



UNITED STATES  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

OFFICE OF THE  
INVESTOR ADVOCATE

July 13, 2015

**Submitted Electronically**

Ronald W. Smith  
Corporate Secretary  
Municipal Securities Rulemaking Board  
1900 Duke Street, Suite 600  
Alexandria, Virginia 22314

**RE: Regulatory Notice 2015-08  
Request for Comment on Draft Amendments and Other Issues Related to MSRB Rule A-3  
on Membership on the Board**

Dear Mr. Smith:

Pursuant to Section 4(g)(4) of the Securities Exchange Act of 1934 (“Exchange Act”), the Office of the Investor Advocate<sup>1</sup> at the U.S. Securities and Exchange Commission (“Commission” or “SEC”) is responsible for, among other things, analyzing the potential impact on investors of proposed rules of self-regulatory organizations (“SROs”). In furtherance of this objective, we routinely review and examine the impact on investors of significant rulemakings of the Municipal Securities Rulemaking Board (“MSRB” or “Board”). As appropriate, we make recommendations and utilize the public comment process to help ensure that the interests of investors are considered as decisions are being made.

**I. Executive Summary**

On June 30, 2015, certain MSRB staff met with the Investor Advocate to discuss MSRB Rule A-3. We are grateful to the staff of the MSRB for explaining the proposed amendments to MSRB Rule A-3, and we appreciate this opportunity to provide comments in regard to Regulatory Notice 2015-08, Request for Comment on Draft Amendments and Other Issues Related to MSRB Rule A-3 on Membership on the Board.<sup>2</sup>

The Exchange Act requires that at least one of the public representatives on the Board represent institutional or retail investors in municipal securities (“Public Investor Representative”). The Public Investor Representative is a very important seat on the Board and should be filled by a highly qualified

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<sup>1</sup> This letter expresses solely the views of the Investor Advocate. It does not necessarily reflect the views of the Commission, the Commissioners, or staff of the Commission, and the Commission disclaims responsibility for this letter and all analyses, findings, and conclusions contained herein.

<sup>2</sup> MSRB Notice 2013-10, *Request for Comment on Draft Amendments and Other Issues Related to MSRB Rule A-3 on Membership on the Board* (June 11, 2015), <http://www.msrb.org/~media/Files/Regulatory-Notices/RFCs/2015-08.ashx?n=1>.

applicant. Thus, we support the MSRB's effort to attract a robust pool of knowledgeable and experienced Board applicants to satisfy this requirement. We also recognize the challenge of finding talented and qualified people who are willing to devote the time and energy to serve in that capacity.

Nonetheless, we believe that the proposed change to the membership qualifications in Rule A-3(g) is deeply flawed because it weakens the standard for material business relationships and allows the Board to consider less independent applicants for the Public Investor Representative seat. In our view, the proposal is based on an overly restrictive view of the existing pool of qualified candidates and focuses far too narrowly on what appears to be one preferred type of candidate. In doing so, it significantly undermines the very purpose of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") amendments in this area. For these reasons and those set forth below, we cannot support Regulatory Notice 2015-08 in its current form.

Instead, we believe that the MSRB's effort would be best served by considering other alternatives identified in the Request for Comment, including potential changes to the length of Board members' service or the allowing confidential treatment of applicants for the Public Investor Representative position. We encourage the MSRB to consider offering specific proposals and draft amendments in either of these areas. We believe that implementing changes to either of these two alternatives would make the proposed changes to member qualifications unnecessary.

## **II. Background**

The Dodd-Frank Act amended Sections 15B(b)(1) and (b)(2)(B) of the Exchange Act, which govern the composition of the Board. These amendments categorized the Board members into two broad groups – Regulated Representatives and Public Representatives – and mandated that the Board be comprised of a majority of Public Representatives.<sup>3</sup> Regulated Representatives are individuals associated with a broker, dealer, municipal securities dealer, or municipal advisor, while Public Representatives are individuals independent of any municipal securities broker, municipal securities dealer, or municipal advisor.<sup>4</sup>

At issue is the appropriate independence standard for a Public Representative. The Dodd-Frank Act did not further define the independence standard applicable to Public Representatives beyond requiring the member be "independent of any municipal securities broker, municipal securities dealer, or municipal advisor." In 2010, the MSRB defined this phrase to mean that the relevant individual must have "no material business relationship" with any municipal securities broker, municipal securities dealer, or municipal securities advisor.<sup>5</sup> The MSRB defined the phrase "no material business relationship" to mean, in part, "at a minimum the individual is not and, within the last two years, was not associated with a municipal securities broker, municipal securities dealer, or municipal advisor."<sup>6</sup>

On July 3, 2013, the MSRB filed with the Commission a proposed rule change to amend MSRB Rule A-3 by modifying the standard of independence for all 11 Public Representatives ("July 2013

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<sup>3</sup> See Pub. L. No. 111-203, 124 Stat. 1376; 15 U.S.C. § 78o-4(b)(1), (2)(B)(i); MSRB Rule A-3(a)(i)-(ii).

