

SECURITIES AND EXCHANGE COMMISSION  
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September 2, 2014

Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Notice of Filing of a Proposed Rule Change Consisting of Rule G-18, on Best Execution of Transactions in Municipal Securities, and Amendments to Rule G-48, on Transactions with Sophisticated Municipal Market Professionals (“SMMP”), and Rule D-15, on the Definition of SMMP

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on August 20, 2014, the Municipal Securities Rulemaking Board (the “MSRB” or “Board”) filed with the Securities and Exchange Commission (the “SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the MSRB. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The MSRB is filing with the Commission a proposed rule change consisting of Rule G-18, on best execution of transactions in municipal securities, and amendments to Rule G-48,<sup>3</sup> on transactions with sophisticated municipal market professionals (“SMMPs”), and Rule D-15, on the definition of SMMP (the “proposed rule change”). The MSRB requests that the proposed rule change be approved with an implementation date one year after the Commission approval date.

The text of the proposed rule change is available on the MSRB’s website at [www.msrb.org/Rules-and-Interpretations/SEC-Filings/2014-Filings.aspx](http://www.msrb.org/Rules-and-Interpretations/SEC-Filings/2014-Filings.aspx), at the MSRB’s

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR § 240.19b-4.

<sup>3</sup> The MSRB recently received approval from the Commission to adopt new Rule G-48, which became effective July 5, 2014. See MSRB Notice 2014-07 (Mar. 12, 2014).

principal office, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the MSRB included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The MSRB has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The MSRB is charged by Congress to protect investors and foster a free and open municipal securities market. The MSRB, consistent with that charge, has advanced a number of initiatives to improve the transparency, efficiency and structure of the municipal securities market. In alignment with these efforts, the MSRB believes that the establishment of a requirement that dealers seek best execution of retail customer transactions in municipal securities will have benefits for investors, promote fair competition among dealers and improve market efficiency.

As generally understood, best-execution obligations and fair-pricing obligations are closely related but distinct. MSRB Rule G-30 (Prices and Commissions)<sup>4</sup> generally requires brokers, dealers and municipal securities dealers ("dealers") to trade with customers at fair and reasonable prices and to exercise diligence in establishing the market value of municipal

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<sup>4</sup> The MSRB recently received approval from the Commission to consolidate and codify former MSRB Rules G-18 and G-30 into a single pricing rule, Rule G-30, which changes became effective July 7, 2014. See MSRB Notice 2014-11 (May 12, 2014).

securities and the reasonableness of their compensation.<sup>5</sup> A best-execution standard generally requires broker-dealers to use reasonable diligence to ascertain the best market for the subject security and to buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. While Rule G-30 contains substantive pricing standards, under which dealers must (among other things) use reasonable diligence in determining a security's fair market value,<sup>6</sup> 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.<sup>7</sup>

In March 2012, the MSRB noted (in connection with a rulemaking initiative related to brokers' brokers) that, while its pricing rules require dealers to obtain prices for their customers that are fair and reasonable, those rules do not address all dealer conduct that would be regulated

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<sup>5</sup> Rule G-30(a), on principal transactions, provides: "No broker, dealer or municipal securities dealer shall purchase municipal securities for its own account from a customer, or sell municipal securities for its own account to a customer, except at an aggregate price (including any mark-up or mark-down) that is fair and reasonable." Rule G-30(b), on agency transactions, provides: "Each broker, dealer and municipal securities dealer, when executing a transaction in municipal securities for or on behalf of a customer as agent, shall make a reasonable effort to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions" and "No broker, dealer or municipal securities dealer shall purchase or sell municipal securities as agent for a customer for a commission or service charge in excess of a fair and reasonable amount."

<sup>6</sup> See MSRB Interpretive Notice, "Review of Dealer Pricing Responsibilities" (Jan. 26, 2004); MSRB Interpretive Notice, "Interpretive Notice on Commissions and Other Charges, Advertisements and Official Statements Relating to Municipal Fund Securities" (Dec. 19, 2001); MSRB Interpretive Notice, "Report on Pricing" (Sept. 1980). See also SEC Report on the Municipal Securities Markets at 149 and n.835 (Jul. 31, 2012) ("SEC Report"), available at <http://www.sec.gov/reportspubs/studies/munireport073112.pdf>.

<sup>7</sup> See SEC Report at 149.

by an explicit best-execution rule.<sup>8</sup> The MSRB stated at that time that it would consider this issue in connection with its ongoing review of its rules.<sup>9</sup>

Shortly thereafter, in July 2012, the Commission issued its Report on the Municipal Securities Market (the “SEC Report”).<sup>10</sup> The SEC Report contained a number of recommendations that the Commission concluded should be considered for improvement of the municipal securities market, including possible legislative reforms by Congress, possible steps to be taken by the Commission itself, possible voluntary initiatives by market participants and possible measures to be considered by the MSRB. Some of those measures were ways in which the MSRB could buttress existing pricing standards, including establishing a best-execution obligation and providing guidance to dealers on how best-execution concepts would be applied to municipal securities transactions.<sup>11</sup> The SEC Report focused to a large extent on the circumstances of retail investors in the municipal securities market and the possible measures that could benefit them, including the facilitation of “the best execution of retail customer orders.”<sup>12</sup>

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<sup>8</sup> See “Notice of Filing of Proposed Rule G-43, on Broker’s Brokers; Proposed Amendments to Rule G-8, on Books and Records, Rule G-9, on Record Retention, and Rule G-18, on Execution of Transactions; and a Proposed Interpretive Notice on the Duties of Dealers that Use the Services of Broker’s Brokers,” Exchange Act Release No. 66625, 77 FR 17548 (Mar. 26, 2012), File No. SR-MSRB-2012-04, at pp. 29-30 (Mar. 20, 2012), available at <http://www.sec.gov/rules/sro/msrb/2012/34-66625.pdf>.

<sup>9</sup> See id.

<sup>10</sup> See SEC Report.

<sup>11</sup> Id. at 149-50.

<sup>12</sup> Id. at ix; see generally id.

In April 2013, the Commission hosted a roundtable on fixed income markets, in which various market participants, academics and the MSRB participated.<sup>13</sup> The roundtable generated important and useful dialogue about the potential application of best-execution concepts to the municipal securities market.<sup>14</sup>

In August 2013, the MSRB published a Concept Proposal on best execution, requesting comment on whether and how a new MSRB rule should apply best-execution concepts to the municipal securities market.<sup>15</sup> The Concept Proposal specifically raised the issue of whether a best-execution requirement would effectively buttress existing MSRB fair-pricing obligations. In addition, the MSRB observed that, although the Financial Industry Regulatory Authority's ("FINRA") best-execution rule, FINRA Rule 5310 (Best Execution and Interpositioning), applies to non-municipal fixed income securities,<sup>16</sup> there are certain concepts and requirements in FINRA Rule 5310 that appeared to be more applicable to transactions in equity securities, particularly those that are a part of the electronically interconnected national market system.

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<sup>13</sup> Roundtable on Fixed Income Markets, Securities and Exchange Commission, April 16, 2013; <http://www.sec.gov/news/otherwebcasts/2013/fix-income-roundtable-041613.shtml>.

<sup>14</sup> See *id.* Tr. pp. 209-19.

<sup>15</sup> Request for Comment on Whether to Require Dealers to Adopt a "Best Execution" Standard for Municipal Securities Transactions, MSRB Notice 2013-16 (Aug. 6, 2013) (the "Concept Proposal").

<sup>16</sup> Under FINRA Rule 0150 (Application of Rules to Exempted Securities Except Municipal Securities), FINRA rules do not apply to transactions in, and business activities relating to, municipal securities. Accordingly, FINRA Rule 5310 on best execution does not apply to the municipal securities market.

