



February 6, 2009

The Honorable Barney Frank
Chairman, House Financial Services
Committee
2252 Rayburn House Office Building
Washington, DC 20515

The Honorable Christopher Dodd
Chairman, Senate Banking, Housing,
and Urban Affairs Committee
448 Russell Senate Office Building
Washington, DC 20510

The Honorable Spencer Bachus
Ranking Minority Member,
House Financial Services Committee
2246 Rayburn House Office Building
Washington, DC 20515

The Honorable Richard C. Shelby
Ranking Minority Member,
Senate Banking, Housing, and Urban Affairs
Committee
304 Russell Senate Office Building
Washington, DC 20510

Dear Congressmen:

President Obama's Administration, Congress and other federal policymakers have stated that an overhaul of the financial markets regulatory structure is a top priority. The tumultuous events of the last year have made it abundantly clear that a comprehensive rulemaking and rigorous enforcement scheme governing the financial markets is imperative to restoring confidence in the markets, and that an overhaul is warranted.

As you grapple with this challenge, the Municipal Securities Rulemaking Board ("MSRB") urges you to develop a regulatory structure that governs municipal market participants that provide certain key services to state and local government issuers. Investor protection, market integrity and market efficiency require nothing less. In furtherance of that goal, the MSRB respectfully submits the following observations about the municipal securities market, and the MSRB's unique qualifications to expand its regulatory authority over these unregulated municipal market participants.

Municipal Securities Rulemaking Board

As you are aware, the MSRB is a self-regulatory organization ("SRO") established by Congress in 1975 under Section 15B of the Securities Exchange Act of 1934 ("Section 15B") to develop rules for securities firms and banks (collectively "dealers") that underwrite, trade and sell municipal securities. The MSRB also operates



information systems such as the Electronic Municipal Market Access System (“EMMA”), designed to promote transparency and access to information in furtherance of its investor protection mandate.

The MSRB stands as a unique SRO for a variety of reasons. The MSRB was the first SRO specifically established by Congress. Further, because municipal securities are unlike other types of securities in certain key respects, Congress created the MSRB as a product-specific regulator with a charter unlike most other securities regulatory bodies. Congress charged the MSRB with establishing a regulatory structure for ensuring investor protection through the adoption of a body of dealer rules that both respects the role of state and local governmental issuers, and is tailored to maintain their independence from federal regulation. The MSRB’s 15-member Board meets throughout the year to make policy decisions, approve rulemaking, enhance information systems and review developments in the municipal securities market. The operations of the MSRB are funded through assessments made on dealers, including assessments for underwritings and transaction fees.

Section 15B provides the MSRB with broad authority to write rules governing the activities of dealers in the municipal securities market. It does not provide the MSRB with authority to write rules governing the activities of municipal securities issuers, nor does it provide the MSRB with the authority to regulate the activities of other professionals in the municipal finance market such as independent financial advisors and swap advisors (collectively, “financial advisors”) and brokers of guaranteed investment contracts and other collateral investment products (“investment brokers”). In fact, many of these market intermediaries are entirely unregulated, and operate without any professional standards, accountability or fair practice responsibilities.

Although the MSRB model of regulation has proven effective historically, the complexity of the current municipal securities market makes regulation over only one of the many professionals active in this market sub-optimal, and necessitates regulation of a broader group of market participants. This need is evidenced by the ever increasing number of federal and state investigations into corruption and pay-to-play activities (beyond those already covered by the MSRB’s dealer rules) involving municipal securities transactions, the ensuing media coverage and the resulting negative impact on investor confidence and market integrity. This currently narrow model of regulation has also caused widespread confusion over how the municipal market is regulated. As such, on January 9, 2009 the MSRB issued a statement asking that specific consideration be given to placing financial advisors, investment brokers and other unregulated market participants in the municipal market under federal regulation.¹

Given our market expertise, we offer for your consideration the following observations on a comprehensive regulatory structure for the municipal securities market, as well as our thoughts about several broader topics which impact our market. We believe that as Congress and the Administration review the regulation of financial advisors, investment brokers and related intermediaries in the municipal market, the MSRB (a creature of the Congress and the SEC), as the agency charged already with municipal market rulemaking, believes it would be the appropriate candidate to be the agency to regulate these unregulated entities.

