

# **Bond Case Briefs**

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## **Bond Fee Disclosures Sought by SEC to End 38-Year Debate.**

After a 38-year debate on how to make trading costs for corporate and municipal debt transparent, regulators are making another attempt at forcing dealers to disclose how much they earn on the transactions.

The Municipal Securities Rulemaking Board will discuss a proposal at the end of the month, Executive Director Lynnette Kelly said yesterday, after U.S. Securities and Exchange Commission Chair Mary Jo White asked the regulator to come up with a plan by year end. The new rules would apply to so-called riskless trades, where firms fill client orders rather than use their own money to opportunistically buy.

Regulators are placing a greater emphasis on making sure smaller buyers don't get fleeced when transacting in the corporate- and municipal-bond market that's grown 36 percent since 2008. While stock brokers must tell investors how much they earn, bond dealers have profited from an opaque market where trades are still often completed over the telephone.

"You don't know how many bites out of a yield are taken by the time you're buying a bond," said Marilyn Cohen, who manages \$320 million of corporate and municipal bonds as founder of Envision Capital Management Inc. "Here we are in 2014 and we're still talking about this."

### **Increasing Prices**

Individuals are especially in the dark about how much they're paying brokers, Cohen said. Investors pay higher prices than securities firms when they trade U.S. state and local government bonds, according to a study of the \$3.7 trillion municipal market released this week by the MSRB.

The price of a municipal bond increased by an average of 1.78 percent when a broker purchased a security from one investor and resold it to another, according to the MSRB analysis of trading from 2003 to 2010. Trades between securities firms, in comparison, increased in price by 0.5 percent.

Concern is mounting that the bond market's antiquated infrastructure will exacerbate losses when sentiment reverses after more than five years of easy-money policies that have suppressed borrowing costs and spurred record demand for debt. Investors have funneled about \$978.3 billion into long-term bond mutual funds since the end of 2008, an amount that's greater than Turkey's annual gross domestic product, according to the Investment Company Institute.

While yields are still close to all-time lows, analysts predict they'll climb as the Federal Reserve ends its monthly purchases of Treasuries and mortgage debt later this year and prepares to raise benchmark interest rates.

### **Drafting Parameters**

The SEC is "very focused" on making changes in the bond market's structure in the "next year or two," White said in a June 20 speech. She also said the SEC asked the MSRB and Financial Industry Regulatory Authority to draft parameters for how to force dealers to disclose their commissions.

"We look forward to working with the SEC on these important topics," George Smaragdis, a Finra spokesman, said in an e-mailed statement.

MSRB's Kelly said in a telephone interview yesterday that the two regulators are working together and that "it's important for there to be regulatory consistency."

The idea of requiring dealers to disclose commissions on certain bond trades isn't new. The SEC has proposed rules on three separate occasions that would require dealers to reveal mark-ups on riskless principal trades, and failed to follow through each time.

### Majority Support

The agency issued the most recent proposal in 1994, and didn't adopt the rule in part because regulators were readying the bond-price reporting system now known as the Trade Reporting and Compliance Engine, or Trace, which went into effect in 2002.

Regulators are more confident they'll follow through this time because a majority of the five-member commission — White and two Republican SEC commissioners, Daniel M. Gallagher and Michael S. Piowar — have called for requiring disclosure.

In addition, a bipartisan Senate bill introduced in March, sponsored by Senator Mark Warner of Virginia and Senator Tom Coburn of Oklahoma, would require dealers to reveal their mark-ups on transactions with customers who placed an order to buy or sell.

"If you have a commission or a mark-up that is three or four percent, that is one year of interest on a bond in many cases," Piowar said in a phone interview. "You can burn your yield up on these transactions. Having it on their confirm would provide another level of transparency."

### Riskless Principal

The main issue of contention is how to determine which trades would be subject to the rule.

Regulators are considering rules that would be dependent on how much time it takes between when a dealer buys and sells a bond. Lobbyists from the securities-brokerage industry are opposed to those parameters, and argue regulations should target trades where firms have client orders in hand when they purchase debt.

"Whether we can get comfortable with this really depends on how the regulators define riskless principal," said Michael Decker, managing director and co-head of municipal securities for the Securities Industry and Financial Markets Association.

"If they are thinking of riskless principal in terms of how long you as a dealer were exposed to market risk, if it's less than an hour or less than a day, that in our view is not a riskless principal trade," he said.

### Declining Costs

The lack of information about brokers' commissions is indicative of the antiquated nature of the \$40 trillion U.S. bond market. Corporate-bond trading has been slow to move to electronic platforms, partly because there are thousands of individual bonds that trade relatively infrequently.

While transaction costs have declined after the advent of bond-price reporting systems, investors still typically pay more to transact in these markets than in equities. In the year after the Trace

bond-price reporting system was introduced, a study found that \$1 billion in commissions were wiped out.

Rules mandating more disclosure of commissions “will probably compress the spreads in terms of how much everyone is making,” Envision’s Cohen said.

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