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MUNICIPAL DERIVATIVES USE AND THE SUITABILITY DOCTRINE

I. INTRODUCTION

The market for the financial instruments known as derivatives[1] has grown tremendously in the past decade.[2] Their emerging ubiquity has not been evenly matched by reform in the regulation of financial markets in the United States. Falling between haphazardly drawn lines of regulatory regimes,[3] derivatives have remained largely unregulated

1. See *infra* note 16 for a definition of derivatives.

2. See *infra* part II for a discussion of derivatives. See *infra* text accompanying notes 27-28 for figures regarding the volume of derivatives use.

3. Several federal agencies currently play a role in derivatives regulation. The Commodity Futures Trading Commission (CFTC) has jurisdiction over commodities futures, commodities options, and options on commodity futures. The Securities Exchange Commission (SEC) has jurisdiction over options on securities and securities indices. Jean S. Chan & Richard L. Zack, *Critical Legal Issues Relating to Derivatives, in* MANAGING RISK EXPOSURE IN DERIVATIVES, at 297 (PLI Corp. Law & Practice Course Handbook Series No. B-893, 1994). The CFTC also has jurisdiction over swaps, but has exempted private swaps from all but antifraud regulation. *See* 7 U.S.C. § 2(i) (1994) (establishing CFTC jurisdiction); 7 U.S.C. § 2(ii) (1994) (exempting swaps not traded on a board of exchange from regulation); 7 U.S.C. § 6b(b) (1994) (antifraud provision for non-exchange-traded swaps). See *infra* note 20 for a definition of swap transactions. Some derivatives (known as hybrids) combine elements of futures and options. This process often creates jurisdictional disputes among regulatory agencies. Kenneth M. Raisler & Barbara J. Morgen, *Legal Aspects of Commodity Derivatives, in* SWAPS AND OTHER DERIVATIVES IN 1992, at 225, 228 (PLI Corp. Law & Practice Course Handbook Series No. 778, 1992). The Federal Deposit Insurance Commission (FDIC) has jurisdiction over all institutions holding Federal Deposit Insurance. *See* FDIC Interpretive Letter (FIL-34-94. May 18, 1994). The Federal Reserve Board regulates bank derivatives activities. *See* News Release, *OCC Issues Guidelines on Bank Derivative Activities*, OCC NR 93-116, 1993 WL

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despite their complexity, size, and growing importance to the rest of the financial system.[4] In the wake of recently publicized reports of heavy losses attributed to the improvident use of derivatives,[5] and following a comprehensive study of the derivatives industry by the General Accounting Office (GAO),[6] House Banking Chair James Leach introduced the Risk Management Improvement and Derivatives Oversight Act (H.R. 20).[7] H.R. 20, a bill that creates a federal derivatives commission, contains provisions which, if adopted, will completely reform regulation of the derivatives market.[8] Recognizing that several municipalities have recently been involved in large derivatives losses,[9]

438487 (Oct. 27, 1993) (announcing and describing regulations) [hereinafter OCC News Release].

In a recent derivatives fraud case, the SEC and the CFTC reached a joint settlement with a defendant (Bankers Trust). *See* News Release, *SEC Announces Institution and Settlement of Proceedings Against BT Securities Involving Derivative Securities Sold to Gigson*, SEC 94-108, 1994 WL 710062 (Dec. 22, 1994) (describing terms of settlement). In addition, the Federal Reserve arranged a written supervisory agreement with the bank. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WRITTEN AGREEMENT BY AND AMONG BANKERS TRUST NEW YORK AND FEDERAL RESERVE BANK OF NEW YORK, 1994 WL 736368 (Dec. 4, 1994) (putting forward terms of agreement). Such duplication of enforcement efforts reflects a diffusion of regulatory oversight. Recognizing the regulatory confusion wrought by the growing hybridization of the finance markets, a pending house bill would merge the CFTC and SEC into a single independent agency. H.R. 718, 104th Cong., 1st Sess. (1995).

4. U.S. GEN. ACCOUNTING OFFICE, REPORT TO CONGRESSIONAL REQUESTERS, PUB. NO. B-257099, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM 8 (1994) [hereinafter GAO REPORT] ("Federal regulators have begun to address derivatives activities through a variety of means, but significant gaps and weaknesses exist in the regulation of many major OTC [over-the-counter] derivatives dealers.").

5. *See* John Greenwald, *The California Wipeout*, TIME, Dec. 19, 1994, at 55; Leah N. Spiro, *Today, Orange County. . . .*, BUS. WK., Dec. 19, 1994, at 28; Kathryn M. Welling, *"Toxic Waste" Cleanup*, BARRON'S, Sept. 26, 1994, at 22.

6. *See generally* GAO REPORT, *supra* note 4 (reporting results of two-year study on use and regulation of OTC derivatives).

7. H.R. 20, 104th Cong., 1st Sess. (1995). This proposed legislation may encourage agencies to institute rulemaking procedures in order to pre-empt legislative mandates. *See* Letter from John Dingell, Chair, House Committee on Energy and Commerce, to Arthur Levitt and Zachary Snow (Aug. 10, 1994) *in* 26TH ANNUAL INSTITUTE ON SECURITIES REGULATION 235, 236 (Vol. III - PLI Corp. Law & Practice Course Handbook Series No. B-868, 1994) (stating that derivatives legislation would follow if agencies did not enact timely and meaningful reforms).

8. H.R. 20, 104th Cong., 1st Sess. (1995).

9. The bankruptcy of Orange County is merely the most notable illustration of municipal loss in which derivatives played a major part. *See* Laura Jereski & Thomas T.

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H.R. 20 provides a regulatory mandate to develop rules applicable specifically to municipal investment in derivatives.[10] Although earlier versions of this bill contained a "suitability" standard with regard to trades in derivatives,[11] Congress removed this provision from subsequent versions of the bill.

Nevertheless, at a series of recent hearings before Congress, a discourse emerged on the utility of applying a "suitability" standard to brokers selling derivatives to municipalities.[12] This Note argues that a

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Vogel Jr., *Orange County Crisis: The Fallout, Other Municipal Funds May Be Burdened with Bitter Results of Risky Investments*, WALL ST. J., Dec. 8, 1994, at A12. ("Across the country, from Southern California to Texas, to Ohio, other towns and cities are grappling with leveraged-investment strategies gone awry.").

10. H.R. 20 provides with respect to municipalities:

§ 104. FUNCTIONS OF COMMISSION.

> . . . .
>
> (a)(3) [T]he Commission may establish differing standards for different classes of financial institutions, including, but not limited to, dealers, end-users, or municipalities as appropriate.
>
> . . . .
>
> (b)(1) [T]he Commission shall consider and may make recommendations for . . . regulatory action by the Federal financial institution regulatory agencies in . . . matters related to financial institutions engaged in derivatives activities, including the need to establish principles and standards for . . .
>
> . . . .
>
> (I) Minimum prudential practices for municipalities and pension funds that may use derivatives . . . .
>
> . . . .

§ 106. RISK MANAGEMENT TRAINING.

> The Commission shall develop training seminars in risk management techniques related to derivatives activities for employees of state or local governments and financial institutions.

H.R. 20, 104th Cong., 1st Sess. (1995).

11. For a discussion of the suitability doctrine, see *infra* part V.

12. At these hearings, the securities industry was vociferous in its opposition to any type of suitability rule: "To impose a responsibility of this type on dealers would encourage counterparties to believe that they are not ultimately responsible for their investment decisions and will encourage litigation to lay financial responsibility for unsuccessful investment strategies at the door of the professional dealer." *Derivative Financial Instruments Relating to Banks and Financial Institutions: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 219 (1995) (statement of Marc E. Lackritz, President, Securities Industry Association) [hereinafter Lackritz statement]. The municipal investor lobby was equally adamant that such controls be instated to protect the public. Noting the "intense marketing of these products to local government finance officers by the broker/dealer industry," and the often limited knowledge of such salespeople, they have called for "clarification or issuance of suitability

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federal suitability standard should be applied to the sale of derivatives to municipalities. Part II introduces the subject of derivatives. Part III examines the nature of municipal investment and the present use of derivatives by municipalities. Part IV discusses the problems associated with state regulation of municipal investing and derivatives use. Part V proposes a clarification of the suitability doctrine that could play a central role in effective federal regulation. Finally, Part VI addresses the possible impact of a strong suitability rule on municipal access to derivatives.

II. DERIVATIVES

The world of finance has evolved significantly in the past several years. National economies are increasingly characterized by global interdependence.[13] Yet world commodities prices, interest rates, and currency exchange rates have become increasingly volatile.[14] Participation in the global economy has increasingly meant exposure to the vagaries of macroeconomic forces out of the control of any individual market participant.[15]

The financial world has responded to these undesired risks of market volatility with a steady stream of sophisticated new investment instru-

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rules for derivatives to assure that the products recommended by a broker or dealer are appropriate for the State or local government entity." *Derivative Financial Instruments Relating to Banks and Financial Institutions, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 162 (1995) (statement of Bonnie Ridley Kraft, President, Government Finance Officers Association and City Manager, City of Gresham, Oregon) [hereinafter Kraft statement].

