Do Municipal Bond Dealers Give their Customers ‘Fair and Reasonable’ Pricing?*

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We focus on the practices of the financial industry in an over-the-counter market where best execution is required but not strictly examined and enforced. The municipal bond market has experienced some decreases in markups to small clients in seasoned issues over the last fifteen years, but the new-issue market has experienced no decrease in markups or markup dispersion despite several significant reforms in pricing and reporting requirements. We explore markup differences both across dealers and within dealers. Across dealers, there is significant dispersion in markups to small customers. While a small set of dealers charge negligible markups, 51% (56%) of the dealers in the market for newly-issued (seasoned-issue) bonds charge median markups of one percent or more. These dealer-specific differences cannot be explained by dealer cost, network centrality, bond characteristics, or bond/day fixed effects. Even when considering trading in the same bond on the same day by different dealers, there are significant costs differences across dealers that range up to two percent. There are also substantial within-dealer differences in pricing, including on identical bonds on the same day, suggesting that many dealers treat their small clients unequally. Overall, our evidence suggests while a subset of dealers focus on best execution for clients, many dealers price municipal bonds opportunistically despite significant changes in the regulatory environment.

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