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THE MUNI IIC NEWSLETTER

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Market Rejuvenation = National Municipal Bond Exchange

Guest Author: **Joseph Fichera***

If the E-Trade baby, in the often repeated commercial for the simplicity of stock trading, can buy or sell a $2 stock in Hong Kong using a smart-phone app, then why not municipal bonds?

In the aftermath of the economic crisis in 1973-4 and the "Big Bang" deregulation of brokerage commissions in 1976, Wall Street restructured the equity marketplace to make it more transparent and fair for all participants. As a result, the equities market became a bigger, more profitable and more efficient source of capital than ever before.

Today, the marketplace for securities issued by state and local governments and not-for-profits faces a moment much like the one the stock market did in the mid-1970s.

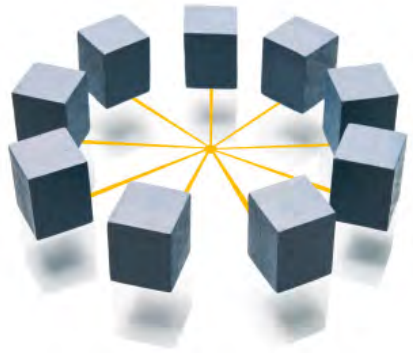
Again the economy is stalled and markets are reeling. New bond sales are down, in part because of concerns over mounting debt. Ratings agencies, rightly or wrongly, have lost trust. The collapse of the bond insurance market has created new "headline risk" that gives investors pause. Cash has fled from mutual funds, shrinking municipal bond portfolios. Congress failed to renew the "Build America Bond" (BAB) program, stifling growth and cooling international investors' interest in the municipal market. Regulators are revisiting the Tower Amendment and considering new regulations to address other perceived shortcomings in the market structure. The municipal tax exemption is in peril and the Obama administration is recommending reinstatement of the BAB program. [1]

Just as the nation needs to attend to its crumbling physical infrastructure, if Wall Street is to again help itself and help Main Street recover it must focus on improving its own infrastructure to increase the transparency, competition and fairness in important markets.

How? Part of the solution for the municipal market might be the same mechanism that has been used so successfully in other markets: a central exchange. By coming together to create a modern municipal bond exchange, Wall Street can prosper, investors can be assured an outdated market structure will no longer impair the value of their investments, and Main Street can get more of the capital it needs at lower cost. A bond exchange is no cure-all, but the steps outlined below can be implemented without new regulations and without requiring federal involvement in local decisions about how, where and when to bring bonds to market.

A Modern Marketplace Built on a Proven Idea: A Central Trading Place

The municipal bond marketplace, like many of the nation's highways and bridges, has been overlooked and neglected. Current research by the Brookings Institute's Hamilton Project confirms what most practitioners already know: the municipal bond market is less efficient and less liquid than other markets. [2] Inefficiency means that it is difficult for bondholders to sell, and for investors to purchase, at a price close to a bond's "intrinsic value". Even though the municipal market is large and popular, the market is opaque, fragmented (it's regional, not national), and provides no reliable and efficient mechanism for investors to resell securities. These structural flaws create a spread between what a bond may be worth vs. what someone is willing to pay for it in a "dark" market and the cost of such liquidity inefficiency was recently estimated to be in excess of $30 billion per year on the $2.9 trillion amount of outstanding municipal bonds. [3]



As a result, the failure of this market segment to keep pace with structural improvements long made in other markets continues to force municipal borrowers issuing new securities pay more in interest to compensate for this liquidity risk, and investors in the secondary market to accept lower prices when selling their bonds. These additional borrowing and trading costs translate directly into higher costs for taxpayers and for the bulk of the investing public.

A central exchange can reduce these costs by gathering many buyers and sellers together in one venue. Currently, the lack of "standardized" municipal bonds makes it very difficult for buyers and sellers of similar municipal bonds to find each other. As an example, a buyer looking for a State of California bond maturing in ten years with a 5% coupon rate may encounter dozens of such bonds, each of which originated in a different primary market offering. Existing data systems, and the patterns and practices of the market, focus

[1] For a snapshot of the adminstration's proposal see http://www.ritholtz.com/blog/2011/09/policy-madness-in-muniland/

[2] Andrew Ang and Richard Green "Lowering Borrowing Costs for States and Municipalities Through CommonMuni" http://www.brookings.edu/papers/2011/02_municipal_bond_ang_green.aspx

[3] Id. at 2 (abstract)

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on the arcane and technical "CUSIP-level data" [4] — that is, a particular 5% bond, maturing on a specified date in the desired maturity year. Without a viable way to quickly identify and examine other securities by CUSIP, it is difficult to make these comparisons.

