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SEC Commissioner's Remarks at the 2014 Municipal Finance Conference.

Remarks At The 2014 Municipal Finance Conference Presented By The Bond Buyer And Brandeis International Business Schooll, SEC Commissioner Michael S. Piwowar, Boston, Massachusetts, Aug. 1, 2014

Thank you, Erik [Sirri], for that kind introduction.

Before I begin I need to take an awkward pause and provide the standard disclaimer that the views I express today are my own and do not necessarily reflect those of the Commission or my fellow Commissioners.

With that out of the way, let me tell you how delighted I am to be here at this excellent conference. I have greatly enjoyed interacting with this wonderful group of academics, practitioners, regulators, and journalists all dedicated to examining the myriad of issues raised by the topic of municipal finance. In particular, it is great to see such a diverse mix of prominent academic researchers interested in this field. People like Dan Bergstresser and John Chalmers, who have made significant contributions to the academic literature on municipal finance over the past several years. People like Jess Cornaggia, who is bringing his expertise in credit ratings to municipal finance. People like Erik Sirri and Kim Cornaggia, who have given their time and talents to serve the public at the Securities and Exchange Commission ("SEC" or "Commission").

On that note, I want to make a pitch to the academics participating in this event to seriously consider coming to the SEC as a visiting academic scholar or economic fellow in our Division of Economic and Risk Analysis ("DERA").[1] The Commission has long benefitted from working with outside experts in academia and industry to strengthen the Commission's foundation of market knowledge. By the end of my speech, I hope you will see that there are a number of exciting research opportunities in municipal finance to pursue at the Commission.

It has been twelve years, almost exactly to the day, since I was first introduced to the municipal securities market. It was my second day on the job as a visiting academic scholar at the SEC. I arrived at the Commission expecting to work on equity market structure issues. My PhD dissertation focused on equity market microstructure, my first published academic journal article focused on equity market microstructure, and my pipeline of market microstructure working papers all focused on the equity markets.

But, my research agenda took an unexpected and serendipitous turn after a brief conversation with SEC Chief Economist Larry Harris. I still remember him asking me: "Did you know that we have a database of every secondary market transaction in the municipal bond market over a one-year period?" "No," I answered. He followed up: "Do you want to work in this area?" Of course, as a young academic with lots of motivation but little quality data, it did not take me long to answer, "Yes." Luckily for me that turned out to be the correct response, because I got the strong impression that had I answered in the negative I might have been fired. Having passed that initial test, I soon found myself sifting not only through municipal bond data, but also gathering data and analyzing transparency initiatives in the corporate bond market. And so began my multi-year exploration of the municipal and corporate bond markets with Larry Harris and fellow SEC economist Amy Edwards.[2]

Our research yielded a number of somewhat surprising conclusions about the municipal bond market. First, municipal bonds do not trade very often. When analyzing trading activity of individual bonds, we needed to calculate the average number of trades per week, not perday. Second, municipal bonds are expensive for retail investors to trade. We found that effective spreads in municipal bonds averaged almost 2% of the price for representative retail-sized trades. In the Fed's current near-zero-interest-rate policy environment, this represents several months of a bond's total annual return. Third, retail-size municipal bond trades are more expensive than institutional-size trades. Unlike in equities, municipal bond transaction costs decrease with transaction size. Fourth, many municipal bonds have several complexity features – e.g., sinking funds, special redemption provisions, credit enhancements – that make valuation more difficult for investors. Secondary municipal bond transaction costs increase with instrument complexity, which suggests that investors and issuers might benefit if issuers could issue simpler bonds.

Each of these conclusions seems to raise more questions than it resolves, which is evidence of the complexity of the municipal securities market. This complexity is one of the reasons I have been fascinated by this market for so long, and continue to seek answers to the many unique questions it generates.

Given what I have just told you about my background and previous work related to the municipal bond market, it is probably not a surprise that one of my first actions as a Commissioner was to gather with SEC staff to discuss improvements for retail investors that could be made in this market. The timing was apt, because the Commission adopted a final municipal advisor definition, which occurred just weeks after I was sworn in.[3] Despite the attention paid to the municipal advisor definition and related efforts aimed at protecting issuers, I knew from my prior work in this space that there remained a number of basic reforms that could be enacted to better serve the retail investors that dominate this market.

