CENTER FOR MUNICIPAL FINANCE

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April 7, 2016

Municipal Securities Rulemaking Board
1300 I Street NW, Suite 1000
Washington, DC 20005

Re: Comments on Rule G-15

Dear Sir or Madam:

Thank you for providing the opportunity to comment on MSRB's proposed rule change regarding Minimum Authorized Denominations. I believe minimums should be eliminated and have presented my case for this view in a blog post at https://learn.neighborly.com/featured/the-end-of-big-in-municipal-bonds/.

The following is excerpted from that post:

In the years since the financial crisis, people saving small amounts of money have not received much love from their banks. Interest rates on money market accounts and certificates of deposits at major banks remain near record lows. For example, a recent rate sheet from JP Morgan Chase shows no alternative yielding more than 0.9% annual interest for deposits below $10,000. Unfortunately, the situation is not much different at Bank of America, Citibank and Wells Fargo.

Small savers wishing to get better returns should look towards municipal bonds. Ten year munis are yielding more than 2% and interest is generally exempt from federal, state and local income taxes. But today, small savers rarely buy municipal bonds. One reason is that most municipal bond offerings have a high minimum denomination (of usually at least $5000).

What are Minimum Denominations?

The Municipal Securities Rulemaking Board (MSRB), which writes the rules for regulators of the US municipal bond market in conjunction with the Securities and Exchange Commission (SEC), defines the minimum denomination as the smallest amount of a bond issue that may be purchased at any one time.

Industry regulations forbid brokers from buying or selling smaller amounts. For example, it would be illegal for a broker to split a $5000 bond in half, so that you and a friend could each invest $2500. In some cases, the minimum denomination is even higher than $5000. In 2014, the Commonwealth of Puerto Rico sold bonds with a $100,000 minimum and the SEC disciplined several brokers for accepting smaller orders.

It is possible to access the municipal bond market with a smaller investment by purchasing a mutual fund or exchange traded fund that holds these securities, but these alternatives have management fees that reduce your returns.

Why are Minimums So High at the Moment?

High minimum denominations unnecessarily exclude small investors from the opportunity to finance community facilities and earn higher rates of interest. High minimums appear to have two justifications: minimizing paperwork and protecting small investors from supposedly complicated and dangerous securities. Both reasons seem dubious.

Minimizing Paperwork

In the old days, bonds were sold in paper form. Each time an interest payment was due, investors clipped a coupon from their bond certificates and presented it for payment. The more investors holding bond certificates, the more payments that needed to be made. This could become a real headache for the municipal finance department or its paying agent. But now, all records are kept in electronic form and payments are made automatically – thus the processing hassle is no longer much of an issue.

Protecting Small Investors

More serious is the perception that municipal bonds are too complex and too risky for "average" people. A major problem with this justification is that small investors are not protected from other types of risky investments. While municipal bonds have aggressively enforced minimum denominations, no such restrictions exist for penny stocks – shares in small companies that are often not listed on an exchange and trade for less than $5 each. The SEC warns investors about the risk of these securities and imposes various requirements on brokers selling them, but there are no minimum denominations. Thus, a small saver can easily buy $500 of stock in an obscure Nevada gold mining company, but can't buy the same amount of Nevada State General Obligation bonds (general obligation bonds typically represent a first claim on a government's tax revenue).

Another very risky investment available to small savers is stock options, which give the owner the right to buy or sell stocks at a certain price on or before the expiration date. Options are highly leveraged, so they can provide enormous returns, but, research shows that over three quarters of option contracts expire worthless. Yet, according to NerdWallet, several brokerage firms allow investors to open option trading accounts with initial balances of $2000 or less.

While penny stocks and stock options are very risky, many types of municipal bonds have strong track records, suggesting a high degree of safety. For example, no state has defaulted on general obligation bonds since 1933 – during the height of the Depression. Further, the two states that defaulted in 1933 ultimately paid back all the overdue principal. You have to go back to the 19th Century to find cases in which states completely failed to redeem their bonds in full.

Bonds issued by cities and counties have had a less perfect track record, but the number of defaults is very low compared to the number of local governments that issue bonds. We have seen a lot of news about the Detroit, Stockton, San Bernardino and Jefferson County bankruptcies but the vast majority of cities and counties make their payments on time, in full and without fanfare. Municipal Market Analytics estimates the annual default rate on general obligation bonds is 0.03%. Also, since Detroit's bankruptcy filing in July 2013, no US city or county has initiated a Chapter 9 bankruptcy process.

Returning to Nevada for a moment, it seems especially strange that any adult can walk into a Las Vegas gambling casino and wager as little as $5 on a game of blackjack or roulette while the option to buy small quantities of municipal bonds is restricted.

Risk vs. Regulation

Regulations that prevent small investors from taking certain risks are hard to justify, but small investors may need protection from discriminatory financial practices. Research has shown that investors buying or selling relatively small amounts of municipal bonds incur proportionately higher brokerage costs than those making bigger trades. But rather than bar small investors from the market, regulators can address this concern by limiting transaction costs (which typically take the form of bid/ask spreads) or by encouraging more competition among brokers.

High Minimums Prevent People from Investing in Their Community

Amidst widespread warnings of a national infrastructure crisis, many Americans would undoubtedly welcome the option to invest in their communities by purchasing municipal bonds. While residents may wish to invest in better parks, playgrounds, bridges, roads and mass transit in their communities, they may have less than $5000 to support neighborhood facilities. High minimum authorized denominations provide little meaningful protection, while excluding a large group of investors from the socially important municipal bond market. For example, Denver has shown an innovative way forward by offering "mini bonds" – with $500 minimum denominations.

Sincerely,

Marc D Joffe

Marc D. Joffe
President