



March 13, 2014

Ronald W. Smith
Corporate Secretary
Municipal Securities Rulemaking Board
1900 Duke Street
Alexandria, VA 22314

Re: **MSRB Notice 2014-02 (February 19, 2014) Request for Comment on Draft Best Execution Rule, Including Exception for Transactions with Sophisticated Municipal Market Professionals**

Dear Mr. Smith:

The Securities Industry and Financial Markets Association (“SIFMA”)¹ appreciates the opportunity to comment on the Municipal Securities Rulemaking Board’s (“MSRB”) Request for Comment on Draft Best Execution Rule, Including Exception for Transactions with Sophisticated Municipal Market Professionals² (the “Proposal”). SIFMA also appreciates the MSRB’s consideration of our ‘execution with diligence’ proposal³. We and our members share the MSRB’s goal of improving the execution standard for the municipal market. Developing a higher standard is in the best interest of investors and the municipal market, and is something SIFMA has been focused on for the past year. SIFMA supports an execution standard for the municipal market that is structurally similar to FINRA 5310 and we support the execution handling *process* in the Proposal.

¹ SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

² MSRB Notice 2014-02 (February 19, 2014) available at <http://msrb.org/~media/Files/Regulatory-Notices/RFCs/2014-02.ashx?n=1>

³ See letter from David L. Cohen, SIFMA, to Lynnette Kelly, MSRB, dated June 24, 2013, available at <http://www.sifma.org/issues/item.aspx?id=8589944578>, proposing an “execution with diligence” standard for the municipal securities market and detailing unique attributes of this market. See also, Letter from David L. Cohen, SIFMA, to Ronald W. Smith, SEC, dated October 7, 2013, available at <http://www.sifma.org/issues/item.aspx?id=8589945474>

I. Executive Summary

SIFMA believes an execution diligence process resulting in a price that is fair and reasonable under prevailing market conditions is more reflective of the appropriate balance of investor protection interests with the need for efficient municipal markets. It also complements a dealer's pricing obligation under Rule G-30. Before the MSRB adopts a final rule, SIFMA requests additional information and guidance from the MSRB relating to the harmonization of Rule G-18 and G-30, as well as compliance issues. Additionally, the MSRB should separately issue a request for data and other information, in particular quantitative data, relating to the benefits and costs that could result from various alternative approaches regarding the standards of conduct and other obligations relating to its Proposal.

II. Background

Soon after the U.S. Securities and Exchange Commission issued a Report on the Municipal Securities Market in July 2012⁴ (the "SEC Report" or "Report"), SIFMA began reviewing and discussing the Report and its recommendations. While we believe the municipal market generally operates fairly and efficiently, we also feel strongly that the issues raised in the Report provide an opportunity to improve public trust and confidence in the municipal securities market. We have taken particular notice of issues raised in the Report that suggest that retail customers are disadvantaged in execution, pricing and disclosure as they may not have access to same information as dealers and institutional customers. One recommendation in the Report designed to address this concern is for the MSRB to consider "possible rule changes that would require municipal bond dealers to seek 'best execution' of customer orders [similar to FINRA's approach to corporate fixed income securities]...and provide more detailed guidance to municipal bond dealers on how 'best execution' concepts would be applied in connection with transactions in municipal securities." SIFMA's goals in addressing this recommendation have been to: 1) support effective and efficient regulation of the municipal securities market that aids market liquidity in a manner consistent with investor protection; 2) promote higher standards for brokers, dealers, and municipal securities dealers that would advance public trust and confidence in the municipal securities market; and 3) articulate a principles-based rule that does not favor one execution venue or counterparty over another.

To that end, we have engaged in numerous individual and group meetings with our membership over the past 20 months with the goal of producing a recommended policy change designed to strengthen trade execution in the municipal market. SIFMA's "execution with diligence" proposal was the product of that effort. The MSRB's Proposal reflects numerous suggestions made by SIFMA.

⁴ U.S. Securities and Exchange Commission *Report on the Municipal Securities Market* (July 31, 2012), available at <http://www.sec.gov/news/studies/2012/munireport073112.pdf>.

SIFMA respectfully disagrees with applying equity-based best execution standards to the municipal market. SIFMA strongly believes that rules and standards regarding execution must reflect their fundamental limitations and objects to rules that implicitly or explicitly import notions of best execution more appropriately applied to markets for more liquid equity and corporate debt securities. Any divergence from existing equity and corporate debt securities execution requirements should not be intended to dilute them, but to impose requirements that are properly tailored for the municipal market. SIFMA does not challenge the notion that the *goal* of a dealer's execution diligence is to provide the customer with the most favorable price. However, SIFMA believes an execution diligence process resulting in a price that is fair and reasonable under prevailing market conditions is more reflective of the appropriate balance of investor protection interests with the need for efficient municipal markets.⁵ It also complements a dealer's pricing obligation under Rule G-30.

