

# Self-Regulation and the Municipal Securities Market



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# I. Executive Summary

The concept of self-regulation of the United States securities markets dates back nearly two centuries and was codified by Congress in the 1930s. The self-regulatory model that was established by the Securities Exchange Act of 1934 (“Exchange Act”) combines government and industry responsibility with the goal of promoting effective and efficient regulation that leverages the oversight capabilities of the federal government but reduces the burden on its limited resources. Despite the inherent conflict of interest presented by an organization partially composed of members that regulate themselves, Congress concluded that effectively regulating the securities industry solely at the federal government level would be cost-prohibitive and inefficient. It also determined that the complexities and nuances of securities trading practices required oversight by organizations with a deep understanding of those practices.

In 1975, Congress adopted the self-regulatory approach for oversight of the municipal securities market, creating the Municipal Securities Rulemaking Board (MSRB), a self-regulatory organization (SRO) whose statutory mission is to protect investors, state and local governments and other municipal entities, and the public interest by promoting a fair and efficient municipal securities market. The regulatory model for the municipal securities market turned on Congress’s recognition of the market’s unique characteristics, which required a tailored legislative response.

Congress, the Securities and Exchange Commission (SEC) and others have periodically re-examined the SRO model — both before and after the creation of the MSRB — and questioned the extent to which SROs have successfully fulfilled their statutory obligations. Most recently, in October 2017, the U.S. Department of the Treasury called for a comprehensive review of the roles, responsibilities and capabilities of SROs with the aim of identifying potential operational, structural and governance improvements of the SRO framework.<sup>1</sup>

While some modifications to SROs have occurred as a result of these periodic analyses, federal lawmakers have repeatedly reaffirmed the benefits of self-regulatory oversight of the capital markets. The SRO model has enabled the municipal securities market to grow into a \$3.8 trillion capital market that provides reliable, long-term income for investors, and supports infrastructure financing, economic development and job creation. The appropriate combination of government and industry oversight also has earned the municipal securities market the confidence of investors, bond issuers and market professionals.

The subject of self-regulation is again garnering attention as policymakers and various commentators review the federal regulatory

framework in the wake of significant changes in the regulation of financial markets under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”).<sup>2</sup> In light of the current focus, this paper provides an overview of the history of self-regulation in the U.S. capital markets and federal reassessment of the SRO model. It explains Congress’s intent in creating the MSRB and outlines its unique features. In addressing criticisms of the SRO model, the paper highlights the advantages of the MSRB’s distinctive SRO model and ultimately seeks to illustrate the application of the SRO model to the municipal securities market with the goal of providing an important perspective in the ongoing dialogue about self-regulation in the U.S. capital markets.

## II. History of Self-Regulation

### A. The Self-Regulatory Model

Regulation of the U.S. securities markets and market participants is grounded, in large part, on the principle of self-regulation. Self-regulation is a system in which national securities exchanges, registered securities associations, clearing agencies and other organizations including the MSRB — the SROs — regulate the activities of their registrants or member securities firms, through rulemaking and, in some cases, disciplinary action, subject to the oversight of the SEC. As discussed further below, the Exchange Act, the federal securities law governing SROs, sets forth a regulatory model that combines government and industry responsibility with the goal of promoting effective and efficient regulation that leverages the oversight capabilities of the federal government but reduces the burden on its limited resources.

The Exchange Act reflects Congress's determination to rely on self-regulation as a fundamental component of U.S. securities market and broker-dealer regulation. Congress favored self-regulation despite the inherent conflict of interest presented by an organization partially composed of members that regulate themselves. Congress concluded that effectively regulating the securities industry solely at the federal government level was cost-prohibitive and

inefficient. In addition, given the complexities and nuances of securities trading practices, Congress determined that it was critical that the securities industry be supervised by organizations with a deep understanding of those practices. With the SRO model, knowledgeable SRO staff and board members would be involved in the oversight of member activities. Moreover, the SROs could set standards that exceed those imposed by the SEC, such as just and equitable principles of trade and similar fair-dealing standards, as well as detailed prescriptive business conduct standards. At the same time, Congress sharply departed from the purely industry-based regulation that pre-existed the federal securities laws. Congress determined that the SRO model, as reflected in the Exchange Act, would provide a workable balance between federal and industry regulation.<sup>3</sup>

Indeed, the success of the SRO model rests heavily on the SEC and its oversight of the SROs. Congress gave the SEC a wide range of tools to ensure that SROs provide adequate protection of investors and promote fair and efficient markets. For example, most SRO rules require SEC approval to become effective and have the force and effect of federal law, and the SEC has the authority to amend SRO rules.<sup>4</sup> The SEC also is authorized to review disciplinary actions taken by SROs against their members.<sup>5</sup> In addition, the SEC has the authority to require SROs to maintain

records and to file reports with the SEC.<sup>6</sup> The SEC inspects SROs for their compliance with the Exchange Act, relevant rules thereunder and the SROs' own rules, and for their enforcement of compliance with requirements by their members.<sup>7</sup> Furthermore, the SEC may bring enforcement actions against SROs for failure to comply with applicable rules and regulations, suspend or revoke any SEC registration of an SRO, and remove from office or censure any officer or director of an SRO.<sup>8</sup>

## B. Self-Regulation and Securities Exchanges

Self-regulation has a long tradition in the U.S. securities markets. In 1792, the New York broker community negotiated the historic Buttonwood Agreement to form the first organized stock market. As the New York Stock Exchange (NYSE) and other stock exchanges developed, trading conventions became formalized as exchange rules. In 1817, the NYSE adopted its constitution and subsequently developed a range of rules governing its members, such as member financial responsibility and financial reporting rules.<sup>9</sup> After the stock market crash of 1929 raised concerns about the oversight of the markets, Congress adopted the Exchange Act establishing the federal regulation of exchanges, and designating them as SROs.<sup>10</sup> Accordingly, each national securities exchange not only operates a trading market, but also is registered with the SEC as an SRO charged with regulating its market and member firms.

