Client Alert

Current Issues Relevant to Our Clients

August 21, 2015

Edward Jones Settles with SEC over Municipal Bond Underwriting Practices

On August 13, 2015, the Securities and Exchange Commission issued a cease-and-desist order against Edward D. Jones & Co., L.P., in response to alleged improper trading practices by the St. Louis-based broker-dealer. The SEC alleged that Edward Jones violated Sections 17(a)(2) and (3) of the Securities Act of 1933 and various rules of the Municipal Securities Rulemaking Board in certain negotiated municipal bond offerings in which the firm acted as co-managing underwriter between February 2009 and December 2012 (the "Relevant Period"). Edward Jones consented to the order without admitting or denying the SEC's allegations. The SEC order is available here. The alleged improper trading practices, resulting sanctions and fines and relevant legal issues are summarized below.

"Edward Jones undermined the integrity of the bond underwriting process by overcharging retail customers by at least $4.6 million and by misleading municipal issuers," said Andrew J. Ceresney, Director of the SEC Enforcement Division. "This enforcement action, which is the first of its kind, reflects our commitment to addressing abuses in all areas of the municipal bond market."

The SEC entered into a concurrent settlement with the former head of Edward Jones' municipal underwriting desk, who agreed to be barred from the securities industry for a minimum of two years.

Background on Negotiated Offerings of Municipal Bonds

In a negotiated offering, a municipal issuer chooses an underwriter to act as sole underwriter or as manager of an underwriting syndicate, and sells its bonds to that underwriter or syndicate at a discount to the final negotiated price at which each bond will initially be sold to investors, that price being the "initial offering price." At closing, the underwriter or senior manager, on behalf of the syndicate, typically executes a certificate, prepared by bond counsel, representing to the issuer and bond counsel, that, among other things, there was a bona fide public offering of all of the bonds at the initial offering prices. This certification is important for ensuring compliance with applicable securities and tax laws, as discussed below. The initial offering prices are printed on the cover or inside cover page of the official statement related to the bonds.

Summary of Findings and Sanctions

In 75 negotiated offerings of new issue bonds during the Relevant Period, the SEC alleged that Edward Jones failed to make a bona fide offering of the bonds at the stated initial offering prices. Acting in the capacity of co-manager, the firm allegedly placed orders with the senior manager for its own inventory and, while syndicate restrictions were in effect that required sales of the bonds to be made at the initial offering prices, sold bonds to retail customers at higher prices. The SEC also alleged that, in other negotiated offerings, Edward Jones refrained from offering any bonds during the initial offering period, and then sold bonds at prices above the initial offering prices when secondary trading commenced. The SEC alleged that these practices resulted in Edward Jones' customers paying at least $4.6 million more for the bonds than they would have had the bonds been sold at their initial offering prices.

The SEC noted that Edward Jones had undertaken significant remedial measures related to its trading practices, including providing written disclosure to its retail customers of the percentage and dollar amount of markup/markdown on all trade confirmations for its principal transactions in municipal securities, implementing supervisory and operating procedures and training in its municipal securities division. Taking these remedial actions into account, the SEC ordered Edward Jones to pay disgorgement and prejudgment interest of $5,194,401.37 (such funds to be returned to current and former customers who purchased bonds at prices higher than the initial offering prices) and assessed Edward Jones a $15,000,000 civil penalty.

Legal Discussion

Section 17 of the Securities Act includes the core anti-fraud provisions of federal securities law. Section 17(a)(2) makes it unlawful "in the offer or sale of any securities … directly or indirectly … to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made … not misleading." Section 17(a)(3) of the Securities Act makes it unlawful "in the offer or sale of any securities … directly or indirectly … to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." Intent or knowledge is not required to establish a violation of Sections 17(a)(2) or 17(a)(3); negligence is sufficient.

In the negotiated offerings discussed above, the SEC alleged that Edward Jones was at least negligent in its failure to disclose to its customers that it had agreed to make, and was expected to make, a bona fide offering of all of the bonds at the initial offering prices. According to the SEC, such information would have been considered material by the firm's customers. And failing to disclose such information allowed Edward Jones to obtain revenues from the sale of the bonds greater than it was contracted to earn from its share of the underwriter's discount.

The SEC also alleged that Edward Jones violated MSRB rules on primary offering practices, fair dealing, and fair and reasonable pricing of municipal securities, and failed to have in place a reasonable supervisory system.

Issue Price

The price at which new issue bonds are sold is important for ensuring compliance with other laws as well, including laws governing the issuance of tax-exempt bonds. The failure of an underwriter to make a bona fide public offering of tax-exempt bonds at the initial offering prices may impact the "issue price" of such bonds. Issue price is a fundamental concept in the U.S. Treasury regulations that govern tax-exempt obligations, and is used to determine bond yield for arbitrage purposes. A lower issue price results in a higher bond yield and potentially lowers payments of arbitrage rebate. Also, where federal tax law imposes limits on amounts of bonds or amounts of proceeds that may be used for various purposes (for example, bank qualification rules), issue price is often used to measure the amount of such bonds or proceeds. Under current U.S. Treasury regulations, a bona fide public offering of all of the bonds at the initial offering price is generally necessary to establish issue price in publicly offered transactions. Failure of an underwriter to make a bona fide public offering of tax-exempt bonds at the initial offering price not only may violate the securities laws as described above, but may also adversely impact the tax-exempt status of the interest on the bonds. The U.S. Treasury has been concerned about the current method of establishing issue price of tax-exempt bonds for several years. In order to address such concerns, the U.S. Treasury recently released proposed regulations that would revise the methods used to establish the issue price of tax-exempt bonds. Under the proposed regulations, the issue price of an issue of tax-exempt bonds can be established based on the initial offering price only if certain conditions are met; otherwise the issue price is based on the actual sales price to the public. (For a more detailed explanation of the proposed regulations please see our *Client Alert* "Memorandum Concerning the 2015 Proposed Issue Price Regulations," dated June 30, 2015. The full *Client Alert* is available here.)

For More Information

Both the SEC and the IRS have shown an ongoing interest in this subject and we will continue to provide *Client Alerts* as additional information becomes available.

To discuss any of the topics covered in this Client Alert, please contact a member of our Public Finance Group or visit us online at chapman.com.

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