



**Remarks of**

**Lynnette Kelly Hotchkiss, Executive Director**

**Municipal Securities Rulemaking Board**

**on**

**Self-Regulation**

**At the**

**Field Hearing on The State of Municipal Securities Market**

**Securities and Exchange Commission**

**Washington, DC**

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Thank you Commissioner Walter. The MSRB appreciates the opportunity to participate in these hearings. We also look forward to reviewing the Commission's assessments and conclusions, and working with the Commission to address issues in the municipal securities market.

These hearings, and their focus on investor protection, come at an opportune time. The municipal securities market has largely weathered the credit crisis that began in late 2008 but economic conditions and financial liabilities continue to stress many municipal bonds issuers. Although the incidence of default in the municipal securities market have remained low so far, it is essential to review the mechanisms for disclosure and transparency in the market and ensure that investor safeguards are appropriate and effective.

The mission of the MSRB is to protect investors and the public interest, and with the enactment of the Dodd-Frank financial reform legislation, the MSRB's mission has been expanded to also protect issuers of municipal securities, public pension plans and other public funds, as well as entities whose credit stands behind municipal securities. The MSRB fulfills this broader mission by regulating securities firms, banks and municipal advisors that engage in municipal securities and advisory activities through a body of fair practice, disclosure, conflicts of interest and other rules. To further protect market participants and facilitate a fair and efficient market, the MSRB promotes disclosure and market transparency through its Electronic Municipal Market Access (EMMA) website and other information systems, provides education and conducts extensive outreach.

In recent years, the Commission and the MSRB have worked closely on several important investor protection initiatives. Our partnership with the Commission, both in terms of our specific initiatives and our day-to-day operations as a self-regulatory organization under the supervision of the Commission, has resulted in a municipal market that is effectively regulated and that operates fairly and efficiently on behalf of the public interest. We expect to continue working in collaboration with the Commission on the challenges that remain in the municipal market.

Under the Dodd-Frank legislation, our two organizations have been further empowered to formulate policies and rules in many previously unregulated areas of the municipal market, and the work we will be doing together under this broader authorization promises to greatly strengthen investor protections in this market. Further, Congress laid a unique new responsibility on the MSRB – to protect

municipal entities and obligated persons – that will call for a fresh perspective on the responsibilities of securities firms, banks and municipal advisors. These new mandates come during a time that, as we all know, the lagging economic recovery in sectors that are key to state and local government finances, combined with the expiration of federal stimulus aid, will make investor and issuer protection rules all the more critical. This is a challenge on which the MSRB has marshaled its full focus and energies.

As I just noted, the MSRB is a Self-Regulatory Organization (SRO) organized under the Securities Exchange Act and is subject to Commission oversight. The SRO model, which Congress conceived as a way to enhance the work of government regulators that have limited resources, provides the opportunity for the private sector to support and further government's efforts. An SRO brings particular strengths and characteristics to bear on the work of regulating the capital markets. Among these are:

- Industry expertise
- A singular focus
- A self-funded structure
- Corporate governance that is free of undue industry influence
- A transparent rulemaking process
- Accountability to the Commission and to the market

The municipal market is unique, with more than 1.3 million individual securities and more than 50,000 issuers. No other market has as broad and as diverse set of instruments and issuers. As an SRO, the MSRB has the specialized knowledge and singular focus required to regulate the municipal market. This expertise and concentration of purpose is unavailable – indeed could not be replicated except at great cost – within the federal government.

On the subject of cost, as a self-funded organization, the MSRB operates completely independent of government funding and has invested tens of millions of dollars over the last three decades to create a comprehensive and transparent regulatory structure for the municipal market. This investment – indeed the continued investment required to protect the municipal market – has been made possible by virtue of our self-funding structure that has allowed the MSRB to prudently assess regulated entities to provide for market protection.

The recent Congressional expansion of the MSRB's mission and jurisdiction was a bipartisan reaffirmation of the wisdom of an SRO for the municipal market. Thirty-five years after our founding, we are proud of the trust that Congress has placed in the MSRB, and we intend to continue to provide prudent regulation of the market.

As an SRO, the MSRB has provided leadership and established industry standards that have raised investor protection safeguards to new levels. These standards include rules on pay-to-play activities by dealers, transparency of prices, the availability of interest rate resets on variable-rate securities and of course, the market disclosures available on EMMA.

### **Leadership in Rulemaking**

A fundamental way that the MSRB has protected investors since its inception is by creating and maintaining rules governing the activities of securities firms and banks that underwrite, sell and trade municipal securities. Investors rely on these firms to buy and sell their securities and to provide them with critical disclosure and market information needed to make investment decisions, and oftentimes also rely on the recommendations of the securities firm or bank in making the investment decision.

