

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-73764; File No. SR-MSRB-2014-07)

December 5, 2014

Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Order Granting Approval 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

I. Introduction

On August 20, 2014, the Municipal Securities Rulemaking Board (the “MSRB” or “Board”) filed with the Securities and Exchange Commission (the “SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² 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 SMMPs, and Rule D-15, on the definition of SMMP (the “proposed rule change”). The proposed rule change was published for comment in the Federal Register on September 8, 2014.³

The Commission received six comment letters on the proposed rule change.⁴ On

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR § 240.19b-4.

³ Securities Exchange Act Release No. 72956 (September 2, 2014), 79 FR 53236 (September 8, 2014) (the “Proposing Release”).

⁴ See Letters from David L. Cohen, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association (“SIFMA”), dated September 29, 2014 (“SIFMA Letter”); Michael Nicholas, Chief Executive Officer, Bond Dealers of America (“BDA”), dated September 29, 2014 (“BDA Letter No. 1”) and October 30, 2014 (“BDA Letter No. 2”); Chris Melton, Executive Vice President, Coastal Securities (“Coastal”), dated September 29, 2014 (“Coastal Letter”); David T. Bellaire, Esq., Executive Vice President & General Counsel, Financial Services Institute (“FSI”), dated September 29, 2014 (“FSI Letter”); and Robert J. McCarthy, Director of Regulatory Policy, Wells Fargo Advisors, LLC (“Wells Fargo”), dated September 29, 2014 (“Wells

November 21, 2014, the MSRB submitted a response to these comments.⁵ This order approves the proposed rule change.

II. Description of the Proposed Rule Change

According to the MSRB, the establishment of a requirement that brokers, dealers and municipal securities dealers (“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.⁶ The MSRB stated that the proposed rule change reflects the MSRB’s belief that a best execution rule should be generally harmonized with the Financial Industry Regulatory Authority’s (“FINRA”) best-execution rule, FINRA Rule 5310 (Best Execution and Interpositioning), for purposes of regulatory efficiency but appropriately tailored to the characteristics of the municipal securities market.⁷ The MSRB further 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.⁸ The MSRB represented that the proposed best-execution requirement generally would target the process by which dealers handle orders and

Letter”). Staff from the Office of Municipal Securities met with representatives from BDA on October 23, 2014, and had a telephonic meeting with a representative from SIFMA on December 3, 2014, to discuss the proposed rule change.

⁵ See Letter to Secretary, Commission, from Michael L. Post, Deputy General Counsel, MSRB, dated November 21, 2014 (“MSRB Response Letter”).

⁶ See supra note 3 at 2.

⁷ Id. at 7.

⁸ Id.

execute transactions, and would complement and buttress the MSRB's existing fair-pricing rules.⁹

1. Proposed Rule G-18

Proposed Rule G-18(a) requires that, in any transaction in a municipal security for or with a customer or a customer of another dealer, 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.¹⁰

Paragraph (a) provides the following factors among the factors that will be considered in determining whether a dealer has used "reasonable diligence," with no single factor being determinative: 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, including any bids or offers, that result in the transaction, as communicated to the dealer.¹¹

Proposed Rule G-18(b) prohibits a dealer from interjecting a third party between itself and the best market for the subject security in a manner inconsistent with paragraph (a).¹² The MSRB stated that paragraph (b) would not prohibit the use of a broker's broker, unless it was inconsistent with the best-execution obligation in paragraph (a).¹³

⁹ Id.

¹⁰ See proposed Rule G-18(a).

¹¹ Id.

¹² See proposed Rule G-18(b).

¹³ See supra note 3 at 10.

Proposed Rule G-18(c) specifies that the obligations described in paragraphs (a) and (b) apply to transactions in which the dealer is acting as agent and transactions in which the dealer is acting as principal.¹⁴ Paragraph (c) expressly states that the best-execution obligations are distinct from the fairness and reasonableness of commissions, markups or markdowns, which are governed by Rule G-30.¹⁵

2. Supplementary Material to Proposed Rule G-18

Paragraph .01 of the Supplementary Material specifies that the principal purpose of proposed Rule G-18 is to promote, for customer transactions, dealers' use of reasonable diligence in accordance with paragraph (a).¹⁶ Paragraph .01 also specifies that "[a] failure to have actually obtained the most favorable price possible will not necessarily mean that the dealer failed to use reasonable diligence."¹⁷ According to the MSRB, 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.¹⁸

Paragraph .02 of the Supplementary Material provides that a dealer's failure to maintain adequate resources (e.g., staff or technology) is not a justification for executing away from the best available market.¹⁹ This paragraph also states that the level of resources that a dealer

¹⁴ See proposed Rule G-18(c).

¹⁵ Id.

¹⁶ See proposed Rule G-18 Paragraph .01 of the Supplementary Material.

¹⁷ Id.

¹⁸ See supra note 3 at 11.

