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**Roundtable on Fixed Income Markets  
Securities and Exchange Commission  
Washington, DC  
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Thank you for inviting the Municipal Securities Rulemaking Board to participate in this roundtable discussion on potential improvements to the market structure for municipal securities. The MSRB has worked tirelessly and in close coordination with the Commission on numerous initiatives designed to promote a fair and efficient municipal securities market and to strengthen investor and municipal entity protections through the MSRB's comprehensive set of rules and its Electronic Municipal Market Access (EMMA) website and related market transparency systems.

In the agenda for this roundtable, the Commission raises a long series of critical questions that bring sharp focus on matters with which the federal regulators and market participants continue to grapple across the fixed income markets, both corporate and municipal. Many of these questions do not have immediate answers, and others will not have a single answer but instead would be best addressed through a series of inter-related rule modifications, market enhancements and new market data initiatives that seek to bring solutions that embrace, rather than ignore, the nuances of these markets. The MSRB looks forward to the back-and-forth discussions at all of today's panels and sees this roundtable as an exciting venue to bring together thought leaders to engage in an open discussion that may not see solutions emerging at the end of the day but that will spark continued work and collaboration along existing and new pathways.

### **The MSRB**

Congress created the MSRB in 1975 to write rules governing the conduct of broker-dealers and banks that buy, sell, trade and underwrite municipal securities. The Dodd-Frank Act made various changes in the MSRB's statutory charter, including additional rulemaking responsibilities in connection with municipal advisors to state and local governments and their public funds on their bond and related financing activities as well as a newly formed majority public governing board. The MSRB's mission today includes not only the protection of investors but also state and local governments and other municipal entities. The MSRB pursues these goals and works to foster a fair and efficient municipal market through rulemaking, disclosure and market transparency programs, educational and market outreach programs, and operation of its website at [www.emma.msrb.org](http://www.emma.msrb.org).

As a self-regulatory organization under the Securities Exchange Act, the MSRB works closely with the Commission on these activities and is subject to Commission oversight. In recent years, the Commission and the MSRB have worked closely on numerous important investor protection initiatives, including MSRB programs for the collection and dissemination of electronic disclosure documents and the establishment of the EMMA website.

## Municipal Market Trading Characteristics

There are about 1.2 million different municipal securities comprising approximately \$3.7 trillion in par value.<sup>1</sup> These securities represent a wide variety of credit structures, call features, put features and other terms and conditions. The municipal market is an over-the-counter dealer market. In contrast with other over-the-counter markets, such as for equity securities, there are no designated market makers. On any given day, the number of securities with firm, two-sided quotations will be relatively small compared to the total number of issues traded and very small compared to the outstanding universe of securities.

There are several electronic trading platforms operating in the municipal market that display offerings to their participants and some venues may post firm, executable quotations. In addition, a number of broker-dealers serve in the role of “broker’s broker” that, through electronic means or traditional voice brokerage, serves the interdealer market through the undertaking of bid-wanted activities or other situational offerings. However, the municipal market can be generally characterized as decentralized. There is no central venue for quotations or other indications of interest. Although most of the par value traded each day occurs among a relatively concentrated group of dealers in large transactions that are priced primarily through negotiation, a much broader range of national, regional and small dealers routinely execute smaller trades, representing the bulk of retail activity in the municipal securities market.<sup>2</sup>

Primary market activity is a very important component of the municipal securities market. Each year, state and local governments issue hundreds of billions of dollars of new municipal securities, with last year’s new issuance totaling \$379.8 billion of long-term bonds and \$60.8 billion of short-term notes.<sup>3</sup> Normally, municipal securities most readily trade during the first month after issuance, with such trading making up approximately 34 percent of the total par value of municipal securities traded in 2012.<sup>4</sup> Thereafter, trading in a particular municipal security drops off significantly for the remainder of the time such security remains outstanding.<sup>5</sup>

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<sup>1</sup> Sources: Bloomberg (based on data available on April 15, 2013) and Federal Reserve statistical release, “Flow of Funds Accounts of the United States,” March 7, 2013.

<sup>2</sup> For example, approximately 91 percent of customer trades, measured by transaction size, are effected by approximately 40 dealers in 2012.

<sup>3</sup> Source: Thomson Reuters (based on data available on April 3, 2013). Long-term bonds include securities with maturities of 13 months or more.

<sup>4</sup> Source: 2012 MSRB Fact Book, p. 16. Includes securities with maturities of two or more years with fixed or zero interest rate.