Many commenters<sup>17</sup> supported the development of an explicit best-execution standard for the municipal securities market, and several major themes emerged from the comments. Commenters expressed a view that any best-execution rule should focus on the order-handling process. In addition, there was a general consensus against requiring a minimum number of quotations to support a determination of the prevailing market price, a general view regarding the importance of dealer inventories in providing liquidity, and a view that any best-execution rule should not favor any one execution venue over another.

The MSRB carefully considered all of the comments received in response to the publication of the Concept Proposal, and determined to publish a request for comment on a draft best-execution rule, including an exception for transactions with SMMPs.<sup>18</sup> The draft rule changes incorporated the feedback received on the Concept Proposal, as appropriate. The MSRB received ten comment letters, in response to the Request for Comment, on draft Rule G-18 and

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<sup>17</sup> The MSRB received eleven comment letters. Comments were received from Ambassador Financial Group: E-mail from Allen Collins dated August 8, 2013 (“Ambassador”); Barclays Capital Inc.: Letter from Jennifer Small, Municipal Compliance, dated October 7, 2013 (“Barclays”); Bond Dealers of America: Letter from Michael Nicholas, Chief Executive Officer, dated October 7, 2013 (“BDA”); Chris Melton: Letter dated September 26, 2013 (“Melton”); Financial Services Institute: Letter from David T. Bellaire, Executive Vice President and General Counsel, dated October 4, 2013 (“Financial Services Institute”); Interactive Data Corporation: Letter from Mark Hepsworth, President, dated October 7, 2013 (“IDC”); Investment Company Institute: Letter from Tamara K. Salmon, Senior Associate Counsel, dated September 20, 2013 (“ICI”); J.J.B. Hilliard, W.L. Lyons LLC: E-mail from Alex Rorke, Director, Public Finance, dated October 4, 2013 (“Hilliard”); Private Investor: E-mail from Private Investor dated September 2, 2013 (“Investor”); Securities Industry and Financial Markets Association: Letter from David L. Cohen, Managing Director and Associate General Counsel, dated October 7, 2013 (“SIFMA”); and Wells Fargo Advisors, LLC: Letter from Robert J. McCarthy, Director of Regulatory Policy, dated October 7, 2013 (“Wells Fargo”).

<sup>18</sup> See MSRB Notice 2014-02 (Feb. 19, 2014) (“Request for Comment”).

the draft amendments to Rule G-48.<sup>19</sup> After carefully considering all of the comments received in response to the Concept Proposal and the Request for Comment, the MSRB determined to file this proposed rule change to adopt an explicit best-execution rule for transactions in municipal securities.

The proposed rule change reflects the MSRB’s belief that a best-execution rule should be generally harmonized with FINRA Rule 5310 for purposes of regulatory efficiency but appropriately tailored to the characteristics of the municipal securities market. The MSRB also believes that, unlike FINRA Rule 5310, it is appropriate to provide an exception from the requirements of the best-execution rule for all transactions with SMMPs, which can only be institutional investors or individual investors with assets of at least \$50 million.<sup>20</sup> The proposed best-execution requirement generally would target the process by which dealers handle orders and execute transactions, and would complement and buttress the MSRB’s existing fair-pricing rules, as further described below under “Summary of the Proposed Rule Change” and under “Self-Regulatory Organization’s Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others.”

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<sup>19</sup> See infra n. 27.

<sup>20</sup> New MSRB Rule D-15, like the former relevant interpretive guidance under Rule G-17, defines the term “sophisticated municipal market professional” to potentially include a customer of a dealer that is a bank, savings and loan association, insurance company, or registered investment company; an investment adviser registered with the Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or any other entity or person with total assets of at least \$50 million. Rule D-15 became effective July 5, 2014. See MSRB Notice 2014-07 (Mar. 12, 2014).

The MSRB requests that the proposed rule change be approved with an implementation date one year after the Commission approval date.<sup>21</sup> This would allow dealers sufficient time to develop or modify their policies and procedures and to acquire or adjust the level of their resources as necessary. It also would allow time for the MSRB to create educational materials and conduct outreach to the dealer community, as appropriate, regarding the new rules.

#### Proposed Rule G-18

Proposed Rule G-18 generally would require dealers to use reasonable diligence in seeking to obtain for their customer transactions the most favorable terms available under prevailing market conditions. Under proposed Rule G-18, dealers would be required 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.

Proposed Rule G-18 includes rule language and supplementary material designed to tailor best-execution obligations to the characteristics of the municipal securities market and to provide guidance on how best-execution concepts apply to municipal securities transactions. This tailoring includes accommodations for: situations involving less availability of quotations and relevant pricing information, the role of broker's brokers in providing liquidity, the role of dealers' inventories in providing liquidity, the variance in the nature of dealers' municipal securities business, and the lack of standardized and publicly reported statistical data regarding the quality of executions of municipal securities transactions. Proposed Rule G-18 gives due consideration to the existing market structure and other current realities of the municipal

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<sup>21</sup> Specifically, the MSRB intends that the proposed rule change become effective for trades having a trade date and time on or after 12:01 a.m. on the first business day occurring one year after the Commission approval date.



securities market; however, it is designed to be sufficiently flexible to allow for the evolution of the market's structure and future developments in applied technology.

Paragraph (a) of proposed Rule G-18 is the core provision of the rule which would require dealers to use reasonable diligence to ascertain the best market for the subject security and to buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Paragraph (a) includes a non-exhaustive list of factors that a dealer must consider when exercising this diligence. The factors that must be considered are: 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.

Paragraph (a) includes a factor that is not listed in the FINRA rule – “information reviewed to determine the current market for the subject security or similar securities.” This factor helps guide the use of reasonable diligence when, for example, there are no available quotations for a security. Moreover, this factor takes into account that dealers may use information about similar securities and other reasonably relevant information.

Paragraph (b) of proposed Rule G-18 prohibits a dealer from interjecting a third party between itself and the best market for the security in a manner inconsistent with paragraph (a), a practice known as “interpositioning.” Historically, in non-municipal securities transactions, a dealer was required to demonstrate that the use of a third party reduced the costs of the transaction to the customer. Over time, however, that standard came to be seen as overbroad. Consequently, under the current FINRA rule, the use of a third party is allowed so long as it is

not detrimental to the customer.<sup>22</sup> Consistent with this current policy, and in light of the role of broker's brokers in the municipal securities market in providing liquidity, paragraph (b) would not prohibit the use of a broker's broker, unless it was inconsistent with the best-execution obligation in paragraph (a).

Also in light of the role of broker's brokers in the municipal securities market, proposed Rule G-18 does not include a provision like that in FINRA Rule 5310(b), which requires dealers to show why it was reasonable to use a broker's broker.<sup>23</sup> In this way, the proposed rule is consistent with the MSRB's objective, supported by commenters on the Concept Proposal, of developing a principles-based rule that does not favor any particular venue over another (on bases beyond the merits of the execution quality available at any venue). Moreover, broker's brokers in the municipal securities market must comply with MSRB Rule G-43 (Broker's Brokers), which serves to address investor-protection issues without additional requirements being imposed by proposed Rule G-18.

Paragraph (c) of proposed Rule G-18 specifies that the rule applies to both principal and agency transactions. It also specifies that best-execution obligations are distinct from certain pricing obligations of dealers under Rule G-30.