The self-regulatory structure for exchanges has been influenced in recent years by a significant increase in competition. There are now 22 registered national securities exchanges as well as other exchange competitors, like alternative trading systems, which are not SROs.<sup>11</sup> This increase in competition has increased the potential conflicts of interest inherent in self-regulation for exchanges — that is, the conflicts of interest between an exchange's regulatory function and the interests of its market operations, its listed issuers, its members and its shareholders. As competition among markets grows, business pressures can create

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a strong conflict between the exchange's regulatory and business functions. For example, there may be economic incentives to avoid disciplining significant order flow providers, or to promulgate market rules that are less stringent than a competitor's rules to attract order flow. Moreover, certain exchanges have responded to the increased competition by demutualizing and becoming for-profit entities. The profit motive also could influence the regulatory decisions of the exchange. Although the exchanges have sought to strengthen their self-regulatory oversight through stronger governance practices, the separation of the regulatory and business functions, and other methods, the potential for conflicts of interest remains.<sup>12</sup>

## C. Self-Regulation and the MSRB

Because municipal securities do not trade on exchanges, the self-regulatory structure for the municipal securities market did not evolve from exchanges, as it did with the equities market. Instead, the regulatory background of the municipal securities market reflected Congress's recognition of the unique characteristics of the market, which required a tailored legislative response.

### 1. Municipal Securities Market

The municipal securities market is distinct among the world's capital markets because of the large number of issuers. In the U.S., there are over 80,000 state and local governments, about

50,000 of which thus far have issued municipal securities, with approximately one million different issues outstanding.<sup>13</sup> No other capital market encompasses so many issuers and so many securities. In addition, municipal securities offerings range in size from multi-billion-dollar financings of large state and city governments to offerings less than \$250,000 in size issued by small localities and various other municipal authorities. The purposes for these offerings include not only financing for basic governmental functions, but also a variety of public needs such as transportation, utilities, health care and housing, as well as some essentially private functions to enhance economic development.

The trading characteristics of the municipal securities market differ from other market segments as well. A primary distinguishing characteristic of the municipal securities market is the absence of any core group of securities that trade frequently and consistently over sustained periods of time. Most municipal securities do not trade with any frequency. In fact, less than one percent of outstanding bonds typically trade in any given day.<sup>14</sup> Although a security may trade frequently immediately after issuance, trading is likely to subside dramatically shortly after issuance and then occur only sporadically throughout the life of the security. On average, 36 percent of the par amount of municipal securities traded in 2016 occurred in the first month after the security was issued.<sup>15</sup>

Because of the large number of municipal securities issuers, the large number of outstanding bonds and the infrequent trading patterns of municipal securities, there has been

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no natural progression toward a centralized exchange marketplace for municipal securities. Instead, municipal securities trade over the counter. This contrasts with the characteristics of the equities market, with its more limited number of issuers and more frequent and consistent trading patterns, which naturally led to the formation of organized markets to facilitate trading among the market's members, as described above with regard to the NYSE.

## 2. History of the MSRB

The framework for municipal securities market regulation was established and further developed by Congress in several landmark pieces of legislation: (1) the Securities Act of 1933 ("Securities Act")<sup>16</sup> and the Exchange Act; (2) the Securities Act Amendments of 1975 ("1975 Amendments");<sup>17</sup> and (3) the Dodd-Frank Act.<sup>18</sup>

### a. Securities Act and Exchange Act

In the 1930s, the Securities Act and the Exchange Act established the statutory foundation for regulation of the municipal securities market. Section 3(a)(2) of the Securities Act exempts municipal securities and their issuers from registration, disclosure and periodic reporting requirements. However, municipal securities transactions are subject to the antifraud provisions of the Securities Act and the Exchange Act.<sup>19</sup> These antifraud provisions generally prohibit any person from making a false statement of material fact, or making a materially misleading omission, in connection with the offer, purchase or sale of any security, including municipal securities.

Congress considered this limited regulatory oversight of the municipal securities market to be justified for several economic and policy reasons. First, Congress was concerned that regulatory requirements, such as registration and disclosure requirements, would place undue economic burdens on municipal securities issuers.<sup>20</sup> Second, Congress determined that the exemption from registration and other exemptions were warranted as the market showed little evidence of needing additional regulation.<sup>21</sup> For example,

the municipal securities market generally enjoyed high levels of investor confidence, had low rates of default, was primarily composed of sophisticated investors, and did not demonstrate evidence of sales or trading abuses comparable to those found in the corporate securities markets. Third, Congress sought to avoid possible constitutional problems related to imposing federal regulations on municipalities.<sup>22</sup>

### **b. 1975 Amendments**

In the early 1970s, the municipal securities market began to experience several changes, including an increase in both the size and volume of transactions, greater retail investor interest, and growing evidence of sales and trading abuses. These trends contributed to New York City's fiscal crisis, when the city came to the brink of default, which would have been the largest municipal default in U.S. history. As a result, Congress determined to expand federal protections for the municipal securities market.<sup>23</sup> Specifically, pursuant to the 1975 Amendments, Congress amended the federal securities laws in three important ways: (1) the creation of the MSRB; (2) the adoption of new registration requirements for municipal securities dealers; and (3) the adoption of what is commonly referred to as the Tower Amendment.

Under the 1975 Amendments, Congress established the MSRB as the primary rulemaking authority for the municipal securities market. As an SRO, the MSRB was charged with establishing rules with respect to the activities of municipal securities dealers and their effectuation of transactions in municipal securities.<sup>24</sup> Subject to oversight by the SEC, the MSRB was granted the authority to create rules and associated guidance establishing fair practices and procedures for the securities firms and banks that are dealers in the municipal securities market (collectively, "dealers"). Congress, however, did not grant the MSRB the power to examine for or enforce compliance with its rules. Instead, Congress divided municipal enforcement responsibilities among the SEC, what is now the Financial Industry Regulatory Authority (FINRA) and three federal banking agencies — the Comptroller

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of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation (collectively, "bank regulators").<sup>25</sup>

The 1975 Amendments also created registration requirements for participants in the secondary market for municipal securities. Dealers were required to register with the SEC as broker-dealers and municipal securities dealers, respectively.<sup>26</sup> Congress gave the SEC broad rulemaking and enforcement authority over these dealers.<sup>27</sup>

The 1975 Amendments incorporated the Tower Amendment, which prohibits the SEC and the MSRB from requiring municipal securities issuers to file information with them prior to the sale of securities.<sup>28</sup> Neighboring provisions further prohibit the MSRB from requiring any municipal issuer to furnish it, or any purchasers or prospective purchasers, with any information about the issuer or its securities either before or after the sale of securities, unless the information is generally available from another source.<sup>29</sup> Congress established the Tower Amendment and related provisions with the intent to keep municipal securities issuers from being subject to federal registration and disclosure requirements.

