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The Hidden - and Outrageously High - Fees Investors Pay for Bonds.

If you are a retail investor who purchases or sells corporate or municipal bonds, do you know the costs you are paying to transact in those securities? Chances are you don't. Because of a regulatory loophole, broker-dealers are currently allowed to withhold essential pricing information from retail investors in fixed-income transactions.

When a retail investor purchases stocks, the broker-dealer is required to disclose the transaction costs the investor paid in the form of a commission on the customer's confirmation statement. However, when a retail investor purchases bonds, the broker-dealer is not required to provide comparable disclosures of the transaction costs the investor paid in the form of a markup or markdown.

Because broker-dealers are not required to provide transaction cost information to retail customers in fixed-income transactions, and because retail investors don't see any transaction costs on their confirmation statements, retail investors may mistakenly believe that they aren't paying any trading costs at all. This opacity allows broker-dealers to charge higher transaction costs than they otherwise would if they were required to disclose.

As a result, retail investors pay substantially more to trade in corporate and municipal bonds than they pay to trade in stocks, where disclosure is required. And, they pay substantially more to trade in corporate- and municipal-bond transactions than sophisticated traders, who are better informed than retail investors and know where to access and how to interpret this information.

Research on retail investors' trading costs for municipal bonds has found that the average cost of a $20,000 municipal-bond trade to be almost 2%. That cost arguably would be quite high even in the context of a normal interest-rate environment. However, in today's low-interest-rate environment, that cost would be even more pronounced–equivalent to almost eight months of the total annual return for a bond with a 3% yield to maturity. Retail investors simply can't afford to pay these sorts of high transaction costs on a low-yield investment.

Relevant cost information is available on FINRA's Trade Reporting and Compliance Engine (TRACE) (for corporate bonds) and MSRB's Electronic Municipal Market Access (EMMA) (for municipal bonds) websites, and some astute investors may know how to find and interpret that data. However, most retail investors likely are not in a position to use those websites with any reasonable degree of expertise. Doing so would require the investor to know not only that those websites exist, but also how to find the precise information one is looking for and, most critically, how to understand and make use of that information to determine the costs one is paying and whether those costs are fair.

The only way to ensure that retail investors receive critical cost information is to provide it directly to them. Such cost information would put them in a better position to assess whether they are paying fair prices and allow retail investors to make more informed investment decisions. That would have the added benefit of fostering increased price competition in fixed-income markets, which would ultimately lower investors' transaction costs.

Even within the highly fractured Securities and Exchange Commission, there seems to be unanimous support among the commissioners to require broker-dealers to disclose transaction costs directly to their retail customers. Commissioner Mike Piwowar has gone so far as to characterize this issue as "low-hanging fruit."

But while there seems to be bipartisan support for forceful action, the two self-regulatory organizations tasked with addressing the issue, FINRA and the MSRB, have offered differing proposals. In my view, FINRA's proposal is stronger and less susceptible to evasion by broker-dealers than the MSRB's proposal and, therefore, any final coordinated approach should follow FINRA's proposal.

Meanwhile, as the respective regulatory agencies debate the technical details of the various proposals, which is likely to complicate and lengthen the process, retail investors remain in the dark.

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