SEC Members Demand Muni Markup Disclosure After Edwards Jones Case.

WASHINGTON — Securities and Exchange Commission members are calling for the adoption of rules requiring broker-dealers to disclose markups and markdowns on municipal securities, warning that if self-regulators do not act, the SEC will propose the rules itself.

Commissioners Luis Aguilar, Daniel Gallagher, Kara Stein and Michael Piwowar made the plea in a statement issued on Thursday after the SEC announced a first of a kind enforcement case, ordering the St. Louis-based brokerage firm Edward Jones to pay more than $20 million for overcharging retail customers for new municipal bonds. A spokesperson said SEC chair Mary Jo White has had the same position since she said in a speech in June 2014 that the SEC would work with self-regulators to develop rules requiring the disclosure of markups in riskless principal transactions.

In the enforcement case, the SEC found that, instead of selling new bonds to customers at the initial offering price, the retail-oriented firm and Stina Wishman, the former head of its municipal syndicate desk, took the bonds into the firm's own inventory and then improperly sold them to customers at higher prices. In other instances, the firm failed entirely to offer bonds until secondary market trading began and also did not monitor the reasonableness of its markups in certain secondary market trades. It is the commission's first case against an underwriter for pricing-related fraud in the primary market for municipal securities.

"Edward Jones undermined the integrity of the bond underwriting process by overcharging retail customers by at least $4.6 million and by misleading municipal issuers," Andrew Ceresney, director of the SEC's enforcement division, said in a release. "This enforcement action … reflects our commitment to addressing abuses in all areas of the municipal bond market." He would not comment on whether the improper pricing is a prevalent practice in the muni market but said the SEC's probe is continuing.

LeeAnn Gaunt, the chief of the SEC's enforcement division's municipal securities and public pensions unit, said the absence of a markup disclosure rule limits trading information. "Because current rules do not require dealers to disclose markups on municipal bonds, investors receive very little information about their dealer's compensation in municipal bond trades," she said in the SEC's release.

The enforcement case comes as the Municipal Securities Rulemaking Board proposed the idea of requiring dealers to disclose markups and markdowns on certain principal trades. The MSRB is collecting public comments on the idea, as well as modifications to an earlier proposal that would require dealers to disclose on customer confirmations a "reference price" of the same security traded on the same day.

The four SEC commissioners called for markup and markdown disclosure on munis, including riskless principal trades. They are trades in which dealers almost simultaneously buy and sell munis so that there is little risk the market will move against them. One obstacle to writing rules is that dealers have been arguing that riskless principal trades can't be defined.

The overcharges in this case occurred through the offer and sale of 156 different bonds in 75 negotiated offerings in which Edward Jones served as a co-manager between February 2009 and December 2012. The order found Edward Jones negligently violated antifraud provisions of the Securities Act of 1933 as well as MSRB Rules G-17 on fair dealing, G-11 on primary offering practices, G-30 on prices and commissions, and G-27 on supervision.

The $20 million to be paid by the firm includes approximately $5.2 million in disgorgement and prejudgment interest for the customers who overpaid for bonds as well as a $15 million civil penalty. Wishman agreed to a $15,000 penalty and a ban from the securities market for at least two years. She retired from Edward Jones in 2013 after creating the firm's municipal syndicate desk in 1993 and running it until she left. She was "primarily responsible for overseeing Edward Jones' underwriting of new issue municipal bonds" during that time, according to the SEC order and was also responsible for keeping the desk in compliance with security laws and MSRB rules as well as doing a yearly review of written procedures on compliance

Edward Jones and Wishman neither admitted nor denied the SEC's findings but agreed to the SEC's orders. Lawyers for Wishman could not be reached.

John Boul, a spokesman for Edward Jones, said the enforcement case effects about 13,000 current and former clients of the firm and that the roughly $5.2 million in compensation and interest to be paid to them works out to about $400 per client. He noted that the case pertains to actions that took place from 2009 through 2013, that the firm has disclosed the SEC probe since 2012 and has fully cooperated with the commission. He also highlighted several of the firm's remedial actions and added the firm is "pleased to have the matter resolved."

