

October 19, 2018

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

Re: Response to Investor Advocate 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 could adversely impact retail investors. The MSRB is the self-regulatory organization that regulates the municipal securities firms, banks and municipal advisors that engage in municipal securities and advisory activities, and operates the Electronic Municipal Market Access (EMMA[®]) system, the official repository for disclosure and transaction information on municipal securities.

As of June 2018, direct retail holdings of municipal securities by households was \$1.625 trillion.¹ Given the sustained and extensive household ownership of municipal securities, the MSRB is committed to continuously build on its regulatory foundation of investor protection.² Like the U.S. Securities and Exchange Commission (SEC), the MSRB closely monitors trends, products and practices in the municipal market, with an eye for those that may present risk to retail investors. As described below, the MSRB is identifying for the Investor Advocate a number of market practices and risk areas based on their potential adverse effect on retail investors. Such risks can be broadly characterized as risks related to: 1) the macroeconomic environment; 2) municipal fiscal health; and 3) market practices.

The Macroeconomic Environment

The MSRB is concerned with potential risks to retail investors that may arise from the convergence of a rising interest rate environment and the potential for financial distress among some municipalities. With the rise in interest rates over the last several months, retail investors

¹ Federal Reserve Board Financial Accounts of the United States. September 20, 2018 (2018: Q2 Release). This category includes individual holdings of municipal bonds, as well as hedge fund holdings of municipal securities, which are not separated by the Federal Reserve Board in its calculations.

² For an overview of the MSRB's regulatory protections and resources for retail investors, please see this educational resource available at <http://www.msrb.org/~media/Files/Education/Regulation-Information-and-Resources.ashx?>

may want to consider reviewing their portfolios with their financial professionals to ensure that they continue to have the appropriate credit exposure and maturity range in their municipal bond holdings. Investors should keep in mind that all else being equal, the price of a bond with a longer maturity is typically subject to more volatility due to changes in interest rates than a bond with a shorter maturity. Investors with exposure to municipal bonds through mutual funds should also be aware that an increase in interest rates may cause a mutual fund's net asset value (NAV) to decline, impacting the overall value of investors' mutual fund holdings. The MSRB has published various educational materials for investors regarding the impact of interest rate movement on municipal bond prices and yields.

Municipal Fiscal Health

Another area of focus for the MSRB from an investor-risk perspective, is how and when retail investors learn of important developments within a municipality, including those that may indicate fiscal distress. The MSRB supports the decision by the SEC to amend SEC Rule 15c2-12 to include additional event notices that will result in issuers of municipal securities and obligated persons publicly disclosing additional information about bank loans and other financial obligations. The EMMA website is the official repository of primary market documents and continuing disclosures, including event disclosures that may signal distress. The MSRB is in the process of updating the EMMA disclosure submission process and public website to accept and display the new event disclosures upon the effective date of the changes to Rule 15c2-12. We anticipate that these changes will ensure a smooth technical implementation of the new disclosure requirements for issuers with the ultimate goal of providing additional useful information to investors and the market. The MSRB is also developing webinars and educational materials to support issuer understanding and compliance with the amended Rule.

The MSRB also is following structures being developed by state and local governments to better monitor municipal health, as well as the significant volume of academic and policy research evaluating existing monitoring systems, including the types of indicators that may serve as predictors of distress. The MSRB notes the Government Accounting Standards Board's (GASB) current review of "going concern" disclosures, and how guidance might be offered to preparers of government financial statements about the issuer's responsibility of evaluating and disclosing factors associated with financial distress.

