

Dealer Networks

Dealers in decentralized over-the-counter markets form networks to mitigate search frictions. The MSRB Transaction Reporting System audit trail shows the dealership network in municipal bonds is sparse and exhibits a tiered core-periphery structure with 20-30 highly interconnected core dealers and several hundred peripheral broker-dealer firms. Order execution quality varies strongly across dealers depending on their centrality. Consistent with lower search frictions, central dealers place bonds more readily with investors than peripheral dealers. Yet, central dealers charge larger markups to investors than peripheral dealers. They can do so by providing better liquidity terms, including pre-arranging fewer trades, keeping bonds longer, and holding larger and more volatile inventories. Investors with high liquidity needs trade with central dealers, in less liquid bonds and when market liquidity is low. Central dealers thus serve as liquidity providers of last resort.

JEL Classification: G12, G14, G24

Key words: Municipal bonds, over-the-counter financial market, trading cost, liquidity, transparency, decentralization, market quality, product differentiation, network analysis