

# Series 52

*Municipal Securities Representative*

Learning Guide / Workbook

# How to Use This Learning Guide

As the instructor presents the material through the On-Demand lecture, use this Learning Guide to take notes, answer questions, and complete activities. Once the On-Demand program is complete, this Learning Guide can be used as an ongoing resource.

## About the Series 52 Exam

<b>1</b> 80 Multiple-Choice Questions	<b>2</b> 75 Plus 5 Experimental Questions	<b>3</b> Two and a Half Hours (150 Minutes) Allotted	<b>4</b> Passing Score is 70% of 75 Questions
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SECTIONS	# OF QUESTIONS
Municipal Securities	45
Economic Activity, Government Policy, and the Behavior of Interest Rates	10
Federal Legal Considerations (SEC and MSRB Rules)	20
<b>Total</b>	<b>75</b>

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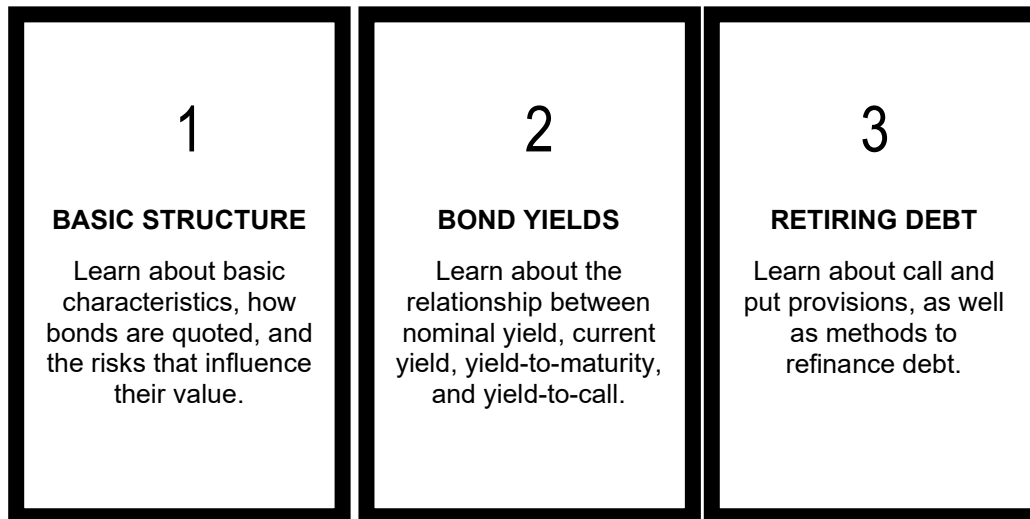
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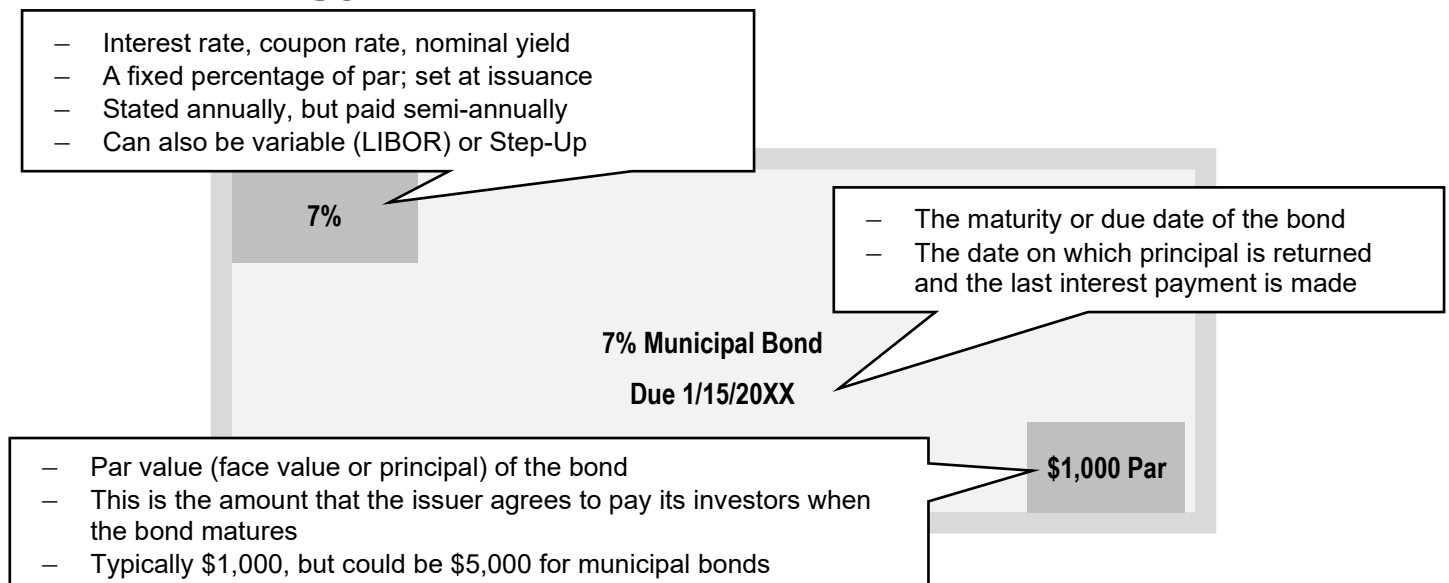


# Chapter 1: Characteristics of Municipal Debt

## Key Topics



## Terminology



# Zero-Coupon Bond

<b>Issued</b>	Issued at deep discount
<b>Maturity</b>	Matures at face value (par)
<b>Interest</b>	Considered the difference between the purchase price and par value
<b>Carrying Value</b>	The investor's carrying value (cost basis) must be accreted yearly
<b>How It Trades</b>	Trades flat (without accrued interest)
<b>Reinvestment Risk</b>	Not subject to reinvestment risk
<b>Suitability</b>	Suitable for an investor who's planning for a specific future investment goal

## Accrued Interest

Interest originally begins to accrue on the *dated date* and then every coupon date thereafter

- Buyer pays the seller the bond's market price plus the accrued interest
  - Start counting at: \_\_\_\_\_
  - And count up to: \_\_\_\_\_
- Municipal bonds calculate accrued interest on a 30/360-day basis
- The following formula is used to calculate the amount of accrued interest that's added to the purchase price:

Calculation:

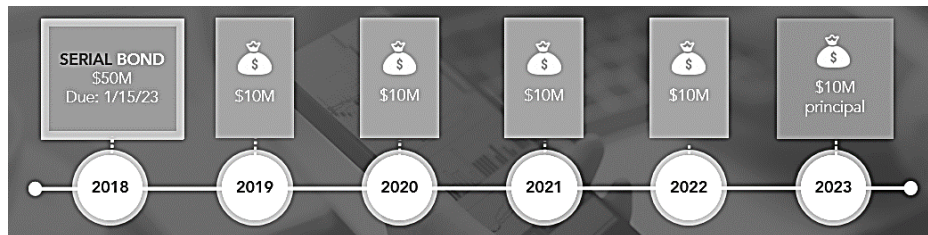
Annual Interest \$

x

$\frac{\text{\# of accrued days}}{360}$

# Term and Serial Maturities

- Two of the ways that an issuer may structure its loan repayment or maturity are term and serial.
  - *Term maturity*: the entire bond offering matures on the same date
    - Generally quoted on a dollar basis
  - *Serial maturity*: the bond offering matures over several years (i.e., a series of maturity dates)
    - Generally quoted on a yield basis
- For both types, bonds are issued on the same date and interest is paid each year
- Level debt service: Some serial maturities are structured so that principal and interest payments represent approximately equal annual payments over the life of the offering.



# Physical or Electronic Ownership

The following are different methods that a client may hold a bond position:

<b>Bearer</b>	In certificate form, with no owner name noted on the physical security (interest coupons physically attached)
<b>Registered to Principal Only</b>	In certificate form, with name of owner evidenced (interest coupons physically attached)
<b>Fully Registered</b>	In certificate form, with name of owner evidenced (interest payments automatically mailed or paid electronically)
<b>Book Entry</b>	Position is held electronically at a depository

# Why Bond Prices Fluctuate from Par

- The par value of a bond can differ greatly from the price that investors pay to purchase the bond.
- Although most bonds are initially sold at par value, as time goes by, these same bonds will trade in the market at prices that are either more than or less than their par value.
- A bond that is selling for less than its par value is a **discount**.
- A bond that is selling for more than its par value is a **premium**.

## Quoting Bonds

Bond prices and interest rates are generally quoted as a percentage of par (\$1,000):

- A bond priced at 100 is selling at 100% of its par value, or \$1,000

Bonds may be quoted in terms of points or dollars

- Each point is equal to 1% of the bond's par value, or \$10.
- Corporate and municipal bonds trade in increments of 1/8 of a point, or \$1.25.

Bonds may also be quoted in yield or basis terms

- Yield generally determines the bond's value.
- Allows comparison of bonds with different characteristics.

