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# MUNICIPAL SMAs:

## *Behind the Velvet Rope of Regulation*

Well-meaning regulation enacted to protect purchasers of municipal bonds has had the unintended consequence of reduced access to new bond inventory. Here, we examine ways to navigate this trend.

**A**t an increasing pace, retail municipal bond investors are shifting money to professional managers via mutual funds or separately managed accounts. While retail investors still account for a meaningful portion of the municipal market, regulatory changes enacted after calls for more market oversight have helped accelerate the industry's realignment. In the wake of these regulations, some investors are struggling to achieve the same level of comfort with, and access to, municipal bond issuance as before. In this environment, professional management has demonstrated its ability to increase value for municipal market participants.

**How did we get here?** It primarily began with SEC Rule 15c2-12 ("the Rule"), which increased disclosure requirements for issuers in the wake of various municipal market scandals and investor pressure. While municipal issuers were historically exempted from the disclosure requirements in the original Securities Exchange Act, the SEC has steadily made it more difficult to access



public markets without conforming. Following the establishment of the Municipal Securities Rulemaking Board (MSRB) in 1975, the Tower Amendment offered a compromise in prohibiting the SEC from directly regulating issuers. Then came the "whoops"—the \$2.45 billion default of the Washington Public Power Supply System in the late 1980s—and Rule 15c2-12 put the burden of issuer disclosure on underwriters (which are regulated by the SEC).

The latest overhaul of the Rule came via the Dodd-Frank legislation that followed the 2008–09 financial crisis. During and after the crisis, buy-and-hold investors who historically relied on ratings agencies, bond insurance or both for protection were forced to reconsider their approach as insurers' ratings plummeted and many issuers could not perform on their obligations. Ratings agencies offered little aid during this time, as the meltdown of AAA-rated subprime debt called their credit-risk acumen into question. Investors who never contemplated the concept of "municipal bankruptcy"



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previously would later be forced to add the term into their vernacular, spurred by bankruptcies of Jefferson County, Alabama in 2011; Stockton and San Bernardino, California in 2012; and Detroit in 2013. Investors were beginning to see the importance of regular and timely disclosure, but still did not have access to it in many circumstances.

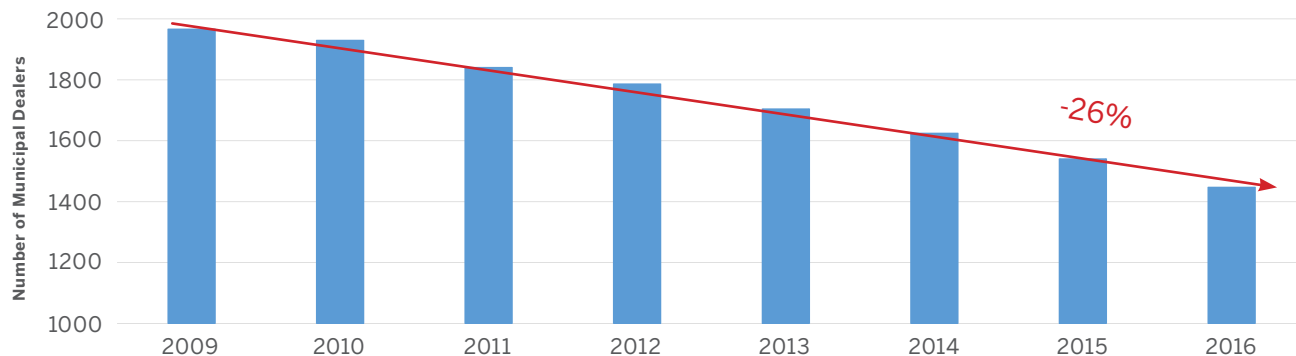
**Investors cannot afford complacency.** According to the MSRB, continuous disclosure “consists of important information about a municipal bond that arises after the initial issuance of the bonds. This information generally reflects the financial health or operating condition of the state or local government as it changes over time, or the occurrence of specific events that can have an impact on key features of the bonds.”<sup>1</sup> Through continuous disclosure, underwriters must ensure that municipal issuers meet the requirements to disclose annual financial information through audited statements, and notices of events including but not limited to delinquencies, defaults,

rights modifications and ratings changes. Despite calls for and attempts at additional transparency, a 2012 SEC report on the state of municipal markets (required under Dodd-Frank) found that the secondary markets in which retail investors trade municipal bonds “remain opaque [as] investors have very limited access to information regarding which market participants would be interested in buying or selling a municipal security and at what price.”<sup>2</sup>

