

Preliminary Recommendation Regarding Certain Principal Transactions with Advisory Clients in Negotiated Municipal Underwritings

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.

The sub-committee is interested in 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.

As such, the Subcommittee proposes alternative requirements for principal transactions involving the purchase of negotiated new-issue municipal bonds. 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.