MSRB
Municipal Securities Rulemaking Board

Implementation Guidance on MSRB Rule G-18, on Best Execution

November 20, 2015

Background

MSRB Rule G-18, establishing the first best-execution rule for transactions in municipal securities, will be effective 120 days from the date of the publication of this implementation guidance, which is March 21, 2016. The best-execution rule requires brokers, dealers and municipal securities dealers (dealers) 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. Related amendments to MSRB Rule G-48, on transactions with sophisticated municipal market professionals (SMMPs), and to MSRB Rule D-15, on the definition of an SMMP, exempt transactions with SMMPs from the best-execution rule. This implementation guidance provides answers to frequently asked questions about the best-execution rule and the SMMP exemption.

Use of This Document

The MSRB is providing in this document general implementation guidance on certain aspects of new Rule G-18 and amended Rules G-48 and D-15 (rules) in a question-and-answer format. This guidance is designed to support compliance with the best-execution rule and the SMMP exemption.[1] The answers are not considered rules and have neither been approved nor disapproved by the Securities and Exchange Commission (SEC).

The MSRB may update these questions and answers periodically, and any updates will include appropriate references to dates of new or modified questions and answers.

Questions concerning this document may be directed to Michael L. Post, General Counsel – Regulatory Affairs, or Carl E. Tugberk, Assistant General Counsel, at 202-838-1500.

[1] The MSRB believes the guidance in this Notice is consistent in all material respects with guidance on best execution obligations on transactions in corporate fixed income securities published by the Financial Industry Regulatory Authority (FINRA) on November 20, 2016, except where the rule or context otherwise specifically requires. The two instances where material differences exist with the FINRA guidance are with respect to (1) the review of policies and procedures and execution quality by dealers, and (2) the timeliness of executions consistent with reasonable diligence. *See* note 12 and accompanying text; VI.1 *infra*; Section 1 (The Duty of Best Execution) and Section 2 (Regular and Rigorous Review for Best Execution) of FINRA Notice to Members 15-46 (November 2015). The MSRB and FINRA will continue to work together with the goal of ensuring that their guidance on best-execution obligations remains consistent in all material respects, unless differentiation is necessary due to differences in the markets for municipal or corporate fixed income securities or their respective rules.

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Questions and Answers Concerning Best Execution and the Exemption for Transactions with Sophisticated Municipal Market Professionals: Rules G-18, G-48 and D-15

I. BEST-EXECUTION STANDARD – GENERAL

I.1: Reasonable Diligence

Q: What do dealers need to do to use reasonable diligence when selling (purchasing) municipal securities out of (into) their inventory to (from) customers[2] who are not sophisticated municipal market professionals (SMMPs)?[3]

A: *Overview of Best-Execution Standard*. Section (a) of MSRB Rule G-18, on best execution, requires dealers, in any transaction for or with a customer or a customer of another dealer, 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. This obligation applies to transactions in which the dealer is acting as agent and transactions in which the dealer is acting as principal.[4] Section (a) includes a non-exhaustive list of factors that dealers must consider when exercising this diligence, which includes: the character of the market for the security (*e.g.*, price, volatility, and relative liquidity), 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, including any bids or offers, that result in the transaction, as communicated to the dealer. A dealer must make every effort to execute a customer transaction promptly,[5] but the determination as to whether a firm exercised reasonable diligence necessarily involves a "facts and circumstances" analysis, and actions that in one instance may meet a dealer's best-execution obligation may not satisfy that obligation under another set of circumstances. The rule is designed to complement existing fair and reasonable pricing standards and improve execution quality for retail investors in municipal securities, while promoting fair competition among dealers and improving market efficiency.

Policies and Procedures. As explained during the rulemaking process for the best-execution rule, dealers can use reasonable diligence in ascertaining the best market for a security by using sound policies and procedures and periodically reviewing and improving them. Indeed, paragraph .08 of the Supplementary Material requires the development of policies and procedures reasonably designed to achieve best execution. Paragraph .08 requires dealers to conduct, at a minimum, annual reviews of their policies and procedures for determining the best available market, assessing whether they are

[2] MSRB Rule D-9 states that, "[e]xcept as otherwise specifically provided by rule of the [MSRB], the term 'customer' shall mean any person other than a broker, dealer, or municipal securities dealer acting in its capacity as such or an issuer in transactions involving the sale by the issuer of a new issue of its securities."

[3] *See* MSRB Rule D-15.

[4] *See* MSRB Rule G-18(c).