<sup>4</sup> See *id.*

<sup>5</sup> See Exchange Act Release No. 63025 at 5 (Sept. 30, 2010) [75 FR 61806 (Oct. 6, 2010)]; MSRB Rule A-3(g)(ii).

<sup>6</sup> Exchange Act Release No. 63025 at 5-6 (Sept. 30, 2010) [75 FR 61806 (Oct. 6, 2010)]; MSRB Rule A-3(g)(ii).

Proposal”).<sup>7</sup> Asserting that the standard adopted in 2010 precluded otherwise viable candidates from serving on the Board as Public Representatives, the July 2013 Proposal sought to redefine the phrase “no material business relationship,” in part, by replacing the “associated with” language in the existing definition with a requirement that an individual is not, and within the last two years, was not an officer, director (other than an independent director), employee or controlling person of any regulated entity.<sup>8</sup> After commenters objected to the July 2013 Proposal, the MSRB withdrew its filing with the Commission.<sup>9</sup>

On June 11, 2015, the MSRB published for comment Regulatory Notice 2015-08, Request for Comment on Draft Amendments and Other Issues Related to MSRB Rule A-3 on Membership on the Board (“June 2015 Proposal”).<sup>10</sup> The June 2015 Proposal seeks comment on draft amendments to modify the application of the standard of independence for one of the required Public Representatives – the Public Investor Representative.<sup>11</sup> The proposed modifications would establish an alternative definition of the phrase “no material business relationship” for applicants to the Public Investor Representative seat exclusively.<sup>12</sup>

Rather than requiring the Public Investor Representative to be an individual that is not and, within the last two years, was not “associated with” a municipal securities broker, municipal securities dealer, or municipal advisor, the proposed draft definition would require that an employee or other representative of an investment adviser is not, and within the last two years, was not an officer, director (other than an independent director), employee, or controlling person of any regulated entity.<sup>13</sup> A discretionary component of the current definition would be retained, requiring the Board to determine if an applicant has a compensatory or other relationship with any regulated entity that could reasonably affect his or her independent judgment or decision making. The proposal identifies three new non-exclusive factors that would be utilized to guide this determination.<sup>14</sup>

The MSRB asserts that this alternative draft definition would allow the Board to consider individuals for the Public Investor Representative seat who, under the current broad definition of the “no material business relationship” standard, would be disqualified automatically because they are employed by or otherwise representative of an affiliate of a holding company that has a separate regulated affiliate.<sup>15</sup> The MSRB contends that the draft definition, discretionary component, and non-exhaustive factors would continue to ensure individuals directly associated with a regulated entity are not eligible to be considered to serve as the Public Investor Representative.<sup>16</sup>

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<sup>7</sup> See Proposed Rule Change Consisting of Amendments to MSRB Rule A-3, on Membership on the Board, to Modify the Standard of Independence for Public Board Members, Exchange Act Release No. 34-70004 (July 18, 2013) [78 FR 44607 (July 24, 2013)], File No. SR-MSRB-2013-06, available at <http://www.sec.gov/rules/sro/msrb/2013/34-70004.pdf>.

<sup>8</sup> See *id.* at 4-5.

<sup>9</sup> See Exchange Act Release No. 70617 (Oct. 7, 2013) [78 FR 62780 (Oct. 22, 2013)].

<sup>10</sup> MSRB Notice 2013-10, *supra* note 2.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

### III. Comments on the Application of the Standard of Independence for the Public Representative of Institutional or Retail Investors in Municipal Securities

Although we support the MSRB's goal of attracting knowledgeable and experienced Board applicants to serve as the Public Investor Representative, we believe the proposal to broaden the group of applicants by weakening the standard for material business relationships is the wrong approach. We also have serious concerns about the adequacy of the MSRB's economic analysis regarding the proposed change.