13. Paul Gillespie, *"Butterfly Effect" Makes Markets Flap*, IRISH TIMES, Mar. 25, 1995, at 10.

14. *See* GAO REPORT, *supra* note 4, at 39-44 (citing historical trend of increasing volatility). *See also* Adam R. Waldman, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance Into the Abyss?*, 43 AM. U. L. REV. 1023, 1033 (1994) (citing stock market fluctuations of 1987 and 1989 as a factor impelling institutional investors to use hedging on a widespread scale); Thomas D. Willett, *The Causes and Effects of Exchange Rate Volatility*, *in* THE INTERNATIONAL MONETARY SYSTEM: A TIME OF TURBULENCE 33 n.7 (Jacob S. Dreyer et al. eds., 1982) (noting study demonstrating that increased volatility creates higher transactions costs in world trade).

15. For example, assume that a U.S. company contracts for the future purchase of a widget from a Mexican company. If they agree on a price in either country's currency, and the currency rates do not remain fixed, one party will benefit and the other will suffer to the extent of the change in currency valuation. Yet neither party intended this result to be a part of their agreement. To the extent that currency fluctuation creates uncertainty, it tends to discourage international trade.

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ments. Derivatives,[16] comprised of variations on forwards,[17] futures,[18] options,[19] and swaps,[20] are a group of investment instruments that market participants may use to free themselves from undesired market risks.[21] Over-the-counter derivatives are individual agreements between two parties to exchange money based on fluctuations in the value of an underlying market.[22] Other types of derivatives may be

16. "The term derivative . . . refers to all financial instruments whose prices are dependent upon the price of cash market items, whether those items be oil, metals, soybeans, stocks or foreign currency." Raisler & Morgen, *supra* note 3, at 258 n.1.

17. The CFTC offered the following definition for a forward contract:

> First, the contract must be a binding agreement on both parties to the contract: one must agree to make delivery and the other to take delivery of the commodity. Second, because forward contracts are commercial, merchandising transactions which result in delivery, the courts and the Commission have looked for evidence of the transaction's use in commerce. Thus, the courts and the Commission have examined whether the parties to the contracts are commercial entities that have the capacity to make or take delivery and whether such delivery, in fact, routinely occurs under such contracts.

OGC Interpretive Statement Regarding Characteristics Distinguishing Cash and Forward Contract and "Trade" Options, 50 Fed. Reg. 39,656, 39,657 (1985) (footnotes omitted), *quoted in* Raisler & Morgen, *supra* note 3, at 235.

18. The CFTC defines a futures contract as follows:

> An agreement to purchase or sell a commodity for delivery in the future: (1) at a price that is determined at initiation of the contract; (2) which is normally traded on a board of trade by members of the exchange; (3) which is used to assume or shift price risk; and (4) which obligates each party to the contract either to fulfill the terms of the contract or offset the contract by entering into an opposite transaction (by far, the more commonly chosen alternative).

CFTC Glossary of Trade Terms, June 5, 1985, *quoted in* Raisler & Morgen, *supra* note 3, at 231.

19. An option is a "[r]ight, exercisable at the option of the holder (and thus not an obligation), to buy or sell a security or commodity at a given price within, or at, a given time." MICHAEL D. RICE, THE PRENTICE-HALL DICTIONARY OF BUSINESS, FINANCE AND LAW 245 (1983) (citation omitted).

20. A swap transaction is "an agreement between two parties to exchange a series of cash flows measured by different interest rates, exchange rates, or prices with payments calculated by reference to a principal base (notional amount)." Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694, 30,695 (1989).

21. For example, airlines can purchase the option to buy jet fuel at specified moderate prices in the future. If the price of jet fuel rises significantly, they can exercise their option and purchase jet fuel at moderate prices and thereby avoid the risks of a volatile fuel market. This process is known as "hedging" risk. See *infra* note 53 for a definition of hedging.

22. *See* GAO REPORT, *supra* note 4, at 24-25.

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purchased through exchanges[23] at prevailing prices.[24] Unlike capital investments, derivatives do not help create wealth; they merely shift risk from one party to another.[25] The technology to manage market risks by the use of derivatives represents an historic breakthrough in the world of finance and stands to make the world a more efficient place.[26] The utility of derivatives to help manage risk has been quickly recognized; in the past ten years, their use has increased over a thousand-fold.[27] With a current notional value estimated above thirty-eight trillion dollars,[28] derivatives are significant economic tools that will become a permanent fixture of modern finance.

Mortgage derivatives, such as stripped mortgage-backed securities and collateralized mortgage obligations, are analogically distinct from derivatives.[29] However, many of the concerns about derivatives are

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23. A number of exchanges sell derivatives. For example, the American Stock Exchange sells options on individual stocks; the Chicago Board of Trade sells futures and options on futures; the Chicago Board of Options Exchange sells options on individual stocks; the Chicago Mercantile Exchange, Coffee, Sugar and Cocoa Exchange, Commodity Exchange, Kansas City Board of Trade, MidAmerica Commodity Exchange, Minneapolis Grain Exchange, and New York Cotton Exchange each sells futures and options on futures; the New York Futures Exchange sells futures and options on stock indexes; the New York Mercantile Exchange sells futures and options on futures; the Pacific Stock Exchange sells options on individual stocks, and the Philadelphia Stock Exchange sells futures and options on individual stocks, currencies, and stock indexes. ROBERT W. KOLB, FINANCIAL DERIVATIVES 79, Table 3.1 (1993).

24. Prevailing prices are determined by "open-outcry," a process by which each bid for sale and purchase of each derivative is offered to all traders in the "pit" at the floor of the exchange that trades that particular derivative. *Id.* at 25. *See also* SHELDON M. JAFFE, BROKER-DEALERS AND SECURITIES MARKETS: A GUIDE TO THE REGULATORY PROCESS 221-24 (1977) (discussing trade on the Chicago Board of Options).

25. Lackritz statement, *supra* note 12, at 217.

26. *See id.* at 218 (stating that "derivatives increase economic efficiency by allowing the transfer of risk to those most willing to bear it").

27. *See* Waldman, *supra* note 14, at 1032.

28. *Recent Derivatives Losses: Hearing Before the Comm. on Banking, Finance and Urban Affairs*, 103d Cong., 2d Sess. 54 (1994) (statement of Henry B. Gonzalez, Chairman) [hereinafter Gonzalez statement].

29. Mortgage derivatives are receivables; they function essentially like variable rate bonds. They are often heavily processed and tailored to create "designer" investment products that perform very differently under varying economic conditions. For example, interest-only strips (IO strips) give the holder the right to receive only the interest portion of a pool of government-administered home loans. In the event prevailing interest rates fall and homeowners prepay their mortgages to refinance (thus avoiding the bulk of interest payments) the holders of IO strips will lose a substantial amount of their

applicable to this market, thus warranting a brief explanation. Created from pools of mortgage obligations accruing from government loan programs,[30] mortgage derivatives are customized by severing mortgage obligations into their fundamental parts, (for example, interest and principal) and creating different financial instruments out of the streams of payments accruing from these parts. These products are then sold in the secondary mortgage markets.[31] Some of these products expose their holders to substantial market risks that depend on unpredictable aspects of the economy.[32] Many purchasers have failed to appreciate the distinction between credit risk and market risk and have sustained large losses on investments they assumed were conservative.[33] Further, the performance of these securities under different economic scenarios is

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investment because the interest payments are no longer owed. *See* Rebecca Curnin, Note, *The NASD's Fair Sales Practice Rules: An Argument for Their Application to Government Securities Transactions, and for the Consideration of Some New Rules in the Mortgage Market*, 1993 COLUM. BUS. L. REV. 191 (1993). For a discussion of recent difficulties experienced with more complicated mortgage derivatives, see Welling, *supra* note 5, at 22-29.

30. The underlying mortgages are created through the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac). *See* Curnin, *supra* note 29, at 198. Ginnie Mae mortgages are backed by the federal government. *Id.* at 198 n.36. Fannie Mae and Freddie Mac are private corporations, considered secure from credit risk. *Id.*

31. For a history and explanation of the secondary mortgage market, see KENNETH G. LORE, MORTGAGE-BACKED SECURITIES, DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET I-14, 15 (1995 ed.). For a discussion of the economic advantages of a secondary mortgage market, see *id.* at I-26.

32. These unpredictable facets of the economy can encompass nearly anything that changes the way in which people pay back their debts: *e.g.*, changes in interest rates or a depression.

33. *See* Randall Smith & John Connor, *Matter of Security: Risky Derivatives Are Huge Source of Funds for Federal Agencies*, WALL ST. J., Jan. 20, 1995, A1, A7 (quoting a 1993 letter from Matthew Raabe, former assistant treasurer of Orange County, to an investor: "We kept risk low by purchasing United States government securities which are universally accepted as having nearly no risk of default."); *see also* Curnin, *supra* note 29, at 192, 211 (decrying the lack of fair practice rules in the government securities industry).

