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Dealers Warn New Best-Ex Provisions on SMMPs Costly, Burdensome.

Dealers are objecting to new provisions added to the best execution standard the Municipal Securities Rulemaking Board filed with the Securities and Exchange Commission for approval that would increase the information customers have to provide to be considered sophisticated municipal market professionals who are exempt from the standard.

David Cohen, associate general counsel of the Securities Industry and Financial Markets Association said the new provisions "would significantly increase compliance costs and burdens" and would run counter to the MSRB's goal of harmonizing the rule changes with Financial Industry Regulatory Authority rules.

Current MSRB guidance under its Rule G-17 on fair dealing says that for a customer to be an SMMP, the dealer was have "a reasonable basis to believe [it] is capable of evaluating market risks and market value independently in evaluating the recommendations of the dealer." The customer must also "affirmatively indicate it is exercising independent judgment" in evaluating the dealer recommendations.

MSRB referred to this language in the MSRB best execution rule proposal released in February and it is virtually identical to the provisions in FINRA Rule 2111.

To comply with this requirement, dealers typically obtain certificates to this effect from customers, although the rule says the information can be obtained verbally instead of in writing.

The new provisions contained in new Rule G-48 would also require the customer to affirmatively indicate "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 of functions and (ii) the dealer does not exercise discretion as to how or when the transactions are executed."

The customer must also affirmatively indicate that it has access to "established industry sources" such as the MSRB's EMMA system and rating agency reports as well as "material information."

Sources say dealers will have to get new certificates or verbal indications from customers.

SIFMA and Bond Dealers of America officials said they are still reading the proposal the MSRB filed with the SEC on Wednesday, which includes proposed changes to the board's Rule G-18 on execution of transactions, as well as amendments to its Rule D-15 and G-48 governing SMMPs.

SIFMA is still unhappy with the proposal. "We continue to believe that the current standard is fair and reasonable, that best execution is an equity market standard that is more appropriate when there is a central exchange and is inappropriately applied to over-the-counter markets," Cohen said.

Jessica Giroux, senior counsel and senior vice president for federal regulatory policy at BDA said,

“We are pleased that transactions with SMMPs remain exempted from the proposal and that rule language and supplementary material tailor best-execution obligations to the unique characteristics of the municipal securities market. Further, it seems as if the supplementary material addresses some of the concerns we continue to discuss with our membership including the promotion of reasonable diligence versus a substantive pricing standard as well as allowances in instances where there are limited pricing information. We still need to more closely analyze the proposal and plan to submit comments to the SEC.”

The MSRB asked the SEC to make the proposed changes to its Rule G-18 on execution of transactions, which are generally similar to those the MSRB issued in February, to take effect one year after the SEC approves them.

The best execution standard generally would require dealers to use “reasonable diligence” to determine the best market for a security and then buy or sell the security in that market so the resulting price to the customer “is as favorable as possible under prevailing market conditions,” the MSRB said.

To meet their due diligence obligations, dealers would have to take into account a list of factors, including 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.

One MSRB factor does not appear in the Financial Industry Regulatory Authority best-ex rule for corporate bonds — information reviewed to determine the current market for the subject security or similar securities. This factor will help guide the use of reasonable diligence when dealers cannot find quotations for a bond, the MSRB told the SEC in the filing.

The board’s action follows recent complaints by some market participants that a best execution rule is not needed because it is very similar to the board’ s Rule G-30 on fair prices and commissions.

But the MSRB told the SEC, “While G-30 contains substantive pricing standards, under which dealers must (among other things) use reasonable diligence in determining a security’s fair market value, a best execution standard is an order-handling and transaction-execution standard, under which the goal of the dealer’s reasonable diligence would be to ascertain among the variety of venues where the municipal security may be executed, the best market for the security.”

As proposed in February, broker-dealers would be exempt from the best execution standard in transactions with sophisticated municipal market professionals. SMMPs are institutional investors or individuals with assets of at least $50 million.

The MSRB’s revised Rule G-18 would differ from the FINRA rule in another major way, as it does not require dealers to show why it was reasonable to use a broker’s broker. The MSRB said it wanted to develop a rule that did not favor any particular market venue over any other.

The MSRB said it received 10 comment letters on its proposed standard and that “many commenters supported the development of an explicit best-execution standard for the municipal securities market.”

The National Association of Independent Public Finance Advisors had raised concerns that the rule could create a different “substantive pricing standard” for issuers than for investors. But MSRB said the rule proposal is an “order-handling and transaction execution standard” that would not impact

dealer behavior in new issuances.

SIFMA had complained about proposed rule's costs and burdens. The MSRB told the SEC that it "welcomes SIFMA's offer to provide the MSRB reliable empirical data." The board also noted that SIFMA proposed "a highly similar order-handling rule" and said, "It has not been shown that the costs of proposed Rule G-18 would be significantly greater than the costs of SIFMA's proposal."

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