



THE ROLE OF
*Municipal Securities
Broker's Brokers*

IN THE MUNICIPAL MARKETS

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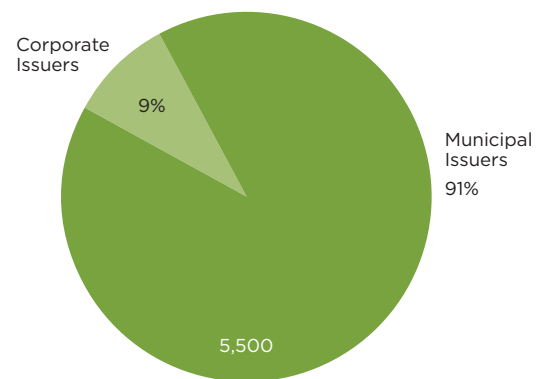
INTRODUCTION

Municipal securities are debt obligations issued by cities, counties, states, and other non-federal governmental entities, which use the proceeds to build schools, highways, hospitals, sewer systems and many other projects for the public good. There are approximately 55,000 issuers of municipal securities nationwide, ranging from small school districts and fire districts to U. S. territories and all 50 states, which have more than 950,000 individual securities outstanding represented by CUSIP numbers.¹ This compares to the public corporate securities market which has approximately 5,500 issuers,² who have approximately 58,000 individual securities outstanding represented by CUSIP numbers.³ As of December 31, 2013, there were about \$3.7 trillion of municipal bonds outstanding,⁴ (approximately \$334.9 billion issued in 2013),⁵ which accounts for approximately 9.2% of the total outstanding debt in the U.S. market. As a comparison there are 872 U.S. Treasury securities represented by CUSIP numbers, representing \$11.9 trillion in outstanding bonds.⁶

Once these bonds are issued, investors buy and sell municipal securities in what is referred to as the “secondary market.” These investors can be individuals, institutional investors as well as broker-dealers acting on behalf of their customers or trading for their own account. Currently, 44.3% of municipal securities are held by private individuals.⁷

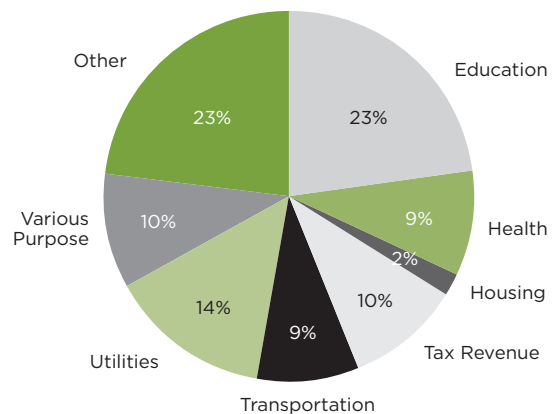
\$11.18 billion flow through the municipal secondary market on a daily basis, with 83% of daily transactions being attributable to retail (customer) transactions.⁸ The graphs, noted on page 2, display the size of the municipal markets as measured by the number of trades as well as trading volume. Both of these factors help explain why the municipal securities broker's brokers (MSBBs) add value to the municipal markets.

Number of Municipal Issuers vs. Corporates



Source: CUSIP Bureau, Thomson Reuters

Trades by Sector, 2013



Source: MSRB Fact Book

¹ Bloomberg. ⁵ Thomson Reuters.
² Thomson Reuters. ⁶ U.S. Treasury.
³ S&P CUSIP Bureau. ⁷ Federal Reserve Flow of Funds.
⁴ Federal Reserve Flow of Funds. ⁸ MSRB.

WHO WE ARE

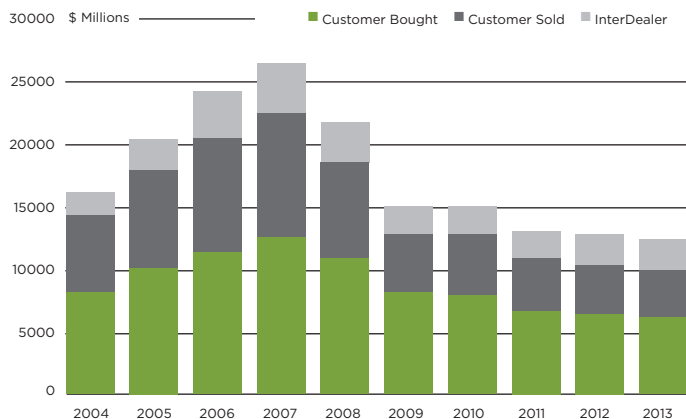
Definition of a Municipal Securities Broker's Broker

