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SEC Asks: Should Muni Bond Pricing Change in Wake of Edward Jones?

CHICAGO – Securities and Exchange Commission lawyers pushed municipal market participants meeting here on Thursday to consider whether industry practices on the pricing of new bonds should change in the wake of the SEC's enforcement case against Edward Jones.

"It's a legitimate, open question as to whether industry practices need to change here," Mark Zehner, the deputy director of the SEC enforcement division's municipal securities and public pensions unit, said after a panel discussion of hot topics in municipal securities law at the National Association of Bond Lawyers' Bond Attorney's Workshop. "Is Edward Jones an aberration or is it a symptom of a larger problem in the municipal market?" he asked.

In its first enforcement case on primary market pricing of bonds, the SEC last month ordered the St. Louis based, retail-oriented dealer Edward Jones to pay more than $20 million for overcharging retail customers for new munis. The commission found that instead of selling new bonds to customers at the initial offering price as required, Edward Jones, acting as a co-underwriter, and the former head of its syndicate desk, took bonds into the firm's own inventory and then improperly sold them to customers at higher prices. In some cases, the firm failed entirely to underwrite and offer the new bonds to investors until secondary market trading began.

Zehner said this is "a very important case" that shows the levels to which some underwriters will go to make money. Before the case, there was an assumption that underwriting syndicate members would adhere to both the bond purchase agreement and agreement among underwriters requirements to sell bonds at the "initial offering price" negotiated with the issuer. But after the case, Zehner said he is "not sure that is a good assumption moving forward."

He encouraged bond and tax counsel to think through what they want to see in issue price certificates, in which the senior managing underwriter certifies the issue price – the price at which at least 10% of a maturity is sold to the public in a bona fide public offering.

Stressing that these are his personal views and not necessarily those of the SEC, Zehner said he is just posing the question of what changes the Edward Jones case might lead to, not answering it.

Rebecca Olsen, deputy director of the SEC's office of municipal securities, raised the same question in an earlier underwriters' counsel roundtable. She asked if the senior managing underwriter can continue to rely on co-managers to comply with their obligations under both the BPA and AAU. Olsen also asked whether bond counsel can continue to rely on issue price certificates executed by the senior managing underwriter on behalf of syndicate members without making inquiries about the pricing of those members' bond sales.

She also asked whether the senior underwriter in a syndicate should start asking co-underwriters to sign the issue price certificate and whether bond counsel should be getting on the Municipal Securities Rulemaking Board's EMMA system and looking at prices at which new bonds were sold. The other panelists, who included a lawyer for a broker-dealer, said a strong no to both questions.

Ernesto Lanza, a panelist and shareholder with Greenberg Traurig in Washington D.C., said the Internal Revenue Service has learned that EMMA is not designed to capture information for purposes of determining the issue price or whether bonds are initially being sold at the issue price.

Lanza said it would be “inefficient” and “ultimately ineffective” to have all syndicate members sign the issue price certificate. Leon Bijou, senior vice president and municipal general counsel with Jefferies in New York, said the likelihood of that happening “seems remote.” Bijou noted that the SEC did not go after the senior managing underwriters in the bond issues where Edward Jones committed pricing abuses.

Lanza said, “everyone should be aware that there is significant evolution going on” following the Edward Jones case, but added it won’t be clear for many months what, if any, changes will occur.

“Expect change in the next year or two in terms of the degree to which syndicate members can trust each other, the degree to which issuers can trust members of the syndicate, and the degree to which lawyers will be pulled into the process,” Lanza said.

Bijou said that underwriters do not have the resources to check what other syndicate members are doing and they assume that the other underwriters are complying with regulations.

“It would be very difficult for us to tap a co-manager on the shoulder and say, ‘By the way, did you comply?'” Bijou said. “We get their signature on the AAU and to go beyond that in the industry process would be considered inappropriate and highly intrusive.”

At least one panelist said syndicate members may be more closely scrutinized by the lead underwriter, but Bijou and others pointed out that issuers sometimes put firms in the syndicate and that lead underwriters do not have the capability or desire to kick them or other firms out.

Paul Maco, a partner with Bracewell & Giuliani, said the senior managing underwriter that signs the issuer certificate can only do so much and that the Edward Jones case showed the SEC looks at each member of the syndicate as being responsible for its own compliance.

An audience member later asked Zehner whether the SEC was concerned that issuers, not just investors, were hurt by Edward Jones. Zehner said the SEC focused on investors, who were clearly hurt by Edward Jones’ actions, in part because the issuers got the deal they thought they were getting. They helped negotiate the initial offering price. “I’m not saying they weren’t victims,” Zehner said, referring to the issuers.

In the earlier session, Maco made the point that when Edward Jones was violating the MSRB’s syndicate rules, it was also violating the securities laws.

“The sea change here” is that the SEC now has a large group of enforcement staff that understand how muni bond pricing and trading desks work and they will be watching this area of the market, Maco said. In addition, the Financial Industry Regulatory Authority will start paying attention to these issues and will probably start looking at syndicate practices and pricing in their examinations of broker-dealers, he said.

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