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Comment

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**Category**

Fair Practice, Market  
Transparency

**Affected Rules**

[Rule G-18](#)

## Request for Comment on Draft Best-Execution Rule, Including Exception for Transactions with Sophisticated Municipal Market Professionals

### Overview

The Municipal Securities Rulemaking Board (MSRB) is seeking comment on draft MSRB Rule G-18 on best execution of transactions in municipal securities. The draft rule requires brokers, dealers and municipal securities dealers (dealers) to use reasonable diligence in seeking to obtain for their customer transactions in municipal securities the most favorable terms available under prevailing market conditions. The MSRB is also seeking comment on draft amendments to proposed MSRB Rule G-48, on transactions with sophisticated municipal market professionals (SMMPs), to exempt transactions with SMMPs from the application of draft Rule G-18. In addition, the MSRB is seeking comment on the likely economic consequences of the adoption of these changes.

Comments should be submitted no later than March 21, 2014, and may be submitted in electronic or paper form. Comments may be submitted electronically by clicking [here](#). Comments submitted in paper form should be sent to Ronald W. Smith, Corporate Secretary, Municipal Securities Rulemaking Board, 1900 Duke Street, Suite 600, Alexandria, Virginia 22314. All comments will be available for public inspection on the MSRB's website.<sup>1</sup>

Questions about this notice should be directed to Michael L. Post, Deputy General Counsel, or Kathleen Miles, Associate General Counsel, at 703-797-6600.

<sup>1</sup> Comments are posted on the MSRB website without change. Personal identifying information such as name, address, telephone number, or email address will not be edited from submissions. Therefore, commenters should only submit information that they wish to make available publicly.

## Background

As the principal regulator of the municipal securities market, the MSRB is charged by Congress to protect investors and foster a “free and open” municipal securities market.<sup>2</sup> The MSRB, consistent with that charge, has advanced many initiatives to improve transparency, efficiency and other structural aspects of the market.<sup>3</sup> In alignment with these efforts, the MSRB believes that the establishment of a requirement that dealers seek best execution of customer transactions in municipal securities will have benefits for investors, promote competition among dealers and improve market efficiency.

As generally understood, best-execution obligations and fair-pricing obligations are closely related but distinct. MSRB Rule G-18 (Execution of Transactions)<sup>4</sup> and Rule G-30 (Prices and Commissions)<sup>5</sup> generally require

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<sup>2</sup> Securities and Exchange Act of 1934 § 15B(b)(2)(C), 15 U.S.C. 78o-4(b)(2)(C).

<sup>3</sup> See MSRB Long-Range Plan for Market Transparency Products (Jan. 27, 2012), available at <http://www.msrb.org/msrb1/pdfs/Long-Range-Plan.pdf>. The MSRB has requested comment and is analyzing information from market participants on potential improvements to the timeliness, fairness and efficiency of price transparency in the municipal market. See Concept Release on Pre-Trade and Post-Trade Pricing Data Dissemination through a New Central Transparency Platform, MSRB Notice 2013-14 (Jul. 31, 2013); Request for Comment on More Contemporaneous Trade Price Information Through a New Central Transparency Platform, MSRB Notice 2013-02 (Jan. 17, 2013). See also SEC Report on the Municipal Securities Market, at pp. 117, 141 (Jul. 31, 2012) (noting transparency initiatives), available at <http://www.sec.gov/news/studies/2012/munireport073112.pdf>.

<sup>4</sup> MSRB Rule G-18 currently provides that:

[e]ach broker, dealer and municipal securities dealer, when executing a transaction in municipal securities for or on behalf of a customer as agent, shall make a reasonable effort to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions.

<sup>5</sup> MSRB Rule G-30 currently provides that:

(a) Principal Transactions. No broker, dealer or municipal securities dealer shall purchase municipal securities for its own account from a customer or sell municipal securities for its own account to a customer except at an aggregate price (including any mark-down or mark-up) that is fair and reasonable, taking into consideration all relevant factors, including the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction, the expense involved in effecting the transaction, the fact that the broker, dealer, or municipal securities dealer is entitled to a profit, and the total dollar amount of the transaction.

dealers to trade with customers at fair and reasonable prices and to exercise diligence in establishing the market value of municipal securities and the reasonableness of their compensation.<sup>6</sup> A best-execution standard generally requires dealers 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. While Rules G-18 and G-30 contain substantive pricing standards, under which dealers must (among other things) use reasonable diligence in determining a security's fair market value,<sup>7</sup> a best-execution standard is an order-handling and transaction-execution standard, under which the goal of the dealer's reasonable diligence is to provide the customer the most favorable price possible. The establishment of a best-execution standard, however, can be accompanied by risks of impacting liquidity and decreasing dealer participation in the market.

