Bond Case Briefs

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Buyers Sing Blues After Memphis Bond Default Goes Unrecognized.

Early last month, a ministry that owns two dilapidated apartment complexes in Memphis said the federal government cut off rental subsidies used to repay $12 million of bonds, triggering a default that would cause the price of the securities to tumble by as much as 81 percent.

Apparently, not all investors got word of the debacle. Seven days after the apartments' owner, Global Ministries Foundation, made the disclosure, the tax-exempt debt was still sold in lots of $25,000 and $50,000 to buyers for as much as 110 cents on the dollar. Within days, they saw the value of their bonds plummet to as little as 21 cents.

"It's odd that the price didn't adjust more quickly," said Richard Ryffel, a former municipal-bond banker at Bank of America Corp. who teaches finance at Washington University's Olin Business School in St. Louis. "Why would they have bought at that price?"

The trades show that small-time investors, who are the biggest holders of state and local debt, may still not be receiving key information when they buy bonds, despite regulators' years-long effort to inject more transparency into one of Wall Street's most opaque niches.

It wasn't until 2005 that investors could even access real-time prices to see whether they were being overcharged when trading in the $3.7 trillion market, where more than 50,000 borrowers have issued over a million securities. In 2009, the Municipal Securities Rulemaking Board, the industry's regulator, created its EMMA system, the first comprehensive, publicly accessible website where issuers report information that could affect the value of their bonds. Yet many investors don't know the records are available or rely on brokers to disclose the risks.

MSRB rule G-47 prohibits dealers from purchasing or selling municipal bonds for a customer without disclosing orally or in writing "all material information known about the transaction, as well as material information about the security that is reasonably accessible to the market." MSRB rules also require that brokers take into account all the factors about the value of the security and charge "fair and reasonable" prices.

"We have what we think are very significant safeguards for retail investors," said MSRB Executive Director Lynnette Kelly, when asked about the Memphis bonds. "We can't opine on whether there's been a rule violation or not. Obviously the enforcement agencies have access to all of this trade information."

The MSRB, whose board includes representatives from securities firms, writes the rules but doesn't enforce them. That's left up to the Securities and Exchange Commission and the Financial Industry Regulatory Authority. SEC spokesman John Nester and Finra spokesman Ray Pellecchia declined to comment.

It's uncertain whether any brokers ran afoul of the rules when trading the housing bonds, which the Cordova, Tennessee-based non-profit ministry sold through a Memphis authority in 2011 to raise money to purchase the apartments. The identities of those buying and selling the bonds isn't publicly disclosed.

Trickling Out

On February 12, Global Ministries posted on the MSRB's website a letter from the U.S. Department of Housing and Urban Development saying that the federal agency was terminating rental assistance because of the decrepit conditions. A letter from the trustee, Bank of New York Mellon Corp., said the loss of federal funds caused a default under the bond contract.

The securities didn't trade again until Feb. 18, when a customer purchased $50,000 of them for 110.67 cents on the dollar.

The price held up the following day, with $25,000 worth changing hands for 110 cents at 9:26 a.m. New York time. Not long before 1 p.m., Standard & Poor's cut the rating on the bonds by ten steps to CCC+, seven ranks below investment grade, saying HUD's action will lead to operating losses and, eventually, a payment default within the next two years unless the apartments can be sold for enough to retire the debt.

Prices on the bonds fell to an average of 64 cents on Feb. 22, the next trading day. By the end of the week, they hit a low of 21 cents.

Ryffel, the former banker, said he doubts the buyers were intentionally left in the dark.

"I don't think a broker-dealer would lightly skirt making lawfully required disclosure," said Ryffel. "Any dealer in the know about these bonds would say the last thing I want to do is fail to disclose when there's hair all over the deal."

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