

Client Alert

Current Issues Relevant to Our Clients

December 12, 2014

MSRB Adopts New Best Execution Rule

The Securities and Exchange Commission (the “SEC”) approved the Municipal Securities Rulemaking Board’s (the “MSRB”) proposal to implement a “best execution” standard for municipal securities transactions. The new rule will take effect December 7, 2015 following a year-long implementation period. The MSRB modeled its rule on the Financial Industry Regulatory Authority’s (“FINRA”) best-execution rule for equity and non-municipal fixed income securities. MSRB Rule G-18 generally requires that, in any transaction in a municipal security for or with a customer or a customer of another dealer, a dealer 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 does not apply to transactions in municipal fund securities (such as 529 college savings plans). The MSRB also amended Rules G-48 and D-15 to provide that a dealer’s best execution obligation will not apply to transactions with “sophisticated municipal market professionals” (“SMMPs”) and to require additional customer affirmations in order to qualify as an SMMP. You may obtain a copy of the MSRB notice [here](#).

Why Did the MSRB Adopt a Best Execution Rule?

“Best execution” obligations for securities professionals can arise under various laws, regulations and common law obligations. For example, broker-dealers have a specific best execution obligation under FINRA Rule 5310 (Best Execution and Interpositioning). However, prior to the new rule, no “best execution” standard applied to municipal security transactions. In August 2013, the MSRB published a concept proposal on best execution. In February 2014, after considering comments to the concept proposal, the MSRB proposed MSRB Rule G-18 which was generally harmonized with FINRA Rule 5310. Finally, the MSRB submitted a slightly revised version of the proposal to the SEC in August 2014 which the SEC recently approved without changes. The new rule will take effect on December 7, 2015. The new rule is among several MSRB initiatives underway that are designed to enhance fairness and transparency in municipal securities transactions.

Best Execution Obligation

The basic best execution obligation in MSRB Rule G-18 is essentially the same as the obligation stated in FINRA Rule 5310. Rule G-18 requires that, in any transaction in a municipal security for or with a customer or a customer of another dealer, a dealer 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 Rule G-18 provides that the rule does not apply to municipal fund securities (such as 529 college savings plans). The MSRB rulemaking also includes amendments to Rule G-48 that 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”?

Rule G-18’s 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. 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 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 requires that a dealer seek the best "market" for a security transaction. 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.

Comments submitted to the SEC expressed concern that the new rule broadens the concept of best "market" beyond FINRA Rule 5310 and the new rule would require dealers to locate the single counterparty that would pay the best price. The MSRB stated that it does not believe that the definition of "market" creates a duty to use reasonable diligence to locate the one counterparty that will pay the best price. The MSRB reiterated that the rule does not contain any substantive pricing standard and the number of counterparties or markets a dealer should consider will depend on an analysis of the factors listed in the rule as well as any other factors that would contribute to a dealer's identification of the best market.

Interpositioning

Rule G-18 prohibits 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.

Annual Review of Execution Quality Policies and Procedures

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 focuses on review of policies and procedures rather than specifically on "quality of execution". Specifically, the rule requires 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 rule further provides 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.

Rule G-18 requires, at a minimum, annual review of a dealer's best execution policies and procedures. While the rule does not specifically mandate more frequent reviews, the supplementary material included with the rule states 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 Execution vs. Fair Pricing

Both the MSRB and FINRA rules include "fair pricing" requirements that are distinct from "best execution" obligations. The MSRB fair pricing obligation currently exists in Rule G-30. For information on that rule, please see our May 15, 2014 Client Alert available [here](#). 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 a dealer exercises 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 to 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).

Additional Affirmations Required for SMMP Qualification

In addition to adopting Rule G-18, the recent MSRB rulemaking amends Rules G-48 and D-15. Revised Rule G-48 provides that, in transactions with SMMPs, dealers will not have any obligations 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. The MSRB further amended Rule D-15 to change the definition of SMMP. To qualify as an SMMP under existing Rule D-15, the customer must affirm orally or in writing that it is exercising independent judgment in evaluating the recommendations of the dealer. The amendments to Rule D-15 create additional elements for the required customer affirmation. Under the amended rule a customer must affirm that:

- it is exercising independent judgment in evaluating:
 - the recommendations of the dealer;
 - the quality of execution of the customer's transactions by the dealer; and
 - the transaction price for non-recommended secondary market agency transactions as to which (i) the dealer's services have been explicitly limited to providing anonymity, communication, order matching and/or clearance functions and (ii) the dealer does not exercise discretion as to how or when the transactions are executed; and
- it has timely access to material information that is available publicly through established industry sources as defined in Rule G-47(b)(i) and (ii).

Due to these amendments, a dealer may not treat any customer as an SMMP after December 7, 2015, unless the dealer reasonably determines that the customer has given the revised, broader affirmation. Supplementary material to revised Rule D-15 continues to allow the affirmation to be given orally or in writing and provides that the affirmation may be given on a trade-by-trade basis, a type-of-transaction basis, on a type-of-municipal-security basis, or on an account-wide basis.

What Should I Do Now?

Prior to the rule and amendments effectiveness on December 7, 2015, dealers should review their current policies and procedures to determine whether changes are necessary to incorporate the factors set forth in Rule G-18. Dealers will also need to obtain new customer affirmations from all clients who potentially qualify as SMMPs. During the interim period between adoption and effectiveness, the MSRB, in coordination with FINRA, plans to provide practical guidance on complying with the best-execution standard with the aim to establish consistent guidance, as appropriate, on the application of best-execution standards in both the municipal securities and corporate debt markets. The MSRB will host an educational webinar about the key provisions of the new rule on February 5, 2015 at 3:00 p.m. Eastern time. You may register for the webinar [here](#).

For More Information

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

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