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Dealer 'Quid Pro Quo' Shapes Bond Markups, Paper Says.

An academic investigation into “reciprocity” among broker-dealers in secondary market trading has found that larger dealer networks tend to boost liquidity and competition while smaller networks bring higher markups for customers and raise questions about collusion.

Presented Wednesday at the Brookings annual municipal finance conference, the paper, “Dealer Quid Pro Quo in the Municipal Bond Market,” examines “favor trading” among dealers who form networks to trade municipal bonds.

The authors were interested in investigating how the characteristics of dealer networks affected trading prices and found a “noticeable gap in examining reciprocal relationships among dealers,” the paper said.

“Does reciprocal ‘favor trading” help liquidity or enable rent extraction?” asked Casey Dougal, an associate professor in the Department of Finance at Florida State University’s College of Business and one of the authors, who presented the paper at the conference.

Dougal co-wrote the paper with Daniel Rettl and Vasiliy Yakimenko, both from the Department of Finance at the University of Georgia’s Terry College of Business.

“Most of the time, dealer cooperation, grounded in a system of favors, reduces markups and passes along the savings to customers,” Dougal said. “For the most part, 98% of the time these relationships are really beneficial to customers,” he said. “Some of the time it looks like there’s some collusion going on,” he said.

“That’s kind of a strong word,” he added. “We didn’t observe the dealer identities, so it’s a shortcoming of our study,” Dougal said. But “we think that probably more investigation into those groups of traders might be warranted.”

The paper finds that among high-centrality dealers in large communities, high reciprocity lowers average markups by 80 basis points.

Among low-centrality dealers in small communities, reciprocity raises markups by 72 basis points, raising questions of collusion.

High-centrality refers to firms that “occupy central positions and have more connections.”

The “small cohort of highly reciprocal, peripheral dealers” tend to “operate in networks roughly one-sixth the size of other peripheral dealers, but their transaction chains are nearly twice as long, indicating repeated trading within the same closed circle,” the paper said.

“Their transactions also feature slightly smaller trade sizes and bonds with more complex contractual features, consistent with a strategic focus on retail investors, who are more susceptible to cognitive biases or limited financial literacy.”

The colluding dealers may be operating in “niche markets” where pricing and trading are “more challenging, leading to longer chains and justified higher markups due to increased risk, effort, and the value of their specialized services,” the authors said.

The study also found a higher incidence of “anomalous trading and strategic pricing” by those dealers. “We find their deals have an unusually high incidence of “round-trip” chains in which the initiating and concluding dealers are identical, raising concerns about pump-and-dump strategies that shift costs onto retail investors.”

The authors used Municipal Securities Rulemaking Board data to study 40 million intra-day municipal bond trades between 2014 and 2018.

The paper “identifies a new force that is quite strong in dealer networks,” said Ivan Ivanov of the Federal Reserve Bank of Chicago, who discussed the paper at the conference. “The authors find that reciprocity does play a role, both at the core of the dealer network and also on the outside, so this is very key.”

Ivanov suggested that the sample time should be expanded since muni trading has changed “immensely” since 2018. It’s unclear what role electronic trading, for example, plays in interdealer trading chains and whether alternative trading systems could mask as reciprocity, he said.

All markup costs have fallen “a ton over time,” Ivanov said, which appears to be due to the role of the ATS.

The suggestion of strategic trading among some of the dealers is a “strong claim,” Ivanov said. “I’m not saying it’s false,” he added. “But there’s a very high burden of proof.”

A broker-dealer in the audience took exception to the paper’s conclusions.

“From a practitioner’s standpoint, at a high level, this generally just doesn’t happen in the market,” he said.

“You have to take into perspective the eat-or-be-eaten mentality of broker dealers” whose highest goal is to place bonds directly with customers, he said. “There’s no feeling of reciprocity among the dealers; they really don’t like each other.”

“I know they don’t like each other, but maybe in a distressed period they’d like to be friends,” Dougal said.

“What you’re talking about is against the law,” the audience member responded.

By Caitlin Devitt

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