### **c. Dodd-Frank Act**

More recently, in 2010, the Dodd-Frank Act expanded the MSRB's mission to include the protection of issuers by granting it rulemaking authority over the activities of municipal advisors, who generally advise municipal entities or obligated persons with respect to the issuance of municipal securities or use of municipal financial products, or solicit municipal entities or obligated

persons on behalf of certain third parties. The Dodd-Frank Act also amended provisions of the Exchange Act governing the composition of the MSRB’s Board of Directors (“Board”), most notably requiring that the number of public representatives exceed the number of representatives of regulated entities, including dealers and municipal advisors.<sup>30</sup>

### D. Periodic Re-Examination of the Self-Regulatory Model

Since the creation of SROs, Congress and the SEC have periodically re-examined the model and the extent to which SROs have successfully fulfilled their statutory obligations, and other stakeholders also have studied the model closely and criticized certain aspects of its execution.

First, several years after adopting the SRO model for the securities markets in 1934, Congress enacted the Maloney Act, which amended the Exchange Act to apply self-regulation to the over-the-counter market by establishing the concept of registered national securities association SROs which investigated the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations.<sup>31</sup> FINRA is the only registered national securities association to date.<sup>32</sup>

The federal government again considered the reliance on self-regulation for the securities market in the 1960s. After problems surfaced regarding the floor operations of certain exchange specialists, Congress authorized the

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### RE-EXAMINATION OF THE SRO MODEL

<b>1934</b>	Maloney Act Establishes Registered National Securities Association SROs
<b>1961-1963</b>	SEC Special Study Examines SRO Governance and Operations
<b>1975</b>	Securities Acts Amendments Create the MSRB
<b>1994</b>	SEC Market 2000 Report Analyzes SRO Model
<b>1996</b>	SEC Pursues Administrative Proceedings against an SRO for Pricing Collusion
<b>2004</b>	SEC Concept Release on the Role and Operation of SROs
<b>2010</b>	Congress Expands MSRB’s Authority with Dodd-Frank Act
<b>2017</b>	U.S. Department of the Treasury Issues Report on Capital Markets and Role of SROs

SEC’s sweeping 1961–1963 Special Study, which investigated the inadequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations.<sup>33</sup> Among other conclusions, the Special Study called for a strengthening of SRO governance, including a reduction in the amount of control that exchange floor members exercised over exchange regulatory operations and governance.

A short time later, Congress reconsidered the role of self-regulation in the securities markets generally, and in the municipal securities markets specifically. As discussed above, when

contemplating the 1975 Amendments that established the MSRB, Congress confirmed the benefits of self-regulation, noting that the self-regulatory model should be “preserved and strengthened.”<sup>34</sup>

In 1994, the SEC reviewed the structure and costs of the SRO model in its Market 2000 Report.<sup>35</sup> This report analyzed a variety of aspects of the SRO model, including the impact of increasing inter-market competition and duplicative SRO rules, the extent to which costs to support the SRO system were being allocated fairly across the markets, the desirability of reallocating the regulatory and market functions of SROs, and the possibility of the SEC assuming a greater role with respect to the functions carried out by the SROs. The report generally concluded that the markets were operating efficiently within the existing regulatory structure.

The SEC also assessed the concept of self-regulation in 1996 when it instituted administrative proceedings against the NASD with respect to over-the-counter market maker pricing collusion.<sup>36</sup> In this context, the SEC discussed various issues concerning the efficacy of the self-regulatory system and the potential problems associated with inherent SRO conflicts. Of particular concern was the lack of independence of the NASD regulatory staff from the market operations of NASDAQ, an over-the-counter market owned and operated by the NASD at that time. Although changes were made regarding governance and regulatory independence to address these issues, the fundamental SRO model was not altered.

More recently, in 2004, the SEC sought public comment on the role and operation of SROs in the securities markets.<sup>37</sup> The SEC examined a number of issues concerning securities industry self-regulation, including: (1) the inherent conflicts of interest between an SRO’s regulatory obligations and the interests of its members, its market operations, its listed issuers, and, in the case of demutualized SROs, its shareholders; (2) the costs and inefficiencies of the current model in which multiple SROs may regulate the same members for the same activity; (3) the

challenges of surveillance across markets by multiple SROs; and (4) the manner in which SROs generate revenue and how SROs fund regulatory operations. The SEC also sought comment on certain possible changes to the current self-regulatory system and several regulatory approaches or legislative initiatives that might address concerns. The SEC has taken no further action on these proposals.

In 2010, Congress again considered the role of self-regulation in the securities markets, and determined to expand its use. As discussed above, Congress passed the Dodd-Frank Act, which, among other things, expanded the MSRB’s statutory mandate to include the protection of municipal entities and obligated persons, and granted the MSRB rulemaking authority over municipal advisors. Finally, as noted earlier, the U.S. Department of the Treasury recently called for a comprehensive review of the roles, responsibilities and capabilities of SROs with the aim of identifying potential operational, structural and governance improvements of the SRO framework.<sup>38</sup>

In addition to government efforts, other stakeholders have examined the SRO model closely. In general, these stakeholders have raised concerns about the level of authority, transparency, independence from oversight and accountability SROs have under the current framework, and, as a result, whether they operate as true self-regulators.<sup>39</sup> Despite raising these issues, none of the critics has argued for the discontinuation of the SRO model, but rather they have suggested reforms to address the concerns and to optimize the execution of the SRO model.

