

The Securities Auction System in The Secondary Municipal Market

An important principle in an auction is the determination of market prices through mutual competition. The Securities Auction System and its Limit Bid feature is instrumental in achieving this principal in the secondary Municipal securities market in that it permits a bidder to implement predetermined bidding strategies based on evolving market conditions in multiple simultaneous auctions.

The process is analogous to a “Stop-Limit Order” in the stock market. “Once the stop price is reached, the stop-limit order becomes a limit order to buy or to sell at a specified price.”¹ In this instance the stop price would be a bid price greater than your current bid and the limit order would be to bid up to a specified price. As in the stock market, this type of order may never be executed because it is subject to a variable market on the specific security.

“The MSRB has a long-standing policy to increase price transparency in the municipal securities market, with the ultimate goal of disseminating comprehensive and contemporaneous pricing data.”² Examination of the methods employed in the Securities Auction System will demonstrate the benefits produced in terms of achieving this goal, not just after a trade has taken place but in a “pre-trade environment” where such information is critical for “obtaining a price for the customer that is fair and reasonable in relation to

¹ From definition of stop-limit order on SEC web site <http://www.sec.gov/answers/stopl原因.htm>

² Proposed Rule Change Concerning Public Reporting of Transactions in Frequently-traded Municipal Securities: Rule G-14 MSRB Dated March 27, 2002

prevailing market conditions”³, “distributing only bona fide prices at the time the quotation is made”⁴ and “ensuring that all persons are dealt with fairly without any deceptive, dishonest, or unfair practice.”⁵

Rules for the auction are predetermined and access to all information pertaining to the auction, or any component thereof, is open to all participants or other interested parties. Bids are immediately displayed to all upon entry. Limits are not displayed to any party until changes in prevailing market conditions cause them to be implemented. The technological aspect of the system overcomes problems that may be encountered accessing the Auction on sophisticated networks common in the financial industry.

The process of determining a bid price involves many variables, some which may not be fully apparent when setting the initial bid or which may change during the auction process. These variables including: the demand for the specific securities; and the assumption of market direction, weigh heavily in the valuation of a security once it’s general credit worthiness has been established. The competitive market environment, made apparent through the transparency of the auction, contributes to the determination of both demand and market direction. The Securities Auction System provides the means for these evolving variables effecting prevailing market conditions to be taken into account throughout the auction process.

³ MSRB Rule G-18

⁴ MSRB Rule G-13

⁵ MSRB Rule G-17

Many bidders have dozens or more bids outstanding at the same time and are continuously bidding on new items throughout the day from various sources including customers, brokers and trading systems. In down or uncertain markets and at times of heavy selling most bids are formulated to include a defensive component; they are discounted based on anticipated declines in the overall market. These variable market conditions alone or in combination justifiably contribute to producing overall lower bids.

By nature a bidder is inclined to pay more knowing that another bidder shares their opinion of the value of a bond. That is to say that they “have company” at their bid level. This reaffirms the validity of their bid. Other bidders would be inclined to minimize or even eliminate the implicit discount to their bids based on anticipated market declines should the assumption of such a decline prove to be inaccurate. Time constraints often limit the ability of a trader to review previous bids upon changes in the prevailing market conditions. The Limit bid feature provides for a timely, efficient, predetermined response to these changing market conditions in multiple simultaneous auctions, by automatically increasing a bid when a new higher competitive bid is submitted on an item. There is no question that the number and price of competitive bids, if such information were available, would be a contributing factor in establishing or improving a bid price. The Securities Auction System makes this information available. The Limit Bid feature provides for a trader to take these factors into consideration without the burden of manually implementing decisions they would most certainly make if given the opportunity. This insures that each bid is the best bid a trader is willing

to make based on contributing factors to prevailing market conditions that were previously unknown.

The Securities Auction System brings the dynamic competitive aspect of open auction bidding to the secondary municipal bond market. The Limit Bid feature, specifically, permits a trader to leverage this with minimum effort.

Jay Caldas
Hartfield Titus & Donnelly LLC.
Jersey City, NJ
Friday, December 19, 2008

Bid and Limit Logic for The Securities Auction System

New Bid only:

1. When there are no bids:
 - a. any bid is accepted.
2. When there are bids:
 - a. the new bid must be greater than or equal to the current high bid + the bid price increment.

New Limit Bid only:

1. When there are no bids yet:
 - a. when there are no other bids on the item a Limit only bid requires a starting bid to be entered with it.
2. When there are bids:
 - a. limit bid must be greater than or equal to current high bid + bid price increment;
 - b. display as the current high bid + the bid price increment but not exceeding the limit.

New bid with a Limit:

1. bid must be greater than or equal to the current high bid + the bid price increment;
2. limit must be greater than the bid entered with it.

(Automated) Action On Bid Entry to Check Limit Bids:

1. increase bids accordingly by bid price increment up to but not exceeding the limit bid;
2. if limit bid falls within the range where:
 - a. limit bid is less than current high bid + bid price increment, and;
 - b. greater than or equal to the current high biduse the limit bid as entered.
3. If any limit bid is less than the resultant new high bid the bid corresponding to said limit bid will be increased to the limit.

(Automated) Sort bids to determine high bid by:

1. price in descending order,
2. then by inserted time in ascending order.