ROUNDTABLE FOR FIXED INCOME LEADERSHIP

BDA Bond Dealers of America

Building the New Normal

CHARTING A COURSE FOR FIXED INCOME AFTER THE CREDIT CRISIS

A SUPPLEMENT TO

THE BOND BUYER

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Steadfast
Amidst Market Turmoil

In the fall of 2005, the Bond Market Association—predecessor to the Bond Dealers of America—hosted the annual Regional Dealers Management Conference. At this meeting, two senior consultants from IBM Consulting presented the findings of their recently completed paper, "The Trader is Dead. Long Live the Trader." In frank terms, the paper laid out the case for the global, do it all investment banks as the future of the securities business, while the regional, middle market dealer would have to change or be destroyed. "You just don't understand our business" was the common refrain from attendees that day.

Fast forward three years and you see investment banks declaring bankruptcy, merging with rivals to remain solvent or converting from investment bank into bank holding company for access to the Fed window. All the while, the "doomed" regional, middle market dealer prospered, provided liquidity to the markets and became market leaders during the darkest hours of the financial credit crisis.

Middle market dealers have always had wonderful stories to tell and truly do put the customer first. Whether focused on the taxable or tax-exempt markets; institutional or retail, middle market dealers continue to thrive during uncertain times.

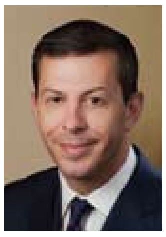
As the leading trade association for firms active in the US fixed income markets, the Bond Dealers of America works hard to ensure it's membership is fully represented in Washington, DC, while also providing forums for dealers to learn, network and problem solve all in an attempt to improve their business and the industry as a whole. This Roundtable for Fixed Income Leadership is a perfect example of one of these forums.

Over 30 professionals from middle market dealers gathered in Chicago on August 10 for a discussion on a variety of topics of direct relevance to the US fixed income markets. Topics ranged from TRACE expansion and market transparency to primary and secondary market muni disclosure to retail distribution to trends, challenges and opportunities in fixed income technology. The discussion and information sharing was vibrant and I think tangibly beneficial to all in attendance.

In the pages that follow, you'll find an edited transcript of that conversation. I think you'll find this document a great opportunity for the entire US fixed income market to witness and appreciate the strong and thoughtful managers who are leading and building middle market dealers from coast to coast. The BDA continues to expand and enhance resources and our presence in Washington thanks to the support of the more than forty middle market dealers that are BDA members. Whether hosting industry events or pounding the pavement in Washington, DC, the BDA is on the front lines on the key issues impacting your fixed income business.

For more information on BDA advocacy or on upcoming industry events please go to www. BDAmerica.org or contact me directly at mnicholas@bdamerica.org or by phone at 202-204-7901.

Thanks for reading!

