

November 7, 2018

Submitted Electronically

Lynnette Kelly
President and Chief Executive Officer
Municipal Securities Rulemaking Board
1300 I Street NW
Washington, DC 20005

RE: Comments on the MSRB Report “*Transaction Costs for Customer Trades in the Municipal Bond Market: What is Driving the Decline?*”

Dear Ms. Kelly:

On behalf of the Bond Dealers of America (“BDA”), I am submitting this letter to provide response comments to the MSRB’s Report on “*Transaction Costs for Customer Trades in the Municipal Bond Market: What is Driving the Decline?*” (the “Report”). The BDA is the only DC-based group representing the interests of securities dealers and banks exclusively focused on the U.S. fixed income markets.

The BDA believes that the MSRB Report does not provide a complete picture of all the major contributing factors that led to the steady decline in the effective spread in the municipal securities market between 2005-2018.

The BDA recognizes that market-wide technological advancements, interest rates, as well as MSRB regulatory activities have each played a role in the decrease in effective spread for dealer-customer municipal securities trades. However, we disagree, as the Report indicates, that market-wide technological advancements as well as MSRB’s regulatory activities alone have likely accounted for a significant portion of this downward trend. We believe that the Report oversimplifies various findings as additional market dynamics have also factored into the evolving nature and trend of municipal securities transaction costs. We also believe that the MSRB should have taken into greater consideration the unique market environment between 2005-2018 (low interest rates, nominal yields, reduced market maker risk, trading dynamics, investments in internal technology), which significantly contributed to the decline in effective spread in the municipal bond market.

- *The BDA believes that a contributing factor to the lower spreads was an overall low interest rate environment, which resulted in lower volatility for market-making firms. Equating lower spreads with good execution is an incorrect premise in many instances.*

Between 2005 to the beginning of 2018, interest rates in the United States and around the world, both short and long-term, were exceptionally low. As such, the time period from which the data sample was collected and analyzed for the findings of this Report, was a unique time and market environment for municipal bonds. As interest rates approached *historical lows during a period of unprecedented quantitative easing*, these lower benchmark interest rates were a major contributing factor to the decline in spreads.

The BDA believes that the Report fails to acknowledge that the correlation of lower yields to lower spreads is high and statistically significant. Lower yields and tighter spreads left less flexibility for higher markups. As interest rates moved lower and volatility decreased, this also added to the perceived reduced risk of holding inventory. The lower the perceived risk of holding inventory, the lower the need for a higher markup, which equates to lower spreads. If interest rates continue to move higher, as we are currently experiencing, the BDA believes that the average effective spread may stabilize or even increase.

- *The BDA believes that the MSRB should have also taken into account the impact of dealer intermediaries in their calculation of transaction costs as a potential factor in the overall reduction in spreads.*

The BDA believes that the MSRB did not gather adequate data for this Report to analyze how dealer intermediaries contributed to a cumulative transaction cost for end investors—where a municipal security is sold through a number of dealers before the end investor purchases the security. The Report does not clearly outline how intermediary transactions were factored in calculating the spread. The yield that the end investor receives is most important in determining overall transaction costs, and the trades that run through intermediaries and alternative trading systems (ATSs) can sometimes show a lower spread, but also result in the investor receiving a lower yield. In addition, transaction costs through various dealer intermediaries may obscure the full cost of transactions because of the lack of full transparency and emergence of more intermediaries. The Report fails to show how multiple transactions by dealer intermediaries may have actually increased overall spreads for end investors.

- *While the BDA recognizes that MSRB rulemaking efforts related to trading have contributed to the reduction in spreads, current trading dynamics in the secondary market have made a greater impact on the reduction in the spread.*

The BDA does not agree with the MSRB Report that there is more frequent turnover of securities among end investors of municipal securities. In the marketplace, 85 percent of a particular bond's lifetime trading activity happens in the first 30 days, primarily because bonds are priced more efficiently, and find an "end investor" sooner. The technology improvements allow broader market access to these market offerings, which are viewed by more investors on a quicker timeline.

