

Preliminary Recommendations Regarding Certain Principal Transactions with Advisory Clients

The Municipal Securities Transparency Subcommittee (“Subcommittee”) of the Fixed Income Market Structure Advisory Committee (“FIMSAC”) was formed to consider the impact of transparency, both pre-trade and post-trade, on the municipal securities markets. As a result of such consideration, this Subcommittee determines whether to make policy recommendations to enhance the liquidity, transparency and efficiency of the municipal bond markets. Further, a mandate of FIMSAC is to consider policy recommendations to improve execution, access, and transparency of fixed-income markets with a specific emphasis on the retail investor.

One area of focus of the Subcommittee has been on direct interactions where retail customers buy and sell individual bonds through their investment advisers or broker-dealers. In a traditional brokerage account, broker-dealers are required to provide a fair and reasonable price to their customer and meet best execution requirements. Mostly, broker-dealers with a customer looking to sell a bond will solicit bids from other market participants (dealers) and quite often may be willing to commit their own capital by providing a bid for the broker-dealers own account. In contrast, for advisory accounts held by broker-dealers that are also registered with the Securities and Exchange Commission (“SEC”) as investment advisers, broker-dealers are not permitted to enter a bid for the broker-dealer’s own account for their client wishing to sell a bond, without complying with the disclosure and consent requirements of the Investment Advisers Act of 1940 (“Advisers Act”). This could cause a client in an advisory account to receive a less favorable price, especially during volatile markets. To address this, the subcommittee would like to recommend alternative means for investment advisers that are registered with the SEC as broker-dealers to meet the requirements of section 206(3) of the Advisers Act when they act in a principal capacity in two types of transactions with their advisory clients.

Another area of interest to the sub-committee is the ability of a dealer to offer and sell negotiated new issue municipal bonds during the order period that the dealer participates in as a syndicate manager, co-manager or selling group member. Currently, a dealer cannot offer/sell negotiated new issue bonds to an advisory client without meeting the disclosure and consent requirements of the Advisers Act. This could cause a client to not have access to new issue bonds that meet their investment criteria or only have access to the bonds in the secondary market at potentially higher prices.

As background, section 206(3) of the Advisers Act makes it unlawful for any investment adviser, directly or indirectly, “acting as principal for his/her own account, knowingly to sell any security to or purchase any security from a client, without disclosing to such client *in writing* before the completion of such transaction the capacity in which he/she is acting and obtaining the consent of the client to such transaction.” The disclosure and consent is required on a transaction-by-transaction basis. In 2007, the SEC adopted temporary rule 206(3)-3T on an interim final basis. The purpose of the rule was to permit broker-dealers to sell their non-discretionary advisory clients certain securities on a principal basis that might not be available on an agency basis, or

might be available on an agency basis only on less favorable terms, while protecting clients from conflicts of interest as a result of such transactions. The rule was originally intended to sunset in 2009, but was extended several times as the effects were evaluated and industry and other commentary was collected. Rule 206(3)-3T was allowed to sunset in 2016. The SEC requested quantitative data and economic analyses, relating to the benefits and costs that could result from alternative approaches regarding the standards of conduct and other obligations of broker-dealers and investment advisers, including associated with rule 206(3)-3T; however, out of over 200 comment letters received by the SEC staff, none contained such analysis regarding rule 206(3)-3T. This could reasonably lead one to the conclusion that these data are difficult to accumulate or that the statistical analysis of available data leads to ambiguous empirical conclusions. In the Subcommittee's view, FIMSAC and the SEC, in considering these recommendations, should not assume that the lack of quantitative analysis indicates that the costs outweigh the benefits; rather the Subcommittee believes that the lack of data more likely reflects difficulty in obtaining the data. It is the Subcommittee's belief that the benefits in terms of additional liquidity and the presence of auditable outputs would far outweigh the cost of the implementation of the recommended rule.

As such, the Subcommittee proposes alternative requirements for two types of principal transactions: (1) the purchase of negotiated new-issue municipal bonds and (2) the liquidation of bonds within the client portfolio. Of course, it is important to insure that the conditions and restrictions for these alternatives be followed by broker-dealers wishing to take advantage of the alternatives.

- 1) Currently, a broker/dealer that negotiates and underwrites a new-issue municipal bond or is a co-manager or is a member of the selling group, is unable to sell bonds in the offering to its advisory clients without meeting the disclosure and consent requirements of the Advisers Act. The result of this is that few (or none) of the underwriting dealer's advisory clients buy bonds in the initial offering of negotiated municipal bonds for which the dealer is a syndicate manager or selling group member. Advisory clients that wish to buy these bonds will buy them after the deal is closed and the bonds are free to trade – typically at a price higher than the original offer price.

Recommendation: The Subcommittee recommends that the SEC consider a rule that permits a broker-dealer that negotiates and underwrites a new-issue municipal bond or is a co-manager or member of the selling group to meet the requirements of section 206(3) of the Advisers Act when acting in a principal capacity to sell new-issue municipal bonds during the negotiated order period.

- 2) There is a regulatory framework which exists today requiring broker-dealers to comply with best-execution requirements. The typical process for the liquidation of client bond positions involves very broad distribution among broker-dealers using various venues including but not limited to Alternative Trading Systems (“ATS”), which provides a full audit trail of activity, or through municipal brokers' broker or other bid-wanted venues which also have

record keeping requirements. If the liquidating account is commissionable, then the order-handling broker-dealer can also contribute a bid. In advisory accounts, the broker-dealer is required to sell the bonds to the highest bid away. This is true even if the order-handling dealer would bid a higher price. We believe that the client could receive better execution, without undermining the process, if a broker-dealer handling such an order could submit a “blind” bid (i.e., without having access to the bids from other dealers and requiring the dealer who initiates the auction submitting their best price to that auction at that time) for advisory clients via a bid-wanted venue.

Recommendation: The Subcommittee recommends that the SEC consider a rule that permits a broker-dealer to meet the requirements of section 206(3) of the Advisers Act when acting in a principal capacity to sell certain client bond positions within the normal liquidation process, by allowing dealers to submit a “blind bid” on a principal basis against its advisory clients.