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Electronic Trading: Strengthening Best Execution in the Muni Market.

In preparing the municipal bond market in late 2015 for a new order-handling standard, the Municipal Securities Rulemaking Board took note of an important trend. “As the availability of electronic systems that facilitate trading in municipal securities increases,” the MSRB wrote, “dealers need to determine whether these systems might provide benefits to their customer order flow.”

The MSRB’s guidance underscored a development seen in other markets and asset classes when electronic trading takes hold. As regulators move to raise execution standards, electronic trading comes to play a significantly more important role in the compliance process.

That is especially the case in a market as complex and fragmented as municipal bonds. Though about half the size of the U.S. corporate bond market in value, the muni market features about 20 times the number of securities and about 10 times the number of issuer entities, by one researcher’s estimate. Those totals include a complicated variety of coupons and structures, as compliance officers can attest. It’s not surprising that a large number of muni issues trade rarely.

Electronic trading proves especially valuable in markets such as municipal bonds, where liquidity is highly dispersed and discontinuous. Market participants gain the power to conduct price discovery efficiently across a broader range of potential counterparties, identifying trading opportunities not available to them through typical voice and messaging channels. Adding to the power of electronic trading in the municipal bond market in the last several months is the emergence of an “all-to-all” marketplace, in which dealers as well as asset managers can interact with one another on an anonymous basis.

In helping solve the muni market’s liquidity puzzle, electronic trading has, in effect, raised the bar on best execution. Market participants who embrace fully integrated electronic trading strengthen their ability to achieve and validate best execution. Overall, electronic trading puts them in a better position to assess market quality across multiple sources of liquidity, audit their activities, measure their outcomes, fine-tune their policies and practices, manage operational risks and respond to customers.

Rule G-18’s Execution Standard

Reflecting the muni market’s complexities and its over-the-counter status, regulatory views on best execution have evolved slowly. It was only last year when the Municipal Securities Rulemaking Board put into effect its first explicit rule for best execution.

MSRB Rule G-18 creates “an order-handling and transaction-execution standard.” The rule requires dealers to exercise “reasonable diligence” to determine the best market in the security it seeks to trade on behalf of a customer. Then dealers must buy or sell securities in that market so that the resulting price to the customer “is as favorable as possible under prevailing market conditions.”

In its guidance, MSRB instructed dealers to establish policies spelling out how they meet the standards, and to review these annually in light of changes in market conditions and market structure, among other factors. The standard does not apply to investors with at least \$50 million in assets as long as they affirm that they meet the MSRB definition of “sophisticated municipal market professionals,” or SMMPs. Also excluded are inter-dealer trades, though customer trades cleared through another dealer are covered by the standard.

It was in the context of identifying the “best market” that the MSRB took note of the growing importance of electronic trading in its guidance in late 2015.

Since then, the emergence of the “all-to-all” electronic marketplace has begun to change the context for addressing the MSRB’s standard. By bringing together bids and offers of major national and regional dealers as well as institutional investment managers, the “all-to-all” environment provides a previously unavailable, dynamic view of market quality and conditions incorporating a wide range of liquidity sources. Potential buyers and sellers see not only levels offered by dealers, but those offered by investment managers as well.

Operational Benefits

With these pricing and liquidity insights come a number of significant operational advantages. At the pre-trade stage, pricing history and current quotes are easily viewed, as well as evaluative data from two widely used sources. Pre-trade and post-trade integration with order management systems helps manage exposures and reduce operational risks. Rounding out these efficiencies is automated settlement.

Of prime importance to the compliance process is the detailed audit trail generated by electronic trading. This gives compliance staff a record of market conditions and levels available at the time of the trade. Audit trails open the way for post-trade analysis and provide relevant data for the annual reviews of dealers’ policies and procedures required by Rule G-18. For investment managers, the audit trail can help them assess the quality of execution they are receiving.

As has been seen in other fixed-income categories, electronic trading starts slowly and then adoption rates over time tend to accelerate. Though in its early stages, all-to-all trading is poised to become a more important factor in the consolidation of muni market liquidity as investment managers grow more comfortable “making” prices as well as “taking” them. In that scenario, best execution — how to achieve and validate it efficiently and credibly — looks likely to remain among the leading factors driving increased adoption of electronic trading in the muni market in the months and years ahead.

The Bond Buyer

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