

Bond Case Briefs

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Is The Used Car Market More Transparent Than The Bond Market?

Summary

- The bond market lacks price transparency.
- A new rule requires disclosure of mark-ups and mark-downs.
- Investors need to do due diligence on bond pricing.

When a customer shops at a used car lot to purchase a previously owned vehicle, she can usually check the dealer markup by comparing the offering price to the book value in the Kelley Blue Book, a well-respected pricing guide.

That way, the consumer can tell if she is about to get ripped off and walk away from a bad deal.

Unbelievably, an investor could not do the same with the bonds bought or sold by her Wall Street broker until two months ago.

Bond pricing is confusing for investors, as a recent Reuters article noted. That's why new, additional disclosure rules should benefit investors.

However, even though the new industry rules require brokerage firms to disclose the bond-pricing information to clients, it may come too late or never be seen.

Let's back up a moment. In the past, brokers were not required to disclose to customers the "markup" or "markdown" on corporate and municipal bonds bought in the secondary market.

"Unlike with stocks, investors don't pay a commission when they buy a bond," according to Reuters. "Instead, they pay a markup, or the difference between the broker's cost and the price charged to the investor. Many brokers don't disclose their markups, meaning investors can't easily compare transaction costs."

"In a 2012 report, the SEC said the lack of price transparency undermined the fairness of the \$3.8 trillion municipal-bond market," according to the article. "In addition to markups, brokers will also have to disclose markdowns, the haircuts investors have to take when selling bonds prior to their maturity."

In the past, many brokers fraudulently told investors that they did not receive commissions on the purchase or sale of bonds. In fact, the brokers in Puerto Rico never disclosed the exorbitant markups or markdowns they charged their customers. This evidence has come to light in numerous investment fraud cases brought against Puerto Rico brokerage firms, including UBS and Santander.

Under the new industry rule that took effect in May, Mom and Pop investors will now learn how much their brokers made selling them bonds. While an improvement for the brokerage industry, some problems remain.

“The disclosures are aimed at addressing long-standing concerns that individual investors who buy bonds don’t know how much they are paying in fees, known as markups, that can eat into returns,” according to the Reuters article. “Retail investors pay a variety of different prices for the same securities.”

The article notes that investors may suffer “sticker shock” when they see the exorbitant charges firms take for purchasing corporate and municipal bonds right off the shelf. For example, if an investor purchased a \$500,000 Puerto Rico municipal bond during the Puerto Rico bond market heyday of 2010 to 2013, an investor would be charged a markup in the tens of thousands of dollars, without any disclosure by the firm.

Nevertheless, most investors will likely still not realize how much they are paying for bonds even with the new rule. The new rule only requires dealers to include the markup on confirmation slips that are sent to investors by the post and do not require a discussion between the broker and customer when the transaction is made.

“The rule only requires dealers to include the markup on slips of paper they already send to investors confirming the details of the transaction,” as Reuters noted. “Though dealers are allowed to electronically confirm customer trades, the vast majority of these confirmations are still snail mailed to customers—meaning they might end up in a pile of junk mail and never be read.”

That means Mom and Pop investors will need to do their due diligence in reviewing confirmation slips when they buy bonds. The new rule is an improvement for bond investors, but unfortunately falls short. There is still no Kelley Blue Book for bonds.

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