

## COMMENT LETTER

July 13, 2015

# ICI Files Comment Letter Supporting MSRB's Proposed Amendments to Rule A-3 (pdf)

July 13, 2015 Mr. Ronald W. Smith Corporate Secretary Municipal Securities Rulemaking Board 1900 Duke Street, Suite 600 Alexandria, VA 22314 Re: Request for Comment on Draft Amendments and Other Issues Related to MSRB Rule A-3 on Membership on the Board (2015-08) Dear Mr. Smith: The Investment Company Institute<sup>1</sup> supports the Municipal Securities Rulemaking Board's proposal to improve the MSRB's ability to identify and select individuals who represent investors and have significant knowledge of the municipal securities market to serve on the MSRB Board.<sup>2</sup> As discussed below, the proposal would increase the opportunity for employees of investment advisers, including advisers to registered investment companies ("fund advisers"), to serve on the MSRB Board. Fund advisers are active participants in the \$3.7 trillion municipal securities markets, providing the means through which many retail and institutional investors participate in these markets.<sup>3</sup> We support the MSRB working toward enhancing the representation of these investors, which should help to ensure the maintenance of fair and efficient municipal markets. Additionally, the MSRB is seeking comments on whether it should extend the length of MSRB Board member service and remove or modify the requirement that the MSRB publish the names of all Board applicants. We support both of these initiatives as well. 1 The Investment Company Institute (ICI) is a leading, global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's U.S. fund members manage total assets of \$18.2 trillion and serve more than 90 million U.S. shareholders. 2 MSRB Regulatory Notice 2015-08 (June 11, 2015) ("Notice"), available at <http://www.msrb.org/~media/Files/Regulatory-Notices/RFCs/2015-08.ashx>. 3 Of the \$3.7 trillion outstanding in the municipal securities markets as of year-end 2014, mutual funds and other registered investment companies held 26 percent. Mr. Ronald W. Smith July 13, 2015 Page 2 of 6 Background Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") amended Section 15B(b)(1) of the Securities Exchange Act of 1934 ("Securities Exchange Act") to require that a majority of MSRB Board members be independent ("Public Representatives"), while the remainder be associated with a broker, dealer, municipal securities dealer, or municipal advisor ("Regulated Representatives"). Accordingly, MSRB Rule A-3 provides for eleven Public Representatives, including at least one representative each of retail or institutional investors, issuers, and

members of the public, and ten Regulated Representatives. The MSRB defines a Public Representative as an individual who has “no material business relationship” with any municipal securities broker, municipal securities dealer, or municipal advisor (“regulated entity”). The MSRB defines “no material business relationship” to mean the individual is not or was not “associated with” a regulated entity within the last two years. In addition, the individual must not have a relationship with any regulated entity that reasonably could affect his or her independent judgment or decision making. The MSRB explains that, in practice, the “associated with” test is without limitation and has disqualified otherwise viable candidates solely due to the presence of a regulated entity within their employer’s corporate structure. It encompasses, for example, individuals who serve as independent directors on the boards of companies within the same corporate family as broker-dealers. It also includes employees of fund advisers if the adviser is affiliated with a municipal advisory firm or with a broker-dealer that engages in the sale of municipal securities or Section 529 College Savings Plans. MSRB’s Proposal To address this shortcoming, in July 2013, the MSRB proposed to amend MSRB Rule A-3 to provide a more function-oriented approach to defining independence for all Public Representatives.<sup>4</sup> Specifically, under the 2013 proposal, the term “no material business relationship” would require that an individual is not, and within the last two years was not, an officer, director (other than as an independent director), employee, or controlling person of any regulated entity. After some commenters expressed concern with the 2013 proposal,<sup>5</sup> the MSRB withdrew the filing with plans to further increase its efforts to identify well-qualified applicants to serve on the MSRB Board, and gain additional experience operating under the existing standard. <sup>4</sup> See Exchange Act Release No. 70004 (July 18, 2013). <sup>5</sup> Commenters opposing the 2013 proposed amendments suggested that the amendments were not consistent with the Securities Exchange Act’s mandate that Public Representatives be independent of regulated entities. In contrast, ICI submitted a letter expressing support for the 2013 proposal, noting that the proposed amendments would improve the quality of representation for both institutional and retail investors on the MSRB Board. See Letter from Dorothy Donohue, Deputy General Counsel-Securities Regulation, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (September 18, 2013), available at <https://www.iciglobal.org/pdf/27584.pdf>. Mr. Ronald W. Smith July 13, 2015 Page 3 of 6 According to the Notice, after making these efforts and gaining additional experience applying the current standard, the MSRB concluded that the existing test for evaluating materiality of a business relationship is overly restrictive. Indeed, the Notice states that the MSRB continues to experience significant challenges in finding a sufficient pool of individuals qualified to serve as the public MSRB board member representing institutional or retail investors in municipal securities (“Investor Representative”). As such, the MSRB proposes to provide an alternative definition of “no material business relationship” to determine whether the Investor Representative is independent. This modified standard of independence would apply only to one Investor Representative; the MSRB would continue to apply the existing definition of independence to all other Public Representatives, which may include Investor Representatives selected under the existing test. The MSRB explains that the proposed amendments are tailored to allow employees and other representatives of investment advisers<sup>6</sup>—who serve the interests of the adviser’s clients, rather than the regulated entities—to serve as the MSRB Investor Representative. The proposed amendments to MSRB Rule A-3(g)(ii)(2) apply a two part test. First, the adviser cannot currently, or within the past two years, be an officer, director (other than independent director), employee, or controlling person of a regulated entity. Second, the test applies a discretionary component to determine if the individual has a relationship with a regulated entity that could affect the individual’s decision making. In making this determination, the board considers a non-exhaustive list of specified factors.

