MSRB
Municipal Securities Rulemaking Board

Regulatory Notice

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Stakeholders
Municipal Securities Dealers, Municipal Advisors, Issuers, Investors, General Public

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Request for Comment

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July 13, 2015

Category
Administration

Affected Rules
Rule A-3

Request for Comment on Draft Amendments and Other Issues Related to MSRB Rule A-3 on Membership on the Board

Overview

The Municipal Securities Rulemaking Board (MSRB or Board) is seeking comment on draft amendments to MSRB Rule A-3, on membership on the Board, to modify the application of the standard of independence for the one public Board member required by the Securities Exchange Act of 1934 (Exchange Act)[1] to be representative of institutional or retail investors in municipal securities. The draft amendments are designed to allow the MSRB to consider and select from a broader group of applicants with no material business relationship with an entity regulated by the MSRB to serve in that Board member position. The current standard of independence will continue to apply to all other public Board members.

Additionally, the MSRB is seeking comment on whether it should modify the length of Board member service and whether it should remove or modify the requirement that the MSRB publish the names of all Board applicants. The MSRB is not, at this time, offering specific proposals or draft amendments to address either of these questions. Rather, this aspect of the request for comment is intended to elicit input from all interested parties to assist the MSRB in determining whether to consider modifying sections of Rule A-3 pertaining to the length of Board member service and the publication of the names of all applicants.

Comments should be submitted no later than July 13, 2015, and may be submitted in electronic or paper form. Comments may be submitted electronically by clicking here. Comments submitted in paper form should be sent to Ronald W. Smith, Corporate Secretary, Municipal Securities

[1] 15 U.S.C. 78.

Rulemaking Board, 1900 Duke Street, Suite 600, Alexandria, Virginia 22314. All comments will be available for public inspection on the MSRB's website.[2]

Questions about this notice should be directed to Robert Fippinger, Chief Legal Officer, or Carl E. Tugberk, Assistant General Counsel, at 703-797-6600.

Application of the Standard of Independence for the Public Representative of Institutional or Retail Investors in Municipal Securities

Background

The MSRB is the self-regulatory organization (SRO) created by Congress to establish rules governing the municipal securities activities of brokers, dealers and municipal securities dealers (collectively, dealers) and the municipal advisory activities of municipal advisors. The MSRB's mission is to protect municipal entities, obligated persons, investors and the public interest, and to promote a fair and efficient municipal securities market. The MSRB fulfills this mission primarily by regulating dealers and municipal advisors, providing market transparency through its Electronic Municipal Market Access (EMMA®) website and conducting market leadership, outreach and education. The importance of the perspective of the investors in municipal securities in determining how best to carry out this mission cannot be overstated.

The requirements for the Board's basic composition (but not its actual size) are set forth in the Exchange Act.[3] As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act),[4] Congress made various amendments to the Exchange Act to make the Board majority public. Those amendments categorized the members of the Board in two broad groups: individuals who must be associated with a broker, dealer, municipal securities dealer or municipal advisor (Regulated Representatives),

[2] Comments are posted on the MSRB's website without change. Personal identifying information such as name, address, telephone number, or email address will not be edited from submissions. Therefore, commenters should only submit information that they wish to make available publicly.

[3] *See* 15 U.S.C. 78o-4(b)(1). Rule A-3 further establishes the Board's composition and sets its size at 21 members.

[4] Pub. L. No. 111-203, 124 Stat. 1376.

and individuals who must be independent of any municipal securities broker, municipal securities dealer, or municipal advisor (Public Representatives).[5] The Dodd-Frank Act amendments further established that the number of Public Representatives shall at all times exceed the number of Regulated Representatives,[6] as well as minimum requirements for certain types of individuals to serve in each category as follows: (1) at least one of the Regulated Representatives must be associated with and representative of a dealer that is not a bank (or subsidiary or department or division thereof); (2) at least one of the Regulated Representatives must be associated with and representative of a dealer that is a bank (or subsidiary or department or division thereof); (3) at least one of the Regulated Representatives must be associated with and representative of a non-dealer municipal advisor; (4) at least one of the Public Representatives must be representative of institutional or retail investors in municipal securities (Investor Representative); (5) at least one of the Public Representatives must be representative of municipal entities; and (6) at least one of the Public Representatives must be a member of the public with knowledge of or experience in the municipal industry.[7] The Dodd-Frank amendments additionally required that each Board member be "knowledgeable of matters related to the municipal securities markets."[8]

The Dodd-Frank Act did not provide a definition of "independent of any municipal securities broker, municipal securities dealer, or municipal advisor," or specify how the Board should evaluate independence. Rather, it delegated the authority to set those requirements to the MSRB, subject to Securities and Exchange Commission (SEC) approval.[9] The MSRB, in 2010, implemented this new standard by amending Rule A-3. The amendments defined "independent of any municipal securities broker, municipal securities dealer, or municipal advisor" to mean that the individual has "no material business relationship" with any municipal securities broker, municipal

[5] *See id.*; 15 U.S.C. 78o-4(b)(1); MSRB Rule A-3(a)(i)-(ii).

