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Best-Ex Rule Presents Liquidity, Compliance Challenges.

FORT LAUDERDALE - The Municipal Securities Rulemaking Board's best execution rule may create liquidity problems for certain areas of the municipal market and will pose compliance challenges for everyone, industry officials said at a conference here on Monday.

The officials spoke at the National Municipal Bond Summit on a panel on the best-ex rule, which was approved by the Securities and Exchange Commission in December and will take effect late this year.

The rule requires dealers to use "reasonable diligence" to determine the best market for a municipal security and then buy or sell the security in that market so that the resulting price to the customer "is as favorable as possible under prevailing market conditions." Dealers do not have any new responsibilities under the rule to investors with assets of at least \$50 million as long as those investors affirm that they are sophisticated municipal market professionals or SMMPs.

Steve Winterstein, managing director of research and chief strategist for municipal fixed income at Wilmington Trust Investment Advisors who was on the panel, said money managers' lawyers may not let them affirm they are SMMPs because that may be seen as an abrogation of the policies and procedures they already have in place to clients, as those client's fiduciaries. And if money managers don't affirm they are SMMPs, then dealers may not want to trade with them because of the additional regulatory burdens.

"I don't think those issues have been fully vetted with in-house counsel," Winterstein said. If a money manager or other investor doesn't sign on with a dealer as an SMMP, it may never hear from that dealer again, he added.

"It could be that there is a part of the market that just won't be able to function," said Tom Vales, the chief executive officer of TMC Bonds, an alternative trading system, who moderated the panel.

Vales pointed out that ATS', which electronically match buyers and sellers to find counterparties for trades, must register as dealers, but do not have any "middlemen" or staff that can provide the due diligence needed to comply with the best-ex rule.

Vales added, however, that TMC Bond's clients are very sophisticated and that the TMC provides a lot of price information for dealers that would help them comply with the best-ex rule.

Sheila Amoroso, co-director of the municipal bond department for Franklin Templeton Fixed Income Group, said from the audience that she is worried the rule will impact liquidity by forcing traders to take more time and be more cautious before bidding on munis.

Angelique David, senior managing director, general counsel and corporate secretary for the dealer firm Ziegler said "that's a challenge." How do you get traders to do their jobs, while documenting everything so that they can show they got a good price? she asked.

Traders have to do due diligence and "document their decision tree" in determining pricing for a

muni, she said. The problem, she added, is that people can disagree over what constitutes “reasonable diligence.”

David said it is critical for dealers to develop and put in place new policies and procedures, as well as to test them, to make sure they will allow a trader to comply with the best-ex rule. “It’s not enough to say you are complying with the fair dealing rule,” she said.

“It’s important to test them ... before [the Financial Industry Regulatory Authority] does” in an examination, she said.

“FINRA will rarely tell you that a price was wrong,” David said. “They will tell you that your procedures and your policies weren’t designed to get you there. They will say your process didn’t get to that fair price.”

Vales asked the panelists how or whether the best-ex rule plays into new bond issuances and whether it would make a difference whether the bonds were sold competitively or on a negotiated basis.

Dan Kiley, senior vice president and head of municipal fixed income trading at Wells Fargo Advisors, said that he doesn’t think a new issue warrants due diligence on pricing. “I think market forces take you to where the market is priced,” he said.

But David cautioned against that view, saying the Securities and Exchange Commission recently visited her firm and wanted to look at primary market transactions.

A number of the panelists questioned how one determines the best price. Winterstein said that munis sometimes have characteristics that must be factored into the price. He used the analogy of a real estate transaction, saying two houses may look the same, but one has an extra bedroom or bathroom or a pool and therefore a higher price.

THE BOND BUYER

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