We recognize that the Dodd-Frank Act requires each Board member, including the Public Investor Representative, to be "knowledgeable of matters related to the municipal securities markets."<sup>17</sup> Unfortunately, the June 2015 Proposal, including the Economic Analysis section, does not describe who the MSRB believes would satisfy this requirement, nor does it attempt to quantify the pool of available candidates for the Public Investor Representative position. Rather, the June 2015 Proposal simply asserts that, "[i]n recent years, the MSRB has found that it is increasingly difficult, due to its broad reading of the 'associated with' test, to identify a robust set of applicants who have the requisite experience and knowledge, and are representative of investors."<sup>18</sup>

The June 2015 Proposal strongly implies that the MSRB has been unable to find highly qualified candidates because the MSRB has been precluded from accepting applications from buy-side portfolio managers who work for investment firms with affiliated broker-dealers.<sup>19</sup> This suggests a very high threshold for the type of applicant the MSRB considers "knowledgeable" – that is, the qualified applicant must have highly specialized experience in the municipal securities markets. As a practical matter, the proposed amendments seem to convert the Public Investor Representative seat into a *de facto* buy-side fund adviser seat.

This high threshold appears to be an abrupt shift from the Board's thinking as recently as 2011. At that time, in response to a commenter's concern about the potential difficulty of filling 11 Public Representative seats with individuals with sufficient knowledge and expertise in the municipal securities market, the MSRB asserted that "[t]he municipal securities market is replete with individuals who, while satisfying Rule A-3's definition of 'independent,' are very knowledgeable about the workings of the municipal securities market and have devoted a considerable amount of their time to the improvement of that market. Previous MSRB searches for public Board members have elicited significant indications of interest from such public servants."<sup>20</sup>

Although we agree that the Board could benefit by having representation from a buy-side portfolio manager, such a narrow view of public member qualification, particularly as applied to the Public Investor Representative, is unnecessary. It may also contradict the purpose of the Dodd-Frank Act amendments, which seem designed to inject greater independence into the Board and avoid the inevitable bias that comes from an insular type of industry group-think. While it is helpful to have both the buy-side and sell-side of the industry represented on the Board, the MSRB could also benefit from *non*-industry representation, particularly in the slot for the Public Investor Representative.

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<sup>17</sup> See 15 U.S.C. § 78o-4(b)(1).

<sup>18</sup> MSRB Notice 2013-10, *supra* note 2.

<sup>19</sup> See MSRB Notice 2013-10, *supra* note 2, at 8-9.

<sup>20</sup> See Letter from Lawrence P. Sandor, Senior Associate General Counsel, MSRB to Elizabeth M. Murphy, Secretary, SEC (Sept. 19, 2011), available at <https://www.sec.gov/comments/sr-msrb-2011-11/msrb201111-4.pdf> (responding to Comments on File No. SR-MSRB-2011-11).

Of course, the Board considers very complex issues, and industry experience is generally helpful. But, it is *not* indispensable. Many of the issues before the Board may require careful explanation, but a grasp of these issues is not beyond the reach of talented men and women with significant investment experience. Moreover, many of the issues that the Board considers come down to relatively straightforward policy choices. The Board could benefit greatly from a fresh perspective as it makes these types of choices.

While the learning curve for a person lacking industry experience may be steep, it is a challenge that can be addressed by extending the term limit for the Public Investor Representative, instead of modifying the standard for independence. As discussed in greater detail below, we would welcome a proposal from the MSRB to modify its rules to allow the Public Investor Representative to serve a full three year term renewable for an additional three-year term.<sup>21</sup> By doubling the tenure of the Public Investor Representative, the challenge of finding quality candidates for the seat could be cut in half, thereby lessening the need for such a drastic change to the standard of independence for the seat.

We are also concerned about the impact the proposed changes would have on the balance of power of the Board. As stated above, the Dodd-Frank Act mandated that the Board be comprised of a majority of Public Representatives.<sup>22</sup> With the current 11 Public Representatives and 10 Regulated Representatives, the June 2015 Proposal would modify the Public Investor Representative seat in a manner that would create the potential to flip the balance of power for the Board.

Perhaps the most disturbing aspect of the proposal is that it subjects the seat for the Public Investor Representative, in particular, to potential conflicts of interest. In our view, while none of the public members should be conflicted, the Public Investor Representative seat is the one that should be shielded most carefully from the influence of regulated entities.