[6] *See* 15 U.S.C. 78o-4(b)(2)(B)(i).

[7] *See* 15 U.S.C. 78o-4(b)(1).

[8] *Id.*

[9] *See* 15 U.S.C. 78o-4(b)(2)(B)(iv).

securities dealer, or municipal advisor.[10] The MSRB defined "no material business relationship" to mean that, at a minimum, the individual is not and, within the last two years, was not associated with a municipal securities broker, municipal securities dealer, or municipal advisor, and that the individual does not have a relationship with any municipal securities broker, municipal securities dealer, or municipal advisor, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision making of the individual.[11]

In practice, the "associated with" test the MSRB adopted in 2010 has eliminated qualified individuals, whom the Board believes, in retrospect, did not have any material business relationship with a regulated entity,[12] from being considered as Public Representatives.[13] The MSRB has considered these individuals to be disqualified solely due to the presence of a regulated entity within their employer's corporate structure—even where the individual's nexus with such regulated entity is remote and cannot reasonably be seen as affecting his or her independent judgment or decision making. For example, an individual, whose only affiliation with a broker-dealer registered with the MSRB is due to the individual's service as an independent director on the board of directors of a company that is in the same corporate family as the broker-dealer, has been disqualified from serving on the board as a Public Representative. Similarly, because many

[10] *See* Exchange Act Release No. 63025 (September 30, 2010); 75 FR 61806 (October 6, 2010) (SR-MSRB-2010-08) (approving the MSRB's standard of independence for Public Representatives); MSRB Rule A-3(g)(ii).

[11] *See* MSRB Rule A-3(g)(ii).

[12] The MSRB anticipates that any proposed amendment to the standard of independence would include a new definition of "regulated entity" to mean a broker, dealer, municipal securities broker, municipal securities dealer, or municipal advisor regulated by the MSRB to simplify the rule text. Such a change would be technical and unrelated to the meaning of "Public Representative" or "Regulated Representative" in Rule A-3. This new definition is included in the draft rule text as subsection (g)(vi) and corresponding changes have been made elsewhere in the draft rule text, including subsection (g)(ii) that defines the standard of independence.

[13] *See* 15 U.S.C. 78c(a)(18) ("The term 'person associated with a broker or dealer' or 'associated person of a broker or dealer' means any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of section 15(b) of [the Exchange Act] (other than paragraph (6) thereof).").

institutional investors have affiliated broker-dealers that engage in municipal securities or municipal fund securities business, any non-clerical individual within such companies, many of whom have the expertise and knowledge to represent investors, and the statutorily-required knowledge of the municipal securities market, have been precluded from serving as a Public Representative even if the individual's role and responsibilities are wholly unrelated to the broker-dealer activity or such broker-dealer activity is an immaterial portion of the overall business of the family of companies. After having consistently used this broad interpretation of the term "associated with," the MSRB has believed, and continues to believe, that the proper way to address these issues would be through consideration of amendments to its rules. In an effort to do so, in July 2013, the MSRB filed with the SEC a proposed rule change to amend Rule A-3 to modify the standard of independence for Public Representatives to be consistent with the approach of the Financial Industry Regulatory Authority (FINRA), another SRO that also has public board members.[14] After commenters expressed concerns with the 2013 proposal, the MSRB withdrew the filing, with a plan to further increase its efforts to identify well-qualified applicants to serve as the Investor Representative and gain additional experience operating with the existing standard.[15]

After making those efforts and gaining additional informative experience applying the standard, the MSRB continues to believe that an applicant should be considered independent only if the person has no material business relationship with a regulated entity. The MSRB believes, however, that the current test for evaluating the materiality of a business relationship is unduly restrictive, resulting in the disqualification of qualified individuals, who have relevant knowledge and expertise that are key to the MSRB's ability to meet its statutory mandate, as Public Representatives. Specifically, the MSRB has continued to experience significant challenges in finding a sufficient pool of individuals qualified to serve as the Investor Representative. Accordingly, the MSRB is proposing to modify the standard of independence by providing an alternative definition of "no material business relationship" to determine whether an individual being considered

[14] *See* Exchange Act Release No. 70004 (July 18, 2013); 78 FR 44607 (July 24, 2013) (SR-MSRB-2013-06) (2013 proposal). *See* FINRA By-Laws, Article I (defining an "Industry Governor," in part, to include an individual who is or has served in the prior year as an officer, director (other than as an independent director), employee or controlling person of a broker or dealer and a "Public Governor," in part, as an individual who is not an Industry Governor and who otherwise has no material business relationship with a broker or dealer).

[15] *See* Exchange Act Release No. 70617 (October 7, 2013); 78 FR 62780 (October 22, 2013) (SR-MSRB-2013-06).

to serve as the Investor Representative is independent, while continuing to use the current definition to determine the independence of all other Public Representatives. This proposed modification is intended to address commenters' concerns with the 2013 proposal in at least three ways. First, it would require the Board to undertake additional analysis to ensure that this particular Public Representative does not have any material business relationship with a regulated entity. Second, as noted, the modification would not apply to any of the other Public Representative positions on the Board; for those, the current definition of "no material business relationship" would remain unchanged. The rationale for the draft amendments, as described above, is specific to the Investor Representative position and does not apply to the other Public Representative positions. Third, although the Exchange Act allows more than one member of the Board to be an Investor Representative, the draft amendments would limit the applicability of the alternative definition to only one such representative.

