



## **RECOMMENDATIONS TO MSRB as sought by MSRB Notice 2013-14 (July 31, 2103)**

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The following suggestions pertain largely to EMMA enhancements and, to a lesser extent, to MSRB sales practice requirements. Additionally, each suggestion describes whether it is intended to result in new or enhanced detail for EMMA or if it is intended to produce more or greater disclosures to customers by brokers and member firms.

“Mark-up/Mark-down” and “Sales credit” are not used interchangeably here. For the purposes of this submission, “Mark-up” is the difference between a dealer’s purchase price and the dealer’s initial offering price, while “Mark-down” is the difference between a customer’s sale price and the dealer’s simultaneous sale price or initial reoffering price to another party (different customer or outside dealer.) As used here, neither definition relies on “prevailing market price.”

“Sales credit” is that amount paid in the form of gross commission to a broker of record for a buy or a sell for any customer account and can at times be lesser or greater than a “Mark-up” or “Mark-down.” I believe that this is an important distinction because client-facing brokers can regulate sales credits somewhat independently of mark-up or mark-down.

In looking to achieve optimal execution, a municipal bond investor is really seeking two things: A fair market return for any specific bond in the case of a purchase (yield to maturity or yield to worst) or the highest available price in the case of a bond sale. Compensation to the broker in both transaction cases should be fair, i.e., sufficient to create an operational profit<sup>1</sup> for the brokerage firm without reducing the purchase yield to a below-market level or without diminishing sale proceeds below a fair-market expectation. If these goals are attained, an investor can be indifferent to the dealer’s cost basis for any bond that that investor may buy from or sell to that dealer.

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<sup>1</sup> Operational profit here means the dollar value of the gross commission minus the dealer’s estimated “ticket cost” and minus the broker’s net commission. Operational profit does not take into account any trading profit or loss sustained in the dealer’s trading account.

While it is my belief that due diligence and best execution practice goals are laudable for the municipal securities market, these are very difficult to implement, defend, and enforce. Here are some reasons:

1. Municipal debt securities are heterogeneous, highly nuanced as to features, and resist a high degree of correlation within their own market universe.
2. Munis trade relatively infrequently and because they trade in a negotiated market, are often subject to pricing inputs that have little to do with their intrinsic worth, e.g., deal size, dealer access, limited price data sets, regional taxation disparities, widely varying indentures and structures, varying associated dealer overhead costs, etc.
3. Asymmetric information sets, i.e., municipal bond dealers often have a great deal more information available to them regarding trading reconnaissance, credit research, pending new issues that could directly impact outstanding issues, order flow, etc., than do investors. This is acutely different than other markets like those for common stocks, high-grade corporate bonds, and treasury and federal agency securities.
4. Drawing fair securities comparisons among municipal bonds is very labor-intensive and time-consuming for broker-dealers and the time that's required often exceeds reasonable segments of market time intervals. While a broker may need one hour or more to gather meaningful comparison offerings or data, the market can easily change and render the starting price proposition moot. As in most industries, time is money, and burdensome due diligence and price comparison requirements will almost necessarily result in increased sales credits and diminished returns for investors.

Additionally, greater education of investors and a fair expectation of due diligence on their part also contribute to an improved investment outcome for investors. Because there is broader availability of municipal bond offering information through a greater number of dealers today, the task of price shopping has become vastly more simplified for investors than in the past. At the same time, dealers should have no more reservation about price competition than suppliers in any other industry because, in the final analysis, they determine the beginning point for price negotiation in the market, much as wholesalers and original assemblers do in other industries. That said, members have (and always have had) the obligation to deal fairly with their customers and it's my opinion that "fair dealing" is very closely linked to "material information."

It is known and accepted that material information is that information that the investor deems important to their decision-making, likewise fair dealing should be viewed as dealings that the investor can be made to see is not unfair. In my view, making available to investors greater information detail about transactions, sales credits and commissions, and other related price aspects can impel greater pricing efficiency and fairer trading activity for both investors and dealers, without imposing difficult, cumbersome, and often unachievable best execution requirements on dealers. In varying transaction scenarios, potential disclosure of certain transaction components can be very informative for customers seeking best execution without relying on the broker to supply price discovery information or to perform due diligence as to market prices for comparable or identical securities. Enhanced price transparency and expanded disclosure requirements will make investors not only better informed but

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also put them in an improved position for price bargaining. Thus situated, customers will have a lesser need to rely on a broker's assertion of best execution as they will have greater information that may reveal deficiencies in price fairness. This is because as the body of information about specific broker compensation for certain transaction types increases, competition among dealers will necessarily increase and thus wholesale pricing for all trade types will become more homogeneous.

Here are my suggestions for expanding and enhancing certain disclosures:

1. Expand trade party identification on EMMA
  - a. Identify trades by broker's brokers (sells and buys) to EMMA
    - i. Lack of definition in current EMMA data can give appearance of interpositioning between dealer parties or mark-ups between subsidiaries
    - ii. Disclosure improves cost transparency for customers
    - iii. Requires trade ticket field
      1. Broker's broker
  - b. Identify to EMMA trades and related prices between or among subsidiaries, i.e., sale from bank to brokerage subsidiary of bank
    - i. Disclosure improves cost transparency for customers
    - ii. Requires trade ticket field
      1. Related party
2. Identify separate dealer buys and sells to EMMA
  - a. Reinforces timely order entry, supporting 3. (below)
    - i. Requires separate trade reports from each party, rather than a single inter-dealer trade report
3. Identify riskless vs. at-risk dealer buys to EMMA
  - a. Reinforces timely order entry as riskless dealer buy time-stamps must closely match counterparty dealer sell and customer buy
  - b. Supports greater compensation for dealers in at-risk trades
  - c. Disclosure improves cost transparency for customers
  - d. Supports MSRB regulation
  - e. Requires trade ticket field
    - i. Riskless/At-risk
4. Require all riskless dealer trades (order-in-hand) be treated as agency trades with mark-ups and mark-downs disclosed to customer.
  - a. Reflects true agency nature of trade
  - b. Improves customer understanding of acquisition/disposition costs
  - c. Promotes dealer competition
  - d. Supports MSRB regulation
  - e. Requires trade ticket fields
    - i. Riskless
    - ii. Markup/mark-down amount (nominal dollar and/or percent of gross price)
    - iii. Agency status

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5. Disclose sales credit to customer on all customer sells to dealer inventory account
  - a. Customer selling does not give rise to dealer costs associated with customer buys, e.g., research, custody, reporting, etc., therefore sales credits for customer sells should be minimal and disclosed.
  - b. Disclosure improves cost transparency for customers
  - c. Disclosure promotes dealer competition
  - d. Requires trade ticket field
    - i. Sales credit amount (nominal dollar and/or percent of gross price)
6. Require disclosure to selling customers whether bid is for inventory or from outside party
  - a. Supports dealer's defense of suitable bid in view of at-risk status of buy
  - b. Discloses to selling customer potential riskless status of trade
  - c. Requires trade ticket field
    - i. Bought for inventory/Sold away
7. Report institutional vs. retail customer status to EMMA
  - a. Allows dealers to defend greater mark-ups required to cover retail customer street-name holdings costs. Unidentified, thin mark-up trades with institutional accounts can wrongly suggest unfair treatment among retail customers.
  - b. Requires trade ticket field
    - i. Institutional account/Full service account
8. Report DVP vs. Street-name (Held) customer buys to EMMA
  - a. While DVP trades have higher instantaneous costs, they involve no continuing costs.
  - b. Requires trade ticket field
    - i. DVP/Held
9. Require disclosure to customer of sales credit for all retail DVP trades
  - a. DVP retail customer buy trades involve reduced total dealer costs, i.e., no more than cost of trade execution. Disclosure of sales credit allows customer to judge fairness of trade cost.
  - b. Trade ticket field required
    - i. Sales credit
10. Require disclosure to customer of inventory status of all recommended buys prior to trade execution
  - a. Improves customer's ability to bargain for recommended securities held in inventory
11. Require disclosure to EMMA of all sales to customers from inventory
  - a. Supports dealer defense of greater mark-up/sales credit
  - b. Affords customer a better bargaining stance
  - c. Trade ticket field required
    1. From inventory

Respectfully submitted,

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