The BDA agrees that electronic trading venues have brought some transparency and efficiency into the marketplace, however, not all of the technological advancements have benefited retail investors.

A major factor that has led to the reduction in spread is related to the investment that market-makers have made in their internal technology to increase transparency and efficiency. A quick look on the Internet by an end retail investor quickly provides thousands of offerings each day on available investments.

The BDA believes that the Report overstates the impact that electronic trading platforms and ATS have had in reducing spreads in the municipal securities market. ATSs have benefitted from the proliferation of algorithmic trading where a bid is generated by machine and upon purchase the ask is automatically piped into the ATS creating an appearance of tight, liquid markets. As market disruptions occur, the “algos” are generally disabled and/or the spreads are widened.

Electronic trading venues and ATSs have represented a major positive development in the municipal securities market and have provided a key venue for municipal securities trading. But we question whether trading on electronic trading platforms have matured to the point where they impact spread to the degree mentioned in the Report. Given that tax-exempt municipal bonds cannot be shorted, there will not be an offer made unless someone (customer, dealer, etc.) owns the bonds. When an offering is made, the normal practice is to make the offering to all ATS s(at the street/retail price) creating the illusion of more choices available in the market, when in fact there is usually only one party that actually controls the offering. Conversely, if a given party “owns the CUSIP”, which is very common, they can make a very tight two-sided market with an above market bid-side to support the offer knowing they will not or cannot hit the bid. On voice trades, counterparties often “call out” these abusive situations by asking for a bid on a comparable bond. With the anonymous nature in electronic trading, most ATS venues do not accommodate this self-policing behavior.

- *The BDA believes that the proliferation of the ATSs, as well as other contributing factors, have caused a shift in behavior by market-makers away from a risk-taking approach acting as principal to a riskless-principal approach.*

Over the last several years, the proliferation of the ATSs have created a prominent shift in behavior among market makers. While it appears retail may benefit in the short term, it is much less certain what the long-term implications will be for the end retail investor, and the municipal market generally.

The BDA believes that the Report overall failed to evaluate whether spreads have been reduced for the actual individual investor who, in many instances, saw spreads increase substantially.

The BDA believes that the Report evaluated data based primarily on trades from dealers to investors and has not taken into consideration structured products by investment advisors and others who will purchase municipal securities from a dealer at thin margins and then re-package those municipal securities into structured products. This results in much higher spreads to the end retail investor, which does not take into consideration the ongoing “management” expense related to maintaining the investment for the client. The increase in managed accounts and structured products has skewed spreads lower while the expenses resulting from these strategies has increased the cost to retail investors.

The BDA believes that the Report narrowly focuses on the reduction in spreads and gives an incomplete analysis of how liquidity in the municipal securities market has decreased over the same period.

The BDA believes that the Report gives an inaccurate analysis of measuring the reduction of liquidity in the municipal securities market since 2010. The Report states that a “metric used to measure liquidity is the turnover ratio, which measures the annual trading volume relative to the amount of outstanding debts.” The BDA asserts that solely using the turnover ratio in a non-stressed financial time does not give an accurate measure of liquidity in the municipal market. We believe that a more appropriate metric to measure liquidity is the number of dealers who consistently commit capital in the municipal securities market. It can also be seen in subjective ways – how traders sense the levels of liquidity in the municipal securities market now as opposed to 2010.

The dramatic increase in legal and compliance costs in a declining profit spread environment are the primary reasons so many dealers have either shuttered their municipal securities business, reduced their capital commitment or exited their fixed income line of business. We also do not believe that liquidity is accurately tested in ordinary market conditions, and the reduction in liquidity does not necessarily adversely affect investors now (as is reflected in the reduction of spreads), however, when the market experiences disruptions like 2008-09, the lack of liquidity may cause enormous harm to investors.

In conclusion, the BDA cautions the MSRB from using this Report as the benchmark for future research and encourages the MSRB to use extreme caution prior to relying on any findings in this Report prior to making any final recommendation for future rulemaking.

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Thank you for the opportunity to provide these comments.

Sincerely,



Mike Nicholas
Chief Executive Officer