The MSRB maintains investor protection rules designed to prevent fraud and manipulation in the market, to promote the mechanisms of a free and open market, and to promote just and equitable principles of trade. MSRB rules create specific responsibilities for dealers effecting municipal securities transactions with investors, including requirements to ensure that the material facts about a proposed transaction are disclosed, that recommended transactions are suitable, and that transaction prices are fair and reasonable. MSRB rules establish specific professional qualification standards and continuing education requirements for dealer personnel, and other rules govern the sale of municipal fund securities, including investments in 529 college savings plans.

The MSRB's recent rulemaking activities in connection with securities firms and banks have focused on the needs of retail investors. Specifically, the MSRB has sought to dramatically increase retail investors' access to disclosure information and market data. Recent MSRB rules and related interpretations also have strengthened requirements that investment professionals use this information and data in analyzing potential investments for purposes of making recommendations to their customers

and in establishing fair market prices. Other initiatives have sought to ensure a fairer and broader distribution of new issue municipal securities, including the establishment of safeguards that require securities firms and banks to honor municipal issuers' directives in connection with retail order periods.

In the last few months since the enactment of the Dodd-Frank legislation, the MSRB has also been focusing closely on creating a sound foundation for the establishment of a new regulatory regime for municipal advisors that serve state and local governments, public pension funds, and other municipal entities. We recently issued our first set of municipal advisor rules as the first in what will likely be a long series of requests for comment, rule filings and interpretive notices establishing strong, fair and effective municipal advisor rules. One of the cornerstones of this regulatory regime will be a body of rules implementing a new federal fiduciary duty owed by municipal advisors to their municipal entity clients. Another key element will be a pay-to-play rule for municipal advisors designed to eliminate the corrosive effect of political contributions to obtain municipal advisory business.

These are all fundamental and critical rules that directly protect investors, municipal advisors and the general public. I'd like to take a moment, though, to talk in greater depth about one of these areas of regulation that has already had a significant positive effect on the integrity of the \$2.8 trillion municipal market as a whole and is poised to strengthen this positive influence within this market and to broaden it to other aspects of public financial and investment activities. This is the area of pay-to-play, or the inappropriate use of political contributions to influence the awarding of public sector business.

Elected public officials often play an important role in the awarding of municipal bond business. Attempts to influence this process by making or soliciting political contributions to those officials could compromise the integrity of the market and create conflicts of interest for both the officials and the underwriters of the securities. Such pay-to-play practices have the potential to harm the underwriting process and compromise the integrity of securities sold to investors.

The MSRB recognized the potential conflicts in the municipal bond underwriting business early on and was a pioneer in establishing rules that seek to prevent undue influence by dealers seeking bond business from governmental entities with bond issuing authority.

The MSRB's political contributions rule, Rule G-37, maintains the integrity of the municipal securities market and prevents pay-to-play practices by banning municipal securities dealers from engaging in municipal securities business after they have made contributions to issuer officials. The rule has served as a model in other financial markets, both in states and at the federal level.

Conflicts of interest between government officials and financial market intermediaries have continued to be a challenge for regulators. The MSRB's standards continue to prove effective and provide a model for other regulators, most recently for the Commission's new rules for investment advisers to pension plans. With our expanded jurisdiction under Dodd-Frank, we plan to propose pay-to-pay rules for municipal advisors. These market intermediaries play an important role in the financial decisions made by municipal governments on a broad range of municipal securities and investment-related matters. The activities of these advisors on bond offerings, derivatives transactions, the investment of municipal bond proceeds and the solicitation of investment advisory work all have the potential to present conflicts of interests for municipal advisors and the public officials they are advising. One of our goals will be to reduce the likelihood that these conflicts will harm the integrity of the municipal market and investor confidence in the market.

We believe that because of the MSRB's early and continued leadership in this area, municipal market investors as well as the public and taxpayers in general have been well-served.

### **Leadership in Market Disclosure and Transparency**

Another fundamental way the MSRB has safeguarded municipal market investors is by facilitating improved disclosure and transparency. Because of the MSRB's diligence in this area, investors now operate in a market where key documents and data are accessible to them when just a few years ago this access to information was unimaginable. The MSRB's self-regulatory structure and resources -- which have enabled it to create and finance the necessary technology -- in addition to market-wide and Commission support for better disclosure have raised disclosure and transparency in the municipal market beyond that in other fixed-income markets.

Price transparency, or the broad dissemination of trade price and volume information of completed trades for specific securities, is an area that the MSRB recognized as fundamental to investor

protection. Over the last 15 years, the MSRB has established critical milestones for market transparency, applying its resources and expertise to developing market information systems that benefit and protect investors.

Prior to 1995, the municipal securities market was essentially “opaque,” that is, no systematic and comprehensive dissemination of trade information existed. The MSRB recognized that price transparency would improve pricing efficiency and investor confidence, and undertook to bring these benefits to the municipal market.