[5] *See* paragraph .03 of the Supplementary Material to Rule G-18.

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 of their policies and procedures in light of those reviews.[6] In short, a dealer can comply with the requirement to use reasonable diligence by developing, following and maintaining policies and procedures that are themselves reasonably designed.

Rule G-18 is designed to provide sufficient flexibility to accommodate the diverse population of dealers, which can adopt 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, and to allow dealers to evidence that they had used reasonable diligence in a manner that is different than that used by other dealers. However, in developing policies and procedures, dealers should consider reviewing and including in their policies and procedures the existing practices of their trading operations, existing best practices within the municipal securities market (particularly those used by similarly-situated dealers), existing best practices in the corporate debt securities market with respect to compliance with FINRA Rule 5310, which requires, among other things, best execution for transactions in corporate debt securities, and any other practices they believe to be relevant. By way of example, if similarly-situated dealers in the municipal securities market typically take certain steps when purchasing municipal securities from a customer, dealers should consider whether their written policies and procedures should provide for those steps to be taken on a consistent and systematic basis.

As explained during the rulemaking process for Rule G-18, the rule is generally substantively consistent with FINRA Rule 5310, with specific tailoring to the characteristics of the municipal securities market. This substantive consistency is in recognition of the efficiencies to be gained from harmonized regulation in similar areas of the fixed income markets. Significantly, the core standard of reasonable diligence in Rule G-18(a) is stated in identical terms to the core standard in FINRA Rule 5310; however, portions of the list of factors that are considered in determining whether a firm has used reasonable diligence are different. As a result, and also in the interests of harmonized regulation, steps by a dealer that meet the reasonable diligence standard under FINRA Rule 5310 generally will be considered to meet the reasonable diligence standard under Rule G-18 in circumstances that are substantially the same. However, dealers should consider whether any additional or different steps may need to be taken to address provisions in Rule G-18 that are tailored specifically for transactions in municipal securities.

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[6] Additionally, paragraph .06 of the Supplementary Material specifically requires dealers to have written policies and procedures in place that address how they will make best-execution determinations with respect to securities with limited quotations or pricing information (and document their compliance with those policies and procedures), but dealers should consider establishing and implementing policies and procedures that address other potential market conditions or variables, such as volatility. *See*, *e.g.*, I.4 *infra*.

I.2: Best Price
Q: Does the term "best execution" (as it relates to municipal securities) mean every trade at a particular point in time must match the best price to have occurred within a short time *thereafter*?

A: As stated in paragraph .01 of the Supplementary Material to MSRB Rule G-18, "[t]he principal purpose of [the] rule is to promote, for customer transactions, dealers' use of reasonable diligence," and a "failure to have actually obtained the most favorable price possible will not necessarily mean that the dealer failed to use reasonable diligence." A trade occurring shortly after a transaction at a materially more favorable price with no significant change in market conditions or the credit worthiness of the security, however, could indicate a lack of reasonable diligence on the part of the dealer or the utilization of inadequate procedures. Such occurrences would suggest that dealers should consider, as part of their periodic review of their procedures, the inclusion of additional markets when handling future customer orders or inquiries.

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I.3: Documentation
Q: How do dealers document reasonable diligence in compliance with the best-execution standard and does documentation need to be made for each and every transaction?

A: The issue of documentation of dealers' compliance with MSRB Rule G-18 arises in at least three areas. First, the rule requires dealers to have written policies and procedures for compliance with the rule. Second, dealers should consider documenting their periodic reviews of their written policies and procedures and the results of those reviews. Third, dealers should consider documenting their adherence to their policies and procedures generally, and paragraph .06 of the Supplementary Material specifically requires documentation of compliance with their policies and procedures with respect to securities with limited quotations or pricing information.[7] The documentation dealers should consider in the third area necessarily would depend on the content of the policies and procedures that the dealer determines to adopt. Only by way of example, recognizing this dependence on the content of the policies and procedures, a dealer could use records providing information displayed on an alternative trading system and reviewed by a trader prior to execution, records of periodic observation of traders, notations by traders and/or records of pre- and/or post-trade reviews.[8] However, these are, again, only examples of documentation methods, and Rule G-18 is designed to provide sufficient flexibility to accommodate the diverse population of dealers, which can adopt 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, and to allow dealers to demonstrate that they had used reasonable diligence in a manner that is different than that used by other dealers. Given this flexibility,

[7] *See* note 6 *supra*. The MSRB also notes that, pursuant to MSRB Rules G-8(a)(xx) and G-27(c), dealers are required to maintain records of written supervisory procedures reasonably designed to ensure that the conduct of their municipal securities activities and those of their associated persons are in compliance with MSRB rules and the applicable provisions of the Securities Exchange Act of 1934 (Exchange Act) and rules thereunder.

