

to trade with the highest bidder, it pays the broker's broker a commission. However, the dealer that initiates the auctioned security has no obligation to make a sale.

The MSRB requires the broker's broker to (a) make a reasonable effort to widely disseminate the bid-wanted, (b) reach dealers with specific knowledge of the issue or a known interest in securities of that kind when securities are of limited interest, and (c) identify a deadline for the acceptance of bids. The broker's broker must agree in writing to comply with prescribed policies and procedures and post them annually in a prominent position on its website.

A broker's broker may also engage in situational trading, in which it finds buyers for an investor's securities at a pre-specified price. This is called an **offering**. The party that offers the security for sale makes use of the broker's broker for its broad market reach. It may also employ a broker's broker to maintain anonymity in the market. When an interested party "bids" a price it is willing to pay for the bonds, the broker's broker will contact the owner of the bonds. Should a negotiation follow, the broker's broker will facilitate it by passing the various bids back and forth between the anonymous parties.

MSRB Rule G-43

FUNCTIONS OF A MUNICIPAL BOND TRADER

Market Making

Market makers are dealers who assume the risk of buying or selling out of their own inventory at posted bid and ask prices. By doing so, they are creating a market for that security. All municipal securities are traded through market makers, who provide liquidity and price discovery for buyers and sellers of that security. Market makers make most of their profits from the spread between bid and ask prices.

Position Trading

Position trading is trading in which investors take a position in the market, anticipating a longer-term upward or downward pricing trend. They will buy securities (assume a long position) or borrow securities (take a short position) and hold that position for several weeks or months to capitalize on what they hope is a long-term upward or downward trend in prices. Position traders typically jump on a trend after it has established itself, and they exit the position when the trend breaks. In periods of high market volatility, position trading is more difficult and its positions are generally reduced.

Joint Trading

Municipals dealers may sometimes team up and form a **joint trading account** to purchase and sell a large block of municipal securities. They share proportionately in the profits and losses according to the share of their participation in the account. Terms and conditions of joint account agreements may vary greatly, but participants are always constrained to offer a single price for the bonds to represent the entire group.

Hedging


Unlike position trading, hedging strategies are made not to increase income, but to reduce risk. More specifically, a **hedge** is an investment made in order to reduce the risk of an adverse price movement in a security by taking an offsetting position in a related security. A common way of hedging the interest rate risk of a municipal bond is to short a Treasury bond. To short a security means to sell something you do not own. For example, suppose you own a 10-year municipal bond, and you fear that rising interest rates will reduce the market value of your holding. You can offset that risk by borrowing a Treasury bond of the same maturity and value and selling it short. U.S. Treasury debt provides the benchmark rate for just about all bonds denominated in dollars, and they are among the most liquid and continuously traded instruments in the world. If interest rates rise, causing your municipal to fall in price, you can purchase the Treasury, whose price also will have fallen, and deliver it back to the lender. The profit you make on the shorted sale will offset the potential losses you have incurred from your municipal bond. Of course, a hedge cannot limit the risk of loss without also limiting the likelihood of gain.

TYPES OF MUNICIPALS QUOTATIONS

FIRM QUOTES

All quotes distributed or published by a securities dealer must be bona fide or firm quotations. A firm bid or offer indicates that the dealer stands ready to buy or sell at the quoted price. The bona fide quote must also reflect the dealer's best judgment as to the fair market value of the bond. If the quotation is made on behalf of another broker or dealer, the dealer making the offer must have reason to believe that the price is based on a reasonable assessment of the fair market value by the broker or dealer for whom it is publishing the quote.

MSRB Rule G-13

 **Example:** One dealer may call another and say, "I will buy 500 IL 2024 non-callable GO at 3.125%." This dealer is obligated to buy 500 non-callable IL GO bonds at 3.125%.

OUT-FIRM QUOTES

Dealers may offer firm quotes with attached restrictions. A quote may be good for one hour or a day, for example, or it may require immediate execution. Firm quotes may also have a recall provision. An **out-firm quote**, or firm with recall, will be firm for a specified period, usually an hour, with a five-minute recall provision. The recall provision allows the party supplying the quote to force the other party to make a decision within a five-minute period or the quote will be withdrawn.

So what is the purpose of an out-firm quote? Suppose a dealer posts an "offer wanted"

request and you respond with a “firm with recall” offer at 4.5%. While you are waiting for a response, a second dealer offers to buy the security at 4.5%. You can respond to the second order with a “subject offer.” You cannot make a firm offer because you still have a commitment to the first dealer. The recall provision allows you to call the first bidder and require him to respond within five minutes or the offer will be withdrawn. If the initial bidder does not confirm the sale, you can go back to the second dealer and accept their offer. In an illiquid market, you don’t want to let any opportunities slip past you.

NOMINAL BIDS

A **nominal quotation** is one that offers an approximate price around which a dealer indicates its potential willingness to purchase securities. It is provided for informational purposes only, offering the dealer’s expectation of the market value of an issue without being an actual bid or offer. A nominal bid is also called an “indication.” A **workable indication** is a nominal bid at a specific price stating a dealer’s willingness to purchase securities at that price. The dealer is free to revise the bid if market conditions change. A dealer that is offering a nominal quote will often say something like, “It looks like ...,” or, “Subject to ...,” or, “It’s around” A **subject quotation** or subject offer is a bid or offer that is subject to the market maker’s reconfirmation. Like a workable indication, a subject quotation may be changed at the dealer’s discretion.

TYPES OF MUNICIPALS ORDERS

An order represents the intent to buy or sell. Orders placed on the market are generally divided into two types: price orders and time orders. A **price order** is an order to execute a transaction at a specified price or better. A **time order** is an order to buy or sell by a specified time, after which it is either cancelled or converts to a market order or limit order, depending on its specifications. Price orders may be categorized as market orders or limit orders. When an investor places a **market order**, she is requesting that the stock be bought at the best available price. Thus, no specific price is stated, but it is assumed that a seller will get the highest bid, and a buyer will get the lowest offer at the time that the order is executed. Market orders will always be filled. With a **limit order**, investors will stipulate a maximum price they are willing to pay to purchase (buy limit order) or a minimum price they are willing to sell (sell limit order). Buy limit orders will be executed at the limit price or lower, and sell limit orders will be executed at the limit price or higher. Limit orders are not always filled, because the market price of the security will not always meet the customer’s limit price.

Time orders are triggered according to the time that the order is intended for execution. A **Good For Day Order** is an order that is only good from the time it is placed until the end of the trading day. A **Fill-or-Kill Order** requires that the entire order be executed immediately (on the first try) or cancelled. These orders are usually used with limit orders. An **All-or-None Order** requires that the entire order be filled or the order is cancelled.