While there have been modifications to the governance and functions of SROs over time, the basic self-regulatory structure has been retained and not radically revised since its establishment. As such, the SRO model has withstood federal policymakers’ previous reviews and is generally considered to function effectively and serve government, industry, investors and the public interest well.

## THE MSRB AND SELF-ASSESSMENT

Although the SRO model has withstood repeated review by federal policymakers, the MSRB is aware of the concerns with and criticism of self-regulation and how it is executed currently by SROs, and, as such, regularly assesses its own performance to identify opportunities for improvement. Every two years, the Board engages in extensive strategic planning, including a periodic comprehensive review of its strategic priorities to ensure they are consistent with the MSRB's mission and address current conditions in the market and the needs of its stakeholders. The MSRB's strategic planning process considers extensive public and industry input collected through a formal request for comment as well through informal discussions. For example, from 2012 to 2017, the MSRB's strategic goals focused on implementing regulatory requirements and standards for municipal advisors; developing and improving municipal market transparency, information and tools for investors and others; enhancing access to, and understanding of, municipal market information by municipal entities and obligated persons; and providing rules, guidance and education, including those recommended in the SEC's 2012 Report on the Municipal Securities Market. In 2017, after soliciting input from key stakeholders and market participants, the MSRB established new, multi-year strategic goals that, in addition to continuing to focus on necessary market oversight and promoting transparency through the continued development of its Electronic Municipal Market Access (EMMA<sup>®</sup>) website, emphasize market data, compliance support, careful financial stewardship and the MSRB's role as an SRO.

The MSRB also recognizes that, to be effective, its rules must be responsive to changes in the municipal securities market and in the economic and technological environment. MSRB rules should be consistent, where appropriate, with rules of other financial market regulators to provide for more efficient compliance. To address these imperatives, the MSRB regularly considers and evaluates its rules, and proposes amendments as appropriate. To supplement the expertise on the Board, the MSRB creates advisory boards or committees to advise on topics of market interest. The MSRB's participatory processes and extensive outreach to stakeholders ensure regular and ongoing opportunities for market participants and the public to share input on the MSRB's strategic priorities and current initiatives.

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# III. Advantages of the MSRB's Unique Regulatory Structure

The MSRB is unique among SROs. As discussed earlier, the MSRB was established by Congress to write rules with respect to transactions in municipal securities by municipal securities dealers and, since 2010, advice provided by municipal advisors. Unlike other SROs, the MSRB does not operate a for-profit marketplace, or a securities marketplace of any kind, but rather provides free centralized market transparency systems. Also unlike other SROs, the MSRB does not have the authority to examine for or enforce compliance with its rules. The SEC, FINRA and bank regulators are charged with these examination and enforcement functions. As discussed below, the MSRB's structure for regulating dealer and municipal advisor conduct in the municipal securities market has been effective in avoiding many of the potential SRO limitations related to conflicts, funding and redundancies, while retaining the benefits of a self-funded organization with market-specific expertise that can achieve its regulatory objectives more quickly, efficiently and cost-effectively than alternative approaches.<sup>40</sup>

## A. Specialized Market Expertise

One of the key benefits of self-regulation is the ability to rely on the specific market expertise and knowledge of the SRO board and staff to enhance the oversight of the relevant securities market. The need for relevant expertise is particularly acute for the municipal securities market, which has features and functions that are vastly different from those of the equities, options and other fixed income markets. The types of participants, trading and securities in the municipal securities market require regulation and transparency initiatives carefully tailored to these characteristics.

The MSRB is an expert in municipal securities regulation and operations, and its statutory activities benefit from the insight of participants in the municipal securities marketplace who serve on the Board. Board members serve staggered four-year terms, with a new class of Board members joining each year, so that the MSRB continually receives fresh perspectives and new input on the application of and experience with MSRB rules.<sup>41</sup> The Board's experience and

expertise — and industry’s representation on the Board — allow the MSRB to design and develop practical rules and maintain high ethical standards specifically tailored to the municipal securities market. The MSRB carefully considers the best approach for every rulemaking, and uses principles-based or prescriptive regulation as appropriate to achieve the desired purpose of the rule as efficiently as possible and to facilitate compliance.

The MSRB applies its deep market expertise and resources to the development of objective, authoritative educational resources that advance understanding of market practices and regulations. It also assumes responsibilities not necessarily undertaken by the federal government that allow for a cost-effective approach to regulation. The MSRB operates a free online Education Center for investors and state and local governments to help them make informed decisions about municipal bonds. To assist dealers and municipal advisors with understanding and complying with municipal market regulations, the MSRB provides interpretive guidance that clarifies the application of the principles of the rules and provides prescriptive information on obligations and impermissible conduct under the rules. Additional compliance resources, such as sample templates and checklists, provide practical assistance in complying with MSRB rules. Provision of this type of compliance support and educational material goes beyond what government alone typically provides to a regulated industry.

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The MSRB’s governance structure is designed to minimize potential conflicts of interest that could inhibit effective regulation.

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## B. Representative Governance

The MSRB’s governance structure is designed to minimize potential conflicts of interest that could inhibit effective regulation. While industry representation in governance is a key component of self-regulation, it has been recognized, throughout the history of self-regulation, that the dominance of members, or of certain large members, in the SRO governance structure and other governance conflicts can undermine the self-regulatory process by leading to poorly targeted SRO rulemaking or under-zealous enforcement of SRO rules. Accordingly, the composition of the Board is structured to ensure that regulated entities do not dominate the Board, and that investors, issuers and other non-regulated stakeholders representing different size organizations and regions of the country have input into the regulatory policies and operations of the MSRB.

