Bond Case Briefs

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Chapman and Cutler: MSRB Proposes Additional Exceptions for Trading Municipal Bonds Below Stated Minimum Denominations.

Municipal Securities Rulemaking Board ("MSRB") Rule G-15(f) prohibits a broker, dealer or municipal securities dealer ("dealers") from effecting a customer transaction in municipal securities in an amount lower than the minimum denomination of the issue stated in offering documents, subject to two current exceptions. The MSRB recently proposed adding two additional exceptions that would allow dealers to sell below stated minimums in limited cases. Both new exceptions would allow below-minimum sales to customers where the transactions would not add to the net below-minimum positions within the market. While Rule G-15(f) has historically not been a point of significant focus, that has changed in recent years. For example, in late 2014, the Securities and Exchange Commission (the "SEC") sanctioned 13 dealers in amounts ranging from $54,000–$130,000 for selling municipal bonds below the minimum denomination stated in the bonds' official statements. Earlier this year, the Financial Industry Regulatory Authority, Inc. ("FINRA") also announced sanctions of seven dealers for similar violations in amounts ranging from $25,000–$200,000. (See the related SEC press release and FINRA disciplinary action report here and here.) For additional information on the MSRB proposal, see the related MSRB notice here.

Current Rule G-15(f)

Rule G-15(f) provides that a dealer may not effect a customer transaction in municipal securities issued after June 1, 2002 in an amount lower than the minimum denomination of the issue. Municipal issuers may impose high minimum denominations to qualify for certain disclosure exemptions from Rule 15c2-12 under the Securities Exchange Act of 1934 or due to a security being below investment grade or for other reasons that might make the securities inappropriate for retail investors likely to purchase securities in relatively small amounts. Where an issuer states a higher minimum denomination for a bond issue, the higher minimum is often $100,000 while a normal minimum is often $5,000.

Current Rule G-15(f) provides two exceptions to the prohibition in order to help preserve liquidity for customers' below-minimum denomination positions. Investors may have below-minimum positions for various reasons, such as a result of a death or divorce, call provisions that allows calls in amounts less than the minimum denomination, investment advisers splitting positions among several clients, or knowingly or unknowingly purchasing an amount below the minimum denomination. The first existing exception permits a dealer to purchase a below-minimum position from a customer if the dealer determines that the customer is selling its entire position. The second existing exception permits a dealer to sell a below-minimum position to a customer if the dealer determines that the position being sold is the result of another customer liquidating an entire position below the minimum denomination. In this case, the dealer must provide written disclosure to the purchasing customer that the quantity of securities being sold is below the minimum denomination for the issue and that this may adversely affect the liquidity of the position unless the customer has other securities from the issue that can be combined to reach the minimum denomination.

The Proposed New Exceptions

The MSRB believes that certain other transactions that are not currently contemplated under the rule would be consistent with the intent of the current second exception. The MSRB is seeking comment on two additional exceptions.

The first new exception would permit a dealer to sell a below-minimum position to one or more customers that currently own the issue if the dealer determines that the below-minimum position being sold is the result of a customer liquidating an entire position below the minimum denomination as long as the increment(s) being sold to the customer(s) is consistent with any restrictions in the issuer's authorizing documents, even if the transaction does not result in any purchasing customer increasing its position to an amount at or above the minimum denomination. Under this exception, a dealer would also be permitted to sell a portion of the below-minimum position to a maximum of one customer that currently does not own a position in the issue. The MSRB's theory for allowing one additional purchaser that does not own any of an issue to buy a below-minimum position in the issue appears to be that it would not result in a net increase in below-minimum positions within the market.

The second new exception would permit a dealer to sell a below-minimum position to a customer that currently owns a below-minimum position in the same issue as long as the transaction results in the customer owning a position at or above the minimum denomination amount. In addition, this exception would allow the dealer to also then sell any remaining below-minimum position to one or more customers that currently own the issue even if the transaction left the customer(s) with a below-minimum position so long as the increments sold were consistent with any restrictions in the issuer's authorizing documents regarding incremental amounts. This situation would appear to bring at least one customer up to a minimum position and not increase the overall number of below-minimum positions within the market.

Consistent with the current rule, a dealer would be able to rely upon customer account records in its possession or upon a written statement provided by the customer to whom the securities are purchased or sold that the customer owns a position in the issue in an amount at or below the minimum denomination. Similar to the existing sale exception in the current rule, under both proposed exceptions a dealer would be required to provide all purchasing customers a statement informing the customer that the quantity of securities being sold is below the minimum denomination for the issue and that this may adversely affect the liquidity of the position unless the customer has other securities from the issue that can be combined to reach the minimum denomination. A dealer would be required to provide this disclosure at or before the completion of any sale in an amount below the minimum denomination.

Best Ex, Suitability and Time of Trade Disclosure Obligations Still Apply

While proposing additional exceptions to the minimum denomination requirement, the MSRB reminds dealers that obligations arising under Rule G-18, on best execution; Rule G-19, on suitability of recommendations and transactions; and Rule G-47, on time of trade disclosure, continue to apply to impose regulatory requirements on dealers regarding customer transactions that supplement the protections afforded by Rule G-15(f) with respect to minimum denominations. As a result, notwithstanding the exceptions, a dealer would have an obligation to have a reasonable basis to believe that a recommended transaction or investment strategy involving a below-minimum municipal bond position is suitable for the customer, bearing in mind that, among other things, the issue has a minimum denomination and the customer's liquidity needs and risk tolerance. In addition, dealers have an obligation under Rule G-47 to disclose to a customer, orally or in writing, at or prior to the time of trade, all material information known about the transaction, as well as material information about the security that is reasonably accessible to the market, including the fact that a sale of a quantity of municipal securities is below the minimum denomination authorized by the bond documents and the potential adverse effect on liquidity of a customer position below the minimum denomination.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group.

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