The factors are whether: (1) the revenue from the regulated entity accounts for a material portion of the revenues of the consolidated entity that includes the investment adviser<sup>7</sup>; (2) the regulated entity facilitates the origination of municipal securities<sup>8</sup>; and (3) the investment adviser has a fiduciary duty to the investment company or other investor clients. The twenty-one members of the MSRB Board are charged with the significant responsibility of protecting municipal entities, investors, and the public interest. Each representative should bring to the table experience and expertise to effectively serve the interests of their constituents. As a starting point, there is only one required Investor Representative position on the MSRB Board—for both retail and institutional investors. The pool of applicants is further narrowed by the “associated with” language within the Public Representative definition, as described above. The proposal offers the potential to improve the quality of representation for both institutional and retail investors, which would enhance the MSRB’s ability to satisfy its investor protection mandate. <sup>6</sup> The term “investment adviser” has the meaning in Section 202(a)(11) of the Investment Advisers Act of 1940. <sup>7</sup> According to the MSRB, an employee or other representative of an investment adviser, which has a relationship with a regulated entity that does not account for a material portion of the revenues of the consolidated entity that includes the investment adviser and the regulated entity, is less likely to have an appropriately disqualifying nexus with or be subject to any significant influence from the regulated entity. <sup>8</sup> If a regulated entity does not underwrite, privately place, or otherwise facilitate the origination of municipal securities, the MSRB suggests that the corporate affiliation with the regulated entity is less likely to affect the independent judgment or decision making of an employee or other representative of the investment adviser. Mr. Ronald W. Smith July 13, 2015 Page 4 of 6

The proposal’s function-oriented approach would allow the MSRB to consider candidates who have the relevant municipal market knowledge and expertise to represent investors, but who technically may have some association or corporate affiliation with a regulated entity. For example, the MSRB’s rulemaking mandate increasingly requires the MSRB to engage in deliberations regarding highly complex issues relating to the structure and operation of the market, including how municipal securities are priced and transacted. As representatives of underlying fund retail and institutional investors, fund advisers invest in the municipal securities market on behalf of fund investors and interact with a variety of market participants. This provides a distinct and at times contrasting view of the municipal market and its structure compared to representatives or employees of regulated entities or other Public Representatives who represent other market participants, such as municipal issuers and insurers. In fact, the MSRB acknowledges that investment advisers with “buy-side” expertise and representative of investors (e.g., fund portfolio managers) could help the MSRB be as informed as possible on all aspects of the municipal securities markets, particularly with respect to current and future market structure initiatives. We agree. The proposal also is appropriately limited in a manner consistent with the Dodd-Frank Act. The modified definition of “no material business relationship” retains the prohibition on an individual having relationships with regulated entities that reasonably could affect his or her independent judgment or decision making. Specifically, the proposal would require the MSRB Board to undertake additional analysis to ensure that the Investor Representative does not have any material business relationship with a regulated entity. As noted above, to help make this determination, the proposal includes a non-exhaustive list of three factors for the board to consider. We support the inclusion of meaningful factors that would enable the MSRB Board to limit the pool of applicants to individuals who are truly independent of any regulated entity and representative of investors. For example, we agree that the amount of revenue from a regulated entity affiliated with an investment adviser is an important factor in determining whether the affiliation impairs independence. The source of that revenue, however, may be equally as important. Specifically, revenue derived from

