Municipal Bond Dealer Markups Q&A

Transparency Series

Editor's Note:

Since the original publication of this report, the Municipal Securities Rulemaking Board (MSRB) has amended MSRB Rule G-15, which will require broker-dealers to disclose any markup (or markdowns) they charge on municipal bond transactions executed on behalf of retail clients. The final version of the rule is set to take effect on May 14, 2018.

In addition to requiring broker-dealers to disclose any markups, the MSRB made the following changes to the original proposed rules:

- Similar to the Financial Industry Regulatory Authority's (FINRA's) sister rule — FINRA rule 2232, which includes like guidelines for Agency and corporate bonds—the final MSRB G-15 rule applies to same-day transactions, rather than to transactions occurring within a two-hour window, which was what the MSRB had originally proposed.
- Broker-dealers must disclose markups as both a dollar amount and as a percentage of the prevailing market price (PMP).
- When determining the PMP, brokers, dealers, or other related parties must use the following hierarchy, or "waterfall":
    1. Contemporaneous trades of the same security
    2. Contemporaneous trades of "similar securities" based on credit quality, issue size, and yield
    3. Prices based on an "economic model," which can include third-party evaluation pricing services

Also of interest, broker-dealers are *not* required to disclose municipal bond markups when dealing with registered investment advisors (RIAs), highlighting the need for RIAs to be particularly vigilant about the price they are paying for municipal bonds.

Summary

While the finance industry has seen marked improvement in transparency, the municipal bond market remains conspicuous in its opaqueness and decentralized nature relative to other asset classes in the industry. Perhaps most amazing is that because dealers are not required to disclose the markup or markdown on a bond to the customer, many investors are oblivious to the imbedded "commission," or worse, are under the misguided impression that they are not being charged at all.

Investors Would Benefit from Increased Regulation and Transparency

- Municipal bond investors could significantly benefit from increased municipal securities market regulation and transparency, specifically regarding the disclosure of dealer markups on municipal bond transactions, which are imbedded in the bond's price and are currently not required to be disclosed to investors.
- Although municipal bond prices are supposed to be "fair and reasonable,"[1] imbedded markups are often substantial and always quite onerous to determine.

Dealer Markups Vary across Asset Classes

- Markups on investment-grade municipal bond trades have an average historical transaction cost of 1.21 percent — or $1,210 — for retail trades of $100,000 or less, compared to a 0.49 percent markup — or $490 — on similar dealer-to-dealer trades, and compared to a 0.85 percent markup —

[1] MSRB Rule G-30 http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-30.aspx

or $850 — for retail investment-grade corporate bond trades.[2]

- Commissions charged on retail trades in equity markets are extremely low when compared to both municipal and corporate bond markups.[3]

Retail Investors Typically Pay Larger Markups

- Retail investors typically pay higher prices — sometimes as much as 5 percent more — for municipal securities than do institutional investors and dealers.[4] The magnitude of markups — sometimes approaching 1 percent to 3 percent — can vary greatly between transactions and absorb part or all of a year's interest on a bond.

The following Q&A, intended to shed some light on this opaque industry, provides a brief background on municipal bond markups and recommendations for avoiding excessive charges.

[2] "Unveiling the Hidden Cost of Retail Bond Buying & Selling." Standard & Poor's. January 2016.https://us.spindices.com/indexology/fixed-income/unveiling-the-hidden-cost-of-retail-bond-buying

[3] Harris, Larry and Keenan, Fred. "Transaction Costs, Trade Throughs, and Riskless Principal Trading in Corporate Bond Markets. USC Marshall School of Business. 22 Oct. 2015.

What Is a Dealer Markup?

A dealer markup is a transaction cost equal to the difference between the price at which a security is bought and sold. For bonds, this transaction fee, which broker-dealers are not required to disclose, is analogous to a brokerage commission charged on an equity trade, and erodes a bond's total return to investors. For example, a broker-dealer may pay $100,000 for a bond and then sell it for $102,000. Not being privy to the broker-dealer's original purchase price, the investor's total return on the bond is effectively eroded by 2 percent as the broker-dealer pockets a $2,000 — or, in industry jargon, a 2-point — markup on the bond. According to S&P Dow Jones Indices, markups on investment-grade municipal bond retail trades have an average historical transaction cost of 1.21 percent, while this measure on dealer-to-dealer trades is only 0.49 percent.[5]

> The substantial difference in commissions in asset classes such as equities, in which commissions or markups are disclosed, and asset classes such as municipal bonds, in which markups are undisclosed and brokers legally exercise broad discretion when determining the size of the markup, begs the question of whether retail investors are being properly protected by current regulation. Alternatively, are the interests of the banks and brokerage firms advantaged at the expense of retail investors?