Unique for SROs, Congress itself codified the fundamental composition of the Board.<sup>42</sup> In passing and amending the legislation establishing the MSRB, Congress focused on ensuring the fair representation of the various parties that would be affected by the MSRB’s rulemaking. Accordingly, the Exchange Act requires that the Board consist of a majority of public members (individuals who are independent of any dealer or municipal advisor),<sup>43</sup> with the remaining members associated with a dealer or municipal advisor.<sup>44</sup> The Exchange Act further required that at least one public member be representative of institutional or retail investors in municipal securities, and one public member be representative of municipal entities (*i.e.*, issuers).<sup>45</sup>

In addition, Congress directed the MSRB to adopt rules related to Board composition to further particular purposes in this area, and the MSRB has adopted rules, with SEC approval, to enhance the diversity and representation of its Board.<sup>46</sup> Specifically, MSRB rules require the consideration of broad geographic representation when nominating new members to serve on the Board, as well as diversity in the size and type of dealers and municipal advisors represented.<sup>47</sup> The overall effect of these composition requirements is a majority-public board with diversity in

the size and type of dealers and municipal advisors represented, enabling the MSRB to be representative of the municipal securities industry and responsive to a broader range of issues, including those of smaller, regional firms, and to avoid becoming dominated by the largest firms in the industry.

### C. Participatory Process

At the direction of the Board, the MSRB advances regulatory proposals and other strategic initiatives. The MSRB's participatory rulemaking process ensures market participants and the public can provide input on MSRB rules as they are developed for consideration by the SEC. Generally, when considering the development of a proposed rule, the MSRB first publishes a request for comment to provide the greatest possible opportunity for industry and public participation. At the earliest stage of the rulemaking process, the MSRB integrates an economic analysis, which identifies the need for a proposed rule and explains how the rule will meet that need.<sup>48</sup> The analysis also articulates a baseline against which to measure the likely economic impact of the proposed rule, identifies and evaluates alternative regulatory approaches, and assesses the benefits and costs, both quantitative and qualitative, of the proposed rule change and the main reasonable alternative approaches, while affording the public an opportunity to comment on all of the above. All comments on rule proposals, including on the economic analysis, have an important impact on the MSRB's deliberations and often result in modifications to a proposed rule. With this extensive public input by market participants and others, as well as the industry's direct participation on the Board, MSRB rules are informed by market practices and behavior. In total, the MSRB generally provides more opportunities for notice and comment than is required of government agencies under the Administrative Procedures Act.<sup>49</sup>

Like other SROs, pursuant to Section 19(b) of the Exchange Act,<sup>50</sup> the MSRB generally must file its proposed rule changes with the SEC prior to effectiveness. The SEC, in turn,

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The MSRB's participatory rulemaking process ensures market participants and the public can provide input on MSRB rules as they are developed for consideration by the SEC.

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publishes proposed MSRB rule changes for additional public comment. Once the MSRB has considered any comments received and finalized its proposed rule change, the SEC reviews the proposal. Most MSRB rules do not become law without the independent determination of the SEC that the proposed rule change is consistent with the requirements of the Exchange Act and the associated rules and regulations thereunder applicable to the MSRB.<sup>51</sup> Further, the SEC has the power under the Exchange Act to amend MSRB rules through its own notice and comment rulemaking.<sup>52</sup>

SROs, such as the MSRB, can communicate more directly and regularly with industry and the public than government agencies can to respond to market needs and provide information and resources that can be used to improve compliance with rules and regulations. The MSRB invites the stakeholders to participate in the development of its long-range strategic plan and shorter-term priorities by issuing public requests for comment and engaging in extensive outreach to market participants. The MSRB also hosts industry events, open webinars, user groups and a customer support service that are among the many mechanisms for the MSRB to hear feedback from market stakeholders. In the interest of corporate transparency and public accountability, the MSRB publicly announces its long-range goals, current rulemaking objectives and advance information about the regulatory agendas for its quarterly Board meetings, as well as a public summary of policy decisions reached by the Board at those meetings.

## D. Reduced Conflicts of Interest and Duplication in Regulation

The absence of examination and enforcement authority is an important distinction of the MSRB's SRO model that significantly reduces the potential for conflicts of interest and increases regulatory efficiency. SROs generally can adopt rules governing their members and to examine for and enforce their members' compliance with those rules.<sup>53</sup> The scope of the MSRB's authority is unique in that it is limited to writing and adopting rules; as noted, the examination and enforcement functions related to MSRB rules are required to be carried out by other regulators. For securities firms, FINRA and the SEC examine for compliance with and enforce MSRB rules. For bank dealers, the appropriate bank regulator, in coordination with the SEC, has this responsibility.<sup>54</sup> The SEC has primary enforcement authority for municipal advisors and has designated FINRA to conduct examinations of municipal advisors that are FINRA members.<sup>55</sup> The MSRB works cooperatively with these examination and enforcement agencies and maintains frequent and close communication to ensure information sharing so that the MSRB's rules are uniformly enforced and regulatory priorities are communicated to examining officials, and general trends and developments in the market discovered by other regulators' field personnel are flagged for the MSRB. The MSRB provides this coordination and cooperation

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The scope of the MSRB's authority is unique in that it is limited to writing and adopting rules; the examination and enforcement functions related to MSRB rules are required to be carried out by other regulators.

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through the interpretation of MSRB rules, transaction reporting for surveillance, other information sharing, and training support for, and regular calls and periodic meetings with, the staff of the examination and enforcement agencies. Because of these ongoing efforts, the MSRB and the other regulators can ensure new and amended rules and regulations are developed and implemented consistently, while remaining cognizant of jurisdictional boundaries, appropriately accounting for differences in asset classes and markets, and avoiding unnecessary and burdensome duplication.

The MSRB's focus solely on rulemaking also prevents a potential conflict of interest raised by traditional self-regulation: inappropriate influences on the examination for and enforcement of compliance with an SRO's rules. Because the MSRB does not have the ability to conduct examinations or enforce its own rules, dealers and municipal advisors (including Board members) cannot influence the zealotry of enforcement of MSRB rules. Furthermore, the structure of relying on other regulators for inspections of MSRB-regulated entities and the enforcement of MSRB rules also eliminates concerns about the MSRB causing examination redundancies in these areas.

The MSRB's unique rulemaking focus also provides for an efficient use of resources, eliminating one aspect of self-regulation that often causes concern among SRO members — redundant rulemaking and enforcement oversight by multiple SROs. The general framework of securities industry self-regulation can exhibit inefficiency in that it can cause duplicative and potentially conflicting regulation. Specifically, the existence of multiple SROs regulating the same conduct can result in duplicative and conflicting SRO rules, rule interpretations, and inspection and enforcement regimes for securities market participants. The system can also result in redundant SRO regulatory staff and infrastructure across SROs. The MSRB's exclusive jurisdiction over SRO rulemaking related to the municipal securities market eliminates the concern about inefficient rulemaking redundancies that can arise in other self-regulatory structures.

