



June 24, 2013

Lynnette Kelly
Executive Director
Municipal Securities Rulemaking Board
1900 Duke Street
Alexandria, VA 22314

Re: SIFMA Recommendation to Improve Customer Execution

Dear Ms Kelly,

As you know, the U.S. Securities and Exchange Commission issued a Report on the Municipal Securities Market in July 2012¹ (the "SEC Report" or "Report"). Since the Report's release, the Municipal Securities Division of the Securities and Financial Markets Association ("SIFMA")² has been 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 take particular notice of issues raised in the Report that suggesting 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 Municipal Securities Rulemaking Board ("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."

¹ 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>.

² 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).

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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 months with the goal of producing a recommended policy change, attached hereto, designed to strengthen trade execution in the municipal market. The following discussion is the product of that effort.

I. Background of Current Municipal Market Structure

The municipal securities market has fundamental differences from other markets, including other fixed income markets, yet SIFMA understands the regulators' desire to move the municipal market *towards* a corporate debt execution standard. Some of these fundamental differences include:

- The municipal market is much more diverse and fragmented: over 1.1 million unique CUSIPS issued by over 55,000 state and local government entities.
- Average issue sizes (on average \$27mm),
- Small unique securities trade sizes (< \$50,000) dominate daily trading activity.
- The municipal market is also dominated by odd-lot transactions in thinly traded issues.
- Municipal bonds are less liquid than corporate bonds. For example in 2011, about 99% of outstanding municipal bonds did not trade on *any* given day³.
- Trades involving retail investors necessarily take place directly into or out of dealer inventories or through platforms or voice brokers that facilitate bid-wanted auctions.
- On any given day, a dealer that is active in the market may have between 2,000 to 5,000 items to potentially bid upon, and therefore review, and may eventually bid upon hundreds of these items. That same dealer could also have a number of items out for bid, for which it will need to devote additional attention.
- Role of brokers broker/voice brokers: Municipal securities brokers provide liquidity to the secondary bond market, extend distribution networks, information flow, and anonymity to market participants. Many have a particular local, regional, or market sector expertise.
- Many bid-wanted do not result in any bids; results from a bid wanted is one piece of information in deciding whether to execute that sale at that price. The fact that most bid-wanted processes do not result in trades may reduce incentives

³ SEC Report at 113-114.

for dealers to bid aggressively. A dealer may be buying or selling from its own inventory, seeking bids from other dealers or using the services of MSBBs or ATS. Some bid-wanted don't trade because the seller doesn't like the prices bid, or was just using the process for price discovery.

II. Proposal Summary

Rule Proposal:

SIFMA proposes that MSRB Rule G-18 be amended to reflect an "execution-with-diligence" standard for transactions with customers. Dealers would be required to "to use reasonable diligence to ascertain market so that the resultant price to the customer is fair and reasonable under prevailing market conditions." Similar to FINRA 5310, SIFMA's proposal contains a non-exhaustive list of factors that may be considered in determining whether a dealer has used reasonable diligence.

Proposal for Supplementary Material:

Recognizing that municipal securities trade in an over the counter market without a central exchange, SIFMA proposes defining the term "market" or "markets" to encompass those brokers, dealers, and municipal securities dealers that are known to transact in a particular security. Additionally, municipal securities dealers would be required to conduct a post trade review of execution quality and compare, among other things, execution prices that they are obtaining via current execution practices to the execution prices they could obtain from alternative trading counterparties.

III. Process

Due to the magnitude of this change, we recommend vetting this proposal among market participants through the use of a concept proposal, with an expanded comment period, and opportunity for feedback at round table discussions and educational events. Regulated firms would need an implementation period of at least six to nine months to be able to code for the necessary systems changes, develop policies and procedures and requisite changes in behavior.

IV. Conclusion

Some points emphasized in the Report suggest the transformation of the secondary municipal market to a central trading platform. However, the market is not yet at that stage of evolution. *SIFMA's proposal moves the industry forward in the short-term, in a realistic and obtainable way.* The MSRB should consider the short-term and long-term costs and potential benefit of any rule making before formally proposing any changes.