As a result, I urged the Director of the SEC's Office of Municipal Securities, John Cross, and his staff to shift their focus from the creation of the municipal advisor regime to potential reforms in the existing municipal securities market structure. As part of this dialogue I encouraged staff to identify areas of "low-hanging fruit" reflecting common sense improvements to the municipal bond market that the entire Commission could support.

While staff worked to develop a proposed set of reforms for the municipal securities market, I publicly advocated for incremental changes to fixed income market structure in a speech this January at the U.S. Chamber of Commerce.[4] As a minority Commissioner, these calls for reform can sometimes fall on deaf ears within the SEC. However, I am pleased that today, rather than continuing to beat the drum for changes that might never see the light of day, I am able to discuss with you concrete steps to improve the municipal bond market that are not only achievable, but are already gaining support. These steps have been thoughtfully developed by SEC staff and are consistent with the changes for which I have been advocating. And in key signs of progress, most of these reforms also recently received the support of Chair Mary Jo White and Commissioner Dan Gallagher.[5] I firmly believe that the common sense reforms I describe today have the momentum behind them to be enacted in the near-term for the benefit of retail investors and the market as a whole.

Riskless Principal Transactions

The first issue that must be addressed in the municipal bond market is the disclosure of markups on riskless principal transactions. This is an area that I specifically referenced in the January speech in which I called for changes in the fixed income market, and there are straightforward reforms that will provide substantial benefits to retail investors.

When retail investors enter into transactions with dealers to purchase municipal securities, those transactions may be executed by dealers either in an agency or a principal capacity. If a dealer completes a municipal security transaction in an agency capacity it must disclose to its customer the commission that it charges for the trade. Yet if the dealer instead chooses to complete the same transaction in a riskless principal capacity, it may disclose to the customer that zero commission was paid on the trade even if a markup or markdown was charged. Thus, under the existing rules, the information received by a customer concerning the compensation paid to a dealer for these two economically equivalent methods of executing the same transaction is vastly different. In effect, the current regulatory environment allows the dealer to hide its compensation from a customer merely by altering the method of execution used. As a result, customers may unknowingly be paying increased transaction costs while believing that their trades have not been subject to any commission payment.

The time has come to require dealers to disclose markups and markdowns on all riskless principal bond transactions on customer confirmations. Retail customers should have the information necessary to fully understand the costs associated with their transactions and to make informed decisions about how they trade municipal securities. In the past, limitations on the data reported for municipal securities transactions may have made it difficult to identify riskless principal transactions, for purposes of compliance with – and enforcement of – a rule requiring disclosure of markups or markdowns on such transactions. These limitations are no longer present in today's market, as pricing data on municipal securities transactions is reported soon after execution. Thus, we already have the data necessary to identify riskless principal transactions. All that remains is to close the current disclosure loophole.

Of course, despite the sufficiency of our current data set for these purposes, the key question that will always arise when discussing the disclosure of riskless principal markups is what time frame should be used to identify relevant transactions? As an initial matter, staff in the SEC's Office of Municipal Securities has indicated a belief that a same-day time frame to identify riskless principal transactions would be both consistent with natural break points in the data and workable for market participants. I look forward to seeing further analysis on this issue and hearing from market participants on their views as we move towards a rule in this area.

When I talk about moving forward on this issue, I am looking squarely in the direction of the Municipal Securities Rulemaking Board ("MSRB") and Financial Industry Regulatory Authority ("FINRA"). The issue of riskless principal markups is common to both the municipal and corporate securities markets, and I strongly encourage both organizations to work together to publish proposed rules for public comment. There will certainly be those who object to such an undertaking, but the time has come for investors to understand the costs associated with their fixed income transactions, and I ask my colleagues at the MSRB and FINRA to push ahead in implementing this much needed reform.

