

## Comment Letter on MSRB Guidance Regarding Municipal Transactions, December 2000

November 30, 2000

Mr. Ernesto A. Lanza  
Associate General Counsel  
Municipal Securities Rulemaking Board  
1150 18th Street, N.W., Suite 400  
Washington, D.C. 20036

### **Re: Notice and Draft Interpretive Guidance on Dealer Responsibilities in Connection with Both Electronic and Traditional Municipal Securities Transactions**

Dear Mr. Lanza:

The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on the Municipal Securities Rulemaking Board's draft interpretive guidance regarding the responsibilities of brokers, dealers and municipal securities dealers (collectively, "dealers") under the MSRB's fair practice, quotation, uniform practice and new issue securities rules.<sup>2</sup> Our members are institutional investors that invest over \$7 trillion of assets on behalf of over 83 million individual shareholders. Of that amount, over \$500 billion are invested in municipal securities, representing one-third of that market.<sup>3</sup> As active participants in the municipal securities markets, our members are keenly interested in the proposal, especially to the extent it would impact investors' timely access to relevant and reliable information relating to municipal securities offerings for both traditional and electronic municipal securities transactions.

The MSRB's stated objective to provide interpretive guidance to "allow electronic trading systems to develop for municipal securities while preserving the high level of customer protection standards now required by MSRB rules"<sup>4</sup> is a laudable one. The Institute strongly supports appropriate initiatives to promote electronic trading in the municipal securities market. Experience on the equity side has shown that electronic trading systems are beneficial to investors by, among other things, decreasing spreads and increasing transparency and liquidity.

Nevertheless, while we support the MSRB's consideration of ways to promote the development of such systems for municipal securities, we strongly oppose the approach it has taken to achieve that result. In particular, the MSRB's proposed creation of a class of "sophisticated market professionals" that would receive a lesser degree of protection under the MSRB rules than other customers of dealers is ill-considered. As discussed below, the two-tier disclosure system promoted in the Draft Guidance is based on faulty premises regarding the current state of disclosure in the municipal marketplace.

Our specific comments on the Draft Guidance are set forth below.

## I. Creation of a "Sophisticated Market Professional" Category

The Draft Guidance is intended to address some of the regulatory questions raised by electronic trading of municipal securities. Rather than adopting different sets of rules for electronic and traditional trading, the MSRB instead proposes to adopt different sets of rules for different categories of investors. The Draft Guidance introduces a new concept, the "sophisticated market professional," which would be used to define a certain class of investor. Specifically, the Draft Guidance provides that if a customer (1) has timely access to all publicly available material facts concerning a transaction, (2) is capable of independently evaluating the investment risk and market value of the securities at issue, and (3) makes independent investment decisions, then the dealer would have reduced obligations under Rule G-17 (fair dealing), Rule G-18 (execution) and Rule G-19 (suitability). For the reasons stated below, the Institute believes the approach the MSRB is proposing is the wrong one.

### **A. The MSRB's Proposed Concept of a "Sophisticated Market Professional" Is Based on a Flawed Premise.**

According to the Draft Guidance, the basic premise underlying the concept of the "sophisticated market professional" is that when a customer is on "equal informational footing" with a dealer, and has the capability of independently evaluating the risk and value of securities based on the available information, the need for the dealer to provide information and make certain assessments for the customer is reduced. This premise is based on the notion that certain categories of investors routinely enjoy timely access to all material information on municipal securities that is available to brokers. But this simply is not accurate. The flaw in this premise is compounded by the lack of sufficient publicly available information about a particular municipal security in the first place.