<sup>5</sup> Thus, after the first month of relatively heavy trading for new issue municipal securities, the level of trading in such issue drops dramatically, hovering at approximately 4-7 percent of total par value traded on a typical day for the remainder of the first year after initial issuance. Measured in terms of number of trades, new municipal securities in their first month after issuance constitute approximately 17 percent of all trades in municipal securities on a typical day and then drop to a level of approximately 3-5 percent of total

## Transaction Transparency

This panel is primarily focused on transparency, particularly pre-trade price transparency, in the municipal securities market. For purposes of this panel, “transparency” refers to the degree to which information regarding quotations for securities, the prices of transactions, and the volume of those transactions is made publicly available in a securities market.<sup>6</sup> Transaction transparency can be categorized as either “post-trade” or “pre-trade.” Post-trade transparency refers to the dissemination of trade price and volume information of completed trades for specific securities. Pre-trade transparency typically refers to public dissemination of information indicating the size and price of prospective trading interest in specific securities. Generally, this means dissemination of firm quotations of a specified size – that is, a commitment to buy or sell a specific quantity of a particular municipal security at a stated price. Pre-trade transparency information may also include pending limit orders from customers (that is, an order placed to buy or sell a set quantity of securities at a specified price or better) or other indications of trading interest. The exact nature of pre-trade transparency information that is (or can be made) available will depend on the structure of the specific market in question.

**Post-Trade Transparency.** Prior to 1995, the municipal securities market was essentially “opaque,” meaning that there was no systematic and comprehensive dissemination of either post-trade or pre-trade information. In spite of strong opposition from some market participants who expressed concern that mandating transaction reporting to provide post-trade transparency would expose market participants’ trading positions and create other negative effects on overall liquidity in the market, the MSRB recognized that such transparency would bring improved pricing efficiency and investor confidence to the municipal market and therefore launched our transaction reporting program in measured steps. This began with a pilot program for next-day public dissemination of certain inter-dealer trades launched in 1995, with purchases and sales by customers of more frequently traded municipal securities added in 1998. By 2003, after incremental increases in the breadth of trades covered by this program, the MSRB was collecting and disseminating comprehensive price data on municipal securities transactions on the morning after the trade date for each transaction. The implementation of the Real-Time Transaction Reporting System (RTRS) in January 2005 created, for the first time ever in the broader U.S. fixed income market, transaction price transparency for municipal securities that is both comprehensive and contemporaneous.

Today, MSRB rules require dealers to report transactions, with limited exceptions, to the MSRB within 15 minutes of trade execution.<sup>7</sup> Trade data is disseminated nearly simultaneously

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trades for the remainder of the first year after initial issuance. Source: 2012 MSRB Fact Book, pp. 16-17.

<sup>6</sup> Principles of Transaction Transparency, Securities Regulators of the Americas (“COSRA”) (1993).

<sup>7</sup> The main exception is primary market trades at the published list or “take-down” price, which must be reported by end of day.

after the transaction report is received.<sup>8</sup> Disseminated trade data includes price, direction of trade (dealer to customer, customer to dealer, or inter-dealer trade) and quantity. For trades greater than \$5 million, a “MM+” indicator is disseminated in real-time while the precise quantity is disseminated on a delayed basis (by five business days) to alleviate concerns about identifying the trading positions of specific market participants.

Since the implementation of real-time trade reporting, market participants have noted reduced information asymmetries, improved pricing and the introduction of new investors drawn to the market because of the additional transparency. In addition, the MSRB is not aware of any reductions in liquidity attributable to the additional transparency.

More recently, the MSRB’s Short-term Obligation Rate Transparency (SHORT) system has addressed transaction transparency with respect to auction rate securities (ARS) and variable rate demand obligations (VRDO). These short-term securities typically are sold at a price of par, with the short-term interest rate reset being the critical market information. Dealers are required to report ARS and VRDO interest rate information to the SHORT system on an end-of-day basis for dissemination to the market.<sup>9</sup> As of December 2012, the program has collected information on nearly 3.7 million rate resets for ARS and VRDOs since the initial launch of the SHORT system in January 2009.<sup>10</sup> In addition, program dealers for ARS must submit information on bids in periodic auctions as well as financing documents setting forth the auction and rate setting procedures, and remarketing agents for VRDOs must submit information on bonds held by banks – typically due to a failed remarketing – as well as key liquidity documents such as letters of credit, reimbursement agreements and standby bond purchase agreements. The information and documents collected through SHORT for municipal ARS and VRDOs are not available on a comprehensive basis in any other market.

The MSRB disseminates real-time trade data and interest rate resets through its EMMA website. The EMMA website integrates this transparency information, consisting of the real-time trade data and ARS/VRDO rate reset information and related documentation, for every issue of municipal securities with access to disclosure documents such as official statements, advance refunding documents, annual disclosures, material event notices and other continuing disclosure documents. The EMMA website was designed specifically to meet the previously unmet needs of retail investors, who make up such a significant portion of the municipal securities market customer base but who did not, prior to 2008, have access to the kind of key

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<sup>8</sup> Processing and automated error checking prior to dissemination generally occur in a matter of seconds.