A central exchange with modern technology could enable prospective buyers to "see across" various issues and locate those that are similar enough to meet their goals. This would significantly improve liquidity and benefit individual investors (who have a growing appetite for high-quality municipal bonds) and institutional investors alike. Working with leading issuers, the dealer community should nurture this demand for bonds by establishing a central trading platform where municipal bonds could be brought to market and traded under a standardized set of rules and using modern technology.

Key improvements over the current system would include:

- Standardized listing formats that display multiple listings of bonds in a searchable format, so investors can quickly find and compare offerings matching their interests;
- A standardized set of rules, to be enforced by the exchange as a self-regulatory organization, that would include best practices for accounting and financial disclosures, as recommended by the Government Accountability Office (GAO) in its January 18 report to Congress;[5]
- Standardized electronic interfaces that enable brokers to easily integrate existing distribution systems with the exchange's central book of orders; and
- Standardized channels to disseminate pricing and financial data to the market at large.

The Technology Already Exists

The most efficient markets are those with great "depth of book," which means that there are large quantities of opposing orders "at the market" and resting just below the highest bid and above the lowest offer. The first markets to adapt were those involving small numbers of well-defined instruments, such as the markets for stocks (approximately 4,000 individual issues), on-the-run Treasury securities (fewer than 20 current notes and bonds), or commodities futures (approximately 100 front and near-month contracts).

In contrast, there are several million municipal bonds in circulation, which makes it difficult at present for any investor to find an "at-the-market bid" for a particular, seasoned bond in the secondary market. While municipal securities will never trade on a "hit-and-lift" basis, technology is available that will "know" where latent holdings of issues lie buried in investor portfolios, when indications of interest (IOIs) and requests for quotes (RFQs) have been published, and where firm orders exist. Today's platforms are already able to automatically pair off different expressions of trader intent and conclude deals, sponsor negotiations, or conduct auctions as most appropriate. And perhaps most important, these platforms incorporate the "human element," in the form of specialists who can blend technology with their market experience and intuition to broker transactions.

Wall Street should lead an effort to deploy similar technology in the municipal bond market to create an intelligent, transparent and efficient "next-generation" electronic marketplace. Institutional investors and leading retail brokers have already invested in technology platforms that would enable them to quickly adapt to a central marketplace for municipal bonds. Considerable momentum could be gained if such investors could view, negotiate, and execute electronically under an established set of rules that promote transparency and fairness. Doing so holds the prospect of creating a national – if not international – marketplace, especially as more fully taxable bond issues are brought to market.

Better Access And Fairer Pricing Will Broaden Participation For Both Retail and Institutional Investors

Issuers are experimenting with new ways to bring bonds to market that include offering bonds in smaller denominations to make offerings more attractive to retail investors .[6] These new methods hold promise, particularly if new offerings can be listed on a central marketplace immediately upon issuance. Every initial public offering of stock benefits from the listing of those new securities on a central exchange such as NYSE, NASDAQ, BATS or the like. The advantages of listing newly issued securities on a central marketplace are obvious, and municipal bonds offered in the same fashion would enjoy the same benefits. Such a listing would make the initial offering more appealing because the investor who purchased the bond at issuance would have a transparent venue through which to later sell the bond if the investor's circumstances change. The market for municipal bonds could be significantly broadened if investors were confident that a decision to buy an individual security wasn't a "lifetime" commitment.

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4 CUSIP An alphanumeric identifier, comprising nine characters, for every class of traded financial instrument in the United States, including all US Government, municipal and corporate securities and syndicated loans.