In March 2012, the MSRB expressed concerns (in connection with its rulemaking related to brokers' brokers) that, while its pricing rules require dealers to obtain prices for their customers that are fair and reasonable, those rules do not govern all dealer conduct that would be regulated by an explicit best-execution rule. The MSRB stated at that time that it would consider this issue in connection with its ongoing review of its rules.<sup>8</sup> Shortly

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(b) Agency Transactions. No broker, dealer or municipal securities dealer shall purchase or sell municipal securities as agent for a customer for a commission or service charge in excess of a fair and reasonable amount, taking into consideration all relevant factors, including the availability of the securities involved in the transaction, the expense of executing or filling the customer's order, the value of the services rendered by the broker, dealer or municipal securities dealer, and the amount of any other compensation received or to be received by the broker, dealer, or municipal securities dealer in connection with the transaction.

<sup>6</sup> The MSRB has a proposed rule change under review by the SEC which would non-substantively consolidate current MSRB Rules G-18 and G-30 into a single pricing rule, Rule G-30. Proposed Rule Change Consisting of Proposed Revisions to MSRB Rule G-30, on Prices and Commissions and the Deletion of Rule G-18, on Execution of Transactions, SR-MSRB-2014-01 (Jan. 29, 2014), available at <http://www.msrb.org/Rules-and-Interpretations/SEC-Filings/~media/Files/SEC-Filings/2014/SR-MSRB-2014-01.ashx>. The MSRB will conform the changes proposed here as appropriate depending on future actions taken on the pending fair-pricing proposal.

<sup>7</sup> See MSRB Notice 2004-03 (Jan. 26, 2004).

<sup>8</sup> See "Notice of Filing of a Proposed Rule Change Consisting of Proposed Rule G-43, on Broker's Brokers; Proposed Amendments to Rule G-8, on Books and Records, Rule G-9, on Record Retention, and Rule G-18, on Execution of Transactions; and a Proposed Interpretive Notice on the Duties of Dealers that Use the Services of Broker's Brokers," Exchange Act

thereafter, in July 2012, the Securities and Exchange Commission (SEC or Commission) issued its *Report on the Municipal Securities Market* (SEC Report).<sup>9</sup> The SEC Report contained a number of recommendations that the SEC concluded should be considered for improvement of the municipal securities market, including possible legislative reforms by Congress, possible steps to be taken by the SEC itself, possible voluntary initiatives by market participants and possible measures to be undertaken by the MSRB. Some of those measures were ways in which the MSRB could consider buttressing existing pricing standards, including establishing a best-execution obligation and providing guidance to dealers on how best-execution concepts would be applied to municipal securities transactions.<sup>10</sup>

In April 2013, the SEC hosted a roundtable on fixed income markets, in which various market participants, academics and the MSRB participated.<sup>11</sup> The roundtable generated important and useful dialogue about the potential application of best-execution concepts to the municipal securities market, including the roles of broker's brokers and dealer inventories in the market, and the lack of statistical data on the quality of executions of transactions.<sup>12</sup>

In August 2013, the MSRB published a concept proposal on best execution, requesting comment on whether a new MSRB rule should apply best-execution concepts to the municipal securities market.<sup>13</sup> The Concept Proposal specifically raised the issue of whether a best-execution requirement would effectively buttress existing MSRB fair-pricing obligations. In addition, the MSRB observed that, although the Financial Industry Regulatory Authority's (FINRA) best-execution rule, FINRA Rule 5310 (Best Execution and Interpositioning), applies to non-municipal fixed income

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Release No. 66625, SR-MSRB-2012-04, at pp. 29-30 (Mar. 20, 2012), 77 FR 17548 (Mar. 26, 2012), available at <http://www.sec.gov/rules/sro/msrb/2012/34-66625.pdf>.

<sup>9</sup> SEC Report, *supra* n. 3.

<sup>10</sup> *Id.* at pp. 149-50.

<sup>11</sup> Roundtable on Fixed Income Markets, Securities and Exchange Commission, April 16, 2013; <http://www.sec.gov/news/otherwebcasts/2013/fixed-income-roundtable-041613.shtml>.

<sup>12</sup> *See id.*

<sup>13</sup> Request for Comment on Whether to Require Dealers to Adopt a "Best Execution" Standard for Municipal Securities Transactions, MSRB Notice 2013-16 (Aug. 6, 2013) (Concept Proposal).

securities,<sup>14</sup> there are certain concepts and requirements in FINRA Rule 5310 that may be more applicable to transactions in equity securities, particularly those that are a part of the electronically interconnected national market system.

After carefully considering all of the comments, the MSRB has determined to propose a best-execution rule that is generally harmonized with FINRA Rule 5310 but tailored to the characteristics of the municipal securities market. The MSRB has also determined to propose an exception from the best-execution rule for all transactions with SMMPs.<sup>15</sup> While an objective of draft Rule G-18 would be to provide a customer with a price that is as favorable as possible under prevailing market conditions, the best-execution requirement generally would target the process by which dealers handle orders and execute transactions, and would complement and buttress the MSRB's existing fair-pricing rules.