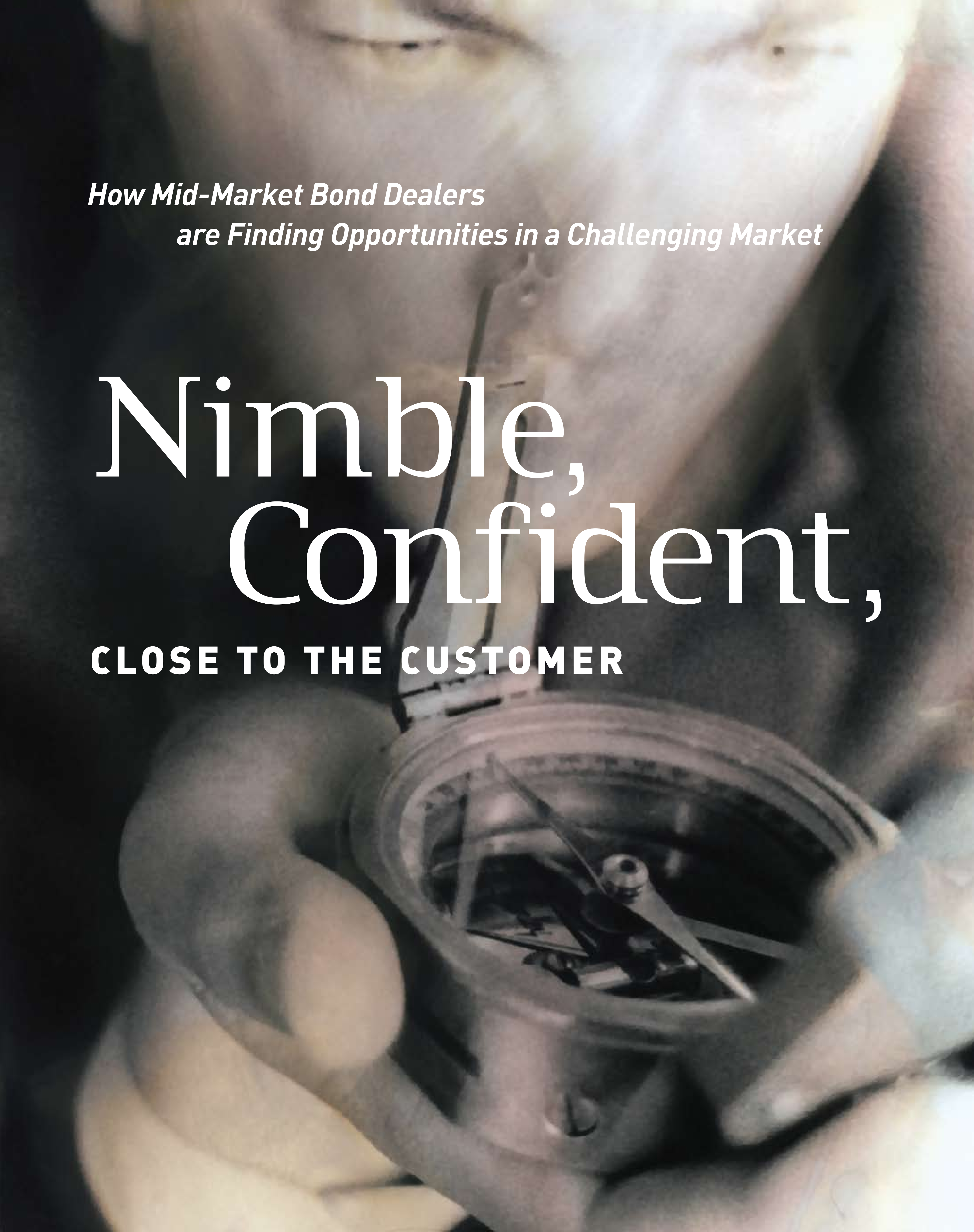


Michael Nicholas
Bond Dealers of America

How Mid-Market Bond Dealers are Finding Opportunities in a Challenging Market

Nimble, Confident,

CLOSE TO THE CUSTOMER



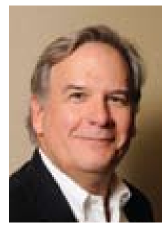
Participants


Peter Adams, Benchmark Solutions

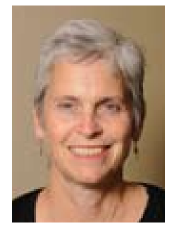

Michael Ballinger, *The Bond Buyer*


Larry Bowden, Stephens Inc.

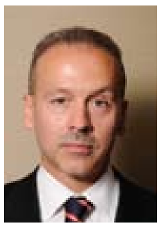

John Cahalane, Tradeweb Retail


Jeff Chapman, Huntington Investments


Cary Cooper, Sterne Agee


Maud Daudon, Seattle-Northwest Securities Corporation


Laura Elliott, Incapital, LLC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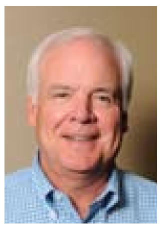
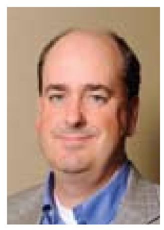

Jim Fitzgerald, BMO Capital Markets


Carl Giles, First Southwest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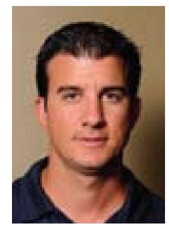
Alan Hogg, Wells Fargo Securities


Lucy Hooper, Davenport & Co.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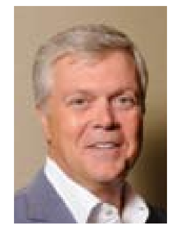
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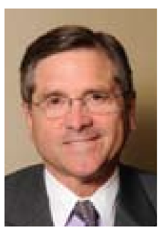
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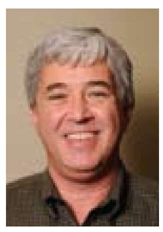
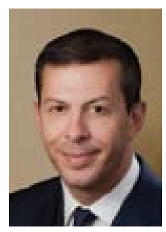
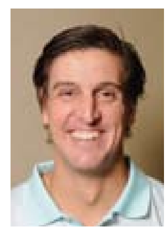