1.00% = 100 basis points

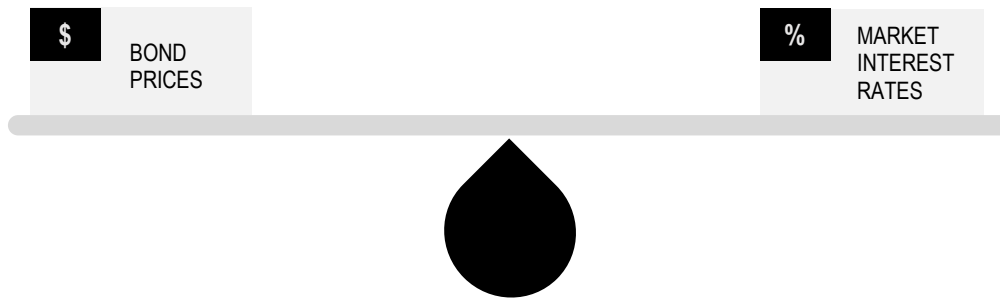
.01% = 1 basis point

## Bond Yields

Yield is the return an investor gets on a bond.

NY	CY	YTM	YTC
Nominal yield <ul style="list-style-type: none"> <li>▪ Same as coupon</li> <li>▪ Fixed percentage of par</li> </ul>	Current yield $\frac{\text{Annual Interest}}{\text{Current Market Price}}$	Yield-to-Maturity <ul style="list-style-type: none"> <li>▪ Same as basis and yield</li> <li>▪ Includes the reinvestment of interest and the gain or loss over the life of the bond</li> <li>▪ Measured to the bond's maturity</li> </ul>	Yield-to-Call <ul style="list-style-type: none"> <li>▪ Includes the reinvestment of interest and the gain or loss if the bond is called</li> <li>▪ Measured to the bond's call date(s)</li> <li>▪ Disclosed if lower than YTM</li> </ul>

# Interest-Rate Risk

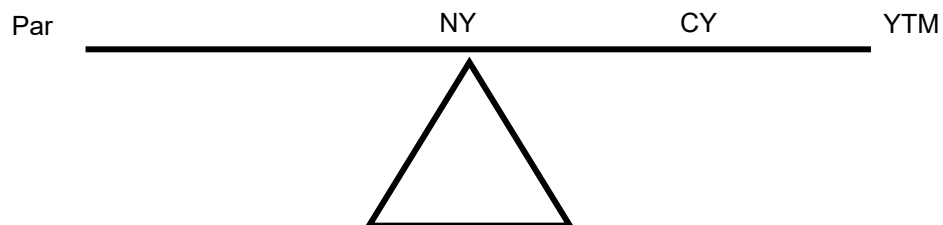


## INVERSE RELATIONSHIP

Interest-rate risk means that as market interest rates change, a bond's price will change in the opposite direction. They have an inverse relationship.

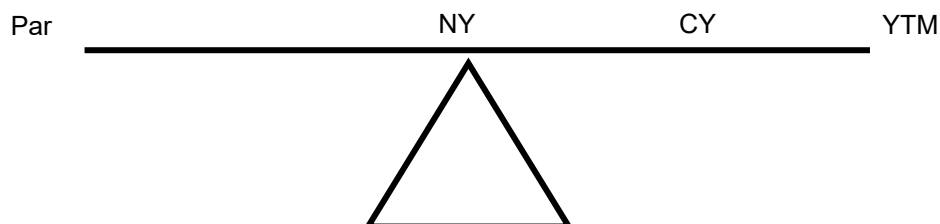
## Price versus Yield Example

Current Yield: 8.45%	1. 98 1/2
YTM: 8.25%	2. 100
Price: _____	3. 103 7/8



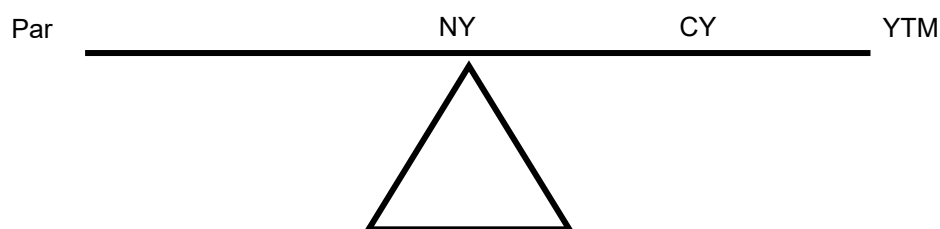
# Price versus Yield Example

Coupon: 6.00%	1. 5.85%
Price: 95.50	2. 6.00%
YTM: _____	3. 6.25%
	4. 6.47%



## Yield-to-Call (YTC)

An investor's yield if a bond is called at par



For Callable Bonds, always quote the lower of YTC or YTM (referred to as yield-to-worst)

- When bonds are callable at par and ...
  - Selling at a discount, use:
  - Selling at a premium, use:



# Price Fluctuation

When interest rates change, which bonds have the largest price change?

- Based on maturity: Long-term or Short-term
- Based on coupon: High coupon or Low coupon
- Based on duration: Longer or Shorter

Which rates are more volatile? Long-term or Short-term

To varying degrees, all bonds are subject to interest-rate risk

# Duration and Convexity

Duration	Convexity
<ul style="list-style-type: none"> <li>▪ The measure, expressed in years, of a bond's price sensitivity to <u>small changes</u> in yields</li> <li>▪ Interest-bearing bonds will have a duration less than the maturity of the bond</li> <li>▪ Zero coupon bonds have the same duration and maturity (since all cash flow is received at maturity)</li> <li>▪ The greater the duration, the greater percentage volatility</li> </ul>	<ul style="list-style-type: none"> <li>▪ Measure of price sensitivity for <u>large changes</u> in yields</li> <li>▪ Positive convexity implies that prices increase more for a decrease in yields than they decrease for an increase in yields (i.e., the upside is better than the downside is bad)</li> </ul>

# Test Your Understanding

Which bond has the MOST interest rate risk?

- a. 3%, 10-year bond
- b. Zero coupon, 10-year bond
- c. 3%, 20-year bond
- d. Zero coupon, 20-year bond

# Retiring Debt Prior to Maturity

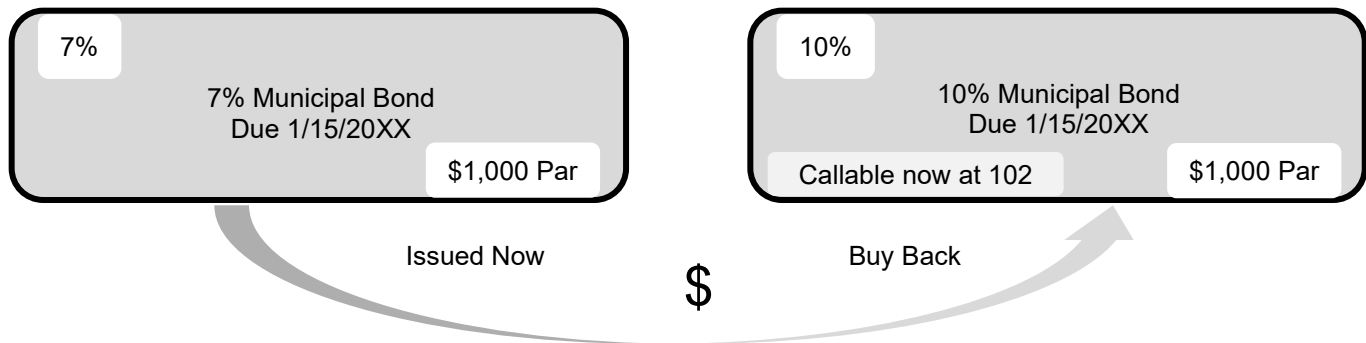
When a bond reaches its maturity date, the bondholder will redeem it back to the issuer and receive the bond's par value plus the last interest payment.

The issuer's obligation to the bondholder has ended and the debt is considered retired.

Some bonds are redeemed *before* they mature.

<p><b>Call Provision</b></p>	<p><b>What is it?</b></p> <ul style="list-style-type: none"> <li>▪ Allows the issuer to redeem bonds prior to maturity - either in-whole or partial (lottery call)</li> <li>▪ If called, the investor receives the full return of principal plus any accrued interest</li> </ul> <p><b>When is it used?</b></p> <ul style="list-style-type: none"> <li>▪ When interest rates are falling</li> </ul> <p><b>Why purchase?</b></p> <ul style="list-style-type: none"> <li>▪ Higher yield</li> <li>▪ Call protection</li> <li>▪ Call premium</li> </ul>
<p><b>Put Provision</b></p>	<p><b>What is it?</b></p> <ul style="list-style-type: none"> <li>▪ Gives the bondholder the right to redeem (or put back) the bond on a date prior to maturity (opposite of a call provision)</li> </ul> <p><b>When is it redeemed?</b></p> <ul style="list-style-type: none"> <li>▪ When interest rates are rising</li> </ul> <p><b>Why purchase?</b></p> <ul style="list-style-type: none"> <li>▪ Allows bondholders to redeem their bonds at values greater than market value as interest rates rise</li> </ul>

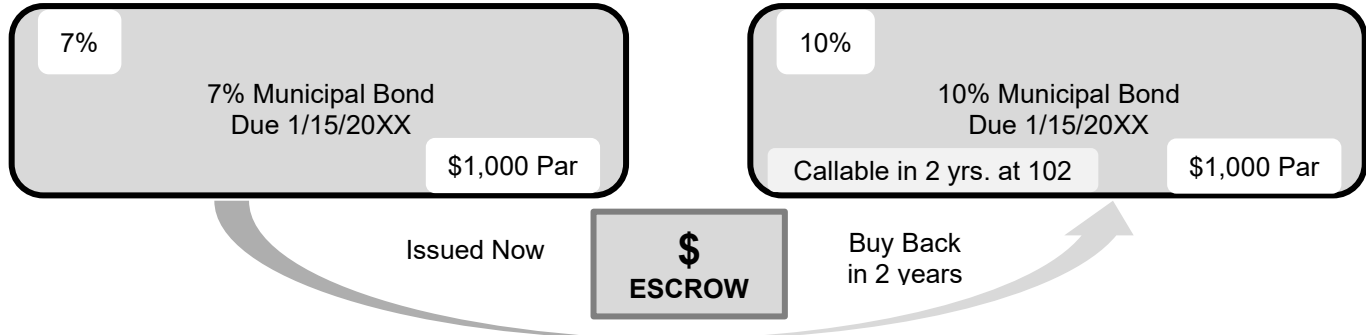
# Current Refunding



An issuer refinances an existing bond to take advantage of lower interest rates

- New bond is issued to raise capital to call the outstanding bond
  - Existing bonds retired within 90 days of refunding issue
- Issuer benefits from lower interest rate
- Existing bondholders must reinvest at lower rate