Draft Amendments to Rule A-3

The purpose of the draft amendments to Rule A-3 is to improve the MSRB's ability to identify and select individuals, who represent investors and have significant knowledge of the municipal securities market, to serve on the Board as the Investor Representative, as required by Section 15B(b)(1)(A) of the Exchange Act. Specifically, the MSRB believes that there are employees and other representatives (*e.g.*, officers and directors) of investment advisers, as defined in the Investment Advisers Act of 1940 (Advisers Act),[16] with "buy-side" expertise and representative of investors (*e.g.*, portfolio managers), who have no material business relationship with regulated entities, but who would, nonetheless, be disqualified from serving as a Public Representative under a broad reading of the "associated with" prong of the MSRB's current definition of "no material business relationship." The MSRB further believes that these individuals could help the Board be as informed as possible, balanced in its perspective on *all* aspects of the municipal securities market, and well-positioned to carry out its statutory mandate, particularly with respect to current and future market structure initiatives.[17] Employees and other representatives of investment advisers have a unique view of the

[16] 15 U.S.C. 80b-2(a)(11).

[17] *See*, *e.g.*, SEC Report on the Municipal Securities Markets (July 31, 2012), available at http://www.sec.gov/news/studies/2012/munireport073112.pdf (recommending MSRB rulemaking and enhancement of industry "best practices" relating to several market structure concerns).

market and knowledge of market structure distinct from the perspective and expertise of most individuals employed by or otherwise representative of regulated entities. Because many of these individuals serve the interests of the investment adviser's clients (*e.g.*, investment companies, as defined under the Investment Company Act of 1940, such as mutual funds, or investors in managed accounts)[18]— not regulated entities—and, therefore, are representative of investors, the MSRB is proposing a modified test for evaluating the materiality of a business relationship under which they may, depending on their individual circumstances, be considered for service as the Investor Representative.

Under the draft amendments to Rule A-3, an alternative standard would be used to determine whether individuals being considered to serve as the Investor Representative have "no material business relationship" and are, therefore, independent. The existing definition will continue to be used to determine the independence of all other Public Representatives. As discussed in detail below, the draft amendments include particular rule language designed to tailor the new definition to allow employees and other representatives of investment advisers, depending on their individual circumstances, to serve as the Investor Representative. This tailoring includes the consideration of factors that relate to whether such an individual has a disqualifying nexus with a regulated entity, as opposed to association solely by virtue of the corporate structure of his or her employer.

The draft amendments are primarily in the definitional section of the rule. In subsection (g)(ii), the base standard of independence is unchanged and requires that an individual has "no material business relationship" with any regulated entity. New paragraph (g)(ii)(1) completes the existing standard of independence that will apply to all Public Representatives, except for applicants being considered to serve as the Investor Representative, using the definition of "no material business relationship" that is currently in Rule A-3. Specifically, this definition includes an automatic disqualifier for individuals who are, or within the last two years, were associated with a regulated entity, and a discretionary component to determine whether, even if not automatically disqualified, an individual has a compensatory or other relationship with any regulated entity that reasonably could affect the independent judgment or decision making of the individual. Finally, the

[18] 15 U.S.C. 80a–3.

Board will continue to have further discretion to determine that additional circumstances constitute a material business relationship.[19]

A new paragraph (g)(ii)(2) would establish the alternative definition of "no material business relationship" that creates a new standard of independence to be applied only to employees and other representatives of investment advisers[20] being considered to serve as the Investor Representative. The alternative definition of "no material business relationship" is similar to the current definition in that it includes an automatic disqualifier and a discretionary component. Unlike the broad associational disqualifier in the existing definition, the automatic disqualifier in subparagraph (g)(ii)(2)(A) is similar to the approach of FINRA, which takes a more function-oriented approach to defining independence. Specifically, the definition will require that an employee or other representative of an investment adviser is not, and within the last two years, was not an officer, director (other than an independent director), employee, or controlling person of any regulated entity.[21] This provision would allow the Board to consider individuals to be the Investor Representative who, under the broad reading of the current definition, would be disqualified automatically simply by being employed by or otherwise representative of an affiliate of a holding company that has a separate regulated affiliate. Despite making the automatic disqualification less restrictive, the new provision would continue to ensure that an individual directly associated with a regulated entity would not be eligible to even be considered under the discretionary component of the definition to serve as the Investor Representative.

In subparagraph (g)(ii)(2)(B), the discretionary component of the alternative definition of "no material business relationship" would (as does the current

[19] The MSRB anticipates that any proposed amendment to the standard of independence would include a technical amendment to Rule A-3(g)(ii) to update the reference to the "Nominating Committee" to reflect its current name, the "Nominating and Governance Committee."