¹ Statement of the Municipal Securities Rulemaking Board Regarding Regulation of the Municipal Market, January 9, 2009 (<http://www.msrb.org/msrb1/Press/Release/MSRBStatementonRegulationoftheMunicipalMarket.asp>).

Current Regulatory Framework of the Municipal Market

When examining a new regulatory structure for our financial markets, it is important to recognize that the municipal securities market is distinct from other securities markets in light of sovereign rights, powers and interests of municipal issuers, diversity of issuer types, federal tax law and state law requirements and restrictions that relate to the issuance and sale of municipal securities. As the regulator of municipal securities dealers, the MSRB is keenly attuned to its role at the boundary between the federal government (establishing an efficient national marketplace and uniform investor protections) and states/localities exercising their public trust to meet the unique needs of their citizens. In the service of these goals, the MSRB has sought to provide informed rulemaking that is based on an understanding of the products that are being created and sold, and the dynamics driving decisions of the issuers, investors and dealers. This requires careful tailoring of basic securities regulation principles to achieve key investor protection objectives without unduly imposing direct or indirect restraints on municipal issuers.

MSRB Rules for Dealers. The MSRB has adopted a substantial body of rules that reflect the special characteristics of the municipal securities market and its unique regulatory needs, and that are designed to regulate dealer conduct in the municipal securities market. MSRB rules recognize that dealer rules that are effective in the context of the corporate securities market where issuers and other market participants are highly regulated may not be nearly as effective in a market where municipal issuers have significant discretion and market professionals other than the dealers are unregulated.

In general, our rules are “principles-based” with specific guidance given where appropriate. MSRB rules can generally be categorized as (1) fair practice rules (*e.g.*, requirements for dealers to provide affirmative disclosures of material facts to investors; to ensure the suitability of dealer recommendations of municipal securities transactions; to fairly price transactions; to avoid conflicts of interest; and to publish fair and accurate advertisements and price quotations); (2) uniform practice rules (*e.g.*, rules to ensure that standard procedures are followed in underwriting, clearing, confirming and settling transactions in municipal securities; helping to ensure the efficiency of market operations while accommodating the differences between municipal securities and other debt instruments); (3) professional qualification rules (*e.g.*, requirements for dealer personnel to pass tests demonstrating competency; continuing education requirement); (4) operational standards (*e.g.*, rules regarding recordkeeping; supervision of professionals); and (5) marketplace disclosure rules (*e.g.*, rules requiring dealer real-time reporting of trade prices; underwriter filing of issuer’s disclosure documents; and dealer disclosure of political contributions to the MSRB for public dissemination). These rules require dealers to observe the highest professional standards in their activities and relationships with customers, and significantly exceed the general anti-fraud principles that constrain federal securities laws.

Two MSRB rules of particular note, Rule G-37 and Rule G-38, have been adopted to specifically address pay-to-play issues and the use of paid political operatives to obtain municipal securities business. These rules, which place severe limits on the ability of dealers to undertake municipal securities business for issuers if certain direct or indirect political contributions have been made to their elected officials, have been emulated by a number of state and local governmental entities to help in their efforts to control pay-to-play issues involving government contractors other than dealers.

Unregulated Parties in the Municipal Securities Market. As noted above, the MSRB’s jurisdiction extends to writing rules for the dealer community only. We have no authority to extend these rules to other market participants.

Financial Advisors and Investment Brokers. As federal lawmakers and policymakers are looking into unregulated intermediaries throughout the financial markets such as mortgage brokers, so too should attention be paid to these intermediaries in the municipal market. As municipal finance transactions have evolved and become more complex, there are many more advisors who work with municipal issuers, and brokers who act as intermediaries between issuers and others who provide necessary investment and other services. These participants have significant influence with issuers, earn significant fees and many times, are not constrained by any prohibitions on political contributions, either participating in pay-to-play, or giving the appearance of a quid pro quo for attaining business. Unfortunately, the regulatory structure over the municipal market has not kept up with the evolving marketplace and nearly all of these participants are unregulated. At a minimum, financial advisors and investment brokers should be held to standards of conduct that protect municipal issuers, taxpayers and investors in this market. The existing MSRB rulebook provides a ready model for the types of rules that could be developed for these market intermediaries.