[8] *See* IV.2 *infra*.

some firms may choose to document their adherence to their policies and procedures on a transaction-by-transaction basis, but the MSRB recognizes that there may be reasonable alternative approaches that would satisfy the requirements of MSRB rules and be sufficient to demonstrate compliance.

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I.4: Extreme Market Conditions
Q: How do extreme market conditions affect dealers' best-execution obligations?

A: In the potential event of extreme market conditions impacting the trading of municipal securities (*e.g.*, a shortage of liquidity and divergent prices during periods of significant ratings changes, interest rate movements or other market-wide events) dealers should consider establishing and implementing procedures that are designed to preserve the continued execution of customers' orders in a manner that is consistent with their best-execution obligations while also recognizing and limiting their exposure to extraordinary market risk. Dealers should consider the following guidelines when evaluating their best-execution procedures during extreme market conditions:

- The treatment of customer orders must remain fair, consistent and reasonable.

- To the extent that a dealer's order-handling procedures are different during extreme market conditions, it should disclose to its customers the differences in the procedures from normal market conditions and the circumstances in which it may generally activate these procedures.[9]

- Activation of procedures designed to respond to extreme market conditions may be implemented only when warranted by market conditions. Excessive activation of modified procedures on the grounds of extreme market conditions could raise best-execution concerns. Accordingly, dealers should document the basis for activation of their modified procedures.

Ultimately, it necessarily involves a facts and circumstances analysis to determine whether actions taken by dealers during extreme market conditions are consistent with the duty of best execution, but the MSRB recognizes that market conditions are an important factor in dealers' best-execution determinations.

[9] However, the disclosure of alternative order handling procedures that are unfair or otherwise inconsistent with the firm's best-execution obligations would neither correct the deficiencies with such procedures nor absolve the firm of potential best execution violations.

II. BEST-EXECUTION STANDARD – APPLICABILITY

II.1: Applicability to Introducing Dealers

Q: Do introducing dealers that execute and clear trades through other dealers have best-execution obligations to their customers?

A: Yes. MSRB Rule G-18 applies to any transaction in a municipal security for or with a customer or a customer of another dealer, without any exception for orders that are routed to another dealer. Paragraph .08(b) of the Supplementary Material to the rule, however, provides that "[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 [of its written policies and procedures] 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." Under this provision, introducing dealers may rely on the best-execution policies and procedures of their clearing firms or other executing dealers, all of which are subject to their own best-execution obligations under the rule. An introducing dealer, however, is not relieved of its obligations to establish written policies and procedures of its own. For example, such an introducing dealer's policies and procedures could provide for the reliance on another dealer's policies and procedures and periodic reviews by the introducing dealer of the other dealer's reviews of its policies and procedures.

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II.2: Inter-Dealer Trades

Q: Do trades between broker-dealers have to comply with the best-execution standard?

A: No. MSRB Rule G-18 applies to any transaction for or with a customer or a customer of another dealer. Paragraph .05 of the Supplementary Material to Rule G-18 provides that "[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," . . . and "[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."

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III. REASONABLE DILIGENCE FACTORS – NUMBER OF MARKETS CHECKED

III.1: General

Q: When effecting a customer transaction in municipal securities, how many dealers and/or markets does a dealer need to check, and how much diligence does a dealer need to conduct in order to have confidence that all appropriate dealers and/or markets are included?

A: The duty of best execution requires a dealer to use reasonable diligence. It does not require a dealer to access every available market, especially given the differences in pricing information and execution functionality offered, and there is no set number of dealers making an offer or collecting bids on behalf of a customer order, or other markets, to check that categorically qualifies as reasonable diligence for compliance with the best-execution obligation. However, in general, dealers should check more than one market or expose customer orders to multiple offerings or bids, and show external offerings and bids to retail customers.[10] For example, a dealer's policies and procedures could require that, after receiving offers or bids, the dealer must evaluate the offer or bid price versus relevant market information to determine whether any additional markets, including, but not limited to, other dealers, should be checked to perform reasonable diligence. Each dealer should consider including in its written policies and procedures how and when its trading desk exposes retail customer orders to multiple offerings or bids and shows external offerings and bids to retail customers (directly or through financial advisors). Some dealers may employ "filters," which generally refer to automated tools that allow the dealer to limit its trading, with, for example, specific parties or parties with specified attributes with which it does not want to interact. If a dealer uses filters on counterparties or filters on specific securities intended to limit accessing bids or offers in those securities, they may be used only for a legitimate purpose consistent with obtaining the most favorable executions for non-SMMP customers, and should be reviewed on a periodic basis and adjusted as needed. The dealer, accordingly, should have policies and procedures in place that govern when and how to: reasonably use filters without negatively impacting the quality of execution of non-SMMP customer transactions; periodically reevaluate their use; and determine whether to lift them upon request.[11]