<sup>9</sup> A number of key items of information are collected, including the length of the interest rate reset period, the minimum denomination of the security, and minimum and maximum rates. For ARS, the par amount auctioned and whether the interest rate set represents a “maximum rate,” “all hold rate” or “set by auction” is collected. For VRDOs, the type and expiration date of any liquidity facility is also collected.

<sup>10</sup> Source: 2012 MSRB Fact Book, pp. 102, 105. The SHORT system began collecting ARS rate reset information in January 2009 and VRDO rate reset information in April 2009.

trade data and disclosure information that market professionals routinely access through market data vendors. EMMA serves as a free, user-friendly platform that brings retail investors onto a more even playing field with market professionals and provides vital information to help investors make more informed investment decisions.<sup>11</sup>

**Pre-Trade Transparency.** There is today no central location in which quotations or offerings or indications of interest in municipal securities are posted for general access to the full marketplace. As noted earlier, the great majority of the par value traded is through negotiated transactions by dealers rather by execution of firm quotations posted on electronic systems. There are approximately 70 issues of municipal securities currently listed for trading on NYSE Bonds, the New York Stock Exchange's bond trading system. Although some have questioned why the market has not naturally gravitated toward exchange trading, in fact little or no exchange trading in these issues has occurred, with these securities still effectively trading exclusively over-the-counter.<sup>12</sup> Another interesting comparison is on-the-run Treasury bonds. Although not exchange-traded, the market for these securities has gravitated to automated systems that provide high levels of pre-trade transparency.

Several characteristics of the market may help to explain why neither of these developments has naturally occurred as they did in the equity and Treasury markets. One previously mentioned unique characteristic is the large number and heterogeneous nature of municipal securities. The approximately 1.2 million municipal securities compares with about 6,000 equities that trade on US exchanges and about 360 Treasury securities. The heterogeneous nature of these securities reflects the various financing needs of tens of thousands of different municipal issuers, including general obligation, revenue and conduit issuers.

Another related and potentially relevant characteristic of the municipal market is the level of trading. On a typical trading day, there are about 39,000 trades in 13,000 different securities.<sup>13</sup> This means that about 99 percent of municipal securities do not trade on a given day. In fact, about 90 percent typically do not trade in a given month. The individual municipal securities that are traded each day change as new issues come to market, are traded, and eventually are purchased by investors that hold them as long-term investments, in many cases

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<sup>11</sup> The MSRB offers various data subscription services providing comprehensive trade information in real-time, at the end of the day or historically, designed primarily for market professionals, information vendors and other high-volume users. A number of subscribers re-disseminate the data on other platforms and are able to use the subscription service to produce additional value-added products for market professionals or retail customers. The MSRB also offers subscription services for the ARS and VRDO information and documents, primary market disclosures and continuing disclosures.

<sup>12</sup> Several commentators have noted municipal bonds were once actively traded on the NYSE during the 1920s. *See* Bruno Biais and Richard C. Green, *The Microstructure of the Bond Market in the 20<sup>th</sup> Century*, August 29, 2007.

<sup>13</sup> *See* 2012 MSRB Fact Book, p. 38.

with the intention of retaining them until maturity.<sup>14</sup> After that time, trading in a typical issue of municipal securities will be sporadic at best. In addition to the occasional sale of a relatively small sized lot based on any number of reasons personal to the current owner of the security, trading may be triggered when an institutional holder sells a large position, which in some cases engenders a small flurry of trades as one or more subsequent inter-dealer trades result in the securities being sold to another institutional investor, but in other cases may result in a significant amount of trading for a short period of time as the securities are sold through other dealers to a number of investors in smaller lot sizes. Some of these sales of large positions by institutional investors may be reflective of such investors' own investment strategies, or may reflect a higher degree of sensitivity by retail investors who participate in the municipal market through mutual funds, exchange traded funds, separately managed accounts or other products, which can effectively force institutional trades if large numbers of retail investors simultaneously invest or divest due to general economic or other news events that can move the market. However, such trading typically subsides after a short period of time – often a matter of one or several days – at which point the security may not trade again for an extended period.