The Draft Guidance recognizes the limitations regarding the public availability of municipal securities information when it acknowledges that "substantial differences" exist between municipal securities and other types of securities.<sup>5</sup> Specifically, the Draft Guidance notes that, compared with equity securities, the "level and timeliness of information [on municipal securities] simply is not available today in the municipal securities market."<sup>6</sup> It also recognizes that the regulatory framework for municipal securities imposes obligations on underwriters regarding primary and secondary market disclosures that are not nearly as extensive or as standardized as the disclosure for equity markets, and that there is no centralized source for secondary market information for municipal securities as there is for equity securities.<sup>7</sup>

Moreover, although the SEC's Rule 15c2-12 obligates underwriters to contract with municipal issuers to make certain primary and secondary market disclosures, the required updates are annual, rather than quarterly, and may be quite stale by the time they are provided. Furthermore, the required material events disclosures are limited in scope, and there are significant exemptions from the disclosure requirements (e.g., money market fund instruments need not comply at all with the relatively minimal continuing disclosure requirements of Rule 15c2-12). Anecdotal evidence suggests that compliance with the requirements is inconsistent, particularly for infrequent issuers.

The paucity of information provided in the municipal securities market is further acknowledged by the MSRB when it concludes that:

In the municipal securities market most investors still need to rely upon a market intermediary to access information about particular investments. Consequently, the dealer remains very important in explaining the product to the investor, ensuring that recommendations are suitable and that transactions are priced correctly.<sup>8</sup>

Thus, given the deficiencies in municipal securities disclosure a reduction in the obligations of dealers under MSRB rules is not justified.

## **B. The Factors Listed in the Draft Guidance Are Not Dispositive.**

The Draft Guidance provides a non-exhaustive list of factors that dealers should consider in determining whether a customer has access to all publicly available material facts concerning a transaction. These factors include: (1) the resources available to the customer to investigate the transaction (e.g., research analysts); (2) the customer's independent access to nationally recognized municipal securities information repositories ("NRMSIRs"), state information depositories ("SIDs"), and information generated by the MSRB's Municipal Securities Information Library system and Transaction Reporting System (collectively, "Information Repositories"), either directly or indirectly through services that subscribe to such systems; and (3) the customer's access to other sources of information concerning material financial developments affecting an issuer's securities (e.g., rating agency data).

While we agree that the availability of research analysts is germane to determining the sophistication of a municipal securities investor, it does not necessarily follow that access by research analysts to Information Repositories and rating agency data means that sufficient "publicly available material facts" are available on a "timely" basis to investors that employ research analysts. As the Draft Guidance points out, not one of the Information Repositories receives all secondary market information from issuers, nor is there any centralized directory of this information. Moreover, the information at the Information Repositories is not available on a no-charge, on-line basis. Furthermore, not all information that is disclosed by an issuer is necessarily filed with or collected by the Information Repositories, and such public information as may be available from the Information Repositories may be too sparse or outdated to provide, on its own, an adequate basis for an investor to make an informed credit decision, no matter how sophisticated its analytical and technological capabilities. In those situations, the dealer selling municipal securities, by virtue of its relationship with the issuer of the securities or its position in the securities, may possess, or be in the best position to acquire, public information that is relevant and material to the investor, but unavailable to the investor or not available on a timely basis. Due to the fragmented nature of currently "available" information about municipal securities, it cannot be presumed that an investor, however sophisticated, has access to all information that has been gathered by or is available to a dealer, and the duty of a dealer to disclose all such material information remains an important and necessary protection for all investors.

## **C. The Concept of a "Sophisticated Market Professional" is Premature Until There are Substantial Improvements in Municipal Securities Disclosure.**

It is against the backdrop discussed above that the MSRB proposes to adopt its current proposal. In the Draft Guidance, the MSRB uses the lack of generally available, timely public information about municipal securities as the foundation for its conclusion that the

MSRB rules should apply to dealers operating electronic trading systems. Yet having done so, it proposes to permit dealers to reduce their obligations under the MSRB rules to certain customers (in traditional trades as well as electronic trades) if they determine that such customers have "timely access to all publicly available material facts concerning a transaction." Given the limited availability of timely and relevant information on municipal securities, we submit that few investors would routinely qualify as a sophisticated market professional if the term were properly construed in the municipal marketplace. However, the Draft Guidance leaves to the dealer's judgment the determination of whether an investor is a "sophisticated market professional," and the likelihood is that, once the concept is created, an increasing number of investors will be shoe-horned into that category to their detriment, even though the municipal market does not yet provide sophisticated investors direct access to all available information.