## Summary of Draft Rule G-18 and Draft Amendments to Proposed Rule G-48

The essence of draft Rule G-18, like FINRA Rule 5310, is the requirement that dealers use reasonable diligence in seeking to obtain for their customer transactions the most favorable terms available under prevailing market conditions. Under draft Rule G-18, dealers are required to use reasonable diligence in informing themselves of the most favorable terms available, among the variety of markets in which a securities transaction could be

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<sup>14</sup> Under FINRA Rule 0150 (Application of Rules to Exempted Securities Except Municipal Securities), FINRA rules do not apply to transactions in, and business activities relating to, municipal securities. Accordingly, FINRA Rule 5310 on best execution does not apply to the municipal securities market.

<sup>15</sup> Current MSRB interpretive guidance under Rule G-17 defines an SMMP as "an institutional customer of a dealer that: (1) the dealer has a reasonable basis to believe is capable of evaluating market risks and market value independently, both in general and with regard to particular transactions in municipal securities, and (2) affirmatively indicates that it is exercising independent judgment in evaluating the recommendations of the dealer." Restated Interpretive Notice Regarding the Application of MSRB Rules to Transactions with Sophisticated Municipal Market Professionals (Jul. 9, 2012).

Proposed MSRB Rule G-48 is currently under review by the SEC and, if approved, would codify existing interpretive guidance under Rule G-17 that modifies dealers' obligations under several other MSRB rules when dealing with SMMPs. See Exchange Act Release No. 70593 (Oct. 1, 2013); 78 FR 62867 (Oct. 22, 2013). These modifications include a reduced pricing obligation when dealing with SMMPs as compared with what would otherwise apply under Rule G-18. The MSRB will conform the changes proposed here as appropriate depending on future actions taken on pending proposed Rule G-48.

executed, and then execute the transaction in the best market to provide the most favorable price possible to the customer. Under the draft amendments to proposed Rule G-48, the best-execution obligations under the draft rule do not apply to transactions with SMMPs.

Draft Rule G-18, as discussed in detail below, includes particular rule language and supplementary material designed to tailor best-execution obligations to the characteristics of the municipal securities market and to provide guidance on how best-execution concepts apply to municipal securities transactions. This tailoring includes accommodations for situations involving less availability of quotations and relevant pricing information, the role of broker's brokers in providing liquidity, the role of dealers' inventories in providing liquidity, the variance in the nature of dealers' municipal securities business, and the lack of standardized and publicly reported statistical data regarding the quality of executions of municipal securities transactions. While the draft rule gives due consideration to the existing market structure and other current market realities, it is nevertheless designed to be sufficiently flexible to allow both the evolution of the market's structure and future developments in applied technology.

## Request for Comment

Paragraph (a) of draft Rule G-18 is the core provision which requires dealers 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. Paragraph (a), like FINRA Rule 5310(a)(1), includes a non-exhaustive list of factors that a dealer must consider when exercising this diligence. The factors that must be considered are: the character of the market for the security, the size and type of transaction, the number of markets checked, the information reviewed to determine the current market for the subject security or similar securities, the accessibility of quotations, and the terms and conditions of the customer's inquiry or order.

To tailor the draft rule to the municipal securities market, paragraph (a) includes a factor that is not listed in the FINRA rule – "information reviewed to determine the current market for the subject security or similar securities." This factor helps guide the use of reasonable diligence when, for example, there are no available quotations for a security. Moreover, this factor takes into account that dealers may use information about similar securities and other reasonably relevant information.

Paragraph (b) of draft Rule G-18 prohibits a dealer from interjecting a third party between itself and the best market for the security in a manner inconsistent with paragraph (a), a practice known as “interpositioning.” Historically, in non-municipal securities transactions, a dealer was required to demonstrate that the use of a third party *reduced* the costs of the transaction to the customer. Over time, however, that standard came to be seen as overbroad. Consequently, under the current FINRA rule, the use of a third party is allowed so long as it is not *detrimental* to the customer.<sup>16</sup> Consistent with this current policy, and in light of the role of broker’s brokers in the municipal securities market in providing liquidity, paragraph (b) does not prohibit the use of a broker’s broker, unless it would be inconsistent with the best-execution obligation in paragraph (a). For example, if a dealer already definitively knew which was the best market for the security, but then unnecessarily interjected a broker’s broker between itself and that market causing an increase in the customer’s costs, the dealer would violate the rule.

