

SEC Approves Rule Establishing Best-Execution Standard for Dealers of Municipal Securities

On December 5, 2014, the SEC approved MSRB Rule G-18 (the “Rule”) and related amendments to MSRB Rules G-48 and D-15, to impose a best-execution standard on dealers of municipal securities.¹ The rule change will go into effect December 7, 2015.²

Requirements

The principal requirement of Rule G-18 is that dealers “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.”³ The Rule provides a non-exhaustive list of six factors to determine whether a dealer has used “reasonable 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;
- the terms and conditions of the customer’s inquiry or order that result in the transaction.⁴

The Rule states that no single factor is determinative of whether the dealer has used “reasonable diligence,”⁵ and that a failure to actually obtain the most favorable price possible does not necessarily mean that the dealer failed to use reasonable diligence.⁶ However, a failure to maintain adequate resources (taking into account the nature of the dealer’s municipal securities business) cannot justify failing to execute with the best available market.⁷ The Rule specifically states that it applies to transactions in which the dealer is acting as agent as well as in which the dealer is acting as principal. Additionally, the Rule expressly states that the best-execution obligation is distinct from the fairness and reasonableness of commissions, markups or markdowns, which are governed by Rule G-30.

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

² MSRB Regulatory Notice 2014-22, at 2 (Dec. 8, 2014) (the “MSRB Notice”).

³ MSRB Rule G-18(a).

⁴ *Id.*

⁵ *Id.*

⁶ Rule G-18, ¶.01 of the Supplemental Material.

⁷ Rule G-18, ¶.02 of the Supplemental Material.

In addition to ascertaining the best market for the subject security, the Rule requires dealers to take “every effort” to execute customer transactions promptly.⁸ It recognizes, however, that certain market conditions may necessitate taking more time to ascertain the best market.⁹ When market conditions are such that there is an absence of pricing information for a security, a dealer should generally seek out other sources of pricing and liquidity, such as past trading partners.¹⁰ The Rule requires that dealers have written policies and procedures to address how it should make best-execution determinations in such circumstances, and that dealers document their compliance with such policies and procedures.¹¹

Dealers must also review their best-execution policies and procedures at least on an annual basis, and potentially more frequently depending on the nature of their municipal securities business.¹² This review must assess the effectiveness of its policies and procedures, taking into account the quality of executions the dealer is obtaining, changes in market structure, new entrants, the availability of new technology and additional pre-trade and post-trade data.¹³ If a dealer routes customer transactions to another dealer (such as a clearing firm) for execution, then it may rely on the executing dealer’s periodic reviews, so long as the results and rationale of the executing dealer’s reviews are disclosed to, and periodically reviewed by, the introducing or originating firm.¹⁴

Finally, the Rule prohibits a dealer from interjecting a third party between itself and the best market for a subject security in a customer transaction if doing so would be inconsistent with its best-execution obligations.¹⁵ The Rule does not ban the use of a broker’s broker if used consistent with the best-execution obligation.¹⁶ In addition, unlike the corresponding FINRA rule for corporate securities, municipal dealers using a broker’s broker do not have an affirmative burden to demonstrate that it was reasonable to do so.¹⁷

The Rule states that the duty to provide best execution also applies to any transaction “for or with” a “customer of another dealer” but not when the other dealer is simply executing a customer transaction against the dealer’s quote.¹⁸ Further, if a dealer receives an unsolicited instruction designating a particular market for execution, the dealer is not required to make a best-execution determination beyond the customer’s specific instruction.¹⁹

⁸ Rule G-18, ¶.03 of the Supplemental Material.

⁹ *Id.*

¹⁰ Rule G-18, ¶.06 of the Supplemental Material.

¹¹ *Id.*

¹² Rule G-18, ¶.08(a) of the Supplemental Material.

¹³ *Id.*

¹⁴ Rule G-18, ¶.08(b) of the Supplemental Material.

¹⁵ Rule G-18(b).

¹⁶ MSRB Notice at 3.

¹⁷ *Id.*; cf. FINRA Rule 5310(b) (“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 in on the member.”).

¹⁸ Rule G-18, ¶.05 of the Supplemental Material.

¹⁹ Rule G-18, ¶.01 of the Supplemental Material.

Definition of “Market”

For purposes of the Rule, the term “market” is defined broadly to specifically include alternative trading systems or platforms, broker’s brokers, and other counterparties, including potentially the dealer itself as a principal.²⁰

Limitations on the Rule’s Scope

The Rule contains several significant carve-outs. Most significantly, the Rule does not apply to transactions with clients defined as sophisticated municipal market professionals (“SMMPs”).²¹ However, in approving the Rule and the accompanying SMMP exemption contained in Rule G-48, the MSRB also amended Rule D-15 to expand the required customer affirmations that a SMMP must provide.²² To be an SMMP, and thus subject to the exemption from Rule G-18’s best-execution obligations, amended Rule D-15 requires a customer to affirmatively indicate that it is exercising independent judgment in evaluating the recommendations of the dealer, the quality of its trade executions by the dealer, and the transaction prices for certain non-recommended secondary market agency transactions.²³ It also must affirm that it has timely access to publically-available material information.²⁴ Dealers must obtain this newly revised, broader affirmation from a client in order to treat it as an SMMP after December 7, 2015.

In addition to not applying to SMMPs, the Rule does not apply to transactions in municipal fund securities (e.g. 529 plans).²⁵

Conclusion

Although dealers of municipal securities have long had an obligation to obtain a “fair and reasonable” price for clients pursuant to Rule G-30, Rule G-18 imposes a distinct best-execution standard for the first time.²⁶ Like FINRA’s analogous Rule 5310, the rule focuses on the process used to execute orders, rather than the result of whether the price obtained for a particular security is the most favorable possible. Therefore, the creation and documented adherence to reasonable best-execution policies and procedures will be critical for compliance with the Rule. The framework firms that use today for compliance with FINRA Rule 5310 for corporate fixed income securities will be a useful starting place for MSRB Rule G-18. However, the SEC and MSRB have recognized that the municipal securities market, with its hundreds of thousands of thinly traded CUSIPs, is unique, and requires separate consideration from other markets.

Exactly how firms should support their municipal bond best execution analysis, however, remains unclear. It may be helpful to gather some execution quality data from counter-party dealers with which a firm transacts, to support the firm’s practice of calling those counter-parties rather than others. Firms that execute principal trades of municipal securities for customers should begin to build support for the argument that their customers receive better executions on these trades than they would if, for example, the firm put out a “bid wanted” on an

²⁰ Rule G-18, ¶.04 of the Supplemental Material.

²¹ Amendments to Rule G-48.

²² Amendments to Rule D-15.

²³ *Id.*

²⁴ *Id.*

²⁵ Rule G-18, ¶.09 of the Supplemental Material.

²⁶ See Rule G-18(c) (best-execution obligations “are distinct from the fairness and reasonableness of commissions, markups or markdowns, which are governed by Rule G-30”).

alternative trading system. Firms may want to document when and how they use alternative trading systems for municipal bonds. We believe FINRA (which conducts municipal securities surveillance on behalf of the MSRB) is likely to conduct its best execution analysis by comparing individual bond executions to information it has available from electronic systems about available quotes for those bonds – using “objective” criteria it will not publicly disclose. Unless the MSRB is more forthcoming, the only guidance member firms will receive is through the disciplinary process. Finally, firms should begin to plan the process of obtaining the new SMMP affirmations from eligible clients.

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