

## Why GAO Did This Study

Municipal securities are debt instruments that state and local governments typically issue to finance diverse projects. Individual investors, through direct purchases or investment funds, own 75 percent of the estimated \$3.7 trillion in municipal securities in the U.S. market. In the secondary market, where these securities are bought and sold after issuance, trading largely occurs in over-the-counter markets that are less liquid and less transparent than the exchange-traded equity securities market. The Dodd-Frank Wall Street Reform and Consumer Protection Act required GAO to review several aspects of the municipal securities market, including the mechanisms for trading, price discovery, and price transparency. This report examines (1) municipal security trading in the secondary market and the factors that affect the prices investors receive, and (2) the Securities and Exchange Commission's (SEC) and self-regulatory organizations' (SRO) enforcement of rules on fair pricing and timely reporting. For this work, GAO analyzed trade data, reviewed federal regulators' programs for enforcing trading rules, and interviewed market participants and federal regulators.

## What GAO Recommends

GAO recommends that SEC collect and analyze information on SROs' fixed-income regulatory programs on an ongoing basis to better inform its risk-based inspection approach. SEC agreed, but noted it would need additional resources to conduct more frequent oversight of the SROs. Such ongoing monitoring, however, could help SEC better leverage its resources for inspections.

View [GAO-12-265](#) For more information, contact A.Nicole Clowers at (202) 512-8678 or [clowersa@gao.gov](mailto:clowersa@gao.gov).

# MUNICIPAL SECURITIES

## Overview of Market Structure, Pricing, and Regulation

## What GAO Found

In the secondary market for municipal securities, both institutional and individual investors trade through brokers, dealers, and banks (broker-dealers). However, GAO analysis of trade data showed that institutional investors generally trade at more favorable prices than individual investors. Broker-dealers said these differences generally reflected the higher average transaction costs associated with trading individual investors' smaller blocks of securities. Market participants added that institutional investors have more resources, including networks of broker-dealers, and the expertise to independently assess prices. In recent years, the Municipal Securities Rulemaking Board (MSRB)—an SRO that writes rules regulating the broker-dealers that trade municipal securities—has required timely and public posting of trade prices in an effort to make post-trade price information more widely available. However, unlike the equities market, the relatively illiquid municipal market lacks centrally posted and continuous quotes, and other sources of pretrade price information are not centralized or publicly available to individual investors. In 2010, SEC began a review of the municipal securities market, in part to examine pretrade price information. MSRB has also begun a study that includes a review of the market structure to determine whether access to additional pretrade price information could improve pricing and liquidity. Both SEC and MSRB plan to complete these studies in 2012.

Several regulators share responsibility for overseeing the municipal securities market. The Financial Industry Regulatory Authority (FINRA)—an SRO that regulates 98 percent of the broker-dealers that trade municipal securities—and federal banking regulators enforce broker-dealer compliance with MSRB rules under their respective jurisdictions through electronic surveillances of trade data and routine examinations. SEC evaluates the quality of FINRA and MSRB's municipal regulatory programs through its SRO inspection program, which has recently evolved to a risk-based approach. SEC last inspected MSRB and FINRA's fixed-income surveillance program, which encompass municipal securities trading, in 2005. SEC staff said that staffing constraints have prevented them from conducting inspections of these SROs sooner, although they have recently begun a new inspection of FINRA's fixed-income surveillance program. SEC's limited monitoring of FINRA and MSRB between inspections may not be sufficient to support its new risk-based inspection approach. For example, SEC's last inspection of FINRA's fixed-income surveillance program predated the financial crisis—and its ensuing volatility in the municipal market—but SEC had collected limited information since its last inspection that would help it assess the quality of FINRA's broker-dealer oversight. SEC currently receives periodic reports from FINRA that provide statistical information on its regulatory activities related to municipal securities trading. According to SEC staff, while they might be able to use the reports to identify significant deviations in FINRA's efforts, they cannot use them solely to determine the effectiveness of FINRA's municipal securities program. Without ongoing collection and analysis of information to assess the effectiveness of SROs' regulatory programs, SEC may be unable to identify and act on regulatory problems in a timely manner.