# Advance Refunding (Pre-Refunding)



- New bond issued with the proceeds deposited into escrow account and invested in U.S. Treasury securities (SLGS); managed by trustee; existing bonds retired more than 90 days after the refunding issue
- Amount deposited is enough to pay debt service

If paid off at call date: *Pre-refunded to the call*

If paid off at maturity: *Escrowed-to-maturity (ETM)*

- Pre-refunded bonds are no longer the issuer's liability (considered AAA rated)
- Defeasance – elimination of restrictive covenants

# Chapter 2 – Types and Analysis of Municipal Securities

## Municipal Bonds and Their Issuers

States and Political Subdivisions	Public Agencies and Authorities	Territories
<ul style="list-style-type: none"> <li>▪ Cities</li> <li>▪ Counties</li> <li>▪ School Districts</li> </ul>	<ul style="list-style-type: none"> <li>▪ Transit Systems</li> <li>▪ Housing Authorities</li> <li>▪ Water, Sewer, and Electric Systems</li> </ul>	<ul style="list-style-type: none"> <li>▪ Puerto Rico</li> <li>▪ Guam</li> <li>▪ U.S. Virgin Islands</li> </ul>

## Types of Municipal Bonds

<b>General Obligation (GO) Bonds</b>	<p>Purpose:</p> <ul style="list-style-type: none"> <li>▪ Issued for general purposes to meet any need of the issuer</li> </ul> <p>Sources for payment of debt service:</p> <ul style="list-style-type: none"> <li>▪ Taxes and the Issuer's full faith and credit</li> </ul> <p>State level:</p> <ul style="list-style-type: none"> <li>▪ Sales taxes, income taxes</li> </ul> <p>Local level:</p> <ul style="list-style-type: none"> <li>▪ Ad Valorem (property taxes) <ul style="list-style-type: none"> <li>• Assessed value x millage rate = tax bill (1 mill = .001)</li> </ul> </li> <li>▪ Parking/licensing fees</li> </ul>
<b>Revenue Bonds</b>	<p>Purpose:</p> <ul style="list-style-type: none"> <li>▪ Issued to fund a specific project</li> </ul> <p>Sources for payment of debt service:</p> <ul style="list-style-type: none"> <li>▪ Revenue (user fees) from a specific project</li> </ul> <p>Typical Projects:</p> <ul style="list-style-type: none"> <li>▪ Toll roads, bridges, stadiums, airports</li> </ul> <p>Considered:</p> <ul style="list-style-type: none"> <li>▪ Self-supporting debt</li> </ul>

# Comparison of GO and Revenue Bonds

Characteristic	GO Bonds	Revenue Bonds
Purpose		
Sources for Payment		
Risk		
Yield		
Voter Approval		
Subject to Debt Limitations		

## Analyzing General Obligation Debt

There are four fundamental factors in determining the ability of the issuer to generate sufficient taxes to pay debt service

<b>DEMOGRAPHICS</b>	Evaluate the tax base, geographic location, businesses, and property values
<b>NATURE OF THE ISSUER'S DEBT</b>	Consider the debt trend, past and present attitude toward debt, and the schedule of debt repayment
<b>ASPECTS THAT AFFECT THE ISSUER'S ABILITY TO PAY</b>	Existing unfunded pension liabilities, tax limitations, tax rates and collections, current financial condition, and outstanding litigation
<b>MUNICIPAL DEBT RATIOS</b>	Issuer's net overall debt (direct and overlapping), debt-to-assessed valuation, and per capita net debt

# Sample Property Tax Bill

TOWN OF HARWICH, MA – PROPERTY TAX BILL	
Fair Market Values (FMV):	
Land	\$120,000
Structure	\$300,000
Total FMV	<b>\$420,000</b>
Total Assessed Value:	<b>\$336,000</b> <span>80% of FMV</span>
Tax Rate:	<b>.007</b> <span>Based on \$7.00 per \$1,000 of Assessed Value</span>
Property Taxes:	<b>\$2,352</b> <span>\$336,000 x .007</span>

## Types of Revenue Bonds

Type	Source for Paying Debt Service
TRANSPORTATION REVENUE	Use tolls and user fees
SPECIAL TAX	Excise taxes on purchases, such as gasoline, tobacco, and liquor
SPECIAL ASSESSMENT	Assessments on the benefitting properties; used for sidewalks, sewers, etc.
DOUBLE BARRELED	Two sources – project revenue and tax dollars (from GO bonds)
MORAL OBLIGATION	If project revenue is insufficient, the state legislature is morally (but not legally) obligated for the shortfall
INDUSTRIAL DEVELOPMENT BOND (IDB)	Issued by a municipality and secured by a lease agreement with a corporate user of the facility

# Types of Revenue Bonds

Type	Source for Paying Debt Service
<b>CERTIFICATE OF PARTICIPATION</b>	Non-interest bearing; investor receives a return based on the lease revenues of a project <ul style="list-style-type: none"> <li>▪ Bond is secured by title to the project</li> </ul>
<b>LEASE RENTAL</b>	Proceeds are used to finance public purpose projects; debt service and maintenance are paid by the lease rentals (e.g., police stations, public office buildings)
<b>EDUCATION</b>	Dormitories, student loans, educational buildings
<b>HEALTH</b>	Hospitals, long-term care, assisted living
<b>TAXABLE</b>	Used for purpose that's not subsidized by the government

## Build America Bonds (BABs)

Issued under the American Recovery and Reinvestment Act of 2009  
(BAB program was discontinued at the end of 2010)

- Designed to assist municipalities in raising funds for capital projects
  - May NOT be used for refundings, working capital, private activities, or 501(c)(3) organizations
- Interest is federally taxable which makes them suitable for tax-exempt fixed-income investors (e.g., pension funds)

The U.S. Treasury reimburses issuers for 35% of the interest paid on the bonds; therefore, an issuer's net cost is 65%

- For example, a BAB issued at 6.25% will cost the issuer 4.06% ( $6.25\% \times 65\%$ )

# 501(c)(3) Organizations

501(c)(3) organizations are not-for-profit entities established under IRS guidelines (e.g., educational, charitable, or religious entities)

These organizations may borrow funds through a conduit issuer for purposes of financing a capital project

- Examples include hospitals, low-income housing, universities, and retirement communities

Interest on the bonds is not subject to the AMT

- The offerings are referred to as “501(c)(3) bonds”
- The bond’s payments and credit strength are based on the 501(c)(3) borrower, not the issuer

For example, the DC University (the conduit issuer) issues revenue bonds for Georgetown University (the 501(c)(3) borrower). The bonds are backed by payments made by the university to the issuer, not by the issuer.

## Test Your Understanding

Rank the yields of the following bonds from the highest to lowest:

- I. Treasury Bond
- II. Taxable Revenue Bond
- III. Taxable General Obligation Bond
- IV. General Obligation Bond
- V. Revenue Bond

Answer:



# Analyzing Revenue Bonds

<b>Feasibility Study</b>	<ul style="list-style-type: none"> <li>▪ A detailed report focusing on the economic viability and the need for the program or service</li> <li>▪ Factors evaluated include:             <ul style="list-style-type: none"> <li>• The anticipated demand for the program</li> <li>• Revenues and costs for similar programs</li> <li>• Engineering aspects of the proposed project</li> </ul> </li> </ul>
<b>Credit Enhancements</b>	<ul style="list-style-type: none"> <li>▪ Credit of an entity other than the issuer provides security of the debt financing</li> <li>▪ Examples include:             <ul style="list-style-type: none"> <li>• Bond insurance</li> <li>• Letters of credit</li> <li>• Guaranteed Investment Contract (GIC)</li> </ul> </li> </ul>

## Covenants

<b>RATE</b>	Pledge to maintain the user fees at a level sufficient to meet debt service and other obligations
<b>MAINTENANCE AND OPERATION</b>	Pledge to maintain the project in good working order and to contribute to a fund for that purpose
<b>INSURANCE</b>	Pledge to carry insurance on the property
<b>CATASTROPHE CALL</b>	Provides the issuer with the ability to retire a bond due to destruction of the revenue source backing the bond
<b>ADDITIONAL BONDS</b>	Pledge not to issue more debt unless certain tests are met
<b>NON-DISCRIMINATION</b>	Pledge to not grant special rates to any one person or group
<b>FLOW OF FUNDS</b>	Establishes the priority for payment of debt service <ul style="list-style-type: none"> <li>▪ Net versus Gross</li> </ul>

# Net versus Gross Revenue Pledge

Net Revenue Pledge Bond	
Start:	Gross Revenue
Deduct:	Maintenance and Operation
Leaving:	Net Revenue
From which is paid:	Debt Service

Gross Revenue Pledge Bond	
Start:	Gross Revenue
Deduct:	Debt Service
From what's left is paid:	Maintenance and Operation

Debt Service Coverage Ratio is calculated by taking the amount *available for debt service* and dividing by the amount *needed for debt service*.

