

Chapman Client Alert

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Current Issues Relevant to Our Clients

MSRB Proposes New Rule on Minimum Bond Trading 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. After proposing two additional exceptions to this rule in April 2016, the MSRB is now proposing new Rule G-49 that would replace existing Rule G-15(f) as a separate rule on below-minimum trading that would apply to customer and certain inter-dealer transactions. The new rule would add exceptions and liberalize certain conditions to exceptions. The MSRB notice proposing the new rule is available [here](#). For information on the April 2016 MSRB proposal, please see our Client Alert available [here](#).

Rule G-15(f) has historically not been a point of significant focus but that has changed in recent years. In late 2014, the Securities and Exchange Commission 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. also announced sanctions of seven dealers for similar violations with sanctions ranging from \$25,000–\$200,000.

Current Rule G-15(f)

Current MSRB 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 rated 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.

Investors may have below-minimum positions for various reasons, such as a result of a death or divorce, call provisions that allow 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. Current MSRB Rule G-15(f) provides two exceptions to the prohibition in order to help preserve liquidity for customers’ below-minimum denomination positions. 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. That determination may be based either on customer account information in the dealer’s possession or upon a written statement by the customer as to its position in an issue.

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.

In April of this year, the MSRB proposed to add two exceptions to Rule G-15(f) where the excepted transactions would not add to the net below-minimum positions in the market. The first new exception would have permitted a dealer to sell a below-minimum position to one or more customers that currently owned the issue if the dealer determined that the below-minimum position being sold was 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) was consistent with any restrictions in the issuer’s authorizing documents (i.e., any “minimum increment condition”), even if the transaction did 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 have been permitted to sell a portion of the below-minimum position to a maximum of one customer that did not own a position in the issue. The second new exception would have permitted a dealer to sell a below-minimum position to a customer that currently owned a below-minimum

position in the same issue as long as the transaction resulted in the customer owning a position at or above the minimum denomination amount. In addition, this exception would have allowed the dealer to also then sell any remaining below-minimum position to one or more customers that currently owned 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 minimum increment condition in the issuer's authorizing documents.

Proposed New Rule G-49

The MSRB is now seeking comment on proposed new Rule G-49 that would replace existing Rule G-15(f) as a separate rule on below-minimum trading. Draft Rule G-49 is largely similar to Rule G-15(f) as it was proposed to be amended in April 2016 with certain modifications. New Rule G-49 would prohibit a dealer from selling or purchasing municipal securities issued after June 1, 2002 in a customer transaction in an amount lower than the minimum denomination of the issue. The draft rule also includes several exceptions to its basic prohibition. In each case, the exceptions are designed to enhance liquidity while also not increasing the net below-minimum positions outstanding in the market.

Exceptions

Purchase from Customer Liquidating Full Position—The rule's prohibition would not apply to a below-minimum purchase of securities from a customer if the purchasing dealer determines that the customer's position in the issue already is below the minimum denomination and the entire position of the customer would be liquidated by the transaction.

Sale to Customer Where Dealer Acquired Securities from Another Customer's Full Liquidation or from Another Dealer—The prohibition would not apply to a below-minimum sale of securities to a customer if the position being sold:

- is the same amount as the below-minimum position that the dealer acquired from a customer in a transaction where the customer fully liquidated its position in the security (as described in the preceding purchase exception), or
- was acquired by the dealer in an inter-dealer transaction and the amount being sold is the same amount as the below-minimum position that the dealer acquired in the inter-dealer transaction.

In effecting such a sale to a customer the dealer may (a) sell the entire below-minimum position to one customer, or (b) sell the entire, or a portion of, the below-minimum position to one or more customers that have a position in the issue and any

remainder to a maximum of one customer that does not have a position in the issue, even if the transaction(s) do not result in a customer increasing its position to an amount at or above the minimum denomination.

Sale to Customer That Already Has a Below-Minimum Position—The prohibition would not apply to a below-minimum sale of securities to a customer that already has a position in the issue below the minimum denomination if the sale will result in the customer having a position at or above the minimum denomination. In this case, the dealer may also then sell any remaining portion of the below-minimum position to one or more customers that already have a position in the issue.

Conditions for Exceptions—The draft rule would require that a dealer relying on the preceding exceptions determine its customer's position in the subject security based upon the account records in the dealer's possession or upon a written statement provided to the dealer by its customer. In addition, if a dealer sells to a customer under an exception, the dealer must deliver a written statement to the customer 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 of the issue. The statement must be delivered at or before the completion of the transaction and may either be included on the customer's confirmation or be provided on a document separate from the confirmation. This statement does not need to be delivered if the dealer's sale to the customer results in the customer having a position at or above the minimum denomination.

Elimination of Minimum Increment Condition Requirement

Exceptions in existing Rule G-15(f) and in the April 2016 proposed exceptions included conditions that a dealer's sale to a customer must be consistent with issuer restrictions regarding minimum increment amounts. These are referred to as "minimum increment conditions" and refer to minimum trading increments above any minimum denomination requirement. Draft Rule G-49 eliminates the minimum increment conditions out of a concern that the conditions would reduce liquidity and industry concerns related to availability and accuracy of minimum increment data.

Elimination of Liquidation Statement Requirement from Other Dealers

Draft Rule G-49 revises two exceptions regarding dealer sales to customers of below-minimum denomination positions (one existing exception and one proposed in April 2016). We

describe these revised exceptions above under “Sale to Customer Where Dealer Acquired Securities from Another Customer’s Full Liquidation or from Another Dealer”. The existing and previously proposed exceptions required that a dealer obtain a “liquidation statement” from a person other than the dealer’s customer from which the below-minimum position was purchased (such as another dealer). The liquidation statement would confirm that the position is from a customer that fully and completely liquidated its below-minimum position. The elimination of this requirement is designed to address difficulties arising in connection with transactions executed through an alternative trading system (“ATS”), broker’s broker or other dealer where a dealer would need to rely on the ATS, broker’s broker or other dealer to verify the complete liquidation by a prior selling customer. Note that draft Rule G-49 continues to require that a dealer confirm that its own selling customer fully liquidated its position in the exceptions that allow a dealer to buy from its customer and then sell to another of its customers.

Inter-Dealer Transactions

Existing Rule G-15(f) does not specifically apply to inter-dealer transactions. In light of the elimination of the liquidation statement described above, the MSRB is proposing to add a safeguard applicable to certain inter-dealer transactions. Accordingly, draft Rule G-49 would prohibit a dealer from selling municipal securities to another dealer in an amount below the minimum denomination of the issue, unless the selling dealer acquired the below-minimum denomination position from (a) a customer in compliance with the purchase exception in the rule described above or (b) from another dealer, and the selling dealer sells the securities to the purchasing dealer in a transaction at an amount that is equal to or greater than the amount of the below-minimum position originally acquired by the selling dealer.

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

As was the case in the MSRB’s April 2016 proposal, the current MSRB notice 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 the minimum denominations rule. 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.

Submitting Comments

You may submit comments to the MSRB through October 18, 2016 by submitting a hard copy or by submitting comments electronically [here](#).

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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