5 GAO-11-267R GASB and the Municipal Securities Market (January 18, 2011).

6 Retail has always been an important market component. MSRB reported in mid-2011 that during the first quarter of 2011, more than half of the trades in the municipal market were in amounts less than $25,000. Issuers are increasingly aware of the importance of retail investors. For one example, in California, Assembly Bill 1408 was signed into law this month and will enable California to sell its general obligation bonds in denominations as small as $25. The concept of these "mini bonds" is not new. Denver used such bonds in 1990 to fund parks, libraries and other facilities in a small offering of $3.1 million. Santee Cooper, South Carolina's state-owned electric utility has conducted annual sales of mini-bonds to fund portions of its capital needs since 1988. Mini bonds offer an excellent way for issuers to connect directly with citizens.

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Industry-Driven Reforms Without Burdensome Federal Oversight On Local Government

Housing the technology platform in a self-regulatory organization that publishes and enforces a standard set of rules (defining which bonds may be listed, who can access the listed securities, and the conduct of execution, settlement and clearing) would maximize the benefits and flexibility of the new market structure.

The "Tower Amendment," enacted in 1975, is a source of continuing controversy. It need not be. In general, the Tower Amendment prohibits the Securities & Exchange Commission (SEC) and the Municipal Services Rulemaking Authority (MSRB) from requiring issuers of municipal securities to file pre-sale disclosure documents similar to those required of corporate issuers.

The MSRB, SEC and the GAO are taking a fresh look at the Tower Amendment and considering new regulations to address perceived shortcomings. At the same time, according to the recent GAO study, leading issuers have increasingly begun improving both the quality and the timeliness of their financial disclosures.

Best practices derived from these efforts by industry leaders could be incorporated in a "rulebook" developed and published by the exchange. The exchange rules would be binding upon any issuer seeking to bring securities to market on the exchange.

The exchange would operate as a self-regulatory organization with capacity to enforce its own rules, just as exchanges serving the equity and derivatives markets do today. Compliance with the rules would be strictly voluntary – issuers and investors who do not like the rules simply need not conduct business on the exchange. But as liquidity coalesces around the exchange – as it will –market forces will inevitably drive further reform without need for federal intervention. Regulation would be focused on the operation of the exchange rather than on the activities of issuers and dealers.

Challenges to Overcome

Exchanges are often born out of crisis when interested parties, often natural competitors, come together to solve common problems. [7] Given the issues confronting today's municipal market, there are compelling reasons for issuers, underwriters and brokers, and investors to cooperate in creating a new structure. The exchange model is a proven, tested vehicle that regulators will accept to enable cooperation among market participants with competing interests. [8]

Of course, there will be challenges. Wall Street dealers are focused on derivatives reform and may not want to be distracted. Some brokers may resist the exchange model if it is perceived as limiting their franchise. The MSRB may insist that the exchange technology be based on EMMA. So-called "story bonds" may not find a home on-exchange and local issuers may balk at doing "something new." To overcome these obstacles, large issuers with market clout will likely need to lead the way, calling on preferred underwriters for cooperation.

Better Wall Street infrastructure and clearly defined rules for financial disclosures will give brokers new tools for offering high-quality bonds to investors – using technology that will make EMMA seem obsolete. An exchange would be an obvious asset for any broker with the capacity to quickly scale its existing systems to grow its franchise to new customers. Market makers will be needed as well.

A "Win-Win" Market Structure

Trading on an exchange improves accessibility, transparency and fairness – benefits that are much needed and well-recognized. [9] The benefits gained by creating a central trading venue for issuers, investors and brokers are clear:

- ✓ Brokers who integrate existing distribution platforms with the exchange will attract new customers who will need execution, clearing, and settlement services in order to access securities listed on the exchange.
- ✓ Issuers will benefit by broadening their investor base, thereby lowering borrowing costs and minimizing burdens on local taxpayers.
- ✓ Investors will find it easier to find offerings that match their interests and to adjust portfolios as their needs change.
- ✓ Investment managers and advisors will benefit from having better information with which to assure their clients that fiduciary standards and Employee Retirement Income Security Act of 1974, ("ERISA") requirements are being satisfied.
- ✓ All market participants would find safe harbor from regulatory complications by conducting business in compliance with the rules of the exchange.

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7 The InterContinental Exchange (ICE) rose to prominence after the 9/11 attacks made it difficult for the energy markets in New York City to function properly.