## E. Market Transparency Systems

In addition to its comprehensive body of rules governing the activities of dealers and municipal advisors, the MSRB, at its own initiative, leverages its role as the municipal securities market's SRO to operate market transparency systems that support its investor-protection and market-efficiency mission. These information systems collect and store key municipal market disclosure documents and transaction data to make the information available to the public through its EMMA website, as well as to federal securities and bank regulators that examine dealers and municipal advisors for compliance with MSRB rules. For a modest fee, the MSRB makes the information available to data vendors, industry utilities, academics and others.

It was in 1990 when the MSRB first articulated the need to improve access to municipal securities information. The impetus behind the creation of the first MSRB market transparency product — the Municipal Securities Information Library (MSIL) System — was “to create a central facility through which important information regarding municipal securities and their issuers is made more readily available to market participants and information vendors.”<sup>56</sup>

With the launch of the pilot version of the EMMA system in 2008, the historical collection of official statements and advance refunding documents submitted through MSIL, as well as such documents associated with current new issues, were made available to the public for free through the EMMA website.

Investors and market participants also need access to updated information throughout the life of a municipal security. Since 1995, issuers and obligated persons for most new issues of municipal securities have entered into continuing disclosure agreements consistent with Exchange Act Rule 15c2-12, pursuant to which continuing disclosures are to be made available to the marketplace. Initially, these disclosures were submitted to one or more nationally recognized municipal securities information repositories (NRMSIRs) designated by the SEC, as well as to the MSRB. To centralize the submission

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The MSRB's structure and resources available to it as an SRO have enabled the organization to centralize municipal securities information, bring greater transparency to corners of the market that were previously opaque, and act nimbly and efficiently to update and enhance its systems as information needs and technology continue to evolve.

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and availability of these disclosures, EMMA became the only designated NRMSIR in 2009, collecting and disseminating all annual financial and operational disclosures as well as required notices of certain events affecting municipal securities.<sup>57</sup> EMMA also collects and makes available disclosures of regulated entities' and their associated persons' political contributions to municipal entity officials, state and local political parties, and bond ballot campaigns pursuant to MSRB Rule G-37.

In addition to the hundreds of thousands of disclosure documents on EMMA, the system also collects and disseminates real-time trade data collected through the MSRB's Real-Time Transaction Reporting System (RTRS), which provides real-time trade price information, in most cases within 15 minutes after the time of trade, for all traded municipal securities.

To address a lack of transparency for variable rates securities, the MSRB in 2009 launched the Short-term Obligation Rate Transparency (SHORT) System, which collects and disseminates data about auction rate securities (ARS) and variable rate demand obligations (VRDOs). The SHORT System was expanded to include related documents and additional data elements for both ARS and VRDOs in 2011.

Today, the EMMA website includes not only security-specific information about virtually every outstanding municipal bond, but also market-wide data and tools such as third-party yield curves and indices, new issue and economic calendars, and the MyEMMA email notification service that provide municipal securities investors and issuers with improved access to information that facilitates and empowers their decision-making.

The MSRB's structure and resources available to it as an SRO have enabled the organization to centralize municipal securities information, bring greater transparency to corners of the market that were previously opaque, and act nimbly and efficiently to update and enhance its systems as information needs and technology continue to evolve, thereby democratizing access to information.

### F. Corporate Transparency

As an SRO, the MSRB is committed to the highest levels of corporate transparency to provide confidence to stakeholders that the organization is fulfilling its mission, that it allocates resources accordingly and appropriately manages risks, and that it is accountable for its actions. Robust corporate transparency also helps ensure that rules and policies established by the MSRB are developed with adequate consideration to associated costs and benefits, and are consistent with the MSRB's statutory mandate.

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To provide stakeholders with corporate transparency, the MSRB ensures the public availability of information about its governance, financial and operational practices.

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To provide stakeholders with corporate transparency, the MSRB ensures the public availability of information about its governance and financial and operational practices. Stakeholders have timely, clear and universally available information to understand and assess the organization's decision-making processes, policy development and market transparency operations. Key elements of the MSRB's corporate transparency include public disclosure of its governance structure including its articles of incorporation, by-laws, conflicts of interest policy and code of ethics and business conduct policy. The MSRB also publicly provides relevant information about the Board and its members, its committees and their charters, Board meetings and Board decisions, and the process for applying to serve on the Board.

Additional transparency provided by the MSRB includes information about the rulemaking process, public comments on proposed rules and concept releases, and rule filings with the SEC. The MSRB also seeks public input on its strategic plan on a biannual basis and discloses key initiatives for each fiscal year. The MSRB communicates with its stakeholders on a regular basis about all new and ongoing initiatives, and announces public appearances of Board members and staff. All communicated information about the MSRB is posted on the MSRB's website at [www.msrb.org](http://www.msrb.org).

### G. Funding and Financial Transparency

The MSRB's operational and self-funding model serves to eliminate potential concerns otherwise related to demutualized SROs that operate for-profit market centers.<sup>58</sup> Unlike many SROs, the MSRB has no profit motives. It does not own or operate a market, nor does it provide clearing services. The MSRB was created by Congress and is a non-stock corporation, having no owners. The MSRB's operations are funded primarily through fees on the entities it regulates. It does not receive any government appropriations or taxpayer funds. About 80 percent of annual revenue is directly tied to municipal securities underwriting and trading volumes, with supplemental revenues coming from registration

and professional fees on regulated entities. In addition, the MSRB receives a small portion of its revenue from rule violation fine revenue pursuant to requirements set forth in the Exchange Act<sup>59</sup> and from data subscriber fees.

To provide transparency around its finances, the MSRB publishes a budget summary, annual audited financial statements, IRS Form 990, and other information on budget and financial policies on its website. An annual report also includes financial highlights and other information about the MSRB's annual objectives.