Thus, although the growing complexity of the municipal securities market has introduced greater interest in the trading of such securities than has traditionally been the case, the municipal securities market nonetheless continues to be characterized as a significantly more “buy and hold” market as compared to the equity market, and this tendency may also help to explain why trading is infrequent and has not resulted in successful exchange trading in the modern markets. That may be related to the essential nature of the investment, which is normally purchased to establish a constant income (generally tax-exempt), rather than to speculate on the security increasing in its market value. In addition, in contrast to holders of equity securities who must sell shares in order to liquidate a position, fixed income investors can, and often do, hold bonds until they mature or are called. This may also partially explain why trading in municipal securities is much less frequent than for equities.

Finally, it is worth noting how transaction size may be related to market structure. With about 70 percent of all municipal securities being held by “households,” either through direct purchases or investments in mutual funds or similar products, retail demand is a critical component of the municipal securities market.<sup>15</sup> In terms of trading, the small par value transaction – \$100,000 or less – accounts for about 7.8 million or 81 percent of the transactions that occur each day. However, 76 percent of the par value traded each day is in transactions of more than \$1 million. With the exception of extremely liquid markets such as the one for

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<sup>14</sup> Although investors in municipal securities have traditionally been viewed as “buy and hold” customers, municipal securities investors in reality reflect the full range of investing styles seen in other marketplaces while retaining a significant segment of investors seeking a stable, long-term investment vehicle.

<sup>15</sup> Federal Reserve statistical release, “Flow of Funds Accounts of the United States,” March 7, 2013. The household category includes both direct investments by individual investors and trust and other accounts (*e.g.*, some types of hedge fund accounts that do not fall into other tracked categories), and the mutual fund category includes both municipal bond funds and money market funds.

Treasury securities, transactions of such large size naturally tend to be negotiated rather than executed from firm quotes or through an order-driven system.

A number of alternative trading systems (ATS) have emerged in the securities markets over the past decade, with some offering municipal securities through their electronic platforms. These electronic platforms may be accessed directly by other dealers (and in some cases institutional investors) and offer continuous listings of bid-wanted and offerings, typically limit access to dealers and institutional investors by subscription, and may offer continuous order matching. In some cases, these platforms may preserve complete anonymity (in which case execution, clearance, and settlement are performed by the system as a riskless principal) or may only preserve anonymity through contract formation (with the parties to the contract left to execute, clear, and settle their transactions). By their nature, ATS typically display the inventory, or selected portions of the inventory, of the dealers that subscribe to their system and bid/offer information is available only to subscribers, although transaction price information is reported to the MSRB and disseminated on EMMA for trades consummated in connection with municipal securities offered through an ATS. Broker's brokers and other market participants also engage in trading activities, whether electronic or through traditional bricks-and-mortar brokerage activity, in which trading interests are exposed to limited universes of market participants for execution or for further negotiation prior to trading.

### **MSRB Long-Range Plan and Its Proposed “Central Transparency Platform”**

In February 2012, the MSRB published a Long-Range Plan for Market Transparency Products to guide the evolution of its market transparency products in support of the MSRB's statutory mission to regulate the municipal market. The Long-Range Plan, which is included with this written testimony, reflects the MSRB's careful consideration of the many suggestions it has received over the last several years from market participants and the general public. The Long-Range Plan sets out the MSRB's vision for the further evolution of its existing and future market transparency products to better fulfill the MSRB's statutory mandate in an efficient and effective manner that provides the protections expected under the Exchange Act while allowing free market forces to shape marketplace activities, practices and structures. Since publication of the Long-Range Plan, the MSRB has undertaken a number of initiatives to enhance its EMMA website platform to better serve as the central public repository for official market data and disclosures, as well as to streamline its existing document and data submission processes consistent with the principles of straight-through processing.

More recently, the MSRB published the first in a series of concept proposals relating to the planned development of a new central transparency platform (CTP) as a successor to RTRS, as contemplated under the MSRB's Long-Range Plan. The January 2013 concept proposal sought public input on the appropriate standard for “real-time” reporting and public dissemination of municipal securities transaction price and related information upon implementation of the CTP. The MSRB sought input on the potential benefits and burdens of providing for more contemporaneous dissemination of trade price information to the public, as well as input on baseline technology, processing and data protocol matters to assist the MSRB in pursuing a CTP architecture that can support a broad array of data types, including both post-trade transaction data and pre-trade bid/offer data.

The input that the MSRB receives on this initial concept proposal – and on the additional concept proposals, requests for comments and other outreach activities that the MSRB will undertake in the process of developing the CTP – should assist the MSRB in designing the internal CTP infrastructure, understanding current and likely future industry participant systems capabilities and limitations, and planning any potential rulemaking necessary to implement the CTP using pre- and post-trade data that reflects, on a forward-looking basis, the real-time needs of an evolving municipal securities market.

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I thank you again for the invitation to participate on this panel and look forward to engaging in today's discussion.