[20] Subsection (g)(iii) is amended to provide that "the term 'investment adviser' has the meaning set forth in Section 202(a)(11) of the Investment Advisers Act of 1940." To accommodate this new definition and the new definition of "investment company," the provision defining the terms "municipal advisor" and "municipal entity," previously in subsection (g)(iii), would move to new subsection (g)(v); no substantive changes are proposed to be made to those definitions. *See* note 25 *infra*.

[21] The new definition includes a minimum two-year cooling-off period that is identical to the cooling-off period in the existing definition of "no material business relationship" and is more stringent than FINRA's one-year period. *See* note 14 *supra*.

definition) require the Board to determine whether an applicant has a compensatory or other relationship with any regulated entity that reasonably could affect his or her independent judgment or decision making. However, to guide and limit the Board's discretion in making that determination, paragraph (g)(ii)(2) would require the Board to consider a non-exhaustive list of specified factors, with no single factor being determinative.[22] The factors are whether: (i) the regulated entity accounts for a material portion of the revenues of the consolidated entity that includes the investment adviser and the regulated entity;[23] (ii) the regulated entity underwrites, privately places, or otherwise facilitates the origination of municipal securities;[24] and (iii) the investment adviser has a fiduciary duty or other similar relationship of trust to investment company[25] or investor clients.

The consideration of these factors would enable the Board to limit the pool of applicants, who would be eligible under the new automatic disqualifier, to individuals who are truly independent of any regulated entity and representative of investors. Specifically, an employee or other representative of an investment adviser, which has a relationship with a regulated entity that does not account for a material portion of the revenues of the consolidated entity that includes the investment adviser and the regulated entity, is less likely to have an appropriately disqualifying nexus with, or be subject to any significant influence from, the regulated entity. Similarly, if such a regulated entity does not underwrite, privately place or otherwise facilitate the origination of municipal securities, then any municipal securities business likely is only an incidental component of the consolidated entity's

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[22] Independence is evaluated in other regulatory contexts by considering relevant factors, including, but not limited to, sources of compensation and affiliation. *See, e.g.*, 15 U.S.C. 78j-3(a)(3); 17 CFR 240.10C-1(b)(1)(ii) (establishing independence requirements for directors serving on compensation committees of companies listed on national securities exchanges).

[23] Two other SROs, International Securities Exchange, LLC (ISE), and ISE Gemini, LLC (ISE Gemini), consider employees of an entity not regulated by the exchanges, but that is affiliated with a broker or dealer regulated by the exchanges, that does not account for a material portion of the revenues of the consolidated entity, and who is primarily engaged in the business of the non-regulated entity, to be "Public Directors." *See* Sections 3.2(b)(iv) and 13.1(t), (w), (cc) of ISE's Second Amended and Restated Constitution; Sections 3.2(b)(ii) and 13.1(r), (u), (z) of ISE Gemini's Constitution.

[24] ISE and ISE Gemini also consider persons affiliated with a broker or dealer regulated by the exchanges that operates solely to assist the securities-related activities of the business of broker-dealer affiliates not regulated by the exchanges to be "Public Directors." *Id.*

[25] New subsection (g)(iv) provides that "the term 'investment company' has the meaning set forth in Section 3 of the Investment Company Act of 1940."

business model primarily used to support the investment adviser's investment activities on behalf of investment company or investor clients (*e.g.*, to reduce transaction costs), and the corporate affiliation with the regulated entity is less likely to affect the independent judgment or decision making of an employee or other representative of the investment adviser. Finally, if the investment adviser has a fiduciary duty or similar relationship of trust to its investment company clients, such as mutual funds, or directly to investors in managed accounts, it has a legal obligation to act in the best interest of those clients.[26] This obligation applies to any employee or other representative of the investment adviser,[27] who participates in advising those clients as contemplated by the Advisers Act.[28] As a result, investment advisers, including their employees and other representatives, must put their clients' interests ahead of their own and the interests of any affiliated regulated entities. Additionally, since the investment companies that actively invest in municipal securities are institutional investors themselves and often include holdings of retail investors, the entities and individuals advising their securities transactions may be viewed as effectively representing the interests of both institutional and retail investors.

In total, although the less restrictive automatic disqualifier in the first prong of the new definition of "no material business relationship" allows for the consideration of individuals with some association or affiliation with a regulated entity, the addition of the tailored, non-exhaustive factor analysis will ensure that only individuals, whose judgment and decision making are not reasonably affected by those relationships, and who are sufficiently representative of investors, will be qualified to serve as the Investor Representative. The alternative definition would be applied only to

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[26] *See S.E.C. v. Capital Gains Research Bureau*, 375 U.S. 180 (1963) (finding that the Advisers Act "reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser - consciously or unconsciously - to render advice which was not disinterested," and that investment advisers are fiduciaries with "an affirmative duty of 'utmost good faith and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' . . . clients"). Other regulatory obligations to investment adviser clients flow from this fiduciary duty, including, but not limited to, requirements that the investment adviser have a reasonable, independent basis for its recommendations and seek best execution for clients' securities transactions. *See* SEC Report on the Regulation of Investment Advisers (March 2013), 22-28, *available at* http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

