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SIFMA Proposes Muni Trade Standard; Wants MSRB to Seek Public Input.

The Securities Industry and Financial Markets Association is proposing a new "execution-wit--diligence" standard for municipal trading that would require a dealer to use "reasonable diligence" to determine the market for a bond so the price it provides to a customer is "fair and reasonable under prevailing market conditions."

The term "market" would be defined to encompass other broker-dealers known to trade the muni security.

Dealers also would be required to conduct post-trade reviews that, among other things, would compare their muni prices with the prices they could have obtained from other dealers.

SIFMA is proposing the Municipal Securities Rulemaking Board adopt the new standard in lieu of a best execution rule that the Securities and Exchange Commission's July 2012 muni report recommended the MSRB consider adopting for the muni market.

The MSRB is expected to take up the SIFMA proposal at its meeting in Boston this week.

Under the SEC's best execution rule, brokers are legally required to seek the best execution reasonably available for their customers' orders. Brokers must evaluate the orders they receive from all customers in the aggregate and periodically assess which competing markets, market makers, or electronic communications networks, offer the most favorable terms of execution.

"Best execution does not work in the current municipal market because it's an over-the-counter market" where there is no one place where a dealer can go to compare muni bond prices, David Cohen, a SIFMA managing director and associate general, said Thursday.

The SEC report also recommended the MSRB consider ways to encourage dealers to use alternative trading systems or other electronic networks that widely disseminate quotes and provide fair access.

Cohen said any kind of central trading platform or exchange for munis is "years down the road."

"We are proposing a rule that works in the current market structure … that is obtainable [in the near term] through the normal rulemaking process,' he said.

The SEC's muni market report said the secondary market for munis "is relatively opaque" and that the prices at which market participants may be willing to buy or sell a muni are "not broadly available."

"The relatively high overall levels of markups and other transaction costs in the municipal securities market generally are attributable to the illiquidity and opacity of the …market," the SEC said. "In addition, some studies have found that markups and transaction costs tend to be higher for smaller-sized 'retail' trades than for larger institutional trades."

Cohen said the SEC report "raised some legitimate issues so we worked with our members to put forward a standard or proposal that would improve the public trust and confidence in the municipal securities market."

"This project has been one of the top priorities of SIFMA's municipal securities division this year," he said.

Cohen said SIFMA's proposed standard is "much more robust and substantive than the rule that currently exists."

The existing rule, the MSRB's Rule G-18 on execution of transactions, is one sentence long and requires broker-dealers, when executing trades for or on behalf of a customer as an agent, to make a "reasonable effort to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions."

Like other MSRB rules, there are a series of interpretations of it.

Cohen said SIFMA's proposed standard, which would be adopted as a new Rule G-18, would adapt for the muni market, the concepts and requirements in the Financial Industry Regulatory Authority's Rule 5310 for equities and corporate bonds. "We said, 'What is in this rule that would work for the muni market,'" he said.

SIFMA described its proposal in a four-page letter sent to the MSRB last month. The group urged the MSRB to issue it as a concept release with an expanded comment period so that it can be fully vetted by market participants.

SIFMA members would need an implementation period of at least six to nine months to be able to develop policies and procedures and make system changes, the letter said.

In an attachment and supplementary material, SIFMA included a non-exhaustive list of factors that dealers could consider to make a reasonable diligence determination that their prices were fair and reasonable.

The factors include the market for the muni, including the demand for it, the availability of it, the price, the volatility of the market, the relative liquidity of it, as well as the size of the issue and the issuer. Dealers could also consider: the size and type of the transaction; information about the market for similar securities; the accessibility of quotations and the likelihood of execution at a particular price; any customer bids, offers or conditions; and whether the broker-dealer is acting as a principal for itself and its inventory, or for as an agent for the customer.

SIFMA said that broker-dealers would have to meet the reasonable diligence standard regardless of whether they were acting as a principle or agent and that they could not excuse themselves by saying they did not have enough resources, technology, or information.

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