8 Exchanges has historically received exemptions from anti-trust requirements. Andrew N. Kleit and James M. Falvey, "Commodity Exchanges and Antitrust" (August 21, 2006). bepress Legal Series. Working Paper 1592. http://law.bepress.com/expresso/eps/1592

9 See, Leaders' Statement: The Pittsburg Summit Sept 24-29, 2009 as modified Feb 3, 2011

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It is not necessary to transform the entire industry overnight – a handful of top-quality issuers could lead this initiative. Doing so would enable even highly-localized markets to grow and strengthen as professional traders and traditional muni investors pull up charts for municipal bonds and send orders to their broker from their desktop, iPad or mobile phone.

Who knows, perhaps we'll soon see an E-Trade commercial in which the baby mentions municipal bonds…which would indicate that both the child and the municipal market (and the economy) are maturing well.

Joseph S. Fichera is one of the founders and current CEO of Saber Partners, LLC, a Senior Advisor to The Williams Capital Group, L.P. and current Lecturer in Public and International Affairs at Princeton University's Woodrow Wilson School. Mr. Fichera's innovations and insights have been profiled in detail in the print media and he has published in The Wall Street Journal, Barron's and Yale Management Review among others. He is a guest commentator on financial news media, including Bloomberg Television, National Public Radio, CNN Financial, and Fox Broadcasting.

Saber Partners, LLC, is an issuer-side financial advisory firm that provides senior-level strategic services for private and public sector clients, including federal and state regulators. An investment banker since 1982, Fichera is unique in having been honored with three "Deal of the Year" awards from independent publications such as Institutional Investor magazine covering his key fields of expertise -- corporate, municipal, and asset-backed finance.

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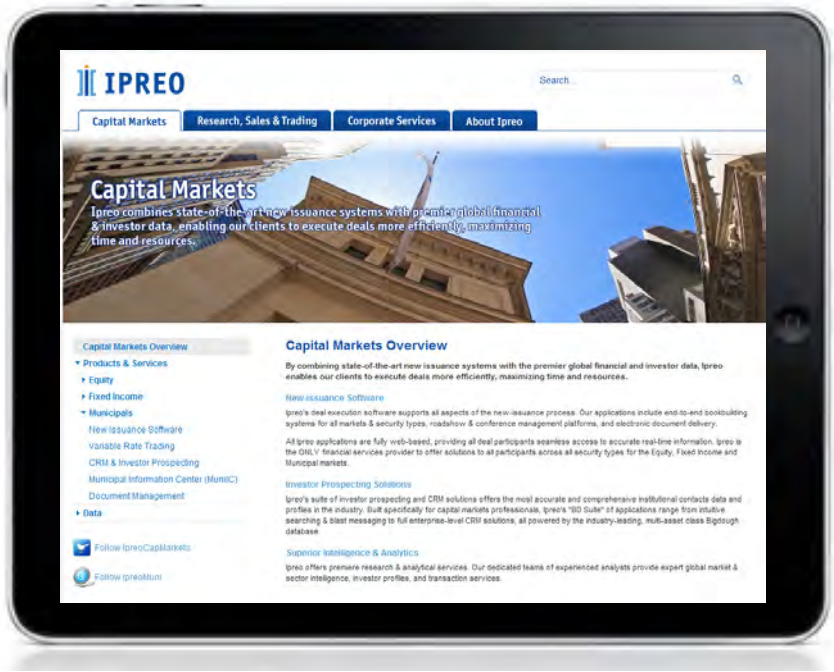
RAISE YOUR VOICE - MuniIC's IDEAS Contest!

Agree or disagree? Ideas? Comments? The MuniIC team would like to hear what you have to say on the topics presented in this newsletter and will award our favorite commentary **A BRAND NEW IPAD2!** Submit your commentary to **muniic@ipreo.com** by **October 31st**. The winner will be contacted by email and announced in the Q4 issue of the MuniIC Newsletter.

(NOTE: All comments may be published or excerpted in the next issue unless otherwise requested by the submitter.)



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Featured Market Statistics *Every issue we will provide relevant municipal market statistics.