[27] *Id.*

[28] *See* note 16 *supra*.

applicants, who are employees or other representatives of investment advisers, being considered for this one statutorily-required Public Representative position on the Board. Therefore, since Board members serve three-year terms, this alternative definition would only be applied to applicants once every three years, unless an Investor Representative serves a partial term.[29]

Economic Analysis

The MSRB has historically given careful consideration to the costs and benefits of its new and amended rules. The MSRB's policy on the use of economic analysis in rulemaking states that, prior to proceeding with a rulemaking, the Board should evaluate the need for the rule and determine whether the rule as drafted will, in its judgment, meet that need. During the same timeframe, the Board also should identify the data and other information it would need in order to make an informed judgment about the potential economic consequences of the rule, make a preliminary identification of both relevant baselines and reasonable alternatives to the proposed rule, and consider the potential benefits and costs of the draft rule and the main alternative regulatory approaches.

1. **The need for the draft amendments to Rule A-3 and how the draft amendments to Rule A-3 will meet that need.**

The need for the draft amendments arises primarily from the Exchange Act, as amended by the Dodd-Frank Act, which specifies the statutory mandate and composition of the Board. Specifically, the Dodd-Frank Act established categories of market participants that must be included as members of the Board, including at least one Public Representative who is both independent of any regulated entity *and* is representative of institutional or retail investors in municipal securities.[30] In recent years, the MSRB has found that it is increasingly difficult, due to its broad reading of the "associated with" test, to identify a robust set of applicants who have the requisite experience and knowledge, and are representative of investors. The MSRB believes this challenge will persist into the future, and may become more severe, if the standard of independence in Rule A-3 remains unchanged. Such a result could negatively impact investor confidence.

[29] *See* note 36 *infra*.

[30] *See* 15 U.S.C. 78o-4(b)(1)(A).

Additionally, meeting the MSRB's rulemaking mandate[31] increasingly requires that the MSRB engage in deliberations regarding highly complex issues related to the structure and operation of the market, and how municipal securities are priced and transacted.[32] Identifying applicants for the Board, who have relevant knowledge and expertise about these issues, is fundamental to the MSRB's ability to perform this function in the most effective and least burdensome manner.

Employees and other representatives of investment advisers often have extensive knowledge of the structure of the market, are familiar with the relevant regulatory framework, understand technological changes that impact investors, and interact frequently with a range of market participants. These individuals also are likely to have views of the market that are distinct from those held by individuals employed by, or otherwise representative of, regulated entities.

Investment companies and other investor accounts, which are managed by investment advisers and actively invest in municipal securities on behalf of retail investors, represent a growing share of retail investment in municipal securities. Between 2010 and 2014, the portion of all municipal securities held by mutual funds grew from approximately 14 percent to more than 18 percent, while shares held directly by retail investors has fallen from nearly 50 percent to 42 percent.[33] However, because many of these funds have affiliated regulated entities, a significant number of individuals, who are employed by or representative of investment advisers and have relevant knowledge, are precluded from consideration for the statutorily-required Investor Representative position on the Board–even if the individual's nexus with a regulated entity is remote and cannot reasonably be seen as affecting his or her independent judgment or decision making. As the total number of

[31] *See* 15 U.S.C. 78o-4(b)(2)(C) (requiring the MSRB's rules to be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities and municipal financial products, to remove impediments to and perfect the mechanism of a free and open market in municipal securities and municipal financial products, and, in general, to protect investors, municipal entities, obligated persons, and the public interest).

[32] *See* note 17 *supra*.

[33] *See* Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Fourth Quarter 2014, Table L. 211, Municipal Securities and Loans at p. 117 (March 12, 2015).

mutual funds that hold municipal securities declines (down more than 27 percent since 2004),[34] it is reasonable to assume that the number of employees and representatives of investment advisers, who manage those funds, is declining proportionally. As a result, the MSRB expects that the difficulty of identifying applicants with no association with regulated entities will likely grow.

The composition of the Board and its continued ability to identify qualified applicants is fundamental to effective, efficient regulation that protects investors, municipal entities, obligated persons and the public interest. If investors perceive that the MSRB is not able to identify a strong pool of applicants, particularly for the Public Representative position that is specifically designated for investor representatives, their confidence in the market may decline, which could have consequences for the market as a whole.

By modifying the standard by which the Board evaluates whether individuals being considered to serve as the Investor Representative have a material business relationship with a regulated entity, the draft amendments would increase the MSRB's ability to identify and select from a pool of qualified applicants. The ability to consider a wider applicant pool for this member position would further the MSRB's ability to meet its statutory mandate and, therefore, confer benefits on investors.

2. Relevant baselines against which the likely economic impact of elements of the draft amendments to Rule A-3 can be considered.

To evaluate the potential impact of the draft amendments, a baseline or baselines must be established as a point of reference. The analysis proceeds by comparing the expected state with the draft amendments in effect to the baseline state prior to the draft amendments taking effect. The economic impact of the draft amendments is generally viewed to be the difference between these two states.