Chris Melton. Coastal Securities


Jay Murray, Vanguard


Michael Nicholas, Bond Dealers of America


Demetri Patikas, Duncan-Williams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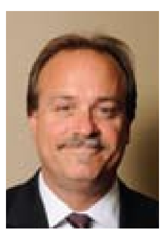
Paul Rosenstiel, De La Rosa & Co.


Michael Stanton, *The Bond Buyer*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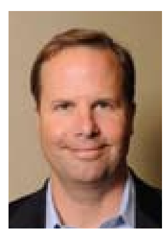
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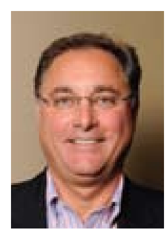
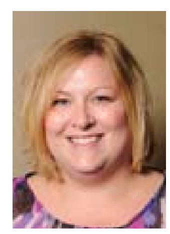

Bill Vulpis, Knight BondPoint


Erica Willems, Robert W. Baird & Co.


Jamison Yardley, Zions Bank Capital Markets

PATHWAYS TO GROWTH IN TODAY'S MARKET: Deeper Relationships, New People, and New Products

JEFF CHAPMAN, HUNTINGTON BANK: How are the people in this room reacting to the Federal Reserve's announcement that it will keep short-term interest rates essentially at zero until 2013? Are you going to add new asset classes to your mix? What are your plans for building your business in a low, sustained low interest rate environment?

DEMETRI PATIKAS, DUNCAN-WILLIAMS: I think a lot of people are confused about what's going to happen in the financial markets. What does a low-interest-rate environment mean in an increasingly transparent market? How do you decide where to invest and hire when our regulators and our elected officials have made it clear that they're going to play a central role in these markets and in how we run our businesses, but they're not making any decisions that allow us to choose where to focus?

MR. CHAPMAN: I think that's a bigger challenge than the low rate environment. We are planning to expand with more structured products, and we are going to launch a commodities business, but with the regulatory environment such as it is, you don't know what expenses you're going to face, so you're making decisions about allocating scarce resources in a pretty uncertain environment. How many people are going to add bodies this year? [25 of 32 participants raised their hands]

JOHN CAHALANE, TRADEWEB RETAIL: While overall volumes in the marketplace have declined due to the rate environment, firms are still looking to upgrade their technology in preparation for a move to higher yields and increased market activity. We're adding resources in technology and business to prepare for that pick up, as well as, to onboard new clients for 2012. We are working aggressively on trading protocols and pre-trade transparency and disclosure tools, since these areas are a real focus of the regulators right now and our current and new clients are showing sensitivity in these areas. We recognize the need to react quickly to regulatory change.

JIM TOFFEY, BENCHMARK SOLUTIONS: And that's an opportunity for firms to deepen their relationships with investors and create a product that looks better than U.S. Treasury yields at 2%. I think there's a lot of opportunity out there right now: People are creating new organizations and companies are creating products that you can finance with cash flows you can see, touch, and feel. I'd rather put my money in a corporate bond at 6 percent than the U.S. Treasury at 2 percent. I think rates will go up—it's a matter of when. So the question is, how do you take advantage of that?

You're going to need research, product, and capital. Building quality credit research is the hardest part: You've got to invest in people rather than in creating a product. Look at the turmoil in the municipal market: For the first time, there will be opportunities for firms to raise capital and profit in the secondary market if they do real credit analysis in that market.

DAN LELAND, SOUTHWEST SECURITIES: The major banks, I feel, aren't going to be able to use their balance sheets like they did in the past, because they have a lot of exposure to Europe and sovereign debt. I think we are going to go back to something similar to what we went through in 2008. I'm already starting to feel part of it in the markets, starting when the Fed came to the market to sell its Maiden Lane holdings and that pushed spreads wider.

A lot of big firms and European banks are long in those markets. So now what do they do? At what point do they start regurgitating this stuff out to the street? You have not seen it yet, but I think that selling is coming—maybe it's after Europe nationalizes its banks and they start selling their assets—and it will be a catalyst for our market to come back to life.

