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Muni Bond Costs Hit Investors in Wallet.

Investors Pay Twice as Much for Municipal Debt as for Corporate Bonds

Investors who put cash into municipal bonds—a widely popular strategy for those seeking safe, tax-free bets—are paying about twice as much in trading commissions as they would for corporate bonds, according to a study for The Wall Street Journal.

Regulators largely bypassed municipal debt as they transformed much of Wall Street over the past 20 years, but are studying it more closely now.

Individuals are the biggest participants in the $3.7 trillion industry, which provides funding for states, cities, hospitals and school districts across the country.

A study of 53,000 municipal and corporate bonds by S&P Dow Jones Indices for The Journal shows how much more investors are trading for the municipal assets.

Individual investors trading $100,000 in bonds of a municipality, such as Washington state, in December paid brokers an average "spread" of 1.73%, or $1,730. That compares with 0.87%, or $870, paid on a comparable corporate bond, such as one issued by General Electric Capital Corp., the data show.

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Brokers of stocks and corporate bonds must disclose market pricing and give individuals "best execution" on trades, ensuring they receive the best prices possible. In the municipal-bond industry, those protections are absent, allowing brokers to pocket higher spreads by buying the bonds low and selling them high.

Individual investors, especially retirees, have long been attracted to municipal debt as a relatively safe investment whose interest payments aren't taxed. They own 45% of all municipal bonds directly and another 28% through mutual funds, amounting to a combined $2.7 trillion, according to data from the Federal Reserve.

The market is supervised by several regulators and structured differently than the stock and corporate-debt markets, and regulation of muni-bond trading has been slow to evolve.

"I think we can do more here for retail investors," said Michael Piwowar, one of five commissioners on the Securities and Exchange Commission, in an interview. "We spend an awful lot of time on the equities side of the market where spreads are counted in pennies—and in the 'muni' market, spreads are counted in dollars."

Brokerages say that municipal bonds cost more to trade because they change hands far less frequently and in smaller amounts than do other securities. They have warned that regulatory changes could hurt activity in the municipal market.

The SEC held hearings on the issue in 2010 and 2011 and proposed changes in a 2012 report, but they haven't been implemented.

Investors bought and sold $183 billion of municipal bonds last year in trades of $100,000 or less, in line with recent years, according to data from the Municipal Securities Rulemaking Board.

One of those investors was Jack Leonard, a 67-year-old resident of Ipswich, Mass., who on July 23 sold bonds promising a 5% annual interest payment from his home state in two lots of $100,000 each.

The broker buying the bonds told Mr. Leonard the best price he could get was about $1,030 per bond, or $206,000.

The following day, a broker sold the same amount of 5% bonds to investors for $1,060 a bond, or $212,000, according to an online history of trading prices maintained by the MSRB. The difference of $6,000 in the two transactions is equal to 3% of the bonds' value.

It wasn't possible to verify that both trades involved Mr. Leonard's bonds from the MSRB database, which doesn't identify trade participants. But in July, MSRB records show brokers collectively sold $1 million in Massachusetts bonds to investors at a 3% average markup from the prices they paid for them, amounting to $30,000 in profits.

"That's a lot of money, and the real question is: Why are they allowed to do it?" said Mr. Leonard.

Mike Becker, a retired options trader in Boca Raton, Fla., said he has grown frustrated trying to get his broker at the Merrill Lynch unit of Bank of America to tell him the best bid being offered for the Florida state bonds he wants to sell and has petitioned the SEC to pass rules giving "the public a fairer shake." Josh Ritchie for The Wall Street Journal
The SEC oversees the MSRB, which sets rules for the industry, and the Financial Industry Regulatory Authority, which enforces them. Oversight coordination has been poor at times because the market is supervised by three regulators rather than one and the issue has had a low priority in Washington, said Hester Peirce, a former SEC staff attorney who is now a research fellow at George Mason University in Arlington, Va. "I think it's going to be under more scrutiny" going forward, she said, referring to Mr. Piwowar's push and recent proposals by the MSRB.

MSRB Executive Director Lynnette Kelly said the board "is working closely with the SEC to address market structure issues in a realistic time frame." John Nester, a spokesman for the SEC, said his group and others "work cooperatively on issues affecting the municipal securities market." Staff from Finra and the MSRB meet frequently "to ensure and sustain this collaborative approach," a Finra spokesman said.

Proposed changes face opposition from brokers, which fund both the MSRB and Finra. Firms such as Charles Schwab & Co. and Wells Fargo Advisors LLC have lobbied against some changes.

"The devil is always in the details when it comes to new regulations, but we commend the MSRB for bringing this issue forward and urge them to continue this important effort," said Jeff Brown, senior vice president of legislative and regulatory affairs at Schwab. Wells Fargo declined to comment.

Meanwhile, the lack of pricing information gives mom-and-pop investors little leverage to negotiate.

"I don't know what the market is, because they won't show me," said Mike Becker, a retired options trader. The 70-year-old Boca Raton, Fla., resident said he has grown frustrated trying to get his broker at the Merrill Lynch unit of Bank of America Corp. to tell him the best bid being offered for the Florida state bonds he wants to sell and has petitioned the SEC to pass rules giving “the public a fairer shake.”

“We have policies and procedures in place that adhere to MSRB guidelines as they pertain to fair pricing,” a Merrill spokeswoman said.

The MSRB proposed a municipal-bond best-execution rule last week that it hopes to enact this year or next and is working on a digital pricing platform, a person familiar with the matter said.

MSRB Chairman Dan Heimowitz, a banker at RBC Capital Markets Corp., said he is working to balance necessary changes against the risk that a rushed overhaul could spur brokers to quit the market, making it harder for individuals to trade. “That is why we go slowly and methodically, but we haven’t given up on this by any means,” he said.

Mr. Piwowar, a former economist who studied trading costs in corporate and municipal bonds, is pushing for fixes he hopes the SEC can enact this year, like requiring brokers to give clients more price information ahead of potential trades. He said stock and corporate-bond brokers also complained that similar reforms would stifle trading when it was imposed on their markets, “but in fact, all the evidence suggests the opposite.”

Peter Coffin, a municipal-bond manager for wealthy individuals at Boston-based Breckenridge Capital Advisors, said it is about time the muni market got an overhaul. “You think of how the retail industry has gone from the local grocery store to Wal-Mart to Amazon,” he said. By contrast, he said, “In municipal bonds, we’re still shopping at the local grocery store.”

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