¹⁹ See proposed Rule G-18 Paragraph .02 of the Supplementary Material.

maintains should take into account the nature of the dealer’s municipal securities business, including its level of sales and trading activity.²⁰

Paragraph .03 of the Supplementary Material provides that a dealer must make every effort to execute customer transactions promptly, taking into account prevailing market conditions.²¹ In addition, in certain market conditions, a dealer may need more time to use reasonable diligence to ascertain the best market for the subject security.²²

Paragraph .04 of the Supplementary Material defines the term “market” or “markets” for purposes of proposed Rule G-18.²³ The term is to be construed broadly and includes, but is not limited to, “alternative trading systems or platforms,” “broker’s brokers,” and “other counterparties, which may include the dealer itself as principal.”²⁴ The MSRB represented that the purpose of this language is to tailor the definition of “market” to the characteristics of the municipal securities market and to provide flexibility for future developments in both market structure and applied technology.²⁵

Paragraph .05 of the Supplementary Material provides that a dealer’s duty to provide best execution in any transaction “for or with” “a customer of another dealer” does not apply in instances when the other dealer is simply executing a customer transaction against the dealer’s

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Id.

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See proposed Rule G-18 Paragraph .03 of the Supplementary Material.

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Id.

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See proposed Rule G-18 Paragraph .04 of the Supplementary Material.

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Id.

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See supra note 3 at 12.

quote.²⁶ In addition, a dealer's duty to provide best execution to customer orders received from other dealers arises only when an order is routed from another dealer to the dealer for handling and execution.²⁷

Paragraph .06 of the Supplementary Material addresses transactions involving securities for which there is limited pricing information or quotations.²⁸ This paragraph requires each dealer to have written policies and procedures that address how the dealer's best-execution determinations will be made for such securities in the absence of pricing information or multiple quotations, and to document its compliance with those policies and procedures.²⁹ This paragraph also provides that a dealer generally should seek out other sources of pricing information and potential liquidity for such securities, including other dealers that the dealer previously has traded with in the security, and generally should, in determining whether the resultant price to the customer is as favorable as possible under prevailing market conditions, analyze other relevant data to which it reasonably has access.³⁰

Paragraph .07 of the Supplementary Material provides that, if a dealer receives an unsolicited instruction from a customer designating a particular market for the execution of the customer's transaction, the dealer is not required to make a best-execution determination beyond the customer's specific instruction.³¹ Dealers are, however, still required to process that

²⁶ See proposed Rule G-18 Paragraph .05 of the Supplementary Material.

²⁷ Id.

²⁸ See proposed Rule G-18 Paragraph .06 of the Supplementary Material.

²⁹ Id.

³⁰ Id.

³¹ See proposed Rule G-18 Paragraph .07 of the Supplementary Material.

customer's transaction promptly and in accordance with the terms of the customer's bid or offer.³²

Paragraph .08(a) of the Supplementary Material requires that a dealer 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.³³ While no more frequent interval is specifically required, a dealer must conduct reviews at a frequency reasonably related to the nature of its municipal securities business.³⁴ In conducting such periodic reviews, a dealer must assess whether its policies and procedures are reasonably designed to achieve best execution, taking into account 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, and to make promptly any necessary modifications to such policies and procedures as may be appropriate in light of such reviews.³⁵

Paragraph .08(b) of the Supplementary Material provides 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

³² Id.

³³ See proposed Rule G-18 Paragraph .08(a) of the Supplementary Material.

³⁴ Id.

³⁵ Id.

disclosed to the dealer and the dealer periodically reviews how the other dealer's review is conducted and the results of the review.³⁶

Paragraph .09 of the Supplementary Material provides that the provisions of proposed Rule G-18 do not apply to transactions in municipal fund securities.³⁷

3. Proposed Amendments to Rule G-48

The MSRB stated that the best-execution obligations under proposed Rule G-18 do not apply to transactions with customers that are SMMPs.³⁸ The proposed amendments to Rule G-48 add a new section (e) to provide expressly that a dealer shall not have any obligation 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.³⁹ The MSRB noted that Rule G-48 is the new consolidated MSRB rule under which all modified obligations of dealers are addressed when dealing with SMMPs.⁴⁰

4. Proposed Amendments to Rule D-15

Existing Rule D-15 contains the SMMP definition.⁴¹ The proposed amendments to Rule D-15 provide that an SMMP is defined by three essential requirements: the nature of the

³⁶ See proposed Rule G-18 Paragraph .08(b) of the Supplementary Material.

³⁷ See proposed Rule G-18 Paragraph .09 of the Supplementary Material.

³⁸ See supra note 3 at 14.

³⁹ See proposed amendments to Rule G-48.

⁴⁰ See supra note 3 at 14.

⁴¹ Under existing Rule D-15, "SMMP" means a customer of a dealer that is: a bank, savings and loan association, insurance company, or registered investment company; or an investment adviser registered either with the SEC 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 (whether a natural person, corporation,

customer; a determination of sophistication by the dealer; and an affirmation by the customer.⁴²

The proposed amendments to Rule D-15 do not change the nature of the customer and the determination of sophistication by the dealer, excluding minor, non-substantive revisions.⁴³ The proposed amendments to Rule D-15, however, expand the existing customer affirmation⁴⁴ to require that the customer affirmatively indicate that it (1) is exercising independent judgment in evaluating: the recommendations of the dealer, the quality of execution of the customer's transactions by the dealer, and the transaction price for certain non-recommended secondary market agency transactions; and (2) has timely access to material information that is available publicly through established industry sources.⁴⁵ The MSRB stated that a dealer could not treat any customer as an SMMP after the proposed best-execution rule is implemented unless the dealer reasonably determined that the customer had given the broader affirmation required under the proposed amendments to Rule D-15.⁴⁶ The MSRB believes that it is important that the definition of SMMP under the proposed amendments to Rule D-15 (as under the existing rule) is

partnership, trust, or otherwise) with total assets of at least \$50 million; and, that the dealer has a reasonable basis to believe is capable of evaluating investment risks and market value independently, both in general and with regard to particular transactions and investment strategies in municipal securities, and that affirmatively indicates that it is exercising independent judgment in evaluating the recommendations of the dealer.