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often difficult to determine.[34] Thus, the argument for a suitability rule for over-the-counter derivatives applies with equal force to mortgage derivatives in the government securities market.[35]

Regardless of their nature, derivatives designed to reduce risk can also be used as a speculative device, thereby increasing exposure to market risks rather than eliminating them.[36] While investors may legitimately use derivatives for both risk-reducing and risk-enhancing activities, the speculative nature of risk-enhancing derivatives and their potential to produce large losses have been a source of growing concern.[37] In some cases, their effects can be simply catastrophic, as the recent Barings Investment Bank bankruptcy makes plain.[38]

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34. For example, determining the percent of homeowners likely to prepay their mortgages under various economic conditions strains the limits of modern computer modeling. Many evaluations of mortgage securities rely on worst-case scenarios, and do not purport to predict investment returns with any degree of accuracy. *See* KENNETH G. LORE, MORTGAGE BACKED SECURITIES app. § 9-67 (1995 ed.) (example of a rating analysis for a pool of home mortgages).

35. *See* Curnin, *supra* note 29, at 217-18 (arguing that regulation of mortgage derivatives is presently inadequate and that new regulations should be implemented to increase risk disclosure and provide fair practice rules).

36. Gonzalez statement, *supra* note 28, at 54-55 (noting that Denis Healy, former British Chancellor of the Exchequer, has estimated that 98% of foreign exchange transactions are speculative in nature).

Returning to the "jet fuel option" hypothetical, *supra* note 21, assume that, instead of an airline, Lemon County is the investor. Lemon County has no intrinsic interest in jet fuel. It can still buy jet fuel options and hope that fuel prices rise. If so, it can sell that option at a higher price to an airline that can no longer afford to feed its passengers because it is spending so much on fuel. Alternatively, if fuel prices fail to rise, and the option expires without being executed or sold (at a deep discount), the investment is a total loss.

37. Former House Banking, Finance and Urban Affairs Committee Chair, Henry Gonzalez has been a vocal critic of speculation in this often arcane area of finance:

> For the past several years I have expressed increasing concern over the rapid growth in the derivatives market, especially the uncontrolled growth in new, complex derivative products that are misunderstood by even the most sophisticated investors.
>
> But the most worrisome aspect of the derivatives market is the fact that much of the underpinnings of the trillion dollar a day global derivatives market is rampant speculation and gambling.

Gonzalez statement, *supra* note 28, at 54.

38. *See* Sara Webb et al., *A Royal Mess: Britain's Barings PLC Bets on Derivatives —And the Cost Is Dear*, WALL ST. J., Feb. 27, 1995, at A1. Twenty-seven-year-old derivatives trader Nicholas Leeson singlehandedly bet and lost nearly a billion dollars, sending Barings, a 233 year old British financial institution, into administration (a

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Moreover, because of the sheer complexity of many derivatives transactions, purchasers may not understand the nature of the risks involved.[39] As a result, providing market participants with greater information about risk is one of the reforms proposed by leading derivative specialists to make the derivatives market a safer place.[40]

III. MUNICIPAL INVESTMENT AND USE OF DERIVATIVES

A. *Municipal Investment Characteristics*

As complex financial entities,[41] municipalities receive money from many different sources, invest it for widely varying terms, and use it to finance a tremendous range of activities.[42] Moreover, much municipal

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proceeding similar to Chapter 11). *Id.*

39. Margery Waxman, *The Lesson of Orange County: It Takes a Crisis to Focus Public Policy on the Need for Adequate Disclosure of Risk*, 63 Banking Rep. (BNA) No. 23, at 944 (Dec. 19, 1994) ("There is no doubt that the complexity of [derivatives] transactions has made it more difficult for even the most sophisticated senior management to understand or evaluate the benefits or the risks associated with using these derivatives.").

40. *See* TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, *Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms, in* 26TH ANNUAL INSTITUTE ON SECURITIES REGULATION, at 187, 207 app. (PLI Corp. Law & Practice Course Handbook Series No. B-868, 1994) (describing risk-reducing proposals for derivatives markets worldwide); Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise Of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1503-13 (1993) (proposing the creation of a system to catalogue all known types of over-the-counter derivatives, their uses and risks, for the benefit of market participants and regulators alike). *See also* GAO REPORT, *supra* note 4; H.R. 20, *supra* note 7.

41. I define municipalities to include towns, cities, and counties. Although counties are technically "quasi-municipal corporations organized as subordinate agencies of the state government," in their capacity as investors they may act for the benefit of localities within their domain rather than as part of the larger state apparatus. CHARLES S. RHYNE, THE LAW OF LOCAL GOVERNMENT OPERATIONS § 1.5 (1980).

42. Municipal funds range from temporary idle cash funds to long-term pension funds for government employees. The risk and liquidity considerations for investing such funds vary considerably. *See Derivative Financial Instruments Relating to Banks and Financial Institutions: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 190-96 (1995) (statement of Robert D. McKnew, Executive Vice President, Bank of America and Chairman, Public Securities Association) [hereinafter McKnew statement].

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revenue derives from taxes.[43] Unlike stockholders choosing to contribute to corporate equity, municipal taxpayers have no meaningful choice in how their funds are invested. Furthermore, many municipalities rely on the revenue they collect to provide for basic social services and infrastructure.[44] For these reasons, prudent municipal-finance principles stress the preservation of principal and the maintenance of liquidity over the often-competing goal of high investment returns.[45] For the same reasons, it is in the public's interest to afford municipalities greater protections than ordinary institutional investors in the financial marketplace.

Finance officers, however, do not invest their own resources. Thus, they lack the natural aversion to risk which tends to arise in investors who feel uncomfortable with the prospect of parting with their own money.[46] Municipal finance officers work in a system in which their performance is measured, to some degree, by the returns they reap on investments.[47] Though finance officers are expected to follow prudential guidelines, and though they risk their jobs when they jeopardize public capital, many feel equally compelled to justify their positions by

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43. *See* LENNOX L. MOAK & ALBERT M. HILLHOUSE, CONCEPTS AND PRACTICES IN LOCAL GOVERNMENT FINANCE 59 (1975) (listing sources of revenues).

44. In his discussion of social welfare and public service provision in the face of capital flight, Robert Burchell stated:

> [R]ecent research indicates that annual expenditures for municipal services in older cities have risen by nearly sixty percent over the past decade. On a per capita basis, central city costs for common municipal functions are twice suburban rates. Abandoned by private capital, left with a severely deteriorated infrastructure and faced by the dire poverty of its residents, the local government of the intergovernmental city is forced to provide divested private services (*i.e.* housing), and to increase levels of traditional public services as well.

ROBERT W. BURCHELL, THE NEW REALITY OF MUNICIPAL FINANCE 11 (1984) (citation omitted).

45. *See* Kraft statement, *supra* note 12, at 224 ("[A]s custodians of public funds needed for public purposes, State and local government jurisdictions have a much lower risk tolerance than their private sector counterparts may."). *Id.*

46. An additional factor, in some municipalities, may be the practice of broker-dealers to make contributions to public officials' campaign funds. *See* Joanne Morrison, *Use Your Head When You Manage Public Investments, SEC's Levitt Warns*, BOND BUYER, June 14, 1995, at 1.

47. *See* MOAK & HILLHOUSE, *supra* note 43, at 29-30 (outlining three goals in local government finance organization). *See also id.* at 201-06 (discussing investment strategies).

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taking risks that may produce generous returns.[48] In times of low interest rates, which generally coincide with lower investment returns, such pressure may become acute.[49] Moreover, if a finance officer's investments perform poorly, that officer's objective interests may diverge from the interests of the municipality. That is, a finance officer with a poorly performing set of investments may desire to take larger risks in order to recoup losses and mitigate an apparent personal failure. At the same time, the objective interests of the municipality would favor accepting the temporary losses and minimizing any further declines. This potential conflict of interests has important implications for the development of a proper regulatory strategy.[50]

B. *Municipal Use of Derivatives*

The sheer number and variety of municipalities make generalizations about their collective use of derivatives difficult. Overall, half of all municipalities are thought to invest in some form of derivative financial device.[51] A recent GAO report provides detailed information on the municipal use of designer over-the-counter derivatives.[52] In 1992, four percent of localities used this type of derivative either as a hedge[53] or

48. Finance officers are often willing to invest funds in financial markets that have a low probability of catastrophe. This tendency may be understood in part by reference to the "threshold effect," the psychological tendency to ignore certain possibilities below a critical threshold level. For a discussion of cognitive bias and derivatives investing, see Hu, *supra* note 40, at 1488-90.

49. In California, reduction of property tax revenues resulting from a decline in real estate values has further exacerbated the revenue pinch and the resultant drive to increase municipal investment returns. Jereski & Vogel, *supra* note 9, at A12.

50. For example, a financial officer may have a personal interest in recouping previous losses that have accrued to a municipality (perhaps fearing the loss of a job due to poor investment returns or poor management). Lesser conflicts may include a finance officer's ego maintenance. From the standpoint of a municipality, these interests are irrational and potentially destructive. In circumstances where it appears that a finance officer's interests conflict with those of a municipality, one solution is to assure that suspicious trades are cleared through an independent person having the interests of the municipality, and not the finance officer, foremost in mind. One way to screen for "suspicious" trades is to scrutinize all trades that may be deemed "unsuitable" for the municipality.

