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## MSRB Requests Comment on Whether to Require Dealers to Adopt a "Best Execution" Standard for Municipal Securities Transactions.

INTRODUCTION

The Municipal Securities Rulemaking Board ("MSRB") is requesting comment on whether to require a broker, dealer, or municipal securities dealer ("dealer") to seek "best execution" of customer orders for municipal securities and provide detailed guidance to dealers on how "best execution" concepts would be applied to municipal securities transactions. This request for comment is intended to elicit input from all interested parties on adoption of a "best execution" or similar standard for the municipal securities market, to more fully appreciate the benefits and impact of this requirement on investors and dealers, including the costs, burdens, any operational concerns, as well as any alternatives for the MSRB to consider. Specific comment is also solicited from dealers on the application of their existing best execution requirements to transactions in other types of fixed income securities under FINRA Rule 5310. These comments will assist the MSRB in determining whether to consider undertaking formal rulemaking to propose a best execution or similar requirement on dealers when executing transactions in municipal securities.

Comments should be submitted no later than October 7, 2013, 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.[1]

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

BACKGROUND

The Securities and Exchange Commission (the "SEC") issued its "Report on the Municipal Securities Market" in the summer of 2012. The SEC Report contained a number of recommendations relating to the structure of the municipal market. Some of the recommendations related to ways in which the MSRB could consider buttressing existing dealer pricing obligations. MSRB 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. However, MSRB rules, unlike rules that apply to the equities and corporate fixed income markets, do not impose a "best execution" standard.

The Commission noted that the lack of such a requirement may give rise to an impression that customers purchasing municipal securities may not be receiving as favorable a price as possible. The Commission has recommended that the MSRB consider a rule that would require dealers to seek "best execution" of customer orders for municipal securities and provide detailed guidance to dealers on how "best execution" concepts would be applied in municipal securities transactions.

The logical starting place for a standard of best execution is FINRA Rule 5310, which applies to both the equity and corporate fixed income markets. In general, FINRA Rule 5310(a)(1) requires a member firm, in any transaction for or with a customer or a customer of another broker-dealer, to use "reasonable diligence" to ascertain the best market for a security and to buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. The rule includes a non-exclusive list of factors that will be considered in determining whether a firm has used "reasonable diligence":

- the character of the market for the security;
- the size and type of transaction;
- the number of markets checked;
- the accessibility of the quotation; and
- the terms and conditions of the order as communicated to the firm.

FINRA Rules 5310(a)(2) and 5310(b)-(e) and the Supplementary Material to Rule 5310 address certain additional obligations of the member firm or standards to be applied if a member firm:

- injects a third party between the member firm and the best available market;
- utilizes the services of a broker's broker;
- staffs an order room or other department to execute customer orders;
- channels customer orders through a third party;
- handles customer orders for securities for which there is limited pricing information or quotations available or securities that do not trade in the United States; or
- receives an unsolicited specific instruction to route a customer's order to a particular market for execution.

The Supplementary Material to Rule 5310 also codifies the obligations of the member firm when it undertakes a regular and rigorous review of the execution quality likely to be obtained from different market centers.

EXISTING MSRB PRICING REQUIREMENTS

MSRB Rule G-18 (Execution of Transactions) and Rule G-30 (Prices and Commissions) 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 dealers' compensation. Rule G-30(a) explicitly provides that the best judgment of the 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 is a relevant consideration. The MSRB issued guidance on the fair-pricing requirements of MSRB Rules G-18 and G-30 in 2004 and addressed the issues relating to the pricing of hard-to-value securities and stressed that "dealers nevertheless should be cognizant of their duty to establish market value as accurately as possible using reasonable diligence" and that "[t]he lack of a well-defined and active market for an issue does not negate the need for diligence in determining the market value as accurately as reasonably possible when fair pricing obligations apply."

REQUEST FOR COMMENT

A "best execution" requirement would augment the existing requirements to trade at prices that are fair and reasonable. While an objective of any "best execution" requirement is to provide a customer with a price that is as favorable as possible under prevailing market conditions, a "best execution" requirement would target the process by which firms handle orders, and as such, would be complementary to existing MSRB Rules G-18 and G-30.

