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Securities and Exchange Commission
100 F ST NE
Washington DC 20549

Re: File No. SR-MSRB-2017-01, MSRB Rule G-49, minimum denominations on municipal bonds

March 7, 2017

Dear SEC:

In the spirit of the President's executive order to identify two rules for elimination for every new rule, this obsolete rule should be near the top of the list for elimination. The rule restricts investors from buying quantities of municipal bonds in sizes smaller than their minimum denominations. There is no similar rule in corporate bonds or equities, nor should there be. This rule puts burdens on investors, brokers, and regulators for no good public purpose. It should be scrapped.

Background

In the bad old days of paper certificates, bonds were physical items, each with a particular par value. It was impractical to issue or trade a bond in anything other than a round lot. Typical physical bonds had a face or par value of $1,000 but some were much higher. MSRB Rule 15(f) was passed in 2002 that

[1] All opinions are strictly my own and do not necessarily represent those of Georgetown University or anyone else for that matter

prohibited dealers from selling bonds in less than the minimum denomination or trading them in less than the minimum increment. The purported purpose of the prohibition was to prevent retail investors from investing in bonds that were too complex or too risky. The proposed changes add some minor exceptions to the prohibition. The proposal, however, fails to consider an alternative much better than merely adding minor but complex exceptions. The Commission should seriously consider the alternative of scrapping this obsolete rule entirely.

The prohibition is no longer needed since other advances help achieve the objective of consumer protection. The prohibition should be scrapped.

Our financial markets have changed significantly since 2002. Our markets are now more automated, and investors now have much more information available than they did many years ago. MSRB's EMMA was launched in 2008 and provides much needed access to information about municipal securities to investors. Investors now have much better access to important documents, trade prices, and continuing disclosure. Indeed, the average retail investor now has instant free access to more information than even a professional could obtain at any price only a few short years ago. The MSRB is to be commended for the improvements it has fostered in the municipal markets.

The prohibition on trading in smaller increments was a crude attempt to protect investors in an era when information about municipal issues and municipal issuers was much harder to obtain. As information is much more easily available now, this limitation has outlived its usefulness. Indeed, the prohibition has serious adverse consequences that would be eliminated if this obsolete rule were scrapped.

This is really an issue of suitability, which is better handled in other ways.

The original objective of the prohibition was to keep small retail investors from buying bonds that may not be suitable for them. For example, the SEC's approval notice in 2002 stated " …an issuer may set high minimum denominations because of a concern that the securities may not be appropriate for those retail investors who would be likely to purchase securities in relatively small amounts."[2]

If an issuer believes that a particular issue is too complex or risky for small retail investors, it can put a "black box" suitability warning on the term sheet or the cover page of the official statement. Official statements are now much more readily available than they were in 2002. Any broker who recommends such a black-boxed security to an investor would be a sitting duck in a FINRA arbitration. This is a far better solution than this rule.

[2] Available at https://www.gpo.gov/fdsys/pkg/FR-2002-02-14/html/02-2588.htm

Furthermore, there is an increasing level of care being taken with respect to retail investors. The DOL's "fiduciary rule" has already caused significant changes in the way firms handle retail investors, even though its implementation has been delayed. Whether the SEC ever exercises its Dodd-Frank authority to promulgate a common-sense version of the "fiduciary rule" remains to be seen. In the meantime, brokers still have an obligation to recommend only suitable securities to investors.

<u>The prohibition increases, not decreases, risks to some investors.</u>

One of the tenets of modern finance is diversification. Investors should diversify their investments to spread the risk around. Thus, even risk-averse investors may suitably desire to invest in a small part of a risky investment if the expected return were high enough.

Although the prohibition was designed to protect investors, the prohibition can actually increase the harm to investors by forcing them to hold more of the bond than they would otherwise hold. Suppose that a particular bond has a minimum denomination of $5,000 and the investor would ordinarily wish to purchase $4,000 worth. However, because of the minimum the investor is induced to purchase $5,000 and now holds a less diversified portfolio that is more exposed to a particular security.

<u>The prohibition forestalls the use of technology to diversify municipal portfolios.</u>

Technology has dramatically reduced transactions costs in our financial markets. Technology will continue to evolve in ways that make new financial products possible at ever lower cost. While it may be impractical at the present for a small retail investor to hold very large number of different municipal securities, it could easily become practical in the not-so-distant future.