Broker's broker activity is defined by the Municipal Securities Rulemaking Board's (MSRB) Rule G-43. Colloquially, a registered broker dealer has been considered an MSBB when it acts as an agent or riskless principal in the purchase or sale of securities for registered broker-dealers, registered municipal securities dealers, dealer banks, sophisticated municipal securities professionals (SMMPs) and institutions. These market participants have been the transactional counterparties of MSBBs when: (i) dealers are seeking liquidity on behalf of themselves or their customers; (ii) dealers are seeking to distribute a new issue or adjust an inventory position; and (iii) dealers, SMMPs and institutions desire direct access to the bid wanted market, which is explained in detail below.

An MSBB acts in the limited capacity of providing anonymity, information flow, liquidity, extended distribution, and order matching. It does not participate in the decision to buy or sell securities, exercise discretion as to the price at which a transaction is executed or determine the timing of a trade. An MSBB does not have or maintain any municipal securities in its brokering or other proprietary accounts, participate in syndicates, hold customer funds, or safekeep customer securities. To protect the integrity of the market and ensure accurate regulatory reporting, an MSBB may only retransmit quotes that it believes are bona fide bids or offers for municipal securities. MSBBs are compensated by a transactional commission rather than a mark-up.

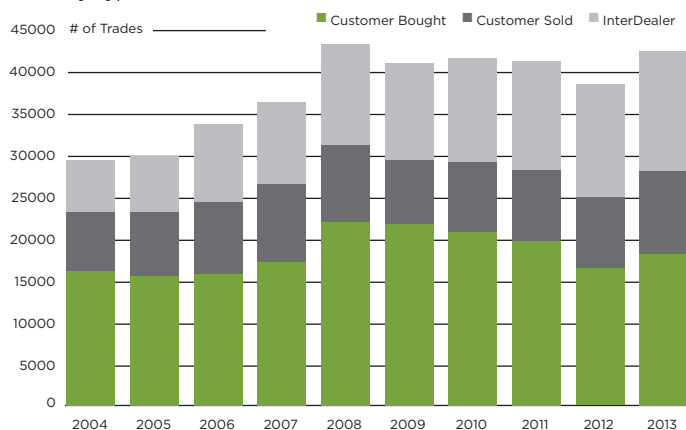
Very simply stated, MSBBs function in two ways. MSBBs solicit buyers either: a) for a security with a price, this is considered an "offering"; or b) ask buyers to give a price on a security, this is considered a "bid wanted".

Average Daily Trading Volume by Dollar Millions
By Type of Order



Source: MSRB Fact Book

Average Daily Trading Volume by Number of Trades
By Type of Order



Source: MSRB Fact Book

Bid Wanted Auctions

The MSRB, which is one of the governing bodies of the industry, requires that broker-dealers “deal fairly” with all persons, and make a reasonable effort to obtain a price for a customer that is fair and reasonable. MSBBs can assist their clients in this obligation through the use of their bid wanted auction process.

In a bid wanted auction, a potential seller contacts the MSBB with a specific municipal bond for which the seller wishes the MSBB to obtain an advantageous price under the current market conditions by the use of a blind auction in which neither buyers nor sellers know each other’s identities. The potential seller provides the MSBB with the par value of the auction item, a description of the bonds, the CUSIP number of the bond, and the time at which the potential seller would like to have the bids reported back to them.

The MSBB then advertises the bonds to the potential bidders, using all the methods (voice and electronic) at the MSBB’s disposal. The MSBB makes an active attempt to contact potential buyers that might have an interest in bidding that particular security. As bids are returned, either by phone or electronically, the MSBB collates the bids and reports them back to the potential seller. If the potential seller decides to trade the bond to the high bidder, the MSBB charges a commission and a trade is affected. It is important to note that the originator of the auction item is not required to trade the securities; the decision to buy or sell remains solely with the owner of the bonds.

