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Chan Warns Of Secondary Market Crackdown.

WASHINGTON - Though the municipal market has recently been focused on primary market disclosure compliance, dealers should expect the Securities and Exchange Commission to start policing the secondary market just as diligently, warned former SEC enforcement lawyer Peter Chan.

In an interview with The Bond Buyer, Chan, who left the SEC early this month and now practices at Morgan, Lewis & Bockius in Chicago, said SEC Commissioners' concerns about activities in the secondary market will inevitably lead to an increased focus on them by the muni enforcement unit.

Market participants have been buzzing about the SEC's Municipalities Continuing Disclosure Cooperation Initiative, created by Chan, which targets misleading statements about continuing disclosures in official statements. But Chan warned that the enforcement division's focus would not remain rooted to that spot.

Commissioners Daniel Gallagher and Michael Piwowar have both voiced repeatedly voiced concerns about secondary market pricing in the fixed income markets, including municipals. Gallagher gave a speech last week highlighting the bond market's overwhelming participation of vulnerable retail investors.

"There is tremendous unanimity and consensus among the commissioners with regard to the municipal market issues. And when two commissioners keep mentioning the same issues on the secondary market, on pricing and transparency, people need to pay attention," Chan said.

"What the commissioners say about the opaqueness of the market is something the staff also listens to," he added. "As much as there have been a lot of discussions from an enforcement standpoint about disclosure at the offering stage, I think there should be an expectation that the other shoe is going to drop with regard to the secondary market."

Chan said market participants should be on the lookout for two types of SEC scrutiny of the secondary market. The enforcement division will be interested in pricing and transaction costs with respect to retail investors, as well as the quality of the dealers' recommendations. Dealers are bound by a duty to deal fairly with their customers and are also bound by suitability rules requiring them to be able to form a reasonable basis to conclude the securities they recommend are good fits for the customers.

The enforcement staff also will be looking to use the antifraud provisions contained in federal securities laws, which make it illegal to commit fraud or deceit, and to make false or misleading statements, in connection with the purchase or sale of securities.

The Financial Industry Regulatory Authority often fines dealers for violating the Municipal Securities Rulemaking Board's fair dealing rule in selling bonds at unfair prices, but the SEC could charge dealers for fraud if the conduct rises to that level," Chan said.

The SEC historically has been hesitant to set a bright line on what constitutes an unfair markup or a good price on a bond sale. Firms should be protecting themselves by having in place a “reasonable, good faith process” in setting prices and markups, Chan said. There is a rich body of casework dealing with excessive markups in riskless principal transactions outside the muni market, he said, cautioning that the enforcement staff will not hesitate to apply antifraud standards from other markets in the muni market.

“What would be an easy mark, or low-hanging fruit, is when they can show that a broker-dealer did not have an adequate process in either price discovery or determination of markup/markdown,” he said.

Chan also said that relying on ratings to satisfy suitability requirements would be dangerous. He said he worked on a 2012 case in which the SEC charged Wells Fargo with improperly selling asset-backed commercial paper structured with high-risk mortgage-backed securities without knowing much about the products and relying almost entirely on their credit ratings. Some broker-dealers use ratings as too much of a surrogate for due diligence, he said.

“It would be a problem if a registered representative recommended a bond without the rep or anyone else at the firm at least going through the offering statement or some of the continuing disclosure information,” he explained.

As with pricing, the commission will look at procedures to see if they are sufficient to form a reasonable basis to believe the investments were suitable, Chan said, stressing that dealers should be looking at the wider securities industry and listening closely to the commissioners for clues as to what to expect.

“I think the cautionary tale is broker dealer reps need to do their homework,” he said.

THE BOND BUYER

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