



James J. Angel, Ph.D., CFA  
Associate Professor of Finance  
Georgetown University<sup>1</sup>  
McDonough School of Business  
Washington DC 20057  
[angelj@georgetown.edu](mailto:angelj@georgetown.edu)  
1 (202) 687-3765  
Twitter: @GuFinProf

Ronald W. Smith, Corporate Secretary  
Municipal Securities Rulemaking Board  
1300 I Street NW, Suite 1000  
Washington, DC 20005

Re: Draft Rule G-49

October 22, 2016

Dear Mr. Smith:

I am a finance professor at Georgetown University and an individual investor. The courses I teach include Fixed Income Securities to both undergraduates and MBAs. Here are my comments on the proposed Rule G-49, which refines the no longer needed prohibition on transactions in less than the minimum denomination of a municipal security.

### **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. Rule 15(f) was passed in 2002 that prohibited dealers from selling bonds in less than the minimum denomination or trading them in less than the minimum increment. The purported

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<sup>1</sup> All opinions are strictly my own and do not necessarily represent those of Georgetown University or anyone else for that matter

purpose of the prohibition was to prevent retail investors from investing in bonds that were too complex or too risky. The proposed changes add two minor exceptions to the prohibition. The proposal, however, fails to consider an alternative much better than merely adding two minor exceptions. The board should seriously consider the alternative of scrapping this obsolete rule entirely.

The Board has requested comment on “all aspects of the proposal.” This is a good time to re-examine whether the prohibition has met its objectives and whether it is still needed given the changes that have occurred in our financial markets since the rule was first adopted in 2002.

**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.

**The DOL’s new fiduciary rule increases protections for retail investors.**

Not only do investors now have much better information than a few years ago, but there has been a general upward shift in the standards of care applicable to retail investors. The Department of Labor’s new rules applicable to retirement accounts generally requires brokers to act in the best interest of their retirement account customers. The SEC is allegedly working on similar rules for other brokerage and advisory accounts. These new rules provide additional protections for investors from the risk that careless or unscrupulous brokers will stuff unsuitable risky municipal bonds into the portfolios of unsophisticated investors.

**Brokers still have a suitability obligation.**

Whether the SEC ever exercises its Dodd-Frank authority to promulgate a version of the “fiduciary rule” remains to be seen. In the meantime, brokers still have an obligation to recommend only suitable securities to investors. If an issuer believes that a particular issue is too complex or risky for retail investors, it can put a “black box” suitability warning on the term sheet or the cover page of the official

statement. Any broker who recommends such a black-boxed security to an investor would be a sitting duck in a FINRA arbitration if anything went wrong.

**The prohibition increases, not decreases, risks to some investors.**

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.

**The prohibition forestalls the use of technology to diversify municipal portfolios.**

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, note how 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.

**Currently used denominations are unrealistically high for many municipal issues.**

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.

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**OFFICIAL STATEMENT**

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**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

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MATURITY SCHEDULE

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**Past enforcement actions have punished reasonable behavior.**

I note that Interactive Brokers was recently fined for permitting trades in some Puerto Rico bonds in increments below their minimums.<sup>2</sup> 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.

**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

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<sup>2</sup> <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543350368>

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 appropriately communicate their risks.

**The prohibition makes it more difficult to strip coupons.**

Security holders generally have the right to do whatever they want with their securities. A bondholder, for example, can strip coupons from a bond and trade them separately from the corpus of the bond. This can create more demand for strippable bonds and lower issuance costs. Alas, as some coupons may be smaller than the minimum denomination, this prohibition would prevent coupon stripping on many municipal bonds. Although such stripping might not be practical at the present, further technological innovation could make it practical and useful in the future as raw material for municipal structured or other products.

**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. The regulatory resources wasted on maintaining and enforcing a useless rule should be spent on other more productive regulatory activities.

**The prohibition is inconsistent with standard safe practices in the equity market.**

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.

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,

James J. Angel, Ph.D., CFA  
Georgetown University