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Dealers: Proposed MSRB Minimum Denomination Rule Would Hurt Liquidity.

WASHINGTON – Dealer groups are concerned that a proposed Municipal Securities Rulemaking Board standalone minimum denomination rule would hurt liquidity and adversely affect participants in the market.

The MSRB's proposed Rule G-49 would incorporate requirements in the board's existing Rule G-15 on confirmation, which was amended in 2002 to prohibit dealers from engaging in transactions with customers in amounts below the minimum denominations of municipal securities set by the issuers. The proposed rule also would include four exceptions to the rule, two of which were included with the 2002 prohibition and two that were proposed in April of this year to help maintain liquidity for below-minimum positions.

The minimum denomination for a bond is the lowest amount of the bond that can be bought or sold, as determined by the issuer in its official statement for the bonds. Issuers sometimes set higher minimum denominations on bonds that are risky to discourage retail investors from buying them. In addition to a minimum denomination, issuers can also set a trading "increment" for their bonds. An increment of $10,000 for example would mean a dealer could sell a customer $110,000 of bonds but not $105,000.

Mike Nicholas, chief executive officer for Bond Dealers of America, said in a comment letter submitted to the MSRB that the proposed rule "is extraordinarily complex and dealers have serious concerns with confusion arising regarding different interpretations of what is a permissible transaction under the rule."

"From a practical standpoint, the result of this complexity is that customers will be left with positions in municipal securities that they will not be able to trade or will only be able to trade at inferior prices," Nicholas said.

He added that the rule should be more narrowly tailored to focus only on those minimum denominations that an issuer sets because of suitability concerns for investors that are not considered sophisticated.

"This change will allow bonds with minimum denominations set due to normal market convention to freely trade without a detrimental impact on liquidity, pricing, or investor protection," Nicholas wrote.

Leslie Norwood, managing director and co-head of municipal securities for the Securities Industry and Financial Markets Association, said that while SIFMA thinks there are some improvements in the standalone rule, it is overly complex and contains several changes that would "result in less liquidity for customers and create additional and unnecessary challenges for dealers."

One change proposed by the MSRB would be the elimination of the current requirement that a dealer, in some situations, must obtain a "liquidation statement" from a party that isn't the dealer's

customer and is the party from which the dealer purchased the securities. The liquidation statement must be obtained before the sale of securities to another customer and must confirm that the original selling customer has fully and completely liquidated its below-minimum position. Dealers had said in previous comment letters that the requirement can be an impediment to using alternative trading systems or broker's brokers to sell below-minimum positions because of concerns about disciplinary actions, among other things.

While the MSRB is proposing to delete the requirement for liquidation statements, it makes clear in its request for comment that it would still require a dealer purchasing a below minimum position from one of its customers and selling it to another to confirm that the selling customer has fully liquidated its position.

The liquidation statement is key to one of the existing exceptions the MSRB adopted as part of Rule G-15. Under that exception a dealer could sell a below- minimum denomination amount of a bond to a customer if the sale is a result of another customer liquidating his or her entire position in the bonds.

The elimination of the liquidation statement requirement would also affect another exception that was proposed in April and would have required such a statement. That exception would allow a dealer that has bought a customer's liquidated position in an amount less than the minimum denomination to sell those bonds to one customer with no prior holdings of the bonds and to any customers who already have positions in the bonds.

SIFMA said in its most recent comment letter that it supports the elimination of the liquidation statement, but noted that its reading of the new proposed rule finds the MSRB narrowed the exception that was proposed in April and would be affected by the liquidation statement change. The exception in the proposed rule says that a dealer can use the provision if the below-minimum position it is selling was acquired by the dealer in an interdealer transaction and the amount being sold is the same amount as the below-minimum denomination position that the dealer acquired in the interdealer transaction, according to SIFMA.

Norwood said that it "seems inappropriate" that the proposed rule allows a dealer to use the exception if the dealer acquires the position in an interdealer transaction but doesn't allow a sale under the exception if the dealer acquired the position from a customer.

"By limiting this exception to positions acquired from dealers, the MSRB is effectively limiting liquidity for customers that have below-minimum denomination positions," SIFMA said. "We believe [the exception] should … be available to dealers, regardless of whether the bonds were purchased from a customer or a dealer …. The source of the bonds should not matter in this instance, as that fact has no impact on whether additional below-minimum denomination pieces are being created."

Norwood added that if the proposed rule is amended as SIFMA is requesting, another exception that the MSRB had written into the rule would become redundant and should be eliminated. That exception would allow a dealer to sell bonds to any customer with a prior position as long as the sale brings the customer to or past the minimum denomination. The dealer could then sell the remaining below-minimum position to any number of customers that already hold the bonds.

She also said SIFMA believes a section of the proposed rule that the MSRB called a "new safeguard" in light of its elimination of the need for a liquidation statement should be deleted. The safeguard would prohibit a dealer engaged in an interdealer trade from selling less than all of a below-minimum denomination position that the dealer acquired either from a customer that fully liquidated its below-minimum position or from another dealer. That prohibition would satisfy the MSRB's goal

by preventing the creation of additional below-minimum denomination positions, the board said.

Norwood, who emphasized the point of the rule is to prevent dealers from engaging in transactions with customers, not dealers, below the minimum, said the MSRB's idea is "unwarranted, harms liquidity and is inconsistent with the original purpose of the rule of customer protection."

Nicholas made a similar argument, saying that "the practical result of [the rule] denying dealers … flexibility is that dealers will be left with positions that will not trade and, therefore, dealers will not provide liquidity in certain situations."

He cited an example where a dealer buys a customer's liquidated position and then sells only a portion of that position to another customer to bring the second customer above the minimum denomination. Under the proposed rule, Nicholas says, the dealer could only sell the remaining part of the original liquidated position to one or more customers with an existing position in the issue and could not sell the remaining position to another dealer.

"BDA members believe that, in this instance, interdealer sales should be given the same treatment as customer sales," Nicholas said.

SIFMA additionally raised concerns about compliance costs to market participants from the rule and asked that the MSRB more effectively leverage its EMMA system to increase transparency related to below minimum denomination transactions. Part of that effort should be amending MSRB Rule G-32 on disclosures in connection to primary offerings to require the filing of minimum denomination information on EMMA on all transactions, according to SIFMA.

In the proposed rule, the MSRB would eliminate a condition it had put into its two additional exceptions proposed in April that would have required a dealer's sale to a customer to be consistent with any restrictions in the issuer's official statements regarding increment amounts.

Commenters had said the increment condition would unnecessarily limit the transfer of positions held by customers instead of providing more flexibility.

The draft rule will also carry over provisions that applied to past exceptions and require a dealer to use account records it has or written statements the customer provides when the dealer is buying from or selling to a customer. Dealers will also still be required to give or send to purchasing customers written statements telling them that the quantity of securities being sold is below the minimum denomination for the bonds and that its below-minimum nature may adversely affect the liquidity of the customer's position.

The Bond Buyer

By Jack Casey

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