WSJ: Search for Muni-Bond Guidepost Sputters.

Regulatory efforts to develop a better guidepost for retail investors in the $3.7 trillion municipal-bond market have been mired by concerns about the integrity of financial benchmarks like the scandal-tarred London interbank offered rate.

The Securities and Exchange Commission wants to give retail investors better access to quality pricing information about the enormous—and largely illiquid—muni market so they can become better informed when buying or selling bonds.

In the wake of Libor's problems, the SEC wants to ensure any new guidepost has "appropriate safeguards of reliability and absence of manipulation in order to protect investors, municipal issuers and the public," said John Cross III, the SEC's municipal-securities chief.

The SEC has struggled to reach agreement with another agency, the Municipal Securities Rulemaking Board, over how best to structure such a benchmark and ensure it can't be manipulated, people familiar with the matter said.

The MSRB, a self-regulator overseen by the SEC, wants a third party to develop a benchmark. But SEC officials are concerned such outsourcing could allow for manipulation and result in the MSRB inadvertently giving a regulatory stamp of approval to a faulty benchmark.

The SEC's concerns are part of a bigger conundrum plaguing Washington, as the Treasury Department and Federal Reserve struggle to find alternatives to Libor for use in financial transactions like swaps and the structuring of new securities. The Treasury last year notably left Libor off a list of potential index rates it asked market participants to consider as a benchmark for proposed securities with floating interest rates.

The project comes as the SEC is grappling with a host of problems in the muni market, including what it sees as lackluster investor disclosures. In a first-of-its-kind case, the agency on Monday settled securities-fraud charges with an Indiana school district and its underwriter for falsely telling investors in a 2007 bond offering that it was meeting promises it made to investors in an earlier bond sale.

The SEC's efforts also come as the muni market has been spooked by the largest-ever municipal bankruptcy, in Detroit, which has more than $18 billion in liabilities, and on the heels of a major debt-market selloff in the second half of June amid fears the Federal Reserve was close to tapering its bond-buying program. Some $22 billion has fled tax-exempt mutual funds since the beginning of June, according to Investment Company Institute data.

Existing muni-market benchmarks couldn't keep up with the rapid movement in market interest rates for several weeks in June, greatly hampering the market's ability to trade. "So a new benchmark, sponsored by a regulator, is making a debut at a very difficult time," said Matt Fabian, managing director at Municipal Market Advisors, which compiles its own benchmark of high-rated debt.

At issue is the inherent subjectivity of deciding which trades in a largely illiquid market should be used as part of a benchmark. Multiple banks have acknowledged trying to rig Libor, which is based on daily estimates by banks about how much it would cost them to borrow from other banks. Libor serves as the basis for rates on everything from residential mortgages to derivatives.

“Anything that has any level of subjectivity is going to have people questioning it,” said Dan Toboja, vice president of capital markets at investment bank B.C. Ziegler & Co., Chicago. “A single muni bond can go for months without a single trade in some cases, so it’s hard to set a price.”

The MSRB is expected to take several more months to complete its muni benchmark, as it works to develop strict controls that prevent an outsourced benchmark from potential for manipulation, according to people familiar with the matter. The MSRB says it doesn’t have the resources to develop the benchmark on its own and is reluctant to launch new products that undercut the private sector.

A retail benchmark for munis would have a much smaller footprint than Libor, on which up to $800 trillion of financial transactions are thought to be valued. Yet the SEC sees the benchmark as an important addition for tax-exempt municipal debt, which differs from corporate bonds in that there isn’t a single liquid benchmark like U.S. Treasurys to help investors and state and local governments assess their bonds’ relative value.

While some pricing information is available to the public, retail investors generally can’t find it, aren’t sophisticated enough to use it or don’t want to pay fees needed to access it, the SEC argues. About 45% of municipal debt is held by households, according to the Federal Reserve.

SEC officials have long argued that muni investors receive second-class treatment, citing the opacity of the market and stale disclosures by states and localities. They also point to key disadvantages for retail investors, including a dearth of pricing information.

As part of a sweeping SEC initiative to boost transparency in the muni market, the agency last summer asked the MSRB to “promptly” ensure retail investors have better access to pretrade pricing information, including benchmark information. The MSRB was asked to post the pricing information on an online web portal, which collects and publishes muni disclosures and trade data.

The MSRB has talked primarily with Municipal Market Data, a unit of Thomson Reuters Corp., about compiling a daily benchmark based on the trade data filed with the MSRB. The Thomson Reuters unit already publishes a proprietary benchmark widely used by banks and institutional investors as a guidepost for pricing new bonds from around the country or for evaluating bonds already in the market. The existing benchmark is based in part on large trades of triple-A-rated munis.

SEC officials warned this spring that the MSRB plan needed more work, saying the board couldn’t just post data from the Thomson Reuters division without getting a better handle on the methodology.

Regulators already are concerned that existing benchmarks in the muni market are set with little transparency. SEC officials have investigated whether muni bankers have sought to tinker with the existing Thomson Reuters benchmark in the same way bankers have been accused of rigging Libor.

But those concerns haven’t stopped the MSRB from working with Thomson Reuters on the retail project, according to people familiar with the matter. The SEC investigation of possible muni-market rigging is ongoing.

A Thomson Reuters spokeswoman didn’t respond to requests for comment.

MSRB officials said they are continuing to discuss the matter with Thomson Reuters, as well as other potential vendors, to provide new price-discovery tools to retail investors.

There are other indexes that provide muni-pricing information, though many are behind subscription paywalls and don’t provide the level of detail individual investors would need for trading purposes.