Ensuring appropriate revenue and expense levels, and overall financial sustainability is a strategic priority of the Board, both to fulfill the MSRB's mission and to meet its obligation to have a fair and equitable balance of fees across regulated entities. MSRB fees support the full spectrum of market oversight responsibilities, including not just regulatory operations but also market transparency, outreach, education and market leadership initiatives. Fine revenue is, however, accounted for separately and, as a matter of Board policy, budgeted to support the MSRB mission but not costs of rulemaking activities. Because the MSRB is focused on financial sustainability rather than profit, it can appropriately continue to fulfill its statutory obligation to oversee the municipal securities market and protect investors, municipal entities and the public interest.

## IV. Conclusion

The fundamental concept of self-regulation is the mutually beneficial relationship between specialized industry expertise and strong government oversight. The MSRB's distinctive SRO structure — defined by statute, free of operating a market and a profit motive, and without examination or enforcement authority — effectively and efficiently mitigates the potential for conflicts of interest or regulatory duplication. In addition, the composition of the Board is founded on market expertise and fair representation, which allow the MSRB to develop practical and tailored rules, which are refined through a robust, and transparent participatory process and subject to appropriate government oversight. The MSRB further fulfills its statutory mandate and achieves its mission by providing resources, including clear interpretations of its rules when necessary, useful compliance aids, objective and authoritative educational materials, centralized and innovative market transparency systems, and other market-wide data and tools, all of which are intended to support a fair and efficient municipal securities market and address the needs of its varied participants.

As a regulator generally, and as an SRO more specifically, the MSRB considers transparency of

its operations and accountability for its actions of the utmost importance. For the former, the MSRB publicly shares detailed financial information related to its budget and operating expenses, which, as a self-funded organization, are borne by the industry it regulates. The MSRB is cognizant of the impact its regulations and other actions can have on the market and its participants, so it proactively and clearly articulates its agenda before and after quarterly Board meetings and on an ongoing basis for specific actions through a variety of communications and media. These efforts allow the MSRB to regularly receive input from the public, market participants and other stakeholders through both formal processes and informal discussions, to which the MSRB always strives to be responsive.

Throughout the history of self-regulation broadly and the MSRB specifically, federal policymakers and others have re-examined the effectiveness and efficiency of the SRO model, but the fundamental principles of self-regulation remain valid. As discussed fully herein, the MSRB's structure and operation are unique among SROs and provide the MSRB with distinct advantages, which make it a particularly successful embodiment of the SRO model.

## Endnotes

- <sup>1</sup> U.S. Dep't of the Treas., *A Financial System That Creates Economic Opportunities: Capital Markets* (Oct. 2017).
- <sup>2</sup> See *id.*; *Examining the Agenda of Regulators, SROs, and Standards-Setters for Accounting, Auditing, and Municipal Securities Before the H. Comm. on Fin. Servs.*, 114th Cong. (2016).
- <sup>3</sup> See generally S. Rep. No. 1455, 73d Cong., 2d Sess. (1934); H.R. Doc. No. 1383, 73d Cong., 2d Sess. (1934); S. Rep. No. 1455, 73d Cong., 2d Sess. (1934).
- <sup>4</sup> See 15 U.S.C. 78s(b)-(c).
- <sup>5</sup> See 15 U.S.C. 78s(d)-(f).
- <sup>6</sup> See 15 U.S.C. 78q(a), (d).
- <sup>7</sup> See 15 U.S.C. 78q(b), 78s(g).
- <sup>8</sup> See 15 U.S.C. 78s(h), 78u.
- <sup>9</sup> The SEC Historical Society chronicles this early history of the stock exchanges on its website: <http://www.sechistorical.org/museum/papers/pre1930/page-2.php>.
- <sup>10</sup> See Pub. L. No. 73-291, 48 Stat. 881.
- <sup>11</sup> A complete list of registered national securities exchanges and other SROs is available at <https://www.sec.gov/rules/sro.shtml>.
- <sup>12</sup> See Exchange Act Rel. No. 50700 (Nov. 18, 2004), 69 FR 71255 (Dec. 8, 2004) (Self-Regulation Concept Release), available at [https://www.sec.gov/rules/concept/34-50700.htm#P103\\_13695](https://www.sec.gov/rules/concept/34-50700.htm#P103_13695).
- <sup>13</sup> See, e.g., MSRB, *Municipal Securities: Financing the Nation's Infrastructure* (2017), available at [http://www.msrb.org/~/\\_media/Files/Resources/MSRB-Infrastructure-Primer.ashx](http://www.msrb.org/~/_media/Files/Resources/MSRB-Infrastructure-Primer.ashx).
- <sup>14</sup> 2016 MSRB Fact Book, available at <http://www.msrb.org/msrb1/pdfs/MSRB-Fact-Book-2016.pdf>.
- <sup>15</sup> *Id.*
- <sup>16</sup> Pub. L. No. 73-22, 48 Stat. 74.
- <sup>17</sup> Pub. L. No. 94-29, 89 Stat. 97.
- <sup>18</sup> Pub. L. No. 111-203, 124 Stat. 1376.
- <sup>19</sup> See 15 U.S.C. 77q(a), 78j(b); 17 CFR 240.10b-5.
- <sup>20</sup> See *Stock Exchange Practices: Hearing on S.R. 84, S.R. 56 & S.R. 97 Before the S. Comm. on Banking and Currency, 73d Cong. (1934); Hearing on H.R. 7852 & H.R. 8720 Before the H. Comm. on Interstate and Foreign Commerce, 73d Cong. (1934).*
- <sup>21</sup> See H.R. Rep. No. 73-8 (1933); *Hearing on S. 873 Before the S. Comm. on Banking and Currency, 73d Cong. (1933).*
- <sup>22</sup> *Id.*
- <sup>23</sup> See S. Rep. No. 94-75, at 3 (1975).
- <sup>24</sup> See 15 U.S.C. 78o-4(b)(2).
- <sup>25</sup> See 15 U.S.C. 78o-4(c)(5), (7). In 2007, the National Association of Securities Dealers (NASD) and the member-related functions of NYSE Regulation, Inc., the regulatory subsidiary of the NYSE, were consolidated. As part of this regulatory consolidation, the NASD changed its name to FINRA. See Exchange Act Release No. 56146 (July 26, 2007), 72 FR 42190 (August 1, 2007).
- <sup>26</sup> See 15 U.S.C. 78o-4(a).
- <sup>27</sup> See, e.g., 15 U.S.C. 78o(c)(1)-(2), 78q(a)-(b), 78o-4(c)(1), 78u(a)(1).
- <sup>28</sup> See 15 U.S.C. 78o-4(d)(1).
- <sup>29</sup> See 15 U.S.C. 78o-4(d)(2).
- <sup>30</sup> See 15 U.S.C. 78o-4(b)(2)(B)(i).
- <sup>31</sup> Pub. L. 75-719, 52 Stat. 1070 (1938).
- <sup>32</sup> See n. 11 *supra*.
- <sup>33</sup> 1961-1963 Special Study of Securities Markets, SEC, Report of Special Study of Securities Markets.
- <sup>34</sup> S. Rep. No. 94-75, 94th Cong., 1st Sess. 7, II (1975).
- <sup>35</sup> Market 2000: An Examination of Current Equity Market Developments, Division of Market Regulation, SEC (January 1994), available at <https://www.sec.gov/divisions/marketreg/market2000.pdf>.
- <sup>36</sup> See *In the Matter of National Association of Securities Dealers, Inc.*, Exchange Act Rel. No. 37538 (Aug. 8, 1996), available at <https://www.sec.gov/litigation/admin/3437538.txt>; Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market (1996), available at <https://www.sec.gov/litigation/investreport/nasdaq21a.htm>.
- <sup>37</sup> See n. 12 *supra*.
- <sup>38</sup> See n. 1 *supra*.

