



Municipal Securities Rulemaking Board

October 17, 2017

Rick A. Fleming  
Investor Advocate  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

**Re: Response to SEC Request Highlighting Municipal Market Practices**

Dear Mr. Fleming:

The Municipal Securities Rulemaking Board (MSRB) is submitting this letter in response to the Office of Investor Advocate’s request for the MSRB to identify products and practices within the municipal securities market that may have an adverse impact on retail investors. As the self-regulatory organization for the municipal securities market whose mission is to protect investors, municipal entities, and the public interest, the MSRB is committed to building on its strong regulatory foundation of investor protection, with a focus on improving price transparency and disclosure practices in the municipal securities market through our Electronic Municipal Market Access (EMMA<sup>®</sup>) website and additional means.

Like your office, the MSRB monitors trends, products and practices in the municipal market, with an eye for those that may present risk to retail investors. We applaud and support the work of the Securities and Exchange Commission on important topics such as senior investor protection and cybersecurity. As described below, the MSRB has identified three areas of concern on which we would specifically like to focus given their potential adverse effect on retail investors. They are: 1) Market practices; 2) Disclosure practices; and 3) Price fairness and transparency.

**Market Practices**

The MSRB is concerned about two practices that may negatively impact retail investors in municipal securities. First is the practice often referred to as “pennying,” or “last-look,” which may affect the prices received by a retail investor during a sale of bonds. A municipal securities dealer will often place a retail client’s “bid-wanted” out to the market and then compile the bids received to determine the winning bid. In pennyning, rather than execute the trade with the highest bidder, the dealer will instead nominally exceed the high bid to the client and buy the bonds for the dealer’s own trading account. The MSRB has previously raised the issue of pennyning in guidance in the context of Rule G-43, on broker’s brokers, and Rule G-17, the MSRB’s fundamental fair practice rule, where we caution against a dealer placing bid-wanted through broker’s brokers solely for the purpose of price discovery, only to purchase the

securities for their own account at a slightly higher price.<sup>1</sup> While a dealer's willingness to improve the highest bid, even nominally, is beneficial to the particular retail client in the short term, the MSRB is concerned that it can be harmful to investors over the long-term if the practice discourages broad market participation in the bidding process and renders the market less efficient. As the MSRB observed in the published guidance, a reduction in bidders can reduce the likelihood that the high bid in a bid-wanted will represent the fair market value of the securities.

The MSRB is also concerned with certain aspects of the practice of filtering (or screening), where a dealer may use automated tools available on an alternative trading system (ATS) to screen out bids and offers received from certain dealers, or, as addressed by Rule G-43(b)(i), where a selling dealer may direct a broker's broker to limit the audience for a bid-wanted. The MSRB recognizes that there are credit, legal, regulatory and other legitimate concerns that justify filtering of certain counterparties or bond characteristics. However, dealers should have policies and procedures in place to govern when and how to: reasonably use filters; periodically review any established filters; and consider lifting them upon request. In addition, they may only be used for a legitimate purpose consistent with obtaining the most favorable executions for retail customers. The MSRB has previously raised the issue of potentially anti-competitive filtering in implementation guidance on Rule G-18, on best execution,<sup>2</sup> and guidance on Rule G-43,<sup>3</sup> and we plan to continue to raise awareness of the topics of filtering and pennyng in the upcoming year as issues that may affect the prices received by retail investors.

Lastly, the MSRB continues to examine the risk to retail investors of holding a position of municipal securities in an amount below the minimum denomination set by the issuer. Below minimum denomination positions are relatively illiquid, and if the investor can liquidate his position, it is generally at a relatively less favorable price. High minimum denominations are primarily set by issuers to help prevent retail investors from holding bonds that the issuer considers to be unsuitable for retail investors. Our outreach to market participants and requests for comment have resulted in input that identifies allocations by investment advisers as a common cause of below-minimum denomination positions, but such positions also may

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<sup>1</sup> See MSRB Notice to Dealers that Use the Services of Broker's Brokers (Dec. 22, 2012) ("Broker's Brokers Notice"), available at <http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-43.aspx?tab=2>.

<sup>2</sup> See Implementation Guidance on MSRB Rule G-18, on Best Execution (Nov. 20, 2015), available at <http://www.msrb.org/~media/Files/MISC/Best-Ex-Implementation-Guidance.ashx>.

<sup>3</sup> See Broker's Brokers Notice, *supra*, note 1.

result from estate planning decisions or issuer-dictated call provisions.<sup>4</sup> While the MSRB has no jurisdiction to address the conduct of investment advisers and their allocation practices, Rule G-15(f) generally prohibits a dealer from effecting a customer transaction in a municipal security in an amount lower than the minimum denomination of the issue, with narrow exceptions and targeted disclosure requirements that are intended to provide liquidity for investors already holding minimum denomination positions.