⁴² See proposed amendments to Rule D-15.

⁴³ The MSRB stated that the proposed amendments to Rule D-15 include non-substantive (e.g., technical, conforming and organizational) revisions to accommodate the substantive changes and improve the readability of the rule. See supra note 3 at 16-17

⁴⁴ The SMMP customer affirmation contained in existing Rule D-15 requires that the customer affirmatively indicate that it is exercising independent judgment in evaluating the recommendations of the dealer.

⁴⁵ See proposed amendments to Rule D-15.

⁴⁶ See supra note 3 at 17.

not self-executing, nor are the contingencies for its application in the unilateral control of the interfacing dealer.⁴⁷

The proposed amendments to paragraph .02 of the Supplementary Material to Rule D-15 would provide that the SMMP customer affirmation may be given, in addition to the existing bases, on a type-of-transaction basis.⁴⁸

5. Implementation Period

The MSRB requested that the proposed rule change be approved with an implementation date one year after the Commission approval date.⁴⁹ According to the MSRB, this implementation period would allow dealers sufficient time to develop or modify their policies and procedures and to acquire or adjust the level of their resources.⁵⁰ The MSRB also stated that this one year implementation period would allow time for the MSRB to create educational materials and conduct outreach to the dealer community, as appropriate, regarding the proposed rule change.⁵¹

A full description of the proposed rule change is contained in the Proposing Release.

III. Summary of Comments Received and the MSRB's Response

As noted previously, the Commission received six comment letters on the proposed rule change and a response letter from the MSRB.⁵² Commenters generally supported the proposed

⁴⁷ Id.

⁴⁸ See proposed amendments to Rule D-15.

⁴⁹ See supra note 3 at 8.

⁵⁰ Id.

⁵¹ Id.

⁵² See supra notes 4 and 5.

rule change, however, some asked for further clarification and provided suggestions to the proposed rule change.⁵³

1. Use of Best Execution

SIFMA, BDA and Wells Fargo do not support the use of the phrase “best execution” in the proposed rule change.⁵⁴ SIFMA and BDA believe that regulatory examiners and enforcement staff will use the phrase to enforce standards that are not applicable to the municipal securities market.⁵⁵ Also, Wells Fargo believes that the term best execution correlates with the equity securities market and is inconsistent with the fundamental goal expressed within proposed rule G-18.⁵⁶ Similarly, BDA believes using a term borrowed from standards applicable to other markets that operate very differently from the municipal securities market is inappropriate.⁵⁷ SIFMA and BDA suggest removing the word “best” in certain instances and replacing “best execution” with “execution diligence” in others.⁵⁸ Wells Fargo recommends the term “best execution” be removed from the proposed rule language, including the title, and be replaced with the term “reasonable diligence.”⁵⁹

The MSRB responded by highlighting that paragraph .01 of the Supplementary Material indicates that proposed Rule G-18 is not intended to create a substantive pricing standard, but

⁵³ Id.

⁵⁴ See SIFMA Letter at 2, BDA Letter No. 1 at 3, and Wells Letter at 4.

⁵⁵ See SIFMA Letter at 2 and BDA Letter No. 1 at 3.

⁵⁶ See Wells Letter at 4.

⁵⁷ See BDA Letter No. 1 at 3.

⁵⁸ See SIFMA Letter at 2 and BDA Letter No. 1 at 3.

⁵⁹ See Wells Letter at 4.

rather an order-handling standard for the execution of transactions.⁶⁰ The MSRB noted that paragraph .01 of the Supplementary Material expressly provides that a failure to have actually obtained the most favorable price possible will not necessarily mean the dealer failed to use reasonable diligence under the circumstances.⁶¹ The MSRB represented that “best execution” is an established term for the concept of execution quality in customer securities transactions in other contexts, and the standard in those contexts is similarly not a most-favorable-price standard.⁶² The MSRB believes that concerns that regulatory examiners and enforcement staff will use the phrase “best execution” to enforce standards that are not applicable to the municipal securities market and that are inconsistent with the MSRB’s stated intent that “the most favorable price possible” will not necessarily be equated with the term “best execution” are speculative in nature, and do not warrant changes to the proposed rule language.⁶³

2. Definition of Market

BDA believes proposed Rule G-18 broadens the concept of “market” well beyond FINRA Rule 5310.⁶⁴ BDA believes there is no concept at all of limiting the market to market centers or what FINRA Rule 5310 considers venues.⁶⁵ BDA believes any dealer or other counterparty in the country can potentially constitute a “market” that needs to be considered.⁶⁶

⁶⁰ See MSRB Response Letter at 2.

⁶¹ Id.

⁶² See MSRB Response Letter at 2-3.

⁶³ See MSRB Response Letter at 3.

⁶⁴ See BDA Letter No. 1 at 2.

⁶⁵ Id.

⁶⁶ Id.