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<sup>22</sup> In approving provisions contained in the precursor to the current FINRA rule, the Commission noted that "the cost to the customer under the proposed rule will 'remain a crucial factor in determining whether a member has fulfilled its best execution obligations under [the rule],' including transactions involving interposed third parties." See Exchange Act Release No. 60635 (Sept. 8, 2009), 74 FR 47302 (Sept. 15, 2009) at 47303, File No. SR-FINRA-2007-024 (Nov. 27, 2007). The Commission also noted that interpositioning "that is unnecessary or violates a member's general best execution obligations – either because of unnecessary costs to the customer or improperly delayed executions – would still be prohibited." *Id.*

<sup>23</sup> FINRA Rule 5310(b) provides: "When a member cannot execute directly with a market but must employ a broker's broker or some other means in order to ensure an execution advantageous to the customer, the burden of showing the acceptable circumstances for doing so is on the member."

Paragraph .01 of the Supplementary Material indicates that Rule G-18 is not intended to be a substantive pricing standard but an order-handling standard for the execution of transactions. The paragraph explains that the principal purpose of proposed Rule G-18 is to promote dealers' use of reasonable diligence in obtaining the best price for customers under prevailing market conditions. This is generally accomplished through the requirements to use, and periodically improve, sound procedures. The paragraph expressly provides that, as characteristic of any reasonableness standard, a failure to have actually obtained the most favorable price possible will not necessarily mean that the dealer failed to use reasonable diligence under the circumstances. Note that existing Rule G-27, on supervision, would require written supervisory procedures reasonably designed to ensure compliance with the proposed best-execution rule, if adopted.

Paragraph .02 of the Supplementary Material provides, like FINRA Rule 5310(c), that a dealer's failure to maintain adequate resources (e.g., staff or technology) cannot justify executing away from the best available market. This paragraph, however, includes an acknowledgement that the level of adequate resources may differ based on the nature of a dealer's municipal securities business, including its level of sales and trading activity.

Paragraph .03 of the Supplementary Material provides that dealers must make every effort to execute customer transactions promptly, taking into account prevailing market conditions. In addition, this paragraph recognizes that in certain market conditions, a dealer may need more time to use reasonable diligence to ascertain the best market for the subject security.

Paragraph .04 of the Supplementary Material defines the term "market" for purposes of proposed Rule G-18, including the rule's core provision, section (a), requiring the exercise of reasonable diligence in ascertaining the "best market" for the security. The definition specifically

includes “alternative trading systems or platforms,” “broker’s brokers,” and “other counterparties, which may include the dealer itself as principal.” The purpose of this language is to tailor the definition of the critical term “market” to the characteristics of the municipal securities market and to provide flexibility for future developments in both market structure and applied technology. For example, the language expressly recognizes that the executing dealer itself, acting in a principal capacity, may be the best market for the security.<sup>24</sup> This tailoring is in recognition of the role of dealer inventories in providing liquidity in the municipal market.

Paragraph .05 of the Supplementary Material is intended to avoid the imposition of redundant or unnecessary obligations on a dealer involved in a transaction when another dealer appropriately bears best-execution obligations. The paragraph provides that a dealer’s duty to provide best execution to customer orders received from another dealer arises only when an order is routed from the other dealer to the dealer for handling and execution. The best-execution obligation does not apply to a dealer when another dealer is simply executing a customer transaction against that dealer’s quote.

Paragraph .06 of the Supplementary Material addresses transactions involving securities for which there is limited pricing information or quotations. It requires each dealer to have written policies and procedures that address how its best-execution determinations will be made for such securities, and to document its compliance with those policies and procedures. The paragraph states that a dealer generally should seek out other sources of pricing information and potential liquidity, including other dealers the dealer previously has traded within the security.

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<sup>24</sup> FINRA Rule 5310 also allows the dealer acting in a principal capacity to be the “best market,” but does not have express language to that effect. Paragraph .09 of the Supplementary Material of the FINRA rule, in discussing the requirements to review execution quality, contemplates a firm’s “internalization” of customer orders.

The paragraph also states that a dealer generally should analyze other relevant data to which it reasonably has access.

Paragraph .07 of the Supplementary Material would allow a customer to designate a particular market for the execution of the customer's transaction. The paragraph provides that, if a dealer receives an unsolicited instruction so designating a particular market, the dealer is not required to make a best-execution determination beyond the customer's specific instruction. A blanket customer instruction obtained through means like account-opening documents would not qualify as an "unsolicited" instruction. The paragraph also provides that, even in the case of a customer's specific instruction, dealers are still required to process the customer's transaction promptly and in accordance with the terms of the customer's bid or offer.

Paragraph .08 of the Supplementary Material specifies dealers' minimum obligations concerning the periodic review of their policies and procedures for ascertaining the best market. This paragraph is a departure from the FINRA rule's requirement that dealers engage in "regular and rigorous review" of execution quality, on at least a quarterly basis, assessing any material differences among markets based on a highly detailed list of factors. Dealers in municipal securities currently do not have access to data similar to that used by broker-dealers in other contexts and the MSRB has modified the proposed review requirement accordingly.

The proposed rule reflects the broad principle that a dealer's policies and procedures must be reasonably designed to achieve best execution. The MSRB believes that proposed Rule G-18 will result in improved dealer policies and procedures and allow for the future evolution of the market by requiring dealers' reviews to take account of: the quality of the executions the dealer is obtaining under its current policies and procedures, changes in market structure, new entrants, the availability of additional pre-trade and post-trade data and the availability of new

technologies. Proposed Rule G-18 would not require in all cases that dealers conduct reviews on at least a quarterly basis (as required by FINRA Rule 5310). It instead would require the frequency of reviews to be at least annual and reasonably related to the nature of the dealer's business, including its level of sales and trading activity. Under this standard, smaller dealers that handle customer transactions in municipal securities infrequently might not, depending on all of the facts and circumstances, be required to conduct reviews of their policies and procedures as frequently as dealers with a more active municipal securities business. Note that existing Rule G-27(f)(i), on supervisory controls, requires at least annual testing, verification and revision of all written supervisory procedures to determine whether they are reasonably designed to achieve compliance with applicable securities laws, including all other applicable MSRB rules.

Paragraph .09 of the Supplementary Material would exempt transactions in municipal fund securities, including interests in 529 college savings plans, from the application of proposed Rule G-18. Such securities are typically distributed through continuous primary offerings at calculated prices (based on the calculated net asset value of the investment portfolio on the day of the contribution), and the decision whether to purchase involves special tax and other considerations unique to such securities, making the application of proposed Rule G-18 inapt.

#### Proposed Amendments to Rule G-48

The proposed amendments to Rule G-48 would provide that the best-execution obligations under proposed Rule G-18 do not apply to transactions with customers that are SMMPs as defined in Rule D-15. Rule G-48 is the new consolidated MSRB rule under which all modified obligations of dealers when dealing with SMMPs are addressed. It provides for a reduced time-of-trade disclosure obligation under Rule G-47, a reduced suitability obligation under Rule G-19, reduced obligations with respect to the dissemination of quotations under Rule

G-13, and a reduced pricing obligation under Rule G-30. With respect to pricing, specifically, Rule G-48(b) relieves dealers of their obligation under Rule G-30 to ensure on a transaction-by-transaction basis that prices are fair and reasonable for non-recommended secondary market agency transactions where: the dealer's services are explicitly limited to providing anonymity, communication, order matching and/or clearance functions. The proposed amendments would add a new section (e) to Rule G-48 to provide that a dealer shall not have any obligations under Rule G-18 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 SMMP is as favorable as possible under prevailing market conditions.