Also in light of the role of broker’s brokers in the municipal securities market, the draft rule does not include a provision like that in FINRA Rule 5310(b) which requires dealers to show why it was reasonable to use a broker’s broker.<sup>17</sup> In this way, the draft rule is consistent with the MSRB’s objective, supported by commenters on the Concept Proposal, of developing a principles-based rule that does not favor any particular venue over another (beyond the merits of the execution quality available at any venue). Moreover, broker’s brokers in the municipal securities market must comply with MSRB Rule G-43 (Broker’s Brokers), which operates to address investor-protection issues without additional requirements being imposed by the draft rule.

Paragraph (c) of draft Rule G-18, like its counterpart in FINRA Rule 5310(e), specifies that the draft rule applies to both principal and agency transactions.

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<sup>16</sup> In approving provisions in the precursor to the current FINRA rule, the SEC noted that “the cost to the customer under the proposed rule will ‘remain a crucial factor in determining whether a member has fulfilled its best execution obligations under [the rule],’ including transactions involving interposed third parties.” See Exchange Act Release No. 60635 (Sept. 8, 2009), 74 FR 47302 (Sept. 15, 2009) at 47303. The Commission also noted that interpositioning “‘that is unnecessary or violates a member’s general best execution obligations – either because of unnecessary costs to the customer or improperly delayed executions – would still be prohibited.’” *Id.*

<sup>17</sup> FINRA Rule 5310(b) provides: “When a 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 member.”

It also specifies that best-execution obligations are distinct from dealers' pricing obligations under other rules.

Paragraph .01 of the Supplementary Material makes clear that the draft rule is not intended to be a substantive pricing standard but an order-handling standard for the execution of transactions. The paragraph explains that the principal purpose of the draft rule is to promote dealers' use of reasonable diligence in obtaining the best price for customers under prevailing market conditions. This is accomplished through the rule's general requirements of the use of, and periodic improvement of, sound procedures. The paragraph expressly provides that, as characteristic of any reasonableness standard, a failure to have *actually* obtained the most favorable price will not necessarily mean that the dealer failed to act *reasonably* under the circumstances.

Paragraph .02 of the Supplementary Material provides, like FINRA Rule 5310(c), that a failure to maintain adequate resources (*e.g.*, staff or technology) cannot justify executing away from the best available market. This paragraph, however, includes an acknowledgment that dealers differ in the nature of their municipal securities business. This acknowledgment is included because the MSRB does not believe that the rule should impose a "one-size-fits-all" standard for "adequate resources."

Paragraph .03 of the Supplementary Material provides that dealers must make every effort to execute customer transactions in a reasonably timely manner, taking into account prevailing market conditions. This is a modification of the "fully and promptly" standard used in paragraph .01 of the Supplementary Material of FINRA Rule 5310, which standard is generally understood to be more applicable to equity-market transactions that typically are executed in seconds or less.

Paragraph .04 of the Supplementary Material defines the term "market" for purposes of draft Rule G-18, including the rule's core provision requiring the exercise of reasonable diligence in ascertaining the "best market" for the security. The definition specifically includes "alternative trading systems or platforms," "broker's brokers," and "other counterparties, which may include the dealer itself as principal." The purpose of this language is to tailor the definition of the critical term "market" to the characteristics of the municipal securities market and to provide flexibility for future developments in both market structure and technology. For example, the language expressly recognizes that the executing dealer itself, acting in a principal capacity, may

be the best market for the security.<sup>18</sup> This could occur where a dealer, through its use of reasonable diligence in accordance with the draft rule, ultimately finds that transacting through its own inventory would result in the most favorable price possible to the customer under prevailing market conditions. This tailoring is in recognition of the role of dealer inventories in providing liquidity in the municipal market.

Paragraph .05 of the Supplementary Material is intended to avoid the imposition of redundant or unnecessary obligations on a dealer involved in a transaction when another dealer appropriately bears best-execution obligations. The paragraph provides that a dealer's duty to provide best execution to customer orders received from another dealer arises only when an order is routed from the other dealer to the dealer for handling and execution. The best-execution obligation does not apply to a dealer when another dealer is simply executing a customer transaction against that dealer's quote.

Paragraph .06 of the Supplementary Material addresses transactions involving securities for which there is limited pricing information or quotations. It requires each dealer to have written policies and procedures that address how its best-execution determinations will be made for such securities, and to document its compliance with those policies and procedures. The paragraph states that a dealer generally should seek out other sources of pricing information and potential liquidity, including other dealers that the dealer previously has traded with in the security. The paragraph also states that a dealer generally should analyze other data to which it reasonably has access.

Paragraph .07 of the Supplementary Material allows a customer to opt out of the best-execution framework for any transaction to the extent it chooses. The paragraph provides that, if a dealer receives an unsolicited instruction from a customer concerning any aspect of the execution of the customer's transaction, the dealer is not required to make a best-execution determination that would supersede the customer's specific instruction. Under the draft rule, a blanket instruction obtained through means like account-opening documents would not qualify as an "unsolicited" instruction.