BDA expresses concern that the proposed definition requires dealers to use their reasonable diligence to locate the one counterparty that will pay the best price, not the best market center, and that such a duty is more expansive than the one under FINRA Rule 5310 and too burdensome to impose.⁶⁷ Coastal believes the definition creates an undue burden not required by FINRA rules by defining each dealer as a market.⁶⁸ Coastal recommends wording the proposed Rule G-18 language in line with existing FINRA rules.⁶⁹

The MSRB responded by stating that it believes that the proposed definition of “market” is appropriate, even as compared to FINRA Rule 5310.⁷⁰ The MSRB noted that FINRA states that its definition of “market” or “markets” in FINRA Rule 5310 also is to be construed broadly to encompass a variety of different venues, including, but not limited to, market centers.⁷¹ The MSRB further stated that FINRA Rule 5310 provides that, in the absence of quotations, “members are not relieved from taking reasonable steps and employing their market expertise in achieving the best execution of customer orders,” and, “[i]n these instances, a member should generally seek out other sources of pricing information or potential liquidity, which may include obtaining quotations from other sources (e.g., other firms that the member previously has traded within the security).”⁷²

⁶⁷ Id.

⁶⁸ See Coastal Letter at 2.

⁶⁹ Id.

⁷⁰ See MSRB Response Letter at 3.

⁷¹ Id.

⁷² See MSRB Response Letter at 3-4 and Paragraph .02 of the Supplementary Material to FINRA Rule 5310.

The MSRB does not believe the definition of “market” creates a duty for dealers to use reasonable diligence to locate the one counterparty that will pay the best price because, as previously noted above, proposed Rule G-18 is an order-handling and transaction-execution standard and does not contain any substantive pricing standard.⁷³ In addition, the MSRB noted that paragraph .01 of the Supplementary Material to proposed Rule G-18 expressly provides that 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.⁷⁴ The MSRB believes that the number of counterparties and/or other markets the dealer should consider would depend on the analysis of the factors articulated in proposed Rule G-18(a), and any other facts and circumstances that would contribute to a dealer’s identification of the best market.⁷⁵

3. Number of Markets Checked

SIFMA requests that “the number of markets checked” factor be deleted from proposed Rule G-18(a).⁷⁶ SIFMA believes this factor is more applicable to the equities market structure of exchanges with a central aggregator of bids and offers as well as constant liquidity.⁷⁷ SIFMA further believes that, unlike equity markets, there is no direct continuously-quoted, bid-and-ask trading market between bond dealers in the municipal markets, so the mere act of contacting other dealers for quotes on fixed income securities does not necessarily result in a more timely or

⁷³ See MSRB Response Letter at 4.

⁷⁴ Id.

⁷⁵ Id.

⁷⁶ See SIFMA Letter at 4.

⁷⁷ Id.

beneficial execution.⁷⁸ SIFMA disagrees with any suggestion that the act of contacting other dealers would be the implicit or requisite procedure to evidence best execution.⁷⁹ SIFMA also believes “the number of markets checked” is covered by another factor – “the information reviewed to determine the current market for the subject security or similar security.”⁸⁰ SIFMA expresses concern that “the number of markets checked” factor is inconsistent with paragraph .04 of the Supplementary Material to proposed Rule G-18, which acknowledges that a dealer itself as principal may be the best market to satisfy best execution for the subject security.⁸¹

The MSRB noted that while the structure of the municipal securities market is different than the equity securities market structure of exchanges, that difference does not necessarily reduce the value of a dealer checking multiple markets, as defined by proposed Rule G-18, to ascertain the best market for executing customer transactions.⁸² The MSRB stated that “the number of markets checked” factor is only one factor in the non-exhaustive list of factors to be considered, and no single factor is determinative.⁸³ The MSRB further stated that, depending on the particular facts and circumstances, it could be consistent with the reasonable-diligence standard for a dealer not to contact other dealers, however, it would be important, given the

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Id.

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Id.

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Id.

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Id.

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See MSRB Response Letter at 4-5.

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Id. at 5.

proposed rule's emphasis on complying with policies and procedures, for a dealer to have written policies and procedures in place that address such circumstances.⁸⁴

The MSRB believes it is important to explicitly include “the number of markets checked” factor to further the objective of promoting fair competition among dealers.⁸⁵ The MSRB does not believe that “the number of markets checked” factor is inconsistent with the definition of “market” in paragraph .04 of the Supplementary Material.⁸⁶ According to the MSRB, although paragraph .04 explicitly states that the dealer itself as principal could be the best market, it does not indicate that such a dealer would always be the best market for purposes of best execution, and, depending on the facts and circumstances, the exercise of reasonable diligence to comply with the proposed rule likely would regularly require a dealer to check other markets in addition to its own inventory.⁸⁷ As such, the MSRB decided not to delete this factor from the non-exhaustive list of factors in proposed Rule G-18(a).⁸⁸

4. Securities with Limited Quotations or Pricing Information

Coastal believes proposed Rule G-18 erroneously presumes retail customers turn in market orders to purchase specific municipal bonds in the secondary market and, consequently, imposes unnecessary regulatory burdens on selling dealers.⁸⁹ Coastal believes, on the sell side, there are no orders to speak of that would benefit from requiring a dealer to complete a process

⁸⁴ Id.

⁸⁵ Id.