For individual retail accounts seeking an advantageous price in the market when they desire to sell a bond, the MSBB auction provides the benefit of extending the distribution of the auction item, providing individualized attention through the voice model specialists, and affording the retail customers an even playing field of full access to the interdealer market.

Offerings

MSBBs are shown bond offerings by potential counterparties on a daily basis. The party that owns

and offers the securities makes use of an MSBB and their associated network of market professionals for a multitude of reasons. MSBB’s provide anonymity, almost instantaneous market reach through their well-developed national network, and knowledge of and access to interested buyers. These qualities increase information, enhance liquidity and bring overall efficiency to the secondary market. When the MSBB elicits interest on an offering from a potential buyer, the buyer will indicate to the MSBB the price that it would be willing to pay to purchase the bonds. The MSBB then calls the owner of the bonds to inform that trader of the “bid” price. Negotiation typically occurs at this point, reported back and forth through the MSBB; if a mutually acceptable price is agreed upon, including a commission for the MSBB, a contemporaneous equally matched trade occurs.

Current MSBB Business Models

Voice brokerage (that is, brokering by the use of a telephone) was originally the business model used by MSBBs in order to disseminate indications of interest and executable prices in the municipal market. MSBBs would communicate with potential counterparties via telephone to either solicit bids on bonds that were being auctioned or to show offerings on blocks of municipal bonds on behalf of potential counterparties.

Over time, as the markets and technology have evolved, MSBBs have added electronic systems to their business models. MSBBs may use their own web sites, on-line platforms, facsimiles, e-mail, and various other electronic platforms to distribute auction items or advertise offerings. The addition of electronic platforms allows MSBBs to more quickly assist their counterparties in finding liquidity through the efficient distribution of information and negotiation. These “hybrid” brokerage business models improve the ability of MSBB’s to penetrate the secondary market on auction items and assist in obtaining access to multiple market participants with possible interest in the security. Further, they permit the execution of orders through: (i) traditional telephone negotiation and execution and (ii) telephone negotiation and execution combined with electronic communication.

ADDED VALUE TO THE MUNICIPAL MARKETS

Introduction

MSBBs add value to the markets in several ways, by: (i) enhancing price discovery and transparency; (ii) providing anonymity and confidentiality; (iii) facilitating market information flow; (iv) enhancing liquidity, particularly for retail-sized or odd-lot sized transactions; (v) improving market efficiency; (vi) extending the distribution network; and (vii) lowering costs. Each of these factors is explained below.

Enhancing Price Discovery and Transparency

Prior to execution, MSBBs distribute bona fide bids and offers for securities through a variety of methods ranging from voice brokering and electronic communications to electronic trading platforms. By soliciting bids for bonds that counterparties wish to sell, MSBBs help market participants via their wide distribution of the bid wanted information, which provides advantageous prices at which to sell the bonds.

Providing Anonymity and Confidentiality

According to industry practice and regulation, an MSBB maintains a confidential relationship with its counterparty, which is especially important during the price discovery process. Because MSBBs do not reveal their counterparties' identity, they prevent competing market participants from learning each other's strategies. For example, a bank or dealer may be looking to acquire or sell a large amount of inventory. If done directly, such massive trades may affect market levels resulting in a negative impact on the dealer's trading strategy. By transacting their business through an MSBB, the bank or dealer can remain anonymous and the large quantity of bonds can be bought or sold in multiple denominations, thus maintaining a stable market and uniform price throughout the transactions.

Facilitating Market Information Flow

An MSBB's role in facilitating the flow of market information - such as security prices, interest in buying and selling securities and transactions in

securities - is a critical service which enhances liquidity and results in improved prices for market participants.

Before a trade, MSBBs collect market information on behalf of potential counterparties. The MSBB will give the potential buyer or seller information on relevant market levels and/or transactions. Because their identities are protected, counterparties are willing to supply information to MSBBs that benefits the market.

