[Bond Case Briefs]

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[Commentary: Muni Industry Best Served by Wider Acceptance of Group Net Syndication Rule.]

This year the municipal industry marks the tenth anniversary of the launch of its milestone breakthrough for market transparency — the creation of EMMA or the Electronic Municipal Market Access. It is a reminder of the imperative of modernizing an industry that provides three-quarters of the annual U.S. infrastructure spend and is a $3.7 trillion market.

While commendable in its creation, the transparency provided by EMMA for municipal bond investors existed for other debt markets years before. Other long-held municipal industry practices are overdue for review and change as well.

Toward the top of the list of areas requiring a fresh approach is the way negotiated bond underwriters are paid. Not how much, but by whom. This arcane issue is stuck in decades-old practice long ago abandoned by other markets such as the corporate and securitization bond sectors.

Some background at this point is useful. Once the municipal debt issuer determines the amount of compensation to be paid to the underwriters, there is also a discussion of syndicate rules or the method by which these dollars will be divided among the underwriters.

In the municipal market, the syndicate rule of choice is "net designated." This approach, selected by many state and local governments, is intended to reward underwriters that deliver actual orders from investors to purchase bonds.

That thought seems initially to have merit, and that may have been so in years past. Why not reward compensation to the underwriters who deliver the orders? But the reality of the market place today, as any institutional investor knows, is that if they place their purchase order with the book running manager as opposed to other firms that are part of the underwriting team, they stand a much better chance of having a larger percentage of their order filled.

That then results in the need for the investor, within syndicate rule guidelines, to "designate" other underwriters a portion of the fees associated with its order. Said clearly, the investor decides which underwriter receives the sales credit or takedown monies associated with the controllable "co-managed designation" related to their order rather than the issuing client.

It is a lingering myth in the municipal market that the discretionary co-manager designations, meaning amounts available to designate above and beyond an issuer's prescribed requirements, are highly correlated to the co-managers' sales effort on the particular issue being sold.

In reality, institutional investors weigh multiple factors in what is typically a thoughtful and defensible co-manager remuneration methodology. The objective criteria forming the assessment may include such items as an evaluation of the underwriter as a liquidity provider, generation of relevant macro/micro economic research, provision of credit facilities or other financing vehicles, and the level of filling bond orders from other issues when serving as book-running senior manager.

The fact is discretionary co-manager designation dollars are deployed in a manner representative of the totality of the relationship between the dealer and the institutional investor, and where that relationship falls within the given institutional investor's determined hierarchy of services. This approach is accepted to the point that if an investor was to have overcompensated a dealer based on a recent set of transactions, that investor would likely recalibrate on upcoming transactions to maintain alignment with the established hierarchy.

But to repeat, some issuing clients may be under the mistaken notion that these designations by institutional investors — monies paid to underwriters from their bond issue — are related solely to the sales efforts on their transaction. In most circumstances, it does not or, at best, is only partially so.

Further, the net designated syndication rule may be providing compensation to an underwriter who may or may not be providing liquidity on that issuers' bonds in the secondary market–a service typically useful to the especially active issuers of debt–but may not be appropriately weighed in the determination of designations by the institutional investor as it relates to a given issuer.

Other markets migrated away from this net-designated approach long ago to a syndicate rule equivalent to "group net" in the municipal market. This option leaves the allocation of underwriting revenues firmly in the hands of the debt manager for the issuing client.

In the parlance of the business, this is a "pot" transaction where all revenues from the sale of securities are pooled and divided among the underwriters by the issuing client representative. Consequently, the issuer, not the institutional investors, determines how much and why a given underwriter is paid.

This approach has the additional benefit of better synching underwriter compensation with the risk allocation the issuer assigns to each member of the underwriting syndicate. Too often, co-managers have a greater risk percentage than the proportional revenues they ultimately receive.

Note that the adoption of this alternative method of distributing underwriting compensation requires no change in federal, state or local law or regulation. It is completely in the hands of the debt issuers' staff and advisors.

Currently, debt managers widely opt for the net designated approach of underwriter compensation but are able to make the change to the group net alternative with relative bureaucratic ease. It is time that they do so.

The net designated syndication rule is one whose time has passed. The municipal market should modernize, following the lead of other markets as to how issuer monies from its bond issues are paid to underwriters.

The Bond Buyer

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