51. Waxman, *supra* note 39, at 944 (citing GAO estimate of use of derivatives by states, municipalities, and pension funds).

52. GAO REPORT, *supra* note 4, at 130.

53. The process of hedging entails "enter[ing] into a transaction intended to protect against losses in another transaction for the purchase or sale of a commodity or security." RICE, *supra* note 19, at 172.

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as a speculative device.[54] Municipalities using these specialized derivatives tended to be much larger entities in terms of market assets than were non-users.[55] Users identified hedging and bolstering rates of return as the most common purposes,[56] and also cited derivatives use as a way to participate in equity markets.[57]

IV. LIMITATIONS OF STATE REGULATION

Municipalities fulfill for their citizens a role similar to that of investment companies for private investors. Nonetheless, Congress explicitly excluded state and local governments from regulation under the Investment Company Act (ICA).[58] Under the ICA, the SEC promulgates prudential standards for holdings of money-market mutual funds with the goal of preserving stable asset values.[59] The municipality exception recognizes federalist principles by preventing direct federal

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54. In the GAO survey, localities are defined as "municipalities, special districts, and counties." GAO REPORT, *supra* note 4, at 130. Four percent translated to 134 localities using over-the-counter derivatives in 1992.

55. *Id.* at 144 (reporting total market assets averaging $490 million for local users of derivatives; non-user market assets averaged $80 million).

56. The GAO asked specifically about improving rates of return because this is an indictor of pure speculative activity. *Id.*

57. States traditionally forbid municipalities to invest in the stock market because stocks are considered unsuitably risky investments. But municipalities may be able to participate vicariously by purchasing options on equities. This is an avenue for future state oversight and reform. *See* Laurie Morse, *Borrowings Raised Ante in Orange County Debacle*, FIN. TIMES, Dec. 15, 1994, at 38 (noting that Orange County invested in tailor-made structured notes while prohibited from investing in common stock).

58. Investment Company Act of 1940, 15 U.S.C. § 80a-2(b). The Investment Company Act provides, in pertinent part:

> No provision in [the Investment Company Act] shall apply to, or be deemed to include . . . a State, or any political subdivision of a State, or any agency, authority, or instrumentality of any one or more of the foregoing . . . or any officer, agent, or employee of any of the foregoing acting as such in the course of his official duty. . . .

15 U.S.C. § 80a-2(b) (1994).

59. *Derivative Financial Instruments Relating to Banks and Financial Institutions: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 61 n.46 (1995) (statement of Arthur Levitt, Chairman, SEC).

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control over state and local finances.[60] However, it also exempts municipal investment decisions from federal oversight.

Although local elected officials and boards of supervisors oversee municipal finance decisions,[61] these officials may have little interest in, or understanding of, complex financial matters.[62] Many local financial officers are themselves elected officials. Awareness of their accountability at the polls may serve as another check on municipal financial activities. However, municipal voters can only exert pressure on elected financial officers to the extent that they are aware of, and are concerned about, investment practices that jeopardize their tax contributions and the quality of their local government services. Unfortunately, it may take a crisis to activate this process.[63]

In the absence of federal control, states have plenary authority in regulating municipal investment activities.[64] Through legislation, states create legal lists[65] which enumerate acceptable municipal investments

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60. *Derivative Financial Instruments Relating to Banks and Financial Institutions: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 13 (1995) (statement of Senator Robert F. Bennett) (characterizing the prospect of regulation of derivatives as "heavy-handed").

61. *See* MOAK & HILLHOUSE, *supra* note 43, at 31 (discussing a basic local government finance hierarchy).

62. John C. Coffee, Jr., *The Suitability Doctrine Revisited: Can Orange County Sue Its Broker for Recommending the Purchase of Unsuitable Securities for Its Fund?*, NAT'L L.J., Jan. 16, 1995, at B4 (noting the minimal oversight elected boards provide over the activities of county treasurers). *See also* Waxman, *supra* note 39, at 945 (describing members of municipal boards as "prominent local citizens").

63. *See* Jodi Wilgoren, *Orange County Picks Moorlach as Treasurer*, L.A. TIMES, Mar. 18, 1995, at A1 (noting Moorlach's warnings to Orange County voters during his unsuccessful campaign against Robert Citron for treasurer).

64. Robert D. McKnew, Chairman of the Public Securities Association, characterizes this federalist accommodation to state power as follows:

> State and local pooled investment funds are not regulated on the Federal level . . . . They are not required to register with the SEC as investment companies or investment advisors, nor are they subject to the Investment Company Act of 1940, the Investment Advisers Act of 1940, and their accompanying rules.
>
> Nevertheless, State and municipal investments are almost without exception heavily regulated at the State and local level.

McKnew statement, *supra* note 42, at 194.

65. The legal-list procedure, also known as the New York Rule, was once a basic principle of fiduciary duty applicable to private trust relationships. The New York Rule governed particular fiduciary relationships. Investing outside a legal list represented a breach of trust. This rule was overturned in Harvard College v. Amory, 26 Mass. (9 Pick.)

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—those that are presumably safe.[66] Sales that do not conform with state investment statutes are *ultra vires*,[67] and therefore void.[68] The legal-list approach to regulatory investments is often inefficiently restrictive and out of date. For example, most states forbid state investment pools from dealing in derivatives entirely.[69] Though this approach may assure safety, rules prohibiting derivatives investments absolutely, or imposing percentage limitations on their use, frustrate two legitimate investment goals: the practice of portfolio diversification and the risk-reducing use of derivatives as hedging devices.[70]

Modern portfolio theory casts doubt on the efficacy of imposing black-letter rules to restrict municipal investments.[71] The theory posits that the degree of risk (represented by price volatility) of a well-diversified portfolio is less than the risk associated with each particular investment device contained within.[72] If the portfolio's

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446 (1830). For a history of the transition of trust guidelines from the "New York Rule" to the "Prudent Man" rule, see Mayo A. Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 OHIO ST. L.J. 491 (1951).

66. For example, the California rules generally restrict municipalities to low-risk investments. 5 CAL. GOV'T CODE § 53635 (West 1983 & Supp. 1995).

67. "[An] *ultra vires* act of [a] municipality is one which is beyond [the] powers conferred upon it by law." BLACK'S LAW DICTIONARY 1522 (6th ed. 1990).

68. In one celebrated case, the British House of Lords declared a swap agreement involving a British municipality void, resulting in a loss by some eighty banks of a billion dollars. Waldman, *supra* note 14, at 1043. *See* Hazell v. Hammersmith & Fulham London Borough Council, [1991] 2 W.L.R. 372 (Eng. H.L.) (nullifying *ultra vires* swap agreement). For a thorough analysis of the issue of *ultra vires* trades, municipalities, and derivatives regulation, see Alexander E. Kolar, Note, *Hammersmith Meets Orange County: "Wishing Upon A Star" With Taxpayer Money in the Municipal Bond Derivative Market*, parts II & III, 49 WASH. U. J. URB. & CONTEMP. L. 315, 319-32 (1996).

69. Only 12 states permit state-run investment pools to invest in derivatives (Arizona, Connecticut, Florida, Idaho, Kansas, Massachusetts, New Hampshire, Oregon, Texas, Utah, Washington, and West Virginia). Sharon R. King, *Most State Pools Avoid the Pitfalls Of Orange County*, BOND BUYER, Dec. 22, 1994, at 1.

70. *See supra* note 53 (discussing hedging).

71. For a discussion of the merits of modern portfolio theory and its limitations, see BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 185-236 (4th ed. 1985). For analysis of the suitability doctrine in light of modern portfolio theory, see Stuart D. Root, *Suitability—The Sophisticated Investor—And Modern Portfolio Management*, 1991 COLUM. BUS. L. REV. 287, 347-54 (1991).

72. *See* MALKIEL, *supra* note 71, at 196. This occurs because individual investments in a well-diversified portfolio have a negative co-variance: that is, when some investments decrease in value, others can be expected to increase. Yet at the same time, the risk

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volatile investments spread the risks in different market sectors, they tend to balance each other out and provide returns higher than those achievable through risk-free investments.[73] Furthermore, certain risky investments may operate in an otherwise conservative portfolio to provide an optimal degree of expected risk and return. For a large institutional investor, derivatives may be well-suited to diversify a portfolio. This may be especially true for municipal investors where the bulk of investments in a portfolio depend entirely on high interest rates for success.[74] To the extent that derivatives may efficiently aid municipalities in this endeavor, prohibition of their use, even as a risk-enhancement device, should not be categorical.[75]

Moreover, derivatives allow municipalities to reduce unwanted risks through the process of hedging.[76] This may be a significant benefit to municipalities who face regional economic fluctuations in tax revenue and whose debt financing often requires fixed payments to municipal bondholders.[77] Ultimately, the categorical prohibition of derivatives use will begin to erode as derivatives become more common and their characteristics and usefulness are better understood.

