# Bond Case Briefs

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## Muni-Tech and E-Trading: Opportunities and Considerations for Investors.

The growth in both equity and fixed income e-trading, also known by its more formal regulatory moniker "alternative trading system," has been a bit of a blessing and a bit of a curse for investors. On one hand, there is no question automation and e-trading platforms give both individual and institutional investors more offerings and improved public market liquidity. This quickly translates into improved pricing, execution and transparency—all the things one wants to have for "fair, orderly and efficient markets."

The curse part is spelled out pretty clearly in the SEC Rule 15c3-5 "Risk Management Controls for Brokers or Dealers with Market Access." Technology increases the speed of complex algorithm-driven transactions across interlinked markets, so that "errors generated by one system or firm can quickly propagate across the marketplace." No one wants a repeat of the flash crash of May 2010 again. Events like that don't exactly bolster investor confidence.

While well established in equity trading, e-trading platforms are also quickly expanding in the fixed-income markets. In 2016, the Securities Industry and Financial Markets Association (SIFMA for short) pulled together a thorough report detailing electronic trading platforms in U.S. corporate and municipal securities. The report outlined, in ten categories and 35 subcategories, the components of e-trading, from trade size to counterparty visibility. Then it applied those in its examination of the nearly 20 platforms currently offering trading functions in the fixed-income markets.

In addition to technological advances, regulations have also been a change agent. This is particularly true in the municipal bond market. In 2014, Municipal Securities Rulemaking Board, the self-regulatory body of the municipal bond market that operates under the oversight of Congress and the SEC, received SEC approval for Rule G-18. The rule codifies the parameters defining "best execution," usually referred to around the market as 'best-ex.' Best execution is to assure that a customer buying or selling a bond is getting the very best price. Charged in its charter to promote fairness and efficiency in the $3.7 trillion municipal securities market, the MSRB instituted the rule to accomplish exactly that.

Perhaps proving the law of unintended consequences, the best-ex rule gave a boost to municipal e-trading platforms . Since e-trading platforms are SEC registered broker-dealers, they are subject to all MSRB rules. So, being SEC compliant and giving access to potentially a larger investor pool with more trade-price transparency, the platforms—there are currently six with muni-specific dedicated interfaces—were a solution to a number of the municipal bond broker-dealers' needs.

One particular need the muni market always has is for better liquidity for retail-size bond offerings. Liquidity can be measured a variety of ways: number of offerings, number of bids, bid-ask spread, time between listing and sale, speed of execution. There is no official designation as to what 'retail size' is, but generally blocks of bonds under $500,000 par value is the accepted rule of thumb. Given that roughly 50% of the bonds in the municipal market are in retail accounts (more if you add bonds held by retail's surrogates—advisors and trusts), it's the largest aggregate part of the market.

All of the major market participants—broker-dealers, funds and registered investment advisors (particularly those managing the burgeoning separately managed accounts business)–saw the best-ex benefits to listing offerings and buying bonds on e-trading platforms. Moreover, the more that joined, the more saw they had to join. It was the network effect writ large.

This did not go unnoticed by the MSRB. "In all markets, efficiency of transactions is improved when a greater number of potential buyers and sellers is involved," said MSRB Executive Director Lynnette Kelly. "Electronic trading has developed into another important venue broker-dealers can use in the municipal market to achieve best execution and fair pricing for their customers."

With the regulators paying attention, so were compliance officers. As municipal e-trading platforms became an established part of the market, compliance teams realized they needed to learn the ins-and-outs of the muni market as well. Even a cursory understanding of e-trading highlighted some key benefits for compliance. Consider the data-capture. In addition to the trade basics of coupon, maturity, yield, price and settlement, e-trading platforms trap virtually everything surrounding the trade: time of listing, time of the trade, number of bids, cover bid (the next highest offer away from the winning bid) and total trades, just for starters.

Other benefits include diminished counterparty risk and a cleaner path for trade clearing. Not only can complete documentation be presented should there ever be a question, but also since everything is digitized the record keeping is simpler. Moreover, the automated process means fewer costly 'fat finger' mistakes to find and unwind. Be it a client, auditor (internal or external), counsel, or regulator, the e-paper trail is consistent and complete.

Municipal e-trading platforms are advancing rapidly, with more participants, more offerings and more robust interfaces. They are pushing the market from over-the-counter to exchange, organizing a market that is comprised of numerous submarkets (*see Muni Bond Manager's Journal: Pay Attention To Bond Submarkets*). As with anything in tech, change is a constant and only constantly changing faster. The issues that gave rise to e-trading—and equally now have arisen from it—are being watched carefully by regulators. For both market and regulatory reasons, it's time to get up to speed.

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by Barnet Sherman, Contributor

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(This is the first article of a two part series on e-trading and the fixed income markets)

*Barnet Sherman is the Senior Managing Partner of The Tenbar Group, a financial services consulting firm advising on successful strategies to manage the credit risk in municipal bond porfolios.*