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MSRB Proposes Clarifying Minimum Denomination Rule Exceptions.

WASHINGTON - The Municipal Securities Rulemaking Board is proposing two clarifying exceptions to its rule preventing dealers from buying or selling bonds below their stated minimum denominations.

The MSRB has asked for comments to be submitted by May 25 on the proposed changes to MSRB Rule G-15 on customer transactions. The rule was amended in 2002 to place the minimum denomination trading restrictions on most dealer transactions.

The minimum denomination for a bond is the lowest amount of the bond that can be bought or sold, as determined by the issuer in its official bond documents. Issuers sometimes set minimum denominations on bonds that are risky to discourage retail investors from buying them. In addition to a minimum denomination, issuers can also set a trading "increment" for their bonds. An increment of \$10,000 for example would mean a dealer could sell a customer \$110,000 of bonds but not \$105,000.

Although dealers are required to adhere to any minimum denominations set in transactions, some investors can be left with amounts below the stated minimums if they have received a share of someone else's holdings, such as from a settlement after a divorce or an inheritance after a death. The MSRB exceptions allow those customers to avoid simply being stuck with these holdings.

Under the current rule, dealers can buy from a customer below the minimum denomination if the dealer determines, based on customer account information or a written statement from the customer, that the customer is selling its entire position in the issue. The dealer can also sell to a customer at an amount below the minimum denomination if it is a result of another customer liquidating his or her entire position in an issue. This exception requires the selling dealer to provide the customer written disclosure explaining that the quantity sold is below the minimum denomination and could adversely affect the customer's liquidity position.

The new proposals would clarify the types of customers a dealer could sell to at amounts less than the stated minimum. The goal of the rulemaking is to make sure that no additional customers with holdings below the denomination are created as a result of the exceptions.

"The MSRB understands that both firms and enforcement agencies could benefit from greater clarity about circumstances in which sales below the minimum denomination could be permissible," said MSRB executive director Lynnette Kelly. "The proposed additional exceptions to the rule would facilitate regulatory efficiency and enhance liquidity for investors that currently hold positions below the minimum denomination while preserving the spirit of the rule."

The first new exception would pick up on the current language and allow a dealer that has bought a customer's liquidated position less than the minimum denomination to sell these bonds, in amounts below the minimum, to one customer with no prior holdings in the bonds and to any customers who already have positions in the bonds.

For example, if a dealer buys a customer's \$75,000 liquidated position in a bond that has a minimum denomination of \$100,000 and an increment of \$5,000, the dealer could sell \$25,000 to a customer with no prior position in the bond, \$35,000 to a customer that owns an existing \$10,000 position and \$15,000 to a customer with an existing \$85,000 position.

The transactions would ideally get the customers with prior holdings closer to the minimum denomination, if they have not already reached them.

The second proposed exception applies to dealers that have holdings below, at, or above the minimum denomination. It would allow a dealer to sell bonds to any customer with a prior position as long as the sale brings the customer to or past the minimum denomination. The dealer could then sell the remaining below-minimum position to any number of customers that already hold the bonds, so long as the sale is consistent with the issuer's stated increment. However, the exception would not allow a dealer to sell below the minimum denomination to a customer that does not currently have a position in the issue.

All dealers using the exceptions would still have to provide the written statements at or before the completion of the transaction informing the customers of the below-minimum amount and the associated liquidity risks.

The MSRB is also reminding dealers that although the proposal would allow for more exceptions to the rule, dealers would still be bound by MSRB Rules G-18 on best execution, G-19 on suitability of recommendations, and G-47 on time of trade disclosure.

The Bond Buyer

By Jack Casey

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