JIM MCKINNEY, WILLIAM BLAIR: We made a big bet in the P3 area—public-private partnerships—and we've had some early success with it. The only trouble is the gestation period on a deal is longer than an elephant. It's a couple years by the time you start, and the political risk is enormous. If you're going to sell a parking lot or an airport, it often causes a lot of "headline risk." Transactions are typically big in dollar amount, so you get a pretty reasonable fee, but the banking on these deals is very expensive because they require a lot of analysis, and a lot of meetings—a traditional bond issue might take three or four board meetings, while a P3 may take 50.

> **"I think local governments still need to provide infrastructure, and part of the opportunity is to help them through what is a horribly difficult time."**
>
> **MAUD DAUDON,** SEATTLE-NORTHWEST SECURITIES CORPORATION

But we see it as a solution for a lot of communities. They're reluctant to sell bonds, but they need money. If you look around, you'll see our mayor here in Chicago is still considering bidding out several projects, including the recycling business. Somewhere else, it could be the water system. But it's still a long road—our bankers are really busy and we're getting a lot of proposals out right now, but we have not seen a lot close this year.

MR. LELAND: Has the market mainly been toll roads so far?

MR. MCKINNEY: Parking has been a good asset for this approach. For example, Chicago's parking meters made $17 million a year for the city. We sold a 75-year concession for $1.2 billion, but they got a lot of grief for that because people said, "well, look at the revenue that it would bring in over 75 years." They don't understand the present value of a dollar. Chicago's downtown garage system was done for $563 million when it was bringing in less than $15 million a year. Then the new guys come in, and they start looking at doing oil changes down there and car washes. They're doing advertising on the walls, and they're maintaining it and keeping it cleaner, like a businessman would run a business—it's hard to expect a city to think that way.

THE OUTLOOK FOR THE MUNICIPAL-BOND MARKET AFTER A DRY FIRST HALF

MICHAEL NICHOLAS, Bond Dealers of America: Talking about new issuance, the first half of the year has been rough, and I'm curious what people think the second half of the year holds.

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*Based on KBP Platform statistics for January 2011.

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PAUL ROSENSTIEL, DE LA ROSA & CO.: In California, some of the regional firms like ours had a pretty good first half because the Governor decided he was going to eliminate redevelopment agencies. A lot of the agencies rushed to market to do a deal before they got killed, and so our firm and Stone and Youngberg, Piper Jaffray and some of the other firms that do that business saw some pretty good volume. Wall Street firms, who don't do much of that business, were very slow. There's going to be a heavy calendar with the State of California in the fall, which didn't do anything at all the first half, but we don't see very much at the local level. Many of the water and sewer and transportation revenue bond issuers accelerated their issuance last year so that they could take advantage of Build America Bonds, so a lot of them are sitting on a lot of money. And many local governments are recognizing that they've got pension problems that are more difficult than they thought, so they're trying not to take on debt because they have to reserve the capacity to deal with their pensions.

> **"I don't read everything, but have I missed all the municipal bond defaults that were supposed to be happening?"**
>
> **CHRIS MELTON,** COASTAL SECURITIES

I also think that whatever comes out of Washington on deficit reduction could have a huge impact on states and local governments in terms of the money that comes to them. The reason that the states can run somewhat balanced budgets is because the Federal government doesn't. So if Washington gets serious about solving its budget problems, that has to have an impact on the states and locals, and could very well affect their willingness to take on additional debt.

MAUD DAUDON, SEATTLE-NORTHWEST SECURITIES CORPORATION: We certainly felt the pain in the first half of the year. The good news is that the past few months we've seen quite a pickup. I agree with Paul that a lot of people rushed to market to get a deal done before the end of last year, so there was a vacuum at the start of this year. Now, we're seeing some issuers come back to market, and we are also doing some refundings because interest rates have gone down so much—which is kind of unbelievable, because we thought we'd basically taken advantage of all of those opportunities.

I think local governments still need to provide infrastructure, and part of the opportunity is to help them through what is a horribly difficult time. I don't know that it's going to take the form of bonds, but there's a lot of intellectual property residing within the firms that are around this table that can really add value to our clients.

We've been devoting some time to talking with our local and state clients and thinking through how to solve our problems without Federal support. And I'm talking across the board: Everything from 'how do you fund schools?' to 'how do you deal with energy efficiency?' to 'what do you do about water issues?' We're trying to get much more local in the solution of some of those issues.