## Credit Ratings

	S&P/Fitch	Moody's
Investment Grade	AAA	Aaa
	AA	Aa
	A	A
	BBB	Baa
Speculative Grade	BB	Ba
	B (etc.)	B (etc.)
	+ or -	1, 2, 3

## Municipal Notes

These *Tax-Free Anticipation Notes* are short-term issues that are normally issued to assist in financing a project or to assist a municipality in managing its cash flow

Types include:

- Tax Anticipation Notes (TANs)
- Revenue Anticipation Notes (RANs)
- Bond Anticipation Notes (BANs)
- Grant Anticipation Notes (GANs)
- Tax-Exempt Commercial Paper
  - Maximum maturity of 270 days and is normally backed by a bank line of credit

# Ratings for Municipal Notes

	S&P	Moody's
Investment Grade	SP 1+	MIG 1
	SP 1	MIG 2
	SP 2	MIG 3
Speculative Grade	SP 3	SG

## Variable Rate Municipal Securities

<b>Variable Rate Demand Obligations (VRDO)</b>	<ul style="list-style-type: none"> <li>▪ Long-term securities marketed as short-term investments</li> <li>▪ Debt securities that offer a variable rate of interest adjusted at specified intervals (e.g., daily, weekly, or monthly)</li> <li>▪ Holders can redeem for par plus accrued interest at any time that rates are reset</li> <li>▪ Include Put provisions</li> </ul>
<b>Auction Rate Securities (ARS)</b>	<ul style="list-style-type: none"> <li>▪ Long-term investments with a variable interest rate that is reset at periodic intervals through a "Dutch Auction"</li> <li>▪ Auction sets the lowest interest rate at which all of the securities being offered for sale will clear the market ("net clearing rate")</li> <li>▪ Interest rate reset periods range from 7, 28, or 35 days</li> <li>▪ Do NOT include Put provisions</li> </ul>

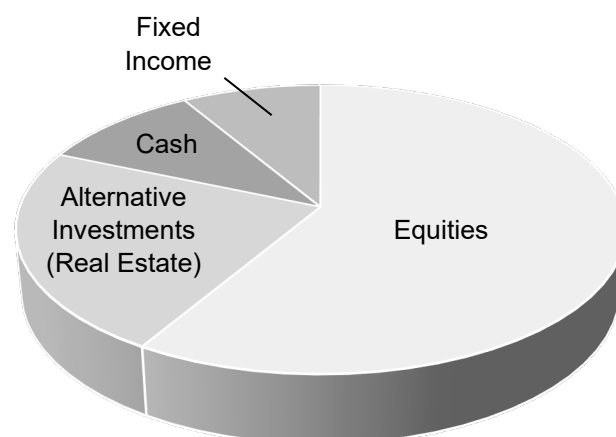
# Chapter 3 – Tax Considerations and Municipal Fund Securities

## Asset Classes

Asset allocation focuses on a portfolio that's constructed of various asset classes

- To approximate the equity percentage, use  $(100 - \text{person's age})$

An optimal portfolio (one producing the greatest return for a given amount of risk) is based on a client's goals, expected return, and risk tolerance



## Types of Investment Risk

Financial (Credit)	Interest Rate	Call and Put
Risk that the issuer may be unable to pay debt service when due (low for Treasury securities)	Risk that changes in interest rates will adversely affect an investor's securities portfolio (higher for long-term bonds)	Risk that a bond may be called by the issuer or the risk of receiving less for a bond when it's put back to the issuer

Inflation (Purchasing Power)	Reinvestment
Risk that the value of assets will be eroded as inflation shrinks the value of a country's currency (low for stocks, but high for bonds)	Risk that falling rates may cause the cash flow from an investment to earn less than the original investment

# Suitability Question

A customer is in her late 40s, is currently in the 15% tax bracket, and considers herself a conservative investor. She recently inherited \$7,000,000 and wants your advice on how to invest the inheritance. Which of the following choices is the BEST method of investing the funds?

- 20% equities, 30% Treasury bonds, and 50% tax anticipation notes
- 80% equities, a 10% mixture of in-state and out-of-state municipal bonds, and 10% in corporate bonds
- 30% equities, 20% in-state municipal bonds, 20% out-of-state municipal bonds, 15% Treasury bonds, 10% revenue anticipation notes, and 5% tax-exempt money-market funds
- 20% in-state municipal bonds, 20% out-of-state municipal bonds, 20% corporate bonds, 20% Treasury bonds, 10% revenue anticipation notes, and 10% tax exempt money-market funds

# Tax Considerations

An investor's tax situation is important when determining how to address objectives

<b>MARGINAL TAX BRACKET</b>	<ul style="list-style-type: none"> <li>At what rate will the individual be taxed?</li> <li>Will the alternative minimum tax (AMT) apply?</li> </ul>
<b>INVESTMENT INCOME</b>	<ul style="list-style-type: none"> <li>Is the individual receiving interest from existing investments?</li> <li>Is the interest from the bonds taxable?</li> </ul>
<b>ESTATE AND GIFT TAXES</b>	<ul style="list-style-type: none"> <li>Gifts up to \$19,000 can be transferred to any number of individuals without tax implication to the donor</li> <li>Married couples can combine for a total of \$38,000</li> </ul>
<b>CAPITAL GAINS AND CAPITAL LOSSES</b>	<ul style="list-style-type: none"> <li>Short-term gains are taxed at ordinary income rates, while long-term gains are taxed at a maximum rate of 20%</li> <li>Capital losses are used to offset capital gains and a maximum of \$3,000 of ordinary income</li> <li>Capital gains on municipal securities are federally taxable</li> </ul>

# Tax Considerations

## Municipal bond interest:

- Interest received is *exempt from federal tax*; however, it **may be** subject to state and local tax if purchased from a state that is not the bondholder's resident state
- Interest paid on bonds issued by U.S. territories and possessions is *triple tax exempt*
- Bank-Qualified (BQ) bonds are issued by "qualified small issuers" that issue no more than \$10 million per year
  - BQ bonds allow banks to deduct 80% of the interest cost paid to the depositors on the funds that are used to purchase these bonds
  - As a result, BQ bonds placed with a bank will generally be sold with a lower coupon than comparable non-BQ bonds

Investors in higher tax brackets benefit more from the tax-exempt nature of municipal debt; however, municipals are generally unsuitable for investors who are in lower tax brackets or as an investment in retirement accounts.

# Additional Tax Considerations

Zero-Coupon Municipals	Capital Appreciation Bonds (CABs)	Private Activity Bonds
<ul style="list-style-type: none"> <li>▪ Annual accreted amounts are considered tax-free interest</li> <li>▪ Accretes to par value at maturity</li> </ul>	<ul style="list-style-type: none"> <li>▪ Issued at deep discount</li> <li>▪ Investment return on initial principal value is reinvested at a compounded rate</li> <li>▪ At maturity, investors receive a single payment representing the initial amount and investment return (discount is not accreted)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Typically taxable for investors who are subject to alternative minimum tax (AMT)</li> <li>▪ Yields are higher than non-AMT bonds</li> <li>▪ Suitable for investors who are not subject to the AMT</li> <li>▪ Classified if a percentage of proceeds will be used to finance a project to be utilized by a private entity (e.g., a corporation or professional sports team)</li> </ul>

# Yield Calculations

An investor is earning 4.55% on a tax-free municipal and is in the 35% tax bracket. What must a taxable bond yield to be equivalent?

Taxable Equivalent Yield Formula:		Tax-Free Yield
		(100% – Tax Bracket %)
$\frac{4.55}{(100\% - 35\%)}$	=	$\frac{4.55}{65\%} = 7.0\%$

An investor purchased a 7.0% corporate bond and is in the 35% tax bracket. What tax exempt yield would be required to equal the taxable yield?

Net Yield Formula:	Taxable Yield x (100% – Tax Bracket %)	
$7.0 \times (100\% - 35\%)$	=	$7.0 \times 65\% = 4.55\%$

## Considering the State Tax

An Ohio resident purchases a State of Ohio G.O. bond yielding 4.25%. He is subject to a 30% federal tax and a 3% state tax. What must a taxable bond yield to be equivalent?

Taxable Equivalent Yield Formula:	=	Tax-Free Yield
		(100% – Federal + State Tax %)
$\frac{4.25}{(100 - 33\%)}$	=	$\frac{4.25}{67\%} = 6.34\%$

Neither federal nor state tax apply since he's an Ohio resident

An Iowa resident purchases the same State of Ohio G.O. bond and is also subject to a 30% federal tax. What is the taxable equivalent yield?

Taxable Equivalent Yield Formula:	=	Tax-Free Yield
		(100% – Federal Tax %)
$\frac{4.25}{(100 - 30\%)}$	=	$\frac{4.25}{70\%} = 6.07\%$

Since she's not an Ohio resident, she's only exempt from federal tax

# OID Bond Taxation

## Original Issue Discount (OID) Bond

- Basis must be **accreted** at a rate that will bring basis to par at maturity
- If sold prior to maturity, capital gain or loss determined by difference between the bond's cost basis and the sales proceeds
- If held to maturity, accreted adjustment is considered tax exempt interest, which results in no taxable gain

The following examples for OID and Premium bond taxation use the straight-line method to adjust the cost basis, which is what's used for any exam questions. However, the actual method is referred to as the *constant yield* or *constant interest method*.