The SEC’s Enforcement Division introduced the Municipal Continuing Disclosure Cooperative Initiative in early 2014 to encourage self-reporting of possible securities law violations, especially in situations when entities misrepresented their compliance with continuing disclosure obligations. The results were discouraging. In 2016, the SEC reported that, under the initiative, the agency had filed actions against “underwriting firms comprising 96 percent of the market share for municipal underwritings.”<sup>3</sup> Understandably, underwriters and

## Number of MSRB-Registered Dealers Declining

Increased regulation and scrutiny have greatly increased the importance of scale in complying with requirements. This has contributed to a continual decline in the number of dealers in the market, due to consolidation and outright exits.



Source: MSRB Fact-Book 2015; MSRB Fact-Book 2016. All dates as of October 1. Data reflect the most recent available time of publication.

dealers who participate in the market feel the increased burden and regulatory pressure for actions that are not entirely under their control, and are finding ways to protect themselves and cope with the costs of conforming. The chart on page 2 shows the decline in the number of registered dealers from consolidation; some are exiting the market completely. For the remaining dealers, self-protection actions have largely resulted in unequal access to certain issuances and trades, leaving nonprofessional managers without a full opportunity set.

#### **Good intentions, unintended consequences.**

The increased regulatory burden, combined with the heightened scrutiny on the industry, has led to some dealers taking the conservative stance of only transacting with Sophisticated Municipal Market Professionals (SMMPs). The figure below provides MSRB definitions and certain exemptions for dealers transacting with SMMPs. Typically, the SMMP group comprises institutional investors with larger-scale operations, more sophisticated trading networks and credit analysts who are often able to more effectively evaluate issues. With many new issues being sold directly to sophisticated investors, it puts individual investors and Registered Investment Advisers—who do not always have access to the full breadth of market issues—at a disadvantage. This

limits the available investment universe and helps solidify the value of professional management. Even for dealers still transacting with non-SMMPs, certain deals that might have value may not pass muster with compliance departments. This may preclude these deals from being shown to all customers for fear of the firm running afoul of one or more of the current or future regulations (especially as Rule 15c2-12 is not finalized and many observers anticipate further additions to the Rule).

Regulators want to protect municipal market investors, and that is an admirable goal—particularly knowing that individual investors are often hardest hit by major market disruptions. This is why we believe that competent research and portfolio management are so important today. Events transpire quickly, and investors can not rely solely on ratings agencies. Even with new disclosure rules, individual investors are often left without essential information and increasingly without access to new issuance. Professional management is valuable for investors who want access to the entire universe of available municipal securities. It is analogous to an event that everyone wants to enter, but many people are left standing outside. Professional management can help get you behind this figurative velvet rope. [B](#)

## **Key MSRB Rules and Provisions**

<b>RULE</b>	<b>IMPACT</b>
D-15	Defines the sophisticated municipal market professional (SMMP).
G-48	Exempts dealers from certain requirements when transacting with SMMPs (including those noted in rules G-19, G-47 and G-18 below)
G-19	Requires customer suitability analysis <b>before</b> transacting.
G-47	Requires disclosure of all material information to a customer <b>before</b> executing a trade.
G-18	<b>The Best Execution Rule:</b> Requires “reasonable diligence” when considering whether a price to a customer is “as favorable as possible under prevailing market conditions.”

Source: msrb.org

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1. <http://www.msrb.org/msrb1/pdfs/SECRule15c2-12.pdf>
2. <https://www.sec.gov/news/studies/2012/munireport073112.pdf>
3. <https://www.sec.gov/news/pressrelease/2016-166.html>