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March 8, 2005

**VIA HAND DELIVERY**

Mr. Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

**Re: Concept Release Concerning Self-Regulation; File Number S7-40-04; Release No. 34-50700 (November 18, 2004)**

Dear Mr. Katz:

The Municipal Securities Rulemaking Board (“MSRB”) welcomes the opportunity to comment upon the Securities and Exchange Commission’s (“SEC” or “Commission”) concept release concerning self-regulation (the “Concept Release”). The MSRB is a self-regulatory organization (“SRO”) established by Congress in the Securities Acts Amendments of 1975 to write rules with respect to transactions in municipal securities effected by brokers, dealers and municipal securities dealers (collectively “dealers”).<sup>1</sup> While the Commission’s Concept Release does not apply directly to the MSRB,<sup>2</sup> the MSRB’s unique perspective and insights may be beneficial to the Commission in considering the various benefits and challenges presented by the current system of securities industry self-regulation. The MSRB believes that the current SRO structure for regulating dealer conduct in the municipal securities market has been effective in avoiding many of the potential SRO limitations identified by the SEC related to conflicts, funding, and redundancies, while retaining the benefits of a self-funded system with market specific expertise enhancing rule promulgation.

<sup>1</sup> Pub. L. No. 94-28, sec. 13, 89 Stat. 131.

<sup>2</sup> In the Concept Release, the SEC recognizes that not all SROs are alike and specifically states that the discussion of the SRO attributes contained in the Concept Release does not, unless specifically noted, apply to the MSRB. While most SROs operate and regulate markets or clearing services in addition to member regulation, the MSRB does not. See Concept Release at footnote 2.

## I. The MSRB's Unique Regulatory Structure and Authority

### A. MSRB Structure

The MSRB was established in 1975 by Congress to develop rules regulating securities firms and banks involved in underwriting, trading, and selling municipal securities, *i.e.*, bonds and notes issued by states, cities, and counties or their agencies to help finance public projects. The MSRB is the only SRO specifically established by Congress. The market that MSRB-regulated dealers operate within is also distinctive, as will be discussed below,<sup>3</sup> in part because the number of issuers (50,000) is so large and so few municipal securities issues trade frequently and consistently over prolonged periods of time.

Also unique is the fact that the legislation, now codified in section 15B of the Securities Exchange Act of 1934, as amended ("Exchange Act"),<sup>4</sup> dictates the dealer-dominated composition of the MSRB Board. When the MSRB was created, the statutorily mandated board composition focused on fair representation of the parties that would be affected by the MSRB's rulemaking. Toward that end, Congress required that the MSRB be composed of members who are equally divided among public members (individuals not associated with any dealer engaging in municipal securities transactions), individuals who are associated with and representative of bank dealers, and individuals who are associated with and representative of securities firms. Congress further required that at least one individual serving on the MSRB must be representative of investors and at least one must be representative of issuers of municipal securities.<sup>5</sup> MSRB rules require broad geographic representation on the MSRB Board, as well as diversity in the size and type of dealers represented.<sup>6</sup> This diversity obligation has enabled the MSRB to be responsive to smaller regional firm issues and avoid becoming dominated by the largest firms in the industry.

The MSRB's structure is also unique because it neither operates a market nor is shareholder owned. As such, the MSRB's regulatory structure works well to eliminate the SEC's concern relating to the profit motive of a shareholder-owned market detracting from proper self-regulation, while retaining direct industry involvement with respect to rulemaking. This direct involvement of industry participants enables the MSRB to proactively refine and target its regulation of dealers in the over-the-counter ("OTC") market for municipal securities.

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<sup>3</sup> See *infra* at pages 6-7.

<sup>4</sup> 15 U.S.C. sec. 78o-4.

<sup>5</sup> Under MSRB Rule A-3, the Board is composed of 15 membership positions, with five positions each for public, bank dealer and securities firm members.

<sup>6</sup> MSRB Rule A-3.

The MSRB is a Virginia non-stock corporation. The operations of the MSRB are funded solely through assessments made on dealers for initial fees, annual fees, fees for underwritings and transaction fees.<sup>7</sup> The MSRB charges only nominal fees to subscribers to its data feeds, as discussed further below. Because the MSRB is a “regulatory-only” organization, its fees are used only to support regulatory operations and are not intended to generate a profit.