⁸⁶ Id.

⁸⁷ Id.

⁸⁸ Id.

⁸⁹ See Coastal Letter at 1.

demonstrating best execution.⁹⁰ Coastal questions the flexibility of the proposed best-execution standard and suggests that the requirements for securities with limited quotations or pricing information is unnecessary.⁹¹ Coastal recommends wording the proposed Rule G-18 language in line with existing FINRA rules.⁹²

The MSRB responded by noting that the application of the proposed best-execution standard does not hinge on whether a customer places a market order or on whether a customer has identified a particular municipal security.⁹³ The MSRB believes that while many customer orders in the municipal securities market are placed in response to offerings made by sellers out of their own inventories, there are customer-initiated orders in the market as well.⁹⁴ The MSRB believes that a significant benefit of the flexible best-execution standard embodied in proposed Rule G-18 is the ability to apply to an evolving market over time.⁹⁵

The MSRB also believes that paragraph .06 of the Supplementary Material of proposed Rule G-18, which requires written policies and procedures that address how a dealer would make its best-execution determinations in cases of limited quotations or pricing information, is consistent with FINRA Rule 5310.⁹⁶ The MSRB stated that the FINRA rule, with which the MSRB has generally harmonized, does not contain further prescriptions than proposed Rule G-

⁹⁰ Id.

⁹¹ Id.

⁹² Id. at 2.

⁹³ See MSRB Response Letter at 6.

⁹⁴ Id.

⁹⁵ Id.

⁹⁶ Id.

18 in this area.⁹⁷ The MSRB believes that including additional language would not 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.⁹⁸

5. Enforcement Concerns

SIFMA and Wells Fargo express concerns with how proposed rule G-18 would be enforced.⁹⁹ SIFMA believes that the non-exhaustive list of factors to be considered by dealers creates a de facto enforcement checklist for FINRA.¹⁰⁰ SIFMA questions how compliance with “the number of markets checked” factor can be proved.¹⁰¹ SIFMA members are concerned that enforcement regulators will challenge a dealer’s trade price because the regulators will have the benefit of hindsight and may be able to show other trades for the same CUSIP at marginally better prices and will assert that the dealer therefore did not provide best execution.¹⁰² SIFMA suggests codifying the MSRB’s view that proposed Rule G-18 is not intended to create a trade-through rule by adding the following to paragraph .01 of the Supplementary Material: “[a] failure to consider a superior price available on another market would not necessarily constitute a violation of the rule.”¹⁰³

⁹⁷ Id.

⁹⁸ Id.

⁹⁹ See SIFMA Letter at 2, 4-5 and Wells Letter at 3.

¹⁰⁰ See SIFMA Letter at 4.

¹⁰¹ Id.

¹⁰² Id. at 4-5.

¹⁰³ Id. at 5.

The MSRB responded by stating that the mandatory factors in proposed Rule G-18(a) would be considered in any examination and/or enforcement activities by regulators, but no single factor would be determinative, and other facts and circumstances could be considered as well in determining whether a dealer has used reasonable diligence.¹⁰⁴ The MSRB noted that it would be important, given proposed rule G-18's emphasis on complying with sound policies and procedures, for a dealer to have written policies and procedures in place that articulate how the dealer would exercise reasonable diligence, which should, at a minimum, include consideration of the number of markets checked factor, as well as the others listed in the proposed rule.¹⁰⁵ Also, according to the MSRB, under the broad standard in proposed Rule G-18, the subsequent discovery of a market that had better prices than the market in which a dealer executed a customer transaction would inform a dealer's development of its policies and procedures and periodic review of them under Paragraph .08 of the Supplementary Material.¹⁰⁶ The MSRB noted, however, a failure to consider such a market would not necessarily constitute a violation of the proposed rule, and, as provided in proposed Supplementary Material .01, a failure to have actually obtained the most favorable price possible would not necessarily mean that the dealer failed to use reasonable diligence.¹⁰⁷ As such, the MSRB does not believe revision of the proposed rule language is necessary at this time.¹⁰⁸

¹⁰⁴ See MSRB Response Letter at 6.

¹⁰⁵ Id. at 6-7.

¹⁰⁶ Id. at 7.

¹⁰⁷ Id.

¹⁰⁸ Id.

Wells Fargo believes that the proposed rule language regarding a dealer’s failure to maintain adequate resources (set forth in paragraph .02 of the Supplementary Material of proposed Rule G-18) may create confusion over enforcement as proposed rule G-18 could be applied inconsistently and arbitrarily based on the activity level and number of ATSs to which a particular dealer subscribes.¹⁰⁹

The MSRB responded by stating that proposed Rule G-18 establishes only one best execution standard for all dealers in the municipal securities market.¹¹⁰ According to the MSRB, paragraph .02 of the Supplementary Material, similar to FINRA Rule 5310(c), addresses the need for dealers to devote adequate resources towards meeting their best-execution obligations, while acknowledging that a “one-size-fits-all” approach to staffing is not required.¹¹¹

6. Request for Clarification/Guidance

BDA, FSI and Wells Fargo request guidance and/or clarification on how to comply with the proposed rule change generally, as well as in more particular circumstances, and how to evidence compliance to regulators.¹¹²

The MSRB responded by stating, at this time, it is not revising proposed Rule G-18 to include any more prescriptive provisions because doing so could negate the benefits of a principles-based rulemaking approach.¹¹³ The MSRB stated that while it understands the desire

¹⁰⁹ See Wells Letter at 3.