Market Practices

The MSRB in April 2018 published a notice for dealers regarding their role in transactions in distressed municipality securities, and the investor protection rules applicable to dealers when effecting customer transactions in securities of distressed municipalities.³ We continue to be concerned that investors may seek yield by transacting in securities of distressed municipalities that may not fit well given their risk tolerance and investment objectives. MSRB Rule G-47

³ [MSRB Notice 2018-07, Notice Regarding Transactions in the Municipal Securities of Distressed Municipalities \(April 12, 2018\)](#).

requires dealers to disclose to their customers all material information known about a transaction, including material information on the security that is reasonably accessible to the market. This might include credit risks and changes to ratings, or whether the issuer has failed to make filings required under its continuing disclosure agreements. Dealers also should be conscious of their suitability obligations and are reminded that, depending on a customer's investment profile, it may not be suitable to recommend the purchase of the municipal securities of a distressed municipality in light of the potential risks of the investment.

As described in our 2017 letter to the Investor Advocate, the MSRB continues to be concerned with certain market practices that may negatively impact prices received by retail investors in municipal bonds. The practice of "pennying," sometimes also referred to as "last-look," occurs when a dealer purchases bonds for its own account, following the dissemination of a bid-wanted (through either an alternative trading system or a broker's broker) for a customer who is seeking to sell a municipal security. The dealer, after reviewing bid information received, either matches the high bid received in response to the bid-wanted or purchases the bonds at a price that is nominally higher than the high bid. The MSRB believes that widespread pennyning may be harmful to retail investors by disincentivizing participation of other dealers in the bid-wanted process. The MSRB is also concerned that pennyning may harm municipal market liquidity by discouraging quotations by market participants. The MSRB is currently seeking comment on this topic, and draft interpretive guidance, to further understand the prevalence of the practice and the potential harm it presents within the municipal market.⁴

An additional practice that the MSRB believes may result in harm to retail investors is certain prearranged trading in connection with primary offerings of municipal securities that is intended to circumvent the priority provisions for allocations of the issuance established by issuers and their underwriters. Examples of this type of prearranged trading are illustrated in several recent SEC enforcement matters.⁵ The MSRB believes this type of prearranged trading in connection with a primary offering may have a negative impact on the fairness and efficiency of the municipal securities market by, among other things, limiting the number of municipal bonds retail and other investors might access during the initial distribution period of an issuance and resulting in some investors paying more for those same bonds in the secondary market. The MSRB intends to continue to study the issue and current market practices in its current fiscal year.

⁴ [MSRB Notice 2018-22, Request for Comment on Draft Interpretive Guidance on Pennyning and Draft Amendments to Existing Guidance on Best Execution \(September 7, 2018\).](#)

⁵ See, e.g., <https://www.sec.gov/litigation/complaints/2018/comp-pr2018-153.pdf>; <https://www.sec.gov/litigation/complaints/2018/comp-pr2018-153-1.pdf>; <https://www.sec.gov/litigation/admin/2018/33-10529.pdf>; <https://www.sec.gov/litigation/admin/2018/34-83840.pdf>.

In recent years, the MSRB's Investor Advisory Group helped ensure that MSRB investor protection activities, such as enhancements to the EMMA website, were informed by input from a diverse set of investors.⁶ This year, the MSRB Board has formed the Retail Investor Advisory Committee, composed of retail investors, retail brokers and others who interface with the retail investor. The MSRB anticipates that the expertise and unique perspectives of the Retail Investor Advisory Committee will inform the Board's work in the area of rulemaking, market practices, transparency and education and outreach.

The MSRB currently publishes certain pre-trade information to the public, such as yield curves, municipal market indices and new issue pricing scales, in addition to collecting and disseminating post-trade data. In the coming days, the MSRB will release an analysis of municipal securities pre-trade data from alternative trading systems (ATSs), which focuses on the usefulness of ATS quotes as pre-trade information. While definitive conclusions as to the utility of pre-trade quote information are at this point premature, the MSRB is working to better understand how pre-trade information might benefit retail investors.

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 style and is positioned above the typed name and title.

Lynnette Kelly
President and Chief Executive Officer

⁶ To further draw on the expertise and perspectives of market participants, the MSRB Board forms advisory boards or committees to advise on topics of market interest.