## OID Sold Prior to Maturity

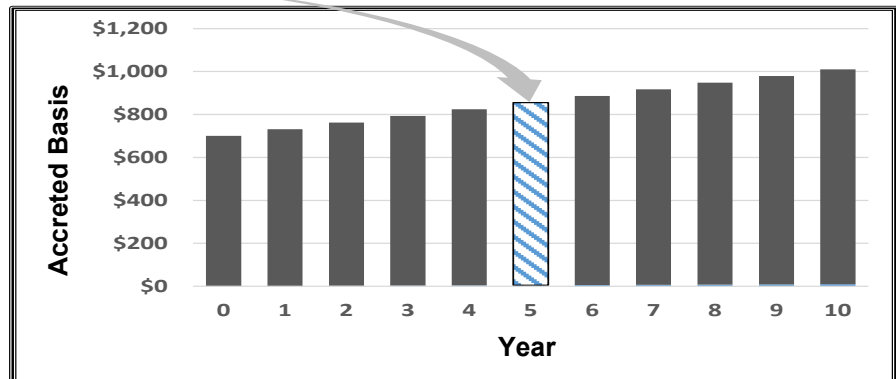
An OID is purchased at \$700 with 10 years to maturity. Five years later, the bond is sold for \$880. What is the result for tax purposes?

$$\begin{array}{r} \$1,000 \text{ par} \\ - \$700 \text{ cost} \\ \hline \$300 \text{ discount} \end{array}$$

$$\frac{\$300 \text{ discount}}{10 \text{ years}} = \$30 \text{ is accreted each year, but not taxable}$$

After five years, the basis is \$850 (\$30 x five years = \$150). The \$150 is treated as tax exempt interest income.

If sold at \$880, the \$30 difference (\$880 – \$850) is treated as a capital gain.





# De Minimis Exception and OIDs

A bond is NOT considered an OID if the discount at issuance is no greater than .25% or 25 basis points per year

For calculation purposes:

- $\text{Par} \times .25\% \times \text{Years to Maturity}$

For example, a 20-year bond is issued

- $\$1,000 \times .25\% \times 20 \text{ years} = \$50$ 
  - If the bond is issued at \$960 (a \$40 discount), the discount may be ignored
  - If the bond is issued at \$900 (a \$100 discount), the bond is considered an OID

## Premium Bond Taxation

Premium Bond:

- Basis must be **amortized** at a rate that will bring basis to par at maturity
- If sold prior to maturity, capital gain or loss determined by difference between the bond's adjusted cost basis and the sales proceeds
- If held to maturity, amortized adjustment is not deductible, which results in no taxable loss

## Premium Bond Sold Prior to Maturity

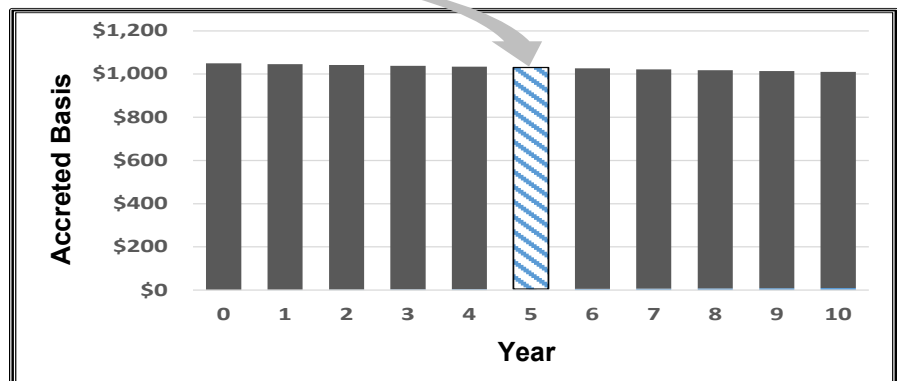
A bond is purchased for \$1,050 with 10 years left to maturity. Five years later, the bond is sold at \$1,030. What is the result for tax purposes?

$$\frac{\begin{array}{r} \$1,050 \text{ cost} \\ -\$1,000 \text{ par} \\ \hline \$50 \text{ premium} \end{array}}{\$50 \text{ premium}}$$

$$\frac{\$50 \text{ premium}}{10 \text{ years}} = \$5 \text{ is amortized each year}$$

After five years, the basis is \$1,025 (\$5 x five years = \$25). The \$25 is an adjustment to the cost basis, but is not deductible.

When sold at \$1,030, the \$5 difference (\$1,030 – \$1,025) is treated as a capital gain.



# Secondary Market Discount Bond Taxation

## Secondary Market Discount Bond

- Bond that was issued at par, but is later purchased at a discount in the secondary market
- The basis is not adjusted
- When the bond is sold or matures, the accreted market discount is taxed as ordinary income

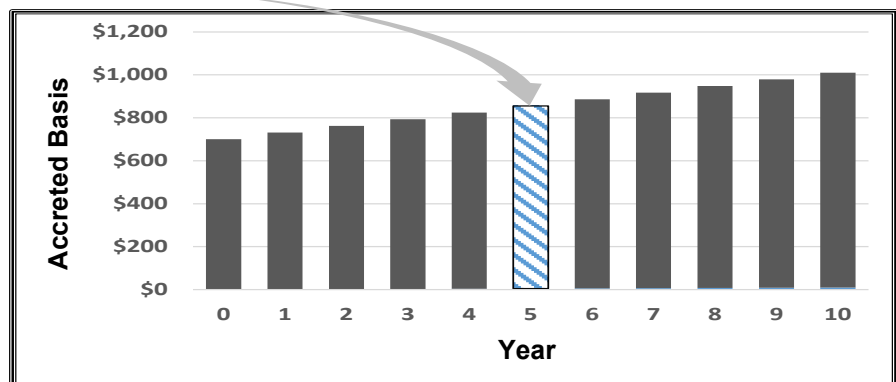
## Market Discount Sold Prior to Maturity

A bond was issued at par, later purchased for \$900 with 10 years left to maturity. Five years later, the bond is sold at \$980. What is the result for tax purposes?

$$\begin{array}{r} \$1,000 \text{ par} \\ - \$900 \text{ cost} \\ \hline \$100 \text{ discount} \end{array} \quad \begin{array}{r} \$100 \text{ discount} \\ 10 \text{ years} \end{array} = \$10 \text{ is accrued each year}$$

After five years, the difference between the cost (\$900) and the proceeds (\$980) is \$80

- \$50 of the difference is treated as ordinary income (\$10 x five years)
- \$30 is treated as a capital gain



## De Minimis Exception and Market Discounts

A bond is NOT considered a discount bond if the discounted price is no greater than .25% or 25 basis points per year

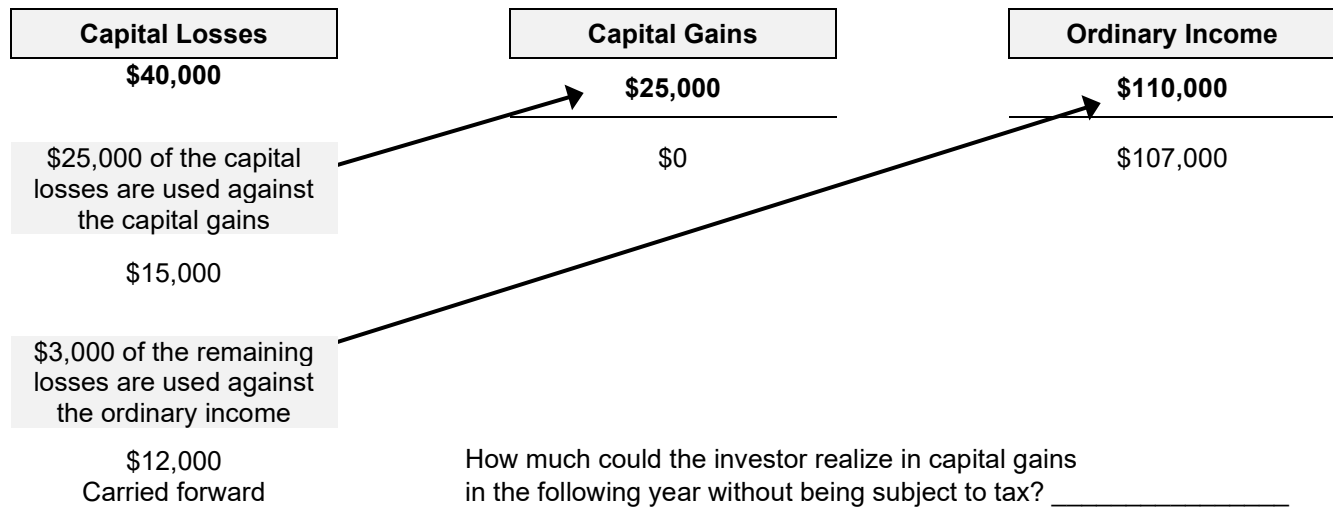
For calculation purposes:

- $\text{Par} \times .25\% \times \text{Years to Maturity}$

For example, a \$1,000 bond is purchased at \$980 and has 10 years left to maturity

- $\$1,000 \times .25\% \times 10 \text{ years} = \$25$ 
  - This is NOT considered a market discount since the discount is only \$20
  - The \$20 is considered a capital gain

# Offsetting Capital Gains and Losses



## Tax Swaps and the Wash Sale Rule

Assets may be sold to generate losses in order to offset taxable gains

However, the IRS will disallow the capital loss if, within 30 days of the sale, the investor purchases *substantially the same* security (or covers a short position and shorts *substantially the same* security)