#### Proposed Amendments to Rule D-15

Rule D-15 contains the MSRB's definition of an SMMP. The proposed amendments to Rule D-15 would help ensure that the exemption for dealer's from the best-execution obligation for transactions with SMMPs would only apply to appropriate customers. To qualify as an SMMP under existing Rule D-15, the customer must affirm that it is exercising independent judgment in evaluating the recommendations of the dealer. Under existing paragraph .02 of the Supplementary Material to Rule D-15, the affirmation may be given orally or in writing, and may be given on a transaction-by-transaction basis, a type-of-municipal security basis, or an account-wide basis. The affirmation requirement is significant because of the elimination under existing Rule G-48(c) of the dealer's obligation under Rule G-19 to make a customer-specific suitability determination for its recommendations when dealing with an SMMP. The proposed amendments to Rule D-15 would create additional elements for the required customer affirmation – one element related to best execution and, consistent with that addition, two elements related to two of the other modified obligations when dealing with an SMMP.

First, significant for the purposes of the elimination, under the proposed new section (e) in Rule G-48, of a best-execution obligation for transactions with SMMPs, the customer would be required to affirm that it is exercising independent judgment in evaluating the quality of execution of the customer's transactions by the dealer.

Second, significant for the elimination, under existing Rule G-48(b), of the dealer obligation to ensure on a transaction-by-transaction basis that prices are fair and reasonable in a specified subset of transactions with SMMPs, the customer would be required to affirm that it is exercising independent judgment in evaluating the transaction price in that subset of transactions. The specified transactions are non-recommended agency secondary market transactions where the dealer's services are 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.

Third, significant for the elimination, under existing Rule G-48(a), of the dealer obligation to make time-of-trade disclosure under Rule G-47 of all material information about the security available publicly from established industry sources, the customer would be required to affirm that it has timely access to "material information" available publicly from "established industry sources" as those terms are defined in Rule G-47(b)(i) and (ii).

Consistent with these changes, paragraph .02 of the Supplementary Material to Rule D-15 would be revised to provide that the customer affirmation may be made on, in addition to the existing bases, a type-of-transaction basis. The ability to make the affirmation on such a basis would become relevant due to the creation of an exemption from the proposed best-execution rule for transactions with SMMPs. The proposed amendments to Rule D-15 also include non-



substantive (e.g., technical, conforming and organizational) revisions to accommodate the above substantive changes and improve the readability of the rule.

Importantly, the definition of SMMP under the proposed revisions to the rule (as under the existing rule) is not self-executing, nor are the contingencies for its application in the unilateral control of the interfacing dealer. Rather, classification as an SMMP would require a particular affirmation by the SMMP.<sup>25</sup> Consequently, any customer that preferred to have its transactions be subject to the best-execution regulatory framework, even if the customer otherwise would qualify as an SMMP, could simply not make the requisite affirmation and not bring itself within the definition of an SMMP. The same would be true for a customer that preferred to have the dealer be subject to any of the other obligations that would otherwise be modified under Rule G-48. Due to the proposed implementation date of the proposed rule change, a dealer could not treat any customer as an SMMP after the proposed best-execution rule is implemented unless the dealer reasonably determined (as required by Rule G-48) that the customer had given the broader affirmation required under the proposed amendments to Rule D-15.

## 2. Statutory Basis

The MSRB believes that the proposed rule change is consistent with Section 15B(b)(2)(C) of the Act,<sup>26</sup> which provides that the MSRB's rules shall:

be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities and municipal financial products, to remove impediments to and perfect the mechanism of a free and open market in municipal securities and municipal financial products, and, in

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<sup>25</sup> See MSRB Rule D-15.

<sup>26</sup> 15 U.S.C. 78o-4(b)(2)(C).

general, to protect investors, municipal entities, obligated persons, and the public interest.

The MSRB believes that the establishment of a requirement that dealers seek best execution of customer transactions in municipal securities will have benefits for investors, promote fair competition among dealers and improve market efficiency.

The MSRB believes that proposed Rule G-18 will protect investors, particularly retail investors, in many ways. The proposed rule would require dealers to use reasonable diligence in seeking to obtain for their customer transactions the most favorable terms available. Specifically, under proposed Rule G-18, dealers would be required to use reasonable diligence to ascertain the best market for the subject security and buy and sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. This would be accomplished through the proposed rule's general requirements of the use of, and periodic improvement of, sound procedures for the handling of orders and execution of transactions. Whether a dealer would be viewed as having used reasonable diligence would depend in part upon a non-exhaustive list of relevant factors. The MSRB believes that these new order-handling obligations will buttress and complement the MSRB's substantive pricing standards and foster compliance with those standards, helping to ensure that investors receive fair and reasonable prices and to improve execution quality for investors in municipal securities.

The proposed rule would also make it a violation for a dealer to interject a third party between itself and the best market for the security but would allow the use of a third party so long as it is not inconsistent with the proposed best-execution obligations. The proposed rule would allow for a dealer to use a broker's broker while retaining sufficient protections for investors because broker's brokers, and dealers who use broker's brokers, are required to comply with the substantial investor-protection provisions of Rule G-43. Proposed Rule G-18 would

provide that dealers must make every effort to execute customer transactions promptly, taking into account prevailing market conditions. Finally, the proposed rule would allow a customer to specifically designate a particular market for the execution of a transaction, and such an instruction would relieve the dealer from making a best-execution determination beyond the customer's unsolicited specific instruction. In addition, the MSRB believes that the proposed amendments to Rule D-15 will protect investors by helping to ensure that the exemption for dealers from the best-execution obligation for transactions with SMMPs (as well as the reduced dealer obligations related to time-of-trade disclosure and pricing) will only apply to transactions with sufficiently sophisticated customers.

The MSRB believes that proposed Rule G-18 will promote fair competition among dealers and improve market efficiency. It would provide that a dealer's duty to provide best execution to customer orders received from another dealer arises only when an order is routed from the other dealer to the dealer for handling and execution. The best-execution obligation would not apply to a dealer when another dealer is simply executing a customer transaction against that dealer's quote. In the case of transactions involving securities for which there is limited pricing information or quotations, the rule would provide that a dealer generally should seek out other sources of pricing information and potential liquidity, including other dealers the dealer previously has traded within the security. The number-of-markets-checked factor of the proposed rule would promote dealers' exposure of quotations to fair competition among dealers (including broker's brokers), alternative trading systems and platforms and any other venues that may emerge. Because the proposed rule does not favor any particular venue over another, the MSRB believes it will support a free and open market in municipal securities. Also, the proposed rule's definition of "market" would be sufficiently flexible to accommodate future developments

in market structure and technology. In addition, because the definition of “market” in the proposed rule would expressly recognize that the executing dealer itself acting as principal may be the best market for the security, a dealer’s inventory could be utilized for sales of municipal securities to that dealer’s customers, in recognition of the role of dealer inventories in providing needed liquidity to investors in the municipal market.

The MSRB believes that the proposed amendments to Rule G-48 and Rule D-15 to effectuate the exemption for transactions with SMMPs will facilitate transactions in municipal securities and help perfect the mechanism of a free and open market in municipal securities by avoiding the imposition of regulatory burdens where they appear not to be needed. The MSRB currently understands that SMMPs typically have as much (and in some cases more) information regarding the different venues at which a transaction in a municipal security might be executed as most individual dealers.

B. Self-Regulatory Organization’s Statement on Burden on Competition

Section 15B(b)(2)(C) of the Act requires that MSRB rules not be designed to impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. In determining whether this standard has been met, the MSRB has been guided by the Board’s recently-adopted policy to more formally integrate economic analysis into the rulemaking process. The Board has evaluated the potential impacts of the proposed rule change, including in comparison with alternative regulatory approaches.