Best Execution

Another part of the municipal securities market structure that is in need of improvement is the standard of execution to which dealers are held. For too long, we have seen a split in the execution standards in the fixed income markets between corporate and municipal bonds, with FINRA applying a best execution standard to corporates, and the MSRB requiring dealers in the municipal space to trade with customers at “fair and reasonable” prices and to exercise diligence. Objections to the application of a best execution standard to municipal securities often cite the complexity of the market and its unique characteristics as reasons for not adopting such a standard. However, it is the inherent complexity of this market – combined with its highly retail customer base – that creates the need for this high standard. Dealers face a wide array of options for fulfilling customer orders in the municipal securities space, from using internal inventory, to seeking out transactions with other dealers, or tapping into the liquidity of an alternative trading system. Each of these methods of execution may at various times benefit a retail customer initiating a specific transaction with a dealer. However, with so many different methods of execution available, it is impossible to verify whether a dealer has executed a transaction based on the best interests of its customer. As a result, it is vital that dealers be subject to a standard of best execution in the municipal securities space in order to provide retail customers with the confidence that they are receiving the best execution available for each transaction into which they enter.

I am pleased that this is an area where we are already seeing positive developments. I commend the MSRB for taking thoughtful and deliberative steps over the past year towards a best execution standard. After first seeking comment on the question of whether to move forward with a proposed best execution rule in August 2013,[6] the MSRB appropriately chose to proceed with a proposed rule that was published for comment in February of this year.[7] I understand that the MSRB is in the process of reviewing the comments submitted and developing a final rule for submission to the Commission. I look forward to receiving such a submission and implementing an effective, workable rule in the near future.

While calling for steady movement towards a best execution standard in the municipal securities market, I am not ignoring the concerns that some market participants have expressed regarding the complexities involved with implementing such a standard, or the unique aspects of the municipal securities market that must be accounted for in any final rule. However, I am confident that these difficulties can be addressed through dialogue between the regulatory community and market participants. In particular, I recognize that many market participants are concerned that how to apply a best execution standard to fixed income markets is already subject to a significant amount of uncertainty in the corporate bond market, where the standard presently exists. These concerns are valid, and reflect the need for further guidance. I know that the MSRB and FINRA are already engaged in a dialogue aimed at providing clarity on this issue through the publication of practical guidance on how to apply a best execution standard in the context of illiquid securities such as certain municipal and corporate bonds. I encourage the MSRB and FINRA to complete this important work, and ask market participants to stay engaged on this issue by working with the MSRB and FINRA to identify key areas where guidance is needed.

Pre-Trade Transparency

A third area of the municipal securities market that stands ready for reform is pre-trade price transparency. Transparency in the fixed income markets is a particular interest of mine. My municipal bond research attributed much of the high cost of trading municipal securities to the lack of transparency in that market. My corporate bond research also addressed transparency by showing that investors benefitted significantly from public dissemination of prices.

The municipal securities market has long suffered from a lack of price transparency, and this deficiency is particularly acute for retail investors. In recent years, however, strides have been made to increase post-trade transparency for municipal securities through the MSRB’s Electronic Municipal Market Access (“EMMA”) system. This service now provides a wealth of historical pricing information in the municipal securities market in an easy to access format.

While the EMMA system reflects a significant advancement in the overall amount of transparency in the municipal securities market, there is still a significant need for publicly available information regarding pre-trade pricing for these financial products. Retail investors currently have little if any insight into the pricing of their transactions. The little pricing information that exists is typically found on alternative trading systems that provide indicative prices and requests-for-quotes to members, but not to the general public. As a result, the retail investors that make up a significant portion of the municipal securities market are left in the unenviable position of not knowing basic information about the prices at which their securities are likely to transact.