Investors in the municipal securities market would be best served by subjecting unregulated market professionals to a comprehensive body of rules that (i) prohibit fraudulent and manipulative practices, (ii) require the fair treatment of investors, issuers and other market participants, (iii) mandate full transparency, (iv) restrict real and perceived conflicts of interests, (v) ensure rigorous standards of professional qualifications, and (vi) promote market efficiencies. The municipal securities dealer community undertook the transition from being unregulated to becoming subject to such a body of rules and standards beginning in 1975 with the creation of the MSRB. The MSRB believes it is now time for the unregulated professionals in this market to undertake this same transition, and that the MSRB is the most appropriate regulatory body to provide this regulation.

While many states and localities have laws that prohibit pay-to-play activities and laws that require disclosures of political contributions for market professionals other than dealers, in many cases based on MSRB Rule G-37, the limited patchwork nature of these state and local laws has not been effective in stopping the possibility and appearance of pay-to-play activities in the unregulated portions of our market. A comprehensive federal approach is required.

Financial Guaranty Insurance Companies. There are other market participants such as financial guaranty insurers that are integral to a well functioning municipal market. The further regulation of these market participants remains an issue under discussion. Currently, insurance is regulated at the state level. However, as we have seen this past year, because of the systemic risk implications of a failure of the bond insurance industry, the MSRB recommends that you consider the potential for federal regulatory oversight for financial guaranty insurance companies or a dual federal/state regulatory structure. The MSRB believes that possibility of federal and/or state credit enhancement and a national and/or state financial guaranty insurer provides an interesting opportunity worthy of further exploration.

Municipal Issuers. The SEC's current jurisdiction includes authority to enforce antifraud laws with respect to issuers of municipal securities, and the SEC has brought enforcement actions in a number of high profile cases in the past few years. We also note that nearly every jurisdiction has laws which purport to address pay-to-play, bribery and outright corruption at the state and local level. In addition, the associations representing state and local municipal issuers (Government Finance Officers Association and National Association of State Treasurers, in particular) also have an extensive body of recommended practices and an impressive educational outreach effort to help municipal issuers adhere to the highest standards of conduct. The MSRB is not

suggesting the need for any additional federal regulation governing municipal issuers. We note the extensive improvements in municipal disclosure over the years primarily due to industry cooperation and coordination, and the influence of the buy-side community to demand additional disclosures for certain sectors and in certain markets. We believe that these ongoing industry efforts and market influences will continue to enhance the quality and timeliness of disclosures in our industry.

Financial Markets Regulatory Structure

We support the concept of a multi-layered regulatory framework as a starting point for consideration of a new regulatory structure for the financial markets, as has been proposed by a number of governmental and non-governmental bodies in recent months.² Such multi-layered regulatory framework would consist of (1) a market stability regulator to address overall conditions of financial market stability that could impact the general economy; (2) a prudential financial regulator to address issues of limited market discipline; and (3) a business conduct regulator (linked to consumer protection regulation) to address standards for business practices.

This approach, or in fact any scenario, requires that these regulatory entities have deep and extensive knowledge of all financial markets. The lack of municipal finance expertise at the federal level became apparent during the past year and resulted in a very late and limited recognition of the impact of the credit crisis on state and local municipal finances, and the failure of federal programs intended to alleviate the economic impact of the credit crisis to address the needs of state and local governments.

To this end, the MSRB strongly recommends that you consider the creation of a Treasury Department office or other significant federal position charged with representing the unique needs of the municipal securities market, or alternatively, consider developing a senior level group to coordinate municipal finance issues among the White House, Department of the Treasury, Federal Reserve, SEC, MSRB and other federal agencies and stakeholders.

Self Regulatory Organizations

The MSRB also believes that there is an important role for market-specific, self-regulatory organizations in any comprehensive regulatory framework. These SROs would continue to adopt rules and standards, establish market mechanisms and systems and standards of operations, and adopt market-specific rules and standards for investor protection. These SRO activities can far exceed the antifraud standards of the federal securities laws and can extend to the regulation of the behavior of market intermediaries, thereby ensuring the goals of investor protection and integrity of the securities markets. SROs are also uniquely situated to work with the industry to develop effective rules and information systems, and can be vital links between the industry and the broader regulatory community. SRO jurisdiction must be flexible and broad enough to encompass new products, market developments, new market entrants, market movements and other changes.

