Bond Case Briefs

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What Happened to Edward Jones and Does it Impact Issue Price?

A few weeks ago, the Securities and Exchange Commission ("SEC") issued an Order stating that the broker-dealer Edward D. Jones & Co. L.P. ("Edward Jones") had to pay a hefty fine to the SEC as well as remuneration to its customers due to certain of its actions in the municipal bond market. You may be asking "what'd you do"? According to the SEC, Edward Jones sold municipal securities at prices in excess of the initial offering prices prior to the time that the bonds were able to be publicly traded and improperly retained bonds in its own inventory. Edward Jones benefitted from such practices by retaining the difference between the higher sales prices and the initial offering prices. Anyone who has spent any time on the Municipal Securities Rulemaking Board's Electronic Municipal Market Access database ("EMMA") has observed that trading in the secondary market at prices in excess of the initial offering prices happens ALL….THE….TIME…. (after the bonds have been sold by the underwriter at their initial offering prices, of course). For years, broker-dealers and financial advisors have affirmed that such practice is common because bonds are originally offered to the public in blocks that are too large for smaller retail customers. Therefore, certain retail-oriented broker-dealers will purchase a maturity and divide it up into multiple smaller pieces and sell the pieces off at slightly higher prices to retail clients. Because of the inefficiency of selling smaller pieces, salespersons need higher compensation on a percentage basis to be incentivized to make those sales. So what's the big deal?

The Big Deal

The big deal is the timing of the sales and the misleading practice that Edward Jones engaged in to effectuate the sales! Specifically, and among other things, [1] the SEC determined that Edward Jones engaged in the following practices which violate the rules in footnote 1 below:

> Edward Jones initially purchased the bonds by placing a "group net" order which is typically a higher priority order reserved for customers of the co-managers rather than for the manager's own account (which orders are referred to as "stock" or "member" orders and given a lower priority). Edward Jones subsequently offered and sold the new issue municipal bonds at prices in excess of the initial offering prices during the period of time when Edward Jones was obligated, pursuant to the underwriting syndicate restrictions, to offer and sell the bonds at the initial offering prices (i.e. before the bonds could be marketed to the public).[2]
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> In violation of its Agreement Among Underwriters ("AAU") (upon which the senior underwriter relied in making the certifications in the issue price certificate), Edward Jones did not offer to sell bonds to its retail customers at the bonds' initial offering prices. Instead, without giving its retail customers an opportunity to purchase the lower priced bonds, Edward Jones first offered and sold securities at prices in excess of the initial offering prices.

What does this have to do with tax? Isn't this a tax blog? Where am I?

For an issue of bonds that are publicly offered, the issue price is based on sales made or expected to be made as of the sale date (i.e., the date on which the issuer and underwriter enter into a written, binding obligation for the underwriter to purchase the bonds) to the general public. The senior manager typically makes the representations in the issue price certificate and in so doing it relies on representations of the co-managers in the AAU.

As a result, once Edward Jones made the representation, the issue price was based off of the initial offering price (i.e., the price paid by Edward Jones to obtain the bonds in the first place) and did not account for subsequent sales. Scandalous! Now, this is not a blog on issue price and there are a number of important tax law concepts (in the TEB world and elsewhere)[3] that are based off of issue price that are beyond the scope of this blog. For purposes of this blog, however, there are a few simple relationships that are important to understand:

- The higher the price of individual bonds, the higher the issue price (insightful, right)?
- The higher the issue price, the lower the yield (see footnote [4]).
- The lower the yield, the lower return that tax-exempt bond proceeds are permitted to generate without constituting arbitrage bonds or owing rebate!

If you've tuned out (can't blame you), here's where you should tune back in. If the higher-priced sales by Edward Jones are taken into account in determining the applicable bonds' issue price, then the issue price established by the issue price certificate is understated and the yield on the issue is overstated.[4] Any issue of bonds whose unspent proceeds are invested in investments that yield a return very close to the yield on the bonds as established by the lower issue price set forth on the issue price certificate run the risk of owing more rebate or losing their tax-exempt status!!![5] This is the point where my boss, Bob Eidnier, politely taps me on the shoulder and we have the following dialogue:

Bob: Joel, aren't you forgetting about a very important line in the definition of issue price?