Given that the rule is designed, in part, to promote fair competition among dealers, generally, a dealer's policies and procedures should facilitate competition for its customer order flow, including by eliminating practices that discourage other dealers from offering (bidding on) securities to (from) its clients. However, exposing customer order flow to other dealers, alone, is not sufficient to satisfy reasonable diligence, and dealers must also consider the non-exhaustive list of factors identified in Rule G-18(a).

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[10] *See* III.5 *infra*.

[11] The scope of a dealer's policies and procedures on the use of filters, as well as the periodic review and adjustment of their use, should be appropriate to the nature of the dealer's municipal securities business and, therefore, may be different than the policies and procedures used by other dealers.

III.2: Use of Broker's Brokers and ATSs

Q: Under what circumstances must a dealer use a broker's broker or alternative trading systems (ATS) to demonstrate reasonable diligence in ascertaining the best market?

A: There is no categorical requirement in MSRB Rule G-18 for dealers to use a broker's broker or an ATS, and the rule is designed specifically not to favor any particular type of venue over another for dealers to meet their best-execution obligations. Paragraph .04 of the Supplementary Material construes the term "market" broadly for purposes of Rule G-18, including the rule's core provision, section (a), requiring the exercise of reasonable diligence in ascertaining the "best market" for the security. Paragraph .04 of the Supplementary Material states: "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." A principal purpose of this broad and even-handed language is to tailor the definition of the critical term "market" to the characteristics of the municipal securities market and provide flexibility for future developments in both market structure and applied technology. For example, the language expressly recognizes a characteristic of the municipal securities market (*i.e.*, the role of dealer inventories in providing liquidity) by providing that the executing dealer itself, acting in a principal capacity, may be the best market for the security.

As the availability of electronic systems that facilitate trading in municipal securities increases, dealers need to determine whether these systems might provide benefits to their customer order flow, particularly retail order flow, and help ensure they are meeting their obligations under Rule G-18(a) with respect to ascertaining the best market for their customer transactions. Similarly, pre-trade transparency, such as through electronic trading platforms, is also increasing in the municipal securities market, and dealers need to periodically analyze and determine whether incorporating pricing information available from these systems should be incorporated into their best-execution policies and procedures.

The MSRB recognizes that different markets provide different levels of price information and execution functionality, and that a dealer's analysis of the available pricing information offered by different systems may take these differences into account. Some systems, including auto-execution systems, both display prices and provide execution functionality, while other systems display prices but provide no execution functionality. Still other systems, such as request-for-quotation systems, may provide indications of interest but not display prices or provide execution functionality. As such, it is the dealers' responsibility to evaluate various markets (*e.g.*, ATSs, inter-dealer brokers, other dealers) and to establish and periodically review reasonably designed written policies and procedures addressing when and how certain markets should be checked to satisfy the requirements of the rule. Pursuant to paragraph .08(a) of the Supplementary Material, "[i]n 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 modification(s) to such policies and procedures as may be appropriate in light of such reviews." As an aspect of this periodic review, dealers should review the execution quality provided by the various markets they choose to use (including the internalization of order flow), and, to the extent information is reasonably available, the execution quality of new markets or markets they do not use to determine whether to use them.[12] This review could include, for example, reviewing EMMA® data for previous executions in the subject security or similar securities.

Additionally, Rule G-18(a) provides a non-exhaustive list of factors that will be considered in determining whether a dealer has used reasonable diligence, with no single factor being determinative, including: (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. Accordingly, a dealer's policies and procedures for best execution should address how these factors will affect the dealer's municipal securities transactions with customers under various conditions.

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III.3: Reliance on Broker's Brokers for Pricing
Q: Is a dealer in compliance with MSRB Rule G-18 if it uses the best bid or offer obtained by a broker's broker as the only basis for the price at which the dealer executes a customer order?

