

Regulatory Notice

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Affected Rules
[Rule G-18](#); [Rule G-48](#);
[Rule D-15](#)

SEC Approves MSRB Rule G-18 on Best Execution of Transactions in Municipal Securities and Related Amendments to Exempt Transactions with Sophisticated Municipal Market Professionals

Overview

The Municipal Securities Rulemaking Board (MSRB) received approval from the Securities and Exchange Commission (SEC or Commission) on December 5, 2014 to adopt the first explicit best-execution rule for transactions in municipal securities, MSRB Rule G-18. The MSRB also received approval of related amendments to MSRB Rule G-48, on transactions with sophisticated municipal market professionals (SMMPs), and MSRB Rule D-15, on the definition of an SMMP.¹

The MSRB is charged by Congress to protect investors and foster a free and open municipal securities market. Consistent with that charge, the MSRB has advanced a number of initiatives to improve the transparency, efficiency and structure of the municipal securities market. In July 2012, the Commission issued its Report on the Municipal Securities Market (SEC Report), making several recommendations that the SEC concluded should be considered for improvement of the municipal securities market. In particular, the SEC recommended measures by which the MSRB could buttress existing fair-pricing standards, such as establishing a best-execution obligation and providing guidance to dealers on how best-execution concepts would be applied to municipal securities transactions. In alignment with this recommendation and its other market structure initiatives, the MSRB has adopted a requirement that dealers seek best execution of retail customer transactions in municipal securities.



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¹ See Exchange Act Release No. 73764 (Dec. 5, 2014), File No. SR-MSRB-2014-07 (Aug. 20, 2014).

The best-execution requirement generally targets the process by which dealers handle customer orders and execute customer transactions. The adopted rule is, for purposes of regulatory efficiency, generally harmonized with the Financial Industry Regulatory Authority's (FINRA) corresponding rule for best execution in the equity and corporate debt markets, but is tailored to the characteristics of the municipal securities market. Accordingly, Rule G-18 is accompanied by amendments to Rules G-48 and D-15 to provide an exemption from the requirements of the best-execution rule for all transactions with SMMPs, a category of customers that must be institutional investors or individual investors with assets of at least \$50 million. The new best-execution obligation will complement, support and foster compliance with the MSRB's existing substantive pricing standards, helping to ensure that investors receive fair and reasonable prices and to improve execution quality for retail investors in municipal securities, while promoting fair competition among dealers and improving market efficiency.

The rule changes will become effective on December 7, 2015. Prior to effectiveness, the MSRB, in coordination with FINRA, plans to provide practical guidance on complying with the best-execution standard with the aim to establish consistent guidance, as appropriate, on the application of best-execution standards in both the municipal securities and corporate debt markets. Questions concerning this notice may be directed to Michael L. Post, Deputy General Counsel, or Carl E. Tugberk, Assistant General Counsel, at 703-797-6600.

Summary of Rule Changes

Rule G-18, on Best Execution of Transactions in Municipal Securities

Rule G-18 generally requires dealers to use reasonable diligence in seeking to obtain for their retail customer transactions the most favorable terms available under prevailing market conditions. The rule gives due consideration to the existing market structure and other current realities of the municipal securities market. It is designed to be sufficiently flexible to be met by a diverse population of dealers, which can adapt policies and procedures to be reasonably related to the nature of their business, including the level of sales and trading activity and the type of customer transactions at issue. It also embodies flexibility to allow dealers to evidence that they had been sufficiently diligent in a manner that is different than that used by other dealers. At the same time, it is designed to allow for the evolution of the municipal market, including with respect to its structure and future applications of technology.

Reasonable Diligence

Section (a) of Rule G-18 is the core provision of the rule which requires 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. Section (a) includes a non-exhaustive list of factors that a dealer must consider when exercising this diligence: 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 .01 of the Supplementary Material provides 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 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 policies and procedures.² 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. The requirement to use reasonable diligence in the order-handling and transaction-execution process is expected to increase the probability that customers receive fair and reasonable prices, but the rule does not itself contain any regulatory standard by which the transaction price is to be evaluated.