[4] SEC Commissioner Statement 2/13/15 http://www.sec.gov/news/statement/making-municipal-securities-market-more-transparent-liquid-fair.html#_edn19

[5] "Unveiling the Hidden Cost of Retail Bond Buying & Selling." Standard & Poor's. January 2016. Https://us.spindices.com/indexology/fixed-income/unveiling-the-hidden-cost-of-retail-bond-buying

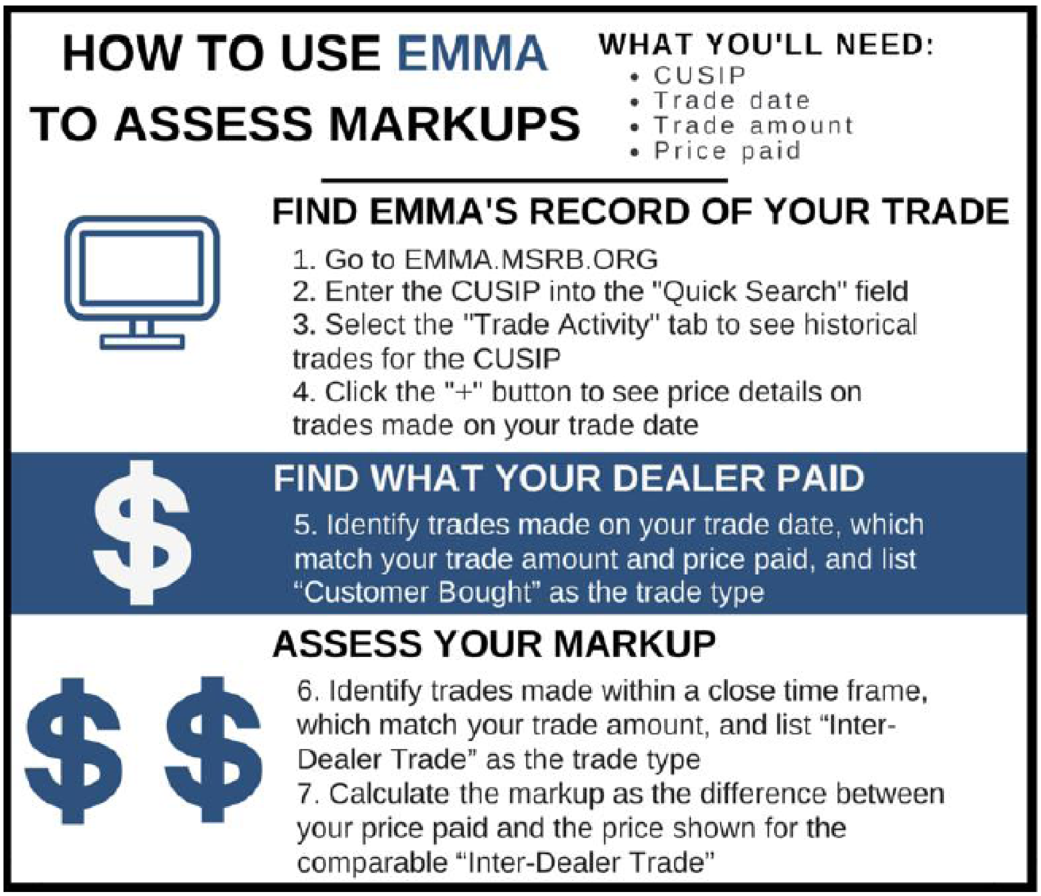
What Are the Current Rules on Deal Markups?
Current regulations do not impose strict standards for disclosing markups on brokers. Instead, the rules are loose and open to interpretation, allowing brokers enormous latitude and causing markups to vary — sometimes significantly — between transactions for the same bond.

The Municipal Securities Rulemaking Board (MSRB) — the governing body for the municipal market — seeks to promote municipal market transparency through several rules, which are often cited in relation to bond markups. While these regulations do offer some guidelines on broker disclosures, they leave enough room for brokers to interpret the language for their own benefit and avoid transparency.

