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'Flipping' Cases Raise Systemic Muni Market Questions.

WASHINGTON – Activities like the flipping and kickback scheme regulators brought to light in California last month could undermine the integrity of municipal offerings, though one market participant suggests such conduct may be an unintended consequence of efforts to police priority order periods.

The Securities and Exchange Commission took administrative actions earlier this week to bar or suspend several more employees of RMR Asset Management, a California-based firm that allegedly participated in a years-long scheme that the SEC is continuing to investigate.

It is unclear how pervasive such conduct is in the muni market, but the Municipal Securities Rulemaking Board is concerned enough with what it calls “pre-arranged” trading that it plans to issue a request for comment regarding the practice.

The actions announced late Tuesday included orders against RMR and seven individuals charged with posing as retail investors in order to gain priority access to new-issue munis that were then “flipped” for profit to their own customers as well as the customers of other broker-dealers. In addition to sanctioning the firm, the SEC barred or suspended RMR owner Ralph Riccardi as well as “independent contractors” David Luttbeg, Philip Weiner, David Frost, Timothy McAloon, Douglas Derryberry, and Dewey Tran.

Taken together with previous actions, nearly the entirety of RMR has now settled with the Commission following separate judgments levied against them in federal court, while neither admitting nor denying the SEC’s findings. Others continue to face litigation.

According to the SEC’s complaint, the men operated as unregistered brokers from 2009-2016 when they used fake business names linked to local zip codes in order to fool issuers of muni bonds into thinking they were local retail investors. This alleged ruse gave them priority to purchase bonds, which they then sold to customers who had indicated interest in them. This was usually “at a price of one dollar above the initial offering price, without negotiation and irrespective of market value,” the SEC said in its complaint.

The case also involved another firm allegedly operating as an unlicensed broker-dealer, Core Performance Management, and the former head of municipal underwriting, sales and trading at registered New Jersey-based broker-dealer NW Capital Markets Inc.

LeeAnn Gaunt, chief of the SEC Enforcement Division’s Public Finance Abuse Unit said last month that the conduct alleged in the complaints “prevented true retail investors from receiving priority in municipal bond offerings.”

The SEC is not alone in its concerns, according to MSRB Chief Regulatory Officer Lanny Schwartz and MSRB General Counsel Michael Post. The two men noted that the MSRB amended its Rule G-11 on primary offering practices in 2013 to require dealers to report to underwriters whether orders they received in a retail order period met the issuer’s requirements for that order period.

MSRB rulemaking over the years has aimed to give the issuer considerable power to make determinations about retail order periods and other preferences, Schwartz and Post said, and conduct undermining those efforts troubles the board.

“Yes, we are concerned,” Schwartz said Wednesday.

The MSRB had been planning to ask the market to weigh in on whether it should issue new guidance under Rule G-17 on fair dealing that would address so-called “pre-arranged trading” that in some cases can look like the conduct alleged in the SEC’s complaints against RMR and Core Performance Management. But because the SEC has brought this enforcement action and is continuing to investigate, Schwartz said, the MSRB is now “waiting for the dust to settle” before returning to the idea in the future.

According to a document circulated by the MSRB, the board is concerned about situations in which a dealer contractually agrees to buy bonds from an investor at a markup in order to have a better chance of getting those bonds into its inventory. The dealer compensates the investor with that mark-up because it believes it will be able to sell those bonds at an even higher price in the secondary market. The MSRB said in that document it has concerns about customer orders being given less priority because orders appearing to be for an investor but which in reality are dealer stock orders get priority.

Such arrangements are often made through institutional investors, rather than retail investors, although some sources said retail investors can also figure into such arrangements.

The MSRB wanted to know, according to the document, whether such conduct was fair and whether or not the MSRB’s concerns were valid. A lawyer who asked not to be identified said there appears to be a roughly equal split on those questions.

Dee Wisor, an attorney at Butler Snow in Denver, said he was not aware of any pervasive problem with “flipping” or pre-arranged trading. But he said issuers would probably care if retail order periods were being flouted.

“That’s where they’d be concerned,” Wisor said. “If somehow bonds weren’t ending up with people in their local communities, if that’s what they want.”

Another lawyer said that pre-arranged trading and flipping are incentivized by the MSRB’s efforts to crack down on the historically more loosely-regulated area of retail and other priority order periods. While the lawyer agreed that colluding to subvert the issuer’s stated criteria for orders was wrong, he said he thought an investor could legitimately purchase bonds to sell to an interested dealer at a profit so long as such activity was not frequent enough to become his or her “business,” as they might then become an unregistered broker dealer because the law defines a dealer as one “engaged in the business” of buying and selling securities.

“How tightly one should define and enforce retail order periods is a question in itself,” the lawyer said. “Are we just going to be chasing our tails for years?”

By Kyle Glazier

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