A: Use of the best bid or offer obtained by a broker's broker for a particular security as the only basis for the price at which a dealer executes a customer order will not qualify categorically as reasonable diligence in compliance with Rule G-18. To the extent a dealer uses such practice alone, the dealer's policies and procedures should establish what facts and circumstances should be considered to allow the dealer to do so (*e.g.*, length of collection period used, number of offers/bids received, accessibility of quotations).

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III.4: One ATS
Q: Can a dealer comply with MSRB Rule G-18 by exposing customer orders to a municipal trading platform that captures offers/bids from multiple markets?

[12] In adopting Rule G-18, and paragraph .08 of the Supplementary Material specifically, the MSRB did not include provisions that are contained in FINRA Rule 5310 pertaining to "regular and rigorous review of execution quality," to tailor the rule to the characteristics of the municipal securities market. Accordingly, the implementation guidance provided herein on dealers' review of execution quality differs from guidance on regular and rigorous review that has been published by FINRA.

A: The market for municipal securities has evolved significantly in recent years. Some dealers have reduced their inventory positions in response to market and regulatory influences and the use of electronic trading systems, including ATSs, continues to grow. In addition, transaction prices for most municipal securities are now widely available to market participants and investors. Although the amount of pre-trade pricing information (*e.g.*, bids and offers) available also has increased, it is still relatively limited as compared to equity securities and generally not readily accessible by the investing public. While new technology and communications in the municipal securities market have advanced, the market remains decentralized, with much trading still occurring primarily through individual dealers.

In light of this evolution of the municipal securities market, the MSRB encourages the use of broker's brokers, ATSs and other markets that typically provide exposure to multiple offers/bids, and it recognizes there may be facts and circumstances under which it may be sufficient for a dealer to check only one such market and satisfy the best-execution obligation. However, utilizing one ATS or other similar market will not qualify categorically as reasonable diligence in compliance with Rule G-18. To the extent a dealer checks only one ATS or other similar market when executing customer orders, the dealer's policies and procedures should establish what facts and circumstances may allow for the checking of only one such market (*e.g.*, competitiveness of the ATS, accessibility of quotations) and what steps would be required to be taken in those situations.

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III.5: Only One Market

Q: How does the best-execution obligation apply when there is only one dealer (*i.e.*, only one market) offering or bidding on the subject security?

A: There is no set number of dealers making an offer or collecting bids on behalf of a customer order the checking of which categorically qualifies as reasonable diligence for compliance with the best-execution obligation, and, in general, dealers' procedures should provide for the checking of more than one market or the exposure of customer orders to multiple offers or bids (*e.g.*, use of an ATS or broker's broker). However, the MSRB recognizes there may be facts and circumstances under which it may be sufficient for a dealer to check only one market, including internal inventory only, and satisfy the best-execution obligation. In order to comply with the best-execution obligation, each dealer's written policies and procedures should address such facts and circumstances and the steps required to be taken in those scenarios. At a minimum, dealers must also consider the other factors identified in MSRB Rule G-18(a), including, but not limited to, information to determine the current market for the subject security (*e.g.*, recent trade history) and information on similar securities (*e.g.*, offerings of similar securities). If a dealer has policies and procedures in place that are reasonably designed and otherwise comply with applicable rules and follows them, it could execute an order for which there is only one available market, as long as such handling and execution also are consistent with the terms of the customer's order or inquiry as communicated to the dealer.

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IV. REASONABLE DILIGENCE FACTORS – INFORMATION REVIEWED TO DETERMINE THE CURRENT MARKET FOR THE SUBJECT SECURITY OR SIMILAR SECURITIES

IV.1: Similar Securities

Q: What constitutes a similar security?

A: The municipal securities market differs significantly from the market for equity securities and options and also can vary significantly depending on the specific municipal security at issue. For example, some municipal securities may trade frequently, be relatively more liquid and have transparent, accessible and firm quotations available. Other municipal securities do not have public quotations or frequent pricing information available, and may trade infrequently; however, some municipal securities that are less liquid also are fungible, meaning that they trade like other, similar securities, and the pricing in these similar securities can be used as a basis for determining prices in a subject security.

Given the wide variety of municipal securities, it is impracticable for the MSRB to provide an exhaustive list of characteristics that qualify a bond as a "similar security" for purposes of MSRB Rule G-18. By way of example, however, issuer, source of repayment, credit rating, coupon, maturity, redemption features, sector, geographical region and tax status are some factors a dealer could use to identify municipal bonds as similar. If a dealer uses a similar securities analysis, its written policies and procedures should establish how the dealer identifies similar securities, as well as how and when to consider the market for them for the purposes of complying with the best-execution rule.

