

Client Alert

Current Issues Relevant to Our Clients

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SEC Seeks Comments on New MSRB Best Execution Rule

The Securities and Exchange Commission (the “SEC”) is seeking comments on the first ever explicit “best execution” rule for municipal securities transactions proposed by the Municipal Securities Rulemaking Board (the “MSRB”). The MSRB modeled its rule on the Financial Industry Regulatory Authority’s (“FINRA”) best-execution rule for equity and non-municipal fixed income securities. Proposed MSRB Rule G-18 would generally 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 in municipal fund securities (such as 529 college savings plans) or to transactions with “sophisticated municipal market professionals” (“SMMPs”). The MSRB intends that the proposed rule change would become effective one year after the date of SEC approval. You can obtain a copy of the SEC release [here](#).

Why did the MSRB Propose a Best Execution 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 March 8, 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 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 proposed a rule that was generally harmonized with FINRA Rule 5310 but tailored to the municipal securities market. For more information on the original MSRB proposed rule and prior concept proposal, please see our February 24, 2014 Client Alert available [here](#). The MSRB has now submitted a slightly revised version of proposed Rule G-18 to the SEC for approval and the SEC is seeking comments on this revised proposal. The SEC must approve the proposal before the MSRB can adopt the rule. While the MSRB received a variety of comments on its original proposed rule, the MSRB made very few changes in the revised version of the rule submitted to the SEC. The few changes

made to the proposed rule are primarily non-substantive and do not appear to have been made in response to comments received on the original rule proposal.

Proposed Best Execution Obligation

The basic best execution obligation in proposed MSRB Rule G-18 is essentially the same as 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. Supplementary material to proposed Rule G-18 provides that the rule does not apply to municipal fund securities (such as 529 college savings plans). The MSRB proposal also includes amendments to Rule G-48 that would provide that a dealer does not have any obligation to an SMMP under Rule G-18 to 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 SMMP is as favorable as possible under prevailing market conditions.

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 supplementary 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 supplementary material generally corresponds with the supplementary 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 June 29, 2012 Client Alert available [here](#).

Annual 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 based on a detailed list of factors, the MSRB rule would focus on review of policies and procedures rather than specifically on “quality of execution”. Specifically, the proposed MSRB rule would require a dealer to conduct annual 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 rule would further provide that in conducting periodic reviews, a dealer must assess whether its policies and procedures are reasonably designed to achieve best execution, taking into account the quality of the executions the dealer is obtaining under its current policies and procedures, changes in market structure, new entrants, the availability of additional pre-trade and post-trade data, and the availability of new technologies, and to make promptly any necessary modifications to such policies and procedures as may be appropriate in light of such reviews.

The original MSRB proposal would not have required a dealer to conduct reviews on any specific interval. Instead, the original proposal would only have required that a dealer conduct “periodic” reviews and 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. The final proposed rule submitted to the SEC differs on this point and would require annual review of policies and procedures. The final proposal also provides that the rule does not specifically require reviews to be more frequent than annual but that a dealer must conduct reviews at a frequency reasonably related to the nature of its municipal securities business, including but not limited to its level of sales and trading activity. As a result, it appears that the MSRB might expect some firms to conduct more frequent reviews. The FINRA best execution rule requires at least quarterly reviews of quality of execution.

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 Rule G-30. A revised version of MSRB Rule G-30 became effective on July 7, 2014, which consolidated MSRB fair pricing obligations into a single rule. These obligations were previously governed by prior Rules G-18 and G-30, along with various interpretive guidance. For information on those rule amendments, please see our May 15, 2014 Client Alert available [here](#).

Submitting Comments

You may submit comments to the SEC by submitting a hard copy, by using the SEC’s Internet comment form link available under SR-MSRB-2014-07 on the page at [this link](#) or by sending an e-mail to rule-comments@sec.gov with File Number SR-MSRB-2014-07 in the subject line. The last day to submit comments will be 21 days following publication of the SEC release in the Federal Register, which should occur in the next several days.

For More Information

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