MICHAEL STANTON, *THE BOND BUYER*: There are still concerns about demand for munis on the long end. BABs solved that problem for a while, but now are there enough buyers for municipal supply on long end?

JOHN ROLANDER, FIFTH THIRD SECURITIES: There hasn't been a lot of supply out there, so maybe the supply and demand are fairly well matched right now. We have seen a fair amount of demand from retail over the past several months.

MR. NICHOLAS: And that's individual retail? We see a lot of headlines about outflows from mutual funds, but is it possible that individuals are buying into what might be an underpriced asset class?

CHRIS MELTON, COASTAL SECURITIES: I don't read everything, but have I missed all the municipal bond defaults that were supposed to be happening?

MR. MCKINNEY: But how many people are seeing really strong retail sales involvement on a new issue with a $3 sales credit in there? There aren't many brokers in America that are going to sell small blocks at those levels, and yet financial advisers continue to sell their issuer clients on this "retail-order period" focus. We had [a major wire house] as our co-manager on a good-sized deal, and they didn't sell any retail. Some of the biggest retail shops in the world aren't doing it, but we continue this focus on a charade.

MR. ROSENSTIEL: If I can put on my previous hat, when I worked for the State of California, we used retail-order periods a lot. One reason issuers use them is to try to generate sizeable demand over and above what comes from the largest institutional investors. This has the potential to drive lower pricing if the retail investors —who

> **"We'll have a much broader audience to talk to over the next 12 months than we had in the last 12 months."**
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> **JIM FITZGERALD,** BMO CAPITAL MARKETS

are by and large the professional retail, the money managers who are buying for individuals— put in a lot of orders and are willing to make a better bid than the institutions.

MR. MCKINNEY: That's a good point. But there's no illusion, though, when you are the issuer, that mom and pop are buying these bonds from a broker for a quarter point given their costs for execution, monthly statements, safe-keeping, etc, right?

MR. ROSENSTIEL: You can get a sense of that by looking at how many orders a firm submits, and relating that to the number of bonds. A firm working primarily with large money managers might put in $10 million in orders, but it might be just six or eight orders. But if you look at Schwab or Fidelity, it might be totally different. Their average order size might be under $100,000, so many of those are real mom-and-pop orders. But, in total, they might not add up to enough bonds to really affect the pricing.

MR. LELAND: So a retail-order period goes out, so you get a multiple amount of orders, but it's for a very small part of the deal, and if it's a negotiated deal, and you're trying to get it done, doesn't the big investor still kind of dictate the price because he says, "If you got 40 million on the long end, I'll take them 15 cheaper." Then you go back and forth to try to pull some other orders. They still kind of have control where it goes, don't they?

MR. ROSENSTIEL: Absolutely.

INVESTING IN NEW HIRES AND PRODUCTS TO PREPARE FOR THE MARKET'S REVIVAL

MR. NICHOLAS: Munis are down, but a lot of you raised your hands when we asked who's hiring. Does that mean you're adding bodies to your taxable fixed income areas? Or is it in asset management?

MR. ROLANDER: There seems to be some good people available right now because the national firms and the wire houses aren't focusing as much attention or resources in our region.

MS. DAUDON: I think your point about people is a great one, because we always see this when Wall Street has a bad year. They tend to be very reactive in the short term, and they tend to lay off a lot of really good people. I'm sure all of us are sitting around trying to pick up those people now.

JIM FITZGERALD, BMO CAPITAL MARKETS: We're going to try to hire to grow our taxable business too, and we have been doing it for the last year. We're not trying to buy people, we just want to find the right people that want to come with us and be part of what we're trying to build, and I think that what's happening with the Wall Street firms will definitely put people on the street. We'll have a much broader audience to talk to over the next 12 months than we had in the last 12 months.

WILL NEW REGULATIONS LIKE THE FIDUCIARY DUTY STANDARD DRIVE A WAVE OF CONSOLIDATION IN THE MIDDLE MARKET?

MR. NICHOLAS: How is Dodd-Frank impacting your business now that we're seeing these rules actually getting written and studies getting finalized? Let's talk about applying the "fiduciary duty" standard. Right now this applies to retail relationships, but the SEC is leaving the door open to apply it to institutional clients as well, down the road.