V. THE SUITABILITY DOCTRINE IN FEDERAL REGULATION

Although the states and localities are the primary regulators of municipal investing,[78] the federal government has traditionally been

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dividend (the payoff required to lure investors away from risk-free investments) remains constantly above that of risk-free investments. *Id.*

73. *Id.* at 204-05.

74. Municipalities invest heavily in U.S. Treasury bills and corporate bonds, both of which rely entirely on the prevailing interest rates. *See* MOAK & HILLHOUSE, *supra* note 43, at 203-06.

75. If other risks involved with derivatives cannot be controlled effectively, then the risks may outweigh the costs, thus making legal-list prohibitions of derivatives the only rational choice for state policymakers. Such risks include mistakes due to information failures and sales of derivatives unsuited to investors' needs, due either to lack of inquiry or lack of knowledge.

76. See *supra* note 21 for an example of hedging.

77. *See* Randy Hamilton, *The World Turned Upside Down: The Contemporary Revolution in State and Local Government Capital Financing, in* CRISIS AND CONSTRAINT IN MUNICIPAL FINANCE, 200, 200-20 (James H. Carr ed., 1984) (discussing ways to incorporate derivatives into municipal bond issues to avoid fixed-rate obligations).

78. *See supra* part IV (discussing state and local regulation of municipal investing).

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deeply involved in the regulation of the nation's financial markets.[79] The suitability doctrine offers a model for the regulation of derivatives use by municipalities.[80] The history and application of the doctrine are relevant to the regulation of the investment process taking place in municipalities.

Federal agencies recently have expressed both concern for the fiscal viability of municipalities, and interest in protecting them from investing their way into economic catastrophe.[81] Federal laws that regulate the conduct of securities brokers[82] provide a model for reaching this goal. In addition, state and federal regulation systems can function harmoniously without being redundant or conflicting.[83] Given the variety of

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79. For a brief history of the federal regulation of securities markets, see Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329 (1988).

80. In his article on the professional responsibilities of broker-dealers, Robert Mundheim provides the following useful explanation of the suitability doctrine:

> A suitability doctrine imposes a responsibility on the broker-dealer to take the risk threshold of his customers into account when he recommends or sells securities to them.
>
> In a broad outline the suitability doctrine, as it develops, should require . . .
>
> 1. When a broker-dealer makes a recommendation to a customer, he must recommend only those securities which he reasonably believes are suitable for the customer—or, to put it another way, he may not recommend any securities which he knows or should know would be unsuitable for that customer.
>
> 2. Even when the broker-dealer makes no recommendation he still has a responsibility to determine, on the basis of information which he has or should have, that the risk aspects of the contemplated investment are within the risk threshold of the customer who is purchasing the security.

Robert H. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 449 (1965).

81. In October, 1993 the CFTC solicited comments on a proposal to exclude municipalities from investing in swaps transactions. The proposal was "in part motivated by the serious concern that [the CFTC had] about whether swaps transactions are being marketed to unsophisticated entities. Even though they are institutions, a lot of less sophisticated municipalities and others are suffering from very severe losses in that market." *'Aggressive Enforcement,' Vows CFTC's New Chief*, NAT'L L.J., Nov. 7, 1994, at B1, B2 (*quoting* Mary Schapiro, Chair, CFTC) [hereinafter Schapiro Interview].

82. The Securities Exchange Act of 1934 defines the term "broker" as "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." 15 U.S.C. § 78c(a)(4) (1994).

83. For example, federal fraud charges against a broker operate independently of state laws governing the permissibility of the fraudulent transaction.

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uses to which derivatives can be put,[84] regulation that concentrates on equitable dealing between brokers and municipal investors might better address the shortcomings of municipal derivatives use than does a system of legal lists.[85]

The federal government, whether acting through legislation or through comprehensive administrative rulemaking, should reform and clarify the scope of the "suitability" doctrine, making it equally applicable to all types of derivative financial instruments. Moreover, the federal government should explicitly permit municipalities to bring private causes of action, if brokers give them recommendations unsuited to their objective financial needs and circumstances.[86]

A. *The Suitability Doctrine: Development and Limitations*

The federal government has the means to deter the sale of unsuitable derivatives to municipalities without impeding the sale of those that are beneficial. The legal framework of the suitability doctrine provides a ready structure within which the government can achieve this goal. The Securities and Exchange Act of 1934 (SEA)[87] requires securities associations to promulgate ethical self-regulatory guidelines as a condition of registration with the SEC.[88] The suitability doctrine developed as a series of disciplinary measures contained in the ethical rules of the National Association of Securities Dealers (NASD),[89] the

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84. *See supra* note 21 (describing hedging with derivatives); *see also supra* note 36 (describing speculating with derivatives).

85. *See supra* note 65 (defining the legal-list concept); *see also supra* note 66 (California's legal-list statute).

86. *See infra* part V.A. (discussing the suitability doctrine).

87. Securities Exchange Act of 1934, 15 U.S.C. § 78(a)-(*ll*) (1994).

88. The SEA of 1934 requires, as a condition of registration, that securities associations promulgate rules, approved by the SEC, that "are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . and, in general, to protect investors and the public interest." 15 U.S.C. § 78o-3(b)(6) (1994).

89. The NASD Rules of Fair Practice, Article III—"Business Conduct of Members," § 2(a), provides:

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is ***suitable*** for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

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New York Stock Exchange (NYSE),[90] and the American Exchange (AMEX).[91]

Notably, the self-regulatory guidelines did not provide the disgruntled investor with a private cause of action against his broker.[92] However, the SEC enacted Rule 10b-5[93] which, in part, embodies the suitability requirements of the disciplinary rules.[94] Rule 10b-5 has been

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NASD SECURITIES DEALERS MANUAL (CCH) ¶ 2152, at 2041 (1990) (emphasis added).

The SEC interprets this rule as imposing an affirmative duty on the broker or dealer to "attempt to obtain information concerning the customer's other security holdings, his financial situation, and his needs so as to be in a position to judge the *suitability* of the recommendation." *In re* Greenberg, 40 S.E.C. 133, 138 (1960) (affirming the expulsion of a securities dealer from the NASD for, *inter alia*, recommending securities to customers without first ascertaining whether the securities were suitable for the customers) (emphasis added).

90. The Board of Directors of the New York Stock Exchange regulates the operations of its individual members. Rule 405, governing the conduct of accounts, provides: "Every member organization is required . . . to use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account . . . ." 2 N.Y.S.E. Guide (CCH) ¶ 2405, at 3696 (1984).

91. "Every member, member firm or member corporation shall use due diligence to learn the essential facts relative to every customer and to every order or account accepted." CONSTITUTION AND RULES, 2 Am. Stock Ex. Guide (CCH) ¶ 9431 (1993).

92. *See, e.g.*, Hoxworth v. Blinder, Robinson & Co., 903 F.2d 186, 200 (3d Cir. 1990) (holding that NASD suitability rule grants no private right of action); Jablon v. Dean Witter & Co., 614 F.2d 677, 681 (9th Cir. 1980) (holding that self-regulatory ethics rules grant no private right of action). *See also* Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 181-82 (2d Cir. 1966) (reviewing congressional intent). *But see* Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. 1021, 1041 (S.D.N.Y. 1977) (finding that NYSE and NASD rules are "sufficiently precise to sustain a cause of action"), *aff'd*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978).

93. Rule 10b-5 provides as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Manipulative and Deceptive Devices and Contrivances, 17 C.F.R. § 240.10b-5 (1995).

94. *Rolf*, 424 F. Supp. at 1041.

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interpreted to grant a private right of action.[95] Under Rule 10b-5, an investor must prove scienter to sustain a suit.[96] In contrast to Rule 10b-5, the proposed Derivatives Suitability Test,[97] by excluding the scienter requirement, arguably sets a strict liability standard.

Courts also enforce the suitability doctrine in actions for common law fraud under state laws.[98] When a broker knowingly recommends an investment that is unsuitable for a client, the act is tantamount to fraud.[99] Furthermore, if recommendations are solicited, the suitability doctrine imposes an affirmative duty on the part of a broker to know enough about the client to make suitable recommendations of securities.[100]

The suitability doctrine is founded on the legitimate notion that buyers of securities have less access to information and less market sophistication than their brokers do.[101] Further, the doctrine enforces a broker's fiduciary duty and counterbalances the inherent conflict of

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95. *See, e.g.*, Village of Arlington Heights Police Pension Fund v. Poder, 700 F: Supp. 405, 407 (N.D. Ill. 1988) ("Unsuitable trading clearly has been established as a basis for 10-b5 liability."). *See also* Keller & Gehlmann, *supra* note 79, at 344-45 ("In adopting the federal securities laws, Congress recognized that private actions for damages could play an important role in assuring compliance.").

96. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (holding that 10b-5 actions require "intent to deceive, manipulate, or defraud" a client). *See also* Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46 (2d Cir.) (finding that recklessness can satisfy the scienter requirement), *cert. denied*, 439 U.S. 1039 (1978).