The MSRB, however, is mindful that copying the existing standards from the equity and corporate fixed income markets may not be the optimal manner to promote fair pricing in the municipal market. Although FINRA Rule 5310 applies to fixed income securities, there are certain concepts and requirements in FINRA Rule 5310 that appear more appropriate for equity securities, particularly those that are part of the national market system. The MSRB believes that any "best execution" requirement should be uniquely tailored to the attributes of the municipal securities market. Any divergence from existing best execution requirements would not be intended to dilute them, but to impose requirements that are properly tailored for the municipal market.

Virtually all of the dealers that are registered with the MSRB are subject to the best execution obligations imposed by FINRA Rule 5310 for trades in equities and corporate fixed income securities. This request for comment seeks to leverage the experiences of such firms to assist the MSRB in developing a regime that would improve secondary market pricing of municipal securities.

The MSRB seeks public comment on the following questions, as well as any other comments on this topic, to assist it in determining whether to consider proposing a "best execution" or similar requirement for dealers. The MSRB particularly welcomes statistical, empirical, and other data from commenters that may support their views and/or support or refute the views or assumptions or issues raised in this request for comment. If the MSRB determines to proceed with rulemaking in this area after reviewing the comments received in response to this request for comment, it would publish a request for comment seeking further industry and public input on specific requirements intended to achieve the goals enunciated herein before making a final decision on whether to file such a proposal with the SEC for its approval.

Would implementation of a best execution requirement help ensure investors receive fair and reasonable prices?

Are there certain segments of the municipal market or categories of municipal securities for which a best execution requirement would not be appropriate, e.g., transactions in new issues or transactions in variable rate demand obligations?

Should a best execution requirement apply to all transactions with customers in municipal securities, or should transactions with certain customers, such as sophisticated municipal market professionals (SMMPs) as defined in the interpretation to Rule G-17, on fair dealing, be exempt?

Would implementing a best execution requirement support compliance by dealers with their fair-pricing obligations to customers? If so, how would the existing requirements for fair pricing be helped by the application of a best execution requirement?

Do dealers currently follow a "best execution" plan in connection with the purchase or sale of municipal securities?

Would disclosure that a firm does not utilize a best execution standard be a reasonable alternative to a best execution requirement?

Should there be a minimum number of quotations that must be received in order to support the prevailing market price established by a dealer?

If a best execution standard is adopted, how often should the MSRB require that dealers conduct a review of their practices relating to best execution? What factors would be relevant to a determination of whether this review should be more or less frequent?

Should procedures address circumstances under which dealers might seek quotations from:

- one or more alternative trading systems?
- one or more broker's brokers?
- one or more affiliates of the dealer's firm?
- the dealer firm's clearing firm?
- dealer firms that participated in the underwriting of the subject municipal securities?

How could a dealer be expected to ensure best execution when selling a municipal security to an investor from the dealer's inventory?

In the municipal securities market, is it a common practice for customers to direct dealers to solicit bid wanteds from particular dealers, alternative trading systems, or through brokers' brokers? If not, should dealers be required to provide these alternatives to customers?

Do customers inquire as to the methods that dealers employ to determine the prevailing market price for municipal securities?

What are the most significant challenges, if any, currently experienced with interpretation and execution of best execution duties for fixed income securities under FINRA Rule 5310?

Are there alternative methods that the MSRB should consider to provide more transparency to the process dealers employ when determining the prevailing market price for municipal securities in the secondary market that may be more effective for investors and/or less costly or burdensome to dealers? Would a best execution or similar requirement have any negative effect on the protection of investors and the public interest, or on the fair and efficient operation of the municipal market? If so, please describe in detail.

What tools do dealers employ to document and preserve diligence undertaken to substantiate the basis of the prevailing market price? What other tools might be needed if a best execution or similar requirement were adopted by the MSRB?

If your firm conducts a post-trade internal review of pricing, does it audit all trades, a sampling of trades and what frequency is employed for such review, e.g., daily, weekly, monthly or on a quarterly basis?

If your firm conducts a post-trade internal review, how often does it adjust pricing?

August 6, 2013

[1] 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.

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