

MSRB

2012 - 63

Request for comment on MSRB rules and interpretative guidance

Responding to 2012-34, duties of bidders

What the MSRB calls throwaway bids are just extreme versions of what every wholesale bid is--the attempt to buy at a profitable discount to a projected selling price.

What the MSRB calls picking off dealers is just an extreme version of the motivation behind every wholesale transaction-- the attempt to further your own interests at the expense of those of the counterparty.

Notice 2012 -34, concerning the duties of bidders, proscribes these extreme versions of normal trading behavior, but there is no standard by which to establish where on the continuum of prices such extreme behavior begins. That means in turn that, no matter how well intentioned the MSRB's determination to protect retail customers, no practical compliance program is possible for bidders that preserves the fundamental dynamic of the market. Traders should no longer strive to create the maximum discount to market value when they buy, in other words, and the maximum premium when they sell, but rather they should try to buy and sell at prices someone else will later determine, on some arbitrary basis, to have been fair.

How do you instruct your traders to do that? I've asked people at FINRA and MSRB, but no one seems to have any idea of how to define fair bids *before the fact*. After the fact, fair bids are those that were close to the market average prices, if such prices exist for the bond in question, and unfair ones are those that were too far away. "Close" and "far away" are, of course, entirely a matter of opinion, but, just as importantly, depend on the activity of parties other than the bidder. If I submit a bid of 90 on a bid wanted that another dealer wins at 98 and then retails at 100, I am going to be off market in someone's judgment but no one will care because I am not a participant in the transaction. If, on the other hand, I win the bid at 90 and I or someone else subsequently sells at 100, I am going to be off market in someone's judgment and regulators may well be interested. Same bid, same bond, different regulatory interest.

There is a sentiment among regulators with whom I have talked that the fair price of a bond is apparent. We don't think it is, particularly in bonds that trade infrequently. Yesterday, the cover bids on our buys varied between 1½ points and 4½ points-- that certainly doesn't suggest consensus. A reasoned consensus probably isn't possible, anyway. Our traders bid several hundred bonds a day. The whole process of bidding a bond takes a minute or less, and this is typical in the industry. The traders don't examine official statements or the latest financial reports in most cases. They don't search out local news stories on current budget stalemates or the financial viability of the largest industrial employers. They may have no history to go on. So of necessity, they must, to some extent, guess at what the appropriate value is-- based on their experience and on the pricing factors noted in the regulations-- and then provide themselves a margin of error. The bond

"must be worth at least this," in other words, is at least a component of almost every bid but is the very approach the notice rejects. Would it be better for traders not to provide these bids and instead rigorously research only a dozen or so? Who would be served by removing that potential liquidity from the market? How do you think a trader develops expertise in a new market area, anyway? He does it by bidding cheap to the market, observing the bid results, and gradually improving his bids until he is competitive. Strictly speaking, that is a violation, too.

Yesterday (12/18/12) we were successful on 5 bids. We will offer all these back to the wholesale trade. 4 of them had no activity in the previous 4 months; 3 of them had no activity in the previous 6 months and so had a blank history on Bloomberg. For the bonds with little or no history, how we reoffer them may determine whether our purchase bid is subsequently deemed "off market," implying a standard of mark up, rather than fair value, that is not explicitly stated anywhere. If we successfully bid at 90 and successfully reoffer at 100, is that too large a mark-up? Does that make the 90 bid off market? Would a 95 reoffer be OK? What about 93 or 96?

I have no idea how to develop a compliance program absent any standard of mark up or of allowable volatility. We have no idea how to temper our legitimate interest in maximizing trading profit with the new requirement to consider the interest of some retail customer we don't even know, if he exists at all. The only safe harbor for us would be never to bid less than the lowest price in the history, never to reoffer at more than the highest price, and to never mark up more than the greatest visible intra day movement. But if everyone did that, of course, the very market making activity which provides what little liquidity there is for the vast majority of bonds would be defeated. Would the customer be better off evaluating no bids rather than a bid someone considers off market? Why can't the customer, aided by his broker, decide what's in his best interest, rather than have us guess at it?

We agree that the retail customer is due some protection because he is at a disadvantage to the dealer. We don't agree that this duty should fall on the wholesale bidder. That turns the whole idea of an active market on its head. The party who should be considering the customer's interest is the broker representing him. Not only is he the only one with access to the customer's intentions but it is the natural place in the market structure for that judgment to be exercised. It seems to us that customers would be better served by encouraging more wholesale bidding activity; and threatening willing bidders with sanctions may in the end decrease liquidity and impair prices instead.

If you can provide us guidance on how to structure a compliance program, we would welcome it.

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