If a buy-side portfolio manager with an affiliate active in the municipal market were to occupy the Public Investor Representative seat, it is not difficult to imagine the potential conflicts of interest that would arise. Revenue from the regulated entity would flow to the consolidated entity, even if the MSRB believes those amounts might be immaterial. Business generated within the regulated entity could lead directly or indirectly to business or investment opportunities for the portfolio manager. In addition, there are other professional and personal ties that could create conflicts for the potential applicant, even if subtly – for example, the portfolio manager may serve on corporate committees with members of the regulated entity. The fundamental problem is that the portfolio manager and the regulated entity ultimately report to the same owners and share a common corporate brand. This could impair the portfolio manager's ability to operate objectively if the MSRB were to consider actions that could negatively impact the regulated entity or the brand. These various conflicts of interest could easily interfere with the portfolio manager's duty of independent representation on behalf of other institutional and retail investors.

Granted, the second prong of the proposed independence definition is designed to exclude any person having any relationship with a regulated entity, compensatory or otherwise, that reasonably could affect the independent judgment or decision making of the individual. However, we question whether the proposed amendments will actually exclude conflicted individuals, particularly when the June 2015

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<sup>21</sup> In the event that a Public Investor Representative resigns without serving out their full term, the replacement could be permitted to serve the unexpired term and a maximum of two additional full three-year terms.

<sup>22</sup> See Pub. L. No. 111-203, 124 Stat. 1376; 15 U.S.C. § 78o-4(b)(1), (2)(B)(i).

Proposal seems to suggest that the MSRB has already concluded that the typical buy-side portfolio manager with an affiliate in the municipal markets is not generally disqualified from serving as the Public Investor Representative.

The proposal also seems to accord undue weight to a particular factor for evaluating potential conflicts of interest. Proposed paragraph (g)(ii)(2) of MSRB Rule A-3 would require the Board to consider three specific factors to determine whether an applicant has a compensatory or other relationship with a regulated entity that reasonably could affect his or her independent judgment or decision-making:

- (i) revenue from the regulated entity accounts for a material portion of the revenues of the consolidated entity that includes the investment adviser and the regulated entity;
- (ii) the regulated entity underwrites, privately places, or otherwise facilitates the origination of municipal securities; and
- (iii) the investment adviser has a fiduciary duty or other similar relationship of trust to investment company or other investor clients.

The third factor seems to credit an applicant for an attribute inherent in his or her status as an investment adviser – *i.e.*, that the person is a fiduciary. We see no reason to include this as a discretionary factor for consideration when it should be true of all applicants who wish to use this new provision. The fact that an investment adviser is a fiduciary should be taken as a given, and not be used as a “credit” to be balanced against the conflicts of interest that are unique to that investment adviser.

In addition, an investment adviser’s role on the Board would be a policymaking role that is separate from the investment adviser role. The fiduciary duty to clients would not govern conduct on the Board. Thus, such fiduciary status should not be given any special weight.

The flaws in the June 2015 Proposal result, at least in part, from a lack of economic analysis and data. The Economic Analysis section fails to adequately quantify the benefits and costs of the proposal or assess any reasonable alternative approaches. Specifically, the June 2015 Proposal fails to quantify the size of the existing pool of potential applicants for the Public Investor Representative position under the current standard for evaluating material business relationships. It also fails to quantify the impact that the proposed changes will have on the size of that pool.

In our view, the current pool of applicants is actually quite large. American households are the largest holders of municipal bonds,<sup>23</sup> and even if a relatively small percentage of these individual investors could be considered “knowledgeable of matters related to the municipal securities markets” as required by the Dodd-Frank Act,<sup>24</sup> there are many thousands of individual investors who could qualify to serve on the Board. In addition, there are tens of thousands of investment adviser representatives who

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<sup>23</sup> At the end of 2014, individuals held 42.2% (\$1.54 billion) of outstanding municipal securities directly. *See* SIFMA, US Municipal Securities Holders: Quarterly Data, available at <http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/Municipal-US-Municipal-Holders-SIFMA.xls> (last visited June 11, 2015).

<sup>24</sup> *See* Pub. L. No. 111-203, 124 Stat. 1376; 15 U.S.C. § 78o-4(b)(1).

work for firms that are not affiliated with regulated entities,<sup>25</sup> many of whom regularly give advice to clients about the purchase or sale of municipal securities. Some of these unaffiliated professionals are advisers to funds with significant holdings of municipal securities.<sup>26</sup>

In comparison to the size of the existing pool of qualified applicants, the proposed change would increase the size of that pool by a very minimal percentage. As described in the June 2015 Proposal, the amendments seem tailored to open the door for a narrow type of applicants – namely, buy-side portfolio managers from investment firms with affiliated broker-dealers. We question the need to loosen the qualifications of the Public Investor Representative to accommodate this type of candidate, particularly when the existing candidate pool is so large and the conflicted buy-side portfolio managers would already qualify for seats on the Board as Regulated Representatives.

