Consumer Federation of America

January 20, 2015

Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
Washington, DC 20006-1506

Ronald W. Smith
Corporate Secretary
Municipal Securities Rulemaking Board
1900 Duke Street, Suite 600
Alexandria, Virginia 22314

Re: FINRA Regulatory Notice 14-52; MSRB Regulatory Notice 2014-20
Pricing Disclosure in the Fixed Income Markets

Dear Ms. Asquith and Mr. Smith:

I am writing on behalf of the Consumer Federation of America (CFA)[1] to express our strong support for FINRA's and MSRB's proposed rules to require heightened confirmation disclosure of pricing information in fixed income securities transactions. By requiring firms to disclose on their customer confirmation the price to the customer, the price to the member of a transaction in the same security, and the differential between those two prices, the proposed rules will provide retail investors with critical cost information. This information will put them in a better position to assess whether they are paying fair prices and whether their dealers are fulfilling their best execution duties. As a result, this information will allow retail investors to make more informed investment decisions. These rules will also foster increased price competition in fixed income markets, which will ultimately lower investors' transaction costs.

The bond market plays a critical role in our nation's economy. The corporate bond market allows companies to finance their medium- and long-term capital investment and growth, and the municipal bond market allows cities, counties, and states to build schools, bridges, roads, sewer systems, hospitals, and other vital infrastructure. The bond market's significance is matched by its size. As of the fourth quarter of 2013, there was approximately $7.46 trillion

[1] CFA is a non-profit association of nearly 300 national, state, and local pro-consumer organizations. It was formed in 1968 to represent the consumer interest through research, advocacy and education.

outstanding in corporate debt and $3.67 trillion outstanding in municipal debt, according to SIFMA.[2]

Retail investors provide corporations and municipalities with a significant amount of that capital by buying the bonds that corporations and municipalities offer. For example, as of March 2013, retail investors held directly or indirectly approximately 28 percent of the total outstanding principal value of the corporate bond market and approximately 75 percent of the total outstanding principal value of the municipal bond market.[3] Retail investors' participation in the municipal bond market is especially striking, as they held approximately 50 percent of outstanding municipal bonds directly.[4]

While retail investors are important participants in fixed income markets, they are disadvantaged in concrete ways when they transact in these markets. First, retail investors pay substantially more to trade in corporate and municipal bonds than they pay to trade in equities. Second, they pay substantially more to trade in corporate and municipal bond transactions than sophisticated traders. Theoretical and empirical evidence suggests that these price discrepancies are largely due to the fact that fixed income markets are opaque, and retail investors are not receiving information that would allow them to make better-informed decisions and pay lower transaction costs. In short, without essential price information, financial intermediaries are able to extract rents from their less well-informed retail customers by charging them higher transaction costs.

SEC Commissioner Michael Piwowar arguably has done more than anyone in recent years to highlight the ways in which retail investors have been harmed in fixed income markets. In 2007, Piwowar astutely observed: "Bond markets have been notoriously opaque….The lack of transparency in the bond markets has allowed market professionals – including sophisticated investors, brokers and dealers – to obtain vast sums of money from unsophisticated investors *and* taxpayers."[5]

Retail Investors' Trading Costs

Research on retail investors' trading costs for municipal and corporate bonds conducted by Piwowar, Lawrence Harris and Amy Edwards, has found that retail investors pay substantially more to trade municipal and corporate bonds than they pay to trade similar-size common stocks. In June 2006, Piwowar and Harris published a paper that examined municipal bond transactions through October 2000, and found, for example, that the average effective spread of a $20,000 municipal bond trade was almost 2 percent (1.98 percent) of the price. To put that cost in perspective, they pointed out that it is the equivalent of almost four months of the total annual return for a bond with a 6 percent yield to maturity. However, in today's low interest rate environment, that cost is even more pronounced; it is the equivalent of almost eight months of the total annual return for a bond with a 3 percent yield to maturity. In comparison to a

[2] SIFMA Statistics, US Bond Market Issuance and Outstanding, http://bit.ly/1CL2CDz.
[3] *See* Luis Aguilar, **"**Keeping a Retail Investor Focus in Overseeing the Fixed Income Market**,"** Remarks at the Roundtable on Fixed Income Markets, Washington, D.C. April 16, 2013, http://1.usa.gov/1wnUjZr. (citing Federal Reserve Flow of Funds data).
[4] *Id*.
[5] Michael S. Piwowar, Corporate and Municipal Bonds, Securities Litigation and Consulting Group, Inc., 2007, http://bit.ly/1CwCN9V.