Joel: Oh yeah, there is that line which reads "[t]he issue price does not change if part of the issue is later sold at a different price." But that line applies once the bonds are sold or expected to be sold to the public. Since Edward Jones did not effect such a sale, wouldn't it be inapplicable?

Bob: Possibly but the definition is designed to determine an issue price as of the sale date and based on reasonable expectations regarding the initial public offering price. Therefore, the issue price would have been established before Edward Jones sold the bonds at the higher prices! Permitting the consideration of sales after the initial sale to the underwriter(s) would introduce uncertainty into the determination of issue price that would make it very difficult, if not impossible, for issuers to comply with any of the tax-exempt bond provisions in the Code!

This is the way most of my disagreements with Bob go which is unfortunate for me but very fortunate for issuers because Bob is always correct (we're not above pandering here at Squire Patton Boggs!). Bob and I did not discuss whether sales by a member of an underwriting syndicate at prices in excess of the initial offering prices calls into question the reasonableness of the sale date expectations regarding issue price, but one would hope that where a member of the syndicate is less than forthcoming in the AAU about the initial offering prices of its sales to the public, the reasonableness of the lead underwriter's sale date expectations regarding issue price would not be impugned.

If the lack of consideration for post-sale date trading strikes you as odd and susceptible to manipulation, you aren't the only one. Interestingly, a few months ago the Service released a revised notice of proposed rulemaking that withdrew a prior, controversial set of proposed regulations governing issue price and replaced those with a more moderate approach. A Squire Patton Boggs tax partner wrote a magnificent blog (I describe it as magnificent because he is a partner) on the revised regulations, so a comprehensive explanation here is unnecessary. However, the proposed regulations do introduce an interesting concept that could be interpreted as the Service's consideration for Edward Jones-type activity. Specifically, if the proposed regulations were applied, when an underwriter has failed to sell at least 10 percent of each maturity of an issue to the general public and then subsequent to the sale date (but before the closing date of the issue), the underwriter sells the bonds at prices in excess of the initial offering prices, the underwriter must certify that the increase in price is due to market fluctuations and the issuer must "not know or have reason to know after exercising due diligence, that the certifications are false." Although the proposed regulations are not directly applicable to the Edward Jones case, they do introduce the concept of monitoring post sale-date trading by imposing a due diligence requirement.

Summary

The issue price rules are written (rightfully) to ensure that issue price can be determined as of the sale date (which would usually be the closing date for private placement bonds), and they currently preclude consideration of post-sale date activity in the determination of issue price. The heightened scrutiny over issue price that has evolved over the last 5-10 years coupled with the language in the proposed regulations may signal that the Service will eventually require issuers (and bond counsel :-)) to scrutinize post-sale date trading more closely. Rest assured, because this would signal a significant shift from current practice, the Service would likely impose any such requirement prospectively and with a lot of guidance.

[1] The SEC found that Edward Jones willfully violated Sections 17(a)(2) and (3) of the Securities Act (anti-fraud provisions), Section 15B(c)(1) of the Exchange Act (duty of municipal advisor), and rules G-17 (obligation of broker dealers to deal fairly), G-11(b) (broker dealer duty to disclose whether securities purchased for own account – priority given to customer orders rather than orders for own account), G-27 (obligation to supervise), and G-30 (requirement that BD sell to customers at price that is fair and reasonable).

[2] As an example, the SEC cited the Amarillo Economic Development Corporation, Taxable Sales Tax Revenue Bonds, Series 2009 (Official Statement) in which Edward Jones served as co-manager.

[3] For example, the 2% costs of issuance limitation is generally based off a proximate of issue price..

[4] In one example included in the SEC order, the increased sales price reduced the yield by more than 43 basis points.

[5] Federal tax law limits the amount of premium that certain tax credit bonds, such as Build America Bonds (Section 54AA of the Code) can have. Another consequence addressed in the SEC order is that bonds that are sold at higher prices could run afoul of this limitation and cause the bonds to no longer be eligible for the applicable tax credits.

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