Bond Case Briefs

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Bonds and the BFF Problem.

A new rule tries to keep muni market players from getting too friendly.

The Beatles let us know that we all “get by with a little help from our friends.” Those nine words from the Awesome Foursome capture the essence of the American municipal bond market. Some new developments, however, could redefine how friends help state and local governments get by in the muni market.

Like all markets, the municipal bond market is about buyers and sellers. The sellers are cities, counties, schools and other public entities that need to borrow money to build roads, bridges, hospitals and other major projects. The buyers are wealthy individuals, property-casualty insurance companies, mutual funds and others who like muni bonds for their secure, tax-free income. In concept, this market is simple and predictable.

Except that it’s not. There are about a million bonds in the market. These bonds are sold by tens of thousands of governments and are backed by hundreds of different revenue streams. There is no central exchange where a buyer can go to find just the right bond. Different states apply different tax rules to the interest investors earn for holding muni bonds. For these and many other reasons, buyers and sellers work hard to find each other and even harder to agree on fair prices.

Fortunately, there are intermediaries—friends, if you will—who can help. Underwriters and financial advisers tell issuers how to design bonds that will appeal to just the right type of investors.

Investors rely on broker-dealers, brokers-brokers and other market makers to deliver the bonds they want. Issuers and investors alike depend on third-party data providers for crucial insights on market prices and dynamics.

That’s why some recent regulatory changes have set the stage for a major shake-up. The Municipal Securities Rulemaking Board (MSRB), which oversees advisers and bond dealers, is now implementing rules that redefine the roles and duties of municipal financial advisers. Perhaps the biggest effect is that a bank or other institution that offers an issuer advice leading up to a bond sale cannot buy those bonds once they’re sold. This rule is designed to prevent cozy friendships from morphing into the sort of corruption we saw in places like Jefferson County, Ala. That makes sense. At the same time, small issuers who access the markets infrequently depend heavily on advisers and other friends to make sense of this complicated market. This rule might limit their access to the market expertise they need just to get by.

Meanwhile, both the MSRB and Securities and Exchange Commission (SEC) are considering new rules to promote “pre-trade transparency.” These changes apply to brokers-brokers, alternative trading systems and other intermediaries who help investors buy and sell bonds that have been out for a while (in what is known as the “secondary market”). The systems these intermediaries have developed are a bit like Craigslist for the muni market. Sellers post bonds they’d like to sell and interested buyers respond. Sometimes trades happen, but usually they don’t. Either way, the information these systems collect can tell us a lot about a bond’s “fair” or “actual” market price.

The SEC and MSRB are considering ways to use that information to improve the market's transparency and efficiency—a worthy objective. Investors who use these systems, however, are wondering why they should have to share such valuable information with anyone other than their closest trading friends.

With these actions, the regulators are sending a clear message. If you sell bonds, your real friends are those who work only for you. If you buy bonds, get ready to share friends-only information with the rest of the market. These changes are designed to focus accountability on buyers and sellers, and to keep friends, both well intentioned and otherwise, at arm's length.

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