See, e.g., U.S. Government Accountability Office, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System* (GAO-09-216), January 8, 2009, available at <http://www.gao.gov/new.items/d09216.pdf>; Group of Thirty, *Financial Reform: A Framework for Financial Stability*, January 15, 2009, available at http://www.group30.org/pubs/pub_1460.htm; U.S. Department of the Treasury *Blueprint for a Modernized Financial Regulatory Structure*, available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

Enforcement

Traditionally, enforcement activities have been spread across numerous federal and state governmental entities and self-regulatory organizations, creating a patchwork of overlapping jurisdiction and inconsistent and uncoordinated enforcement activities. While some coordination of enforcement activities currently exists, the MSRB strongly recommends that each of the entities that are charged with the enforcement of securities laws – regardless of the genesis of those laws – develop a more formal process to coordinate their regulatory and enforcement activities. Coordinated actions could avoid regulatory gaps, provide clearer statutory authority and promote an efficient and consistent enforcement mechanism for the industry.

Derivative Products

The current state of the law as articulated in the 2000 Commodities Futures Modernization Act prohibits regulation of swap agreements which are broadly defined, and the issue of whether and how to regulate credit default swaps and other derivative instruments remains controversial. While municipal derivatives play an important risk management role in the overall municipal securities market, municipal derivatives are only a fraction of the overall derivatives markets. While we do not advocate any particular position on the regulation of derivatives, we believe that derivative instruments based on municipal securities should be subject to the same comprehensive regulatory framework that may be developed for swaps and other types of derivative financial products in other markets, albeit such development should be done in consultation with experts in the municipal and other markets.

The proposals under discussion for increased oversight of the derivatives market include the development of a central clearinghouse for credit default swaps (“CDS”); the use of a central counterparty; filing disclosures by hedge fund managers, brokerages, and institutional investors; disclosure by CDS dealers of their trades and positions; and minimum capital reserves. Each proposal appears reasonable, appropriate and worthy of further study. Should enhanced disclosures in derivative instruments be a part of any regulatory scheme, the MSRB is well poised with its EMMA system to provide disclosures of municipal derivative contracts and provide the necessary transparency for our market.

Conclusion

Since its creation in 1975, the MSRB has worked diligently to foster and preserve a fair and efficient municipal securities market that serves the public interest. The dual goals of investor protection and market integrity have guided this mission. However, the increased sophistication of our market, changing financial markets generally, and the importance of investor protection in the market require a review of the regulatory structure of this market.

To that end, we make the following recommendations:

- We believe that financial advisors, investment brokers and other intermediaries in the municipal market should be brought under a comprehensive regulatory scheme. Further, we believe that the MSRB is the appropriate regulatory body to regulate these unregulated municipal market participants.

- We support a multi-layered overall regulatory framework for the financial markets consisting of a market stability regulator, a prudential financial regulator and a business conduct regulator.
- We believe that there is an important role for market-specific SROs that are charged with adopting rules and standards, establish market mechanisms, information systems and standards of operations that embody and expand upon the basic antifraud standards of the federal securities laws.
- We recommend the creation of a Treasury Department office or other significant federal position charged with representing the unique needs of the municipal securities market, or alternatively, a senior-level multiple-agency group to coordinate municipal finance issues among all market stakeholders
- We strongly recommend that federal and state entities charged with the enforcement of securities laws develop a more formal process to coordinate their regulatory and enforcement activities.
- We believe that derivative instruments based on municipal securities should be subject to the same comprehensive regulatory framework that may be developed for swaps and other types of derivative financial products in other markets.

The rules governing dealer activity developed by the MSRB over its history provide an appropriate model for the comprehensive regulation that should apply to all financial intermediaries active in the municipal market. We stand ready to assist in this important work.

Respectfully submitted,



Ronald A. Stack
Chair

cc: Timothy F. Geithner, Secretary, Department of the Treasury
Ben S. Bernanke, Chair, Board of Governors of the Federal Reserve
William C. Dudley, President, Federal Reserve Bank of New York
Mary L. Schapiro, Chair, Securities and Exchange Commission