- Disallowed loss is added to the basis of the newly purchased security
- What is *substantially the same*?
  - For bonds – at least two of the following three items must be different:
    - Issuer, coupon, maturity



# Municipal Fund Securities

Local Government Investment Pools (LGIPs)	Prepaid Tuition Plans	529 Plans
<ul style="list-style-type: none"> <li>Created by state and local governments to provide municipal entities a place to invest funds</li> <li>Government entities purchase interest in the trust (LGIP)</li> <li>Provides safety and diversification</li> <li>Not open to the public</li> </ul>	<ul style="list-style-type: none"> <li>A type of college savings plan</li> <li>Purchaser buys college tuition credits               <ul style="list-style-type: none"> <li>Locks in tuition costs at current levels</li> <li>Protects against future cost increases</li> </ul> </li> <li>Not self-directed</li> </ul>	<ul style="list-style-type: none"> <li>Primarily a type of college savings plan</li> <li>Account owner chooses a plan, but may alter the investment direction</li> <li>Not self-directed</li> <li>More detail on next slide</li> </ul>

## 529 Plans

- Funded with after-tax dollars; investment grows tax-deferred
- Money invested in one state's plan may be used in another state
- To avoid gift tax, the maximum contribution is \$19,000 per person, per year (doubled for married couples)
  - The plan allows for front-loading five years of contributions (\$95,000 per person or \$190,000 for married couples)
- A federal tax exemption is provided to the beneficiary for qualified withdrawals:
  - College tuition, books and supplies, room and board, a maximum withdrawal of \$10,000 for tuition and books for grades K-12

## 529 Plans

- Any person may be a donor, even the beneficiary
- States may impose dollar limits
- States may provide a tax exemption for in-state schools
- Summary of 529 plan changes:
  - Changes may be made to the named beneficiary without limitation; each time a beneficiary is changed, the selection of investments may change
  - Changes may be made to the investment options of a 529 plan by the account owner no more than twice per calendar year
  - The account owner is permitted to rollover funds from one 529 plan to another 529 plan for the same beneficiary, but only once per year

# 529 Plans and 529 ABLÉ Plans

529 plans may be direct-sold or adviser-sold:

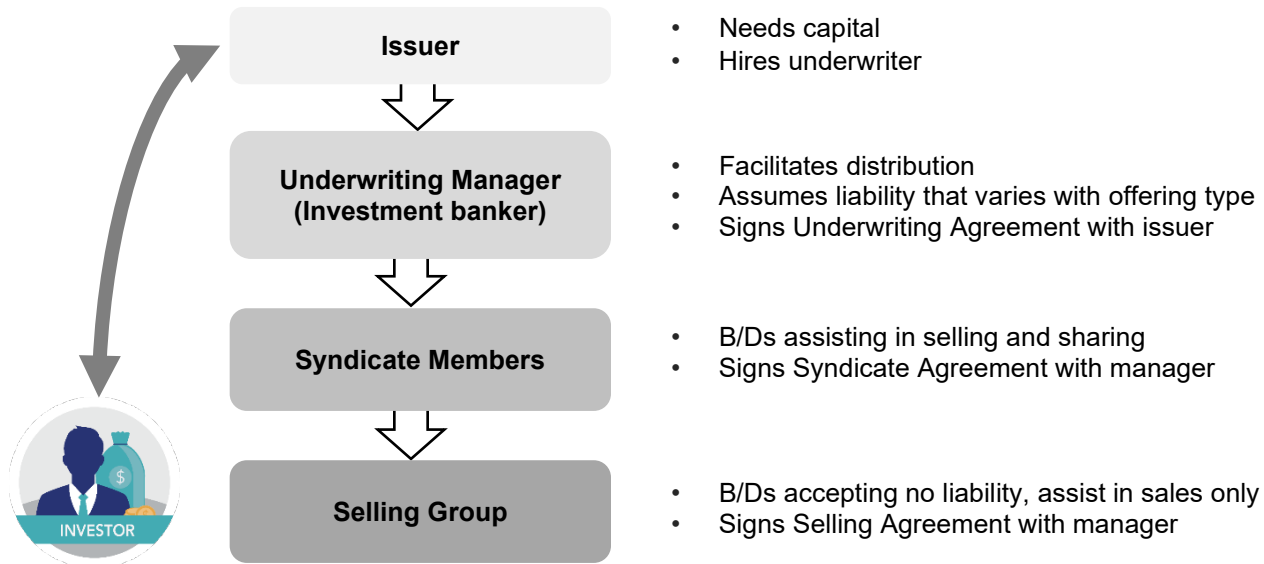
DIRECT-SOLD	ADVISER-SOLD
<ul style="list-style-type: none"> <li>Involves no salespersons; instead, the plan is sold directly through the 529 savings plan's website or through the mail</li> </ul>	<ul style="list-style-type: none"> <li>The plan is sold through a broker-dealer that has entered into a selling agreement with the primary distributor of the 529 plan</li> </ul>

529 ABLÉ (529A) Plans (Achieving a Better Life Experience)

- Available to individuals who are disabled and are receiving Social Security disability, Medicaid, or private insurance payments
  - Maximum contribution is \$19,000 per year (no front-loading)
  - Disability payments continue if account value doesn't exceed \$100,000
  - Distributions are tax-free if used to pay qualified expenses
  - Can only be purchased in the person's state of residency

# Chapter 4 – The Market for Municipal Securities

## The Primary Market



## Issuing G.O. and Revenue Bonds

Municipal debt issues are exempt from the registration and prospectus requirements

ISSUING GENERAL OBLIGATION (GO) BONDS	ISSUING REVENUE BONDS
<ul style="list-style-type: none"> <li>Typically requires voter approval</li> <li>Subject to debt limitations placed on the municipality               <ul style="list-style-type: none"> <li>These limit its ability to add debt above its <i>debt ceiling</i></li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Don't require voter approval since they're backed by fees that are paid for use of the system or services</li> <li>A consultant is hired to produce a <i>feasibility study</i></li> </ul>

# Municipal Documents / Information

<b>Official Statement</b>	Used by municipal issuers as a disclosure document, although not required <ul style="list-style-type: none"> <li>Provided by the issuer to the underwriter</li> </ul>
<b>Legal Opinion</b>	Prepared by Bond Counsel which renders its opinions as to: <ul style="list-style-type: none"> <li>Issuer's legal, valid, and enforceable obligation</li> <li>Tax exempt status of the issue</li> <li>Unqualified versus Qualified</li> </ul>
<b>New Issue Confirmations</b>	Provided to purchasers, along with a copy of the official statement, by no later than settlement date
<b>New Issue Information Dissemination Service (NIIDS)</b>	Requires the managing underwriter to send new issue information for <i>depository eligible</i> municipal securities (DTC) within two hours of first execution

## Selecting an Underwriter

There are two different methods that a municipality may use when selecting its underwriter

Competitive Sale	Negotiated Sale
<ul style="list-style-type: none"> <li><i>Notice of Sale</i> advertises the offering to underwriters <ul style="list-style-type: none"> <li>The Notice is prepared by the issuer</li> <li>Contains relevant details about the issue</li> </ul> </li> <li>Issuer is inviting underwriters to submit sealed bids <ul style="list-style-type: none"> <li>Underwriting generally awarded to lowest bid</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Issuer appoints its managing underwriter</li> <li>Both issuer and underwriter "negotiate" terms of the deal</li> </ul>

Municipal Advisor – typically employed by a municipality to assist in selecting an underwriter

# Competitive Sale – Syndicate Practice

Syndicate manager prepares the “Official Bid Form”

- Figure re-offering scale
- Determine the price to be paid to issuer
- The bid is summarized with a single number based on interest cost
  - Net Interest Cost (NIC) – interest paid over bond's life divided by bond years  
OR
  - True Interest Cost (TIC) – takes into account time value of money (Canadian method)
- Winning syndicate bid (lowest gross interest cost) takes bonds as a firm commitment

## Computing Net Interest Cost

\$60,000 bond offering with a 5% coupon			
\$ Amount	Maturity	Bond Years	Interest
10,000	3 years		
10,000	4 years		
20,000	5 years		
20,000	6 years		

$$\text{NIC} = \frac{\text{Total Interest}}{\text{Bond Year Total}} = \frac{\$14,500}{\$290,000} = 5\%$$

A bid of \$1,020 is placed (a 2% premium),  
which equals \$1,200 (\$60,000 x 2%)

$$\frac{\$14,500 - \$1,200}{\$290,000} = \text{NIC of 4.58\%}$$



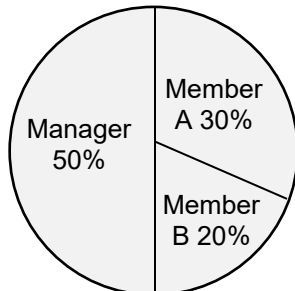
# Syndicate Practice

## Formation of a Syndicate

- Manager invites other B/Ds to participate and share in liability by sending *Syndicate Letter (Agreement Among Underwriters)*
- Syndicate Letter addresses the following:

Size and type of offering (most offerings are firm commitments)
Percentage required to participate (manager usually assumes the most responsibility)
Type of Syndicate <ul style="list-style-type: none"> <li>▪ Undivided (Eastern) – each member is responsible for a specific percentage of unsold bonds</li> <li>▪ Divided (Western) – members are not responsible for bonds that are left unsold by others</li> </ul>
Priority of orders <ul style="list-style-type: none"> <li>▪ How credit for orders is allocated among members of the distribution group</li> </ul>