III. Relationship between G-18 and G-30

For over thirty years, municipal securities dealers have followed the guidance published by the MSRB in its 1980 *Report on Pricing*⁶ to provide direction in determining the fairness of prices that customers receive. The substance of this report has been reaffirmed⁷ and built upon since then⁸. SIFMA concurs with the views repeated by the

⁵ The phrase "best execution" carries with it a clear meaning, which as SIFMA and MSRB have acknowledged is not the standard that MSRB is trying to adopt for the municipal securities market with this proposed rulemaking. Unfortunately, enforcement examiners, reporters, and others who are not intimately familiar with the MSRB's intent with this "best execution" standard will apply the plain meaning of this phrase and hold dealers to standards in enforcement actions, regulatory exams, and reporting that are inconsistent with the MSRB's intent. The best way to avoid that outcome is to discontinue using the "best execution" label in favor of a label that does not imply anything other than the reasonable diligence standard that the MSRB is proposing.

⁶ MSRB *Report on Pricing* (September 26, 1980, republished on October 3, 1984) available at http://msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-30.aspx?tab=2#_F9EBEC49-FAD0-4200-B016-A7002071FDF3 (the "Report on Pricing").

⁷ *Id.*

⁸ Republication of the Report on Pricing (October 3, 1984), *supra* Note 3; Rule G-30 Interpretive Notice, *Review of Dealer Pricing Responsibilities* (January 26, 2004) (the "2004 Notice") available at http://msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-30.aspx?tab=2#_A5756731-6EF3-45A9-BB32-0EACF2074FD8; , *Guidance on Disclosure and Other Sales Practice Obligations to Individual and Other Retail Investors in Municipal Securities* (July 14 2009) (the "2009 Notice"), available at <http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2009/2009-42.aspx?n=1>; Restated Interpretive Notice Regarding the Application of MSRB Rules to Transactions with Sophisticated Municipal Market Professionals (July 9, 2012), available at http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-17.aspx?tab=2#_D37D3EF9-F642-4A63-A40D-3A6B33B5260A ; Interpretive Notice Concerning the Application of MSRB Rule G-17 to underwriters of Municipal Securities (August 2, 2012), available at <http://msrb.org/Rules-and-Interpretations/Regulatory-Notices/2012/2012-25.aspx>; see also MSRB Interpretation of November 29, 1993, *Factors in Pricing* (the "1993 Interpretation"), available at http://msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-30.aspx?tab=3#_2499EFE4-BC98-490D-A145-70C9D62B91A6

MSRB in its recent filing with the SEC⁹ that Rule G-30's standards for fair and reasonable pricing should be preserved, as the rule appropriately balances investor-protection interests with the need for efficient municipal markets. This standard reflects the current market structure and unique attributes of the municipal securities market. Rule G-30's substantive pricing standards complement a dealer's order-handling and transaction-execution responsibilities. While they are separate obligations, they are necessarily linked. Yet the entirety of prior MSRB rule making and guidance regarding pricing is being consolidated into revised Rule G-30. Accordingly, SIFMA requests that the MSRB provide guidance on the interplay between G-18 and G-30, specifically the applicability of Rule G-30's "Relevant Factors in Determining the Fairness and Reasonableness of Prices" to proposed Rule G-18. Market participants must be given the opportunity to understand and comment on how these two rules will continue to work hand in hand, or not.

IV. Demonstrating Compliance

Some of SIFMA's members currently follow as a business practice the order handling process under FINRA 5310 for municipal securities. Accordingly, they are looking for guidance¹⁰ from the MSRB as to how they would demonstrate "best execution" "reasonable diligence" compliance versus current fair dealing obligations, and what, if any, additional steps would need to be taken to adhere to the new standard as the scope of the duty and the methods of demonstrating satisfaction diverge substantially from the traditional methods of best execution for equity securities. This guidance would also be instructive to dealers that do not currently utilize such a robust order handling and post trade review of execution quality.

V. Prevailing Market Conditions

SIFMA members have shared with us anecdotally that they are often required in examinations to defend and justify the execution price of a customer trade against a higher or lower customer trade of the same CUSIP that took place *later* the same day, T+1, T+2, or even further out. This, alas, requires pre-cognition. Prevailing market conditions should be defined within G-18 as those conditions that are reasonably known to the market at the time of execution. Pricing of municipal bonds is inherently somewhat subjective. Absent guidance that assures the industry that the regulators understand and agree that the term "best execution" (as it relates to municipals) does not mean every trade at a particular point in time (within 24 to 48 hours) must match the best price to have occurred *thereafter*, the

⁹ SR-2014-01 (January 29, 2014), *Proposed Rule Change Consisting of Proposed Revisions to MSRB Rule G-30, on Prices and Commissions and the Deletion of Rule G-18, on Execution of Transactions*, available at <http://msrb.org/Rules-and-Interpretations/SEC-Filings/~//media/Files/SEC-Filings/2014/SR-MSRB-2014-01.ashx>

¹⁰ As noted in Section II, above, the SEC Report recommends to the MSRB, in addition to rule making, that it provide more detailed *guidance* on how "best execution" concepts would be applied in connection with transactions in the municipal market.

result will be fewer and fewer firms willing to make markets and the further result will be much worse execution for investors over time.