The MSRB does not believe that the proposed rule change would impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. The MSRB has considered whether it is possible that the added costs associated with the compliance and supervisory requirements of the proposed rule change may lead some dealers of municipal

securities to consolidate with other dealers. For example, some dealers may choose to consolidate with other dealers in order to benefit from economies of scale (e.g., by leveraging existing compliance resources of a larger firm) rather than to incur separately the costs associated with the proposed rule change. Based in part on public comments received, it appears that the costs associated with the proposed rule change are unlikely to be of such a magnitude as to significantly affect consolidation decisions on a broad market basis. Moreover, many smaller firms may rely on other dealers to handle execution of their customers' orders and may leverage upon the practices and periodic reviews of the executing broker as a means to help ensure that the firm is meeting its best-execution obligations.

The MSRB also considered whether the proposed rule change would affect the dimensions, or attributes, upon which market participants compete. A rule that focuses on a single execution attribute, such as a price, could diminish competition for other execution attributes that might be valued by investors, such as speed of execution. In addition, to the extent dealers might consider the difficulty of fulfilling their best-execution obligations to be greater with respect to some securities, such as those that are less widely traded, the Board considered whether the proposed rule change could have an effect on the relative marketability of such securities. Based in part on public comments received, the Board does not believe that any such effect will result in a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

The MSRB solicited and received comment on several potential burdens of the proposed rule change in the Concept Proposal and in the request for comment on the proposed rules. The MSRB also solicited comment on the potential burdens of the proposed rule change in the most

recent request for comment.<sup>27</sup> The specific comments and responses thereto are discussed in Part 5 below.

The MSRB believes that the proposed rule change will not impose an undue burden on smaller dealers. Proposed Rule G-18 would provide that a failure to maintain adequate resources (e.g., staff or technology) cannot justify executing away from the best available market; however, because Paragraph .02 of the Supplementary Material contains an acknowledgment that dealers differ in the nature of their municipal securities business, including their level of sales and trading activity, the proposed rule change does not impose one standard for “adequate resources” on all dealers. The proposed rule would not require a dealer to purchase evaluated pricing or other market and reference data but rather generally provides that a dealer engaged in transactions involving securities for which there is limited pricing information or quotations, should analyze data to which it reasonably has access. The proposed rule would not require in all cases that dealers conduct reviews of their policies and procedures on a specified interval. It instead would require the frequency of reviews to be reasonably related to the nature of the dealer’s municipal securities business, including its level of sales and trading activity. Under this standard, smaller dealers that handle customer transactions in municipal securities infrequently may not, depending on all of the facts and circumstances, be required to conduct reviews of their policies and procedures as frequently as dealers with a more active municipal securities business.

C. Self-Regulatory Organization’s Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The MSRB received ten comment letters in response to the Request for Comment.<sup>28</sup> The comment letters are summarized below by topic.

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<sup>27</sup> See MSRB Notice 2014-02 (Feb. 19, 2014) (“Request for Comment”).

## Support for the Proposal

Most commenters supported to some degree the initiative to establish an explicit best-execution rule for the municipal securities market. NYC stated that requiring dealers to use reasonable diligence in seeking to obtain for customers the most favorable terms available under prevailing market conditions would foster a more open, transparent, even-handed market environment for individual investors. IDC supported the objective of the rule proposal to safeguard investor interests while promoting competition among dealers and improving market efficiency. NYSE supported the proposal on the grounds that it would help create a more transparent and fair market for all investors, particularly retail investors.

Several other commenters expressed support for specific provisions of the proposed rule change. SIFMA and Wells Fargo supported the execution handling aspects of draft Rule G-18. RBI supported the provision of draft Rule G-18 that would not prohibit the use of a broker's broker unless it proves detrimental to the customer. In general, SIFMA and Wells Fargo supported draft Rule G-18's approach to the review of execution quality because it does not mirror the type of regular and rigorous review requirements in FINRA Rule 5310. NYC

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<sup>28</sup> Comments were received from Bond Dealers of America: Letter from Michael Nicholas, Chief Executive Officer, dated March 21, 2014 ("BDA"); City of New York, Office of the Comptroller: Letter from Scott M. Stringer, New York City Comptroller, dated March 21, 2014 ("NYC"); Coastal Securities: Letter from Chris Melton, Executive Vice President, dated March 21, 2014 ("Coastal"); Interactive Data Corporation: Letter from Andrew Hausman, President, dated March 21, 2014 ("IDC"); National Association of Independent Public Finance Advisors: Letter from Jeanine Rodgers Caruso, President, dated March 21, 2014 ("NAIPFA"); NYSE Euronext: Letter from Martha Redding, Chief Counsel, dated March 31, 2014 ("NYSE"); Regional Brokers, Inc.: Letter from H. Deane Armstrong, CCO, dated March 14, 2014 ("RBI"); Securities Industry and Financial Markets Association: Letter from David L. Cohen, Managing Director and Associate General Counsel, dated March 13, 2014 ("SIFMA"); Wells Fargo Advisors, LLC: Letter from Robert J. McCarthy, Director of Regulatory Policy, dated April 2, 2014 ("Wells Fargo"); and Wulff, Hansen & Co.: Letter from Chris Charles, President, dated March 21, 2014 ("Wulff").

commended the MSRB for introducing policy and procedure guidelines into draft Rule G-18 that would require dealers to address how best execution determinations would be made for securities with limited pricing information or quotations and stated that the rule should maintain elements of flexibility in its policies and procedures in order to reduce compliance costs and allow continued diversity of dealer characteristics. IDC stated that draft Rule G-18(a)(4) represents an important factor for determining whether a dealer has used reasonable diligence to ascertain the best market for the subject security and also stated that paragraph .06 of the Supplementary Material is valuable and in particular supported the MSRB's view that dealers should seek out other sources of pricing information and analyze other data to which they reasonably have access in making best-execution determinations. BDA and SIFMA supported the proposed amendment to Rule G-48 that would create an exception to the best-execution obligations for transactions with SMMPs.

#### The Relationship Between Best-Execution and the MSRB's Pricing Standards

NAIPFA stated that draft Rule G-18 creates a new pricing standard because dealers must strive to obtain the best price possible whereas existing Rules G-18 and G-30<sup>29</sup> establish pricing floors, *i.e.*, the prices must be at least fair and reasonable. NAIPFA stated its belief that dealers wishing to avoid violations of MSRB rules must either (a) obtain the most favorable price or (b) in the event that the most favorable price is not obtained, show that reasonable diligence was utilized in attempting to obtain the most favorable price and that the price ultimately obtained was nevertheless fair and reasonable.

Wells Fargo stated that the existing fair-pricing standards were better situated to municipal market conditions than a best-execution requirement based upon FINRA's equity-

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<sup>29</sup> See Request for Comment at nn.4-6.



oriented best-execution rule. Wulff stated that the concept of “best execution” as applied to more liquid markets in which individual securities are widely known and trade frequently is an inappropriate standard for the municipal market as there is simply not enough price information available for a traditional best execution standard to be workable. SIFMA requested that the MSRB provide guidance on the interplay between draft Rule G-18 and current pricing rules, in light of the consolidation of years of fair-pricing guidance into Rule G-30, specifically the applicability of interpretive guidance entitled “Relevant Factors in Determining the Fairness and Reasonableness of Prices.”

NAIPFA stated that, if the best-execution obligations apply within the context of a new offering of securities, this will create an inconsistency in terms of a dealer’s obligations to issuers and investors under the interpretive guidance adopted by the MSRB in 2012<sup>30</sup> because the G-17 Underwriters’ Notice provides, among other things, that the underwriter has a duty to purchase securities from the issuer at a fair and reasonable price. NAIPFA recommended that the MSRB either limit the application of a best-execution rule to secondary market transactions or, in the alternative, ensure that Rule G-17 does not conflict with the new rule. NAIPFA further suggested that the term “customer” is not defined in draft Rule G-18 and therefore an issuer of municipal securities could arguably be considered a customer for purposes of the rule proposal.

