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WSJ: Finra Scrutinizes Banks' Role in Bond Market.

Regulators have stepped up their scrutiny of the booming bond markets, launching an inquiry into Wall Street banks' trading profits and expanding a probe into how new offerings are doled out to investors, according to officials.

The Financial Industry Regulatory Authority, a Wall Street self-regulator, is taking a broad look at the trading profits of banks and other middlemen in some bond transactions. Finra is crunching through reams of trading data, looking for instances in which the middlemen have earned unusually large profits on bond deals, officials said. The inquiry could lead to a regulatory instruction to the banks to reduce the spreads between buying and selling prices they charge on certain trades, or even to enforcement action."There might be enforcement action with respect to the outliers," Richard Ketchum, Finra's chairman and chief executive, said in an interview with The Wall Street Journal. "We're certainly looking."Finra also is investigating how banks apportion hot bond offerings among investors, Mr. Ketchum said, alongside a previously reported Securities and Exchange Commission probe.

The Federal Reserve also has been asking large money-management firms about inefficiencies in the bond markets, said people familiar with the matter, which hasn't previously been reported. Among other things, the inquiry focuses on investors' troubles buying and selling bonds when credit markets tumbled in May of last year after the Fed signaled intentions to wind down its bond buying. A spokeswoman for the Fed declined to comment.

The spotlight on bond markets comes as regulators have launched several inquiries into potential inequities in the stock and commodities markets, where access to trading information can give certain investors advantages. Some market participants suspect dealers sometimes favor certain clients over others. Bond investors have complained for decades that their markets have been slow to adopt new technologies and that pricing and trading information should be more openly distributed.

The U.S. bond markets total about $40 trillion, twice the size of the approximately $19 trillion U.S. stock market. They provide ways for companies, the U.S. government and homeowners to obtain credit. Last year, companies borrowed a record $1.47 trillion in the U.S. corporate-bond market, including Verizon Communications Inc., VZ -0.44% which raised $49 billion in the biggest corporate-bond deal ever. Thus far, this year's new issuance is running apace, according to Dealogic.

The SEC has sought information on new bond sales from a number of big banks, including Goldman Sachs Group Inc., GS -1.97% Citigroup Inc., C -1.28% Deutsche Bank AG DB -1.41% and Morgan Stanley, MS -3.11% people familiar with the matter said. The Wall Street Journal reported in February that the SEC's inquiries of banksincluded Goldman Sachs and Citigroup. The banks haven't been accused of wrongdoing in relation to bond deals.

The SEC and Finra are together looking at whether banks are favoring the biggest money managers and giving them unfair influence over the pricing of new corporate bonds, which would disadvantage smaller investors.

“There aren’t allocation rules in the U.S. at the present time,” Mr. Ketchum said. “But there are issues about quid pro quos and other questions that can be raised.”

One particular aspect of new bond issues the regulator is looking at, he said, is “flipping opportunities,” or the chance for big investors to quickly sell newly acquired bonds—at a significant profit—to investors shut out of the deal initially.

Traders at investment firms sometimes call it a “kiss,” said one large money manager, referencing the term often used to describe a range of favors investors can get from bankers working on selling and trading new bonds.

When a bond issue comes to market, bankers often give the largest portions of the deals to their biggest customers, who also may frequently trade with the bank or use its other services, said several investors and people familiar with dealer trading desks.

Bond deals, like stocks sold in initial public offerings, often rise in value just after they are issued. About 87% of the bonds issued in 2013 rose in price within five days of the initial sale, said Peter Tchir, a strategist at Brean Capital LLC, a registered broker-dealer.

In trading after Verizon’s record $49 billion bond sale last September, investors made about $3 billion on three portions of the deal within the first week, according to an analysis by Mr. Tchir.

The Verizon deal is one of the offerings the SEC has asked banks about, the Journal previously reported

A Verizon spokesman didn’t respond to requests for comment.

In its new inquiry into bond trading, Finra is scrutinizing the profits banks and other dealers make, known as markups and markdowns—the difference between selling and buying prices. Dealers typically keep a small profit on each trade facilitated. But bond prices aren’t always publicly quoted, so it is difficult to know what competitors may be paying for the same bonds.

The regulator is zooming in on what Mr. Ketchum called “matched trades,” where dealers are matching a seller with buyers, often very quickly. It estimates these now make up 60% to 70% of trades in corporate and municipal bonds.

Securities dealers are trying to reap profits from selling and trading debt as other aspects of their businesses have become more challenged. Interest rates remain at some of the lowest levels in history, and trading desks have been crimped by postcrisis regulation that limits assets they can hold and trade for their own books.

Regulators don’t set a fixed limit on what markups banks can charge, instead judging what is excessive based on industry best practice.

Mr. Ketchum said that, for these matched trades, where the risk is “relatively limited,” markups of more than 1.5% to 2% would be “questionable.”

Christopher Sullivan, chief investment officer at the United Nations Federal Credit Union, which oversees about $2.25 billion in assets, said that even worse than getting a smaller-than-wanted chunk of a new bond deal is then being offered the bonds from a trader right after the deal is priced “at some unjustifiably higher price.”

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