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<sup>18</sup> FINRA Rule 5310 also allows the dealer acting in a principal capacity to be the "best market," but does not have express language to that effect. Paragraph .09 of the Supplementary Material of the FINRA Rule, in discussing the requirements to review execution quality, contemplates a firm's "internalization" of customer orders.

Paragraph .08 of the Supplementary Material specifies dealers' minimum obligations concerning the periodic review of their policies and procedures for ascertaining the best market. This paragraph is a departure from the FINRA rule's requirement that dealers engage in "regular and rigorous review" of execution quality, on at least a quarterly basis, assessing any material differences among markets based on a highly detailed list of factors. The MSRB does not believe that dealers in municipal securities currently have access to data similar to that used by broker-dealers in other contexts and has modified the review requirement accordingly.

The draft rule reflects the broad principle that a dealer's policies and procedures must be reasonably designed to achieve best execution. The draft rule, however, allows for the future evolution of the market by requiring dealers' reviews to take account of: changes in market structure, new entrants, the availability of additional pre-trade and post-trade data and the availability of new technologies. Finally, the draft rule does not require in all cases that dealers conduct reviews on at least a quarterly basis. It instead requires the frequency of reviews to be reasonably related to the nature of the dealer's business, including its level of sales and trading activity. Under this standard, smaller dealers that handle customer transactions in municipal securities infrequently may not, depending on all of the facts and circumstances, be required to conduct reviews of their policies and procedures four times each year.

Paragraph .09 of the Supplementary Material exempts transactions in municipal fund securities from the application of the draft rule.

The draft amendments to proposed Rule G-48 provide that a dealer shall 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.

## **Economic Analysis**

The MSRB recently adopted a policy to more formally integrate economic analysis into its rulemaking process. Under the policy, the MSRB should, prior to proceeding with a rulemaking, evaluate the need for the draft rule and determine whether the rule as drafted will, in its judgment, meet that need. The MSRB also should identify, prior to proceeding with a rulemaking, data and other information it would need in order to make an informed judgment about the potential economic consequences of the draft rule. In addition, the MSRB should make a preliminary identification of both relevant baselines

and reasonable alternatives to the draft rule. Finally, the MSRB should consider the potential benefits and costs of the draft rule and the main alternative regulatory approaches.

**1. The need for draft Rule G-18 and how the draft rule will meet that need.**

The MSRB has previously observed a need to improve the quality of execution of transactions beyond the baseline requirement of assuring a fair and reasonable price for customer transactions under existing rules.<sup>19</sup> In adopting MSRB Rule G-43, the MSRB recognized the importance of providing for price improvement for retail investors by establishing standards of practice for broker's brokers and dealers that effect transactions through broker's brokers.<sup>20</sup> Comments from industry participants during that rulemaking process suggested varying practices and understanding of the importance of price improvement for customer transactions in the context of their overall fair-pricing obligations under existing MSRB rules. The MSRB noted that it would take under advisement the question of whether there should exist an explicit best-execution obligation under its rules. Shortly thereafter, the SEC recommended in the SEC Report that the MSRB consider possible rule changes that would require dealers to seek "best execution" of customer orders in connection with municipal securities transactions. In addition, the SEC Report recommended that the MSRB provide guidance to dealers on how "best execution" concepts would be applied in connection with transactions in municipal securities.

The draft rule articulates a best-execution standard for dealers of municipal securities that is broadly consistent with existing standards of execution for equities and corporate debt securities transactions. The principal purpose of this rule is to promote, for customer transactions, dealers' use of reasonable diligence in ascertaining the best market and obtaining the most favorable price possible under prevailing market conditions.

The ultimate objective of the draft rule is to use the best-execution standard to promote higher quality trade executions for customers engaging in municipal securities transactions. The draft rule promotes dealers' exercise of reasonable diligence through the use of, and periodic review and potential improvement of, sound procedures for the execution of customers' transactions. The draft rule targets the process by which firms handle orders

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<sup>19</sup> See *supra* n. 8.

<sup>20</sup> See *id.*

and is complementary to current municipal securities dealer obligations for reasonable diligence and fair pricing. Such a process includes dealers' periodic reviews of their written policies and procedures for the executions of customer transactions.

Furthermore, draft Rule G-18 furthers a goal to harmonize MSRB rules with analogous rules of other securities regulators, to the extent appropriate given the nature of the municipal securities market, to help ensure that a consistent standard is applied to both the execution of municipal securities transactions and the execution of transactions in other types of securities. This could promote more effective and efficient compliance by dealers and examination and enforcement by enforcement authorities. Unlike in the equities and corporate fixed income markets, dealers effecting municipal securities transactions do not have an explicit duty to seek "best execution" for customer orders by evaluating where, among the variety of venues at which municipal securities may be executed, the most favorable price for the customer might reasonably be obtained. Draft Rule G-18 would establish such standards for the municipal securities market.

