Conflicts of Interest in Municipal Bond Advising and Underwriting

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Conflict of Interest: "a situation in which a party to a transaction can potentially gain by taking actions that adversely affect its counterparty" (Mehran and Stulz, 2007)

Conflicts of interest common when acquiring financial information

- Credit Rating Agencies
  (Jiang, Stanford and Xie, 2012; Griffin and Tang, 2011)
- Equity Research
  (Agrawal and Chen, 2008; Fang and Yasuda, 2009)
- Retirement planning services
  (Boyson, 2019; Bhattacharya, Illanes and Padi, 2019)

Of potential conflicts in muni bond issuance, focusing on underwriters who also sell advice

"Right now, a financial professional advising a municipality can guide the municipality towards securities tailored to his firm's advantage, then resign and act as underwriter. This is a classic example of conflict of interest."

- Mary Schapiro, Chair of the SEC, May 7, 2010

Quasi-Experiment from Recent Regulation:

- Dodd-Frank (2010) charged SEC and MSRB with regulating advice
- May 2011, MSRB updated Rule G-23: "Activities of Financial Advisors"
- Forbids advisors from underwriting same issue, in effect Nov. 27, 2011

Does prohibiting advisors from underwriting affect borrowing costs?

- Fixing a conflict of interest lowers costs (SEC, 2010; MSRB, 2011)
  - Advisor Underwriter $\downarrow \implies$ Advice Quality $\uparrow \implies$ Costs $\downarrow$
- Taking away a potential underwriter raises costs (Bond Dealers of America, 2019)
  - Advisor Underwriter $\downarrow \implies$ Underwriter Competition $\downarrow \implies$ Costs $\uparrow$

Effect of limiting dual advising on 20,038 competitive bond sales

- Diff-in-diff Results: Borrowing costs $\downarrow$ by 5.3% (11.4 basis points)
- Driven in part by $\uparrow$ underwriter competition: 0.9 more non-advisor underwriters competing
  - Larger impact on less competitive auctions, schools

Municipal Bond Issue Data

Four primary data sources:

- SDC Platinum for bond issues and characteristics
- The Bond Buyer for bids and bidder identities
- MSRB EMMA for secondary market prices and yields
- Financial advisor ownership from Bergstresser and Luby (2018)

Sample of interest:

- 20,038 tax-exempt, general obligation, **competitive** issues over $1 million, repeat issuers
- 4,093 unique issuers issuing 4.9 times on average
- Sample ends in 2015 before fiduciary rule (Rule G-42)

Research Design: Difference-in-Differences

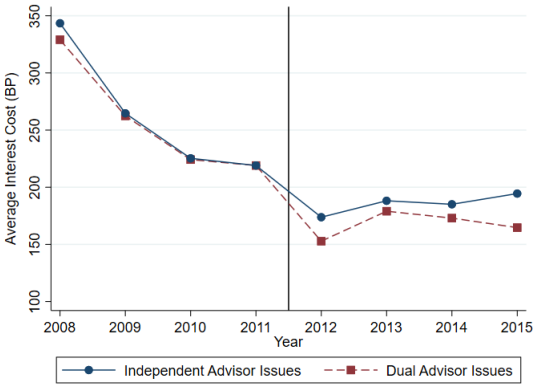
- Potential "Dual advisor" $\equiv$ advisors whose firm underwrites issues they advised pre-2011
- Dual Advisor market shares and trends

Difference-in-Differences Regression Model

$$Y_{ijt} = \alpha_j + \beta(\text{Dual}_{ijt} \times \text{Post}_t) + \delta_2 \text{Dual}_{ijt} + \delta_1 \text{Post}_t + \xi X_{ijt} + \varepsilon_{ijt}$$

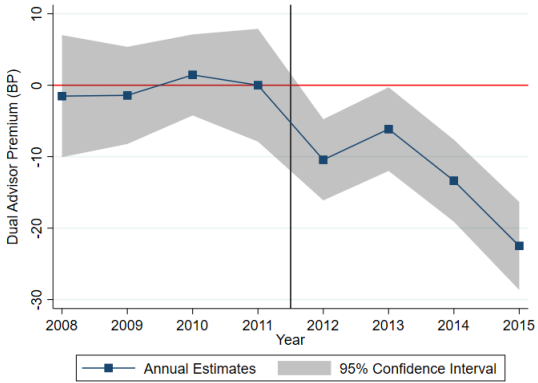
- i denotes issue, j denotes municipality, while t denotes date
- Y_{ijt} is the interest rate or number of auction participants
- Post_t is an indicator function for dates after November 26, 2011

