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Commentary: Questions Remain as Bond Market Prepares for Markup Disclosure Rule.

As broker-dealers prepare for bond markup rules slated to take effect by May 2018, questions remain about the implications for the fixed income industry as well as how broker-dealers will report trading disclosures to customers.

While few would argue the benefits of having a more transparent, easy-to-use mechanism in place to provide more information to the marketplace, broker-dealers are now tasked with devising a systemic, robust way of determining prices for securities, including values for hard-to-price, illiquid bonds. Yet, guidance from the Financial Industry Regulatory Authority and Municipal Securities Rulemaking Board has been vague, especially with respect to illiquid bonds.

The regulations approved by the Securities and Exchange Commission require dealers to disclose markups and markdowns on fixed income transactions for securities held for no longer than a day. This disclosure, which is calculated from the bond's prevailing market price and expressed as a total dollar amount and percentage amount, is the culmination of a decades-long attempt to bring more transparency to a market where trades are largely conducted via telephone and prices are somewhat nebulous.

The new rules are designed to narrow the mark-up differential between what retail and institutional investors pay for similar trades. Regulators have long supported this oversight, claiming that retail fixed income customers almost never compare prices between dealers. In contrast to other types of securities, no central marketplace for bond quotes currently exists. As a result, rule makers argue that customers are in the dark regarding the often wide disparities between quotes provided by various broker-dealers. In fact, retail investors sometimes pay more than 2% in markup, while institutional investors only pay about 0.05%. While much of the higher markup for smaller retail trades factors in spreading the high cost of sourcing bonds over less principal, proponents of the regulations claim there is room to narrow the gap between retail and institutional trades.

While retail investors should certainly benefit from increased transparency, not everyone is sanguine about the prospects for these new regulations. Critics argue that investors already have access to price information through the FINRA and MSRB websites, and that markups are a fair way to generate income, just as traditional retail stores selling consumer goods have done for years.

In addition to adhering to the new regulations and navigating the challenge of implementing these new systems, broker-dealers are faced with a number of significant questions. Can markups be done manually? If fully automated, can they accurately tabulate prices for illiquid bonds?

Broker-dealers will now have to disclose markups on all trades for which they have an offsetting transaction that day, including those that do not fall under the category of riskless principal transactions. Transactions that fall outside of the "riskless principal" categorization occur when firms enter into trades that are undertaken as principal but then receive a client order for the same bond during the same day. In this scenario, firms are now required to disclose the markup, however there is often not an interdealer print from which to source the market price. As a result, the firm must resort to waterfall analysis – analyzing “comparable” bonds to determine the market price. This step is difficult to automate, and can provide unreliable data.

Waterfall analysis begins with an examination of trades in a specific bond. For illiquid bonds, data from other trades may not exist, and in this case broker-dealers are directed to use the pricing of “comparable” bonds in their analysis. This presents a significant challenge, as finding “comparable” bonds is much more of an art than a science, and again this process is difficult to automate.

Even more questions about the markup disclosure rule remain. Could these regulations meant to help retail investors cause some firms to stop servicing them because of the increased cost of compliance? How will commission be affected? Will broker-dealers be forced into a basis point model? How can these new systems be implemented within the next 12 months?

While questions certainly remain, markup disclosure rules are sure to change how retail investors and broker-dealers alike participate in the fixed-income market.

The Bond Buyer

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