similar-sized equity trade of 500 shares of a $40 stock ($20,000), Piwowar and Harris found that this would be equivalent to an effective spread of 80 cents per share. Even the most illiquid stocks rarely have spreads that wide.[6]

A 2007 paper by Piwowar, Harris, and Edwards examined corporate bond transactions in 2003 and found that the average effective spread of a $20,000 corporate bond trade was 1.24 percent of the price, making it the equivalent of over two months of the total annual return for a bond with a 6 percent yield to maturity. Putting that cost in perspective relative to today's interest rates, it is equivalent to almost 5 months of the total annual return for a bond with a 3 percent yield to maturity. In comparison to a similar-sized equity trade, Piwowar, Harris, and Edwards found that this cost would be equivalent to an effective spread of 52 cents per share.[7]

In both studies, researchers found that trading costs decrease dramatically with trade size, meaning that retail investors generally pay substantially more than institutional investors to trade a bond. This is in stark contrast to equity markets, in which retail investors generally pay lower transaction costs than institutional investors to buy and sell stocks due to the lower price impact of trading smaller amounts. These results are consistent with the theory that dealers charge their less sophisticated, less well-informed customers much more than their more sophisticated, more well-informed customers.

Research by Erik Sirri on trading costs in the municipal securities market found a similar price impact based on trade size.[8] Sirri found that the average total price differential of moving municipal securities from one non-dealer investor to another dropped demonstrably as trade size increased. For example, Sirri found that trade sizes of up to $5,000 had an average total customer-to-customer differential of 246 bps (2.46 percent), whereas trade sizes of $25,000, which was the median trade size, had an average total customer-to-customer differential of 198 bps (1.98 percent). Larger trade sizes experienced even greater reductions in average total customer-to-customer differentials, with $100,000 trades resulting in a 28.7 percent lower average total customer-to-customer differential compared to $25,000 trades, and $1 million trades resulting in a 64.9 percent lower average total customer-to-customer differential compared to $100,000 trades.

In addition, Sirri found that 25 percent of all customer-to-customer transactions resulted in a total customer-to-customer differential of more than 288 bps (2.88 percent), and 10 percent resulted in a total customer-to-customer differential of more than 365 bps (3.65 percent). While these transaction chains did not factor in the number of dealers involved, the trade size, or the total length of time necessary to execute, these numbers suggest that it may not be out of the ordinary for many retail investors to pay extremely high transaction costs for their municipal bond transactions.

---

[6] Lawrence Harris and Michael Piwowar, Secondary Trading Costs in the Municipal Bond Market, *Journal of Finance* 61, 1361-1397 (2006), http://bit.ly/1J3owpC.

[7] Amy Edwards, Lawrence Harris, and Michael Piwowar, "Corporate Bond Market Transaction Costs and Transparency," *Journal of Finance* 62, 1421-51 (2007), http://bit.ly/1Bb6y0y.

[8] Erik R Sirri, Report on Secondary Market Trading in the Municipal Securities Market, July 2014, http://bit.ly/1xuslwC.

Sirri also found that paired-trade differentials are noticeably higher when trades involve a customer, as opposed to another dealer. For example, the average customer-to-customer differential was 178 bps (1.78 percent), whereas the average differential of moving municipal securities from another dealer to a customer who bought municipal securities was 146 bps (1.46 percent), and the average differential of moving municipal securities from a customer who sold municipal securities to another dealer was 67 bps (0.67 percent). As expected, the average differential of moving securities from one dealer to another dealer was the lowest, at 50 bps (0.5 percent). This evidence supports the conclusion that dealers may be taking advantage of less-informed customers by charging them higher transaction costs, while charging each other minimal costs to trade securities.

Bond Market Opacity

For all the recent attention U.S. equity market structure has received recently, there is much greater price transparency in our equity markets than there is in our fixed income markets. For example, retail stock investors can see a continuous stream of publicly available information about the prices at which other market participants may be willing to buy or sell stocks. No publicly available pre-trade price information exists in the bond market.