MSBBs also facilitate post-execution price transparency. After a municipal bid-wanted trade is executed, an MSBB may provide the purchasing counterparty with information about the total number of bids received and about the cover bid, which is the next best bid after the level at which the bond traded. This is important information for dealers to have in assessing the depth of the market and the risk involved in bidding or offering bonds at particular levels. This information also permits dealers to quote markets with greater certainty and, presumably, at lower spreads

Enhancing Liquidity

Due to the size, complexity and lack of homogeneity of the municipal securities market, MSBBs tend to specialize in securities of that market based on region, issuer or type of bond. In this manner, an MSBB's expertise eliminates the need for a desk-to-desk search on the part of potential buyers and sellers of a given security. Because traders, typically, have multiple responsibilities, they often look to MSBBs and their specialists' expertise in finding buyers and sellers. This can be especially helpful for retail customers, who may hold bonds in blocks less than \$50,000 par value in size or are rarely traded.

Improving Market Efficiency

MSBBs save their counterparties time by making it easier for trading desks to complete more trades in the course of a day, efficiently and at interdealer market levels. (The interdealer market is the wholesale market for the municipal securities industry.) With the information flow and access to the MSBBs extended distribution network, trading desks can spend less time

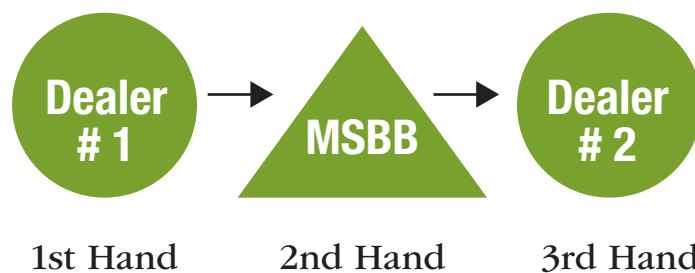
The Three Handed Trade

As MSBBs broker securities for broker dealers, dealer banks, SMMPs, and institutions, they often serve as an intermediary for the interdealer market. In these transactions, there are three parties involved in the completion of this trade (thus, the term “Three Handed Trade”).

- An interdealer counterparty that wants to buy or sell securities (“1st Hand”) contacts its MSBB (“2nd Hand”).
- The MSBB, through its network of market participants, will find a counterparty willing to sell or buy the securities (“3rd Hand”).
- The MSBB, having arranged for an equally matched transaction or set

of transactions, contemporaneously purchases and sells the municipal securities.

- In the three handed trade, there is one economic transaction, two separate trades, and four submissions to the MSRB’s Real-Time Transaction Reporting System for trade transparency.



The Five Handed Customer Trade

When MSBBs broker securities for the interdealer market they often serve as an intermediary for an ultimate customer. In these transactions, there are five parties involved in the completion of this trade (thus the term “Five Handed Trade”).

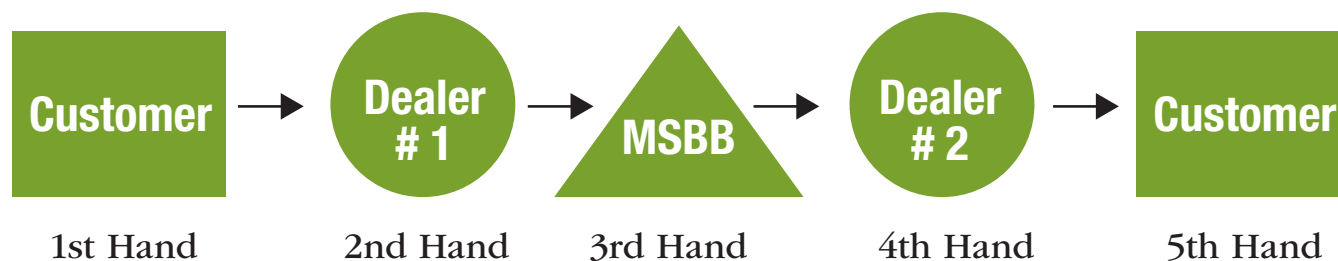
- A retail or institutional customer that wants to buy or sell securities

(“1st Hand”) contacts its dealer (“2nd Hand”). If the securities do not meet the dealer’s trading inventory parameters, the desk will place an inquiry looking for an offering on bonds or a bid wanted item out with an MSBB (“3rd Hand”).

- The MSBB, through its network of market participants, will find a

counterparty willing to sell or buy the securities (“4th Hand”).

- The market participant who is willing to sell or buy the securities from the MSBB will have a retail customer or institution who is interested in selling or buying the securities (“5th Hand”).



soliciting interest in bonds they want to buy or sell (with its potential negative market effect) and more time executing trades for their proprietary accounts or their customers. For traders, the timesaving element of working with MSBBs may make the difference between executing or missing a trade as well as obtaining the best interdealer market price on their securities.

