Bond Case Briefs

Municipal Finance Law Since 1971

Muni Markets: Let the Sun Shine In.

SIFMA believes that tremendous strides have been made in improving market transparency for retail investors over the past twenty years – yet for people who are familiar with the equities market that operates with a central exchange and constant trading activity, the municipal market may still seem opaque. In fact, the municipal market operates differently-but those differences are not incomprehensible and they are not part of any deliberate plan to obscure the facts or impede the ability of investors to understand bonds or their pricing. Continuing retail investor confidence in the municipal bond market that has financed four million miles of roads, half a million bridges, 16,000 airports and 900,000 miles of water pipes all across the country is critical.

First, the bond "market" is not the same as the stock "market". There are several structural differences between the two. There is no central place or exchange to sell or buy municipal bonds; the municipal market is a huge "over-the-counter" market consisting of a network of over 1,600 independent dealers across the country. The muni bond market is so vast that its size, which consists of approximately $3.7 trillion of outstanding bonds, is sometimes hard to imagine. This year alone, state and local governments across the country have accessed over $215.4 billion in funding through the municipal bond markets.

Second, stocks are traded frequently by investors-so frequently that there is a minute-by-minute ticker of trades that took place seconds ago. In contrast, municipal bonds tend to be a "buy and hold" product. Most retail investors do not ever intend to trade their bonds; they bought them to collect the interest and receive a return of principal at maturity. Third, there are many more municipal bonds than stocks – over a million different bonds versus several thousand different stocks; and the number of units of each security available are very different allowing investors to select a bond based upon the maturity that best fits their individual goals and risk profile, as well as tax benefits. While a public company often has millions of shares of stock outstanding, a single maturity of a municipal bond issue has far fewer bonds outstanding (several hundred is typical).

This means that for the vast majority of municipal bonds bought and sold in the secondary market, there just aren't a lot of trades. Overall, there are on average 42,000 trades per day in the municipal bond market, versus 10,500,000 in the stock market. In other words, the vast majority of individual bonds do not trade on a given day, resulting in the absence of a continuous two-sided market (one with lots of bids and offers), limited depth of market (few people buying and selling), and the absence of fresh, up-to-the-minute pricing data (infrequent trading of most bonds).

Regulation may be able to enhance the way the muni market trades, but it cannot create a minute-by-minute two-sided market for the simple reason that most bond-owners don't care to sell their bonds.

As a result of all this, the process for selling municipal bonds is very different from selling stocks. When customers want to sell publicly traded stock, their sell orders are generally executed within seconds of being placed. In contrast, selling municipal bonds generally involves one of two possibilities. The financial firm may simply buy them back from the customer (this practice makes it easier for customers to quickly sell their bonds, known as "liquidity"). Or there may be a bid solicitation process: when a customer decides to sell a municipal bond, the financial advisor's firm must actively look for bids to buy that bond. To find the best bid, one of the firm's bond traders places the bond out for bid. Some firms do this through a municipal securities broker's broker or through an electronic trading platform – that connects many, but not all, bond dealers throughout the country to solicit anonymous bids. In some cases, one trader inside a financial services firm may bid on bonds placed on the bid-wanted listing system by another trader at the same firm without knowing the source of that bid wanted.

But, as discussed, there are many, many different bonds and not a large number of trades. Sometimes a bond that is for sale does not receive any bids, or may receive a bid that is, in the trading firm's opinion, not reflective of a fair price for the bond, even if it is the best available bid in the market at the time. As a result, a customer seeking to sell a bond may be left with a difficult choice: either sell the bond at a price below perceived or expected value, or hold the bond in anticipation of more buyers (and potentially better bids) entering the market, though there can be no assurance that this will occur. In fact, it is possible that the bids will be lower later or there may not be a bid available at all. In such cases, a firm may make an accommodation bid — the purchasing firm buys the bond for its own account and will seek to sell the bonds at a later time. As with any bid, the customer may either accept the accommodation bid or reject it.

Strengthening the execution standard in the municipal market is something that SIFMA has long championed. Adding additional protection for investors, firms will soon be subject to a muni best-execution rule that is based on the best-execution rule that governs the equities and other fixed income markets. Municipal bond dealers will be required to diligently search for the best price for a customer. Some firms have already put such rules in place internally, despite the considerable technology costs of implementation.

As for transparency, more trade and transaction data is available to retail investors than ever before. The MSRB began the limited dissemination of prices for the municipal securities market in 1995 (when not everyone had a computer), and has increased price transparency in a series of measured steps as technology, and access to it, has advanced. These initial transparency efforts began with daily price transaction reports, available only to subscribers. In 1998, SIFMA's predecessor made this data publicly available to investors free of charge through its investor education website. By 2000, the MSRB was making all trade data public on a one-day delay. And in 2005, the MSRB began disseminating near-real-time, or immediate, municipal bond prices, which continued to be made publicly available by SIFMA.

Ten years after SIFMA began making municipal bond prices available to the public, the MSRB launched its EMMA website – emma.msrb.org – in 2008 as a free online source of key municipal market information for retail investors. Since 2009, EMMA has been the centralized repository of all primary offering disclosure documents as well as continuing financial and significant event disclosures in the municipal market pursuant to Securities and Exchange Commission (SEC) Rule 15c2-12. Along with this development, the market moved to an "access equals delivery" standard for distribution of official statements. This standard allows brokers to notify customers to whom they are selling municipal securities that offering documents are immediately available on EMMA rather than provide them with mailed, printed copies.

In addition to disclosures identified in SEC rules (issuers contractually agree with bondholders to make these disclosures via EMMA), the MSRB also provides issuers and obligated persons with the ability to voluntarily post additional disclosures about their securities to EMMA. The EMMA website also serves as the go-to web venue for public access to variable rate security information, transaction data, dealer reportable political contributions, as well as market statistics and investor education. Funded by a $1 per trade technology fee tax paid by dealers that has raised in excess of

$22 million since 2011, the MSRB has made significant improvements to EMMA including adding comprehensive investor education tools and other functionality. Through the investor tools at this website, anyone with internet access can track his or her own portfolio, easily review daily and historical trade data, view trade price and trade yield graphs, and utilize the Price Discovery Tool which allows the user to find and compare trade prices of municipal bonds with similar characteristics.

The "access equal delivery" model for primary market disclosures has been very successful and puts customers in control of deciding how much and what kind of information they want to review. It is efficient and cost effective. SIFMA believes that this model should be followed for other municipal market information that may be of interest to investors. Dealers should be encouraged to direct retail customers to EMMA instead of creating costly new systems to provide customers with data that is already publically available and easily accessible on EMMA.

As securities regulators consider regulatory reforms to the fixed income markets, SIFMA urges them to weigh the unique characteristics and structural realities of each of these varied over-the-counter markets. Copying the existing standards from equity and other fixed income markets is simply unfeasible. "Square peg; round hole; force to fit" is a bad recipe for success. We all want to advance investor protection and improve, where possible, market liquidity in the municipal market. But it will not aid investors familiar with the operation of the equities market if regulators impose the exact same rules and unrealistically expect the same results. Improvements in the municipal market should be market-participant driven. Some changes, such as an expressed desire for increased electronic trading, should evolve organically and are already occurring. SIFMA will continue to support regulatory reform that reflects the unique characteristics and structural realities of the municipal bond market, and which appropriately balances investor-protection interests with the need for efficient municipal markets and the economic impact of such proposals on all participants.

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