## **B. Scope of MSRB Authority**

While the MSRB believes it effectively carries out its obligation to regulate the conduct of dealers in connection with municipal securities transactions, it also recognizes the limitations of its authority. Section 15B of the Exchange Act provides that, “The Board shall propose and adopt rules to effect the purposes of this title with respect to transactions in municipal securities effected by brokers, dealers and municipal securities dealers.”<sup>8</sup> Section 15B provides the MSRB with broad authority to write rules governing the activities of municipal securities dealers, but does not provide the MSRB with authority to write rules governing the activities of other participants in the municipal finance market such as issuers and their agents (*e.g.*, independent financial advisors and public finance lawyers).

Municipal securities also are exempt from the registration and prospectus delivery requirements of the Securities Act of 1933 and are exempt from the registration and

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<sup>7</sup> These fees are set forth in MSRB Rules A-12 through A-14.

<sup>8</sup> 15 U.S.C. §78o-4(b)(2)(C). Section 15B lists several specific purposes to be accomplished by Board rulemaking and provides a broad directive for rulemaking designed to:

Prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling and processing information with respect to and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market and, *in general, to protect investors and the public interest.*

(Emphasis added).

reporting requirements of the Exchange Act.<sup>9</sup> Thus, there is no direct issuer disclosure requirement in the municipal securities market.<sup>10</sup>

Section 15B also limits the MSRB's authority to regulation of dealer conduct in connection with municipal securities transactions; the MSRB has no authority to regulate dealers in connection with their activities in areas of municipal financing that do not involve municipal securities. This is significant given the growing use of financing instruments in the public sector that are not municipal securities, such as derivative products, interest rate swaps, certain municipal leases, and other similar products that are largely unregulated.

This system of municipal securities dealer regulation is an example of "functional" or "product-line" regulation in the securities markets. It involves both securities firms and banks in the development of dealer conduct standards that benefit all participants in the municipal securities market—issuers, dealers, and investors. The basic concern of Congress for equal regulation of all municipal securities dealers has guided the MSRB in its rulemaking activities. The MSRB's rules are intended to apply to *all municipal securities dealers* in a uniform and consistent manner. Nonetheless, it must be recognized that the limitations on the MSRB's authority sometimes result in unequal regulation among *all participants* in the municipal securities market. For example, in the context of the MSRB's Rule G-37,<sup>11</sup> the rule only regulates the conduct of dealers, and does not restrict the use of political contributions by independent financial advisors, unregulated swap advisors, swap counterparties, or public finance lawyers to influence the awarding of municipal finance business by issuer officials.

### C. MSRB Activities

The MSRB's authority is limited to writing rules that govern dealers' conduct in municipal securities transactions. The Exchange Act directs that the inspection and enforcement functions relative to MSRB rules be carried out by other agencies. For securities firms, the NASD, along with the SEC, perform these functions. For bank dealers, the appropriate federal banking authorities, in coordination with the SEC, have this responsibility. The use of existing enforcement authorities for inspection and enforcement of MSRB rules provides for an efficient use of resources, eliminating one aspect of redundant SRO regulation most troubling to SRO members—multiple inspection and enforcement regimes. The MSRB works cooperatively with the

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<sup>9</sup> In addition, because municipal securities are exempt from the Securities Act and Exchange Act's registration and reporting requirements, professionals who assist in the preparation of municipal disclosure documents do not "practice before the SEC" and thus are not subject to the SEC's Rules of Practice.

<sup>10</sup> SEC Rule 15c2-12 (17 C.F.R. §15c2-12) obligates municipal underwriters (dealers) to obtain and review a near-final official statement prior to purchasing or selling an issuer's municipal securities.

<sup>11</sup> For a discussion of MSRB Rule G-37, *see infra* at pages 8-9.

enforcement agencies and maintains frequent and close communication to ensure both that: (1) the MSRB's rules and priorities are known to examining officials; and (2) general trends and developments in the market discovered by field personnel are made known to the MSRB.

While this limitation can present some communication and coordination issues,<sup>12</sup> it also prevents many of the conflicts identified by the SEC in its Concept Release. For example, because the MSRB does not have the ability to conduct member surveillance or enforce its own rules, dealers (including MSRB Board members) cannot influence the zealotry of enforcement.