Raw Difference-in-Differences (Winning Bid)



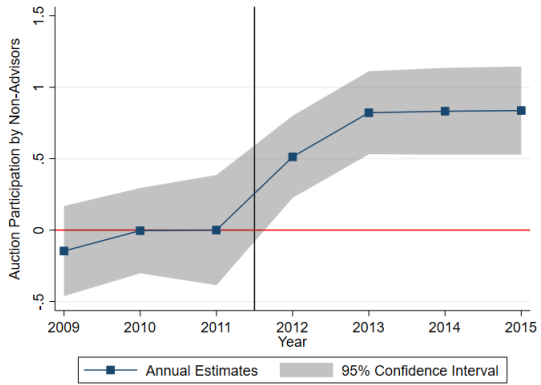
- Normalizing levels in 2011

Conditional Difference-in-Differences (Winning Bid)



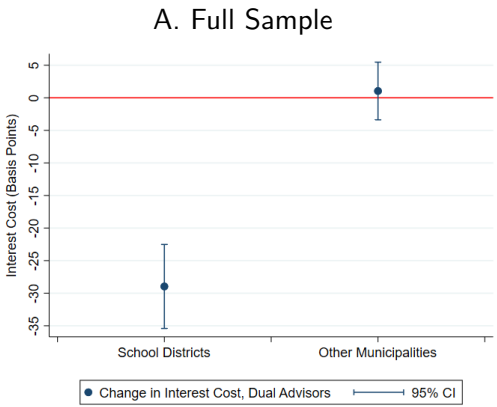
- Borrowing costs decrease by 11.4 basis points on average

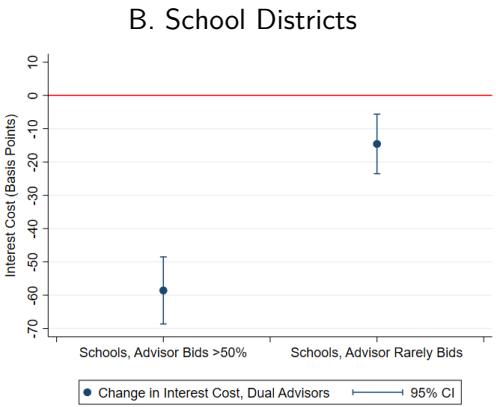
Conditional Difference-in-Differences (Number of Bids)



- Auction participation by non-advisors up by 0.9
- Total auction participation increases by 0.4

Change in Winning Bid by Issuer Type





Research Design: Difference-in-Differences

Identifying assumption: parallel trends

- Without intervention, dual and independently advised issue outcomes change in parallel

Threats to Identification and Tests

- Selection into using dual advisor changing?
  - Define issuer-level treatment $Dual_j \in [0, 1]$ based on pre-regulation behavior
- Dual advisors specialize in small, long maturity issuers. Different outcomes?
  - Complementary cross-sectional identification using selection model (ATE)
- Market factors influencing types of advisors differently?
  - Placebo test using untreated advisors associated with investment banks

Mechanisms: Increasing Standardization, Liquidity

Several margins where bond structure can affect borrowing costs

- Advisors can "guide the municipality towards securities tailored to his firm's advantage"
- Find 3 changes in bonds issued with dual advisors after regulation:
  - School bonds increase likelihood of credit ratings (Wes Clarke, 1997)
  - School bonds increase likelihood of credit enhancements
  - School bond term structure changes slightly (shorter maturities, one CUSIP per year, etc.)
- Manifests as increased liquidity and decreased price dispersion in secondary markets

Mechanisms: Asymmetric Information in Auctions

- In a common value auction with asymmetric information:
  - Informed underwriter (advisor) gets positive information rents
  - Other underwriters randomize bids for zero expected rents
- **Hypothesis:** advisor wins auction $\implies$ larger profits (gross spread)
- Calculate gross spread as bid minus average market yield (7 day)
- In preperiod, regress spread on advisor bid and advisor win indicators
  - Gross spreads 3.5 bp (6%) lower when advisor bids and loses
  - Auctions that the advisor wins have higher gross spread
- Evidence of asymmetric information and **winner's curse** pre-MSRB Rule G-23

Does prohibiting advisors from underwriting affect borrowing costs?

- Yes, borrowing costs decrease when advisors cannot underwrite
- Advisor bids more than fully replaced by other underwriters
- Low competition issuers, schools are the winners in the regulation
- Fiduciary rules, alone, would not fix negatives of allowing advisors to underwrite due to harming competitive interactions