97. *See infra* part V.C.

98. *See, e.g.*, Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 720-22 (Cal. Ct. App. 1968). In *Twomey*, the court equated a breach of the suitability doctrine with fraud and breach of fiduciary duty, and admonished that "[g]ood ethics should not be ignored by the law. It would be inconsistent to suggest that a person should be defrocked as a member of his calling, and yet not be liable for the injury which resulted from his acts or omissions." *Id.* at 721-22.

99. "Unsuitability" rises to the level of fraud if a plaintiff can prove:

> (1) that the securities purchased were unsuited to the buyer's needs; (2) that the defendant knew or reasonably believed the securities were unsuited to the buyer's needs; (3) that the defendant recommended or purchased the unsuitable securities for the buyer anyway; (4) that, with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to the suitability of the securities; and (5) that the buyer justifiably relied to its detriment on the defendant's fraudulent conduct.

Brown v. E. F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993).

100. *See In re* Greenberg, 40 S.E.C. 133, 137-38 (1960).

101. *See infra* note 123 (discussing "boiler-room tactics").

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interest a broker has with regard to a client—the interest in making a sale.[102] The suitability doctrine articulates a duty of care that is adaptable to any broker-client relationship.[103] The doctrine imposes a risk of discipline (or of loss, in the case of a civil damages suit) on brokers who knowingly make deals inconsistent with the risk tolerance of their customers.[104]

Significant exceptions to the suitability doctrine serve to protect brokers from unwarranted exposure to liability. For example, if a broker notifies a client that a particular investment is unsuitable for the client, the broker is deemed to have properly fulfilled the fiduciary duty owed to the client.[105] Further, if a client directs a trade, without seeking any type of recommendation from the broker, the client has no cause of action against the broker.[106]

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102. Unsuitability is distinct from, but related to, churning. Churning entails excessive trading designed to advance the broker's interest in commissions in derogation of the investor's financial interests. While churning relates to the "quantity" of trades, unsuitability refers to the "quality" of the trades and implies that the trades were inappropriate for the investment objectives. Nevertheless, they are often committed together. Tiernan v. Blyth, Eastman, Dillon & Co., 719 F.2d 1, 5 (1st Cir. 1983).

103. The duty follows the contours of standard negligence doctrine: "[I]f the probability be called P; the injury, L; and the burden, B; liability depends upon whether B is less than L multiplied by P: i.e., whether B < PL." United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947). *See* HARVEY E. BINES, THE LAW OF INVESTMENT MANAGEMENT ¶ 4.03(1)(a)(ii) (1978). Further, the scope of the fiduciary relationship, and thus the nature of the duties required of a broker, depends on a number of factors:

> [T]here is in all cases a fiduciary duty owed by a stockbroker to his or her customers; the *scope* of this duty depends on the specific facts and circumstances presented in a given case. These include the relative sophistication and experience of the customer; the customer's ability to evaluate the broker's recommendations and exercise an independent judgment thereon; the nature of the account, whether discretionary or non-discretionary; and the actual financial situation and needs of the customer.

Duffy v. Cavalier, 264 Cal. Rptr. 740, 753 n.10 (Cal. Ct. App. 1989).

104. Suitability is evaluated at the time of a recommendation, not in light of subsequent events. Proposal to Adopt Rules Under Section 15(b)(10) of the Exchange Act, Exchange Act Release No. 7984 [1996-1967 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,412, at 82,770 (Oct. 25, 1966).

105. *See* Mundheim, *supra* note 80, at 449.

106. *See* Powers v. Francis I. DuPont & Co., 344 F. Supp. 429, 433 (E.D. Pa. 1972) (noting that a contrary result would turn a broker into an insurer for the client who would "obviously be given an incentive to assume greater risks in the securities market, engaging in excessive activity far beyond his means"). The *Powers* court also suggested a possible exception in the case of a "compulsive investor" engaged in "irrational gambling." *Id.*

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In 1989, the SEC added a procedural embellishment to the suitability rule with Rule 15g-9 (the Penny Stock Rule).[107] Applicable to risky, over-the-counter securities, the Penny Stock Rule mandates that a broker provide in writing the basis for finding that a given stock is suitable for a particular investor.[108] This process accomplishes two important goals: First, it forces the transfer of information between buyer and seller; and secondly, it establishes clear accountability for the trade on the part of the buyer.[109] The Penny Stock Rule thus provides a model of one way the SEC can manage a category of investments that may be unsuitably risky for the large majority of investors.

Unlike the SEC, which requires rules for all registered broker associations, the Commodities Futures Trading Commission (CFTC) has not implemented a suitability requirement for commodities dealers.[110] Though the CFTC enforces the Commodities Exchange Act's (CEA) antifraud provision, this statute does not include a suitability requirement.[111] Neither the CFTC[112] nor the courts[113] have been willing

107. Penny Stock Rule, 17 C.F.R. § 240.15g-9 (1989).

108. The "suitability" procedure, as summarized in the Penny Stock Rule, requires "broker-dealers who recommend purchases of certain low-priced, non-NASDAQ over-the-counter securities to persons who are not established customers . . . to make a documented suitability determination regarding the purchaser, and to obtain the purchaser's written agreement to the first three purchases of these securities." Sales Practice Requirements for Certain Low-Priced Securities, Security Exchange Act Release No. 34-27160, 44 S.E.C. Dock. (CCH) at 600 (Aug. 22, 1989).

109. Comparably, if a broker fails to comply with the Penny Stock procedures, or makes an inadequate determination of suitability given the facts, the broker's own accountability for the loss is equally straightforward. *Id.*

110. The Federal Reserve Board has issued "appropriateness" guidelines, but they are explicitly not intended for the protection of investors. Rather, the purpose is to preserve the solvency of banking institutions by assuring that the investors with whom they contract are likely to remain solvent. *See* OCC News Release, *supra* note 3 (announcing and describing regulations).

111. *See* Commodity Exchange Act, 7 U.S.C. § 6b (1995) (antifraud provision).

112. *See* Welzant v. Merrill Lynch Futures, Inc., CFTC Docket No. 92-R030, (C.F.T.C. Jan. 12, 1993) ("[T]his Commission has explicitly rejected any suitability rule for this industry.") (citing Phacelli v. ContiCommodity Servs., Inc., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,250, at 32,674 (1986)) (CFTC refusing to imply a suitability standard from text of CEA antifraud provision, in a case where plaintiff was impoverished, partially deaf, functionally illiterate, and clearly did not understand the nature of commodity trades his broker recommended and purchased with his life savings).

113. Puckett v. Rufenacht, Bromagen & Hertz, Inc., 903 F.2d 1014, 1020 (5th Cir. 1990) (refusing to imply suitability standard from text of CEA antifraud provision).

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to imply such a requirement from the statute. Because derivatives regulation presently transcends the boundaries of the SEC and the CFTC,[114] it remains to be seen whether the future regulation of derivatives, under an emerging new regulatory structure, will embrace the suitability doctrine.[115]

B. *Application of the Suitability Doctrine to Municipalities: The Problem of the Sophisticated Investor*

Municipalities present special regulatory problems. In addition to federalism principles which define the role of the federal government,[116] there remains the question of the municipality's status as a naive or sophisticated investor. Despite the large sums of money involved, many municipal investment decisions are overseen by relatively inexperienced officials.[117] Currently, a broker's responsibility to an investor may vary with the degree of the investor's knowledge.

The applicability of the suitability doctrine in cases involving large and sophisticated investors is an unsettled area of law.[118] Some courts

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114. *See supra* note 3 (regarding the cross-agency apportioning of roles in the regulation of the derivatives market).

115. Indeed, it remains an open question whether existing securities antifraud provisions will be interpreted to apply to derivatives transactions:

> The continuing evolution of new derivatives will provide further questions about what derivatives fall within the federal securities laws' definition of a security. Similarly, if derivatives are purchased by new classes of investors, issues such as suitability may gain added importance. Because these principles have been developed in cases which involved securities different in some respects from derivatives, their exact application to derivatives will await further development of the law.

Joseph I. Goldstein et al., *Application of the Antifraud Provisions of the Federal Securities Laws to the Sale of Derivatives, in* MANAGEMENT AND AVOIDANCE OF DERIVATIVES LITIGATION 243, 252 (PLI Corp. Law & Practice Course Handbook Series No. B-893, 1995).

116. *See supra* note 64.

117. *See supra* part III.A.

118. As a threshold issue, there is debate about whether large investors—corporations, institutions, and government entities—should be considered sophisticated per se. *See generally Government Securities Reform: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 102d Cong., 1st Sess. 7 (1991) (statement of Mario J. Palumbo, Attorney General of West Virginia) ("A State is not a [sic] necessarily a sophisticated investor. In fact, most public entities can't afford the best securities professionals and probably rely more on the dealers for investment advice.").

