

Bond Case Briefs

Municipal Finance Law Since 1971

Butler Snow: MSRB's Execution Guidance Under Rule G-18 - Forward With Flexibility.

The Municipal Securities Rulemaking Board ("MSRB") recently released its best execution guidance under MSRB Rule G-18 (the "Rule" or "Rule G-18"). The Rule will be effective as of March 21, 2016. The Rule provides: "The best-execution rule requires brokers, dealers and municipal securities 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 prevailing market conditions." You can find the full text of Rule G-18 [here](#) and MSRB's guidance on implementation [here](#). This post provides a summary of the rule and offers a few observations about its impact going forward.

Who Does Rule G-18 Apply To?

The MSRB said it best: "Rule G-18 applies to any transaction in a municipal security for or with a customer or a customer of another dealer, without any exception for orders that are routed to another dealer." Rule G-18 applies to transactions both when the dealer acts as an agent and when the dealer acts as the principal.

Paragraph .08 of the Supplementary Material to the Rule also states that "[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."

Rule G-18 does not apply to transactions in municipal fund securities, nor does it apply to "inter-dealer" trades between broker-dealers. Further, amendments to Rules G-48 and D-15 exempt sophisticated municipal market professionals (defined in Rule D-15) from the requirements of Rule G-18.

Rule D-15's definition of sophisticated municipal market professionals includes banks, savings and loan associations, insurance companies, registered investment companies, investment advisers registered with the Securities and Exchange Commission under Section 203 of the Investment Advisers Act of 1940 (or like state securities commission), or another entity with over \$50 million in total assets that the broker, dealer, or municipal securities dealer has a reasonable basis to believe can evaluate investment risks and market values independently.

One more note on whom Rule G-18 applies to: Dealers also cannot interject a third party between themselves and the best market for a security if the third party would subvert compliance with Rule G-18.

Reasonable Diligence

Under Rule G-18, "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.”

What does that mean exactly? In a nutshell, the dealer does not have to find the best possible price for a security, but is instead allowed some reasonable level of judgment in determining the best price that it expects that the particular security can fetch on the bond market, so long as (a) the dealer reaches that conclusion under after satisfying the “reasonable diligence” test factors under the Rule; (b) the dealer documents its reasonable diligence via adopted policies and procedures; and (c) the dealer records and retains evidence of adhering to those policies and procedures.

The “reasonable diligence” standard is not defined explicitly within the Rule, but the MSRB has structured the Rule to include a list of factors to guide the inquiry concerning whether a dealer has acted with reasonable diligence. The listed factors are as follows:

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.

No one factor is determinative in the inquiry and the aim of the list is to set a group of six factors in a “reasonable inquiry” test that allows dealers the flexibility to operate in the marketplace, but provides guidelines on how to document their compliance with Rule G-18 with examples of what information should be reviewed to determine the market for subject or similar securities.

Accordingly, determining whether a dealer acted with “reasonable diligence” is a “facts and circumstances” analysis. That’s good and bad news for dealers, as the standard has some flexibility, but also does not provide a hardline rule for compliance.

While the fact and factor-based inquiry does create some ambiguity, the MSRB again provides some useful guidelines to help dealers know whether they’re on the right track. Paragraph .08 of the Supplementary Materials is particularly instructive. Paragraph .08 states that dealers must “at a minimum, conduct annual reviews of its policies and procedures for determining the best available market for the executions of its customers’ transactions.”

The MSRB’s implementation guidance further suggests that those reviews should consider the quality of the dealer’s recent transactions, new market entrants, available data, implementing new technologies to assist in best execution, and developing procedures to implement changes identified by the dealer’s review. Dealers are also instructed to document their compliance with their best execution procedures.

One more point worth noting from the implementation guidance is that provision should be made for “extreme market conditions” in adopted policies and procedures to ensure that the best execution obligations are complied with, though recognizing that the dealers have a need to limit exposure due to market risk.

Conclusion

As the title of this post states, Rule G-18 represents a step forward in terms of defining steps dealers

should take to be reasonably diligent in facilitating transactions for their clients. However, Rule G-18 keeps a level of flexibility that accounts for marketplace uncertainty and allows dealers to design policies and procedures that fit their areas of business.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

Last Updated: December 7 2015

Article by Adam C. Parker and Dee P. Wisor

Butler Snow LLP

Copyright © 2024 Bond Case Briefs | bondcasebriefs.com