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New Best Execution Requirement For Municipal Securities Transactions: Morgan Lewis

Although the MSRB's new best execution rule is generally consistent with FINRA's, differences exist and questions remain regarding FINRA's examination and enforcement of the requirements.

On December 5, 2014, the U.S. Securities and Exchange Commission (SEC) approved a Municipal Securities Rulemaking Board (MSRB) proposal to establish explicit best execution requirements for brokers, dealers, and municipal securities dealers (Dealers) effecting transactions in municipal securities, subject to certain exceptions.¹ The MSRB's best execution rule is largely consistent with the best execution rule of the Financial Industry Regulatory Authority (FINRA), with some key differences.²

The MSRB characterizes its best execution rule as an order-handling standard, and not a pricing standard, that would require Dealers to use "reasonable diligence" in seeking to obtain the best price for a customer under prevailing market conditions. Although the MSRB already requires that Dealers trade with customers at fair and reasonable prices, and exercise diligence in establishing the market value of municipal securities and the reasonableness of their compensation, it is unclear whether the MSRB's new best execution rule will conflict with the MSRB's existing pricing standards because, for example, those pricing standards explicitly recognize that Dealers are "entitled to a profit."³ The substantive requirements of the MSRB's best execution rule are discussed below, as are some of the issues that Dealers might consider when implementing the requirements of the new rule.

The MSRB's best execution rule becomes effective on **December 7, 2015**.

BEST EXECUTION

New MSRB Rule G-18—Best Execution—consists of three main provisions and nine paragraphs of supplementary material that inform the best execution standard. We provide an overview of each of these provisions below.

General Best Execution Standard

MSRB Rule G-18(a) contains the substantive best execution standard. In relevant part, MSRB Rule G-18(a) requires Dealers 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 customer is as favorable as possible under the prevailing market conditions.

Although MSRB Rule G-18(a) does not specifically define "reasonable diligence," it does identify six factors for determining whether a Dealer has used "reasonable diligence," with no single factor being determinative:

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
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

Although the substance of MSRB Rule G-18 is substantially similar to FINRA's best execution rule (FINRA Rule 5310), MSRB Rule G-18 contains an additional factor not found in FINRA's Rule—the information reviewed to determine the current market for the subject security or similar securities. As explained by the MSRB when it proposed the rule, this additional factor is intended to “guide the use of reasonable diligence when, for example, there are no available quotations for a security . . . [, and] take into account that [D]ealers may use information about similar securities and other reasonably relevant information.”⁴

Interpositioning Prohibited

As with FINRA Rule 5310(a)(2), MSRB Rule G-18(b) prohibits “interpositioning,” which is the practice of unnecessarily interjecting a third party between the Dealer and the best market for a security. Unlike FINRA Rule 5310(b), however, which requires FINRA members to show why it is reasonable to use a broker's broker when effecting a transaction for a customer, the MSRB's best execution rule does not require Dealers to establish such a showing. Indeed, the definition of a “market” for purposes of the MSRB's rule (as discussed below) includes broker's brokers.

MSRB Rule G-18 Not a Pricing Standard

Finally, MSRB Rule G-18(c) states that the obligations under MSRB Rule G-18 are distinct from the pricing obligations in MSRB G-30. It is unclear, however, whether MSRB Rule G-30 and its various interpretations will cause interpretive dilemmas for Dealers, in particular, if regulatory examiners misapply the standard from the FINRA rule when reviewing a Dealer's compliance with the MSRB rule.

Supplementary Material

The supplementary material to MSRB Rule G-18 is intended to clarify certain aspects of MSRB Rule G-18. In particular, the supplementary material addresses the following:

Failure to Obtain the Most Favorable Price: The supplementary material clarifies that the failure to have actually obtained the most favorable price will not necessarily mean that a Dealer failed to use reasonable diligence in connection with the Dealer's best execution obligations under the rule.⁵

Adequate Resources: Under the rule, a failure to maintain adequate resources, such as staff or technology, is not a justification for executing away from the best available market. ⁶ This provision parallels a similar requirement in FINRA Rule 5130(c).

Timing of Execution: Paragraph .03 of the supplementary material acknowledges that although customer transactions should be executed promptly, under certain circumstances, Dealers may need more time to use reasonable diligence to determine the best market for a security.⁷

Definition of Market: The rule defines the terms “market” and “markets” broadly to include

brokers' brokers, alternative trading systems or platforms, and other counterparties. Significantly, the rule makes clear that a market through which a most favorable price could be obtained includes a Dealer acting as principal.⁸ In contrast, the definition of "market" in FINRA Rule 5310/.02 does not explicitly include a FINRA member acting as principal.