Our board met with SEC Commissioner Elise Walter, who is a real proponent of applying the fiduciary standard to broker-dealers. She started off by telling us that, "you're not going to notice a difference between the suitability standard and the fiduciary standard. You shouldn't be too concerned about this." But you hear the exact opposite from staff at the SEC, who think there is a big difference

"I think the Wall Street firms have gone so far up market right now we have an opportunity to get some business that we have not in the past."

JEFF CHAPMAN, HUNTINGTON BANK

Are folks already spending money getting ready for a new tougher legal standard that's going to be applied, at least for now, to the retail side of the business?

MR. MCKINNEY: It's going to drive everybody to managed accounts, because you aren't going to cross a bond to a retail buyer for a dollar if it means taking on a lifetime exposure to getting sued.

MR. NICHOLAS: That's a point that we made to the SEC: You're going to drive firms to sell packaged products only, or they're going to get out of the retail business altogether. Ultimately, it's going to negatively affect the investor.

MR. LELAND: It's not simple to apply. What if a broker is sitting there working with a customer, and the broker believes that interest rates are going to rise, and the customer believes interest rates are going to fall, and they want to buy the longest term bond that's out there. What do you do? Are you not supposed to do the trade with the customer because you disagree with them? If you do a trade, are you in violation of your fiduciary duty?

MR. PATIKAS: My opinion is that the fiduciary standard issue is going to cause consolidation in the market due to people feeling over regulated. Eventually folks will just say, "That's it, I'm out."

MR. MELTON: If you're talking about a real consolidation down from 5,500 broker-dealers to 500, we're starting to hear about that at a fairly rapid pace. Everybody's saying that for a small shop to keep up with all the regulations is impossible, and it's getting more and more difficult for a reasonably-sized, but not large shop to keep up. I know the figures that we spend in the risk compliance function, and I can't imagine how a shop that has a $3 million or $4 million profit in a good year will be able to survive.

BEYOND THE RULES:
Dealing With Today's Regulators and The Enforcement Process

MR. STANTON: Is there a regulatory approach that would be materially better than what you're seeing today?

MR. MELTON: I personally think they need to get people regulating fixed income that know what it is. You read about the people they put in—so and so moved from market regulation at the exchange and is now going to fixed-income. They need to get these people (people that understand fixed income) or they're going to have a big giant mess. I don't see how a good regulator could not have seen some of the problems coming from the products that came forward prior to 2007 and 2008.

"The municipal market is becoming more of a credit market and we're all a lot closer to a lot of these credits."

JAY HINIKER, CRONIN & CO.

MR. MCKINNEY: I just finished a project on behalf of FINRA as an expert witness on a case they were working on for a long time. And I would say their attorneys don't have any real experience in fixed income, but these are smart guys, and their reconnaissance is superb now. Within seconds, they can know every trade you ever made.

MR. MELTON: They don't treat thinly traded nonrated bonds any different than if they were Dallas, Texas GOs. And it permeates everything they do related to fixed income, not just the muni market. It's a true lack of understanding of the product..

MR. PATIKAS: We are resolved to fight every fine that we feel is unjustified, whether it is $120 or $120,000. I truly believe that if we just pay the small fines to be done with them, we are setting a bad precedent for the future of our industry.

> "I think it's very positive that when the question was asked, 'how many people are hiring?' so many hands went up."
>
> **DEMETRI PATIKAS,** DUNCAN-WILLIAMS

THE MIDDLE-MARKET FIXED-INCOME GROWTH STORY:

Spotting And Seizing Opportunities To Serve Clients That Have Been "Left Behind" By The Larger Broker-Dealers, With Capital, People, and Service

MR. NICHOLAS: As we come into the home stretch, let's end on a positive note: What's going right in fixed income? I mean, from your perspective, middle market, regional fixed income dealers, what's really working right now?

MR. CHAPMAN: I think the Wall Street firms have gone so far up market right now we have an opportunity to get some business that we have not in the past. I mean because some of the other folks are no longer with us, the Bears and Lehmans.

MR. PATIKAS: I think it's very positive that when the question was asked, "how many people are hiring?" so many hands went up. I think that speaks to why we started this entire group. It speaks to the culture of the firms around this table, and that's huge.

MR. HINIKER: The municipal market is becoming more of a credit market and we're all a lot closer to a lot of these credits. A lot of these institutions now are valuing that knowledge a lot more than they were, and that's certainly something that's helping us gain market share in a tough time. ■

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> **CHRIS MELTON,** COASTAL SECURITIES

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