

Client Alert

Current Issues Relevant to Our Clients

February 24, 2014

MSRB Proposes Best Execution Rule

For the first time in its history the Municipal Securities Rulemaking Board (the “MSRB”) has proposed a “best execution” rule for municipal securities transactions. The MSRB modeled the rule on the Financial Industry Regulatory Authority’s (“FINRA”) best-execution rule for equity and non-municipal fixed income securities. The MSRB is accepting comments on the proposal through March 21, 2014. A copy of the proposal is available [here](#).

Why is the MSRB Proposing the Rule?

“Best execution” obligations for securities professionals can arise under various laws, regulations and common law obligations. Broker-dealers have a specific best execution obligation under FINRA Rule 5310 (Best Execution and Interpositioning) but the FINRA rule does not apply to municipal securities. For more information on FINRA Rule 5310, please see our May 31, 2012 Client Alert available [here](#) and our January 11, 2012 Client Alert available [here](#).

Contrary to FINRA rules, MSRB rules do not contain a specific “best execution” standard applicable to municipal securities. In August 2013, the MSRB published a concept proposal on best execution shortly after the Securities Industry and Financial Markets Association (“SIFMA”) submitted its own draft rule to the MSRB that suggested that the MSRB propose an “execution-with-diligence” standard for municipal securities transactions. After considering comments on the concept proposal, the MSRB essentially followed the SIFMA recommendation and proposed a rule that is generally harmonized with FINRA Rule 5310 but tailored to the municipal securities market. For more information on the MSRB concept proposal and the SIFMA draft rule, please see our August 9, 2013 Client Alert available [here](#).

Best Ex vs. Fair Pricing—What’s the difference?

Both the MSRB and FINRA rules include “fair pricing” requirements that are distinct from “best execution” obligations. Fair pricing obligations generally require that dealers make reasonable efforts to obtain prices for customers that are “fair and reasonable” in relation to prevailing market conditions. Fair pricing obligations also generally require that dealers exercise diligence in establishing the *market value of a security* and the *reasonableness of its own compensation* received in all

customer transactions (including any markup or markdown). Best execution obligations are closely related but separate from fair pricing requirements. Best execution focuses on order handling and transaction execution, requiring a dealer to use reasonable diligence to ascertain the *best market* for a security and to obtain the *most favorable overall transaction price possible under prevailing market conditions*. A best execution standard tends to assess overall transaction execution as opposed to fair pricing requirements that tend to focus specifically on security price and reasonableness of dealer compensation. For example, a dealer could execute a bond transaction at a price and compensation that is fair and reasonable but could potentially violate a best execution obligation if the price was not the most favorable available in the best market for the security (although lowest price is not necessarily the only consideration).

The MSRB fair pricing obligation currently exists in Rules G-18 and G-30 but the Securities and Exchange Commission is currently seeking comments on a MSRB proposal to consolidate these obligations into a revised Rule G-30. For information on that proposal, see our February 20, 2014 Client Alert available [here](#). FINRA has also proposed rule changes related to fair pricing, markups, markdowns and commissions. For information on the FINRA rule proposals, see our February 5, 2013 Client Alert available [here](#).

Proposed Best Execution Obligation

The basic best execution obligation in proposed MSRB Rule G-18 is essentially identical to the obligation stated in FINRA Rule 5310. Proposed Rule G-18 would require that, in any transaction in a municipal security for or with a customer or a customer of another dealer, a dealer must use “reasonable diligence” to ascertain the best market for the subject security and buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. This basic

best execution obligation would not apply to transactions with sophisticated municipal market professionals (SMMPs) under proposed amendments to MSRB Rule G-48 and would not apply to municipal fund securities (such as 529 college savings plans).

What is “Reasonable Diligence”?

The proposed best execution obligation focuses on a dealer’s use of “reasonable diligence” in ascertaining the best market and obtaining the most favorable price for a transaction. A failure to have actually obtained the most favorable price would not necessarily mean that the dealer failed to use reasonable diligence. Proposed Rule G-18 includes a non-exhaustive list of factors to be considered in determining whether a dealer has used “reasonable diligence”. These factors are similar, but not identical, to FINRA Rule 5310 and include the:

- character of the market for the security (e.g., price, volatility, and relative liquidity);
- size and type of transaction;
- number of markets checked;
- information reviewed to determine the current market for the subject security or similar securities;
- accessibility of quotations; and
- terms and conditions of the customer’s inquiry or order, including any bids or offers, that result in the transaction, as communicated to the dealer.

The fourth factor with respect to “information reviewed” is not part of FINRA Rule 5310. The MSRB believes that the additional factor helps guide the use of reasonable diligence when, for example, no available quotations for a security are available and takes into account that dealers may use information about similar securities and other reasonably relevant information.

Ascertaining the Best “Market” for a Security

The best execution obligation would require that a dealer seek the best “market” for a security transaction. Proposed supplemental material to the rule generally provides that the term “market” encompasses a variety of different venues, including but not limited to broker’s brokers, alternative trading systems or platforms, or other counterparties, which may include the dealer itself as principal. The supplemental material generally corresponds with the supplemental material to FINRA Rule 5310 in providing that “market” is to be construed broadly, but also gives recognition to the fact that municipal securities currently trade over the counter without a central exchange or platform.

Interpositioning

Proposed Rule G-18 would prohibit interpositioning—a dealer interjecting a third party between itself and the best market for a security in a manner inconsistent with the basic best execution obligation described above. This provision matches a similar provision of FINRA Rule 5310 with one exception. The FINRA rule provides that when a FINRA member cannot execute directly with a market but must employ a broker’s broker or some other means in order to ensure an execution advantageous to the customer, the burden of showing the acceptable circumstances for doing so is on the FINRA member. The MSRB did not include similar language due to the more significant use of broker’s brokers in municipal bond transactions and because MSRB rules include specific obligations for broker’s brokers in MSRB Rule G-43, adopted in 2012. For information on Rule G-43, see our Client Alert available [here](#).

Review of Execution Quality Policies and Procedures

Proposed Rule G-18 supplementary material departs somewhat from the FINRA Rule 5310 requirement that firms conduct regular and rigorous reviews of execution quality. While the FINRA rule requires FINRA members to conduct “regular and rigorous reviews” of the quality of the executions of its customers’ orders, the MSRB rule would focus on review of policies and procedures rather than on quality of execution. Specifically, the proposed MSRB rule would require a dealer to conduct periodic reviews of its policies and procedures for determining the best available market for the executions of its customers’ transactions. The reason for this departure is that municipal securities dealers tend not to have access to data similar to that used by dealers in other securities transactions. The proposed MSRB rule also does not require a dealer to conduct reviews on any specific interval (the FINRA rule requires at least quarterly reviews). Instead, the MSRB proposal would require that a dealer conduct reviews at a frequency reasonably related to the nature of its business, including but not limited to its level of trading activity.

Submitting Comments and MSRB Webinar

You may submit comments to the MSRB by submitting a hard copy or by submitting comments electronically [here](#) through March 21, 2014. The MSRB is also hosting an educational webinar on the main aspects of the proposed rule on March 6, 2014 at 3:00 p.m. Eastern Time. You may register for the webinar [here](#).

For More Information

To discuss any topic covered in this alert, please contact a member of the Investment Management Group, or visit us online at chapman.com.

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