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have claimed that an investor's sophistication does not affect the suitability requirement for a broker.[119] Other courts have held that sophisticated investors have no action for unsuitability claims; typically in these cases, the courts decline to recognize a fiduciary relationship.[120] Still other courts view sophistication as one of many factors in determining the presence of a fiduciary relationship or the broker's obligations under it.[121] Furthermore, the SEC has recognized the need for suitability rules even for sophisticated investors. In a recent proposed rulemaking under the Investment Advisors Act, the SEC suggested that suitability rules should be applied to sales involving sophisticated investors.[122]

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119. *See* Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969) ("The fact that . . . customers may be sophisticated and knowledgeable does not warrant a less stringent standard.") (citing Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989, 992 (5th Cir. 1969) (holding that one bank could maintain an unsuitability action against another). *See also* Scherk v. Alberto-Culver Co., 417 U.S. 506, 526 (1974) (Douglas, J., dissenting) ("The Act does not speak in terms of 'sophisticated' as opposed to 'unsophisticated' people dealing in securities. The rules when the giants play are the same as when the pygmies enter the market.").

120. *See* Platsis v. E.F. Hutton & Co., 642 F. Supp. 1277 (W.D. Mich. 1986) (denying presence of fiduciary duty due to plaintiff's sophistication and active participation), *aff'd*, 829 F.2d 13 (6th Cir. 1987), *cert. denied*, 485 U.S. 962 (1988); Leboce, S.A. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 709 F.2d 605 (9th Cir. 1983) (denying claim for unsuitable trade based on theory of breach of fiduciary duty and citing the sophistication of plaintiff in the transaction). *Contra* Duffy v. Cavalier, 215 Cal. App. 3d 1517, 1536 (Cal. Ct. App. 1989) (criticizing *Leboce* as a misapplication of California common law of fiduciary duty).

121. *See Duffy*, 215 Cal. App. at 1536 n.10 (noting that scope of fiduciary duty owed depends on a number of factors, including degree of sophistication of client). *See also* Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 954-55 (E.D. Mich. 1978) (listing "age, education, intelligence," investment experience, naivete, degree of personal involvement between parties, number of investments made without prior approval, and degree of investor's interest in account as factors involved in determining locus of control in a churning case), *aff'd*, 647 F.2d 165 (6th Cir. 1981).

122. The proposed rule under the Investment Advisors Act provides as follows:

> The prohibition against providing unsuitable advice would apply to advice to institutional clients as well as to individual clients. Institutional investors have experienced significant losses as a result of recommendations to invest in complex financial products that they did not fully understand. The rationale underlying the duty to make suitable recommendations, although developed largely in the context of investors who are not deemed to be "sophisticated," applies also to those who are ordinarily considered to be "sophisticated."

Suitability of Investment Advice Provided by Investment Advisers, 59 Fed. Reg. 13,464, 13,466 n.11 (1994) (to be codified at 17 C.F.R. § 275) (proposed Mar. 22, 1994) (citations

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Applying the suitability doctrine to a large financial entity like a municipality makes clear the two fundamentally different purposes the ethical rules mandated by the SEA fulfill. First, the SEA seeks to protect naive investors from unscrupulous or merely negligent brokers.[123] Second, the rules protect all investors and the reliability of the financial exchanges in general, both by imposing a minimum duty upon brokers and by eliminating unfair practices such as insider trading and price manipulation.[124] As recent losses from municipalities make clear, exempting brokers from their duties when dealing with large entities because the entities are assumed to be "sophisticated," fails the second purpose of the ethical rules.[125] As a matter of public policy, at least the same level of vigilance should be applicable to the municipal purchase of derivatives as to sophisticated institutional investors.

Municipalities may have vast amounts of funds to invest and their funds may be managed by financial officers who are experienced accountants or financial planners.[126] These officers, however, may also rely to a large extent on the representations of their brokers.[127] In the complex financial world of derivatives, it is likely that brokers will have a significant amount of influence over the purchasers of derivatives.[128]

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omitted).

123. The suitability rules of the NASD were crafted as a direct response to "boiler-room" tactics: high-pressure telephone sales pitches that promised returns on investments too good to be true. *See* United States v. Ross, 321 F.2d 61, 64 (2d Cir.), *cert. denied*, 375 U.S. 894 (1963).

124. Andrews v. Blue, 489 F.2d 367, 373 (10th Cir. 1973) ("[SEA] is intended to promote full disclosure to every investor regardless of his particular business background."); SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226, 1228 (S.D.N.Y. 1976) (stating that Rule 10b-5 was intended to "insure that even the most sophisticated investor is not duped simply because he is not privy to information made available only to a favored few").

125. "[T]he problems which were once thought to concern only the 'unsophisticated' market clearly prevail with institutional investors as well. They are capable of being sold unsuitable investments given the variety and complexity of new securities and investment strategies." Root, *supra* note 71, at 307-08. Indeed, the degree of systemic risk to the financial world would be far greater with the collapse of a large corporation, bank, or municipality than with the bankruptcy of an individual investor.

126. *But see* MOAK & HILLHOUSE, *supra* note 43, at 406 (noting the scarcity of financial officers with adequate professional training).

127. *Id.* at 206 ("[T]he degree of expertise required for successful investment . . . is likely to be much greater than that possessed by, or available to, the average local government [officer].").

128. *See supra* notes 122 and 125.

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Financial officers may understand the nature of derivatives, but it is less likely that they appreciate the nuances as well as experts in the trade.[129]

Brokers should be held accountable for selling unsuitable derivatives to municipalities.[130] Requiring reasonable accountability, following the Penny Stock procedure,[131] would supply brokers with a strong incentive

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129. *See* Laura Jereski, *Merrill Lynch Saw Big Profit on Orange Fund*, WALL ST. J., Jan. 26, 1995, at A4. For example, Orange County lost substantial amounts of money on a series of eight structured notes (mortgage derivatives). These investments gave returns according to a complex formula based on the difference between a fixed rate and a short-term floating rate, altered by a series of timed changes in the first (fixed) rate, with a multiplier attached to the second rate. According to the former treasurer, Robert Citron, the county found it difficult to simply determine the value of the notes without the aid of its broker. *Id.*

Similarly, though fraud is not typical in derivatives transactions, the following excerpt from a taped conversation shows the ease with which a derivatives dealer misled a purchaser as to the extent of losses incurred: "I mean we told him $8.1 million when the real number was 14. So now if the real number is 16, we'll tell him that it is 11. You know, just slowly chip away at that differential between what it really is and what we're telling him." Complaint, *In re* BT Sec. Corp., CFTC Docket No. 95-3, 1994 WL 711224 at *2 (C.F.T.C. Dec. 22, 1994).

130. One of Orange County's allegations in its case pending against Merrill Lynch seeks affirmation of this notion under existing law:

> As an expert in municipal finance, Merrill Lynch knew that the investment scheme which it permitted and encouraged Citron to implement was wholly inappropriate and unsuitable for the County for, among others, the following reasons:
> (a) Given their complexity, the investment transactions pursued by Citron were not capable of being monitored without access to sophisticated proprietary computer models and software which Merrill Lynch and other prominent brokerage firms possessed, but which Merrill Lynch knew the County did not have access to;
> (b) Given their complexity and specialized nature, no ready and efficient market (that is, where a small spread between bid and asking prices routinely exist) existed for the instruments in which Citron invested since they were, due to their complexity, only sold in negotiated transactions;
> (c) These leveraged transactions exposed the County to enormous and unacceptable levels of risk and jeopardized principal; and
> (d) The investment program developed by Merrill Lynch did not conform to the County's need for liquidity and thus jeopardized the County's ability to provide essential services to its citizens.

Complaint, County of Orange v. Merrill Lynch & Co., at ¶ 30, *in Denis M. Forster, Derivative Litigation: An Overview—Liability Theories and Tactical Considerations, in* MANAGEMENT AND AVOIDANCE OF DERIVATIVES LITIGATION, at 427, 513 (PLI Corp. Law & Practice Course Handbook Series No. B-893, 1995). Under present law, the legitimacy of this complaint is unresolved.

131. *See supra* text accompanying notes 107-09.

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to take actions commensurate with the high standards of their profession and the duties implicit in a fiduciary relationship. Prior to recommending the sale of derivatives to a municipality, a broker should be fully informed about the risk tolerance of the municipality and the risk characteristics of the product.[132] Thus, the broker must inquire into the municipality's investment portfolio and liquidity needs.[133] Because the basis for making a suitable recommendation entails the municipality's objective needs and not the investment philosophy of its investment officer, such inquiry would help to expose conflicts of interest between a municipality and its investment officer.[134]

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132. A broker will almost certainly be able to determine the suitability of a particular derivative for a municipality at lower cost than could the municipality itself. Such an inquiry is essential when investing in derivatives; thus, it may be socially efficient to mandate that brokers perform this function. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 111-13 (4th ed. 1992) (discussing situations in which information disclosures may be mandated without causing a net efficiency loss to society). The separate question of broker liability for failure, negligence, or fraud with regard to this inquiry involves distinct economic considerations.