- <sup>39</sup> See, e.g., David Burton, *Reforming FINRA* (The Heritage Found., 2017), available at <http://www.heritage.org/markets-and-finance/report/reforming-finra>; Hester Peirce, *The Financial Industry Regulatory Authority: Not Self-Regulation after All* (Mercatus Ctr. at George Mason Univ., 2015), available at <https://www.mercatus.org/system/files/Peirce-FINRA.pdf>; Pub. Investors Arbitration Bar Ass'n, *REPORT: FINRA Governance Review: Public Governors Should Protect the Public Interest* (2017), available at <https://piaba.org/piaba-newsroom/report-finra-governance-review-public-governors-should-protect-public-interest>.
- <sup>40</sup> The SEC recognized the unique nature of the MSRB in its Self-Regulation Concept Release, noting that the discussion focused on the NASD (now FINRA) and the exchanges, and did not necessarily relate to the MSRB. See Self-Regulation Concept Release, *supra* n. 11, at n.2
- <sup>41</sup> See MSRB Rule A-3(b)(i).
- <sup>42</sup> See 15 U.S.C. 78o-4(b)(1).
- <sup>43</sup> See MSRB Rule A-3(g) (defining independence).
- <sup>44</sup> See 15 U.S.C. 78o-4(b)(1).
- <sup>45</sup> *Id.*
- <sup>46</sup> See MSRB Rule A-3.
- <sup>47</sup> *Id.*
- <sup>48</sup> See MSRB Policy on the Use of Economic Analysis in MSRB Rulemaking, available at <http://msrb.org/Rules-and-Interpretations/Economic-Analysis-Policy.aspx>. This policy is consistent with the SEC's 2012 guidance on economic analysis in rulemakings, and it is designed to help the SEC meet its statutory obligations to consider whether its approval of an MSRB proposed rule will promote efficiency, competition and capital formation.
- <sup>49</sup> 5 U.S.C. 553.
- <sup>50</sup> 15 U.S.C. 78s(b).
- <sup>51</sup> A proposed rule change for any SRO, including the MSRB, may be effective immediately upon filing with the SEC if designated by the SRO as: (i) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the SRO; (ii) establishing or changing a due, fee, or other charge imposed by the SRO on any person, whether or not the person is a member of the SRO; or (iii) concerned solely with the administration of the SRO or other matters which the SEC, by rule, consistent with the public interest and the purposes of Exchange Act, may specify as without being subject to the SEC approval process. See 15 U.S.C. 78s(b)(3)(A).
- <sup>52</sup> See 15 U.S.C. 78s(c)(1).
- <sup>53</sup> Congress granted the MSRB broad authority to propose and adopt rules "with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers and advice provided to or on behalf of municipal entities or obligated persons by brokers, dealers, municipal securities dealers, and municipal advisors with respect to municipal financial products, the issuance of municipal securities, and solicitations of municipal entities or obligated persons undertaken by brokers, dealers, municipal securities dealers, and municipal advisors." 15 U.S.C. 78o-4(b)(2).
- <sup>54</sup> See 15 U.S.C. 78o-4(c)(5), (7).
- <sup>55</sup> See 15 U.S.C. 78o-4(c)(7)(A)(iii); Exchange Act Release No. 70462, at 409 (Sept. 20, 2013), 78 FR 67468, 67581 (Nov. 12, 2013).
- <sup>56</sup> The MSIL system was discontinued upon the establishment, by the MSRB, of EMMA's Primary Market Disclosure Service. See Exchange Act Rel. No. 57577 (Mar. 2, 2008), 73 FR 18022 (Apr. 2, 2008).
- <sup>57</sup> See Exchange Act Rel. No. 59061 (Dec. 5, 2008), 73 FR 75778 (Dec. 12, 2008).
- <sup>58</sup> Demutualized SROs that operate markets have sought to reduce conflicts of interest by, for example, relying on boards composed of a majority of members that are independent from the SRO members and separating business and regulatory functions. See, e.g., n. 12 *supra*.
- <sup>59</sup> The Exchange Act requires fines collected by the SEC for violations of MSRB rules to be equally divided between the SEC and the MSRB, and that one-third of fines collected by FINRA allocable to violations of MSRB rules will be paid to the MSRB, although the portion of such fines payable to the MSRB may be modified at the direction of the SEC upon agreement of the MSRB and FINRA. See 15 U.S.C. 78o-4(c)(9).



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