Even in the area of rulemaking, where the dealer representatives who serve on the MSRB have an interest, the MSRB structure and rulemaking process limit the potential for self-interest to affect MSRB rulemaking. The MSRB rulemaking process is extremely open, ensuring that the MSRB takes into consideration the opinions of all interested parties, not just dealers. There are several steps in the MSRB's rulemaking procedure. Generally, when considering the adoption of a proposed rule, the MSRB first publishes it for comment to provide the greatest possible opportunity for industry and public participation. Comments on rule proposals have an important impact on the MSRB's deliberations and often result in modifications of a proposed rule.

Like other SROs, the MSRB must file its proposed rule changes with the SEC prior to effectiveness. Once the MSRB has considered public comment and finalized its proposed rule change, the SEC reviews the rule change proposal pursuant to the procedure set forth in section 19(b) of the Exchange Act. MSRB rules do not become law without the independent determination of the SEC that the proposed rule change is consistent with the requirements of the Exchange Act and the associated rules and regulations promulgated under the Exchange Act that are applicable to the MSRB. The SEC thus provides oversight of the MSRB's rulemaking and ensures that the MSRB's statutorily mandated dealer dominance does not weaken the standards imposed on the broker-dealer community.

The MSRB has a formal long-range planning process and the MSRB publicly announces its long-range goals and current rulemaking objectives. The MSRB also hosts an annual Industry Roundtable to share important topics among all municipal securities industry participants. Recently, the MSRB formed two Advisory Groups, one made up of

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<sup>12</sup> For example, because other regulators enforce the MSRB's rules, primarily the NASD, the MSRB must coordinate and communicate effectively with these regulators. The MSRB takes its coordination and communication obligations very seriously. To the extent that there are shortcomings in the present structure that divides the rulemaking function from the enforcement function, the MSRB believes that any shortcomings can be reduced or eliminated by improving the processes of coordination and communication, rather than undertaking structural changes to the organization.

municipal issuers and one made up of municipal securities investors, to provide the MSRB additional input from these important constituencies. Both Advisory Groups will regularly discuss whether MSRB rules adequately address their concerns in the municipal securities market—both in the context of holding dealers to high ethical standards and ensuring that detailed dealer conduct rules are effective and efficient given the mechanics of the municipal securities market.

## **II. The Structure of the Municipal Securities Market Calls for Special Expertise**

Not only is the MSRB a uniquely structured SRO, but the municipal securities market also has features and functions that are vastly different from those of the equity or options markets. These distinctive features call for special expertise in dealer regulation. Moreover, while many MSRB rules are similar or identical to the rules of the NASD when they can be, differences from broker-dealer regulation in the equity, corporate debt or options markets do exist because of the nature of the municipal securities market.

In the United States, there are approximately 80,000 state and local governments, about 50,000 of which have issued municipal securities. The market is unique among the world's major capital markets because the number of issuers is so large—no other direct capital market encompasses so many borrowers. Municipal securities issues range from multi-billion dollar financings of large state and city governments to issues less than \$100,000 in size, issued by localities, school districts, fire districts and various other issuing authorities. The purposes for which these securities are issued include not only financing for basic government functions, but also a variety of public needs such as transportation, utilities, health care and housing as well as some essentially private functions to enhance industrial development.

Municipal securities are bought and sold in the OTC market rather than on an organized exchange. A primary distinguishing characteristic of the municipal securities market is the lack of any core group of issues that trade frequently and consistently over sustained periods of time. In the municipal securities market on even the heaviest trading days, less than one percent of all outstanding issues will trade at all.<sup>13</sup> Most issues that trade at all do not trade with frequency (*i.e.*, more than four times) during a trading day. When frequent trading does occur in an issue, it generally occurs immediately after issuance and then subsides dramatically. After that, substantial trading in a specific issue generally is sporadic.<sup>14</sup>

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<sup>13</sup> An MSRB study of municipal issues traded during a one-year period (May 1998-April 1999) as a percentage of all outstanding issues revealed that only 31.2% of the total issues outstanding traded at any time during the year.

<sup>14</sup> A study of December 1999 transaction data collected by the MSRB's Transaction Reporting System revealed that on an average day the total number of issues traded was 16,469 but only 1,626 of those issues (or 9.9%) traded four or more times in a day.