A pilot program for inter-dealer trades launched in 1995, and over the next decade and earlier than any other fixed-income market, the MSRB implemented a transaction reporting program that brought post-trade transparency to the market. The implementation of the Real-Time Transaction Reporting System (“RTRS”) in January 2005 created transaction price transparency that is both comprehensive and contemporaneous.

Today, MSRB rules require dealers to report transactions, with limited exceptions, to the MSRB within 15 minutes of trade execution. Trade data, including the price, direction and quantity of the trade, is disseminated – and available to investors on EMMA -- nearly simultaneously after the transaction report is received.

Providing post-trade price transparency established a foundation for the MSRB’s continued commitment to overall municipal market transparency. The MSRB has continued to create market-leading transparency programs that take advantage of our expertise and the flexibility we have to address market issues.

The MSRB plans to now undertake a study of the municipal securities market, including a review of market structure and trading patterns. The study will review transaction costs, price dispersion and other market data to help the Board assess whether the market is operating as efficiently and fairly as possible. It also will assist the Board in evaluating whether pricing mechanisms and liquidity in the market could be improved with higher levels of pre-trade price transparency.

A core part of the MSRB's mission is to promote a fair and efficient market, and this study on pricing efficiency and liquidity is consistent with that mission. Once the study is completed, we can determine whether additional pre-trade information would provide benefits to market participants.

Last year, the MSRB launched a system to provide disclosure of interest rate reset information for short-term securities in the municipal market that never before was available to investors. The MSRB's Short-term Obligation Disclosure Program requires dealers to report interest rate information for auction rate securities and variable rate demand obligations on an end-of-day basis for dissemination to the market. The MSRB also collects and makes available the length of the interest rate reset period, the minimum denomination of the security as well as minimum and maximum rates. As of October 2010, the program had collected information on over 1.2 million rate resets for ARS and VRDOs.

Our leadership on transparency in the short-term market will continue with the expansion in 2011 of publicly available information that will provide investors with access to key documents about their bonds. We plan to begin collecting – and making available on EMMA -- bank liquidity agreement documents for variable rate demand obligations and bidding information for auction rate securities. These additional disclosures will improve transparency for investors seeking to evaluate critical information about the level of dealer support and underlying liquidity of auctions and resale of variable rate securities. Bidding information for auction rate securities allows investors to better understand liquidity and depth of the market, and liquidity facility documents provide key information about the support available for variable rate securities. Free access to this data will assist investors in evaluating these securities.

I have mentioned throughout my remarks today our EMMA system, which the MSRB launched on a pilot basis in 2008. In just a few short years, EMMA has transformed municipal disclosure and transparency for all investors. I mentioned that MSRB disseminates real-time trade data and interest rate resets through the EMMA website. EMMA also integrates this transaction information with crucial disclosure documents such as official statements, advance refunding documents, annual financial disclosures, and material event notices, such as default notices, rating change notices, and other continuing disclosure documents. This means that investors and the general public have free access to comprehensive market data and documents to help inform their investment decisions.

As with our commitment to providing transparency, the MSRB continues to enhance EMMA with additional disclosures and information that help investors evaluate their securities. Just last week we began collecting and making available to the public additional ongoing disclosures made by municipal securities issuers and obligated persons about their bonds. This development was in response to recent Commission amendments to Securities Exchange Act Rule 15c2-12 on continuing disclosure. To permit issuers to comply with the Commission's amendments, the MSRB modified EMMA to allow for submission of new categories of disclosures such as tender offers, bankruptcy, insolvency, receivership or similar proceeding, among other categories.

In 2011, EMMA will provide investors with new information about whether the issuer or other obligated persons has agreed to provide continuing disclosure information required under Rule 15c2-12, as well as the timing by which annual financial information is expected to be available on EMMA. Issuers also will be able to provide voluntarily on EMMA additional information about the timing and preparation of their annual financial disclosure as well as preliminary official statements and other pre-sale documents.

The MSRB also is planning to make municipal bond ratings freely available on EMMA which will enhance investor access to material information. Credit quality is a crucial consideration for investors, and ratings can be a key indicator in assessing an issuer's credit strength. Making rating information available together with the real-time trade data and disclosure documents on EMMA will provide unparalleled market transparency.

Thank you, Commissioner Walter, for this opportunity to provide you with information about how the MSRB has advanced investor protection. I hope that I have illustrated for you the value of independent municipal market oversight that operates under Commission supervision. Because of our self-funded nature, the MSRB has been able to deploy substantial funds to improving investor protection and to moving deliberately to create information systems that serve investors' needs. All of the market initiatives and rulemaking advanced by the MSRB have been developed and implemented with complete transparency and the full oversight of the Commission.

Together, the MSRB and the Commission have created a regulatory structure for the municipal market that seeks to continually address investor protection. The MSRB intends to continue to seek

ways in the future to improve investor protection through rulemaking, information systems and market leadership.