

September 26, 2013

Ronald W. Smith, Corporate Secretary
Municipal Securities Rulemaking Board

Re: MSRB Notice 2013-16

Mr. Smith:

Thank you for the opportunity to comment on the Board's continued quest to apply best-ex to the municipal market. At first blush, this seems like a wonderful idea. However, even the concept of best-ex can be confusing. What is "best execution"? FINRA Rule 5310 defines best execution not as obtaining the best price, but as utilizing due diligence to establish that the client's transaction is executed on the best market to ensure that the client receives the most favorable price under prevailing market conditions. Logic would dictate that the drafters of the rule presumed that the rule would apply where there are multiple markets for a security. This would certainly apply to over the counter and exchange traded equity securities, where the transactions are executed on an almost exclusively agency basis. But is there a reasonable application of this principle to the municipal market?

Although FINRA Rule 5310 attempts to address unquoted markets, it does so in such a fashion as to direct dealers to utilize their expertise to obtain the best execution for clients without defining or providing guidance as to how that is to be accomplished. The Rule does require broker-dealers to establish policies and procedures to ensure that customer orders receive best execution in the absence of a quoted market. Consequently, dealers refer to policies and procedures in demonstrating compliance with FINRA Rule 5310 in the execution of most fixed income transactions.

It should go without mentioning that the municipal market is not a quoted market. The nature of the municipal market- over a million individual securities, many of which are issued in sizes conducive to being held by a single owner- is extremely detrimental to creating a quoted market. Furthermore, unlike equities, municipal securities are not traded on different markets. The municipal market generally consists of dealers buying and selling bonds out of their inventories. Municipal dealers usually will only post bids in response to requests and only offer securities that they own or are fairly certain that they can acquire. The existence of electronic platforms can expedite the process of obtaining responses to bids wanted, but serve the function of a technologically advanced broker's broker. We have all seen the potential negative results of presuming that one's pricing obligations are met by placing a client bid wanted with a third party where the dealer involved does not possess market expertise in a security. A municipal dealer is performing due diligence by making a professional determination as to where the best bid for a certain security may lie. Unlike with equities, it is not the best market, but the dealer with the best understanding of that particular municipal security that will enable a client to obtain the best price. (An argument could be made that the regulators have been on a dedicated march to remove these very market participants from the market, but that is an argument for another day.) In contrast with an agency traded equity security, the broker-dealer whose client asks to

sell a block of municipal securities must use their expertise to determine from whom, not on which market, to obtain the best bid.

Complicating matters is the fact that the bid a municipal dealer may choose to execute might likely be their own. It is understandable that regulators would wish to craft a rule to protect clients in such an instance, particularly when the municipal pricing rule requires that a dealer obtain a price that is fair and reasonable, rather than requiring that a dealer obtain a price indicative of best execution. "Reasonable" just does not appear to the naked eye to be as fair as "best." The fact remains, however, that FINRA's "best" rule applies to determining a market (although granted many refer to it as the "best price" rule), and the Board's rule specifically addresses price. There may be an opportunity to more closely align the municipal rule with FINRA Rule 5310 as it applies to debt securities by adding a due diligence requirement with regard to a sell order that is received from a client. However, any attempt to define the municipal market as several components, all of which are unquoted, would place a burden on municipal market participants that is not applied to participants in any other securities market.

One cannot possess even a basic understanding of the municipal bond market and believe that it is possible to craft a functional best execution rule for instances where securities are offered to clients. With the exception of new issue offerings (where pricing is established by the offering document), rarely do clients ask for a broker to buy a municipal security at market. Generally, a municipal security is offered to a client by a dealer that either owns or controls the municipal security in question. Municipal securities possess very unique descriptive qualities and if a dealer does not own a security, it is extremely unlikely that dealer can locate a party with that security on inventory, buy it and offer that security at a price more favorable to the client than that of the party that owned the security. In other words, the party owning the security is going to have the best offering for that security, because it is the only offering for that security. The issue of the uniqueness of a principally owner-offered market is addressed in the current pricing rules. Additionally, Rule G-13 requires published quotes to be bona fide. No sane individual would make a bona fide offer to sell ninety-nine point nine percent of the municipal securities issues outstanding without having ownership or control of that security. As I have said before, you can find muni sell side best- ex guidance right next to tips on how to ride a unicorn.

Thank you again for the opportunity comment on this issue.

Sincerely,

Chris Melton