



Submitted by Mark O. Conner, Principal

The Municipal Securities Rulemaking Board (MSRB) is proposing to change requirements under its Rule D-15 regarding Sophisticated Municipal Market Professionals (SMMP.) One specific change would allow municipal bond dealers transacting with small- to medium-sized Registered Investment Advisor firms to assume that such RIAs are *de facto* SMMPs. This is a fallacious assumption that the SEC and the MSRB seem ready to accept as valid, largely because dealers say it's valid. It is not.

Small- to medium-sized RIAs have customers for which an RIA may invest in municipal bonds. In doing so, the RIA will transact with municipal bond dealer firms to buy and sell bonds on their customers' behalf. These counterparty dealers must determine if they have a lesser degree of disclosure obligation to a RIA customer if they are deemed to be a SMMP. If these dealers are simply allowed to presume SMMP status of their RIA customers when they are in fact not sophisticated, it jeopardizes the RIA's customers.

Let's look at the rule and assess whether RIAs with assets under management (AUM) of <\$1 billion qualify (emphases added):

MSRB Rule D-15

The term "sophisticated municipal market professional" or "SMMP" is defined by three essential requirements: the nature of the customer; a determination of sophistication **by the broker, dealer or municipal securities dealer ("dealer")**; and an affirmation by the customer; as specified below.

Second Chair Note: The weakness of the rule in relying on a dealer determination is that RIAs are typically serviced by dealers through institutional salespeople who are eager to execute trades and collect a commission – no trade, no commission, so salespeople are prone to removing obstacles to getting paid, i.e., ignoring non-sophistication. Alternatively, and more commonly, RIAs often simply trade off a screen without any interaction with a dealer representative who could make any assessment. The RIA looks at the investment quality rating of a bond displayed on their screen, that's the extent of their credit research, and there is no sophistication assessment.



(a) Nature of the Customer. The customer must be:

(1) a bank, savings and loan association, insurance company, or registered investment company;

(2) an investment adviser registered either with the Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or

Second Chair Note: This proscribes all small- and medium-sized RIAs.

(3) any other person or entity with total assets of at least \$50 million.

Second Chair Note: This standard is both vague and archaic, though is not addressed in any proposed changes by the MSRB.

(b) Dealer Determination of Customer Sophistication. The dealer must have a reasonable basis to believe that ***the customer is capable of evaluating investment risks and market value independently***, both in general and with regard to particular transactions and investment strategies in municipal securities.

Second Chair Note: Evaluating investment risks associated with municipal bonds is very challenging and few if any small- to medium-sized RIAs have the resources or personnel required.

1. Small- to medium-sized RIAs lack credit research capabilities. This is in contrast to large RIA complexes that employ a staff of municipal credit research analysts whose sole duty is to *independently* keep apprised of any changes in the creditworthiness of issuers and inform their portfolio managers of such changes. Small- to medium-sized RIAs have no such personnel or capability and typically rely on ratings agencies assessments which themselves are not as informative as on-going, independent research conducted by trained and experienced analysts using sophisticated technology and research resources.
2. RIAs lack the knowledge to conduct appropriate price-discovery, required under MSRB Rule G-18, Best Execution. RIAs often simply look at a bond's rating and its yield to maturity but fail to seek the best price. This is a common practice among small- to medium-sized RIAs. It is evidenced in transaction history in the MSRB's EMMA facility wherein a dealer selling to an RIA is *simultaneously* buying from another dealer, marking up the price, and selling to the RIA, while the RIA makes no effort to identify and access directly the original dealer offering. (The MSRB even acknowledges that this is a problematic custom in the market for new issues of municipal bonds.) Large-scale asset managers employ staff to handle trade execution and they do so in an auction-like, competitive manner. Not so for small- to medium-sized RIAs, most often they simply buy third-party dealer offerings displayed on their clearing firm's platform.
3. Nearly all small- to medium-sized RIAs lack the training, knowledge, and experience to employ municipal bond investment strategies used by truly sophisticated asset managers (e.g., BlackRock, Nuveen, and large-scale municipal bond mutual funds.) These strategies can include sector-swaps, rolling-down-the-yield-curve, barbell maturity distributions, immunizing, and simple bond swaps (selling and buying equal dollar values without diminishing portfolio performance.)
4. Sophisticated capability to assess risks associated with municipal bonds and bonds in general calls for robust and specialized technology commonly not available to small- to medium-sized RIAs. Most notably, these include portfolio management software programs that can perform important *fixed-income* portfolio management tasks such as instantaneous swap analyses, valuation effect of portfolio duration change, and concentration limitations compliant with the Investment Company Act of 1940. Nearly all small- to medium-sized RIAs rely on their clearing firms' platforms for analyzing portfolios and these clearing firms have very unsophisticated software modules for doing so.

(c) Customer Affirmation. The customer must affirmatively indicate that it:

(1) is exercising independent judgment in evaluating:

(A) the recommendations of the dealer;



(B) the **quality of execution of the customer's transactions by the dealer**;

Second Chair Note: Most small- to medium-sized RIAs execute purchases and sales without any assessment of quality of execution by dealer counterparties. As many RIAs are former wire-house brokers and do not employ dedicated municipal bond traders, they are simply not knowledgeable enough about the nuances of the municipal bond market and other bond markets generally (i.e., treasury and corporate bonds) to make such evaluations. This awareness is critical in making comparisons not only to similar and close-in-time municipal bond transactions, but also taxable bond alternatives. Additionally, because small- to medium-sized RIAs lack research capabilities, they may not be aware of certain information known to the larger market, such as published notices from ratings organizations that signal possible changes in rating. The summary danger for the customers of RIAs is that an RIA may simply affirm sophistication in order to get the trade done.

and

(C) **the transaction price** for non-recommended secondary market agency transactions as to which (i) the dealer's services have been explicitly limited to providing anonymity, communication, order matching and/or clearance functions and (ii) the dealer does not exercise discretion as to how or when the transactions are executed; and

Second Chair Note: See above note.

(2) has **timely access to material information** that is available publicly through established industry sources as defined in Rule G-47(b)(i) and (ii).

Second Chair Note: A simple example of this is when small- to medium-sized RIAs are simply unaware of the potential for investment quality downgrades and upgrades. If an RIA is acting with discretion in managing a client portfolio, this is critical information. Because a RIA's clearing firm will most likely be the source for such information, there are often time lapses before the RIA is aware of a change, impeding their ability to take timely action on behalf of a customer.

Supplementary Material

.01 Reasonable Basis Analysis. As part of the reasonable basis analysis, the broker, dealer or municipal securities dealer should consider the amount and type of municipal securities owned or under management by the customer.

.02 Customer Affirmation. The customer affirmation may be given either orally or in writing, and may be given on a trade-by-trade basis, a type-of-transaction basis, a type-of-municipal-security basis (e.g., general obligation, revenue, variable rate), or an account-wide basis.

(End of Rule D-15)