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IV.2: Trade Review

Q: In the absence of a market and the absence of previous trade history with other dealers in the subject security, how should dealers use reasonable diligence in compliance with their best-execution obligations?

A: The MSRB encourages dealers to incorporate pre- and/or post-trade review(s) into their written policies and procedures for compliance with MSRB Rule G-18, but Rule G-18 does not mandate any specific trade review process and the MSRB recognizes that multiple approaches to trade reviews could satisfy a dealer's best-execution obligations. Rule G-18 is designed to provide sufficient flexibility to accommodate the diverse population of dealers, which can adopt 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, and to allow dealers to evidence that they have used reasonable diligence in compliance with the rule in a manner different than that used by other dealers. Accordingly, dealers can use a variety of data, such as comparisons to similar securities, internal models for assessing the quality of execution or potential execution and/or other tools or measurements of quality of execution, as part of their policies and procedures for best execution or the evaluation thereof. To fully inform themselves when determining what procedures to use for customer transactions, dealers should consider what procedures they use or would use for executing

the same or similar transactions for their own accounts, although such procedures are not absolutely required to be the same.

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IV.3: Evaluated Pricing
Q: Can dealers use evaluated pricing as a component of their procedures to comply with the best-execution obligation?

A: Yes. MSRB Rule G-18(a) 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, including the information reviewed to determine the current market for the subject security or similar securities. Accordingly, dealers can use a variety of data, which is not required to include, but can include, evaluated pricing as part of their written policies and procedures for best execution or the evaluation of their policies and procedures; however, such use would not categorically make those policies and procedures sufficient for compliance with Rule G-18.

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V. MAINTENANCE OF ADEQUATE RESOURCES

V.1: Appropriate Level of Resources

Q: How does a firm establish that it has the appropriate level of resources?

A: Paragraph .02 of the Supplementary Material to MSRB Rule G-18 states that "[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." Additionally, paragraph .02 states that "[t]he 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." This provision was designed to provide flexibility to accommodate the diverse population of dealers. Accordingly, an appropriate level of resources will depend on many factors, including, but not limited to, a firm's amount of business, and dealers need to employ enough resources to assure that they can establish, implement, follow and periodically review and improve written policies and procedures reasonably designed to achieve best execution.

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VI. SECURITIES WITH LIMITED QUOTATIONS OR PRICING INFORMATION

VI.1: Execution Timing

Q: Are there municipal bonds that require more time for a dealer to use reasonable diligence when effecting a customer transaction, and how does a dealer demonstrate such diligence?

A: Paragraph .03 of the Supplementary Material to MSRB Rule G-18 requires dealers to make every effort to execute a customer transaction promptly, taking into account prevailing market conditions. Taking a relatively shorter time can suggest a lack of reasonable diligence to ascertain the best market, while taking a relatively longer time can suggest a failure to execute promptly. There is no specific amount of time that is too short or too long to effect a customer transaction; it necessarily will depend on the particular facts and circumstances. Paragraph .03, which is tailored for the municipal securities market and varies from the language of FINRA Rule 5310, therefore, goes on to recognize that, in certain market conditions, dealers may need more time to use reasonable diligence to ascertain the best market for the subject security. This provision clarifies that a dealer should not be considered to have failed to execute promptly in market conditions that are beyond the dealer's control that cause reasonable diligence to be more time-consuming. This provision, at the same time, is designed to temper the promptness requirement so that it does not undermine the goal of the rule to promote reasonable diligence. By way of example, such market conditions could be illiquidity or infrequent trading of the subject security, low demand for lower-rated bonds, low demand for distressed bonds and low demand for bonds with uncommon structural characteristics.

The absence or limitation of accessible quotations or pricing information is not uncommon for many municipal securities, but does not relieve a dealer of its best-execution obligations. Indeed, paragraph .06 of the Supplementary Material to Rule G-18 specifically requires dealers to have written policies and procedures in place that address how the dealer will make its best-execution determinations with respect to securities with limited quotations or pricing information and to document its compliance with those policies and procedures. Such policies and procedures could establish what bonds/market conditions are subject to any variance in the dealer's other order-handling procedures, including establishing what it means to have limited quotations or pricing information, what additional procedures, if any, are required to be followed by dealer personnel, and how such steps are to be documented. For example, these securities may require dealers to take additional steps in order to satisfy the best-execution standard, including, but not limited to, seeking out other sources of pricing information and potential liquidity, including, but not limited to, directly contacting dealers with which they previously have traded the security or that are otherwise known to trade in the security.