In addition, firms are required to provide on their customer's confirmation the transaction costs the customer paid for all stock transactions, regardless of whether the firms executed the transaction in an agency or principal capacity. In bond transactions, firms are only required to provide on their customer's confirmation the customer's transaction costs if the firm executed the transaction in an agency capacity. Thus, if an intermediary arranges a trade for a customer on an agency basis, the intermediary must disclose on the customer's trade confirmation the transaction costs he or she paid, reflected as a commission. However, if an intermediary arranges a trade for a customer on a principal basis, the intermediary has no duty to disclose on the customer's trade confirmation the transaction costs he or she paid, reflected as a markup or markdown. This is essentially a regulatory loophole that allows bond intermediaries to treat functionally equivalent transactions differently for disclosure purposes, based on how they choose to characterize their transactions.

Given this regulatory inconsistency, which allows firms to choose whether their clients receive confirmation disclosure of the costs they are paying, it is hardly surprising that firms execute virtually all customer transactions in a principal capacity. This allows firms to effectively withhold information from their clients that their clients would find useful. As a result, firms are able to charge more than they otherwise would if they provided that cost information to their clients. Ironically, because customers do not see any transaction costs on their confirmations, they may mistakenly believe that they aren't paying any trading costs on their bond transactions. In reality, they are likely paying some of the highest trading costs in the market.

We recognize that there have been notable efforts to increase post-trade transparency in the bond market in recent years. In July 2002, Transaction Reporting and Compliance Engine (TRACE) began requiring bond dealers to report transaction data in U.S. corporate bonds in near real-time to what was then the National Association of Security Dealers (now FINRA), which made that transaction data available to the public for free. Similarly, in January 2005, the MSRB began disseminating U.S. municipal bond pricing data to the public in real-time and for free. Market information was first posted on the Bond Market Association's investor education website, but was relocated in March 2008 to MSRB's Electronic Municipal Market Access (EMMA) website. There is evidence that overall transaction costs have decreased, both for corporate and municipal bond transactions, since transaction data has been made available.[9]

However, while overall bond trading costs have fallen as a result of increased price transparency, the evidence suggests that those benefits have not been noticeable for all investors. According to Commissioner Piwowar, for example, while institutional and sophisticated investors have seen their bond trading costs fall, retail investors' trading costs remain high. This is likely because institutional and sophisticated investors know that TRACE and EMMA exist, know how to access the information on those sites, and know how to interpret the transaction information that they find in order to gauge whether they are paying fair prices. Most retail investors, on the other hand, likely do not know the websites exist and, even if they did, are not in a position to use those websites with any reasonable degree of expertise. As a result, they likely are not able to realize the benefits that these websites can offer.

Unrealistic Expectations of Retail Investors

It's not realistic to expect retail investors to use TRACE and EMMA with any reasonable degree of expertise. In order to use TRACE and EMMA, one has to know each website exists and what specifically each website offers. It would likely confuse an investor that he or she has to go to different websites to see different types of recent bond transactions. Even assuming that a retail investor knows that those websites exist, one would have to know the precise information one is looking for; then, one would have to actually find that information. Finally, assuming that a retail investor knows what information to look for and finds it, one would need to be able to understand and make use of that information for one's benefit.

Assuming an investor Googles "FINRA TRACE" and clicks on the first option, the investor would somehow need to know—or find through trial and error—that out of the roughly seventeen options, he or she should click on "corporate bond data." Then the investor would have to click on www.finra.org/marketdata to find information on individual bonds, then enter relevant search terms, followed by agreeing to the user agreement, before coming to the relevant recent trade data. Once an investor finally navigated to the relevant data, he or she would have to make sense of it all. That would require an understanding of what all of the different columns mean (trade quantity, price, yield, coupon, maturity, time of execution, trade data), what the various rows mean in relation to one another, and how the rows and columns relate to the price the investor paid. Expecting an unsophisticated retail investor to navigate through this burdensome maze and then understand all of the data presented so that it is useful is too tall an order.

---

[9] Bessembinder, Maxwell, and Venkataraman (2006), Edwards, Harris, and Piwowar (2007), and Goldstein, Hotchkiss, and Sirri (2007) conclude that the increased transparency associated with TRACE transaction reporting was associated with a decline in investors' average trading costs in corporate bonds. *See* Hendrik Bessembinder and William Maxwell, Markets, Transparency and the Corporate Bond Market, Journal of Economic Perspectives, Volume 22, Number 2, Spring 2008. Deng (2013) and Sirri (2014) conclude that the MSRB's Real Time Reporting System and EMMA were associated with a decline in investors' average trading costs in municipal bonds. *See* Gene Deng, Using Emma to Assess Municipal Bond Markups, Securities Litigation Group, 2013.