133. *See* Root, *supra* note 71, at 356-57 (presenting model letter to broker identifying nature of investing institution, liquidity needs, and tolerance for hedging devices). Other legal doctrines may likewise serve the purpose of ensuring that purchasers get what they want. For example, because many purchasers invest in derivatives in order to hedge against market risks to which they are exposed, the Uniform Commercial Code's Warranty of Fitness for a Particular Purpose may provide a useful guide for fashioning an appropriate standard of broker obligation in the specific context of requests for recommendations for derivatives to hedge against a known risk exposure. The Warranty of Fitness for a Particular Purpose provides as follows:

> Where the seller at the time of contracting has reason to know any particular purpose for which the goods are required and that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods, there is unless excluded or modified under the next section an implied warranty that the goods shall be fit for such purpose.

U.C.C. § 2-315 (1992). When a buyer requests a derivative in order to hedge against specific risks, a broker should be able to warrant that a recommended derivative is suitable for that particular purpose. Moreover, this requirement would create a sharp distinction between derivatives purchased as hedges and those purchased for speculation. Such a distinction would be very useful for effective state and local oversight of municipal derivatives purchases.

134. *See supra* notes 46-50 and accompanying text (discussing a potential conflict of interest between a financial officer's interest and the objective interest of a municipality's portfolio). To accomplish this purpose, an actual portfolio or other independent proof of tolerances should be sent to a broker.

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C. *Proposal*

The regulatory agency(s) responsible for derivatives oversight should promulgate a rule incorporating the following principles:

DERIVATIVES SUITABILITY TEST (DST)

Before a broker recommends a derivative investment to a municipality, that broker shall:

1. Approve the buyer as a suitable derivatives candidate by reference to an adequately detailed and current financial statement supplied by the buyer. This process should occur once per fiscal quarter. The broker should encourage the municipality to resubmit an updated financial statement whenever the municipality makes significant changes in asset allocation. For confirmation of exceptional trades, the broker should obtain the name of a pre-designated second agent who is an elected municipal official not working as a finance official;
2. Provide to the buyer, in writing, all recommendations made for trading in derivatives, including a description of why each particular derivative recommended is suitable for the buyer.
3. If a broker determines that a buyer is an unsuitable candidate for derivatives and informs the buyer of such in writing, the broker may sell derivatives to the buyer but must first follow PLAN B.
4. If a broker determines that a buyer is a suitable candidate for derivatives but the buyer requests recommendations for an unsuitable character of derivative for the buyer's portfolio, and the broker informs the buyer of such in writing, the broker may sell these derivatives to the buyer but must first follow PLAN B.
5. Violation of these rules may be cause for disciplinary action and, if the violation results in harm, legal action.

PLAN B. No sales to unsuitable derivatives candidates or sales of unsuitable derivatives may take place before the broker has received approval or denial from a pre-designated second agent.

D. *Discussion*

The proposed rule adopts a suitability standard that is familiar to the Self-Regulating Organizations (SROs),[135] the SEC, and the courts.[136]

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135. AMEX, NYSE and NASD are all self-regulating organizations.

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Unlike the original suitability rules, the DST incorporates a fixed procedure.[137] Breach of the rule may result in disciplinary action by the appropriate SRO, the SEC, or other appropriate oversight agency, and may constitute a private right of action at law.[138] Failure to follow the rule would create a presumption of unsuitability.[139] Alternatively, properly following the established procedure would lead to a presumption of suitability.[140]

The DST's clearly defined procedure would provide brokers with greater assurance that they are operating within the permissible parameters of the law. Unlike the DST and the Penny Stock rule, the traditional suitability doctrine often creates an ambiguous duty that diffuses a sense of accountability between the two parties. This lack of clear accountability may discourage vigilant oversight on both sides of the transaction.

It is unclear from the text of the DST whether a broker is liable if that broker determines unsuitability, contacts a second agent, receives a denial of approval, and yet makes a sale anyway.[141] This is a purposeful ambiguity. To the extent that fear of liability may be used to deter dangerous behavior, both parties should fear liability in this circumstance. Any pre-determined resolution of this state of affairs might

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136. See *supra* notes 87-100 and accompanying text for a discussion of the suitability rule and its use by the SROs, the SEC, and the courts.

137. In this regard, the DST is similar to the Penny Stock Rule as promulgated by the SEC in 1989. *See supra* notes 107-09 and accompanying text.

138. This is a departure from the traditional suitability rule, which presently has quasi-legal force through Rule 10b-5 and in common law actions for fraud, breach of fiduciary duty, and breach of contract, but not as an independent cause of action outside the disciplinary realm. *See supra* notes 93-97 and accompanying text (discussing suitability and private rights of action). A private right of action is necessary in light of the significant difficulties involved with regulating this large and complex area of finance. The Chair of the CFTC recently discussed the limitations of her agency with regard to overseeing derivatives transactions: "This is a highly technical and complex area of financial regulation. We also need, therefore, to be able to hire very, very highly skilled people. And we have the lowest pay of any financial regulator in the federal government." Schapiro Interview, *supra* note 81, at B2.

139. The broker could rebut this presumption by demonstrating that the municipality actually was a suitable derivatives buyer; that the broker actually sold suitable derivatives; or that the pre-designated second agent granted the requisite permission. *See* DST Plan B, *supra* part V.C.

140. A party could rebut the presumption of suitability by showing that the broker improperly evaluated the portfolio, or that the broker failed to evaluate, or improperly evaluated the derivative.

141. *See* DST Plan B, *supra* part V.C.

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create an incentive for one party to deny responsibility for reckless acts and then hold the other party accountable. This also gives municipalities an incentive to resolve issues about derivatives investing in advance of a sale and promotes inquiry into the political repercussions of alternatives.

VI. FUTURE ACCESS TO DERIVATIVES

There are two economic arguments against applying strong suitability rules to municipal investors. First, any proposal that would shift the risk of investment loss onto a broker would tend to increase the cost of brokerage services. Second, any proposal that might encourage litigation would increase the costs, or decrease the availability of derivatives. In either case, the argument goes, the result would be a decrease in appropriate municipal use of derivatives.[142]

The argument that the threat of liability would discourage municipal use of derivatives may be illusory. Municipalities may already be reluctant to enter the derivatives market in the face of potential catastrophic loss, while brokers may be wary of taking unknown risks. Under the present state of the law, the private liability of brokers for making unsuitable derivatives recommendations to municipalities is an open question.[143] Furthermore, municipalities have no meaningful way of knowing that the information they receive regarding derivatives is complete or even adequate to inform them of potential risks.[144] Clear accountability, centered on the conveyance of information about risks, would improve the confidence of municipalities investing in derivatives. Healthy trade practices, reinforced by a strong suitability rule, should make the market more attractive to prospective municipal investors.

By clarifying the scope of the suitability rule and spelling out the contours of liability, brokers can avoid lawsuits brought by municipalities

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142. "[P]lacing additional responsibilities on the dealer community—may entail considerable indirect costs to the economy .... If... legal risks are exacerbated dealers are likely to charge an additional premium ...." *Derivative Financial Instruments Relating to Banks and Financial Institutions: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 53 (1995) (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System).

143. *See* City of San Jose v. Paine, Webber, Jackson & Curtis, Inc., 1991 WL 352485 (N.D. Cal. 1991) (denying defendant's motion for J.N.O.V. and conceding that actual legal basis for judgment under an unsuitability claim was "not clear").

144. *See supra* note 129.

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alleging unsuitability. The legal unsuitability rule that currently deters broker activity does not contain clear, process-based rules that define liability.[145] By promulgating such rules, information would be more readily disbursed between parties. In addition, brokers would know that their actions were legal and proper.

An effective suitability rule for derivatives would have a further benefit. State intervention to prohibit or severely curtail the sale of derivatives to municipalities is a very real prospect.[146] This response by the states would curb the evolution of the process of hedging risks and could substantially decrease the market for derivatives.[147]

VII. CONCLUSION

Derivatives are an extremely valuable form of financial technology. Yet because of their complex nature, they are susceptible to misuse, potentially causing great harm. Present regulations are inadequate to ensure that risks are understood and minimized. This is especially true for municipal investors, who are investing the funds that support their communities' basic services.

The federal government can effectively solve many of these problems in the specific case of municipal investors by instituting a suitability rule like the proposed Derivatives Suitability Test. Such a rule would increase the flow of information about risks and provide clear rules of accountability in the sale of derivatives.

Timely federal government intervention may help to prevent the next Orange County incident. Furthermore, it may prevent the need for potentially over-restrictive state intervention that would inhibit the evolution of this product in the service of municipal investing.

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145. *See supra* part V.A.

146. Less than one month after Orange County declared bankruptcy, the California State Legislature introduced a bill that would severely curb investments in derivatives. *See Reforms Sought By Legislature As Orange County Boosts Loss Estimate*, 64 Banking Rep. (BNA) (Jan. 2, 1995).

147. Academic-level mathematics research drives, in large part, the state-of-the-art derivatives analysis. In a field where one must purchase innovation, this research is extremely expensive, yet basically unpatentable. *See* Hu, *supra* note 40, at 1476-95 (discussing importance of capital-intensive research and development and the disincentive to invest sufficient capital to reach a full understanding of the nature of the product produced).

* J.D. 1996, Washington University.

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