If the regulatory framework of the municipal marketplace provided investors access to financial and operating information for all securities within reasonable time limits after the end of the applicable reporting period, if certain exemptions to Rule 15c2-12 were repealed, and if a workable, centralized system for the accessing of available public information about municipal securities were implemented and available free of charge, an argument could be advanced for dispensing with certain of the broker-dealer's responsibilities under the MSRB rules in transactions involving categories of customers deemed capable of accessing such public information without the dealer's assistance. But that is not the current state of affairs. Given the present disclosure in the municipal market, as acknowledged by the Draft Guidance, the concept of a "sophisticated market professional" is flawed, and for all the reasons stated above, the MSRB should not, in the course of developing sensible rules for electronic trading systems, jettison dealer responsibilities and investor protections while such a need remains.

## II. Application of MSRB Rules to Electronic Transactions

In the Draft Guidance, the MSRB, while recognizing that dealers that operate electronic trading systems may perform different functions from traditional dealers, affirms that its rules apply to electronically executed transactions. We agree with the MSRB's assessment that its rules should be equally applicable to dealers transacting business through electronic trading systems. All other things being equal, there is a powerful incentive for business transactions to migrate to the least regulated environment, and exempting electronic transactions from some or all of the MSRB rules could, over time, result in a municipal market in which traditional person-to-person transactions are disfavored by dealers. By the same token, if the MSRB promotes lower duties by dealers towards "sophisticated market professionals" than are in place for retail investors, retail investors may find themselves shut out of many electronic or other trading systems because the operators do not wish to take on the additional duties under the MSRB rules towards the "unsophisticated" investor. None of this would be healthy for the municipal marketplace.

The Draft Guidance asserts that, despite the distinctions between electronic trading and traditional brokerage of securities, the MSRB "has made a preliminary determination not to create a separate set of rules" to govern the activities of dealers that operate electronic trading systems. For the reasons stated above, we agree that the basic MSRB rules should apply with equal force to electronic trading. The Institute recognizes, however, that the application of the MSRB rules in the impersonal context may raise some questions for which the dealer community is entitled to regulatory guidance. Accordingly, any such guidance provided by the MSRB with respect to electronic trading should focus on how its rules should be implemented as a practical, technical matter in the electronic context, and not on whether the investor protection standards embodied in the rules should be maintained in full.

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The Institute appreciates the opportunity to comment on the MSRB's Draft Guidance. If you have any questions regarding our comments, please feel free to contact me at (202) 326-5824 or Barry Simmons at (202) 326-5923.

Sincerely,

Amy B.R. Lancellotta  
Senior Counsel

cc: Carolyn Walsh  
Assistant General Counsel

### ENDNOTES

<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,325 open-end investment companies ("mutual funds"), 489 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about \$7.232 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

<sup>2</sup> Notice and Draft Interpretive Guidance on Dealer Responsibilities in Connection with Both Electronic and Traditional Municipal Securities Transactions (September 28, 2000) ("Draft Guidance").

<sup>3</sup> See ICI Mutual Fund Fact Book (40th ed.) at 24.

<sup>4</sup> See Draft Guidance at 5-6.

<sup>5</sup> Id. at 3.

<sup>6</sup> Id. at 4.

<sup>7</sup> For example, while equity investors can locate, on-line, quarterly disclosure filings, market data, historical charts and securities analyses, often at no charge, through the Securities and Exchange Commission's Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system and other repositories of the periodic reporting required from issuers of publicly traded equity securities, no such centralized repository of secondary market information is available to investors in municipal securities.

<sup>8</sup> Draft Guidance at 4.