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Judge rules against SEC, may be key to muni probe

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WASHINGTON, May 7 (Reuters) - A judge's ruling last week may make it tougher for regulators to police alleged wrongdoing in the municipal bond market linked to derivatives, an attorney involved in the case said on Monday.

The ruling comes at a time when federal regulators are in the midst of an unprecedented campaign to investigate alleged price fixing associated with derivatives and investments used to park muni proceeds.

Administrative Law Judge James Kelly on Thursday ruled against the U.S. Securities and Exchange Commission in its efforts to convict two former JPMorgan bankers of violating one of the rules in the muni market designed to stop "pay-to-play" practices.

Kelly's 50-page "initial decision" also cast doubt on the SEC's position that it has authority in some cases to regulate derivatives even when they are not directly linked to a muni bond issue.

Derivatives are considered contracts, not securities, so they fall mostly out of the jurisdiction of securities regulators.

"This decision reminds the SEC that its jurisdiction is limited to municipal securities," said Lisa Mathewson, a partner of Welsh & Recker that represents one of the bankers. "The ruling imposes a heavy burden on regulators to prove there is a municipal securities component in a deal in question."

SEC officials can appeal the ruling to the full commission. Whether it will was not immediately known.

"We don't comment on administrative law judge decisions," said SEC spokesman Kevin Callahan.

Derivatives are a fast-growing and lucrative part of the muni market for investment banks. The decision would have been much more significant had the judge sided with the SEC, Mathewson said.

"That would have been an enormous story," she said. "But what regulators are stuck with is a toolbox where none of the tools seem to fit."