Thus, by articulating a best-execution standard for dealers of municipal securities, the draft rule addresses the need for an execution standard that promotes execution quality in a manner that is broadly consistent with the execution standards applied to customer transactions in other types of securities markets. The draft rule also addresses the need of dealers for guidance on how best-execution concepts would be applied to municipal securities transactions.

## **2. Relevant baselines against which the likely economic impact of elements of the draft rule can be measured**

To evaluate the potential impact of the draft rule's requirements, a baseline, or baselines, must be established as a point of reference. The analysis proceeds by comparing the expected state with the draft rule in effect to the baseline state prior to the rule taking effect. The economic impact of the draft rule is measured as the difference between these two states.

One baseline that can be used to evaluate the impact of the draft rule is the current state under existing MSRB Rules G-18 and G-30. These rules generally require dealers to trade with customers at fair and reasonable prices and to exercise diligence in establishing the market value of municipal securities and the reasonableness of their compensation.

Another baseline for dealers that are also subject to FINRA rules is FINRA Rule 5310 (Best Execution and Interpositioning). That subset of dealers currently must have systems in place to comply with a best-execution obligation for equity and non-municipal fixed-income securities.

### **3. Identifying and evaluating reasonable alternative regulatory approaches.**

The MSRB policy on economic analysis in rulemaking recommends that reasonable potential alternatives to the draft rule should be identified and discussed. In addition to the alternatives considered below, the MSRB also can invite public comment to suggest alternative regimes as well as comments on the potential costs and benefits of alternative regimes.

One alternative to the draft rule would be for the MSRB not to engage in additional rulemaking, and thus, not establish an explicit best-execution standard. Under this alternative, execution standards for customer transactions in the municipal securities market would remain potentially inconsistent with the execution standards in other securities markets. Thus, some dealers may not seek further price improvement for their customers once they have determined that they have been able to achieve a fair and reasonable price for a municipal security.

Another alternative would be to completely adopt the FINRA standard of best execution embodied in FINRA Rule 5310. Certain concepts and requirements in FINRA Rule 5310, however, appear more appropriate for equity securities, particularly those that are part of the national market system. The draft rule has been designed to reflect the characteristics of the market for municipal securities and therefore differs from the FINRA rule in important ways.

Although there may be advantages for the administration of compliance programs from having a completely uniform best-execution standard across all securities markets, there may also be costs to using a single standard that does not account for unique characteristics of the municipal securities market.

### **4. Assessing the benefits and costs, both quantitative and qualitative, of the draft rule and the main alternative regulatory approaches.**

The MSRB policy on economic analysis in rulemaking provides for consideration of the likely economic consequences of the draft rule, against the context of the economic baselines discussed above.

A threshold matter for the MSRB to address is whether the costs and benefits of the draft rule can be reasonably quantified. If not, MSRB policy would require that an explanation be offered as to the reasons why quantification is not possible. In evaluating the economic impact of the draft rule, it would be helpful to have estimates or empirical evidence from market participants or the research community of likely improvements in the quality of executions for customer transactions relative to the baseline. It would also be helpful to have estimates or empirical evidence from market participants or the research community of the costs likely to be incurred by dealers from implementing and maintaining a compliance program with respect to the draft rule's approach for applying best-execution principles. Input from commenters on this notice should include such estimates or empirical evidence to the extent possible, which the MSRB would take into account in finalizing its economic analysis and making its final determination regarding whether to propose the draft rule to the SEC for approval. However, the MSRB is currently not aware of any reasonably reliable estimates or reasonably relevant empirical evidence that is publicly available and would assist in quantifying such costs and benefits, and therefore quantifying the likely economic effects of the draft rule is currently not possible. If the draft rule is adopted, sufficient data may eventually be generated that would allow for an after-the-fact empirical evaluation of the draft rule's impact. Requests for public comment may provide some additional insight into the draft rule's likely dollar costs and benefits.

### **Benefits**

A principal potential benefit of the draft rule's explicit best-execution requirement is that it could reinforce the existing fair-pricing obligations of dealers and could improve execution quality for municipal securities investors. The draft rule could foster price competition among dealers and result in reduced effective spreads and reduced transaction costs for market participants. It is possible, however, that the improvements on each individual transaction may be small, even if the aggregate improvement across all transactions were large.

Another potential benefit from the draft rule comes from detailed guidance to dealers on how best-execution concepts would be applied in connection with transactions in municipal securities. The draft rule, by providing related guidance with respect to best-execution requirements, provides a potential benefit to dealers of municipal securities who could otherwise face greater uncertainty about whether and how to apply best-execution concepts to municipal securities transactions to complement their existing fair-pricing duties.

