supreme Court cases that determined a failure to act means the agency did not take an action it was required to do and could be compelled to do by a court.

The definition does not apply to the SEC in this case because the state Republican groups are not asking the court to force the commission to take an action and even if they were, the court could not do so because of the appropriations act, the SEC’s lawyers wrote.

A lawyer for the three Republican state groups said they plan to file a response within the next few days and do not believe the court will grant the SEC’s motion.

The MSRB has maintained that Rule G-37 is a “vital measure promoting the integrity” of the muni market and has said it intends to “vigorously defend the policies it believes should be in place to address quid pro quo corruption and the appearance of this type of corruption.”

Rule G-37 was previously challenged after the SEC first approved it for dealers in 1994. Alabama bond dealer William Blount filed suit against the MSRB and SEC, arguing the rule violated his constitutional right to free speech. The D.C. Circuit Court rejected that argument in a 1995 ruling, saying the rule was “narrowly tailored to serve a compelling government interest.” The Supreme Court declined to take up Blount’s appeal after the ruling.

The Republican groups from New York and Tennessee that are currently opposing G-37 also unsuccessfully challenged an SEC-approved pay-to-play rule covering investment advisors. The U.S. Court of Appeals for the District of Columbia dismissed that lawsuit in August 2015 on a technicality, finding the two groups missed the 60-day deadline to challenge the rule after it went into effect.

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By Jack Casey

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