Extending the Distribution Network

MSBBs extend the distribution network of their counterparties by directly and, in most instances, personally soliciting bids and offers from literally hundreds of desks around the country. The counterparties (or potential counterparties, as the case may be) of MSBBs, in turn, reflect the bids or offers to their own customers, thus multiplying the number of accounts exposed to the original inquiry or bid wanted.

Because MSBBs are prohibited from maintaining inventory, they focus on providing access to an extended and specialized distribution network. It is an MSBB's job to build and maintain this network because this is a fundamental component of their value to their counterparties and the market in whole.

Lowering Costs

By collecting information from market participants on an independent basis, MSBBs lower costs for their counterparties in two ways; first, the presence of MSBBs means that dealers do not have to hire staff to search for inventory at market prices; and second, without MSBBs, trading desks would have to expose their identity to the marketplace as they search for liquidity, which would impair their bargaining position and raise their costs because the desks' identity and strategy would be used against them in the marketplace.

REGULATION:

Who Regulates MSBBs?

MSBBs conduct business in a highly regulated environment that requires compliance with rules and regulations of these entities:

- the Municipal Securities Rulemaking Board (MSRB), which is the municipal securities industry's principal regulator, writes the rules for municipal securities dealers and MSBBs and coordinates with FINRA on enforcement actions;
- the Financial Industry Regulatory Authority (FINRA), audits MSBBs, enforces compliance with the rules of the MSRB, and is a self regulatory organization responsible for rule creation and enforcement in other securities markets;
- the Securities Exchange Commission (SEC) oversees both the MSRB and FINRA by reviewing the rules of the MSRB and the audit reports and enforcement reports actions of FINRA; and
- the U.S. Treasury, which promulgates the nation's anti-money laundering regulations.

Trade Reporting and Transparency

Each dealer's buy or sell is reported to the MSRB's Real-Time Transaction Reporting System (RTRS) within 15 minutes of the trade time. When both the dealer buy side and sell side match, the trade is then displayed on the MSRB's Electronic Municipal Market Access System (emma.msrb.org). There will be two RTRS submissions indicating the trade into the MSBB, and two RTRS submissions indicating the trade out of the MSRB. The two trades together are one economic transaction. See also the text box on "The Three Handed Trade".

CONCLUSION:

As shown by the information provided in this brochure, the role of an MSBB is integral to an efficient and stable market. As an intermediary, MSBB's provide for anonymity, information flow, transparency, and liquidity in secondary market municipal bond transactions. MSBB's are able to widely distribute bid-wanted and offerings through their large network of counterparties via voice brokerage and electronic platforms. Most importantly, MSBB's allow owners of small retail-sized lots, odd-lots, and thinly traded issues to find liquidity in the secondary market.

TRANSACTION SUMMARY

Total par amount traded in \$ millions

	2010	2011	2012	2013
Total	3,749,730	3,285,766	3,225,803	3,119,816

By Trade Type				
Customer Bought	1,956,906	1,670,951	1,619,769	1,526,057
Customer Sold	1,220,495	1,088,513	975,487	972,901
InterDealer	572,330	526,302	630,547	620,859

By Coupon Type				
Variable	1,584,165	1,271,220	1,195,640	1,082,656
Fixed Rate	1,734,705	1,614,755	1,677,625	1,748,069
Zero Coupon	99,691	134,484	129,023	116,151
Other ¹	331,168	265,307	223,515	172,939

By Source of Repayment				
General Obligation	748,160	704,025	731,491	705,142
Revenue	2,496,929	2,132,012	2,112,740	2,142,322
Double Barrel	77,455	73,570	68,988	60,679
Other ¹	427,186	376,159	312,584	211,673

By Tax Status				
Tax Exempt	2,921,186	2,656,646	2,736,514	2,712,300
Taxable	503,719	294,909	272,799	247,209
AMT	172,448	158,514	127,927	128,256
Other ¹	152,377	175,697	88,562	32,051

By Security Type				
Bond	1,714,934	1,644,676	1,703,642	1,766,948
Long Note	80,452	82,704	82,284	79,248
Short Note	39,011	21,859	20,721	18,025
Variable (Long and Short)	1,584,165	1,271,220	1,195,640	1,082,656
Commercial Paper	300,902	231,540	203,445	161,654
Other ²	30,266	33,767	20,071	11,285

¹ Includes municipal commercial paper and issues that could not be categorized based on available data.

