Bond Case Briefs

Municipal Finance Law Since 1971

DOL Fiduciary Rule Gets It Half Right On the Municipal Bond Market.

Shrinking the pool of muni sellers does not help investors

While some modifications have been made, municipal-bond investors are still left in a potentially tight spot with regard to the Department of Labor's fiduciary rule.

To its credit, the DOL seems to be listening to feedback with an open mind, which was illustrated by a revision to the 2015 draft version of the rule. Originally, firms acting as principals would have been prohibited from directly purchasing and selling muni bonds from or into a client's retirement account. The April version of the rule was changed to allow principals, which hold muni bond inventories, to purchase bonds from clients, essentially expanding the market of potential buyers of the bonds.

This is good for investors. The DOL clearly recognized that, particularly in times of market stress, there is no logical upside to limiting the universe of potential buyers of a security that an investor wants to sell.

However, for some reason, the DOL seems to be holding firm, for the time being, on not allowing principals to sell muni bonds out of its inventory to clients investing through their individual retirement accounts.

For a lot of financial advisers this might seem like a small or even a non-issue. Some might argue that it's more important that a client has better access to a buyer of a security, particularly in times of market turbulence, than a seller.

But, considering the breadth and depth of the sweeping DOL rule, this looks more like an oversight, which could negatively affect investors in muni bonds.

To be clear, prohibiting firms that hold bond inventories from selling muni bonds to clients in their IRA accounts doesn't mean those clients can't buy muni bonds — it just means the principal can't participate or compete with other broker-dealers looking to sell bonds to that investor.

The logic behind this is not clear, especially when the DOL has already revised its rule to allow principals to buy muni bonds from clients in IRA accounts.

A statement from the DOL regarding the principal transaction exemption that allowed for the purchase, but not the sale to investors in retirement accounts, failed to address the specific issue. However, it alluded to a means of seeking a specific exemption to this aspect of the rule.

"This is an area that was subject to public comments and, in fact, the department did make changes from the proposed principal transactions exemption," the statement reads.

"We also added a mechanism for parties wishing to expand the exemption as it applies to purchases by plans and IRAs, if parties seek an individual exemption, and we made changes so that municipal bonds can be sold in agency and riskless principal transactions under the [best interest contract] exemption," according to the statement.

In other words, without further comment or clarification from the DOL, one might conclude the rule is leaving a loophole for those principals willing to jump through some hoops.

Based on that, the question remains as to why the DOL didn't just open up the sale to retirement plan clients the same way it opened it up to purchases?

As the DOL pointed out, this particular limitation does not only apply to muni bonds, it also applies to some securities that don't meet certain liquidity or investment-grade standards.

But one reason it could negatively affect investors in muni bonds is that the $3.5 trillion municipal bond market is made up of 65,000 different issuers of debt. This is not a globally commoditized market, like Treasury bonds or even corporates.

The muni bond market is made up of participants with developed expertise in specific markets, but not necessarily all markets, or all 65,000 issuers across the country.

With that in mind, it makes even less sense to limit the number of participants available to sell bonds to investors.

"The DOL recognized that when the market is falling there's no reason to limit the pool of potential buyers of a security, but why are they still limiting the pool of potential sellers especially when sellers are required by the rule to put their clients' interests first?" said Ron Bernardi, president of Bernardi Securities.

"We can deal with it," he added. "But in certain instances it might be limiting our clients' choices."

Essentially, unless the DOL can find a way to lift the restrictions on muni bond sales to IRA accounts, it is merely requiring advisers to act as fiduciaries without actually enabling them to act as fiduciaries.

Investment News

By Jeff Benjamin

Jul 7, 2016 @ 12:09 pm