Executing Brokers: Supplementary Material .05 indicates that a Dealer's duty to provide best execution to customer orders received from another Dealer arises only if that other Dealer routes the order to the Dealer for handling and execution.⁹

Limited Quotations and Pricing Information: The rule requires that a Dealer (1) have policies and procedures in place that address how its best execution determinations will be made for securities in which there is limited pricing information or quotations and (2) document compliance with such policies and procedures.¹⁰

Customer Instructions: Paragraph .07 of the supplementary material states that a Dealer is not required to make a best execution determination if the Dealer receives an unsolicited instruction from a customer that designates a particular market for execution.

Periodic Reviews: On at least a yearly basis, a Dealer is required to review its policies and procedures for determining the best available market for the execution of its customers' transactions.¹¹ In conducting the review, a Dealer is required to assess whether its policies and procedures are reasonably designed to achieve best execution while taking certain factors into account, such as the following:

- The quality of execution that the Dealer is obtaining under its current policies and procedures
- Changes in market structure
- New entrants
- The availability of pre-trade and post-trade data
- The availability of new technologies

Municipal Fund Securities: Excluded from the scope of MSRB's best execution rule are transactions in municipal fund securities.¹² A municipal fund security is a municipal security issued by an issuer that, but for the application of section 2(b) of the Investment Company Act of 1940 (1940 Act), would constitute an investment company within the meaning of section 3 of the 1940 Act.¹³ Examples of municipal fund securities include local government investment pools and 529 college plans. As explained in the Proposal, municipal fund securities are typically distributed through continuous primary offerings at calculated prices, and the decision to purchase such funds involves special tax and other considerations unique to such securities, making the best execution standard in proposed MSRB Rule G-18 "inapt."¹⁴

Exceptions for Sophisticated Municipal Market Professionals; Affirmations

In connection with its best execution framework, MSRB also amended MSRB Rule G-48—transactions with Sophisticated Municipal Market Professionals (SMMPs)—to exclude transactions with SMMPs from the best execution requirements. The MSRB also amended the definition of an SMMP in MSRB Rule D-15 to indicate that, to qualify as a SMMP, a customer must affirmatively indicate that it is exercising independent judgment in evaluating the recommendations of a Dealer. More specifically, the affirmation would require the customer to indicate that it

- is exercising independent judgment in evaluating the recommendation of the Dealer, the quality of execution of the customer's transactions by the Dealer, and the transaction price for nonrecommended secondary market agency transactions as to which the Dealer's services have been explicitly limited to providing anonymity, communication, order matching and/or clearance

functions and

- the dealer does not exercise discretion as to how or when the transactions are executed, and has timely access to material information that is available publicly through established industry sources as defined in MSRB Rule G-47(b)(i) and (ii).

The supplementary material to MSRB Rule D-15 indicates that this affirmation may be given, either orally or in writing, (1) on a trade-by-trade basis, (2) on a type-of-municipal-security basis, or (3) on an account wide basis.

Implications

Although compliance with the MSRB's best execution rule is roughly a year away, Dealers should begin to consider what changes they have to make to their order management and back office systems to comply with the rule. In particular, Dealers should review their current practices for complying with FINRA Rule 5310 and MSRB Rule G-30 and determine how to incorporate, in their policies and procedures, the enumerated factors in MSRB Rule G-18 that can be used to establish the use of "reasonable diligence" in fulfilling the best execution obligations under the rule. Although the "reasonable diligence" factors identified by the MSRB are intended to be nonexclusive, Dealers may want to address in their policies and procedures why a particular factor was not included. In this regard, we caution, as some commenters on the Proposal did,¹⁵ that rather than view the list as nonexhaustive, FINRA examination staff might take the view that each of the factors needs to be addressed in any policies and procedures to ensure compliance with the rule.

In addition, although MSRB's best execution rule indicates that a Dealer's inventory holdings qualify as a market that can be used to satisfy their obligations under the rule, Dealers should take care to ensure that other markets do not offer comparable or better pricing for a fixed-income product that satisfies the attributes that a customer is seeking. This is particularly the case because MSRB rules do not contain a direct methodology for establishing the prevailing market price for a security as does FINRA Rule 2121/.02 (Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities). Although the MSRB did propose creating such a methodology,¹⁶ it never filed a notice with the SEC to do so. Such a methodology would be helpful in connection with the information reviewed to determine the current market for the subject security or similar securities, especially when reviewing the market for "similar securities" when engaging in a reasonable diligence exercise. Dealers may want to establish criteria for determining what qualifies as a "similar security," and in this regard, may want to reference the discussion of a "similar" municipal security in the 2010 MSRB Mark-Up Proposal. That proposal states that "a 'similar' municipal security should be sufficiently similar to the subject security that it would serve as a reasonable alternative investment to the investor. At a minimum, a market yield for the subject security should be able to be fairly estimated from the yields of the similar securities." The 2010 MSRB Mark-Up Proposal then goes on to identify the following factors for evaluating the similarities between securities:

- Credit quality considerations, such as whether the municipal security is issued by the same or similar entity, bears the same or similar credit rating, or is supported by a similarly strong guarantee or collateral as the subject security (to the extent that securities of other issuers are designated as "similar" securities, significant recent information of either issuer that is not yet incorporated in credit ratings should be considered (e.g., changes to ratings outlooks)).
- The extent to which the spread (i.e., the spread over U.S. Treasury securities of a similar duration) at which the "similar" municipal security trades is comparable to the spread at which the subject security trades.
- General structural characteristics and provisions of the issue, such as coupon; maturity; duration; complexity or uniqueness of the structure; callability; the likelihood that the municipal security will

be called, tendered, or exchanged; and other embedded options, as compared with the characteristics of the subject security.

- Technical factors, such as the size of the issue, the float and recent turnover of the issue, and legal restrictions on transferability as compared with the subject municipal security.
- The extent to which the federal and/or state tax treatment of the “similar” municipal security is comparable to such tax treatment of the subject security.¹⁷

Finally, we note that with respect to SMMPs, Dealers may want to amend their account-opening documents to include materials through which SMMPs can make the required affirmations under MSRB Rule D-15. As mentioned in the Approval Order, however, for existing customers that are SMMPs, Dealers will likely have to get new affirmations. ¹⁸

Conclusion

As explained by the MSRB, the best execution rule is among several initiatives under way to fulfill the MSRB’s long-term plan for market transparency and to align MSRB rules with recommendations from the SEC’s 2012 Municipal Securities Report.¹⁹ Indeed, the MSRB and FINRA recently coordinated on requesting comments from their respective members regarding a proposal to disclose pricing information and price differentials in customer confirmations for many same-day transactions.²⁰ We will continue to monitor these and other developments as they progress.

Footnotes

1. See Securities Exchange Act Release No. 73764 (December 5, 2014), 79 Fed. Reg. 73658 (Dec. 11, 2014) (Approval Order). A copy of the approval order is available [here](#). See also SEC Approves MSRB Rule G-18 on Best Execution of Transactions in Municipal Securities and Related Amendments to Exempt Transactions with Sophisticated Municipal Market Professionals, MSRB Regulatory Notice 2014-22 (December 8, 2014) available [here](#).
2. See FINRA Rule 5310.
3. See MSRB Rule G-30/.02(b)(iii) (indicating that a factor a Dealer may consider in determining fairness and reasonableness of prices is that the Dealer is entitled to a profit).
4. Securities Exchange Act Release No. 72956 (September 2, 2014), 79 Fed. Reg. 53236, 53238 (September 8, 2014) (Proposal).
5. MSRB Rule G-18/.01.
6. MSRB Rule G-18/.02. The supplementary material also indicates that “[t]he level of resources that a dealer maintains should take into account the nature of the [D]ealer’s municipal securities business, including its level of sales and trading activity.”
7. MSRB Rule G-18/.03.
8. MSRB Rule G-18/.04.
9. MSRB Rule G-18/.05.
10. MSRB Rule G-18/.06. By way of example, the supplementary material states that a Dealer should generally seek out other sources of pricing information and potential liquidity for such a security, including other dealers that the Dealer previously has traded within the security. In addition, the supplementary material states that 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.

11. MSRB Rule G-18/.08.

12. MSRB Rule G-18/.09.

13. Section 2(b) of the 1940 Act states: “No provision in this title [1940 Act] shall apply to, or be deemed to include, the United States, a State, or any political subdivision of a State, or any agency, authority, or instrumentality of any one or more of the foregoing, or any corporation which is wholly owned directly or indirectly by any one or more of the foregoing, or any officer, agent, or employee of any of the foregoing acting as such in the course of his official duty, unless such provision makes specific reference thereto.”

14. Proposal, 79 Fed. Reg. at 53240.

15. Approval Order, 78 Fed. Reg. at 73662 (indicating a belief among some commenters that the exhaustive list of factors to be considered by Dealers could become a de facto enforcement checklist for FINRA).

16. See Request For Comments On Draft Interpretive Guidance On Prevailing Market Prices And Mark-Up For Transactions In Municipal Securities, MSRB Notice 2010-10 (April 21, 2010) (2010 MSRB Mark-Up Proposal).

17. Id. See also SEC, Report on the Municipal Securities Market (July 31, 2012) (Municipal Securities Report), pages 129–130, available [here](#).

18. Approval Order, 78 Fed. Reg. at 73663.

19. Supra note 17.

20. Please see our previous LawFlash for a discussion of these proposals, available [here](#).

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