The Dodd-Frank Act and the 2010 amendments to Rule A-3 established the relevant baseline. As discussed above, the Dodd-Frank Act charged the MSRB with including on the Board at least one individual who is independent of a regulated entity and is representative of institutional or retail investors in municipal securities. The Dodd-Frank Act delegated authority to establish the

[34] *See,* Investment Company Institute, 2015 Investment Company Fact Book at p. 177 (May, 4, 2015).

requirements regarding the independence of Public Representatives to the MSRB, subject to SEC approval.[35]

Existing Rule A-3 specifies how members of the Board are selected and defines membership criteria, including the standard by which an applicant would be considered independent of any regulated entity.

3. Identifying and evaluating reasonable alternative regulatory approaches.

The MSRB recognizes that there are alternatives to the approach proposed by the draft amendments that range from taking no action, seeking other ways to incorporate the expertise of employees or other representatives of investment advisers, or utilizing factors other than those proposed in these draft amendments to evaluate whether individuals being considered to serve as the Investor Representative have a material business relationship with a regulated entity.

The MSRB could elect not to engage in additional rulemaking and continue to rely exclusively on outreach efforts to identify applicants. Based on several years of experience since the enactment of the Dodd-Frank Act and given the declining number of mutual funds that hold municipal securities and the likelihood that the most active of those will have an affiliation with a regulated entity, the Board anticipates that outreach will not be sufficient to identify reliably a robust pool of applicants who have the requisite experience and knowledge, are representative of investors as required by the Exchange Act, and meet the current standard to be considered Public Representatives.

The Board could elect not to engage in additional rulemaking and consider employees or other representatives of investment advisers, who are associated with a regulated entity, for positions on the Board as Regulated Representatives. This approach would provide access to the knowledge and expertise of these individuals, but it explicitly would not address the MSRB's concern about attracting a robust pool of applicants to satisfy the Exchange Act requirement that at least one of the Public Representatives must be representative of institutional or retail investors in municipal securities. Further, these individuals may not possess the knowledge and expertise to properly represent regulated entities.

[35] *See* note 9 *supra*.

The MSRB could seek to incorporate the expertise of employees or other representatives of investment advisers informally by, for example, adding such individuals as non-voting members of the Board or creating an advisory committee made up of them. While these alternatives might provide access to relevant knowledge and expertise, they likely would not address the MSRB's concern about attracting a robust set of applicants to serve as the Investor Representative. In addition, incorporating the views of an advisory group or a non-voting member might make Board processes more complex and may not result in the full incorporation of investor viewpoints in Board decision making, as can be expected to flow from full Board member voting authority.

The MSRB could utilize factors other than those proposed in the draft amendments to evaluate whether employees or other representatives of investment advisers being considered to serve as the Investor Representative have a material business relationship with a regulated entity.

The MSRB could amend Rule A-3 to define "no material business relationship" solely on the basis of whether the individual is not and, within the last two years, has not been an officer, a director (other than an independent director), an employee, or a controlling person of any regulated entity. Under such an alternative, the Board would not necessarily conduct an additional analysis of factors to evaluate the presence of any material business relationship. This alternative likely would achieve similar benefits to the draft amendments but might risk a perception that a Board member selected under this standard was not sufficiently independent.

Finally, the MSRB could adopt objective, "bright-line" tests to determine the materiality of business relationships, rather than using the factors as considerations. Strict tests may not provide sufficient context for the Board to make reasonable judgements about materiality.

4. **Assessing the benefits and costs of the draft amendments to Rule A-3 and the main alternative regulatory approaches.**

The MSRB policy on economic analysis in rulemaking addresses consideration of the likely costs and benefits of the rule with the draft amendments fully implemented against the context of the economic baseline discussed above.

Benefits

The draft amendments are intended to increase the MSRB's ability to identify and select from a pool of qualified applicants who do not have a material business relationship with a regulated entity and are representative of

institutional or retail investors in municipal securities. This, in turn, will ensure that the MSRB can continue to effectively and efficiently meet its statutory mandate.

The MSRB expects that expanding the pool of applicants will also ensure that future rulemaking efforts take full account of the realities of the market, and are informed by the knowledge and expertise often possessed by employees or other representatives of investment advisers.

Costs

The MSRB might incur limited costs associated with gathering information relevant to determine the materiality of business relationships of employees or other representatives of investment advisers. Beyond these costs, however, the MSRB is aware of no other direct costs associated with the draft amendments, relative to the baseline state.

The MSRB is requesting comment on whether the draft amendments could result in other direct costs, indirect costs or unintended impacts on the MSRB or market participants.

Effect on Competition, Efficiency, and Capital Formation

The MSRB does not expect the draft amendments to directly impact competition, efficiency or capital formation. The MSRB expects that the availability of a broad and qualified applicant pool will positively impact future MSRB efforts.

