

Bond Case Briefs

Municipal Finance Law Since 1971

Welcome to a Know-Your-Fees World, Muni-Bond Buyers.

If you don't know how much you're paying, you may be paying too much. That's the idea behind a major change being ushered into the \$3.9 trillion state and local government debt market, a haven for retail investors where the trading fees that securities dealers charge have largely gone undisclosed. That will change on May 14, when brokers will be required to start disclosing some of the fees that are embedded in the prices investors pay — or receive — when they buy and sell their securities.

1. What prompted the rule change?

Securities regulators are trying to inject more transparency into the trading of municipal bonds, which are largely held by individual investors looking for tax-free income. By forcing the disclosure, regulators think it may increase competition among brokers and ultimately drive down costs for investors.

2. Will the fees on all trades be disclosed?

No. A broker will have to break out how much it marked up the price of a bond — or how much they marked it down when buying from a client — to individual investors only in some circumstances. The disclosure will be required when the dealer uses its own money that day to trade the same securities as its customer, unless the volume of that trading is less than what the client bought or sold. For example, if a customer sold \$5,000 of New York City bonds to a dealer that only resold \$1,000 worth that day, the mark-down wouldn't be reported. So the fee reporting will capture cases where the broker soon offloads a bond, rather than taking on the risk of holding it in inventory.

3. How many trades are we talking about?

A sizable chunk. The Municipal Securities Rulemaking Board, the industry's regulator, estimated that it would have covered 8,546, or about 55 percent, of the trades of bonds with a face value of \$100,000 or less made each day during the third-quarter of 2015 when the dealer acted as a principal by using its own money to buy or sell the security. It's possible, though, that some dealers may report the mark-ups on all their secondary-market trades with individual investors in the interest of transparency or to avoid the hassle of determining whether they need to on a case-by-case basis.

4. How is the mark-up calculated?

The firm must disclose the mark-up or mark-down in both dollar terms and as a percentage of the prevailing market price. For example, if a dealer went out and bought \$10,000 of New York City bonds from another dealer at 99 cents on the dollar and then resold them to a customer that ordered them at par, the mark-up would be 1 percent, or \$100.

5. What if there was a big mid-day market move?

If the market was whipsawed by a big price move between the time when a dealer bought the

securities and resold them, the broker will have to rely on a more complicated, step-by-step procedure known as “the waterfall.” In such cases, the first step would be to use trades between securities firms as a baseline. If there’s none to go on, they can rely on trades by big institutional investors — like mutual funds — that are made in blocks of \$1 million or more. Absent that, they can turn to the quotes dealers put out for bid on electronic trading platforms. Similar securities or pricing models could serve as benchmarks as a last-ditch option, if all the others aren’t available.

6. What will this mean for investors and brokers?

Giving buyers the information will help ensure they’re not overcharged and may put some downward pressure on fees. Mutual-fund managers — who would love for investors to invest through them instead of trading in their own accounts — hope they will see an influx of cash from sticker-shocked investors surprised at the size of the fees they’re paying. It cost about 0.54 percent a year to invest through such fee-based accounts in 2016, about half what the average trading fee was, according figures from the Investment Company Institute and S&P Global Inc. But some brokers are dismissive, saying buy-and-hold investors are better off paying a one-time fee, even if it’s bigger, than paying their fund manager year after year.

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