Interpositioning

Section (b) of 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 section (a), a practice known as "interpositioning." In light of the role of broker's brokers in the municipal securities market in providing liquidity, section (b) will not prohibit the use of a broker's broker, unless it is inconsistent with the best-execution obligation in section (a), and will not include a provision (like that in the FINRA rule) which requires dealers to show why it was reasonable to use a broker's broker. This approach is consistent with the MSRB's objective of developing a principles-based rule that does not favor any particular venue over another on bases beyond the

² Existing MSRB Rule G-27, on supervision, requires written supervisory procedures reasonably designed to ensure compliance with all MSRB rules, including the best-execution rule once implemented.

merits of the execution quality available. Moreover, broker's brokers in the municipal securities market must comply with MSRB Rule G-43, on broker's brokers, which serves to address investor-protection issues without additional requirements being imposed by Rule G-18.

Scope

Section (c) of Rule G-18 specifies that the rule applies to both principal and agency transactions. It also provides that best-execution obligations are distinct from the pricing obligations of dealers under MSRB Rule G-30, which generally require dealers to trade with customers at fair and reasonable prices and to exercise diligence in establishing the market value of municipal securities and the reasonableness of their compensation.

Maintenance of Adequate Resources

Paragraph .02 of the Supplementary Material provides 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 the dealer's municipal securities business, including its level of sales and trading activity.

Execution of Customer Transactions

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.

Definition of "Market"

Paragraph .04 of the Supplementary Material defines the term "market" for purposes of Rule G-18, including the rule's core provision, section (a), which requires 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 recognition that the executing dealer itself, acting in a principal capacity, may be the best market for the security is based on the role of dealer inventories in providing liquidity in the municipal market.

Securities with Limited Quotations or Pricing Information

Paragraph .06 of the Supplementary Material addresses transactions involving securities for which there is limited pricing information or quotations, and strikes a balance between a principles-based and more prescriptive approach in such cases. 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 with whom the dealer previously has traded the security. The paragraph also states that a dealer generally should analyze other relevant data to which it reasonably has access.

Customer Instructions

Paragraph .07 of the Supplementary Material allows 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 will 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.

Periodic Review of Policies and Procedures and Execution Quality

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.

Paragraph .08 and Rule G-18 generally are designed to improve dealer policies and procedures and allow for the future evolution of the municipal securities 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. Rule G-18 will not require, in all cases, that dealers conduct reviews on at least a quarterly basis (as required by the FINRA rule). It

instead will 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, depending on all of the facts and circumstances, dealers that handle customer transactions in municipal securities rarely might not be required to conduct reviews of their policies and procedures more frequently than annually, while dealers with an active municipal securities business might be required to do so more frequently than annually.³

Municipal Fund Securities

Paragraph .09 of the Supplementary Material exempts transactions in municipal fund securities, including interests in 529 college savings plans, from the application of 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 Rule G-18 inapt.

Rule G-48, on Transactions with SMMPs, and Rule D-15, on the Definition of SMMP

The amendments to Rule G-48 will provide that the best-execution obligations under Rule G-18 do not apply to transactions with customers that are SMMPs as defined in Rule D-15. Rule G-48 is the consolidated MSRB rule under which all modified obligations of dealers when dealing with SMMPs are addressed. It provides for a reduced suitability obligation under MSRB Rule G-19, reduced time-of-trade disclosure obligation under MSRB Rule G-47, reduced obligations with respect to the dissemination of quotations under MSRB Rule G-13, and a reduced pricing obligation under Rule G-30 in certain non-recommended agency secondary market transactions. The amendments will add a new section (e) to Rule G-48 to provide that a dealer shall not have any obligations under Rule G-18, in transactions with SMMPs, 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.