² Includes issues that could not be categorized based on available data.

DEFINITIONSⁱ

BANK DEALER – See: **DEALER BANK**.

BID WANTED – The process by which an investor or broker-dealer actively solicits bids on a position of securities from the marketplace.

BROKER – A person or firm that acts as an intermediary by purchasing and selling securities for others rather than for its own account through agency trades. A broker engaged in the business of effecting agency trades in municipal securities is known as a “municipal securities broker.” For purposes of the Securities Exchange Act of 1934, the terms “broker” and “municipal securities broker” generally do not include a bank. **Compare: BROKER’S BROKER; DEALER. See: BROKER-DEALER.**

BROKER-DEALER – A general term for a securities firm that is engaged in both buying and selling securities for customers (i.e., agency trades) and also buying and selling for its own account (i.e., principal trades). The term generally would not be used (except in this Glossary) to refer to a dealer bank or a broker’s broker. For purposes of this Glossary, the term broker-dealer is used as a collective term for any firm that is a broker (including a broker’s broker) and/or a dealer (including a dealer bank). **Compare: BROKER’S BROKER; DEALER BANK. See: BROKER; DEALER.**

BROKER’S BROKER – A broker-dealer that executes securities transactions exclusively with other broker-dealers and not with public investors. Broker’s brokers generally do not take inventory positions in securities. A broker’s broker engaged in the business of effecting trades in municipal securities is known as a “municipal securities broker’s broker” or, colloquially, a “municipal securities broker.”

DEALER – A person or firm that engages in the business of underwriting, trading and selling securities for its own account acting as principal. A person or firm engaged in the business of effecting principal trades in municipal securities is known as a “municipal securities dealer.” Although for purposes of the Securities Exchange Act of 1934 the term “dealer” generally does not include a bank, the term “municipal securities dealer” expressly does include a bank, or a separately identifiable department or division of a bank, that is engaged in underwriting, trading and selling

municipal securities for its own account, other than in a fiduciary capacity. In colloquial usage, these terms are used to refer to both securities firms and dealer banks. **Compare: BROKER. See: BROKER-DEALER; DEALER BANK.**

DEALER BANK – A bank, or a separately identifiable department or division of a bank, that is engaged in the business of buying and selling municipal securities for its own account. Dealer banks must be registered as dealers or municipal securities dealers under the Securities Exchange Act of 1934. **See: DEALER.**

INSTITUTIONAL CUSTOMER – A term that generally refers to banks, financial institutions, bond funds, insurance companies or other business organizations that possess or control considerable assets for large scale investing. **Compare: RETAIL CUSTOMER.**

ODD LOT – A principal amount of securities that is smaller than what is considered a normal trading unit. An odd lot is often traded at a price that includes a differential attributable to the size of the lot (e.g., a broker-dealer may bid lower for an odd lot than for a larger block). **Compare: ROUND LOT.**

OFFER – A proposal to sell securities at a stated price or yield.

RETAIL CUSTOMER – Any customer other than an institutional customer. Retail customers generally include individual investors and small organizations. **Compare: INSTITUTIONAL CUSTOMER.**

ROUND LOT – The increment in which securities are traded without a potential addition or deduction of a price differential due to the size of the block. There is no consensus in the industry as to what constitutes a round lot of municipal securities. Although it depends upon the size of the broker-dealer and the nature of the investor, at the time of this publication many industry participants consider \$1,000,000 par value to constitute a round lot with respect to institutional sales and \$100,000 par value to constitute a round lot with respect to retail sales. **Compare: ODD LOT.**

SPREAD – With respect to securities trading in the secondary market, the differential between the bid price and the offering price in a two-sided market quotation. This is often referred to as a “bid-offer spread” or “bid-ask spread.”

ⁱ All definitions are adapted from the MSRB’s glossary of municipal securities terms that can be found at www.msrb.org.



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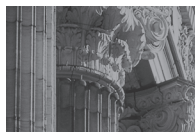
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