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Dealers Say MSRB Minimum Denomination Rule Would Hurt Investors

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WASHINGTON – Dealer groups are still opposed to a proposed standalone minimum denomination rule from the Municipal Securities Rulemaking Board after several changes, arguing it would hamper liquidity and should be abandoned for altered suitability requirements.

Bond Dealers of America and the Securities Industry and Financial Markets Association made their comments about the proposed standalone Rule G-49 in letters sent to the Securities and Exchange Commission. The MSRB made several changes to the proposed rule before filing it with the SEC, most significantly by eliminating one exemption under the original proposal.

BDA, which is asking the commission to reject the proposed rule, said the muni industry would be better served if the SEC directed the MSRB to eliminate both its current and proposed minimum denomination requirements and instead draft an interpretive release to its Rule G-19 on suitability to appropriately regulate the concern at the center of the proposed rule – protecting investors.

"The real regulatory need here is that dealers need to be required to honor an issuer's determination of investor suitability in transactions where the authorized denominations are \$100,000 or above," said BDA chief executive officer Mike Nicholas.

Nicholas added that "the greatest impediment to a fair market and the greatest source of investor harm" is the current MSRB minimum denomination regulatory framework under Rule G-15. The interpretive release BDA is asking for should be "narrowly constructed to address suitability concerns for transactions in municipal securities" with minimum denominations of \$100,000 or more, Nicholas wrote.

Leslie Norwood, managing director and co-head of the municipal securities division for SIFMA, said SIFMA "is disappointed in the recent amendments to the MSRB's draft rule and feels strongly" that they do not serve their stated purpose. She also wrote that the MSRB's goals with the proposed rule could be effectively achieved by making consideration of liquidity as a result of a below-minimum denomination position a part of Rule G-19 suitability analyses.

"Assuming consideration of the liquidity of a below-minimum denomination position is handled in Rule G-19, there would be no need for Rule G-49 other than with respect to confirmation disclosure, a matter that would be best addressed in Rule G-15," Norwood wrote.

Rule G-49 would contain current requirements in Rule G-15 that prohibit dealers from engaging in transactions with customers in amounts below the minimum denominations of municipal securities set by issuers. It would also include two current exceptions to the prohibition as well as one more exception first proposed in April 2016. That exception would allow a dealer that has bought a customer's liquidated position in an amount less than the minimum denomination to sell those bonds to one customer with no prior holdings of the bonds and to any customers who already have positions in the bonds.

The standalone rule would also eliminate the current requirement in G-15 that a dealer, in some situations, must obtain a "liquidation statement" from a party that isn't its customer but rather the party from which the dealer purchased the securities. The liquidation statement must be obtained before the sale of securities to another customer and confirm that the original selling customer fully and completely liquidated its below-minimum position.

By taking away the liquidation statement, the MSRB felt that another safeguard was needed for an existing exception under G-15 that says a dealer can sell a below-minimum amount of a bond to a customer if the sale is a result of another customer liquidating his or her entire position in the bonds.

It proposed a new "safeguard" that would prohibit a dealer engaged in an interdealer trade from selling less than all of a below-minimum position that the dealer acquired either from a customer that fully liquidated its below-minimum position or from another dealer. That prohibition would satisfy the MSRB's goal by preventing the creation of additional below-minimum positions, the MSRB has said.

The other current exception to the MSRB's minimum denomination rule would not be affected by the liquidation statement changes. That exception allows dealers to buy munis below the minimum denomination from customers if the dealer determines, based on the customer's account information or written statement, that the customer is selling its entire position in the bonds.

SIFMA is asking the SEC to ensure that the MSRB's proposed "safeguard" is removed before the rule is approved because it would limit interdealer transactions and hurt liquidity. Norwood added that it would also create concerns about the timing of sales or keep a dealer from pursuing a transaction if, for example, the dealer is selling a below-minimum denomination position and finds a customer without prior holdings in the securities to buy a portion of the below-minimum amount but then can't locate customers with prior holdings to buy what's left over.

"The benefits of the elimination of the liquidation statement ... are completely outweighed by the negative impacts of limiting interdealer transactions," Norwood wrote.

SIFMA also wants an amendment to the rule after determining that it can be read to prohibit breaking up a below-minimum position if the position is acquired from a customer but permits breaking up the position if it is acquired from a dealer.

"SIFMA and its members see no reason why there should be a prohibition on dealers selling the below-minimum denomination position to more than one customer if the position is acquired from a customer," Norwood wrote. She included two separate alternatives to the MSRB's current language that would clear up the group's concerns.

The letter also includes a number of examples that illustrate the group's point that prohibitions on breaking up positions acquired from customers and prohibitions on interdealer trades where the selling dealer breaks up its position could prevent transactions that would ultimately lower the number of minimum denomination positions in the market.

SIFMA is also asking that the MSRB require the filing of minimum denomination information on its EMMA system on all transactions and to clarify what "entire position" means for a customer that has more than one account with a firm.



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