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Regulators Keeping an Eye on Post-Pricing Bond Trade Ups.

Regulators' focus on whether municipal market participants are fulfilling their fiduciary duty during primary market bond sales is partly driven by the issue of bonds trading up in price immediately after a negotiated deal compared to a competitive deal.

That's according to Dave Sanchez, director of the Securities and Exchange Commission's Office of Municipal Securities, and Gene Davis, a regulator with the Financial Industry Regulatory Authority. The duo highlighted the issue Thursday during a two-day compliance outreach program for municipal advisors and municipal securities dealers hosted by the SEC, FINRA and the Municipal Securities Rulemaking Board.

"We're looking at the difference in pricing between competitive and negotiated [deals] and what's happening post-pricing," Sanchez said. "There's enough there to be concerning [that] some folks aren't doing the job they should be doing, particularly on the municipal advisor side," he said.

The issue is part of the long-standing municipal market debate over whether negotiated or competitive deals are better for bond issuers. Municipal advisors have more responsibility to the issuer in the area than broker dealers under MSRB rules.

"The activity that we're concerned about is happening more often and on a bigger level on the negotiated sale side, and that's why we have highlighted this as an issue, particularly with respect to municipal advisors," Sanchez said.

Deals priced through a conduit issuer seem to have lower trade ups compared to deals brought by a government entity, he added. "I feel like it's maybe because the conduit is paying a lot more attention to the pricing [than the government entity] and may be less likely to allow that kind of trade up," he said.

When bonds trade up – increase in price – immediately after a sale, it signals the issuer may not have received the lowest yield possible. It's important to regulators because "inefficient pricing" means issuers, and therefore taxpayers and ratepayers, are not getting the best price, Sanchez said.

"The logical question is, why did it trade up if it was priced correctly?" said FINRA's Davis. "If we see something that traded up, we will ask, what happened here?" he said. "There may be a completely reasonable extenuating circumstances so that's what we want to get an understanding of."

FINRA is looking for "some movement" between preliminary pricing and the final scale if, for example, a deal is oversubscribed. "If there's not movement, that's probably where you're going to hear from an examiner," he said. The best practice is to document the pricing process and the steps taken in building a book of demand, he said.

A two or three basis points trade up is not likely to attract attention and regulators take into account larger market moves that might affect deal prices, Sanchez said. But if "you're still eight basis points off the market, it's fair for people to be skeptical of that," he said.

The growth of technology and artificial intelligence in the market is shedding more light on the issue, Sanchez said.

"It's way easier to track pricing now," he said. "Regulators are going to be using that information to start the conversation, so people should not be surprised that it's happening."

By Caitlin Devitt

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