¹¹⁰ See MSRB Response Letter at 7.

¹¹¹ Id.

¹¹² See BDA Letter No. 1 at 3-4, BDA Letter No. 2 at 1, FSI Letter 2-3, and Wells Letter 2-3 and 5.

¹¹³ See MSRB Response Letter at 7.

on the part of dealers for concrete steps to follow for their particular business models, such a prescriptive rule might undermine the flexibility the rule is designed to provide.¹¹⁴ The MSRB represented that, if the proposed rule change is approved, the MSRB plans to provide practical guidance on complying with the best-execution standard prior to implementation of the proposed rule change, in coordination with FINRA.¹¹⁵

7. Proposed Amendments to Rules G-48 and D-15

a) Public Comment

SIFMA and Wells Fargo express concerns that the MSRB did not request public comment on the proposed amendments to Rule D-15 prior to filing the proposed rule change with the SEC.¹¹⁶ Additionally, SIFMA and Wells Fargo believe the SEC should have provided a lengthier comment period.¹¹⁷ Wells Fargo believes this aspect of the proposed rule change should be withdrawn until additional time is provided.¹¹⁸

The MSRB responded by noting that the SEC determines the length of the public comment period and it provided 21 days for comment on the proposed rule change, specifically soliciting comment on the proposed amendments to Rules G-48 and D-15.¹¹⁹ The MSRB stated that any additional solicitation of comments, prior to the SEC's publication of a proposed rule

¹¹⁴ Id. at 7-8.

¹¹⁵ Id. at 8.

¹¹⁶ See SIFMA Letter at 2 and 6 and Wells Letter at 2.

¹¹⁷ See SIFMA Letter at 9-10 and Wells Letter at 4.

¹¹⁸ See Wells Letter at 4.

¹¹⁹ See MSRB Response Letter at 8.

change, by a self-regulatory organization, such as the MSRB, is not required.¹²⁰ The MSRB also noted that it provided two rounds of public comment, focusing first on the concept of applying a best execution standard to customer transactions in municipal securities and, second, evaluating specific rule language articulating such standard.¹²¹ According to the MSRB, the issues related to the proposed amendments to Rules G-48 and D-15 are derivative of changes in response to comments and are consistent with well-established requirements applicable to qualification as an SMMP.¹²² As such, the MSRB does not believe the proposed amendments to Rules G-48 and D-15 warrant another round of comment in this rulemaking matter.¹²³

b) Economic Analysis

SIFMA believes the MSRB did not discuss any economic analysis as it relates to the proposed amendments to Rule D-15.¹²⁴ SIFMA expresses concern that the proposed amendments to Rule D-15 fundamentally alter how a dealer determines if a customer qualifies as an SMMP.¹²⁵ SIFMA suggests that the MSRB should have conducted an economic analysis consistent with its Policy for Integrating Economic Analysis in MSRB Rulemaking (“Policy”) in proposing the amendments to Rule D-15.¹²⁶ FSI believes that, prior to approving the proposed rule change, the MSRB should publish a cost-benefit analysis to determine whether the proposed

¹²⁰ Id.

¹²¹ Id. at 8-9.

¹²² Id. at 9.

¹²³ Id.

¹²⁴ See SIFMA Letter at 8.

¹²⁵ Id.

¹²⁶ Id. at 8-9.

rule change would have consequences for liquidity in the municipal securities market which would impact retail investors.¹²⁷

The MSRB responded by clarifying that the Policy does not apply to rulemaking initiatives, like this one, that were initially presented to the MSRB Board of Directors before September 26, 2013.¹²⁸ The MSRB represented that it had been particularly mindful of potential costs and burdens of the proposed rule change, and that the proposed exemption for transactions for or with SMMPs is one such example.¹²⁹ The MSRB noted that although no economic analysis of the proposed amendments to Rule D-15 is required pursuant to the Policy, the MSRB, as appropriate, has provided additional analysis in the MSRB Response Letter in response to the commenters' concerns.¹³⁰ The MSRB, however, does not believe that the proposed amendments fundamentally alter the conclusions of its preliminary economic analysis.¹³¹ The MSRB further stated that some of the costs associated with compliance with proposed Rule G-18 would be reduced in the aggregate due to the exemption for transactions with SMMPs, as compared to an alternative approach in which there was no such exemption.¹³² The MSRB believes the costs

¹²⁷ See FSI Letter at 3.

¹²⁸ See MSRB Response Letter at 9.

¹²⁹ Id.

¹³⁰ Id.

¹³¹ Id.

¹³² Id.

associated with the amendments to Rule D-15 must be evaluated in light of the overall cost mitigation that flows from the existence of the SMMP exemption.¹³³

c) SMMP Customer Affirmation

SIFMA and Wells Fargo express concerns regarding the invalidation of existing SMMP customer affirmations after the effective date of the proposed rule change.¹³⁴ BDA states that its members believe that some if not many institutional investors will be unwilling to provide an affirmation that has the effect of excluding them from the application of a best execution rule on the dealer.¹³⁵ BDA recommends that the SMMP customer affirmation should be bifurcated into two affirmations: (1) the existing SMMP customer affirmation and, if an institutional investor provides such affirmation, the investor should be treated as an SMMP for all purposes other than for the application of the best execution rule; and (2) an affirmation tailored just to the best execution rule.¹³⁶ Wells Fargo believes there is no benefit to invalidating existing SMMP customer affirmations and BDA does not see the value in expanding the existing SMMP customer affirmations.¹³⁷

According to the MSRB, it is important for the SMMP customer affirmation to be unified and speak to all of the modified dealer obligations.¹³⁸ The MSRB believes that unnecessary inefficiencies and additional burdens on dealers would result from a piecemeal approach, under

¹³³ Id.