### **Disclosure Practices**

Municipal market disclosure practices are a topic of ongoing concern for the MSRB. Over the past year, the MSRB continued to focus on improving and calling attention to disclosure practices in the municipal market. In September 2017 the MSRB published a market advisory on selective disclosure, in which issuers provide certain investors access to information that is not broadly available to other classes of investors or the public.<sup>5</sup> The goal of the advisory is to increase awareness of this issue in the municipal market, educate market participants on its potential negative impact and promote the development and use of best practices to avoid selective disclosure. The MSRB received considerable feedback from the market on this topic prior to and as a result of the market advisory, and we plan to continue raising awareness about this issue in the coming year.

With respect to bank loans undertaken by issuers of municipal securities, the MSRB continues to be concerned that retail investors may not have a full understanding of an issuer's debt profile when bank loan and other alternative financing information is not voluntarily disclosed through the EMMA website. Last year, we enhanced EMMA with features to facilitate the voluntary disclosure of bank loans and other alternative financings. While the number of bank loan disclosures has increased substantially from prior years, to date there are just over 1,100 bank loan documents on the EMMA website. Given estimations of the size of the bank loan market, we believe that this represents only a small fraction of bank loan transactions by municipal issuers. We encourage issuers to make bank loan information available to the investing public, and support the Commission's efforts to enhance disclosures with respect to

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<sup>4</sup> The SEC has recognized that below-minimum denomination positions can be created by investment advisers who allocate positions they purchase among several clients. *See* Exchange Act Release No. 45338, File No. SR-MSRB-2001-07 (Jan. 25, 2002), 67 FR 6960, 6960 n.4 (Feb. 14, 2002).

<sup>5</sup> [http://www.msrb.org/Market-Topics/~/\\_media/A270A4C8CB29490094D07431A59EBCA2.ashx](http://www.msrb.org/Market-Topics/~/_media/A270A4C8CB29490094D07431A59EBCA2.ashx)

bank loans and direct-purchase debt, information which is imperative for retail investors to make informed decisions when buying or selling municipal securities.<sup>6</sup>

### **Price Fairness and Transparency**

The MSRB believes that improving price transparency in the municipal market is essential to ensuring a fair market for retail investors. In 2016, the MSRB implemented a best-execution rule for transactions in the municipal market. The requirement aims to improve execution quality for retail investors by requiring dealers to use reasonable diligence to identify the best market for a security and to execute trades in that market to achieve the most favorable price possible under prevailing market conditions. Recent amendments to MSRB Rule G-15, effective in May 2018, require dealers to disclose additional information on retail customer confirmations for a specified class of principal transactions, including the dealer's mark-up or mark-down from the prevailing market price of the security. The rule changes also require dealers to disclose on all retail customer confirmations (regardless of whether mark-up or mark-down disclosure is required) the time of trade for the customer's transaction and a link to the EMMA website, where investors can view their trade and use the information on their confirmation to evaluate the quality of their price relative to other trades in the same security. In 2017, as a continuation of our efforts to improve price transparency and support regulated entities' compliance with MSRB rules, we published implementation guidance on mark-up disclosure that addressed questions posed from dealers, trade associations and vendors to assist dealers in coming into compliance with the new requirements. We are also planning an extensive education campaign for retail investors as we near the effective date to ensure a complete understanding of this new trade disclosure.

With regard to price transparency, the MSRB has also made several enhancements to the EMMA website that provide investors with daily snapshots of market-wide information. In July, the MSRB for the first time made available on EMMA a free municipal market yield curve and multiple indices to help investors better evaluate the level and direction of municipal bond interest rates, and provide the ability to compare relative yields of specific securities. This month we added Bloomberg's BVAL AAA municipal curve to EMMA, and the MSRB anticipates adding more yield curves in the coming year. We also recently added a new-issue calendar to EMMA, to assist retail investors in locating upcoming bond offerings that may be of interest. The new-issue calendar also provides final pricing information and yields for bond issues sold through competitive and negotiated sales, potentially valuable information for individual

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<sup>6</sup> <http://www.msrb.org/msrb1/pdfs/MSRB-Comment-Letter-SEC-Proposed-Amendments-15c212-April-2017.pdf>

investors and their advisors when considering buying or selling bonds trading in the secondary market.

The MSRB feels strongly that the ability of retail investors to access important market information and trade data is essential to a fair market. The MSRB also echoes the Commission's concern about the current lack of pre-trade price transparency in the municipal market. We are in the process of analyzing available data to determine what types of pricing data might be most helpful to retail investors without harming liquidity.

### **Conclusion**

The MSRB appreciates the opportunity to provide perspective on products and practices within the municipal securities market that may have an adverse impact on retail investors. We look forward to working with the Office of the Investor Advocate to take meaningful steps toward increasing awareness and addressing the areas mentioned above for the benefit of retail investors. If we can provide additional information, please do not hesitate to contact me.

Sincerely,

A handwritten signature in blue ink that reads "Lynnette Kelly". The signature is written in a cursive, flowing style.

Lynnette Kelly  
Executive Director