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Investors Pay More for Munis than Dealers, MSRB Report Shows.

WASHINGTON — Investors pay more for municipal securities than dealers, particularly when there is more time between trades, according to a long-awaited report commissioned by the Municipal Securities Rulemaking Board.

But market sources said that the report's finding is not surprising and that the report is limited in its results.

Erik Sirri of Babson College in Massachusetts conducted the study, which he has been working on since January 2011. The work analyzed millions of municipal market trades and provides an analysis of the muni market's structure, the price differential between two trades of the same security, and the impact of near real-time trade reporting.

MSRB director of research Marcelo Vieira said that the report provides the MSRB a clear picture of how municipal securities move through the market and the information about the impact of its Real-Time Transaction Reporting System reinforces the importance of price transparency. Many market participants have said for years that the many small, retail customers in the muni market typically pay more for the same securities than either institutional customers or dealers.

Fifty percent of all trades had a trade size at or below $25,000, the study reveals. But the study did not differentiate between institutional and retail customers.

Vieira said the MSRB did not pay Sirri, a former director of the division of trading and markets at the Securities and Exchange Commission, for the study. But the professor does retain the rights to the data and its use in future research.

“This report provides a highly detailed benchmark analysis on secondary market trading from the MSRB, an independent and objective source of information, and the key regulator of the municipal securities market,” MSRB executive director Lynnette Kelly said in a release Tuesday. “The MSRB supports the use of data in its oversight of the market and encourages further analysis by others into the intricacies of municipal market trading.”

The report examines the four types of “trade pairs” that exist in the market: a dealer purchase from a customer followed by a dealer sale to a customer; a dealer purchase from a customer followed by an inter-dealer trade; an interdealer trade followed by a dealer sale to a customer; and interdealer trade followed by an interdealer trade.

Sirri found that the average basis point spread from a dealer purchasing a muni from a customer and selling it to a customer was 178, compared to 146 for a dealer buying a muni from a dealer and selling it to a customer, 67 for a dealer purchasing a muni from a customer and selling it to another dealer, and 50 for a dealer purchasing a muni from a dealer and selling to a another dealer. The average increase for all transactions was 127 basis points.

“Paired-trade differentials are noticeably higher when trades involve a customer, as opposed to another dealer,” the report concludes. “Using an [interdealer-interdealer] trade pair as a starting point, replacing either side of the trade pair with a customer trade serves to increase the paired-trade differential relative to the [interdealer-interdealer] pair. This is perhaps not surprising if higher costs are associated with identifying and trading with a customer versus another dealer.”

The basis point differentials shrank when Sirri looked only at transactions that took thirty minutes or less between the first trade and second. The overall spread dropped to 80 basis points from 127, and fell to 76 for trades occurring within 14 minutes of each other.

The study also examines the impact of the RTRS. Beginning on Jan. 31, 2005, prices for most trades of municipal securities became available to the public on a near real-time basis, within 15 minutes after trade execution. Prior to that, prices became available the next day.

The study shows that the average basis point change in a trade dropped to 160 in 2006 from 213 in 2003, but had edged up to 208 by 2010. The report points to the 2007 financial crisis as a probable factor in the increase of basis points.

“It reflects the importance of transparency,” Vieira said. “From our perspective, it’s all about transparency.”

The study did not attempt to examine riskless principal trades, or purchases and sales of the same munis at almost the same time which do not expose dealers to market risks. SEC commissioners have said that dealers should be required their markups on these trades.

David Cohen, managing director and associate general counsel at the Securities Industry and Financial Markets Association, said the report contains no surprises. The efforts of Sirri and the MSRB underscore the unique characteristics of the muni market, Cohen said, and the role of dealers in an environment that includes many small trades and some securities that trade very infrequently. Cohen added that the report deals with aggregated data, and that the facts and circumstances of individual trades differ considerably.

“There’s a story behind each trade,” Cohen said. “I think it’s important to take that into consideration.”

Joseph Fichera, chief executive officer of Saber Partners LLC., said the study has to be viewed with some qualifications noted in Sirri’s report. The price change data is not analagous to the formal concepts of “mark ups and mark downs,” and the report was never meant to be used as a measure of whether transactions are fair or not for regulatory purposes. It also doesn’t account for specific circumstances, such as changes in credit worthiness.

“Time is money, inventory is a cost, and dealers have a right to make a profit when making markets, especially over time,” Fichera said.

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