

Bond Case Briefs

Municipal Finance Law Since 1971

Bond Markups as Low as 3% Said Excessive to Finra in Trading.

The Wall Street watchdog that culls bond-trade data is honing in on limits for acceptable commissions that are lower than their stated guidelines.

While dealers have been told for decades that they can't mark up bonds more than 5 percent without regulators deeming their fees excessive, the Financial Industry Regulatory Authority considers the real ceiling for most corporate-bond trades as 3 percent or even less, according to three people with direct knowledge of the matter.

Government agencies have been more closely examining transactions that traditionally occurred over the telephone in a U.S. [debt market](#) that's almost doubled in the last decade to \$40 trillion, attracting record cash from the growing population of pensioners and retirees in need of fixed income. Finra is going through its bond-price data looking for evidence of wrongdoing as it tries to nab brokers who charge customers more than they should.

"You've got a gotcha situation where people are trying to figure out what the limit is," said W. Hardy Callcott, a securities attorney at Sidley Austin LLP in [San Francisco](#). "They do have thresholds for different securities, but they don't tell you what those thresholds are."

Brokers who take too big of a cut on bond trades may be fined by Finra or receive disciplinary actions they're required to disclose in [public records](#).

Tolerating Markups

Regulators probably have opted not to reveal specific limits on commissions because such guidance may lead traders to charge as much as they can, Callcott said in a telephone interview last week.

Finra has different thresholds for acceptable commissions based on market conditions and the credit quality of the bonds being traded, one of the people said. The watchdog is willing to tolerate higher markups for riskier debt, said the person, who asked not to be identified because the conversations are private.

[Nancy Condon](#), a Finra spokeswoman, declined to comment. Finra is an independent organization that writes and enforces rules governing the activities of more than 4,140 securities firms.

Scrutiny of practices in the debt market is increasing after individuals poured about \$588 billion into bond funds since the beginning of 2009, according to Investment Company Institute data.

Litvak Verdict

The [U.S. Securities and Exchange Commission](#) is separately examining to what extent smaller

buyers are disadvantaged and whether the behavior constitutes market manipulation, [Bloomberg News](#) reported March 20. Brokers can choose which rivals and clients may see their bond prices on electronic trading systems by turning quotes on and off.

Bonds aren't traded as frequently as [stocks](#), which are listed on exchanges. Some will rarely change hands, making it difficult for buyers and sellers to assess a market rate.

Finra next month is expanding its bond-price reporting into the \$1.5 trillion market for private company debt, which is only sold to institutional buyers. The plan extends the reach of a system introduced in 2002 into an area more likely to be rife with questionable practices because the securities are less frequently traded.

The watchdog plans to use the data to help identify dealers who profit from excessive fees, according to the people. It's historically been more profitable to trade bonds than stocks because the debt markets are less transparent, making it easier for brokers to take a bigger fee for each exchange.

Being Scared

Finra's computer-enhanced surveillance has helped fuel uncertainty about what constitutes acceptable practices on [Wall Street](#), especially after former Jefferies Group LLC mortgage-debt trader Jesse Litvak was convicted in March for taking markups on some trades that were too big.

Litvak, a former managing director, was found guilty by a federal jury on March 7 of [securities fraud](#) and making false statements connected to the U.S. government's Troubled Asset Relief Program. He was scheduled to be sentenced May 30 and planned to appeal the decision.

Prosecutors accused Litvak of defrauding investors of \$2 million by misrepresenting how much sellers were asking for securities, or what customers would pay, and keeping the difference for New York-based Jefferies.

"You can understand why people would be scared," said [Neil Barofsky](#), a white-collar defense attorney at Jenner & Block and former special inspector general of the U.S. government's Troubled Asset Relief Program.

1943 Study

For Litvak, the U.S. "had a case where the facts were not overwhelming and a defense that 'Everyone is doing it,'" Barofsky said.

The conviction may bolster government efforts to prosecute other traders and banks related to the 2008 financial crisis and its aftermath, according to Barofsky. When asked if charges against others were likely, Assistant U.S. Attorney Eric Glover said in March the investigation is "ongoing and active" and declined further comment.

Finra's board adopted what became known as the "5 percent policy" based on a study conducted in 1943 to serve as a guideline of what's an acceptable markup in [bond trading](#). The watchdog said last year that it's working on completing an updated version of the rules.

Concrete Guidance

In 2011, Finra proposed dropping a numerical guideline altogether, then decided to retain the 5

percent reference in the latest draft of the rule released in 2013.

“Other than being on the opposite side of an enforcement proceeding, it is the only concrete guidance that Finra has issued,” attorneys at law firm Bingham McCutchen LLP wrote in a February 2013 report posted on their website.

Since the 5 percent threshold for bond-trade profits is based on a 71-year-old study, “it leaves the industry to an ever-changing and arbitrary determination of what appropriate markups should be,” they said.

In 2002, a Finra predecessor introduced the Trace bond-pricing reporting system to foster competitive pricing, starting with 500 bonds. It will begin disseminating prices on corporate bonds sold privately under Rule-144A for the first time in June.

Those bonds aren’t traded as frequently, so Wall Street takes more risk in brokering the debt and usually expects to be compensated accordingly. Finra has said it’s also planning to add trades in non-agency mortgage-backed securities, another less-liquid corner of the [bond market](#), to Trace.

The expansion is exacerbating angst among bond traders concerned that they face retroactive punishment for activities that once were accepted, according to Callcott.

“If you tell people what they’re supposed to do, in my experience the vast majority are going to try to comply with it,” Callcott said. “The thing that’s frustrating to me is that they have a number and they won’t tell you what the number is.”

By Lisa Abramowicz May 16, 2014 12:50 PM PT

To contact the reporter on this story: Lisa Abramowicz in [New York](#) at labramowicz@bloomberg.net

To contact the editors responsible for this story: Bob Ivry at bivry@bloomberg.net Caroline Salas Gage, Shannon D. Harrington