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MSRB Reminds Dealers of Existing Guidance on Filtering of Bids and Offers

The Municipal Securities Rulemaking Board (MSRB) recently released data reflecting the robust use of alternative trading systems (ATSs) by brokers, dealers and municipal securities dealers (collectively, “dealers”) for inter-dealer municipal securities transactions.¹ In light of developments in the use of ATSs and the role of broker’s brokers, as well as almost two years of experience since the implementation of MSRB Rule G-18, on best execution, which has been a regulatory and examination priority for enforcement agencies,² the MSRB is publishing this regulatory reminder to remind dealers about existing regulatory responsibilities related to certain aspects of the practice of filtering (or screening), which may have a negative impact on dealers’ customers, particularly retail investors, and market efficiency.

Filtering occurs when a dealer, handling a customer’s order, uses automated tools available on an ATS to screen out bids received from and offers made available by certain dealers, or when a selling dealer directs a broker’s broker to limit the audience for a bid-wanted (*i.e.*, a request for quote). Some dealers may also use filters on specific securities or specific attributes of securities. The MSRB recognizes that there are legitimate purposes that justify the use of filters; however, it is concerned that their use otherwise may limit access to and competition in the market, which could reduce liquidity and have a negative impact on the quality of executions and,

¹ The MSRB, which collects municipal securities pricing and other data, released statistics on November 9, 2017, showing that, from September 2016 to September 2017, an average of approximately 59 percent of trades between dealers—and 29 percent of par volume traded—were executed on an ATS. See [MSRB Fact Sheet on Inter-Dealer Municipal Trading](#). The MSRB also found that about 90 percent of ATS trades were conducted on transactions of \$100,000 or less, an amount that is typically a proxy for a retail-sized transaction, and that 25 percent of all retail-sized trades in the municipal market were conducted on ATSs. *Id.* Finally, the data indicate that 7 percent of inter-dealer trades occurred through a broker’s broker. *Id.*

² See *e.g.*, [Financial Industry Regulatory Authority 2017 Regulatory and Examination Priorities Letter](#) (Jan. 4, 2017).



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ultimately, the prices paid or received by customers. The MSRB has addressed the subject of filtering previously.

In 2012, the MSRB issued guidance in the context of MSRB Rule G-43, on broker's brokers, regarding the fair-pricing duties under MSRB Rule G-30, on prices and commissions, of selling dealers that use broker's brokers.³ Rule G-43 establishes standards for the conduct of broker's brokers when executing transactions for or on behalf of other dealers. The 2012 guidance explained that, although Rule G-43(b)(i) permits filtering for a bid-wanted by a broker's broker at the selling dealer's direction, "such screening may reduce the likelihood that the high bid represents a fair and reasonable price." The MSRB stated that "[s]elling dealers should, therefore, be able to demonstrate a reason that is not anti-competitive (*e.g.*, credit, legal, or regulatory concerns), rather than trying to eliminate access by a competitor, for directing broker's brokers to screen certain bidders from the receipt of bid-wanted or offerings." As an example of one possible means of demonstrating compliance, the MSRB suggested that "a selling dealer might maintain a list of the firms it would be unwilling to accept as a counterparty and the reasons why."

The MSRB more recently addressed the subject of filtering in guidance provided as answers to frequently asked questions about Rule G-18.⁴ The best-execution rule requires dealers, in any transaction for or with a customer or a customer of another dealer, to use reasonable diligence to ascertain the best market for the subject security and to buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. The rule was designed to complement existing fair-and-reasonable pricing standards and to improve execution quality for retail investors in municipal securities, while promoting fair competition among dealers and improving market efficiency. Accordingly, the guidance stated that, while there is no set number of dealers making an offer or collecting bids on behalf of a customer order, or set number of other markets, to check that categorically qualifies as reasonable diligence for compliance with the best-execution obligation, dealers, in general, should check more than one market or expose customer orders to multiple offerings or bids, and show external offerings and bids to retail customers.

³ [Notice to Dealers That Use the Services of Broker's Brokers](#) (Dec. 22, 2012). Rule G-30 generally requires dealers to transact for or with customers at fair and reasonable prices.

⁴ [Implementation Guidance on MSRB Rule G-18, on Best Execution](#) (Nov. 20, 2015); *see also* [MSRB Notice 2015-23](#) (Nov. 20, 2015).

The guidance also stated that, “[i]f a dealer uses filters on counterparties or filters on specific securities intended to limit accessing bids or offers in those securities, they may be used only for a legitimate purpose consistent with obtaining the most favorable executions for non-SMMP customers, and should be reviewed on a periodic basis and adjusted as needed.”⁵ There may be a variety of such legitimate purposes such as screening affiliates with which a dealer cannot trade, or filtering out counterparties that have created a high concentration of compliance issues for the dealer by attempting to trade at prices away from the market. Filtering specific securities by, for example, CUSIP or an attribute, such as credit rating, when the dealer would offer those securities to its customer out of its own inventory, may be a use of filtering that is inconsistent with Rule G-18. The MSRB’s best-execution guidance further states that dealers “should have policies and procedures in place that govern when and how to: reasonably use filters without negatively impacting the quality of execution of non-SMMP customer transactions; periodically reevaluate their use; and determine whether to lift them upon request.” Finally, as with all policies and procedures required for compliance with Rule G-18, the MSRB stated that the policies and procedures on, as well as the periodic review and adjustment of, the use of filters “should be appropriate to the nature of the dealer’s municipal securities business and, therefore, may be different than the policies and procedures used by other dealers.”

Accordingly, whether dealers use filters through a broker’s broker or on an ATS, the MSRB reminds firms that filters are to be used only for legitimate purposes and that dealers should have in place, and periodically review, policies and procedures to govern when and how the firm uses filters. In establishing and reviewing these policies and procedures, dealers could consider, for example:⁶

⁵ An “SMMP” is a sophisticated municipal market professional, as defined in MSRB Rule D-15. Rule G-18 does not apply to transactions for or with SMMPs.

⁶ The MSRB is issuing this reminder as a resource that dealers can use to strengthen their compliance with MSRB rules and other applicable federal securities laws. This reminder does not imply that any issues discussed exist at any particular dealers, and it should not be read by dealers, enforcement agencies, or any other market participants and stakeholders as creating new legal or regulatory requirements, or new interpretations of existing requirements. Additionally, the examples and considerations referenced herein may be effective for compliance with relevant MSRB rules in appropriate circumstances, and some dealers may be able to use them as a resource in tailoring their compliance and supervisory programs to their business; however, there should be no inference that the MSRB requires dealers to implement any specific practices described in this report that extend beyond the requirements of existing MSRB rules.

- What are the criteria for or factors considered when establishing, modifying and removing filters (*e.g.*, a counterparty is the source of regular fails and/or other regulatory concerns), and how are they determined?
- What are the processes for establishing, modifying and removing filters?
- Is authorization required to establish filters, and, if so, who gives that authorization (*e.g.*, a supervisory principal, a committee, etc.)?
- With what frequency are filters reviewed, what do the reviews entail and by whom are the reviews performed?
- With what frequency are the policies and procedures related to filtering reviewed, what do the reviews entail, and by whom are the reviews performed?

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