# Bond Case Briefs

*Municipal Finance Law Since 1971*

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## SIFMA: Fatal Flaws in Markup Research Paper.

A research paper released last week suggests that widespread violations of MSRB fair pricing rules are rampant in the municipal market.  Scratching just below the surface, however, reveals serious flaws in the methodology and assumptions underlying the authors' conclusions.

First, the paper does not provide any indication as to how the authors determined markups on municipal bond transactions. The authors indicate that they use data collected by the MSRB under their Real-Time Transaction Reporting System. However, RTRS data does not separate out markups, which need to be inferred from trade price information. Without knowing how the authors used trade price data to determine markups, it is nearly impossible to replicate their calculations or determine their validity.

Second, the authors pay virtually no attention to the Financial Industry Regulatory Authority's robust examination and enforcement system for detecting unfair pricing activity and sanctioning violators. Rooting out fair pricing violations is a key element of virtually all FINRA municipal examinations.

Third, the authors state that "the MSRB instructs members to calculate markups on municipal bond trades as the difference between the prices charged to the customer and the prevailing market price and to calculate markdowns as the difference between the prices paid to investors and the prevailing market price. The broker-dealers' contemporaneous cost of acquiring…the bonds through inter-dealer trades or offsetting trades with investors establishes a presumption of the prevailing market price." In fact, MSRB rules do not include any such instruction. The citation provided by the authors refers to draft MSRB interpretive guidance which was never adopted. Rather, MSRB Rule G-30 requires dealers to buy or sell securities "at an aggregate price (including any mark-down or mark-up) that is fair and reasonable." The MSRB's fair pricing rule does not directly set guidelines or standards for markups and does not use the concept of contemporaneous cost.

Fourth, in their discussion of markups, the authors take no account of fundamental issues such as costs to dealers of financing and hedging inventories and servicing customer accounts and for market movements that could account for differences in the prices at which dealers purchase and sell securities. One of the examples cited by the authors involves an inventory position which, according to the authors, a dealer acquired then sold off in a series of customer trades over a four-week period. Without analyzing those specific bonds, generally the authors fail to address questions such as how market benchmarks performed over that period and what the dealer's cost of financing and hedging that inventory over four weeks was.

Moreover, a key issue the authors neglect throughout the paper relates to the cost of servicing customer accounts. The markup earned by a dealer on a single sale must often cover the cost of servicing that customer position, including periodic valuations and statements, possibly for decades.

Fifth, the authors overstate the portion of outstanding municipal securities held by individuals. Citing SIFMA data, the authors state that "one half of the $3.7 trillion in municipal bonds outstanding at the end of 2012 was directly held by individual investors." Our data on holdings of municipal securities come from the Federal Reserve Board's "Flow of Funds" publication, which tracks holdings of "households," not individuals. Moreover, "households" are a residual category, meaning that household holdings really reflects the holdings of any category of investors not otherwise accounted for, including individuals but also including others. In addition, a growing portion of the municipal market held by individuals is owned through separately managed accounts, which are professionally managed and generally buy and sell bonds in block-size transactions.

Sixth, the authors make no distinction between trades involving fee-based accounts and traditional brokerage accounts. This distinction is important because with a fee-based account, because a dealer earns periodic fee revenue based on the size of the account, markups on transactions can be smaller. With traditional brokerage accounts, all the dealer's revenue is derived from markups on customer sales, so markups must be larger to account for dealer costs of servicing accounts. Including markups on trades involving fee-based accounts makes the average and median markups smaller than they would be on trades involving only traditional brokerage accounts. For an "apples-to-apples" comparison, the authors should have analyzed markups on fee-based and traditional accounts separately.

Seventh, the authors' proposals for addressing perceived shortcomings in municipal securities pricing rules are deeply flawed. They suggest a municipal securities pricing rule based on "dealers' contemporaneous cost," an elusive concept in a market like ours where most bonds trade very infrequently. When a dealer buys a bond that remains in inventory for weeks, the dealer's "cost" relative to current market pricing is often almost impossible to determine. That is the reason the MSRB has successfully administered a rule based on fair pricing rather than markup regulation for decades.

Finally, Misters Deng and McCann are not independent academics but rather professional witnesses closely affiliated with plaintiffs and claimants in securities litigation and arbitration cases against broker dealers. It should come as no surprise that their conclusions suggest significant numbers of pricing violations against investors, potentially leading to actions in which the authors would have a financial interest.

Enforcing fair pricing standards in a thinly traded market like that for municipal securities is difficult and complex. Determining fair prices is often subject to interpretation, and intelligent and informed market professionals can and often do disagree about the value of a bond at particular time. While it is appropriate for regulators to periodically review pricing rules to ensure customers' prices are fair, and academic research can help inform that process, there is no systemic mispricing of customer transactions as the authors claim.

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