Syndicates like the ones Edward Jones participated in for the negotiated offerings typically have "agreements among underwriters" that lay out standard terms for the deals, according to the SEC order. It is generally understood that these AAUs obligate syndicate members to sell the bonds at the initial offering prices negotiated with the issuer before trading begins, something the SEC found Edward Jones repeatedly failed to do. The SEC also found Edward Jones failed to prioritize customer orders over its own accounts, in violation of Rule G-11.

In addition to issues in primary market trading, the SEC also found Edward Jones did not have an adequate supervisory system to ensure markups charged for principal transactions in the secondary market were not excessive. A markup is designed to compensate dealers for the risk they take on when holding securities in their inventory for principal trades, the SEC said. However, Edward Jones did not have "an adequate system for reviewing certain of its principle trades," which "may have prevented [it] from determining whether the markups it charged for certain principal transactions were reasonable," the commission said. The firm did not hold securities for principal transactions very long and "because of the short holding periods, it faced little risk as a principal and almost never experienced losses on these intraday trades," the SEC said.

The SEC order provided some examples of the firm's practices. In November of 2009, the firm acted as a co-managing underwriter for a $38.83 million issuance of taxable tax revenue bonds issued by the Amarillo Economic Development Corporation. Edward Jones did not inform its financial advisors about the offering until after the order period had closed, making it impossible for customers to place orders at the initial offering price. Instead, the firm acquired $3.665 million of the term bonds and, between the time the order period closed and the bonds began trading, the firm offered the bonds to customers at higher than initial offering prices. All of the other underwriters in that deal sold their entire allocations at the initial offering price, the SEC said.

The list of problematic Edward Jones bonds the SEC attached to its order includes 25 separate Build America Bond maturities, including one offering from the Nebraska Public Power District for which Edward Jones was a syndicate member. The firm improperly sold a portion of the bonds above the initial offering price and caused the Internal Revenue Service to conclude a portion of the offering did not qualify for BAB subsidies because it exceeded the de minimis amount of premium over the stated amount of the bond. The NPPD resolved the dispute by agreeing to pay the IRS $350,000 in exchange for continuing to receive subsidy payments. About $145,000 of that amount came from Edward Jones, Boul said. He said the firm has no open issues with the IRS in connection with the bonds listed in the SEC enforcement case. The firm refunded $122,891 for eight BAB maturities that were sold with more than a de minimis amount of premium, the SEC said.

In assessing the sanctions, the SEC took into account the remedial actions Edward Jones took, Ceresney said in a call with press. The firm started voluntarily disclosing its markups in 2013, Ceresney said. Edward Jones also: has hired a compliance officer for its fixed income desk; reduced its maximum markups and markdowns on municipal bond buy orders; produced a new written supervisory procedure; and retained a consulting firm to review the firm's municipal business and make recommendations for improvement.

Carol McCoog, chair of the National Association of Bond Lawyers' securities and disclosure committee, said the SEC enforcement action" sheds some light on behavior that's eye-opening" that hurt both investors and issuers. "It's difficult to know how it's going to affect the market," she said. "We're still trying to grapple with the proposed issue price rules" that the IRS released earlier this summer.

"We're going to see how all of this is intertwined," she said, adding that the case shows that now both the SEC and IRS are focused on pricing practices.

Elaine Greenberg, a partner at Orrick, Herrington and Sutcliffe and former head of the SEC's municipal securities and public pension unit, said the SEC order sends "a message to firms that by this action the SEC [is] putting other firms on notice and if [it] find[s] violations similar to those" that were found in this case, then they "will likely pursue enforcement actions," Greenberg said.

It would not be surprising to see the SEC bring more such cases in the future, due to a two-fold waterfall effect, said one source who did not want to be identified.

First, the SEC enforcement staff has developed expertise in syndicate practices and muni bond pricing in this case and knows what to look for, the source said. In addition, the Financial Industry Regulatory Authority will also likely be looking out for similar wrongdoing.

THE BOND BUYER

BY JACK CASEY

AUG 13, 2015 3:31pm ET

Copyright © 2024 Bond Case Briefs | bondcasebriefs.com