An additional benefit potentially accruing from the draft rule comes from articulating a best-execution standard for dealers of municipal securities that is broadly consistent with existing standards of execution for equities and corporate debt securities transactions. Consistency in the application of execution standards across different types of securities transactions may be a benefit to those dealers who execute customer transactions in different markets. The benefit to these dealers would come from having similar compliance standards across markets, which could reduce costs that might otherwise be incurred from complying with multiple standards.

### **Costs**

In this section we analyze the potential costs of the draft rule relative to the appropriate baseline. Our preliminary analysis does not consider all the costs associated with the draft rule, but instead focuses on the incremental costs attributable to the draft rule's requirements that exceed the baseline case. The costs associated with the baseline case are in effect subtracted from the costs associated with the draft rule in order to isolate the costs attributable to the incremental requirements attributable to the draft rule.

If a best-execution standard were adopted, dealers would need to establish or revise compliance policies and written supervisory procedures, as well as implement additional monitoring and surveillance. This additional surveillance element would result in costs related to the adoption (and perhaps creation) of new technology systems. Moreover, a review of practices related to best execution would need to occur on a periodic basis.

The costs associated with requirements of the draft rule likely would be most pronounced for those dealers that would be required to implement a compliance system for the first time. These dealers would include the subset of dealers that are not subject at all to FINRA's best-execution rule. These "start-up" costs may be significant. These costs may include seeking the advice of legal and compliance professionals to establish a compliance system. In addition, once a compliance system was implemented, or enhanced, dealers of municipal securities would incur recurring costs of maintaining an ongoing program. For those dealers subject to FINRA Rule 5310, the incremental costs that may be required to adapt existing systems to transactions in municipal securities may be relatively less significant.

Some of the costs associated with compliance with the draft rule are reduced in the aggregate due to the exception for transactions with SMMPs, compared to a scenario in which the draft rule did not except those transactions.

**Effect on Competition, Efficiency and Capital Formation**

It is possible that the costs associated with the compliance and supervisory requirements of the draft rule relative to the baseline may lead some dealers of municipal securities to consolidate with other dealers. For example, some dealers may determine to consolidate with other dealers in order to benefit from economies of scale (*e.g.*, by leveraging existing compliance resources of a larger firm) rather than to incur separately the costs associated with the draft rule. It appears, at this preliminary stage of the rulemaking process, however, that the costs associated with the draft rule are unlikely to be of such a magnitude as to significantly affect consolidation decisions on a broad market basis. Moreover, many smaller firms may rely on other dealers to handle execution of their customers' orders and may leverage upon the best execution and periodic reviews of the executing broker as a means of ensuring that the firm is meeting its best-execution obligations.

It is also possible that a best-execution rule would affect the dimensions, or attributes, upon which market participants compete. A rule that focuses on a single execution attribute, such as a price, could diminish competition for other execution attributes that might be valued by investors, such as speed of execution.

In addition, to the extent dealers might consider fulfilling their best-execution obligations to be more difficult with respect to some securities, such as those that are less widely traded, the rule could have an effect on the relative marketability of such securities.

In addition to any other subject that commenters may wish to address related to draft Rule G-18, the draft amendments to proposed Rule G-48, and the economic analysis, the MSRB seeks comment on the specific questions below. The MSRB particularly requests statistical, empirical, and other data that may support commenters' views or support or refute the views or assumptions contained in this request for comment.

- 1) One goal of requiring that dealers seek best execution of customer transactions in municipal securities is to help customers obtain the most favorable price possible under prevailing market conditions. Could this goal be better achieved through alternative regulatory measures such as encouraging interdealer competition for customer orders or by requiring greater transparency with respect to the quality of executions obtained by dealers?

- 2) Is the desire to have a consistent, explicit best-execution standard applied to both the execution of municipal securities transactions and the execution of other types of securities a worthwhile goal?
- 3) To what extent would the draft rule result in increased transactional efficiency?
- 4) What additional compliance and supervision costs, relative to the existing baseline, would be incurred by dealers to comply with a best-execution requirement?
- 5) What additional costs would be incurred by dealers to periodically review policies and procedures related to best execution?

February 19, 2014

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## Text of Proposed Amendments<sup>21</sup>

### Rule G-18: Best Execution ~~Execution of Transactions~~

(a) In any transaction in a municipal security for or with a customer or a customer of another broker, dealer, or municipal securities dealer (“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. Among the factors that will be considered in determining whether a dealer has used “reasonable diligence,” with no single factor being determinative, are:

- (1) the character of the market for the security (e.g., price, volatility, and relative liquidity);
- (2) the size and type of transaction;
- (3) the number of markets checked;
- (4) the information reviewed to determine the current market for the subject security or similar securities;
- (5) the accessibility of quotations; and
- (6) the 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.