¹³⁴ See SIFMA Letter at 2, 6 and 9 and Wells Letter at 4.

¹³⁵ See BDA Letter No. 2 at 1.

¹³⁶ Id.

¹³⁷ See Wells Letter at 4 and BDA Letter No. 1 at 3.

¹³⁸ See MSRB Response Letter at 10.

which dealers would potentially have different customers that are SMMPs only with respect to several different permutations of modified dealer obligations.¹³⁹ The MSRB believes this belief is supported by SIFMA's statement that, if the SEC approves the proposed amendments to Rule D-15 as is, or even if the affirmation did not need to be unified, some of SIFMA's members would prefer a unified affirmation, as it would be much easier to implement and administer.¹⁴⁰ Further, the MSRB believes the unified approach to the SMMP customer affirmation provides greater protection to investors, as it would help ensure that dealer obligations would be modified only for transactions with customers that are knowingly willing to have their dealer subject to the several reduced obligations provided in Rule G-48.¹⁴¹ The MSRB believes that this added investor protection, as well as the mitigated costs of compliance with the best execution obligation provided by the SMMP exemption, would justify the costs of requiring dealers to obtain new affirmations from all SMMP customers, including existing SMMPs.¹⁴²

SIFMA, BDA and Wells Fargo express concerns regarding the operational impact of deharmonizing the SMMP qualification process from the FINRA Rule 2111 process and precluding dealers from satisfying the SMMP affirmation requirement by receiving a FINRA Rule 2111 affirmation.¹⁴³ Wells Fargo believes this aspect of the proposed rule change

¹³⁹ Id.

¹⁴⁰ Id.

¹⁴¹ Id.

¹⁴² Id.

¹⁴³ See SIFMA Letter at 2, 6-7, and 9, BDA Letter No. 1 at 3-4 and Wells Letter at 2 and 4-5.

contradicts the MSRB's previously stated goal to seek harmony with FINRA rules.¹⁴⁴ SIFMA believes an SMMP customer affirmation that mirrors FINRA's affirmation process as closely as possible makes the most economic sense, encourages cross-over investors, and eases dealer compliance regimes.¹⁴⁵ SIFMA believes the costs of maintaining separate affirmation systems for institutional accounts across product lines will be unduly burdensome.¹⁴⁶ SIFMA proposes an alternative revision to Rule D-15 which would require dealers to have a reasonable basis to believe that an SMMP would like to avail itself to the conveniences of SMMP status.¹⁴⁷ As an alternative approach, SIFMA suggests a negative consent letter sent to institutional customers.¹⁴⁸ BDA and Wells Fargo also favor a negative consent approach for SMMPs effectively to opt out of SMMP status.¹⁴⁹

The MSRB does not believe the proposed amendments to Rule D-15 would inappropriately deharmonize the rule from FINRA's affirmation or contradict the MSRB's established position on SMMP customer affirmations.¹⁵⁰ Previously, the MSRB stated that it "considers it desirable from the standpoint of reducing the cost of dealer compliance to maintain consistency with FINRA rules, absent clear reasons for treating transactions in municipal

¹⁴⁴ See Wells Letter at 4.

¹⁴⁵ See SIFMA Letter at 7.

¹⁴⁶ Id. at 6.

¹⁴⁷ Id. at 7.

¹⁴⁸ Id. at 8.

¹⁴⁹ See BDA Letter No. 1 at 4 and Wells Letter at 4.

¹⁵⁰ See MSRB Response Letter at 11.

securities differently.”¹⁵¹ According to the MSRB, consistent with this goal, the proposed amendments to Rule D-15 are aligned to harmonize with FINRA Rule 2111 but with adjustments associated with the SMMP exemption from the best-execution obligation, as well as the other modified dealer obligations currently covered by Rule G-48.¹⁵² The MSRB noted that FINRA Rule 2111(b) and paragraph .07 of the Supplementary Material thereto provide an institutional investor exemption to the suitability obligation under that rule, which is similar to the existing exemption dealers have from the suitability requirement of MSRB Rule G-19 under Rule G-48(c), however, neither FINRA Rule 2111 nor any other FINRA rule provides a similar exemption from best execution or any other obligations for its member firms comparable to those included in Rule G-48.¹⁵³ The MSRB further noted that no commenter expressed an objection to the proposed exemption from best execution under Rule G-48, and BDA and SIFMA have explicitly endorsed the exemption in comment letters relating to the proposed rule change.¹⁵⁴ The MSRB believes clear reasons exist for the proposed amendments to Rule D-15 to vary from FINRA’s affirmation under FINRA Rule 2111, as the amendments would facilitate the exemption supported by commenters and mitigate the burden of compliance with proposed Rule G-18 by reducing the number of customers to which the obligation would apply.¹⁵⁵

¹⁵¹ See MSRB Response Letter at 11 (quoting from Securities Exchange Act Release No. 66772 (April 9, 2012)).