#### **IV. Comments on Length of Board Member Service**

As noted above, we believe that the MSRB could offer a specific proposal and draft amendment to modify the length of Board member service for the Public Investor Representative. We believe that allowing a knowledgeable and experienced public member to remain on the Board for one additional three-year term would more effectively address the objectives that appear to underlie the Request for Comment, without altering the current standard for evaluating material business relationships.

To the extent the MSRB is concerned about continuing to locate well-qualified applicants for the Public Investor Representative on the Board, doubling the term limit for this position could effectively cut in half the challenge of finding such candidates. Importantly, lengthening the potential term of service for well-qualified applicants that already meet the independence standard under the existing MSRB Rule A-3 would not appear to raise the concerns described above. In addition, such a proposal might provide the advantages of greater continuity and more effective use of expertise and experience with respect to the specialized work of the Board.

Any proposal should, however, still assure appropriate turnover of Board membership. A restriction from serving more than two consecutive full terms may appropriately balance this interest in fresh ideas against the countervailing advantages of longer serving Public Investor Representatives making more effective contributions to the work of the Board.

#### **V. Comments on Requirement to Announce Publicly the Names of All Board Applicants**

Similarly, we believe that the MSRB could develop a specific proposal and draft amendment to modify the requirement to announce publicly the names of Board applicants for the Public Investor Representative position. Although we appreciate the need to maintain transparency in the selection

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<sup>25</sup> At the end of 2014, there were 10,895 registered investment advisers. Only 4.2% (456) reported directly engaging in broker-dealer activity and only 21.3% (2,323) reported they were affiliated with broker-dealers, municipal securities dealers or government securities broker-dealers. Importantly, around 36.8% of registered investment advisers (4,005) reported having no financial industry affiliations at all. See 2014 Evolution Report – A Profile of the Investment Adviser Profession, Investment Adviser Association & National Regulatory Services (2014), available at [https://www.investmentadviser.org/eweb/docs/Publications\\_News/Reports\\_and\\_Brochures/IAA-NRS\\_Evolution\\_Revolution\\_Reports/evolution-revolution\\_2014.pdf](https://www.investmentadviser.org/eweb/docs/Publications_News/Reports_and_Brochures/IAA-NRS_Evolution_Revolution_Reports/evolution-revolution_2014.pdf).

<sup>26</sup> 28.4% (\$1.04 billion) of municipal bonds are held indirectly through mutual funds. See SIFMA, US Municipal Securities Holders: Quarterly Data, *supra* note 23. Banking institutions and insurance companies held 13.1% (\$475.9 billion) and 12.9% (\$469.5 billion), respectively, with the other 3.5% held by various other entities. *Id.*

process, we nonetheless believe that an applicant for the Public Investor Representative position should have the opportunity to request and be granted confidential treatment of the application.

This alternative, like extending the tenure of the Public Investor Representative, could better address the objectives that appear to underlie the Request for Comment, without altering the current standard for evaluating material business relationships. If the MSRB is concerned about continuing to locate well-qualified applicants for the Public Investor Representative on the Board, providing some level of anonymity to those who seek confidentiality could increase the availability of interested Board applicants who meet the existing standards. This modification would not raise the concerns described above.

Any proposal should continue to ensure adequate transparency for the Board application process, but the interest of transparency should be appropriately balanced against the applicants' interest in anonymity and the potential harm to the professional reputations of rejected applicants.

## **VI. Conclusion**

Although we support the MSRB's efforts to attract a robust pool of knowledgeable and experienced Board applicants to represent institutional or retail investors on the Board, we have significant reservations about the potential consequences of modifying the application of the standard of independence in order to achieve the underlying objective. Such a change could have a significant impact on public representation on the Board. We encourage you to consider alternatives that would attract qualified applicants without raising such concerns.

Should you have any questions, please do not hesitate to contact me or Senior Counsel Ashlee Connett at (202) 551-3302.

Sincerely,



Rick A. Fleming  
Investor Advocate

cc (electronically): Lynnette Kelly, Executive Director  
Robert Fippinger, Chief Legal Officer  
Carl Tugberk, Assistant General Counsel