The MSRB has used its market specific expertise to design and develop a transaction reporting system that works for the municipal securities market. The MSRB implemented a limited transaction reporting facility for the municipal securities market in 1995<sup>15</sup> and has since increased price transparency in the municipal market in a series of measured steps. By 2000, the MSRB was making all trade data public on a delayed basis and was providing T+1 transaction data at no cost. The market's reaction to the increasing levels of transparency has been positive. The use of the data in those reports by market professionals and pricing services indicates its value and suggests the additional value that will be derived from real-time price data.

In January 2005, the MSRB implemented the final stage in the evolution of price transparency in the municipal securities market, which is a system for comprehensive, real-time price dissemination, the Real-Time Transaction Reporting System ("RTRS"). The MSRB charges only a nominal fee to subscribers to its RTRS data feed and has worked with the Bond Market Association to develop a retail-oriented non-commercial web site operated by the Bond Market Association to provide free real-time price data for all municipal bond trades.

In addition, as discussed above, in the municipal securities market dealers are the only regulated parties and municipal securities are exempt from the registration and reporting requirements of the Securities Act and the Exchange Act. This lack of issuer regulation creates challenging disclosure issues for the municipal securities market. The MSRB sought to improve disclosure practices and assist in the dissemination of important information to the market by adopting Rule G-36, on delivery of official statements, advance refunding documents and Forms G-36(OS) and G-36(ARD) to MSRB, and developing the Municipal Securities Information Library ("MSIL") system. Rule G-36 requires an underwriter to submit to the MSRB final official statements and advance refunding documents for most primary offerings. MSIL is a repository of official statements, escrow deposit agreements, and certain material event disclosures. The MSRB makes the MSIL information available to market participants. Prior to the MSRB's development of the MSIL system there was no centralized system for the collection and preservation of municipal securities' initial offering documents.<sup>16</sup>

Because the MSRB is authorized to regulate only one participant in the market, the dealers, the MSRB cannot address all problematic market practices and inefficiencies. However, the MSRB has been very aggressive in the past few years with an outreach

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<sup>15</sup> In 1995 the MSRB initiated a transaction reporting program for municipal securities serving the dual role of providing price transparency and supporting market surveillance. Surveillance data is made available to regulators with authority to enforce MSRB rules, including the NASD and SEC.

<sup>16</sup> When issues arose concerning the availability of secondary market information, the Board developed the Continuing Disclosure Information ("CDI") system to respond to market needs for information beyond official statements and advance refunding documents.

program designed to promote education and responsible behavior among all market participants.

The MSRB's outreach program has focused on bringing market participants together to develop common understanding and voluntary solutions to industry issues, even though the MSRB may not have regulatory authority over these issues. For example, in the past few years the MSRB has focused on disclosure issues in the municipal securities market and was instrumental in the formation of the Muni Council, a voluntary group comprised of 20 municipal market participants. Muni Council is working to improve secondary market disclosure in the municipal markets.<sup>17</sup> The MSRB also has heightened awareness of issues such as the use of derivatives in public finance to assist in the development of responsible voluntary practices intended to protect the integrity of the municipal securities industry.

Another unique feature of the municipal securities market is that the intersection of politics and securities issuance creates the potential for conflicts of interest to affect the integrity of the underwriting process. This characteristic of the market prompted the MSRB to create a comprehensive set of political contribution and consultant disclosure rules (Rules G-37 and G-38) that have no application in other markets. In 1994, Rule G-37 was adopted to remove the real or perceived conflict of interest that exists when issuers receive political contributions from dealers and award municipal securities business to such dealers.<sup>18</sup>

Although Rule G-37 initially included certain limited disclosure requirements for consultants used by dealers to obtain municipal securities business, in 1996, the MSRB

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<sup>17</sup> The Muni Council recently announced the opening of its Central Post Office (CPO) to all municipal market participants. The CPO is expected to serve as a one-stop filing venue for issuers' secondary market disclosure documents and to improve the way the documents have been indexed at the existing nationally recognized municipal securities information repositories (NRMSIRs) and state information depositories (SIDs).