2011 Municipal Bond League Table - Top Issuers (Year-To-Date)

Rank	Issuers	Market Share	Par Amount (US$ mil)	# of Issues	# of Bids
1	State of Texas	4.67	10,194.49	6	76
2	State of California	4.24	9,263.62	3	0
3	State of Illinois	1.69	3,700.00	1	0
4	Dormitory Authority of the State of New York	1.64	3,574.81	22	19
5	New York City Transitional Finance Authority	1.44	3,149.43	7	27
6	New Jersey Economic Development Authority	1.29	2,824.41	9	3
7	New York City Municipal Water Finance Authority	1.06	2,304.96	6	9
8	City of Houston	0.87	1,907.71	6	35
9	State of Wisconsin	0.84	1,833.38	4	62
10	State of Oregon	0.80	1,752.45	8	15
11	City of New York	0.80	1,751.10	8	50
12	Indiana Finance Authority	0.80	1,747.19	12	0
13	New York State Thruway Authority	0.77	1,677.51	3	0
14	The Regents of the University of California	0.73	1,599.72	6	0
15	City of Los Angeles	0.72	1,581.33	3	17
16	The Commonwealth of Massachusetts	0.71	1,556.45	6	18
17	Massachusetts Development Finance Agency	0.71	1,540.50	19	0
18	Commonwealth of Puerto Rico	0.64	1,400.64	3	0
19	City of Chicago	0.64	1,394.13	5	0
20	County of Los Angeles	0.60	1,300.00	1	0
	Top 20 Total	25.67	56,053.79	138	331
	Total All	100.00	218,397.02	8,649	20,270

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MSRB Trade by Type for 9/21/11

Total Number of Trades by Type

Number of Trades Greater than 1MM

Total Par Amt of Trades by Type (Excludes Trades 1MM+)

These reports represent certain inter-dealer and customer trades in municipal securities that have been reported by dealer to the MSRB. The reports do not necessarily reflect all transactions that were effected on the specific trade date noted. There is the possibility of errors in the trade submission process or errors or omissions in other processing of data, or delays in delivery of data reported by dealers or reported by the MSRB. These reports should not be used as the sole basis for pricing or executing transactions in municipal securities. Prices for transactions vary with market conditions and can be affected by trade size and other factors. Neither the MSRB nor its suppliers of data products or other services used to generate the transaction reports warrant or guarantee the accuracy of the data contained in these reports.

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Featured Investor Snapshot *Every issue we will profile a different investor that may be of interest to municipal issuers

The Value Change for the below profile represents change since 6/30/11. The Value Positions are current and from the latest available data.

Deutsche Investment Management Americas, Inc. — New York

345 Park Ave.
New York, New York 10154-0004
Tel: +1 212-250-2500
Fax: +1 212-223-3127

Portfolio Stats

Fixed Income Assets ($M)	49,987.9
Total Reported Assets ($M)	242,269.2
Institution Type	Investment Advisor-Mutual Fund
# of FI Securites	10,360

Deutsche Investment Management Americas, Inc. invests in global investment grade corporate and government bonds as well as in structured debt.
The firm invests in hard and local currency denominated global government and corporate bonds, U.S. structured debt, and U.S. municipal bonds. The firm seeks global government bonds rated B- to AAA and global corporate bonds rated D to AAA both across all maturities. Deutsche Investment also focuses on U.S. ABS rated CCC to AAA with maturities between 4 to 10 years and U.S. MBS rated CCC to AAA with maturities up to 10 years. At last, the firm invests in U.S. municipal bonds rated CCC to AAA with

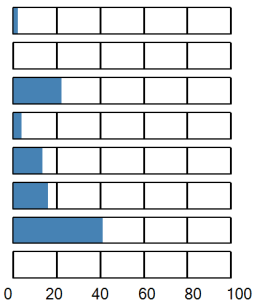
Contacts

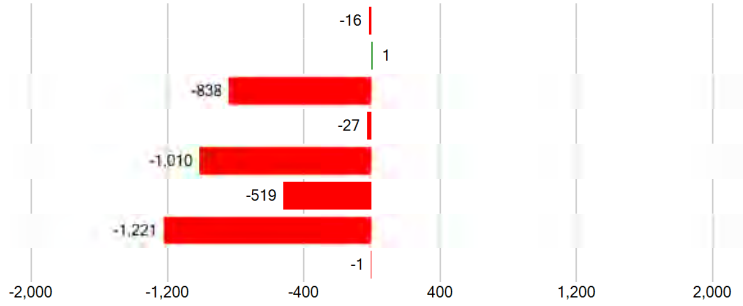
Name	Role	Phone Number
Mr. Stephen M. Johnson CFA	Chief Investment Officer, Portf	+1 212-250-2500

Johnson is CIO of Americas, managing director and a fixed income portfolio manager at Deutsche Investment Management Americas, Inc. He was previously CIO of the fixed income group at INVESCO. Prior to that, Johnson was a fixed income portfolio at the capital management division of PNC Bank. He received a BS in Petroleum Engineering from the University of Kansas and a MBA from Rice University.