¹⁵² See MSRB Response Letter at 11.

¹⁵³ Id.

¹⁵⁴ Id.

¹⁵⁵ Id.

The MSRB believes that the proposed amendments to Rule D-15 would enhance protections to customers by addressing the full scope of modified obligations that dealers would be relieved of performing, providing clear disclosure to SMMPs regarding the modified dealer obligations and obtaining affirmative statements that SMMPs can, for example, exercise independent judgment in performing the evaluations related to best execution, suitability and the other modified dealer obligations.¹⁵⁶ The MSRB also believes that any changes to dealer affirmation systems made in an effort to comply with the proposed amendments to Rule D-15 would be justified by the need to tailor the rule to the particular interests and characteristics of the municipal securities market, which are not reflected in FINRA rules.¹⁵⁷ Additionally, according to the MSRB, a negative consent letter to institutional customers would not be an appropriate alternative, as it would be important for customers to take affirmative action to be treated as an SMMP.¹⁵⁸

8. Implementation Period

SIFMA supports the one-year implementation period for proposed Rule G-18 and the proposed amendments to Rule G-48.¹⁵⁹ If the SEC approves the proposed amendments to Rule D-15, however, SIFMA requests an additional six-month implementation period.¹⁶⁰

The MSRB believes a one-year implementation period would be sufficient for dealers to comply with the proposed rule change, including amendments to Rule D-15.¹⁶¹ According to the

¹⁵⁶ Id.

¹⁵⁷ Id.

¹⁵⁸ Id.

¹⁵⁹ See SIFMA Letter at 9.

¹⁶⁰ Id.

MSRB, one year would be adequate for dealers to develop systems, establish policies and procedures, conduct training and obtain the expanded SMMP customer affirmations.¹⁶²

IV. Discussion and Commission Findings

The Commission has carefully considered the proposed rule change, the comments received, and the MSRB's response to the comments, and finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the MSRB. In particular, the Commission finds that the proposed rule change is consistent with Section 15B(b)(2)(C) of the Act,¹⁶³ which requires, among other things, that the rules of the MSRB 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 general, to protect investors, municipal entities, obligated persons, and the public interest.

The Commission notes that its Report on the Municipal Securities Market, issued July 31, 2012, recommended that the MSRB consider a rule that would require municipal bond dealers to seek "best execution" of customer orders for municipal securities. The Commission believes that the establishment of a requirement that dealers seek best execution of customer transactions in municipal securities, as required by the proposed rule change, will have benefits for investors,

¹⁶¹ See MSRB Response Letter at 12.

¹⁶² Id.

¹⁶³ 15 U.S.C. 78o-4(b)(2)(C).

improve market efficiency and promote fair competition among dealers. The Commission believes that the new order-handling obligations of dealers will complement the MSRB's existing substantive pricing standards, helping to ensure that investors receive a price that is as favorable as possible under prevailing market conditions. The proposed rule change is appropriately designed to buttress existing dealer pricing obligations and promote better execution quality for investors in municipal securities.

Moreover, the Commission 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 if they are not needed. In addition, the Commission believes that the proposed rule change 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 apply only to transactions with SMMPs. The Commission believes it is important that the definition of SMMP is not self-executing nor in the unilateral control of the interfacing dealer. The Commission also believes that the proposed rule change is beneficial to the municipal securities market and that the changes will enhance investor confidence and protection.

In approving the proposed rule change, the Commission has considered the proposed rule change's impact on efficiency, competition, and capital formation.¹⁶⁴ The Commission believes that the proposed rule change includes accommodations that help promote efficiency because the proposed rule change 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

¹⁶⁴ See 15 U.S.C. 78c(f).

trading activity and the type of customer transactions at issue. The Commission also believes that the reasonable diligence standard and the SMMP customer affirmation are sufficiently flexible to be met by a diverse population of dealers and allows a dealer to evidence compliance in a manner that may be different from that used by another dealer. The Commission 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 since it would apply to all dealers who engage in municipal securities transactions. The Commission also believes that the proposed rule change takes into account competitive concerns that could arise from the diversity of dealer characteristics because proposed Rule G-18 embodies a broad and flexible principles-based standard. The Commission has reviewed the record for the proposed rule change and notes that the record does not contain any information to indicate that the proposed rule change would have a negative effect on capital formation.

As noted above, the Commission received six comment letters on the filing. The Commission believes that the MSRB considered carefully and responded adequately to comments and concerns regarding the proposed rule change. While commenters suggested changes to the filing or opposed certain aspects of the proposed rule change, the Commission notes that no commenters argued that the proposed rule change was inconsistent with the applicable provisions of the Act.

For the reasons noted above, including those discussed in the MSRB Response Letter, the Commission believes that the proposed rule change is consistent with the Act.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁶⁵ that the proposed rule change (SR-MSRB-2014-07) be, and hereby is, approved.

For the Commission, pursuant to delegated authority.¹⁶⁶

Kevin M. O'Neill
Deputy Secretary

¹⁶⁵ 15 U.S.C. 78s(b)(2).

¹⁶⁶ 17 CFR 200.30-3(a)(12).