EMMA is significantly easier to use than TRACE, with video tutorials and visual depictions of recent trade information. However, even EMMA requires a certain amount of sophistication to make use of the data that is presented. Despite EMMA's more user-friendly design, it is unrealistic to expect an unsophisticated retail investor to understand all of the data that is presented, and then to make productive use of that data.

To understand why it is unrealistic to expect retail investors to use TRACE and EMMA productively, one must consider a typical retail investor's financial literacy. Extensive research has documented the disturbingly low levels of financial literacy among American investors. For example, the SEC's August 2012 study regarding financial literacy among investors found that retail investors "do not possess basic knowledge of interest rates, inflation or risk, all of which are essential to making well-informed investment decisions."[10] More specifically, they are essential to making well-informed bond transaction decisions. If retail investors do not possess these basis levels of knowledge, there is little likelihood they will be able to use TRACE and EMMA with any degree of skill or expertise or even that they will know of their existence.

It may be particularly unrealistic to expect fixed income retail investors to use TRACE and EMMA. Fixed income markets are generally tilted to the elderly, and the elderly have been shown to use the internet in lower percentages than the general population. For example, while roughly 80 percent of American adults use the internet, only 54 percent above the age of 65 use the internet.[11] Thus, the retail investors who would most benefit from certain pricing information may not have access to it.

Method of Delivery Matters

The only way to ensure that retail investors are receiving necessary cost information is to provide it directly to them. Research shows that the method that information is delivered matters. Information must be provided in an easily accessible manner, with as few barriers as possible, to have the highest impact and be most effective. Just because the information is available somewhere does not mean that it will be accessed. And, in fact, when CFA surveyed investors for a report on internet disclosures, investors were very skeptical of disclosures being made available but not being provided directly.[12]

Therefore, for bond price disclosures to be the most effective and to fulfill investor preferences, we strongly support directly providing retail investors on their confirmations the costs they are paying, the costs their dealers are paying, and the differentials between those two prices. Directly providing retail investors with this information rather than requiring them to search it out on their own will lower the barriers to access that retail investors currently confront, increasing the likelihood that they see and understand the transaction costs they are paying. With this information presented to them, they will be in a better position to assess whether they are

[10] Study Regarding Financial Literacy Among Investors, As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Staff of the Office of Investor Education and Advocacy of the U.S. Securities and Exchange Commission, at vii-viii, August 2012, http://1.usa.gov/1fMABVZ.

[11] *See* Barbara Roper, Can the Internet Transform Disclosures for the Better?, Consumer Federation of America, January 2014, http://bit.ly/1CwEbJS.

[12] *Id*.

receiving a fair deal and whether their dealers are fulfilling their best execution duties. As a result, this information will allow retail investors to make more informed investment decisions.

With regard to the specific proposal, we believe FINRA and MSRB have done a sensible job in crafting a workable rule that is likely to benefit retail investors significantly. Regarding a few specific points:

- Defining "qualifying size" as a purchase or sale transaction of 100 bonds or less or bonds with a face value of $100,000 or less strikes us as a reasonable attempt to capture those trades that are retail in nature. According to Sirri's research in the municipal securities market, 14.7 percent of all trades were in par amounts over $100,000. Assuming those numbers are similar in the corporate context, it is likely that those trades are being undertaken by more sophisticated, wealthier investors, possibly even small institutions. However, it is still possible for unsophisticated retail investors to be trading more than what is considered a qualifying size under the rule. Moreover, it might be possible for dealers to game the system by conducting transactions that fall just outside the size limits of the rule. Therefore, we urge FINRA and MRSB to continue to monitor the costs of transactions that fall outside the definition. If it appears that certain investors are transacting in larger quantities and par amounts and are being taken advantage of by paying excessively high transaction costs, and FINRA and MSRB believe that they are paying those costs because the definition of qualifying size is too narrow or too rigid, FINRA and MSRB should seek to expand the definition of the rule.
- Limiting the proposal to same trading day appears to be a reasonable constraint on the application of the rule. FINRA has observed that over 60 percent of retail-size customer trades recently had corresponding principal trades on the same trading day. In over 88 percent of these trades, the principal and the customer trades occurred within thirty minutes of each other. Similarly, Sirri found that 57.7 percent of the total number of trade pairs occurred on the same day, and that almost 85 percent of same day pair trades occurred within thirty minutes of each other. If current trading patterns continue, these trades will be captured under the rule. However, it is possible that dealers' trading patterns might change to avoid having to comply with the rule. For example, they could hold positions overnight to avoid being subject to the disclosure requirements of the rule. While we don't think firms are likely to subject themselves to substantial increases in risk merely to avoid complying with the rule, we cannot rule out the possibility that they would view this as a reasonable risk. We therefore urge FINRA and MSRB to continue to monitor trading activities to ensure that the intent of the rule is being fulfilled to the maximum extent possible.
- We strongly support requiring disclosure of pricing information for all trades in the same security on the same day of trading rather than limiting disclosure to riskless principal transactions. We agree that it will allow for a more mechanical approach by firms than a riskless principal approach, which may require firms to conduct a trade-by-trade analysis to determine whether a specific trade was "riskless." This approach will also allow for a