Fixed Income Market Sector

Market Sector	Percent of Portfolio	Value ($M)	Value Change ($M)
ABS		$1,163.5	-16
Convertibles		23.3	1
Corporate		11,139.3	-838
Fixed Income - Other		2,002.7	-27
Government		6,806.2	-1,010
MBS		8,127.8	-519
Municipal Bonds		20,676.1	-1,221
Preferred		48.9	-1





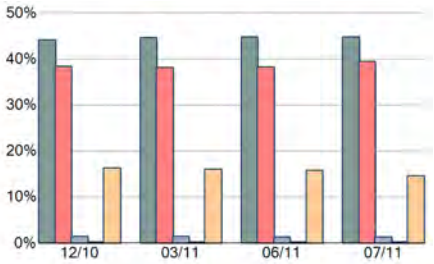
Allocation in Municipal Debt

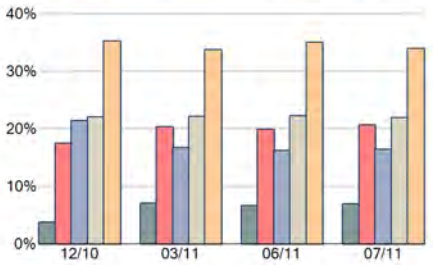
Municipal Rating Breakdown

Rating	Value ($M)
AAA-AA	$9,259.1
A-BBB	8,142.8
BB-B	246.0
CCC-C	15.3
Other	3,013.0

Municipal Maturity Breakdown

Time to Maturity	Value ($M)
Maturing in < 1 Yr	$1,445.0
Maturing in 1-5 Yrs	4,278.2
Maturing in 5-10 Yrs	3,393.0
Maturing in 10-20 Yrs	4,540.2
Maturing after 20 Yrs	7,019.8



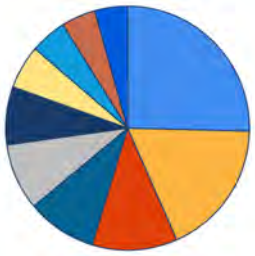


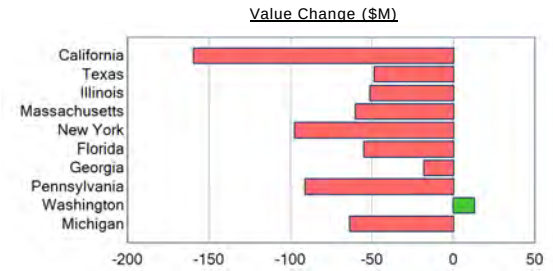
Municipal Use of Proceeds Breakdown

Use of Proceed	Value ($M)	Change ($M)	% Port
General Purpose/Public Improvements	$4,756.2	$-154.0	23.00
Transportation	3,149.9	-9.8	15.23
Education	2,037.1	-142.4	9.85
Health Care	1,989.2	-151.3	9.62
Utilities	1,265.2	0.2	6.12
Water & Sewer	1,148.4	-31.9	5.55
Economic Development	159.0	-3.4	0.77
Public Safety	150.9	-27.3	0.73
Pollution Control	122.1	0.0	0.59
Housing	116.5	-68.9	0.56
Industrial Development	66.7	-24.0	0.32
Recreation	57.9	-5.1	0.28
Sanitation	37.1	0.0	0.18
Pension/Retirement/Disability	7.0	-1.0	0.03
Veterans	1.2	0.0	0.01

Top 10 Municipals By Issuer State

State:	Value ($M)
California	$3,424.9
Texas	2,426.5
Illinois	1,524.7
Massachusetts	1,250.6
New York	1,194.0
Florida	1,038.1
Georgia	776.9
Pennsylvania	651.5
Washington	614.9
Michigan	584.5





Bond Positions: Morningstar, Inc.

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