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Study Claims Billions of Dollars of Excessive Muni Markups.

Broker-dealers charged billions of dollars in excessive markups and markdowns on municipal bond trades from 2005 to 2013, according to a study by the Fairfax, Va.-based Securities Litigation and Consulting Group, Inc.

The SLCG, which provides consulting services and expert witnesses to law firms, companies, banks, brokerage firms, and individuals involved in class-action suits and other litigation, used the Municipal Securities Rulemaking Board definitions of markups and markdowns for its study. The MSRB defines markups as the difference between the prices charged to the customer and the prevailing market price. Markdowns are the difference between prices paid the customer and the prevailing market price.

Using the MSRB's EMMA website, SLCG researchers Geng Deng and Craig McCann sampled 13.7 million dealer trades with customers with a par amount of $3.9 trillion — about 30% of the fixed coupon muni bond trades during more than six-years — and found that 21% of those trades included markups that either were more than twice the median markup for similar trades or were more than 0.5% larger than the markup charged on recent trades of the same bond.

"We estimate that investors were charged $10.65 billion in municipal bond markups between 2005 and 2013 in our sample — $6.45 billion in trades on which excessive markups appear to have been charged," the study states. "We have determined that between $1.84 billion and $6.45 billion of excessive markups and markdowns have been charged since 2005 on our subset of publicly municipal bond trades."

Extrapolating the data in their sample to cover the entire $3.7 trillion municipal securities market, the authors estimate that dealers charged $20 billion of markups from 2005-2013, about $10 billion of which were excessive.

The study provides some examples, including a recent deal involving debt issued by the City of Commerce, Calif. On Jan. 17, 2013 a customer bought $1.45 million of bonds for $101.36 that had just been sold four minutes earlier for $99.00," the study states. Compared to the average inter-dealer trade price that day of $99.22, the investor paid a $30,909 markup — almost 30 times the median.

Broker-dealers have wide discretion to charge the markups when they sell the bonds to investors. But the study argues this results in a transfer of taxpayer wealth to the brokerage community that could be eliminated by routinely disclosing markups.

The MSRB and the Financial Industry Regulatory Authority have written rules designed to prevent excessive markups and FINRA has levied fines when firms have flagrantly broken the regulations.

MSRB Rule G-17 on fair-dealing states brokerage firms must deal fairly with all parties in a transaction. Rule G-30 on prices and commissions prohibits either selling or purchasing securities at rates that are not "fair and reasonable."

FINRA also has very similar rules.

In April 2012, FINRA found that David Lerner Associates, Inc. charged excessive markups on sales of municipal bond sales and mortgage obligations. In 2011, FINRA and Morgan Stanley entered into a settlement under which the firm paid a $1.0 million fine and $371,000 in restitution for excessive markups and markdowns on both corporate and municipal bonds after violating FINRA rules 2110 and 2440, as well as G-17 and G-30.

McCann said he and Deng had been considering a study of municipal bond markups over the past two or three years and that there was plenty of academic literature out there but none that put their findings into really concrete terms.

“Something that was missing was an estimation of how big the markups were,” he said.

The study concludes that if dealers’ markups were accessible to the market, the markups would soon drop to much lower rates.

“Sunshine would eliminate much of the municipal bond markup abuses we have identified,” the report states. “Dealers are already required to determine that the prices and markups charged are fair. This can only be done by reference to prevailing market values, typically grounded in the dealer’s contemporaneous cost. Prevailing market values and markups are already estimated by dealers every time they execute a trade. If dealers disclosed to investors what markup was being charged, the markups charged on municipal bonds would quickly drop to markups found on other securities. This sunshine would benefit both taxpayers and investors.”

Commenting on the report, Bond Dealers of America said: “The BDA is supportive of increased transparency in the market, especially through enhancements being considered by the MSRB to their EMMA system, which will only serve to better educate the investing public. However, it is necessary to point out that without taking a closer look at individual transactions, general statements in the aggregate indicating that investors are being taken advantage of can be misleading and damaging to the market as a whole and furthermore, there is no clear consensus that the retail investor is getting anything but fair and reasonable prices in the fixed income market.”

The BDA added that spreads exist in distressed bonds and that supply and demand move bond prices. The study examples include some distressed bonds.

Michael Decker, co-head of municipal securities at the Securities Industry and Financial Markets Association, also critiqued the study.

“I think it’s flawed in several ways,” Decker said.

The methodology the authors used to cull markup figures from EMMA is unclear, said Decker. Additionally the study appears to make no distinction between trades of bonds in traditional brokerage accounts vs. those in fee-based accounts, where markups will naturally be higher. Decker added that in the muni market, where securities are infrequently traded, the price a dealer sells a security at may have no bearing on the cost the firm paid for it weeks or more earlier. Lastly, he said, markups are one aspect of pricing regulated by the MSRB rules, but the MSRB does not regulate markups alone.

by: KYLE GLAZIER