Rule D-15 contains the MSRB's definition of an SMMP. The amendments to Rule D-15 will help ensure that the exemption for dealers from the best-execution obligation for transactions with SMMPs will only apply to

³ Rule G-27(f)(i) 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.

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, which is significant because of Rule G-48(c)'s elimination of the dealer's obligation under Rule G-19 to make customer-specific suitability determinations when dealing with an SMMP. The amendments to Rule D-15 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. These amendments are designed to ensure that SMMPs have affirmatively and knowingly provided some of the grounds on which a dealer may treat them as investors receiving various lesser protections under MSRB rules.

First, the customer is required to affirm that it is exercising independent judgment in evaluating the quality of execution of the customer's transactions by the dealer. Second, the customer is required to affirm that it is exercising independent judgment in evaluating the transaction price in 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, the customer is 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 provides that the customer affirmation may be made on, in addition to the several existing bases, a type-of-transaction basis.

Due to these amendments, a dealer may not treat any customer as an SMMP after December 7, 2015, unless the dealer reasonably determines (as required by Rule G-48) that the customer has given the revised, broader affirmation.

December 8, 2014

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Text of Amendments⁴

Rule G-18: Best Execution

(a) In any transaction in a municipal security for or with a customer or a customer of another broker, dealer, or municipal securities dealer (“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. Among the factors that will be considered in determining whether a dealer has used “reasonable diligence,” with no single factor being determinative, are:

- (1) the character of the market for the security (e.g., price, volatility, and relative liquidity);
- (2) the size and type of transaction;
- (3) the number of markets checked;
- (4) the information reviewed to determine the current market for the subject security or similar securities;
- (5) the accessibility of quotations; and
- (6) the terms and conditions of the customer’s inquiry or order, including any bids or offers, that result in the transaction, as communicated to the dealer.

(b) In any transaction for or with a customer or a customer of another dealer, a dealer must not interject a third party between itself and the best market for the subject security in a manner inconsistent with paragraph (a) of this rule.

(c) The obligations described in paragraphs (a) and (b) above apply to transactions in which the dealer is acting as agent and transactions in which the dealer is acting as principal. These obligations are distinct from the fairness and reasonableness of commissions, markups or markdowns, which are governed by Rule G-30.

---Supplementary Material:

.01 Purpose. The principal purpose of this rule is to promote, for customer transactions, dealers’ use of reasonable diligence in accordance with paragraph (a). A failure to have actually obtained the most favorable price possible will not necessarily mean that the dealer failed to use reasonable diligence.

.02 Maintenance of Adequate Resources. 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. The level of resources that a dealer maintains should take into account the nature of the dealer’s municipal securities business, including its level of sales and trading activity.

⁴ Underlining indicates new language; strikethrough denotes deletions.

.03 Execution of Customer Transactions. A dealer must make every effort to execute a customer transaction promptly, taking into account prevailing market conditions. In certain market conditions a dealer may need more time to use reasonable diligence to ascertain the best market for the subject security.

.04 Definition of “Market.” The term “market” or “markets,” for the purposes of this rule, unless the context requires otherwise, encompasses a variety of different venues, including but not limited to broker’s brokers, alternative trading systems or platforms, or other counterparties, which may include the dealer itself as principal. The term is to be construed broadly, recognizing that municipal securities currently trade over the counter without a central exchange or platform. This expansive interpretation is meant both to inform dealers as to the breadth of the scope of venues that must be considered in the furtherance of their best-execution obligations and to promote fair competition among dealers (including broker’s brokers), alternative trading systems and platforms, and any other venue that may emerge, by not mandating that certain trading venues have less relevance than others in the course of determining a dealer’s best-execution obligations.

.05 Best Execution and Executing Brokers. 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 quote. 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.