As an example of financial technology, firms like Folio Investing have made it very easy and inexpensive for individual investors to hold portfolios of large numbers of equity securities. Alas, the prohibition at issue here prevents firms like Folio Investing from offering similar innovative products in municipal securities. This will make it harder for individual retail investors to hold well diversified portfolios of municipal securities. The Commission should be making it easier, not harder, for retail investors to own municipal securities.

<u>Currently used denominations are unrealistically high for many municipal issues.</u>

Although Treasuries trade with a minimum denomination of $100, many plain vanilla municipal obligations have much higher minimum denominations. For example, the following shows part of the official statement for a recent offering of general obligation bonds by the Borough of Baden, a small municipal issuer in Beaver County, Pennsylvania that happens to be my hometown. There is nothing excessively risky or complex about the offered bonds, and indeed the bonds are insured by Municipal Assurance Corporation and carry a AA rating. The offering consists of a series of bonds maturing from

2016 through 2032. There is no particular reason why retail investors should not consider these bonds. Indeed, the bonds might be particularly attractive for a Pennsylvania investor who desired a ladder of bonds maturing in different years. Yet the denomination is set at $5,000.00 for each bond.

There is no logical reason for punishing a broker who would facilitate a $1,000 investment in such bonds. While one could argue that it is inefficient to trade bonds in smaller quantities, if investors are willing to pay the price to trade in smaller lots they should be permitted to.

OFFICIAL STATEMENT

New Issue
Book Entry Only

Ratings: (See "Ratings" herein)
MAC Insured

In the opinion of Bond Counsel, under existing laws, regulations, rulings and court decisions, interest on the Bonds (including any original issue discount property allocable to an owner thereof) is excluded from gross income for federal income tax purposes and is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations; however, for purposes of computing the alternative minimum tax imposed on certain corporations (as defined for federal income tax purposes), such interest is taken into account in determining adjusted current earnings. Under existing law, the Bonds are exempt from personal property taxes in Pennsylvania and the interest on the Bonds is exempt from Pennsylvania personal income tax and from Pennsylvania corporate net income tax. In rendering this opinion, Bond Counsel has assumed continuing compliance by the Borough with certain tax covenants designed to satisfy certain provisions of the Internal Revenue Code of 1986, as amended (the "Code"). See "Tax Exemption and Other Tax Matters" herein.

The Borough has designated said Bonds as "qualified tax-exempt obligations" within the meaning of Section 265(b)(3) of the Code (relating to the deductibility of interest expenses by certain financial institutions).

$3,825,000
THE BOROUGH OF BADEN
Beaver County, Pennsylvania
General Obligation Bonds, Series of 2016

Dated: Date of Delivery
Due: December 1, as on inside front cover
Denominations: Integral multiples of $5,000

Interest Payable: June 1 and December 1
First Interest Payment: December 1, 2016
Form: Book- Entry Only

<u>Past enforcement actions have punished reasonable behavior.</u>

I note that Interactive Brokers was recently fined for permitting trades in some Puerto Rico bonds in increments below their minimums.[3] Interactive Brokers is a self-service firm that does not recommend securities to clients. Indeed, their clients are generally highly sophisticated investors who engage in a plethora of trading strategies. Their customers can and do trade highly risky common stocks (including OTC and foreign securities), options, and futures in addition to bonds. It is highly likely that the Interactive Broker customers who traded in the Puerto Rico bonds were short-term speculators rather than long-term buy-and-hold investors. The risk level that Interactive Brokers' customers willingly assumed from their speculations in Puerto Rico bonds was far lower than they could have undertaken in other licit investment products also available through Interactive Brokers. Furthermore, the investors' losses, if any, on those positions is far less than they would have been had they been forced to trade in larger amounts.

[3] https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543350368

The prohibition is a crude form of merit regulation.

The fundamental theme of U.S. securities regulation is based on disclosure, not merit. The overall thrust of U.S. regulatory policy has been to make sure that there is appropriate disclosure so that investors can know what they are buying. Investors generally have the freedom to invest in any securities for which there is appropriate disclosure. Banning the trading of some instruments in small sizes is a crude and clumsy way of imposing merit regulation on investors. The only securities that should be off limits to smaller investors are those that lack disclosures that appropriate communicate their risks.

The prohibition wastes inspection, enforcement, and compliance resources.