services provided to affiliated investment advisers and other affiliated entities may be less of a factor in determining whether an individual has a disqualifying nexus with a regulated entity, than revenue derived from third parties. We also note that the proposed third factor—"the investment adviser has a fiduciary duty to the investment company or other investor clients"—is not necessary because the first part of the proposed modified definition of "no material business relationship" only applies to investment advisers, which by law are fiduciaries.<sup>9</sup> Investment advisers are required to make decisions in the best interests of 9 An adviser's fiduciary duty to its clients is a fundamental tenet of the regulatory framework for investment advisers. See, e.g., *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 184-85 (1963). See also Information for Newly-Registered Investment Advisers, Prepared by the Staff of the Securities and Exchange Commission's Division of Investment Management and Office of Compliance Inspections and Examinations (November 2010), available at <https://www.sec.gov/divisions/investment/advoverview.htm>. Mr. Ronald W. Smith July 13, 2015 Page 5 of 6 their clients. Other safeguards that complement an adviser's fiduciary duty to its clients include firewalls between the asset management and banking/underwriting divisions of commercial and investment banks. Codes of ethics and restrictions on communications further ensure the functional independence of investment advisers.<sup>10</sup> For all of these reasons, we strongly support the proposed amendments to MSRB Rule A-3. Other Issues Raised by MSRB The MSRB also requests comment on whether it should extend the length of the board member service, and, if so, in what manner. Currently, board members are divided into three seven- member classes who serve three-year, staggered terms and can only serve consecutive terms under special circumstances.<sup>11</sup> The MSRB believes allowing members to serve on the board for longer than three years will improve the effectiveness of the board because board members typically take multiple years to fully understand the MSRB's rulemaking process and oversight obligations.<sup>12</sup> We agree, and would support modifications to Rule A-3 that would allow board members to serve, for example, consecutive three-year terms without the special circumstances exception, similar to the length of service for FINRA governors. We also share the MSRB's concerns that the current requirement to publicly announce the names of all board member applicants deters applicants who are concerned that not being selected will negatively impact their professional career. As an alternative to removing the requirement, the MSRB is considering whether it should publish other identifying information, such as the names of the applicants' employer, to maintain the anonymity of the individual applicants. We would support such an approach. \* \* \* \* 10 See, e.g., Rule 204A-1 under the Investment Advisers Act (requiring advisers to adopt a code of ethics including, among other things, a standard of business conduct that reflects the adviser's fiduciary obligations; and Section 204A under the Advisers Act (requiring advisers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information). 11 See MSRB Rule A-3(b)(i). Board members may serve consecutive terms only under two scenarios: (1) by invitation from, and due to special circumstances as determined by, the Board; or (2) having filled a vacancy under Rule A-3(d) and, therefore, having served only a partial term. 12 The Notice states that the average tenure for members on other boards is 8.4 years. Mr. Ronald W. Smith July 13, 2015 Page 6 of 6 We look forward to working with the MSRB as it continues to examine these critical issues. In the meantime, if you have any questions, please feel free to contact me directly at (202) 218-3563 or Jane Heinrichs, Associate General Counsel, at (202) 371-5410. Sincerely, /s/ Dorothy Donohue Dorothy Donohue Deputy General Counsel—Securities Regulation cc: Jessica S. Kane, Director Office of Municipal Securities Securities and Exchange Commission Lynnette Kelly, Executive Director Municipal Securities Rulemaking Board

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