Ms. Lynnette Kelly
Municipal Securities Rulemaking Board
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We look forward to a continuing dialog with the MSRB on this important issue.
Please do not hesitate to call me with any questions at 212-313-1265.

Sincerely,

A handwritten signature in blue ink, reading "D. L. Cohen". The signature is fluid and cursive, with the first name "David" and last name "Cohen" clearly legible.

David L. Cohen
Managing Director and
Associate General Counsel

SIFMA MUNICIPAL MARKET EXECUTION PROPOSAL
"Execution with Diligence"

Rule G-18: [Municipal Market] Execution

(a)(1) In any transaction for or with a customer, a broker, dealer, or municipal securities dealer shall 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. Factors that may be considered in determining whether a broker, dealer, or municipal securities dealer has used "reasonable diligence" include, but are not limited to:

(A) the character of the market for the security (e.g., demand, availability, price, volatility, relative liquidity, including size of the issue and issuer);

(B) the size and type of transaction;

(C) information reviewed to ascertain the current market for the subject security or similar securities;

(D) accessibility of any quotations¹ and the likelihood of execution at that price;

(E) the terms and conditions of the customer's inquiry including bids and offers, if any, which result in the transaction, as communicated to the broker, dealer, or municipal securities dealer;

(F) the capacity, principal or agent, of the broker, dealer, or municipal securities dealer affecting the transaction; and

(2) In any transaction for or with a customer, no broker, dealer, or municipal securities dealer shall interject a third party between the broker, dealer, or municipal securities dealer and the buyer or seller for the subject security in a manner inconsistent with paragraph (a)(1) of this Rule.

(b) Failure to maintain adequate resources such as staff, technology, and market and indicative information necessary to perform reasonable market diligence cannot be considered justification for executing away from a fair and reasonable price.

(c) The obligations described in paragraphs (a) and (b) above exist regardless if the broker, dealer, or municipal securities dealer is acting as agent or principal. Such obligations should be considered in conjunction with MSRB Rule G-30.

¹ MSRB Rule G-13 defines "quotation" as "any bids for, or offers of municipal securities, or any request for bids for or offers of municipal securities, including indications of 'bid wanted' or 'offer wanted'."

SIFMA MUNICIPAL MARKET EXECUTION PROPOSAL
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• • • **Supplementary Material:** -----

.01 Execution of Customer Transactions. A broker, dealer, or municipal securities-dealer must make every effort to execute a customer transaction promptly in accordance with the terms of the customer's bid or offer and other instructions.

.02 Definition of "Market." Recognizing that municipal securities trade in an over the counter market without a central exchange, for the purposes of Rule G-18 and the accompanying Supplementary Material, the term "market" or "markets" encompasses those brokers, dealers, and municipal securities dealers that are known to transact in a particular security. This interpretation is meant to both inform brokers, dealers, and municipal securities dealers as to the breadth of the scope of counterparties that may be considered in the furtherance of their execution obligations and to promote fair competition among brokers, dealers, municipal securities dealers, such as dealers acting as municipal securities "broker's brokers" as defined in Rule G-43, alternative trading systems or platforms, as well as any other counterparties that may emerge, by not mandating that any trading counterparties have more or less relevance than others in the course of determining a firm's execution obligations.

.03 Execution and Municipal Securities. Rule G-18(a)(1)(D) provides that one of the factors used to determine if a broker, dealer, or municipal securities dealers has used reasonable diligence to ascertain the market for the subject security so that the resultant price to the customer is fair and reasonable is the "accessibility of the quotation." In the context of the municipal securities market, this means that, when "quotations", as defined in MSRB Rule G-13, are available, the appropriate regulatory agencies will consider the accessibility and the likelihood of execution of such quotations when examining whether a broker, dealer, or municipal securities dealer has used reasonable diligence. Accessibility is only one of the non-exhaustive reasonable diligence factors set out in Rule G-18(a)(1). In the absence of accessibility, brokers, dealers, or municipal securities dealers are not relieved from taking reasonable steps and employing their market expertise in conducting reasonable diligence.