<sup>18</sup> In general, Rule G-37 prohibits dealers from engaging in municipal securities business with issuers if certain political contributions have been made to officials of such issuers; prohibits dealers and municipal finance professionals ("MFPs") from soliciting or bundling contributions to an official of an issuer with which the dealer is engaging or seeking to engage in municipal securities business; and requires dealers to record and disclose certain political contributions, as well as other information, to allow public scrutiny of political contributions and the municipal securities business of a dealer. The rule also seeks to ensure that payments made to political parties by dealers, MFPs, and political action committees ("PACs") not controlled by the dealer or MFP do not represent attempts to make indirect contributions to issuer officials in contravention of Rule G-37 by requiring dealers to record and disclose all payments made to state and local political parties.

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adopted a separate Rule G-38, on consultants, intended in large measure to prevent persons from circumventing Rule G-37 through the use of consultants.<sup>19</sup> The impact of Rules G-37 and G-38 has been very positive. The rules have altered the political contribution practices of municipal securities dealers and opened discussion about the political contribution and consultant practices of the entire public finance industry.

Another important area in which the MSRB has adapted its rules to ensure investor protection in a rapidly evolving market has been the Section 529 college savings plan market. Although 529 plans, in many ways, resemble mutual funds, 529 plans are municipal securities issued by state entities as savings vehicles for paying the costs of higher education. The MSRB has in place a broad array of customer protections under its rules for 529 plans marketed by broker-dealers. These include rules and interpretive guidance on suitability, fair and reasonable commissions and sales loads, advertising, and sales contests and related sales practices. Many state 529 plans by-pass broker-dealers to directly market to customers using state personnel. Because these state personnel are not dealers or employed by dealers, they are not subject to the MSRB's rules. In addition, some banks that market 529 plans may, as a result of the definitions of "broker" and "dealer" under the Gramm-Leach-Bliley Act, not be subject to Board rules. The MSRB believes that it has established effective and efficient rules of fair dealing that—even where other parties may not be legally obligated to comply with them—merit voluntary compliance, if not to the letter of the rules at least to the spirit of such requirements.

### **III. Conclusion**

Self-regulation is a critical part of the regulation of dealer conduct in connection with U.S. securities transactions. The MSRB encourages the SEC in its efforts to examine the role and operation of SROs in today's markets and appreciates that this examination requires the balancing of the benefits and challenges of the current system and alternatives proposed. However, the MSRB believes that maintaining industry specific knowledge is vital to the proper regulation of dealer conduct, especially with regard to dealer conduct in connection with municipal securities transactions. Consequently, the MSRB does not believe that dealer regulation of municipal securities related activities should be subsumed within a single or multi-purpose regulator because important issues unique to the municipal securities market would not receive sufficient attention. Moreover, market specific rules would still be required under a single

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<sup>19</sup> Rule G-38 currently requires dealers who use consultants to evidence the consulting arrangement in writing, to disclose, in writing, to an issuer with which it is engaging or seeking to engage in municipal securities business information on consulting arrangements relating to such issuer, and to submit to the Board, on a quarterly basis, reports of all consultants used by the dealer, amounts paid to such consultants, and certain political contribution and payment information from the consultant. The MSIL system provides access through the MSRB's website to dealer reports on political contributions and consultants.

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regulator approach because of the many differences between equity and debt securities, and between municipal debt and other debt, *i.e.*, corporate, treasury, and asset-backed.

Furthermore, because the MSRB does not operate a market and is a “regulatory-only” organization it does not have the potential conflicts identified by the SEC with market operations, issuers, or shareholders. Additionally, concern about unequal regulation of dealers is eliminated because the MSRB does not have examination or enforcement authority; its rules are enforced by other agencies (primarily the NASD).

In conclusion, the current MSRB structure addresses a number of the issues raised by the SEC in the Concept Release while retaining the fundamental benefits of self-regulation: market expertise and adequate funding that allow it to be effective and efficient in regulating dealer conduct in the municipal securities market. We hope that our sharing of the MSRB’s unique perspective and structure will assist the Commission in its review of potential approaches to securities industry regulation. Please do not hesitate to contact Christopher A. Taylor, Executive Director, or Carolyn Walsh, Senior Associate General Counsel, at 703-797-6600, if you have any questions.

Sincerely yours,

/s/

Francis J. Ingrassia  
Chairman,  
Municipal Securities Rulemaking Board

/s/

Christopher A. Taylor  
Executive Director,  
Municipal Securities Rulemaking Board

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