Entity: Rule	Description
MSRB: Rule G-14[6]	This rule requires dealers to report all trades within 15 minutes.
MSRB: Rule G-15[7]	This rule requires brokers and dealers to provide the customer with a written confirmation at or before the completion of a transaction, which includes the price of the bond; however, this will not specify the dealer's markup.
MSRB: Rule G-17[8]	This rule requires brokers, dealers, municipal securities dealers, and advisors to be fair and honest with all persons.
MSRB: Rule G-18[9]	This rule requires dealers to use "reasonable diligence" to identify and execute a transaction in the best potential trading market for a particular security. Note: This rule will be effective on March 21, 2016.
MSRB: Rule G-30[10]	This rule requires that brokers, dealers, and municipal securities dealers must buy and sell municipal securities at an aggregate price that is "fair and reasonable," taking into consideration all relevant factors, including the best judgment of the broker, dealer or municipal securities dealer at the time of the transaction and of any securities exchanged or traded in connection with the transaction; the expense involved in effecting the transaction; the value of the services rendered by the dealer; the fact that the dealer is entitled to a profit; the total dollar amount of the transaction; the availability of the securities in the market; the service provided in effecting the transaction; the securities' rating and call features; the maturity of the security; the nature of the dealer's business; and the existence of material information about a security through EMMA or other established sources.

[6] MSRB Rule G-14 http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-14.aspx
[7] MSRB Rule G-15 http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-15.aspx
[8] MSRB Rule G-17 http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-17.aspx?tab=2
[9] MSRB Rule G-18 http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-18-12-7-2015.aspx
[10] MSRB Rule G-30 http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-30.aspx

Additionally, the MSRB requires dealers to report all sales or purchases within 15 minutes,[11] and makes this information publicly accessible through its Electronic Municipal Market Access (EMMA) system; using this tool, RIAs and individual investors can sometimes use EMMA to determine the markup on a bond post-trade.



As an example, the EMMA screenshot below shows that a $20,000 bond lot of CUSIP 00037CSD3 was traded twice on April 15, 2015 — once as an inter-dealer trade at a price of 118.582 and once as a customer purchase at a price of 120.805. The $2.223 — or 1.84 percent — markup in this example resulted in a commission of $444.46 paid by the customer to the dealer for a bond with a total cost of $24,170 that the dealer held for less than a minute.

As a means of comparison, for a $50 stock, this would amount to a commission of 92 cents per share, almost unheard of in a day when Charles Schwab is charging $8.95 per trade,[12] or about 2 cents per share for an analogous $20,000 equity trade.

[11] Charles Schwab Fees and Minimums. http://www.schwab.com/public/schwab/investing/pricing_services/fees_minimums

[12] Charles Schwab Fees and Minimums. http://www.schwab.com/public/schwab/investing/pricing_services/fees_minimums

Trade Date/Time	Settlement Date	Price (%)	Yield (%)	Trade Amount ($)	Trade Type	Special Condition
04/15/2015 12:06 PM	04/20/2015	118.582	2.05	20,000	Inter-dealer trade	
04/15/2015 12:06 PM	04/20/2015	120.805	1.734	20,000	Customer bought	

While EMMA is a useful tool that brings investors a step closer to knowing what is being paid for their municipal bonds, it does have certain limitations.

Notably, EMMA is unable to easily provide transparency on bonds sold from dealer inventory. As an example, the fact that the inter-dealer and customer trades in the illustration above occurred same-day made it easier to assess the markup; however, had the inter-dealer trade taken place a week prior and the bonds been held in the broker's inventory until the customer's purchase on April 15, 2015, it would have been much more difficult to determine when and at what price the dealer purchased the bonds, making it impossible to assess the markup with certainty.

Additionally, EMMA is unable to provide transparency into the price of bonds, which were initially bought as part of a larger, institutional-sized block before being allocated across portfolios or sold in smaller blocks. For that reason, bond lot sizes shown on EMMA may not match bond lot sizes shown on custodial statements.

What Are the Proposed Rules on Dealer Markups?

Proposed rules and amendments to current regulations have promised increased transparency, but have been unable to provide real transparency. Recent proposals from the MSRB and the Financial Industry Regulatory Authority (FINRA) would require dealers to disclose additional price information on retail-sized principal transactions on non-municipal fixed income securities,[13] with the MSRB's proposal specifically requiring dealers to disclose the municipal bond markup.[14] FINRA's proposal was approved by its board of governors in late February. The plan will be submitted to the Securities and Exchange Commission for review and approval.[15] FINRA and MSRB are considering a coordinated approach to the potential rulemaking, but even if passed, these proposals fall short of true transparency.