Unlike the treasury or stock markets, there is not a quoted market for municipal securities. There is not a single "screen" to look at that *determines* the price and even if there were such a single point of overall market inspection, it would only represent what a particular dealer was willing to pay at a particular point in time. Factually, there are very rarely numerous buyers and sellers of a given municipal security over a short time span, which would (if they existed) allow market price convergence to occur and permit an equity-type best execution rule to be meaningful. Unfortunately, rules alone cannot create this behavior. Even if a single automated trading system were to dominate the market place, such behavior is not going to happen, because the MSRB cannot control the ordinary commercial decision-making of bond *owners* and there are too many individual municipal securities.

The MSRB 2013 Fact Book illustrates the problem nicely in its chart titled "Average Trading Volume by Day of Week, 2013"¹¹. As is made clear by the data at the bottom of that page, on average, an individual municipal security trades less than 3 times per day. Since some securities (particularly new issue securities) do trade multiple times a day, the ordinary trade frequency of secondary market municipal securities is even lower.

VI. Economic Analysis

SIFMA and its members believe that evaluating the costs and burdens of new regulation, and weighing those costs against any benefits derived from such new regulation, is critical to ensure efficient regulation. An essential component of this principle is conducting a true, reality-based, (and if possible dollar-specific) cost-benefit analysis of new rule proposals and other initiatives. Fully consider the costs and burdens to both the MSRB and its funders weighed against potential benefits, which we understand are much more difficult to value, as well as reasonable alternatives. SIFMA is pleased that the MSRB has adopted a formal framework for its approach to integrate economic analysis into its proposed rulemaking.¹²

SIFMA agrees with the MSRB's goal to improve the execution quality for customer transactions. And while the MSRB acknowledges concerns raised, in response to the MSRB's prior concept release on whether to adopt a best execution

¹¹ MSRB 2013 Fact Book page 14, available at <http://www.msrb.org/msrb1/pdfs/MSRB-Fact-Book-2013.pdf>. Averages are derived from the data: Monday 2.66 trades/CUSIP; Tuesday 2.73 trades/CUSIP; Wednesday 2.75 trades/CUSIP/ Thursday 2.75 trades/CUSIP; Friday 2.67 trades/CUSIP. Of course, some securities traded far more often in a given day, and others only traded once.

¹² Policy on the Use of Economic Analysis in MSRB Rulemaking (September 26, 2013) available at <http://msrb.org/About-MSRB/Financial-and-Other-Information/Financial-Policies/Economic-Analysis-Policy.aspx>

rule¹³, that imposing a best execution standard on the municipal market would impose significant additional costs on dealers, which may result in some dealers discontinuing offering municipal securities to their retail customers negatively impacting liquidity in this market – yet the MSRB’s economic analysis in the Proposal does not reach any conclusions other than to say in essence that the data is not available. SIFMA believes that any new rulemaking should not hinder liquidity in the market. It is critical that the MSRB strike the appropriate balance between investor protection interests and the efficient operation of the municipal markets. SIFMA would be pleased to work with the MSRB to obtain reliable empirical data to assist it in quantifying such costs and benefits. As SIFMA has said in prior comment letters, such data cannot be obtained in the tight time frame of a Request for Comments deadline¹⁴. A data request could include: the costs of developing and maintaining a comprehensive compliance and supervisory system, procedures and training programs to implement the new standard, as well as updates when regulatory guidance is updated, or legal precedent and/or firm practices change. In terms of the costs components for developing, preparing, and maintaining such systems the following should be considered: (i) outside legal costs, (ii) outside compliance consultant costs, (iii) other out-of-pocket costs, and (iv) employee- and staff related costs. Expense categories that could comprise estimates of “out-of-pocket” costs could include: information technology and vendors, information technology systems, hardware and software, support and testing/audit; business review, risk review and surveillance.

Additionally, SIFMA believes that the proper baseline for comparing and evaluating the costs and benefits of the Proposal is current Rule G-18 as well as the reasonable alternative proposed by SIFMA in the form of its “execution with diligence proposal”.

VII. Proposed Exemption for Transactions with Sophisticated Municipal Market Professionals

The Proposal contains an exemption from best execution for transactions with Sophisticated Municipal Market Professionals (“SMMPs”). SIFMA supports this exemption as it is consistent with the SEC Report’s focus on retail investors. It is also consistent with the treatment of SMMPs under existing MSRB rulemaking.