We can do better for retail investors. That is why I support efforts to incrementally increase pre-trade price transparency in the municipal securities market by amending Regulation ATS to mandate the public dissemination of pricing information for certain transactions on significant alternative trading systems.
I use the term “incrementally” in recognition of the difficulty of this task and the need to approach it with care. As with any transparency initiative, there is a risk that shining a light on one portion of the market will cause transaction volume to flee further into the dark. This type of movement could have severely negative impacts in a market like that for municipal securities, which already suffers from a lack of liquidity. However, after talking with relevant SEC staff I believe that we can develop an approach that will provide valuable pricing information to retail investors without over-burdening the market and pushing liquidity away from the trading venues that participate in a transparency initiative. This approach could start with requiring public dissemination of pricing information for smaller transactions typically entered into by retail investors. By focusing first on the disclosure of these transactions, we can provide retail investors with a wealth of valuable pricing information without harming the ability of other market participants to execute large transactions. This is undeniably a delicate task, but the potential benefit for retail investors is too great for us not to undertake meaningful reforms in this area.

Before leaving the topic of transparency, I would like to briefly circle back to the subject of municipal bond complexity that I mentioned earlier as one of the surprising conclusions from my research. This is an area that continues to puzzle me. Despite the potential benefits of increased standardization for both investors and issuers, municipalities continue to issue exceedingly complex bond offerings. The complexity of these offerings is frequently mentioned as one reason why municipal securities do not trade on exchanges, which would provide pre-trade price transparency to retail investors.

I recognize that municipal issuers face unique legal and tax considerations that can influence the design of municipal securities, and therefore may limit their ability to make offerings as simple as they might desire. At the same time, improvements to liquidity from issuing simpler bonds should result in higher valuations and lower issuance costs. These factors alone should help drive the municipal bond market towards greater standardization rather than into the complexity that we see in current issuances. This contradictory result merits further attention, particularly given the potential for decreased costs, increased liquidity, and increased transparency that could result from greater standardization in the municipal bond market. I look forward to receiving feedback from all interested parties regarding what should be done to address this challenging problem.

MSRB Efforts

It is clear by the nature of the market structure reforms I have outlined that much of the initial work must be undertaken by the MSRB. Given what I have seen of the MSRB during my time as a Commissioner, I have full faith that they are up to the task.

The Dodd-Frank Act ushered in a number of changes at the MSRB, including major changes to its board structure and new responsibilities related to the oversight of municipal advisors. I had the opportunity to meet with the revamped MSRB board in May, and I left impressed by the combined knowledge of its members and their willingness to get into the weeds on the many thorny issues present in the current municipal securities market.

In addition to its board, Lynette Kelly and her staff at the MSRB have done yeoman's work during the past months producing an impressive number of rule proposals. Just this past week, the MSRB submitted a rule filing for approval that would establish supervisory and compliance obligations for municipal advisors.

This recent filing represents the first of many related rule filings to come as the MSRB seeks to get the municipal advisor regime up and running. That is why I am particularly pleased that the MSRB recently hired its first Chief Economist, David Saltiel, to help bolster the economic analysis contained in these rule filings. I look forward to future rule filings from the MSRB and to the positive impacts that will come from Mr. Saltiel's involvement with these proposals.

One final comment I would like to make about the MSRB is to commend it for commissioning Erik Sirri to complete the recently published Report on Secondary Market Trading in the Municipal Securities Market.[8] Tapping into the expertise of outside academics is an excellent way to bring rigorous economic analysis to bear on regulatory issues that are all too often debated primarily on the basis of competing business models of market participants. Erik's report provides an excellent baseline for further analysis by academics, regulators, and market participants of the secondary market trading practices in the municipal securities market, and it supports the type of data-driven approach to regulation that I believe is most effective in meeting the regulatory challenges of the day.

MCDC Program

I would be remiss if I failed to mention the topic that is probably the biggest cause of anxiety for municipal finance practitioners right now, the SEC's Municipalities Continuing Disclosure Cooperation Initiative ("MCDC Initiative").[9] The stated intention of the MCDC Initiative is to address potentially widespread violations of the federal securities laws by municipal issuers and underwriters of municipal securities in connection with certain representations about continuing disclosures in bond offering documents. The MCDC Initiative is designed to encourage self-reporting of possible violations by placing a cap on the civil penalties for issuers or underwriters that self-report by the September 10, 2014 deadline.