Dealers have argued that requiring markup disclosure would add costs and hurt liquidity by causing dealers to leave the market.[16] In contrast, the MSRB states that the disclosure would provide investors with information that could foster engagement between customers and dealers, as well as competition among dealers, potentially reducing transaction costs for the

[13] FINRA Regulatory Notice 14-52 https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_14-52.pdf

[14] http://www.msrb.org/~/media/Files/Regulatory-Notices/RFCs/2015-16.ashx

[15] "Wall Street watchdog's board approves bond-markup rules." Reuters. February 26, 2016. http://www.reuters.com/article/finra-bonds-markups-idUSL2N1651QN

[16] How Much Do You Pay for Muni Trades? Regulators Want You to Know." Bloomberg. November 22, 2015. http://www.bloomberg.com/news/articles/2015-11-23/how-much-do-you-pay-for-muni-trades-regulators-want-you-to-know

customer, increasing investor confidence, and improving liquidity.[17]

The MSRB disclosure proposal intends to increase transparency through markup disclosure, formally defining a markup as "the difference between the price to the customer and the prevailing market price for the security."[18] Each proposal includes a convoluted hierarchy of pricing factors used to determine the prevailing market price of the municipal security, and therefore determine the markup on the bond. Under this hierarchy, the dealer would have to consider contemporaneous trades — or transactions that occur "close enough in time to the subject transaction that it would reasonably be expected to reflect the current price for the municipal security."[19] If contemporaneous trades are not available, this structure allows for alternatives upon which to base the prevailing market price calculations, allowing dealers to look at contemporaneous trades on similar securities with a comparable yield, or, if that is not available, the dealer can base the prevailing market price calculations on economic models measuring credit quality, interest rates, industry sector, maturities, and call provisions.[20] This pricing structure proposal could potentially allow the dealer to obfuscate the price of the bonds and, in effect, evade the increased transparency that the proposal seeks to create.

Entity: Rule	Description
MSRB: Disclosure Proposal	This proposed disclosure rule amendment, originally drafted in November 2014,[21] would require dealers to disclose the markup or markdown on a certain class of transactions with retail investors. The original proposal would have required the markup or markdown to be disclosed if the dealer trades the same security within a two-hour window of the transaction. The timeframe has been debated through public comment, and may be changed to reflect FINRA's proposal to require disclosure if dealers has a corresponding trade on the same trading day.
FINRA: Notice 14-52	This proposed rule, originally drafted in November 2014,[22] would require firms to disclose on the customer confirmation the price to the customer, the price to the member of a transaction in the same security, and the differential between the two prices for same-day, retail-size principal transactions.

[17] MSRB Regulatory Notice. September 24, 2015. http://www.msrb.org/~/media/Files/Regulatory-Notices/RFCs/2015-16.ashx

[18] "Dealers Want MSRB, FINRA to Adopt Same, Less Costly Markup Proposals." The Bond Buyer. December 14, 2015. http://www.bondbuyer.com/news/washington-securities-law/dealers-want-msrb-finra-to-adopt-same-less-costly-markup-proposals-1091799-1.html

[19] MSRB Regulatory Notice 2016-07 http://www.msrb.org/~/media/Files/Regulatory-Notices/RFCs/2016 07.ashx?n=1

[20] "Initial Support for MSRB Pricing Guidance Proposal." The Bond Buyer. February 19, 2016. http://www.bondbuyer.com/news/washington-securities-law/initial-support-for-msrb-pricing-guidance-proposal-1096988-1.html

[21] MSRB Regulatory Notice November 17, 2014. http://www.msrb.org/~/media/Files/Regulatory-Notices/RFCs/2014-20.ashx

[22] FINRA Regulatory Notice 14-52 https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_14-52.pdf