## Syndicate Liability for Unsold Bonds



A three-member syndicate is involved in a firm commitment underwriting of a \$100 million bond offering

### Reallocation of:

Member	Sales	Divided Acct.	Undivided Acct.
Manager	\$50 million		
Member A	\$30 million		
Member B	\$5 million		

# Priority of Orders

The hierarchy by which underwriters allocate orders among the distribution group

<b>1) Pre-Sale or Retail</b>	In a competitive underwriting, <i>pre-sale</i> orders are received before bonds are awarded and priced. In a negotiated underwriting, the term <i>retail orders</i> is used (defined by the issuer).
<b>2) Group Net</b>	Benefits all syndicate members according to their percentage interest
<b>3) Designated</b>	Buyer determines which member(s) will receive credit for the sale
<b>4) Member</b>	Syndicate member that places the order is the only member to receive credit for the sale

## Components of the Spread

- Manager's fee – fee not shared with other members of the syndicate
- Total Takedown – fee received by underwriter if it sells the bonds to a customer
- Additional Takedown – fee received by underwriter for bonds sold by selling group
- Concession – fee received by selling group if it sells the bonds to a customer

Manager's Fee	Additional Takedown	Concession

# Components of the Spread

Total Takedown $\frac{3}{4}$ or \$7.50		
Manager's Fee	Additional Takedown	Concession
$\frac{1}{4}$ or \$2.50	$\frac{1}{4}$ or \$2.50	$\frac{1}{2}$ or \$5.00

Example: A customer buys \$10,000 worth of bonds. How is the spread distributed?

	Manager Sells	Member Sells	Selling Group Sells
Manager:			
Member:			
Selling Group:			

## Electronic Municipal Market Access (EMMA)

MSRB website offered free of charge; used by issuers and underwriters to submit documents

<b>Electronic Access</b>	<ul style="list-style-type: none"> <li>Provides electronic public access to information about the municipal market, including:             <ul style="list-style-type: none"> <li>Trade activity and market statistics</li> </ul> </li> </ul>
<b>Documents</b>	<ul style="list-style-type: none"> <li>Issuers and underwriters submit various disclosure documents:             <ul style="list-style-type: none"> <li>Pre-sale documents, official statements, and continuing disclosures</li> </ul> </li> </ul>
<b>Plan Info</b>	<ul style="list-style-type: none"> <li>Includes 529 plan information</li> </ul>

## Secondary Market Trading

Broker's Broker
<ul style="list-style-type: none"> <li>Firm that deals exclusively with other brokerage firms or banks</li> <li>Do not underwrite new issues, maintain inventory, or deal with the public</li> </ul>
Municipal Bond Trader
<ul style="list-style-type: none"> <li>Position trading</li> <li>Secondary market joint account</li> <li>May use futures to hedge</li> </ul>

# Trading Terms

<b>Multiples of:</b> Units of a stated multiple that must be filled
<b>Out Firm:</b> Bonds that have been offered for a stated period – To be sold during the given period, the B/D must release the bonds
<b>All-or-None:</b> The entire order must be filled or none of it
<b>Fill-or-Kill:</b> The entire order must be filled immediately or it's cancelled
<b>Locked Market:</b> The bid and offer are equal
<b>Covered Bid:</b> The difference between the winning bid and next highest bid

## Municipal Market Indexes

### Bond Buyer Indexes

- 20-Bond: Average yield of 20 G.O.s
  - 20-year maturities with average rating of AA/Aa2
- 11-Bond: Average yield of 11 of the 20 bonds above
  - Average rating of AA+/Aa1
- Revenue Bond: Average yield of 25 revenue bonds
  - 30-year maturities with average rating of A+/A1
- Municipal Bond: 40 actively-traded bonds
  - Minimum 19 years to maturity with rating of A or better

### SIFMA Index

- Average weekly rates on VRDOs

### MMD Index

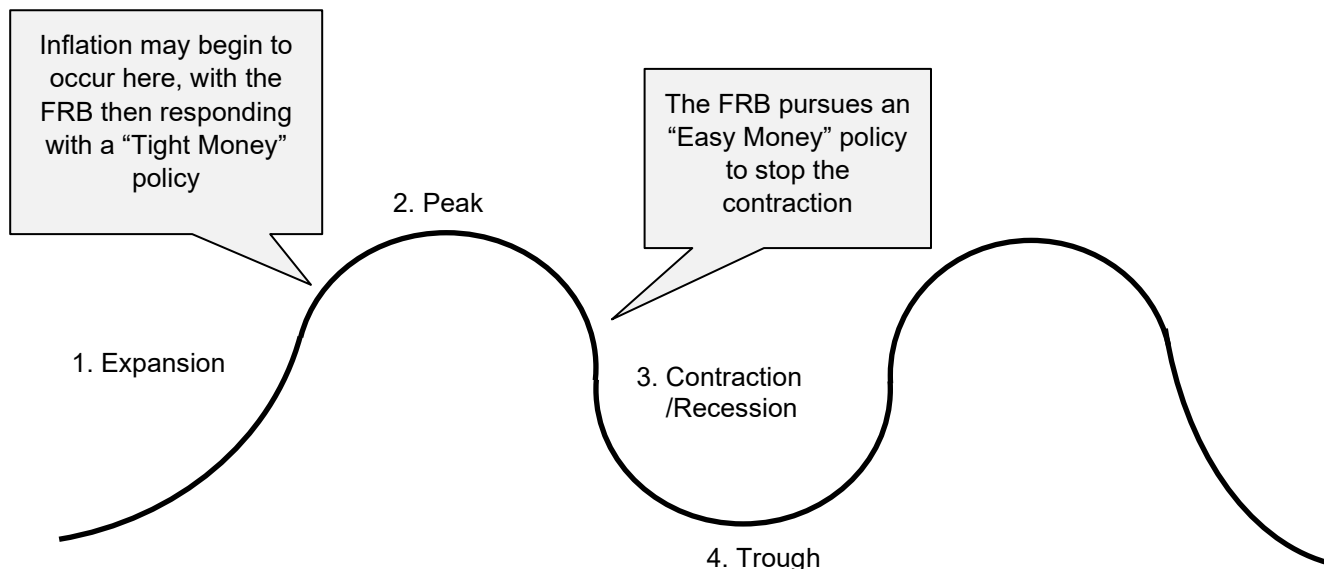
- Yield curve on AAA rated, state-issued G.O.s
- Provided by Thompson Financial

# Chapter 5 – Monetary and Fiscal Policy

## Economic Terms

<b>Gross Domestic Product (GDP)</b>	Measurement of the output of goods and services produced within the U.S. (disregards origin of producer) <ul style="list-style-type: none"> <li>▪ Key measure of aggregate economic activity</li> </ul>
<b>Consumer Price Index (CPI)</b>	Measures the change in prices of goods purchased by a typical consumer <ul style="list-style-type: none"> <li>▪ Key measure of inflation</li> </ul>
<b>Inflation</b>	“Too much money chasing too few goods” <ul style="list-style-type: none"> <li>▪ Leads to a rise in prices of goods and services</li> <li>▪ High inflation usually accompanies high interest rates</li> </ul>
<b>Deflation</b>	A general decline in prices, often caused by a reduction in the supply of money or credit <ul style="list-style-type: none"> <li>▪ Interest rates trend downward</li> </ul>

## The Business Cycle



# Economic Indicators

Leading Economic Indicators	Coincident Economic Indicators	Lagging Economic Indicators
<ul style="list-style-type: none"> <li>▪ Building permits, private housing units</li> <li>▪ Manufacturers' new orders, consumer goods, non-defense capital goods</li> <li>▪ S &amp; P 500 Index</li> <li>▪ Initial claims for unemployment insurance</li> <li>▪ Interest rate spreads, 10-year T-bonds less federal funds</li> </ul>	<ul style="list-style-type: none"> <li>▪ The Index of Industrial Production</li> <li>▪ Employees on non-agricultural payrolls</li> <li>▪ Personal income less transfer payments</li> </ul>	<ul style="list-style-type: none"> <li>▪ Change in the Consumer Price Index for services</li> <li>▪ Average prime rate charged by banks</li> <li>▪ Average duration of unemployment</li> </ul>

# Monetary and Fiscal Policy

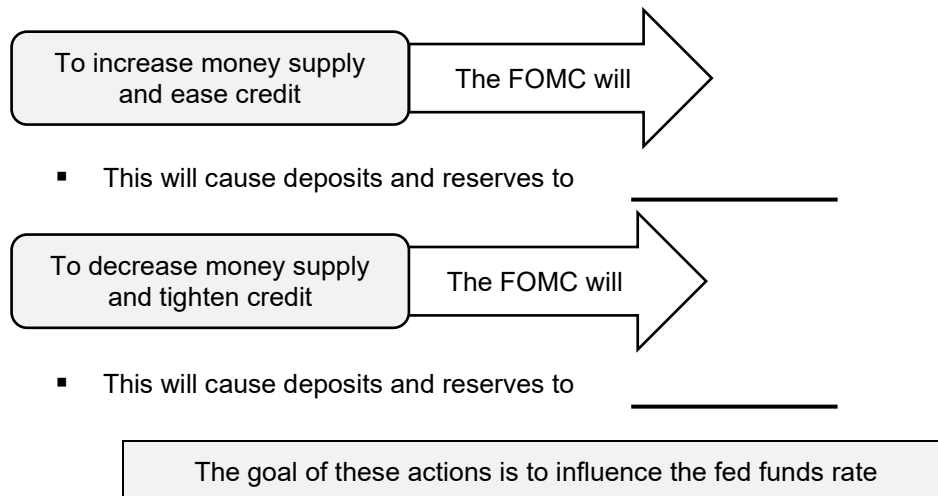
	KEYNESIAN	MONETARIST
Principally attempt to influence		
Type of policy		
Responsible for implementation		