.04 Execution and Executing Brokers. A broker, dealer, or municipal securities dealer's duty to use reasonable diligence to ascertain the market for the subject security so that the resultant price to the customer is fair and reasonable in any transaction is, unless otherwise specified in this rule and supplemental materials to this rule, limited to their own customers and not to customers of other brokers, dealers, or municipal securities dealers. A broker, dealer, or municipal securities dealer's duty to use reasonable diligence to ascertain the market for the subject security so that the resultant price to the customer is fair and reasonable in any transaction arises only when a bid or offer is directed to them for the purpose of transaction handling and execution. It does not apply in instances when the broker, dealer, or municipal securities dealer's services with respect to the transaction have been anonymous and explicitly limited to communication, order matching, and/or clearance functions. Additionally, the duties of a dealer acting as a "broker's broker" are defined in MSRB Rule G-43.

.05 Bids and Offers Involving Securities with Limited Quotations or Pricing Information. Although the market diligence requirements in Rule G-18 apply to bids and offers for all municipal securities, markets for securities may differ dramatically. One of the areas in which a broker, dealer, or municipal securities

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dealer must be diligent in ensuring that it has met its market diligence obligations is with respect to customer bids and offers involving securities for which there is limited pricing information or quotations available. Diligence in these circumstances shall include a procedure to learn information as necessary to meet the reasonableness standard, even though the means of information gathering may be different than that for other municipal securities. Each broker, dealer, or municipal securities dealer must have written policies and procedures in place that address how they will ascertain the market for such a security in the absence of relevant pricing information or multiple bids or offers and must document its compliance with those policies and procedures.

.06 Customer Instructions Regarding Handling of Bid or Offer. If a broker, dealer, or municipal securities dealer receives an unsolicited instruction from a customer to execute a transaction in a particular manner, the broker, dealer, or municipal securities dealer is not required to make any execution handling determination beyond the customer's specific instruction. Brokers, dealers, or municipal securities dealers are, however, still required to act promptly with respect to that customer's bid or offer promptly and in accordance with the terms of the bid or offer, or any instructions of the customer.

.07 Review of Execution Quality.

(a) No broker, dealer, or municipal securities dealer can transfer to another person its obligation to make use reasonable diligence to provide fair pricing for its customers' bid or offer. As part of its system of supervision, a broker, dealer, or municipal securities dealer must have procedures in place to ensure the broker, dealer, or municipal securities dealer periodically conducts reviews of the fairness of customers' execution prices. Firms should also periodically analyze whether the frequency of their reviews are sufficient.

(b) To assure that a broker, dealer, or municipal securities dealer complies with its obligation to provide fair and reasonable pricing for customer transactions, it should compare, among other things, execution prices that the broker, dealer, or municipal securities dealer is obtaining via current execution practices (including the internalization of customer transactions) to the execution prices that the broker, dealer, or municipal securities dealer could obtain from alternative practices. In reviewing and comparing the execution quality of its current execution practices to the execution quality with other counterparties, a broker, dealer, or municipal securities dealer may consider the following factors:

- (1) price improvement opportunities (i.e., the ability to obtain better prices from alternate counterparties);
- (2) the likelihood of execution of limit orders;
- (3) the speed of execution;
- (4) the size of execution;
- (5) transaction costs; and

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(6) customer needs and expectations.

(c) A broker, dealer, or municipal securities dealer that directs its customer transactions to another broker, dealer, or municipal securities dealer that has agreed to handle those transactions as agent, or riskless principal for the customer (e.g., a clearing firm or other executing broker-dealer) may rely on that broker, dealer, or municipal securities dealer's periodic review as long as the results and rationale of the review are fully disclosed to the broker, dealer, or municipal securities dealer and the broker, dealer, or municipal securities dealer periodically reviews how the review is conducted, as well as the results of the review.