As most of you are probably aware, the Commission issued a press release yesterday announcing certain modifications to the MCDC Initiative. These modifications both extend the deadline for issuers to self-report from September 10, 2014 to December 1, 2014, and create a tiered penalty cap for small- and mid-sized underwriters.
Extending the deadline for issuers until December 1, 2014 is intended to address the difficulty of ensuring that the tens of thousands of issuers across the country – particularly the smaller issuers – are aware of the initiative and each have adequate time to consider whether they should self-report. In addition, the tiered penalty cap responds to feedback indicating that many underwriters may reach the current $500k cap, but that a penalty at that level would impair their ability to conduct business.

Finally, the press release also makes a statement related to the difficulties some market participants have encountered in accessing data from the Nationally Recognized Municipal Securities Information Repository ("NRMSIR") system, which pre-dated EMMA. The press release indicated

that enforcement staff would consider “reasonable, good faith, and documented efforts” to investigate potential violations in the NRMSIR, which should alleviate the concerns expressed by some that discrepancies in the NRMSIR might result in failures to properly self-report.
These important changes address many of the issues conveyed to me by market participants, and I applaud the SEC staff for developing tailored modifications based on widespread concerns in the market. The changes should serve as confirmation to market participants that our staff listens to the legitimate concerns expressed and responds in a reasonable manner. To the extent that you identify further issues of concern, I encourage you to continue to raise them with the staff, as they have assured me that they remain ready and willing to discuss your questions and provide clarity wherever possible.

Thank you for your attention.

[1] See Division of Economic and Risk Analysis Opportunities for Economists and Other Experts and Professionals with DERA, available athttp://www.sec.gov/divisions/riskfin/rfemployment.shtml.
[2] See Lawrence Harris & Michael Piwowar, “Secondary Trading Costs in the Municipal Bond Market,” Journal of Finance 61, 1361-1397 (2006), available athttp://onlinelibrary.wiley.com/doi/10.1111/j.1540-6261.2006.00875.x/pdf; Amy Edwards, Lawrence Harris & Michael Piwowar, “Corporate Bond Market Transaction Costs and Transparency,” Journal of Finance 62, 1421-51 (2007), available athttp://onlinelibrary.wiley.com/doi/10.1111/j.1540-6261.2007.01240.x/pdf.
[3] See Press Release, SEC Approves Registration Rules for Municipal Advisors (Sept. 18, 2013), available athttp://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539817759.
[4] See Commissioner Michael S. Piwowar, Remarks before the U.S. Chamber of Commerce,Advancing and Defending the SEC’s Core Mission, (Jan. 27, 2014), available athttp://www.sec.gov/News/Speech/Detail/Speech/1370540671978.
[5] See Chair Mary Jo White, Remarks before the Economic Club of New York, Intermediation in the Modern Securities Markets: Putting Technology and Competition to Work for Investors(June 20, 2014), available athttp://www.sec.gov/News/Speech/Detail/Speech/1370542122012; Commissioner Daniel M. Gallagher, Remarks at Municipal Securities Rulemaking Board’s 1st Annual Municipal Securities Regulator Summit (May 29, 2014), available athttp://www.sec.gov/News/Speech/Detail/Speech/1370541936387. Commissioner Gallagher also spoke about the need for additional steps to improve the transparency of the accounting for public pensions.
[6] See MSRB Notice 2013-16 – Request for Comment on Whether to Require Dealers to Adopt a “Best Execution” Standard for Municipal Securities Transactions (Aug. 6, 2013),available at http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2013/2013-16.aspx?n=1
[7] See MSRB Notice 2014-2 – Request for Comment on Draft Best-Execution Rule, Including Exception for Transactions with Sophisticated Municipal Market Professionals (Feb. 19, 2014),available at http://www.msrb.org/~/media/Files/Regulatory-Notices/RFCs/2014-02.ashx?n=1.
[8] See Report on Secondary Market Trading in the Municipal Securities Market (July 2014),available at http://www.msrb.org/msrb1/pdfs/MSRB-Report-on-Secondary-Market-Trading-in-the-Municipal-Securities-Market.pdf
[9] See Municipalities Continuing Disclosure Cooperation Initiative, Division of Enforcement, U.S. Securities and Exchange Commission, available at http://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml.