March 21, 2014

VIA ELECTRONIC MAIL

Ronald W. Smith
Corporate Secretary
Municipal Securities Rulemaking Board
1900 Duke Street, Suite 600
Alexandria, VA 22314


Dear Mr. Smith:

On behalf of the Bond Dealers of America (“BDA”), I am pleased to submit this letter in response to Municipal Securities Rulemaking Board (“MSRB”) Notice 2014-02 (“Notice”) seeking comment on draft MSRB Rule G-18 (the “Draft Rule”) on best execution of transactions in municipal securities. BDA is the only DC-based group representing the interests of middle-market securities dealers and banks focused on the U.S. fixed income markets. Accordingly, we believe that we uniquely offer insight into how a best execution rule would impact the middle-market securities dealers who provide essential liquidity to the municipal securities through their specialization of regional and unique credits.

Inconsistency with FINRA Rule 5310. The BDA agrees with the MSRB that, as a general matter, the way that FINRA Rule 5310 regulates the execution of transactions of unquoted debt securities is how MSRB Rule G-18 should regulate the execution of transactions of municipal securities. We are concerned, though, that this is not what the Draft Rule does. While the text of Draft Rule G-18 gives an appearance that it regulates the trading of municipal securities like FINRA Rule 5310 regulates the trading of unquoted debt securities, there is a subtle but significant shift in the Draft Rule that would change that.

Within the Supplemental Material under FINRA Rule 5310, section .03 speaks to how FINRA Rule 5310 applies to unquoted debt securities, and makes a significant allowance for those circumstances. Note .03 under Supplemental Materials reads as follows:

“.03 Best Execution and Debt Securities. Rule 5310(a)(1)(D) provides that one of the factors used to determine if a member has
used reasonable diligence in exercising best execution is the “accessibility of the quotation.” In the context of the debt market, this means that, when quotations are available, FINRA will consider the accessibility of such quotations when examining whether a member has used reasonable diligence. For purposes of debt securities, the term “quotation” refers to either dollar (or other currency) pricing or yield pricing. Accessibility is only one of the non-exhaustive reasonable diligence factors set out in Rule 5310(a)(1). In the absence of accessibility, members are not relieved from taking reasonable steps and employing their market expertise in achieving the best execution of customer orders.” (italics added)

In short, Note .03 means that if a dealer has accessibility to a quotation for a debt security, then that accessibility is a major factor in considering whether the dealer exercised reasonable diligence. But, “in the absence of accessibility,” then dealers must take reasonable steps. That is, in the case of unquoted debt securities, dealers really cannot comply with the full text of FINRA Rule 5310 because of the inaccessibility to quotations and thus the Supplemental Materials provide that dealers still need to use reasonable efforts.

As a practical matter, BDA members find that in the case of unquoted debt securities, this requires dealers to maintain policies and procedures that ensure that they are taking reasonable steps in the execution of a transaction. That is, complying with FINRA Rule 5310 in the trading of unquoted debt securities comes down to creating and maintaining reasonable policies and procedures that address the available venues where those debt securities are traded and ensure that the dealer is considering those venues. Further, in examinations, the experience of BDA members is that FINRA examiners evaluate dealers’ compliance with FINRA Rule 5310 on this basis.

While the Draft Rule is modeled after language of FINRA Rule 5310, the Draft Rule does not provide the supplemental material that is necessary to explain how dealers are to comply with a transaction-by-transaction best execution rule in a municipal securities market that is not quoted on a centralized exchange. Yet, unlike the markets that FINRA Rule 5310 was primarily designed to regulate, the municipal securities market consists almost entirely of securities that are like those described in the last sentence of .03 of the supplemental materials of FINRA Rule 5310, where quotes are not accessible. As posited in our October 7, 2013 letter, municipal securities are highly diverse in terms of types of issuers, kinds of credits, sizes of issuers and credit quality. Much of the trading is accomplished by regional dealers who rely upon local knowledge, deal in bonds that trade very infrequently and may ever attract only one bid, and are willing to take bonds into inventory.

Despite these inexorable facts about the municipal market, the Draft Rule provides a new and quite expansive definition of “market”. As a result, BDA members are concerned that a standard that is far more stringent is being applied to the municipal market than what FINRA Rule 5310 applies to unquoted debt securities. At the same time the proposed rule overreaches, broker-dealers do not have a clear understanding of
what they would need to do to comply with the Draft Rule. The following are examples of where the Draft Rule fails to provide adequate guidance sufficient for broker-dealers and examiners alike to understand how to comply:

(1) Exactly what steps does a dealer need to take to sell municipal securities out of its inventory?

(2) If a dealer is purchasing a municipal security from a customer, when can a dealer purchase the municipal security into inventory?

(3) If a dealer is purchasing a municipal security from a customer and intends to place the security out for bid to other dealers, how many dealers does the dealer need to solicit and how much diligence does the dealer need to conduct in order to have confidence that all appropriate dealers are included?

(4) When does the dealer need to access an alternate trading system?

BDA supports the MSRB developing a rule that imposes on dealers in the municipal securities market the same obligations that dealers have in unquoted debt securities under FINRA 5310, but that is not what the MSRB has done. Instead, the Draft Rule imposes a reasonable diligence standard in an almost entirely unquoted market without the necessary supplemental materials in FINRA Rule 5310 that address unquoted markets. As recommended in our October 7 letter, we believe that requiring the creation and maintenance of policies and procedures is the appropriate way to apply a best execution rule to the municipal securities market, particularly in those instances in which a bond to be sold is thinly quoted. This is consistent with the current manner in which FINRA Rule 5310 applies with respect to debt securities when quotations are not available.

We ask the MSRB to be mindful that dealers already must comply with fair pricing and suitability rules that protect the pricing customers receive on trades. Where dealers effect their trades in the municipal securities market has much less to do with what pricing a customer receives than the proper diligence of a dealer in ensuring that customers received a fair and reasonable price. The rules that are going to protect the pricing customers receive will be the MSRB’s fair pricing and suitability rules. These rules, combined with current improvements and future strides in the transparency of the municipal securities market, such as the availability of ATS’s, an enhanced, public electronic database through EMMA and possibly, the creation of an index for retail customers, may improve that pricing.

We do not believe that new rules that govern where dealers effect their trades will materially improve pricing – and if the rules are designed improperly, they will actually impair liquidity by forcing small and middle market dealers in lesser-known, thinly traded securities to exit the market.

**SMMPs.** Consistent with our October 7 letter, BDA members agree with the MSRB’s creation of an exception in the Draft Rule for sophisticated municipal market
professional ("SMMPs"). We think that this is very important because SMMPs can have as much if not better access to trading venues and other dealers as the dealers themselves, and do not require the protection of the rule.

**Similar Securities.** BDA appreciates the MSRB’s recognition of the fact that for some municipal bonds, more than one quotation may not be available. We believe that an approach based upon having policies and procedures is needed in that instance. Responding to the structure of the MSRB proposed rule, however, if the use of “similar securities” as a measure of the market is to be proposed, BDA recommends that the MSRB place a better definition around the term “similar securities” as used in paragraph (a)(4) of the Draft Rule. We believe that the term is not clear and could be misunderstood in examinations. In addition, given the wide array of factors that could be weighed to determine what constitutes a “similar” security -- such as, geographical region, credit type and quality, terms and conditions and maturity -- any definition of “similar securities” should incorporate as an overriding factor the judgment of the dealer in determining the factors that are most relevant in determining whether a given security is similar.

BDA appreciates the efforts by the MSRB to engage broker-dealers in discussion of a best execution rule both through the concept release and proposed rulemaking. We would like to have further discussion and time to consider the proposal beyond what a 30-day window could permit, and are hopeful that the MSRB will allow additional comments and provide further proposals before finalizing a rule. BDA would like to work with the MSRB to ensure that the final rule is in a format that appropriately honors the nature of the municipal market and is as understandable to broker-dealers as it will be to those seeking to enforce the rule. Thank you for the opportunity to submit these comments, and feel free to contact me or my staff with any questions or concerns.

Sincerely,

Michael Nicholas
Chief Executive Officer