more mechanical regulatory review for compliance by FINRA and MSRB. Toward this end, we are pleased that vague and difficult to apply terms such as "essentially riskless" and "nearly contemporaneous" were not included in the rules' language.

- One clarification in the proposal is absolutely necessary regarding disclosure of the difference between the customer's price and the intermediary's price. We strongly urge FINRA and MSRB to require dealers to disclose the amount of the price differential BOTH as a percentage of the total amount AND as a total dollar amount based on the number of bonds purchased or sold. Ample research shows that retail investors have trouble comparing percentages and total amounts in costs, and that total dollar amounts are far more compelling to investors than percentages.[13] Furthermore, as question 5 in FINRA's proposal demonstrates, even in the simplest of transactions, several steps would be required for an investor to compute the total dollar amount differential. The likelihood of human error is extremely high. And, if retail investors do in fact make computational errors, the utility of this entire proposal will be seriously diluted. Therefore, it is imperative that this information be provided to retail investors in the clearest way possible.

Countering Industry's Arguments

We expect extensive industry opposition to this proposal, given that dealers have a vested interest in maintaining a certain level of opacity in this market so they can continue to extract rents from less-informed customers. This proposal is likely to threaten dealers because fostering increased price awareness and competition will ultimately lower investors' transaction costs, thereby lowering dealers' profits. We would like to address several industry arguments we have already seen:

- "Investors may see the prices and price differentials they are paying, but not understand them in the context in which dealers operate. Those prices don't reflect all the work dealers undertake to arrange customer transactions." That may be true. Dealers are entitled to reasonable compensation for their services, and if certain services, such as locating and arranging transactions in illiquid securities, are more labor intensive, dealers should be paid accordingly. However, that does not mean their customers should not be provided necessary cost information. What it means is dealers should be able to justify the costs that they charge their customers.
- "Investors will be annoyed and confused to see the costs they are paying." The implication of this argument is that investors are not aware of the costs they are paying now, and letting them in on the truth of what they're actually paying will make them upset. Perhaps they should be upset to learn the amount of transaction costs they've been paying. As a result of providing customers cost information directly, it may create an environment in which they are able to be more cost sensitive.
- "More price transparency will harm bond market liquidity." This is the same argument the Bond Market Association, the trade organization for bond dealers, made when

[13] *Id*.

TRACE became operational. While industry claimed that corporate bond trading would be more difficult, several studies found that trading costs decreased, and liquidity and trading activity increased. There is no reason that providing much of the same information through a more effective transmission channel will have any deleterious effect on liquidity.

Conclusion

While we do not believe that disclosure alone can address the many issues that affect retail investors, disclosure is an essential investor protection tool that, if done properly, can increase the likelihood that investors make more informed choices. Even minor improvements to the content and delivery of the disclosures that retail investors receive can influence investors' understanding of information and the choices they make as a result.

Retail investors in fixed income markets currently are paying extremely high transaction costs, and evidence suggests that they are paying those costs because they are not being provided essential cost information. These proposals will put retail investors in a better position to understand the costs they are paying and to assess whether those costs are reasonable. The information that is provided will also foster increased price competition in fixed income markets, which experience suggests will ultimately lower investors' transaction costs. We therefore strongly support FINRA's and MSRB's proposals to enhance fixed income market transparency for retail investors.

Respectfully submitted,

Micah Hauptman
Financial Services Counsel