The MSRB recognizes that, in some instances, obtaining quotations from multiple markets could adversely affect execution quality due to delays in execution or other factors.[13] Therefore, a dealer generally should analyze other data to which it reasonably has access to determine whether it has ascertained the best market for the subject security, but its policies and procedures should also establish under what facts and circumstances it would be appropriate to obtain quotations or other pricing information from multiple markets. Additionally, if pricing information related to the subject security, such as a dealer's previous trades in the security, or other pricing information, such as a quotation from another market, is limited or unavailable, a dealer may also consider previous trades in a similar security, if that security and those previous trades constitute a reasonable basis for comparison. As with all policies and procedures related to best execution, paragraph .08 of the Supplementary Material to Rule G-18 requires dealers to periodically review these specific policies and procedures, assess whether they are reasonably designed to achieve best execution, and make promptly any necessary modifications in light of such reviews.

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[13] The MSRB notes that a dealer providing a price in response to a bid request or bid list presented to the dealer or other competitive bidding process would not be subject to a best-execution obligation since the dealer has not accepted a customer order for the purpose of facilitating the handling and execution of such order. This situation is analogous to paragraph .05 of the Supplementary Material to Rule G-18, which draws a distinction between those situations in which a dealer acts solely as the buyer or seller in connection with an order presented against its quote as opposed to accepting an order for handling and execution.

VII. RELATIONSHIP TO FAIR PRICING

VII.1: MSRB Rule G-30

Q: How does MSRB Rule G-18, on best execution, relate to MSRB Rule G-30, on prices and commissions?

A: Rule G-18 is intended to complement, support and foster compliance with the MSRB's established substantive pricing standards, which are governed by Rule G-30, by improving execution quality for customers and promoting fair competition among dealers resulting in increased market efficiency. However, the rule makes clear that its obligations are distinct from, for example, the fairness and reasonableness of commissions, markups or markdowns.

Rule G-30 requires 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. Rule G-18, on the other hand, does not contain any substantive pricing standard; it is an order-handling and transaction-execution standard, under which the goal of the dealer's reasonable diligence is to provide the customer the most favorable price possible under prevailing market conditions. Paragraph .01 of the Supplementary Material makes explicit that Rule G-18 is not an absolute "best-price" standard. The rule requires dealers to exercise reasonable diligence with the goal of obtaining the most favorable price possible under prevailing market conditions, which is accomplished through the use and periodic improvement of policies and procedures; it does not require the dealer to actually obtain the most favorable price possible in each transaction (although it frequently will do so through the use of reasonable diligence), and a failure to obtain the most favorable price possible in a transaction will not necessarily mean that the dealer failed to use reasonable diligence under the circumstances.

Despite the different purposes of Rules G-18 and G-30, some of the relevant factors in determining the fairness and reasonableness of prices and commissions or service charges, such as the availability of the securities and the nature of the dealer's business, may also be relevant to the application of the best-execution requirement. Further, although the best-execution rule does not itself contain any substantive standard by which the transaction price itself is to be or could be evaluated, 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.

(November 20, 2015)

VIII. SMMP EXEMPTION – GENERAL

VIII.1: Qualification

Q: Does the best-execution obligation apply to all customer transactions?

A: No. However, the only variance in the requirements of MSRB Rule G-18, according to the characteristics of the customer, is codified in MSRB Rules G-48 and D-15 in the form of the SMMP exemption. Section (e) of Rule G-48, which is the consolidated MSRB rule under which all modified obligations of dealers when dealing with SMMPs are addressed, provides that the best-execution obligation under Rule G-18 does not apply to transactions with customers that are SMMPs as defined in Rule D-15.

(November 20, 2015)

VIII.2: Applicability to Non-Recommended Transactions

Q: Will the SMMP exemption from the best-execution rule apply to non-recommended transactions?

A: Yes. The applicability of the SMMP exemption to MSRB Rule G-18 is triggered by a customer's status as an SMMP, not whether or not a transaction is recommended by the dealer. However, the applicability of the exemption for any particular SMMP is controlled by the scope of the customer affirmation required by MSRB Rule D-15(c) and provided to the dealer. Specifically, paragraph .02 of the Supplementary Material to Rule D-15 provides that "[t]he customer affirmation may be given either orally or in writing, and may be given on a trade-by-trade basis, a type-of-transaction basis, a type-of-municipal-security basis (*e.g.*, general obligation, revenue, variable rate), or an account-wide basis." As such, any transaction not covered by a customer's affirmation would remain subject to the best-execution obligation.

