August 9, 2013

MSRB Requests Comment on Whether to Adopt a Best Execution Standard (After SIFMA Proposes Its Own Rule)

The Municipal Securities Rulemaking Board (the "MSRB") recently requested comment on whether to require dealers to seek "best execution" of customer orders for municipal securities and provide detailed guidance to dealers on how best execution concepts would be applied to municipal securities transactions. The MSRB is not currently proposing a specific rule governing best execution but is instead seeking comments on the general concept of establishing a best execution standard for municipal securities. Comments will assist the MSRB in determining whether to propose best execution rules in the future. The MSRB request is available here.

Best Execution Background and the MSRB Request

"Best execution" obligations for securities professionals can arise under various laws, regulations and common law obligations. Broker-dealers have a specific best execution obligation under FINRA Rule 5310 (Best Execution and Interpositioning) for equity securities and non-municipal bond transactions.[1] However, FINRA Rule 5310 does not apply to municipal security transactions and MSRB rules do not contain a specific best execution standard applicable to brokers, dealers and municipal securities dealers (collectively, "dealers").

Current MSRB Rules G-18 and G-30 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 compensation. Guidance issued by the MSRB in 2004 addressed certain issues relating to the pricing of hard-to-value securities, noting that dealers are required to use reasonable diligence in meeting their duty to establish market values as accurately as possible, even where well-defined and active markets may be lacking. The MSRB recently proposed a revised Rule G-30 to consolidate these current rules and guidance into a single fair pricing rule. For a discussion of that proposal, please see our client alert available here. The MSRB notes that a new best execution requirement would augment these requirements.

The MSRB notes that virtually all of its registered dealers are subject to the best execution obligations imposed by FINRA Rule 5310 for corporate equity and bond trades and is a logical starting place for developing its own best execution requirements. FINRA Rule 5310 generally requires its members to use reasonable diligence in any transaction for or with a customer (or a customer of another broker-dealer) to ascertain the best market for a security to be bought or sold at the price most favorable to that customer under prevailing market conditions. The FINRA rule also includes provisions related to interpositioning (i.e., interjecting a third party between the member and the best available market), the use of a broker's broker, the staffing of order rooms, and the application of the best execution requirements to other parties. Supplementary material to FINRA Rule 5310 also codifies the obligations of member firms when undertaking regular and rigorous review of the execution quality likely to be obtained from different market centers.

In seeking comment on whether to adopt its own best execution requirements, the MSRB notes that simply copying the existing FINRA standards may not result in requirements suitably tailored to the attributes of the municipal securities market. The MSRB notice seeks comments on, and welcomes statistical, empirical and other data regarding, a number of specific questions related to a best execution obligation. For information on the specific MSRB requests for comment, please refer to the MSRB notice linked above.

SIFMA Issues Its Own Recommendation

The MSRB request for comment follows on the heels of a recommendation of the Securities Industry and Financial Markets Association ("SIFMA") for a municipal securities

1 For more information on FINRA Rule 5310, please see our May 31, 2012 Client Alert, available here, and our January 11, 2012 Client Alert, available here.

execution obligation, which was publicly announced about ten days prior to the MSRB's request. Contrary to the MSRB request, however, SIFMA submitted an actual draft rule to the MSRB that would impose a specific "execution-with-diligence" standard for municipal securities transactions. A copy of the SIFMA rule proposal, press release and related information is available here.

In June 2013, SIFMA submitted a proposal to the MSRB that would amend MSRB Rule G-18 to be very similar, in many respects, to current FINRA Rule 5310. A copy of SIFMA's recommended Rule G-18 blacklined against FINRA Rule 5310 is available here.

SIFMA's recommended Rule G-18 would provide that in any transaction for or with a customer, a dealer must use "reasonable diligence" to ascertain the market for the subject security so that the resultant price to the customer is fair and reasonable under prevailing market conditions. SIFMA notes that its proposal is similar to the approach in FINRA Rule 5310, but is modified to encompass the practical differences of the municipal securities market—namely fragmentation, illiquidity, the prevalent use of broker's brokers and bid-wanted auctions, and the lack of a centralized exchange. SIFMA has stated that this would impose a higher standard for dealers to meet than what is currently in place under existing MSRB rules. Similar to FINRA Rule 5310, SIFMA's proposal contains a non-exhaustive list of factors that may be considered in determining whether a dealer has used "reasonable diligence."

SIFMA's proposal also included an interpositioning provision similar to FINRA Rule 5310 that would provide that in any transaction for or with a customer, no dealer could interject a third party between the dealer and the buyer or seller for the subject security in a manner inconsistent with the rule's basic reasonable diligence obligation. The SIFMA interpositioning provision, as well as related portions of the rule and supplementary material, differ slightly from FINRA Rule 5310 to reflect the existence of MSRB Rule G-43 governing "broker's brokers" in light of the fact that a broker's broker rule does not exist under FINRA rules.

SIFMA requested that the MSRB allow for an implementation period of at least six to nine months for any new policy that may be adopted.

Submitting Comments to the MSRB

You may submit comments to the MSRB in response to its general request for comment by submitting a hard copy or by submitting comments electronically at http://www.msrb.org/CommentForm.aspx. You may submit comments on the proposed rule through October 7, 2013.

For More Information

To discuss any topic covered in this client alert, please contact an attorney in the Investment Management Group or visit us online at Chapman.com.

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