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FINRA Examining Puerto Rico Bond Sales; SIFMA Sends Out Notice.

WASHINGTON — The Financial Industry Regulatory Authority is examining allegations that broker-dealers violated municipal rules by trading bonds from Puerto Rico's recent $3.5 billion general obligation deal to customers in sizes less than the required $100,000 minimum denomination.

"FINRA is aware of this situation and is examining trading activity in this Cusip," a FINRA spokesman said, referring to the 74514LE86 identifier of the bonds.

Also on Friday, the Securities Industry and Financial Markets Association sent out a notice to members urging them to make sure they are complying with the minimum denomination requirement.

"We urge firms to examine the minimum denomination provisions of the official statement carefully and to take steps to ensure that all trades are in compliance with the minimum denominations established by the issuer," SIFMA said in the notice. "For example, we urge firms to take care in cases where customers may request to split trades among accounts in ways that would result in trade sizes smaller the minimum denomination."

The actions follow a story The Bond Buyer released Wednesday morning that said broker-dealers — in some 70 transactions executed between 9:16 a.m. on Tuesday, March 11, through 4:30 p.m. on Tuesday, March 18 — sold the Puerto Rico bonds to customers in amounts below $100,000.

The OS for the bonds stipulated that they should not be sold in minimum denominations of less than $100,000 unless of one of three major rating agencies — Standard & Poor's, Moody's Investors Service and Fitch Ratings — upgraded the rating on them to investment-grade from speculative.

The idea behind the minimum denomination requirement was to ensure the bonds would not be sold to retail customers who might not fully appreciate the risk of holding them.

The MSRB's Rule G-15 on uniform practice requirements prohibits broker-dealers from executing trades in sizes below the minimum denomination set by the issuer, except in very limited circumstances. The board's guidance on Rule G-17 on fair dealing says that a dealer would violate that rule if it fails to disclose to a customer that it is buying bonds below a required minimum denomination and that this could affect the liquidity of the customer's position.

In a new examination of the trade data on the MSRB's EMMA system, The Bond Buyer found six more sales of less than $100,000 of Puerto Rico bonds to customers, including two of $35,000 each executed on Thursday.

Michael Decker, SIFMA managing director and co-head of munis, told The Bond Buyer in an interview he initiated on Friday that he has been talking to members about the situation.

"It is true that some firms inadvertently did execute customer trades below the minimum denomination," he said. Some of them have cancelled those trades when alerted to the requirement, he added.

"The minimum denomination provision is really novel," Decker said, "I've not heard before a minimum denomination feature that's triggered off of the bond rating," adding some traders "didn't pay close enough attention" to the provision.

"It's very important that traders and sales people read the official statement carefully, understand the minimum denomination provision and make sure that all the trades they execute are in compliance," he said.

"Dealers have to take responsibility for this issue," he said. "They shouldn't depend on the trustee, the clearing utility or trading platforms to monitor any of this," he said.

Susan Collet, senior vice president of government relations at Bond Dealers of America, said Friday, "We certainly support regulators getting to the bottom of what occurred. She said trades below the $100,000 minimum denomination represent an "operational failure" and that "Clearly, broker-dealers need to follow the rules."

BY LYNN HUME and KYLE GLAZIER

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