(November 20, 2015)

VIII.3: Applicability to Transactions with Other Broker-Dealers

Q: Do dealers need to rely on the SMMP exemption to be relieved of the best-execution obligation for transactions for or with broker-dealer clients?

A: No. MSRB Rule G-18's best-execution obligation only applies to transactions for or with a customer or a customer of another dealer, and the MSRB's definition of "customer" in Rule D-9 does not include broker-dealers acting in their capacity as broker-dealers.[14] Accordingly, there is no need for dealers to rely on the SMMP exemption when executing transactions for or with other broker-dealers, and, therefore, no need for customer affirmations for those broker-dealers to qualify as SMMPs.

(November 20, 2015)

[14] *See* note 2 *supra*.

VIII.4: Existing Customer Affirmations
Q: Can dealers rely on customer affirmations based on existing MSRB Rule D-15?

A: No. As of the effective date of MSRB Rule G-18 and the amendments to MSRB Rules G-48 and D-15, a customer will not qualify as an SMMP unless it makes the broader affirmation required by Rule D-15, as amended, which addresses all of the modified dealer obligations provided in Rule G-48, including the exemption from the best-execution obligation. Accordingly, any customer affirmations based on existing Rule D-15 would be ineffective to qualify for the SMMP exemption.

(November 20, 2015)

VIII.5: Piecemeal Customer Affirmations and Waiver of Dealer Obligations
Q: Can an SMMP waive time-of-trade disclosures, but still have its trades subject to the best-execution rule?

A: No. A customer cannot waive, and a dealer is not exempt from the time-of-trade disclosure obligation, unless the customer qualifies as an SMMP.[15] In order to qualify as an SMMP, the customer's affirmation, according to MSRB Rule D-15, must be unified and speak to all of the modified dealer obligations provided in MSRB Rule G-48, including the modified obligations with respect to both time-of-trade disclosure and best execution. The MSRB has determined that, if a customer is not prepared to forgo all of the legal protections afforded by the dealer obligations that would be modified under Rule G-48 if they were an SMMP, then the customer likely does not have the sophistication necessary to qualify as an SMMP. However, the exemption from the best-execution obligation provided by Rules G-48 and D-15 does not preclude a dealer from following its best-execution policies and procedures when handling SMMP orders.

(November 20, 2015)

VIII.6: Customer Affirmation Updates
Q: If a dealer reasonably concludes a customer is an SMMP, is the initial affirmation sufficient for all future trades for that customer, or is there a periodic update requirement for customer affirmations?

A: Although there is no explicit periodic update requirement for customer affirmations, MSRB Rule G-48 requires that dealers "reasonably conclude" a customer is an SMMP. After a certain lapse of time, it will become unreasonable for the dealer to continue to rely on the stale affirmation, and the dealer, therefore, could no longer "reasonably conclude," as required, that the customer is an SMMP.

(November 20, 2015)

[15] *See* 15 U.S.C. 78cc(a) ("Any condition, stipulation, or provision binding any person to waive compliance with any provision of [the Exchange Act] or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void.").

VIII.7: FINRA Rule 2111

Q: Will an institutional investor's suitability form/letter in compliance with FINRA Rule 2111 satisfy the affirmation requirement to qualify as an SMMP pursuant to MSRB Rule D-15?

A: No. FINRA Rule 2111(b) and paragraph .07 of the Supplementary Material thereto provide that one element of the suitability obligation of member firms under that rule is fulfilled if the institution affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations. This is similar to the existing exemption dealers have from the suitability requirement of MSRB Rule G-19 under MSRB Rule G-48(c). But neither FINRA Rule 2111 nor any other FINRA rule provides a similar exemption from best execution or any other obligations for its member firms comparable to those included in Rule G-48. Accordingly, a suitability form/letter limited in its terms to comply with FINRA Rule 2111 would not address the full scope of obligations that dealers would be relieved of fulfilling under the exemptions provided by Rules G-48 and D-15. Therefore, a customer will not qualify as an SMMP unless it makes the affirmation required by Rule D-15, which does address all of the modified dealer obligations provided in Rule G-48.

(November 20, 2015)