RBI stated that the municipal market is a negotiated, subjective market where prices of bonds are developed based on many factors, including supply and demand, interest rate fluctuations, creditworthiness of any issue and the cost of carry. Traders make assumptions about these and other factors as they decide what price they should pay for a bond in order to be able to sell it at a profit. Unlike the stock market, traders in the municipal market must often be willing

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<sup>30</sup> See MSRB Notice 2012-25 (May 7, 2012) (“G-17 Underwriters’ Notice”).

to take bonds into their inventories and carry them for days or weeks. The fact that assumptions play a role in the pricing of municipal bonds means, inherently, that there can be no exact price at which a bond should trade on any given day. RBI was concerned that an attempt to hold traders to a strict “best execution” rule would have a chilling effect on the willingness of some traders to place bids in a market that already faces liquidity problems. RBI stated that traders will be even more leery of exposing themselves to regulatory scrutiny with a fear that regulators might argue that there is only one exact price that should be paid for a bond. RBI asked the question, “which prices on EMMA are correct?”

BDA stated that where dealers effect their trades in the municipal securities market has much less to do with what pricing a customer receives than the proper diligence of a dealer in ensuring that customers receive a fair and reasonable price. MSRB’s fair-pricing and suitability rules, combined with current improvements and future strides in the transparency of the municipal securities market, such as: the availability of alternative trading systems; an enhanced, public electronic database through EMMA; and, possibly, the creation of an index for retail customers, may improve pricing. NYC noted that its own ability as an issuer to increase transparency in the secondary market for municipal securities is limited. Municipal securities are not traded on an exchange; therefore, firm bid and ask quotations are generally unavailable and individual investors in particular have limited access to information regarding which market participants would be interested in buying or selling municipal securities, and at what prices. NYSE also noted that the fragmented view of dealer inventory and limited distribution of “bids wanted” price information contribute to opacity and stated its belief that the creation of a consolidated feed of these data would be an extremely powerful information tool for customers engaging in municipal securities transactions because it would increase market transparency,

facilitate retail investors' ability to make informed investment decisions, enhance a broker's best execution process, and improve regulator's surveillance of the market. NYSE suggested that for investors to fully realize the benefits of a best-execution rule, the MSRB should propose a rule that will advance the efforts of pre-trade transparency.

Coastal asked what dealer conduct that is not currently regulated would be regulated by an explicit best-execution rule.

As the MSRB explained in the Request for Comment, the proposed best-execution rule is an order-handling and transaction-execution standard, under which the goal of the dealer's reasonable diligence is to provide the customer the most favorable price possible under prevailing market conditions. Although fair-pricing and best-execution standards are closely related, they are "distinct."

The best-execution requirement generally would target the process by which dealers handle orders and execute transactions, which is not directly addressed in the MSRB's fair-pricing rules. And, unlike the fair-pricing rules, the proposed rule does not contain any substantive pricing standard. Paragraph .01 of the Supplementary Material makes clear that the rule is not intended to be a substantive pricing standard but an order-handling standard for the execution of transactions. Paragraph .01 explains that the principal purpose of the rule is to promote dealers' use of reasonable diligence in ascertaining the best market for the subject security and obtaining the most favorable price possible under prevailing market conditions. This is accomplished through the rule's general requirements of the use, and periodic improvement, of sound procedures. Moreover, this paragraph expressly provides that, as characteristic of any reasonableness standard, a failure to have actually obtained the most favorable price possible will not necessarily mean that the dealer failed to use reasonable diligence under the circumstances.

A requirement to use reasonable diligence in the order-handling and transaction execution process likely would increase the probability that customers receive fair and reasonable prices, but the proposed rule does not itself contain any standard by which the actual transaction price is to be (or could be) evaluated. The MSRB therefore does not believe that additional guidance related to any interplay between fair pricing and proposed Rule G-18 is needed at this time.

NAIPFA's comment regarding an inconsistency with the G-17 Underwriters' Notice appears to be premised on a misunderstanding of the proposed rule. As explained above, proposed Rule G-18 would not change the substantive pricing standard of fair-and-reasonable. An underwriter would continue to owe an obligation to issuers to purchase newly issued bonds at a price that is fair and reasonable, and must balance that obligation with an obligation to customers to sell them bonds at a price that is fair and reasonable. NAIPFA reads the rule as requiring underwriters to "attempt to sell municipal securities to investors at prices that are the most favorable to such investors." The rule, however, contains no such open-ended requirement and is much more targeted and limited. It would require dealers to use reasonable diligence in the handling and execution of customer orders, and that order-handling obligation would not impact an underwriter's role in the pricing of a new issuance of municipal securities.

The text of proposed Rule G-18 does not include a definition of "customer" because the term "customer" is defined in Rule D-9 (unless specifically provided otherwise) for purposes of all MSRB rules. NAIPFA's concern regarding an issuer being treated as a customer under the proposed rule is fully addressed by the definition in Rule D-9 because it excludes an issuer in transactions involving the sale by the issuer of a new issue of its securities.<sup>31</sup> In short, proposed

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<sup>31</sup> Rule D-9 provides: except as otherwise specifically provided by rule of the Board, the term "customer" shall mean any person other than a broker, dealer, or municipal

Rule G-18, as written, does not apply to a sale of municipal securities by an issuer in a new issue of its municipal securities.

The MSRB believes that a best-execution standard carefully tailored to the municipal securities market, coupled with the MSRB's fair-pricing rules, will help to ensure that retail customers receive fair pricing. In addition to this rulemaking initiative, the MSRB has advanced many initiatives to improve transparency, efficiency and other structural aspects of the market<sup>32</sup> as a part of its efforts to protect investors and foster a "free and open" municipal securities market.<sup>33</sup> The MSRB is committed to continuing its efforts to engage with the industry to assist it in the development of transparency systems to improve both pre-trade and post-trade transparency.

#### Consistency with the FINRA Rule's Treatment of Securities with Limited Quotations

BDA stated that there is a significant difference in draft Rule G-18's treatment of securities with limited quotations when compared to FINRA Rule 5310 because draft Rule G-18 does not include the provisions of FINRA's Supplementary Material paragraph .03. As a result, BDA stated that draft Rule G-18 does not provide supplementary material that is necessary to explain how dealers are to comply with a transaction-by-transaction best-execution rule in a

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securities dealer acting in its capacity as such or an issuer in transactions involving the sale by the issuer of a new issue of its securities (emphases added).

<sup>32</sup> See MSRB Long-Range Plan for Market Transparency Products (Jan. 27, 2012), available at <http://www.msrb.org/msrb1/pdfs/Long-Range-Plan.pdf>. The MSRB has requested comment and is analyzing information from market participants on potential improvements to the timeliness, fairness and efficiency of price transparency in the municipal market. See Concept Release on Pre-Trade and Post-Trade Pricing Data Dissemination through a New Central Transparency Platform, MSRB Notice 2013-14 (Jul. 31, 2013); Request for Comment on More Contemporaneous Trade Price Information Through a New Central Transparency Platform, MSRB Notice 2013-02 (Jan. 17, 2013). See also SEC Report at pp. 117, 141 (noting transparency initiatives).

<sup>33</sup> Securities and Exchange Act of 1934 Section 15B(b)(2)(C), 15 U.S.C.78o-4(b)(2)(C).

municipal securities market that is not quoted on a centralized exchange. BDA noted that, unlike paragraph .03 of the Supplementary Material of the FINRA rule, draft Rule G-18 does not remind a dealer that, in the absence of accessibility of quotations, dealers are not relieved from taking reasonable steps and employing their market expertise in achieving best execution of customer orders.