Length of Board Member Service

Currently, the Board is divided into three seven-member classes who serve three-year, staggered terms.[36] Board members may only serve consecutive terms under two scenarios: (1) by invitation from, and due to special circumstances as determined by, the Board; or (2) having filled a vacancy under Rule A-3(d) and, therefore, having served only a partial term.[37]

From experience and feedback from current and former Board members, the MSRB has learned that Board members often take multiple years to fully

[36] *See* MSRB Rule A-3(b)(i).

[37] *Id.*

understand the MSRB's rulemaking process and oversight obligations. The MSRB believes that allowing members to serve on the Board longer could improve the engagement and effectiveness of individual members, and improve the continuity and knowledge transfer on the Board as a whole. The current, standard three-year term of Board member service is significantly shorter than the average tenure of 8.4 years for members of other boards.[38] Accordingly, the MSRB is considering whether it should modify the length of Board member service to gain these benefits and be more consistent with best practices in general. For example, the Board could consider modifying Rule A-3 by allowing members the opportunity to serve two or more consecutive three-year terms without the special circumstances exception, similar to the length of service for FINRA governors,[39] or by increasing the term length.

The MSRB is requesting comment on whether it should modify the length of Board member service, and, if so, in what manner.

Requirement to Announce Publicly the Names of All Board Applicants

In 2011, the SEC approved an MSRB rule provision that requires the Board to publish on its website the names of all applicants, who agree to be considered for membership, no later than one week after the announcement of the names of new Board members for the following fiscal year.[40] The rationale for this requirement was to provide transparency. However, in practice, the MSRB believes this information can be misleading since the selection of Board members is based on a number of factors, including, but not limited to, merit of the applicant and there is no public disclosure explaining the basis for the selections. As a result, the MSRB believes that the requirement deters applications by qualified individuals, who are concerned that a failure to be selected will negatively affect their professional

[38] *See* Spencer Stuart Board Index 2014, 5, *available at* https://www.spencerstuart.com/~/media/pdf%20files/research%20and%20insight%20pdfs/ssbi2014web14nov2014.pdf%20target; Governance Minutes by the Society of Corporate Secretaries and Governance Professionals – Director Tenure (February 26, 2014), *available at* http://main.governanceprofessionals.org/governanceprofessionals/memberresources/resources/viewdocument/?DocumentKey=37b09de5-7404-4eab-bc70-10741cbf7138 (stating that average board member tenure is 8-10 years and that board members typically experience a 3-4 year learning curve).

[39] *See* FINRA By-Laws, Article VII, Section 5.

[40] *See* Exchange Act Release No. 63764 (January 25, 2011), 76 FR 5417 (January 31, 2011) (SR-MSRB-2010-17); MSRB Rule A-3(b)(vi).

reputation. Accordingly, the MSRB is considering whether it should eliminate or modify the publication requirement to remove this deterrent, and foster a more robust pool of applicants. As an alternative to removing the requirement entirely, the MSRB could consider an approach that could maintain a level of transparency by modifying Rule A-3 to provide for the publication of other identifying information, such as the names of the applicants' employers or categories of positions on the Board for which applicants were considered, while maintaining the anonymity of the individual applicants themselves.

The MSRB is requesting comment on whether it should eliminate or modify the requirement to announce publicly the names of all Board applicants, and, if it should modify the requirement, in what manner.

Request for Comment

The MSRB seeks public comment on the following questions, as well as any other comments on these topics, to assist it in determining whether it should: (1) proceed with the development of the draft amendments to the standard of independence for the Board member position representative of investors in Rule A-3; (2) modify the length of Board member service; and (3) remove or modify the requirement to announce publicly the names of all Board applicants. The MSRB particularly welcomes statistical, empirical and other data from commenters that may support their views and/or support or refute the views, assumptions or issues raised in this request for comment.

Application of the Standard of Independence for the Public Representative of Institutional or Retail Investors in Municipal Securities

1. Would the draft amendments likely increase the number of qualified applicants to the Board who have no material business relationship with regulated entities and are representative of institutional or retail investors in municipal securities?

2. What portion of investment advisers are affiliated with a regulated entity? Of those that are affiliated, what is the primary function of the regulated affiliate? Of those that are affiliated, what portion of annual revenue does the affiliated entity contribute to the consolidated entity that includes the investment adviser and the regulated entity?

3. For those investment advisers that are affiliated with a regulated entity, how should the MSRB evaluate the materiality of the annual revenue contributed by the regulated entity to the consolidated entity? Is there a percentage of annual revenue contributed by the

regulated entity to the consolidated entity above which all affiliations should be considered a material business relationship? If so, what is that percentage?

4. Are there additional factors the Board should consider if it were to apply the alternative standard by which the MSRB evaluates the materiality of business relationships?

5. Should the alternative standard by which the MSRB evaluates the materiality of business relationships include objective, "bright-line" tests, which must be satisfied or proved, in addition to or instead of minimum factors for consideration?

6. Does the fiduciary obligation owed by investment advisers to investment companies and other investor clients provide a meaningful level of independence from any affiliated regulated entities?

7. What, if any, changes are needed to the draft amendments to Rule A-3 to ensure that the alternative standard by which the MSRB evaluates the materiality of business relationships does not inadvertently dilute the public majority of the Board?