.06 Securities with Limited Quotations or Pricing Information. Although the best-execution requirements in this rule apply to transactions in all municipal securities (other than municipal fund securities), markets for municipal securities may differ dramatically. One of the areas in which a dealer must be especially diligent in ensuring that it has met its best-execution obligations is with respect to customer transactions involving securities for which there is limited pricing information or quotations available. Each dealer must have written policies and procedures in place that address how the dealer will make its best-execution determinations with respect to such a security in the absence of pricing information or multiple quotations and must document its compliance with those policies and procedures. For example, a dealer generally should seek out other sources of pricing information and potential liquidity for such a security, including other dealers that the dealer previously has traded with in the security. Additionally, a dealer generally should, in determining whether the resultant price to the customer is as favorable as possible under prevailing market conditions, analyze other data to which it reasonably has access.

.07 Customer Instructions Regarding Handling of Bids or Offers. 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. Dealers are, however, still required to process that customer’s transaction promptly and in accordance with the terms of the customer’s bid or offer.

.08 Review of Policies and Procedures and Execution Quality.

(a) 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. While no more frequent interval is specifically required, a dealer must conduct these reviews at a frequency reasonably related to the nature of its municipal securities business, including but not limited to its level of sales and trading activity. In conducting its 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.

(b) A dealer that routes its customers' transactions to another dealer that has agreed to handle those transactions as agent or riskless principal for the customer (e.g., a clearing firm or other executing dealer) may rely on that other dealer's periodic reviews as long as the results and rationale of the review are fully disclosed to the dealer and the dealer periodically reviews how the other dealer's review is conducted and the results of the review.

.09 Exemption for Municipal Fund Securities. The provisions of this rule do not apply to transactions in municipal fund securities.

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Rule G-48: Transactions with Sophisticated Municipal Market Professionals

A broker, dealer, or municipal securities dealer's obligations to a customer that it reasonably concludes is a Sophisticated Municipal Market Professional, or SMMP, as defined in Rule D-15, shall be modified as follows:

(a) - (d) No change.

(e) *Best Execution.* The broker, dealer, or municipal securities 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.

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Rule D-15: Sophisticated Municipal Market Professional

The term “sophisticated municipal market professional” or “SMMP” ~~shall mean a customer of a broker, dealer or municipal securities dealer that is:~~ is defined by three essential requirements: the nature of the customer; a determination of sophistication by the broker, dealer or municipal securities dealer (“dealer”); and an affirmation by the customer; as specified below.

(a) Nature of the Customer. The customer must be:

(1) a bank, savings and loan association, insurance company, or registered investment company; ~~or~~

(2) an investment adviser registered either with the ~~Securities and Exchange~~ 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

(3) any other person or entity ~~(whether a natural person, corporation, partnership, trust, or otherwise)~~ with total assets of at least \$50 million; ~~and,~~

(b) Dealer Determination of Customer Sophistication. The dealer must have ~~that the broker, dealer or municipal securities dealer~~ has a reasonable basis to believe that the customer 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 broker, dealer or municipal securities dealer.~~

(c) Customer Affirmation. The customer must affirmatively indicate that it:

(1) is exercising independent judgment in evaluating:

(A) the recommendations of the dealer;

(B) the quality of execution of the customer’s transactions by the dealer; and

(C) the transaction price for non-recommended secondary market agency transactions as to which (i) the dealer’s services have been explicitly limited to providing anonymity, communication, order matching and/or clearance functions and (ii) the dealer does not exercise discretion as to how or when the transactions are executed; and

(2) has timely access to material information that is available publicly through established industry sources as defined in Rule G-47(b)(i) and (ii).

---Supplementary Material:

.01 No change.

.02 Customer Affirmation. The customer affirmation may be given ~~A customer may affirm that it is exercising independent judgment either orally or in writing, and such affirmation may be given on a trade-by-trade basis, a type-of-transaction basis, or on a type-of-municipal-security basis (e.g., general obligation, revenue, variable rate, etc.), or on an account-wide basis.~~