FINRA Rule 5310 applies to other types of securities in addition to debt securities. Accordingly, paragraph .03 of the Supplementary Material of the FINRA rule specifically addresses firms' best-execution obligations for transactions in debt securities. Proposed Rule G-18, by contrast, has been developed solely for transactions in a particular class of debt securities – municipal securities. It includes rule language and supplementary material to tailor the best-execution obligations to the characteristics of the municipal securities market and provide guidance on how best-execution concepts apply to municipal securities transactions. As explained in the Request for Comment and above, this tailoring includes accommodations for the frequent unavailability of quotations and pricing information, the relative illiquidity of the market generally, the role of broker's brokers in providing liquidity, the role of dealers' inventories in providing liquidity, the variance in the nature of dealer's municipal securities business, and the lack of retrospective statistical data regarding the quality of execution.

The MSRB believes that proposed Rule G-18 generally and paragraph .06 of the Supplementary Material specifically strike an appropriate balance between a principles-based approach and providing more prescriptive guidance to dealers in cases where there are limited quotations or pricing information. The proposed rule would allow a dealer to determine how it will use reasonable diligence, and paragraph .06 requires written policies and procedures that address how the dealer will make its best-execution determinations in case of limited quotations

or pricing information. In any event, the FINRA rule, with which the MSRB has endeavored to harmonize (as appropriate), does not contain further prescriptions than proposed Rule G-18 in this area. Paragraph .03 of the Supplementary Material of the FINRA rule simply reiterates to FINRA member firms that in the case of limited quotations, firms are not relieved from taking reasonable steps to achieve best execution of customer orders. The MSRB does not believe that including such language would materially add to proposed Rule G-18, which already contains the core requirement that dealers use reasonable diligence and is tailored to the characteristics of the municipal securities market.

#### Define or Clarify Certain Terms

IDC and BDA stated that dealers would benefit from a definition of “similar securities” as used in proposed Rule G-18(a)(4). IDC stated that this new factor is notable and distinguishable from FINRA Rule 5310. BDA stated that the term is not clear, could be misunderstood in examinations and noted that given the wide array of factors that could be weighed to determine what constitutes a “similar” security such as geographical region, credit type and quality, terms and conditions and maturity, the MSRB should include a definition in the rule that should incorporate, as an overriding factor, the judgment of the dealer in determining the factors that are most relevant in determining whether a given security is similar.

IDC recommended that the MSRB provide dealers with additional clarity regarding the use of evaluated pricing in support of best execution compliance and specifically include in the rule a non-exhaustive list of examples of acceptable sources of pricing information or other data which might include recent trade activity, evaluated pricing and related, relevant market, assumptive and reference data. IDC stated that ambiguous interpretations of rules create higher compliance costs and other operational complexity.

SIFMA recommended that the MSRB provide additional information and guidance related to compliance issues and specifically how a dealer should demonstrate best execution “reasonable diligence” compliance versus current fair-dealing compliance. Wells Fargo stated that the MSRB needs to elaborate on the steps needed to evidence how reasonable diligence can be demonstrated. Several questions were posed by Wells Fargo to illustrate the point. What does it mean to have “limited pricing information or quotations?” What constitutes “adequate resources” and how does a firm establish that it has the appropriate level of resources? What are the acceptable “other sources” of pricing information? Wells Fargo also requested that the MSRB delineate how diligence obligations may differ when effecting customer purchases versus customer sales of municipal securities and additional guidance to illustrate how dealers can identify trades that require more time to show reasonable diligence. RBI requested guidance as to how to demonstrate compliance given that the MSRB doesn’t provide a guideline for dealers to use to support the basis for determining the “correct or proper” price given the issues with using prices reported to the Electronic Municipal Market Access (“EMMA”®) system. BDA requested guidance relating to sales out of, or into, dealer inventory.

The MSRB believes that proposed Rule G-18 strikes an appropriate balance between a principles-based approach and providing greater prescriptions. Proposed Rule G-18 embodies the broad principle that dealers must use reasonable diligence in executing customer transactions. It is designed to allow flexibility for each dealer to adapt its policies and procedures to be reasonably related to the nature of its business, including its level of sales and trading activity and the type of customer transactions at issue. The reasonable diligence standard is sufficiently flexible to be met by a diverse population of dealers and allows a dealer to evidence that it has been sufficiently diligent in a manner that may be different from that used by another dealer.



Notably, some commenters contend that the guidance regarding similar securities and other information that is included should not be included in the rule (e.g., Coastal), whereas others contend that more guidance should be provided (e.g., BDA, IDC).

The proposed rule change, therefore, does not include a definition of “similar securities,” provide examples of acceptable sources of pricing information or data, or further elaborate on how dealers would evidence reasonable diligence. Doing so could negate the benefits of a principles-based rulemaking approach. While the MSRB understands the desire on the part of dealers for concrete steps to follow for their particular business model, such a prescriptive rule might undermine the flexibility the rule is designed to provide. The MSRB may, however, consider providing additional guidance on this and other matters related to the proposed rule at a future date. Finally, the proposed rule also does not define “prevailing market conditions.” This phrase is used in the MSRB’s fair-pricing rules and guidance, and is used in FINRA Rule 5310 without elaboration.

#### Number of Markets Checked

SIFMA and Wulff objected to the suggestion that the act of contacting other dealers would be the implicit or requisite procedure to evidence best execution because making an inquiry could move the market away from the customer.

In proposed Rule G-18, the reasonable diligence factor on the number of markets checked is only one factor in a non-exhaustive list of factors to be considered, “with no single factor being determinative.” Depending on the particular facts and circumstances, it could be consistent with the reasonable-diligence standard for a dealer not to contact other dealers. It, however, would be important, given the proposed rule’s emphasis on complying with sound procedures, for a dealer to have written procedures in place that address the subjects of when and on what

basis it would not contact other dealers. The MSRB believes, for these reasons, that this factor should not be deleted from the non-exhaustive list. Its inclusion does not compel a dealer to contact other dealers in cases where the executing dealer has reasonably concluded that such activity would be detrimental to the customer, or otherwise would not be part of “reasonable diligence” to ascertain the best market.

#### Information Reviewed to Determine Current Market for Similar Securities

Coastal stated that the MSRB has unnecessarily increased the obligations of a dealer beyond that required of a dealer in corporate securities by requiring a dealer to utilize the market of an undefined “similar security” to determine the market price of the subject security.

In proposed Rule G-18, the reasonable-diligence factor on the information reviewed to determine the current market for the subject security or similar securities was included to tailor the rule to the municipal securities market. This factor helps guide the use of reasonable diligence when, for example, there are no available quotations for a security. It also takes into account that dealers may use information about similar securities and other reasonably relevant information.

#### Best-Execution Standard

NYSE suggested that the rule provide that a dealer has not satisfied its best-execution obligation if it ignores a superior price available on another “market” (as defined in the rule) that offers fair access, transparent pricing and firm electronic quotes.

The suggested change would go beyond a best-execution standard and create, in effect, a trade-through rule. Proposed Rule G-18 embodies a broad and flexible principles-based standard, using a non-exhaustive list of relevant factors with no single factor being determinative. The suggested change would instead focus on a short, exhaustive list of factors and make them

determinative. Under the broad standard in the proposed rule, the existence of such a market, assuming under all of the circumstances that it is one about which a dealer reasonably should know, would inform a dealer's development of its procedures and periodic review of them under Paragraph .08 of the Supplementary Material. A failure to consider such a market, however, would not necessarily constitute violation of the proposed rule.