(b) In any transaction for or with a customer or a customer of another dealer, a dealer must not interject a third party between itself and the best market for the subject security in a manner inconsistent with paragraph (a) of this rule.

<sup>21</sup> Underlining indicates new language; strikethrough denotes deletions.

(c) The obligations described in paragraphs (a) and (b) above apply to transactions in which the dealer is acting as agent and transactions in which the dealer is acting as principal. These obligations are distinct from the fairness and reasonableness of commissions, markups or markdowns, which are governed by Rule G-30.

**---Supplementary Material:**

**.01 Purpose.** The principal purpose of this rule is to promote, for customer transactions, dealers' use of reasonable diligence in ascertaining the best market and obtaining the most favorable price possible under prevailing market conditions. A failure to have actually obtained the most favorable price will not necessarily mean that the dealer failed to use reasonable diligence.

**.02 Maintenance of Adequate Resources.** A dealer's failure to maintain adequate resources (e.g., staff or technology) is not a justification for executing away from the best available market. The level of resources required to be maintained by a particular dealer, however, will vary depending on the nature of the dealer's municipal securities business, taking into account its level of sales and trading activity.

**.03 Execution of Customer Transactions.** A dealer must make every effort to execute a customer transaction in a reasonably timely manner, taking into account prevailing market conditions. In certain market conditions a dealer may need more time to use reasonable diligence to ascertain the best market for the subject security.

**.04 Definition of "Market."** The term "market" or "markets," for the purposes of this rule, unless the context requires otherwise, 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 term is to be construed broadly, recognizing that municipal securities currently trade over the counter without a central exchange or platform. This expansive interpretation is meant both to inform dealers as to the breadth of the scope of venues that must be considered in the furtherance of their best-execution obligations and to promote fair competition among dealers (including broker's brokers), alternative trading systems and platforms, and any other venue that may emerge, by not mandating that certain trading venues have less relevance than others in the course of determining a dealer's best-execution obligations.

**.05 Best Execution and Executing Brokers.** A dealer's duty to provide best execution in any transaction "for or with a customer of another dealer" does not apply in instances when the other dealer is simply executing a customer transaction against the dealer's quote. A dealer's duty to provide best execution to customer orders received from other dealers arises only when an order is routed from another dealer to the dealer for handling and execution.

**.06 Securities with Limited Quotations or Pricing Information.** Although the best-execution requirements in this rule apply to transactions in all municipal securities, markets for municipal securities may differ dramatically. One of the areas in which a dealer must be especially diligent in ensuring that it has met its best-execution obligations is with respect to customer transactions involving securities for which there is limited pricing information or quotations available. Each dealer must have written policies and procedures in place that address how the dealer will make its best-execution determinations with respect to such a security in the absence of pricing information or multiple quotations and must document its compliance with those policies and procedures. For example, a dealer generally should seek out other sources of pricing information and potential liquidity for such a security, including other dealers that the dealer previously has traded with in the security. Additionally, a dealer generally should, in determining whether the resultant price to the customer is as favorable as possible under prevailing market conditions, analyze other data to which it reasonably has access.

**.07 Customer Instructions Regarding Handling of Bids or Offers.** If a dealer receives an unsolicited instruction from a customer concerning any aspect of the execution of the customer's transaction, the dealer is not required to make a best-execution determination that would supersede the customer's specific instruction. Dealers, however, are still required to process that customer's transaction in a reasonably timely manner and in accordance with the terms of the customer's bid or offer.

**.08 Review of Execution Quality.**

(a) A dealer must, at a minimum, conduct periodic reviews of its policies and procedures for determining the best available market for the executions of its customers' transactions. While no specific interval is required, a dealer must conduct these reviews at a frequency reasonably related to the nature of its business, including but not limited to its level of trading activity. In conducting its periodic reviews, a dealer must assess whether its policies and procedures are reasonably designed to achieve best execution, taking into account 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.

(b) A dealer that routes its customers' transactions to another dealer that has agreed to handle those transactions as agent or riskless principal for the customer (e.g., a clearing firm or other executing dealer) may rely on that other dealer's periodic reviews as long as the results and rationale of the review are fully disclosed to the dealer and the dealer periodically reviews how the other dealer's review is conducted and the results of the review.

**.09 Exemption for Municipal Fund Securities.** The provisions of this rule do not apply to transactions in municipal fund securities.

~~Each broker, dealer and municipal securities dealer, when executing a transaction in municipal securities for or on behalf of a customer as agent, shall make a reasonable effort to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions.~~

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**Rule G-48: Transactions with Sophisticated Municipal Market Professionals**

A broker, dealer, or municipal securities dealer's obligations to a customer that it reasonably concludes is a Sophisticated Municipal Market Professional, or SMMP, shall be modified as follows:

(a) - (d) No change.

(e) *Best Execution.* The broker, dealer, or municipal securities dealer shall not have any obligation 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.