¹³ MSRB Notice 2013-06 (August 6, 2013) *Request for Comment on Whether to Require Dealers to Adopt a “Best Execution” Standard for Municipal Securities Transactions* available at <http://msrb.org/Rules-and-Interpretations/Regulatory-Notices/2013/2013-16.aspx?n=1>

¹⁴ As a point of comparison, interested parties were given 120 days from publication in the Federal Register to comment on and respond to the Securities and Exchange Commission’s Request for Data and Other Information (Release No. 34-69013; IA-3558; File No. 4-606) available at <http://www.sec.gov/rules/other/2013/34-69013.pdf>

VIII. Implementation Period

Any regulatory scheme takes time to implement properly. Implementing a best execution standard for the municipal market is revolutionary. Dealers will need a reasonable time to allow for a sufficient implementation period to develop, test, and implement compliance and supervisory policies and procedures, systems and controls, testing/auditing as well as extensive training. Therefore, SIFMA requests an implementation period, which would be no less than one year from approval by the SEC, before the Proposal becomes effective.

IX. Comments on Specific Language

i. G-18(a)

Among the list of “factors” that will be considered in determining whether a dealer has used “reasonable diligence” is “the number of markets checked¹⁵”. 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. A municipal bond trader may seek quotes from other dealers, but depending on the facts and circumstances, doing so may not be in the interest of the customer as it would permit market participants to become aware of interest in a bond, which could have the effect of moving the market away from the customer. Further, 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 beneficial execution. Accordingly, we strongly disagree with any suggestion that the act of contacting other dealers would be the implicit or requisite procedure to evidence best execution.

ii. Supplementary Material

Supplementary Material .01 Purpose includes the statement: “A failure to have actually obtained the most favorable price will not necessarily mean that the dealer failed to use reasonable diligence”. SIFMA believes this sentence is a critical part of ensuring that the rule reflects the unique characteristics of the municipal market. Implicit in this language is that best execution does not mean that every trade must match or be at the same price as the trades around it, particularly the trades following. Our 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

¹⁵ At most larger dealers, a municipal bond trader has multiple “screens” open at any given time showing, for example, internal inventory, offerings on one or two ATSS, offerings made via constantly scrolling messaging systems, as well as ordinary e-mail. While messages can be retrieved and keystrokes captured, how could a trader *prove* that he or she had actually checked three screens and read two messages as they scrolled by before deciding to execute a purchase for a customer at a particular price?

execution. Uncertainty surrounding what constitutes “reasonable diligence” may result in reduced willingness to bid bonds or offer bonds to retail customers, which would harm liquidity in the municipal market. Consistent with the SEC’s recommendation in the SEC Report, SIFMA requests guidance from the MSRB to assist dealers in demonstrating compliance with any new best execution requirements and give clarity to enforcement regulators.

Supplementary Material .08 Review of Execution Quality requires a dealer to conduct periodic reviews of its policies and procedures for determining the best available market for the execution of its customer’s transactions. Execution quality relates to customer pricing and under the current market structure this would necessarily include a post-trade price review. Accordingly, we suggest adding “under which the goal is to provide the customer with a fair and reasonable price possible under prevailing market conditions”. Accordingly the complete first sentence of Section .08(a) would read: “A dealer must, at a minimum, conduct periodic reviews of its policies and procedures for determining the best available market for the executions of its customer’s transactions under which the goal is to provide the customer with a fair and reasonable price possible under prevailing market conditions.”

X. Conclusion

SIFMA sincerely appreciates this opportunity to comment on the Proposal. SIFMA supports raising the execution standard in the municipal market in a way that reflects the current market structure and unique characteristics of the municipal market. We believe SIFMA’s “execution with diligence” proposal accomplishes this goal. Before the MSRB adopts a final rule SIFMA requests additional information and guidance from the MSRB. Additionally, the MSRB should separately issue a request for data and other information, in particular quantitative data, relating to the benefits and costs that could result from various alternative approaches regarding the standards of conduct and other obligations relating to its Proposal.

SIFMA looks forward to continuing its dialog with the MSRB on this important topic.

Please do not hesitate to contact me with any questions at (212) 313-1265.

Sincerely yours,

A handwritten signature in blue ink that reads "David L. Cohen". The signature is fluid and cursive, with the first name being the most prominent.

David L. Cohen
Managing Director
Associate General Counsel

Mr. Ronald W. Smith
Municipal Securities Rulemaking Board
Page 9 of 9

cc:

Municipal Securities Rulemaking Board
Lynnette Kelly, Executive Director
Gary L. Goldsholle, General Counsel
Michael L. Post, Deputy General Counsel
Kathleen Miles, Associate General Counsel