### Economic Analysis

SIFMA recommended that the MSRB should separately issue a request for data and other information, in particular quantitative data, relating to the benefits and costs that could result from the various alternative approaches regarding the standards of conduct and other obligations relating to the rule proposal. SIFMA specifically suggested that data be requested for the costs of developing and maintaining a comprehensive compliance and supervisory system, the costs of developing procedures and training programs to implement the new standard, as well the costs for updates when regulatory guidance is updated, or legal precedent and/or firm practices change. In addition, SIFMA asked that data be requested for the cost components for developing, preparing, and maintaining a comprehensive compliance and supervisory system including outside legal costs, outside compliance consultant costs, other out-of-pocket costs, and employee or staff related costs. SIFMA offered to work with the MSRB to obtain reliable empirical data and stated that such data cannot be obtained in the tight timeframe of a request for comment deadline.

In addition, SIFMA stated that the proper baseline for comparing and evaluating the costs and benefits of the proposal are the current Rule G-18 (as of the date of SIFMA's letter) as well as the "execution with diligence" proposal that SIFMA suggested as a reasonable alternative.

The Request for Comment incorporated the MSRB's preliminary economic analysis of the proposed rule change and specifically invited comment on the likely economic consequences of the adoption of the rule changes.<sup>34</sup> The Request for Comment further invited commenters to provide statistical, empirical, and other data that may support commenter views and/or support or refute the views and assumptions in the Request for Comment.<sup>35</sup> Given those requests, the MSRB expected that interested persons would submit any empirical data they wished to submit as part of the official rulemaking process. Although the comment period for the MSRB's Request for Comment has closed, the MSRB welcomes SIFMA's offer to provide the MSRB reliable empirical data. The MSRB believes that such data, whenever it is available, can be useful for considering whether additional modifications to any proposed rule or any adopted rule are warranted. With respect to the proposed rule change currently under consideration, the MSRB notes that SIFMA proposed a highly similar order-handling rule and it has not been shown that the costs of proposed Rule G-18 would be significantly greater than the costs of SIFMA's proposal.

With respect to the proper baseline, the MSRB regards the current consolidated Rule G-30 (which now contains the substance of the former Rule G-18) as one relevant baseline to compare and evaluate the costs and benefits of the proposal, as noted in its preliminary economic analysis. In addition, the MSRB has considered SIFMA's reasonable diligence proposal as a

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<sup>34</sup> On September 26, 2013, the MSRB publicly announced its adoption of a policy to more formally integrate the use of economic analysis in MSRB rulemaking. By its terms, the policy does not apply to rulemaking initiatives, like this initiative, that were initially presented to the MSRB Board of Directors before September 26, 2013. The MSRB has, however, historically taken account of the likely costs and burdens of its rulemaking initiatives, including those associated with the proposed rule change.

<sup>35</sup> The Concept Proposal, published August 6, 2013, also specifically invited commenters to provide statistical, empirical, and other data that may support commenter views and assumptions.

reasonable alternative to the proposed rule and the proposed rule captures many elements of the SIFMA proposal. As noted, it has not been shown that the costs of proposed Rule G-18 would be significantly greater than the costs of SIFMA's proposal.

#### Compliance Burden on Small Dealers

NYC requested that the MSRB consider the potential burden additional compliance could place on small dealers in particular and stated that regulations are often criticized for taking a costly one-size-fits-all approach. NYC suggested that draft Rule G-18 should maintain elements of flexibility in its policies and procedures in order to reduce compliance costs and allow continued diversity of dealer characteristics.

The MSRB agrees that flexibility and responsiveness to the diversity of dealer characteristics is important to retain in the proposed rule. For example, the requirements regarding the level of adequate resources and the frequency of reviews of the dealer's policies and procedures provide for consideration of the nature of the dealer's municipal securities business, including its level of sales and trading activity.

#### Costs of Compliance

IDC, a financial information provider, stated that compliance with the proposed rule may result in higher costs and other operational complexities related to ambiguous interpretations of the rule. IDC stated that by specifying that evaluated pricing can help inform best execution assessments, dealers would be better positioned to determine the potential scope and cost of any changes to their existing compliance workflows.

The MSRB continues to believe that the flexible and principles-based approach followed in proposed Rule G-18 has advantages and permits a dealer (rather than the MSRB) to use its judgment, so long as it is reasonable, to determine whether its policies and procedures will

include the use of a high quality evaluated pricing tool as its source of pricing information. This allows each dealer to make a determination, so long as it is reasonable, whether the cost of evaluated pricing services should be borne by it or whether there are any less costly alternatives that would better serve its purposes.

#### Dealer Sales of Securities Out of Inventory

Coastal stated that a major flaw in the proposal is that the rule does not address a situation where a dealer is offering a unique security out of inventory. Coastal believed that a significant challenge is presented when no other dealers are willing to make a bona fide offering to sell a municipal security with the full realization that they would be creating a potentially unfillable short position. Further, the price at which a dealer offers municipal inventory when compared to other allegedly similar securities certainly should be a regulatory pricing issue, not an execution issue. Coastal stated, nevertheless, that the proposal might adequately address the situation where the client owns a security that the client wishes to sell.

As stated above in the responses to other commenters, the MSRB believes that proposed Rule G-18 strikes an appropriate balance between a principles-based approach and providing greater prescriptions. The proposed rule allows flexibility for each dealer to adapt its reasonably designed policies and procedures to take account of the nature of its business and the type of customer transactions at issue. Proposed Rule G-18, by its flexible nature, expressly contemplates that an executing dealer acting in a principal capacity may be the best market for the subject security.

#### Implementation Period

SIFMA requested an implementation period of no less than one year from approval by the Commission.

The MSRB agrees with the comment and has requested Commission approval of the proposed rule change with an implementation date one year after Commission approval. This timeframe should provide sufficient time for dealers to develop or modify their policies and procedures and to acquire or adjust the level of their resources as necessary.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period of up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- (A) by order approve or disapprove such proposed rule change, or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act.

As noted above, to qualify as an SMMP under existing Rule D-15, the customer must affirm that it is exercising independent judgment in evaluating the recommendations of the dealer. The proposed amendments to the SMMP definition in Rule D-15, in conjunction with the proposed amendments to Rule G-48, generally reflect a unified approach to SMMP status, which would require additional affirmations by the customer regarding the customer's sophistication on certain matters to qualify for SMMP status and which would result in exemptions from certain associated MSRB rules for dealer transactions with SMMPs. Relevant to the proposed best execution obligation for dealers, the proposed amendments to the SMMP definition would

require an additional affirmation by the customer that the customer is exercising independent judgment in evaluating the quality of the dealer's execution of the customer's transactions in order for the customer to qualify for SMMP status and the proposed amendments to Rule G-48 would provide an exemption from a dealer's best execution obligation to customers for transactions with SMMPs. The Commission requests comment on the proposed unified approach to SMMP status, including the particular context of the proposed best execution obligations for dealers. The Commission requests comment on whether or not there are circumstances in which an otherwise-eligible SMMP may prefer to affirm that it is exercising independent judgment in evaluating the recommendations of a dealer and not be covered by the protections of the dealer's obligation to conduct a customer-specific suitability analysis, but not to affirm that it is exercising independent judgment with respect to the dealer's quality of execution of the SMMP's transactions and remain protected by the proposed best execution obligation imposed on dealers. Commenters also are invited to provide comments regarding the required customer affirmations generally under the SMMP definition.

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-MSRB-2014-07 on the subject line.

Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

All submissions should refer to File Number SR-MSRB-2014-07. This file number should be



included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the MSRB. All comments received will be posted without change; the Commission does not edit

personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-MSRB-2014-07 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, pursuant to delegated authority.<sup>36</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>36</sup> 17 CFR § 200.30-3(a)(12).