Having a useless rule on the books is not without costs to society. Companies need to have policies and procedures in place to comply with the rule. Personnel need to be trained. Compliance officers need to monitor and document that training and compliance. Regulators need to inspect firms to monitor compliance, and commence investigations when they suspect a lack of compliance. FINRA devotes substantial resources to producing "report cards" to help firms with their compliance obligations on this rule.[4] The regulatory resources wasted on maintaining and enforcing a useless rule should be spent on other more productive regulatory activities.

If this rule made any sense, why is it not in place in the corporate bond market or the equity market?

To the best of my knowledge, there is no equivalent rule in the corporate or Treasury bond markets. Nor should there be, because this rule is totally useless. Again, it was put forth at a time when information on municipal issues was far less available than it is today and the rule is obsolete.

There is no equivalent rule in equities, either. Even though the round lot for trading equity shares in the U.S. is generally 100 shares, investors can trade odd-lots if they so desire. Indeed, firms such as Folio Investing and Charles Schwab make it possible for investors to hold fractional shares. In a world where paper certificates have almost entirely disappeared, minimum denominations no longer make sense.

The MSRB's assertions as to the merits of the prohibition are not proof.

The MSRB's rule proposal is long on assertions and short on any kind of justification for the existence of the rule. Their stated reason in the proposal is "The policy underlying the prohibition is to protect investors from holding positions that are smaller than the limits established by the issuer."[5] The release

[4] http://www.finra.org/industry/report-center/msrb-report-cards

[5] Available at https://www.sec.gov/rules/sro/msrb/2017/34-79978.pdf

gives no clear indication as to why this prohibition is a good idea in the first place. The MSRB does not even bother to go back to the original purported purpose of protecting investors from bonds that were too risky. The MSRB merely asserts in general boilerplate without convincing proof:

> "The MSRB believes that the proposed rule change is consistent with the Act in that proposed new Rule G-49, regarding transactions below the minimum denomination of an issue, like its predecessor, Rule G-15(f) is designed to protect investors and issuers of municipal securities, with respect to transactions in municipal securities effected by dealers, from fraudulent and manipulative acts and practices and to promote just and equitable principles of trade."

In its filing, the MSRB gives no examples of any types of fraudulent or manipulative acts that this rule prevents, because in fact there are none. The MSRB gives no evidence as to what is "just and equitable" about a rule that imposes additional costs and risks on investors with no commensurate benefit. There are some vague mentions that smaller denominations may be less liquid, but that is more a result of the rule than a reason for it. All the MSRB says, without proof, explanation, or justification, is "…The MSRB believes the general prohibition in effect for many years continues to serve a beneficial investor protection function, and is not proposing rescission…" If it so great, why haven't the corporate and equity markets followed suit? Because this rule is not so great.

<u>The Economic Analysis fails to identify and evaluate reasonable alternative regulatory approaches.</u>

The MSRB's economic analysis pays lip service to identifying and evaluating reasonable alternative approaches. Yet their analysis does not even consider dropping the useless rule altogether. Indeed, they just assert the following: [6]

> **3. Identifying and evaluating reasonable alternative regulatory approaches.**
>
> The MSRB recognizes that there are alternatives to the approach taken in the draft amendments. For example, the MSRB could propose additional exceptions and/or liberalize the existing exceptions. While the MSRB recognizes that such alternatives might reduce the burden on dealers and increase the liquidity of below-denomination positions, the MSRB believes that they would also be likely to increase the number of below-denomination positions that potentially put investors at risk.

[6] See the *MSRB Regulatory Notice 2016-13*, page 6. Available at https://www.sec.gov/rules/sro/msrb/2017/34-79978-ex2.pdf

Yet the MSRB has made no attempt to document the alternatives it claims to have considered, or to quantify the burden of the existing rule on dealers and investors even though they realize that it could be reduced.

The proposed rule makes compliance a more complex process.

The new rule adds further complex exceptions to the general prohibition on below-denomination transactions. This just adds further complexity to the rulebook when it would be much simpler to eliminate the rule.

Having a rule that applies only to municipal securities but not to corporates or MBS creates a more complex compliance environment. Firms have to go to extra expensive lengths to make sure that that their employees and their systems understand this rule that applies only to munis but nowhere else.

For all of these reasons, the prohibition on selling municipal securities in amounts less than their minimum denomination or increment should be scrapped. If regulators are so inclined as to keep this useless and obsolete rule, then it should apply only to securities that are lacking in suitable disclosures.

Respectfully submitted,

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