8. Would the draft amendments impose any costs or burdens, direct, indirect, or inadvertent, on investors, municipal entities, obligated persons or regulated entities? Are there data or other evidence, including studies or research, that support commenters' cost or burden estimates?

9. Are there alternatives to the draft amendments that would address the stated need at the same or lower cost?

Length of Board Member Service

10. Would modifying Rule A-3 to provide Board members with a longer tenure increase the engagement and effectiveness of individual Board members, and provide for greater continuity and knowledge transfer on the Board collectively? If so, would either allowing members the opportunity to serve two or more consecutive three-year terms without the special circumstances exception or increasing the term length accomplish these goals?

11. Are there alternative approaches to modifying the length of Board member service the MSRB should consider?

12. Would modifying the length of Board member service impose any costs or burdens, direct, indirect, or inadvertent, on investors, municipal entities, obligated persons or regulated entities? Are there data or other evidence, including studies or research, that support commenters' cost or burden estimates?

Requirement to Announce Publicly the Names of All Board Applicants

13. Is the MSRB's requirement to announce publicly the names of all Board applicants a deterrent to potential applicants, and would eliminating or modifying it likely increase the number of applicants to the Board? Would the publication of other identifying information, such as the names of the applicants' employers or the categories on the Board for which they were considered, provide adequate transparency to the process?

14. Are there alternative approaches to modifying the publication requirement to provide applicants anonymity that the MSRB should consider?

15. Would eliminating or modifying the requirement to announce publicly the names of all Board applicants impose any costs or burdens, direct, indirect, or inadvertent, on investors, municipal entities, obligated persons, or regulated entities? Are there data or other evidence, including studies or research, that support commenters' cost or burden estimates?

16. Are there other changes to Rule A-3 that the MSRB should consider to further the MSRB's ability to meet its statutory mandate, and enhance its structure and governance?

June 11, 2015

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Text of Proposed Amendments[41]

Rule A-3: Membership on the Board

(a) *Number and Representation*. The Board shall consist of 21 members who are knowledgeable of matters related to the municipal securities markets and are:

(i) **Public Representatives.** Eleven individuals who are independent of any regulated entity~~municipal securities broker, municipal securities dealer, or municipal advisor~~, of which:

(1)-(3) No change.

(ii) **Regulated Representatives.** Ten individuals who are associated with a regulated entity~~broker, dealer, municipal securities dealer, or municipal advisor~~, of which:

(1)-(3) No change.

(b)-(f) No change.

(g) *For purposes of this rule:*

(i) No change.

(ii) the term "independent of any regulated entity~~municipal securities broker, municipal securities dealer, or municipal advisor~~" means that the individual has "no material business relationship" with any regulated entity~~municipal securities broker, municipal securities dealer, or municipal advisor~~.

(1) Except as otherwise provided in paragraph (g)(ii)(2), ~~T~~the term "no material business relationship" means that, at a minimum, the individual (A) is not and, within the last two years, was not associated with a regulated entity~~municipal securities broker, municipal securities dealer, or municipal advisor~~, and ~~that the individual~~ (B) does not have a relationship with any regulated entity~~municipal securities broker, municipal securities dealer, or municipal advisor~~, whether compensatory or otherwise, that reasonably could affect ~~the~~his or her independent judgment or decision making ~~of the individual~~. The Board, or by delegation its Nominating and Governance Committee, may determine that additional circumstances involving the individual constitute a "material business relationship" with a regulated entity~~municipal securities broker, municipal securities dealer, or municipal advisor~~.

[41] Underlining indicates new language; strikethrough denotes deletions.

(2) For an employee or other representative (*e.g.*, officer or director) of an investment adviser being considered by the Board to serve as the Public Representative of institutional or retail investors in municipal securities required by Section 15B(b)(1)(A) of the Act, the term "no material business relationship" means that, at a minimum, the employee or representative (A) is not and, within the last two years, was not an officer, director (other than an independent director), employee, or controlling person of a regulated entity, and (B) does not have a relationship with any regulated entity, whether compensatory or otherwise, that reasonably could affect his or her independent judgment or decision making. In making a determination under subparagraph (B), the Board shall consider relevant factors, including but not limited to, whether:

(i) revenue from the regulated entity accounts for a material portion of the revenues of the consolidated entity that includes the investment adviser and the regulated entity;

(ii) the regulated entity underwrites, privately places, or otherwise facilitates the origination of municipal securities; and

(iii) the investment adviser has a fiduciary duty or other similar relationship of trust to investment company or other investor clients.

(iii) the term "investment adviser" has the meaning set forth in Section 202(a)(11) of the Investment Advisers Act of 1940.

(iv) the term "investment company" has the meaning set forth in Section 3 of the Investment Company Act of 1940.

(v) the terms "municipal advisor" and "municipal entity" have the meanings set forth in Section 975(e) of the Dodd-Frank Act.

(vi) the term "regulated entity" means a broker, dealer, municipal securities broker, municipal securities dealer, or municipal advisor regulated by the MSRB.

(h) No change.