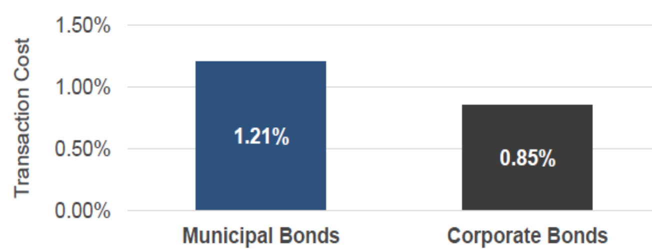
Furthermore, the original proposed rule would only require that the markup or markdown be disclosed if the dealer trades the same security within a two-hour window of the transaction; qualifying the disclosure in this way could potentially prompt dealers to simply avoid the disclosure requirement by waiting just over two hours between transactions. This timeframe may be changed to reflect FINRA's proposed rule for the corporate and agency debt markets, which intends to increase transparency through price disclosure, but would only require that the markup or markdown be disclosed if the dealer trades the same security in the same day; qualifying disclosure in this way could potentially prompt dealers to simply avoid the disclosure requirement by waiting just over one day between transactions, maintaining bonds in inventory in the meantime.

How Do Dealers Markups in the Municipal Securities Market Compare to Other Asset Classes?

Markups across and within asset classes can vary significantly, and those on municipal bonds typically exceed all others. According to S&P Dow Jones Indices, markups on investment-grade municipal bond trades (with an average historical transaction cost of 1.21 percent for retail trades of $100,000 or less) are significantly higher than markups on investment-grade corporate bond trades (with an average historical transaction cost of 0.85 percent for retail trades of $100,000 or less),[23] and commissions charged on retail trades in equity markets are extremely low when compared to both municipal and corporate bond markups, according to a study by the USC Marshall School of Business.[24] As an example of the significant variance that can exist across and within asset classes, an equity trade of $10,000 placed through a Charles Schwab brokerage account would be charged a total of $9 — or 9 basis point — commission, according to Bloomberg Business news;[25] In comparison, on average, a retail municipal bond trade of this size placed through a broker would historically have been charged $121.

Because broker-dealers operating in the municipal bond space are not required to disclose market pricing, these discrepancies between municipal bond markups, corporate bond markups, and equity commissions remain hidden from investors.

Average Historical Bond Transaction Costs for Retail Trades of $100,000 or Less



Source: S&P Dow Jones Indices January 2016 Fixed Income Update

Further, there is also a potential for "asset churning," or unnecessary purchase and sale of

[23] "Unveiling the Hidden Cost of Retail Bond Buying & Selling." Standard & Poor's. January 2016. https://us.spindices.com/indexology/fixed-income/unveiling-the-hidden-cost-of-retail-bond-buying

[24] Harris, Larry and Keenan, Fred. "Transaction Costs, Trade Throughs, and Riskless Principal Trading in Corporate Bond Markets. USC Marshall School of Business. 22 Oct. 2015.

[25] Steverman, Ben. "An Investor's Guide to Fees and Expenses 2014." Bloomberg Business. 8 Oct. 2014. http://www.bloomberg.com/news/articles/2014-10-08/an-investor-s-guide-to-fees-and-expenses-2014

securities, if a retail advisor earns a commission on each trade.

How Do I Avoid Being Overcharged?
Buyers who are aware that markups are charged on municipal bonds can start a conversation with their dealers to determine the markup, and potentially negotiate a more favorable price prior to the sale. Understanding the market conditions by comparing prices and utilizing EMMA to determine prior sales can provide leverage to negotiate with a dealer.

In addition, investors can avoid excessive markups by using institutional managers who do not rely on one dealer, or even a small handful of dealers, to buy or sell bonds and are able to buy bonds in the same manner that dealers do— at the bid price, with no markup at all, rather than waiting for dealers to market the bonds at an increased level, and who will only buy bonds out of dealer inventories when the price levels are justified. In the absence of economies of scale, individual investors typically pay higher prices — sometimes as much as 5 percent more — for municipal securities than do institutional investors and dealers.[26] Investors buying bond lot sizes of under $100,000 paid an average markup of 1.55 percent to 1.79 percent from 2005 to 2013, according to a study from the Securities Litigation & Consulting Group.[27]

Please feel free to contact us at research@gurtin.com for additional information.

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[26] SEC Commissioner Statement 2/13/15 http://www.sec.gov/news/statement/making-municipal-securities-market-more-transparent-liquid-fair.html#_edn19

[27] Deng, Geng, and Craig McCann. "Using EMMA to Assess Municipal Bond Markups." Securities Litigation & Consulting Group. 11 June 2013. http://www.slcg.com/pdf/workingpapers/Using EMMA to Assess Municipal Bond Markups.pdf

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