# Tools of the Fed

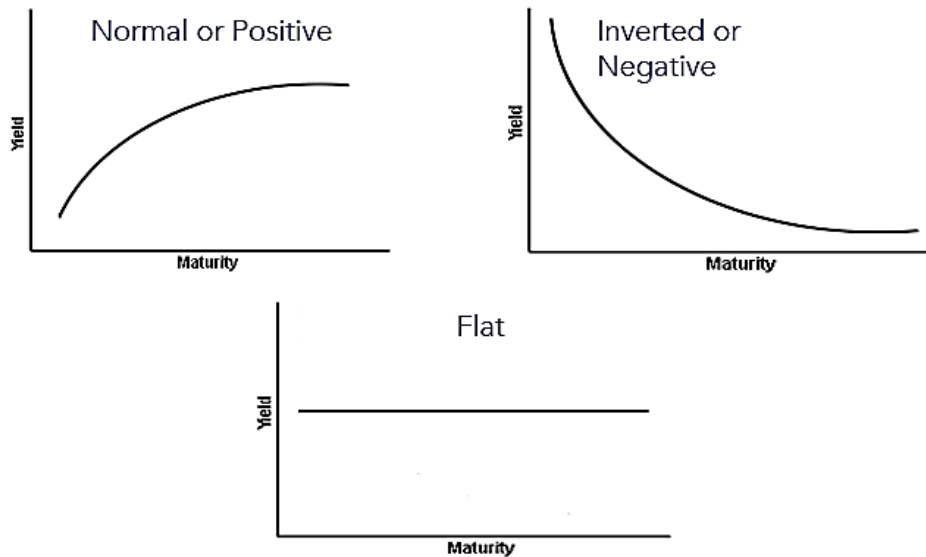
The following “tools” are listed from the least to the most used

<b>Regulation T</b>	Extension of credit by broker-dealers
<b>Discount Rate</b>	The only rate that’s directly controlled by the Fed
<b>Reserve Requirement</b>	Amount of money that a bank must maintain based on a percentage of deposits
<b>Federal Open Market Committee (FOMC)</b>	Trades U.S. Treasuries through “primary government dealers”

## Actions of the FOMC



# Yield Curves



# Foreign Exchange

Exchange rates are determined by supply of demand of a countries currency

- If the U.S.D. increases or strengthens against a foreign currency the effect is:
  - The price of U.S. exports will increase becoming less competitive and
  - The price of U.S. imports will decrease becoming more competitive
- If the U.S.D. decreases or weakens against a foreign currency the effect is:
  - The price of U.S. exports will decrease becoming more competitive and
  - The price of U.S. imports will increase becoming less competitive



# International Economic Factors

## Interest Rates

- An inverse relationship exists between the U.S. dollar and foreign currencies
- Rising interest rates in U.S. will normally be accompanied by a strengthening of the dollar in relation to other currencies

## Balance of Trade

- System of recording all of a country's economic transactions with the rest of the world over a specific period
  - Favorable balance of trade:
    - A decline in the dollar (relative to other currencies)
    - When the U.S. exports more than it imports
  - Unfavorable balance of trade
    - An increase in the dollar (relative to other currencies)
    - When the U.S. imports more than it exports



# Chapter 6 – SEC Rules and MSRB Qualification Rules

## Exempt Securities

The following securities are exempt from SEC registration:

- U.S. Government and Agency securities
- Municipal securities
- Securities issued by banks
- Securities issued by non-profit organizations
- Short-term corporate debt; maturities not exceeding 270 days
- Securities issued by Small Business Investment Companies

All remain subject to antifraud provisions of the Act

## SEC Rule 15c2-12

- Since municipal securities are exempt from SEC registration, the SEC requires underwriters to have a reasonable basis for recommending the new issue
- To fulfill this obligation, the underwriter reviews the accuracy of the issuer's disclosure information
- SEC Rule 15c2-12 requires an underwriter to:
  - Obtain and review the official statement prior to bidding
  - Contract with issuer to receive a sufficient number of final official statements
  - Send final official statements at or prior to sending written confirmation to customers or within one day of a request being made by a customer or member firm

## SEC Rule 15c2-12

Exemptions from SEC Rule 15c2-12:

A primary offering of municipal securities with an aggregate principal amount of less than \$1,000,000	Bonds that are sold to investors in units of no less than \$100,000 and are sold to no more than 35 sophisticated investors (private placement)	Bonds that are sold in \$100,000 minimum denominations and mature in nine months or less
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# Continuing Disclosure Requirements

According to SEC Rule 15c2-12:

- Underwriter is required to ensure that an issuer or another obligated person has entered into a contract (agreement) to provide continuing disclosure information to EMMA
- Use of a dissemination agent
- Material event notices must be filed with the MSRB
- The issuer will provide a date to distribute annual financial information

SEC Rule 15c2-12 ensures municipal securities issuers enter into agreements to provide certain information to the MSRB about their securities on an ongoing basis.

## Municipal Securities Rulemaking Board

- MSRB formulates and interprets the rules that apply to:
  - Broker-dealers and salespersons engaged in municipal business and
  - Municipal advertising
- MSRB rules don't apply to municipal issuers
- Since the MSRB has no enforcement power, its rules are enforced by a separate regulatory agency:

For broker-dealers:	For bank dealers:
<ul style="list-style-type: none"> <li>▪ FINRA or</li> <li>▪ SEC</li> </ul>	<ul style="list-style-type: none"> <li>▪ Comptroller of the Currency</li> <li>▪ FRB or</li> <li>▪ FDIC</li> </ul>

## Registration and Fees

### Municipal securities broker-dealers and dealer banks must register with the SEC

- Form BD is used by a Broker-Dealer (B/D)
- Form MSD is used by a Dealer Bank

### Fees

- Initial fee is \$1,000
- Annual fee is \$1,000 due by October 31
  - First remittance to MSRB is \$2,000
- Municipal advisors also pay an annual professional fee

B/Ds must promptly notify the MSRB of any change of status

- Change in name, address, or registration number
- Termination of business in municipal securities

# Registration Information

On behalf of their associated persons, municipal securities firms file Form U4 (employment questionnaire) with FINRA. Form U4 includes:

- Name (including aliases)
- Date of birth
- Personal and business history for past 10 years (no continuity lapse)
- Residential history for past five years
- Conviction of any felony or securities misdemeanor
- List of registration denials or disciplinary actions

U4 retained for three years after person leaves the firm

A person expelled or suspended from another association or exchange is disqualified for MSRB membership

# Registration Information

At the time of hiring, member firms must verify information that's obtained for the preceding three years
All registered personnel must be fingerprinted
When a person's association with a member firm ceases, Form U5 is filed by the firm (Form U5 indicates the reason for termination)
If a person ceases business for a period of longer than two years, his registration will lapse

# Associated Persons

Defined as employees of MSRB member firms (broker-dealers) and include all of the following:

- Officers, directors, partners, or branch managers
- Employees (unless the employee's function is solely and exclusively clerical or ministerial)
- Person engaged in investment banking or securities business

Certain associated persons are required to be registered as either representatives or principals

# Qualifications (G-3)

Registration categories under MSRB governance:

<b>Securities Industry Essentials (SIE)</b>	<b>Municipal Securities Limited Sales Representative (passed Series 7 after November 7, 2011)</b>
<b>Municipal Securities Representative (Series 52)</b>	<b>Municipal Securities Principal (Series 53)</b>

Cannot transact business in municipal bond funds, trusts, or exchange-traded funds

<b>Municipal Securities Sales Principal (Series 10)</b>	<b>Municipal Fund Securities Limited Principal (Series 51)</b>
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FINRA rules require that the Series 7 be passed prior to taking the Series 10

Firms must maintain a listing of all persons designated as principals and their responsibilities for six years after change of status

## Qualifications

<b>Municipal Securities Limited Sales Representative – Investment Companies (Series 6)</b>
<b>Municipal Advisor Representative (Series 50)</b>

- Municipal advisory activities are defined as “providing advice to a municipality or obligated person with respect to municipal financial products or the issuance of municipal securities.”
- Exemptions are available to underwriters that are already registered with the MSRB, are registered investment advisers, or are commodities trading advisors (CTAs) that are registered with the CFTC in order to provide advice concerning swaps.

# Municipal Securities Principal – Series 53

Responsible for direct supervision of personnel and activities related to municipals

All new accounts	<b>A Municipal Securities Principal must promptly review and approve in writing ...</b>	All communication with the public, including summaries/abstracts of Official Statements
All municipal transactions		All written customer complaints

*Complaint* is defined as any written statement alleging a grievance involving the activities of the dealer or any of its associated persons with respect to a customer's account

## Continuing Education

Regulatory Element	Firm Element
<ul style="list-style-type: none"> <li>Applies to all registered personnel; no grandfathering</li> <li>Initially due on December 31 of the calendar year following the year in which they became registered and by December 31 of every year thereafter               <ul style="list-style-type: none"> <li>If not completed, registration becomes inactive</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>On-going training directed by the firm</li> <li>Based on needs assessment</li> <li>Training plan must be re-evaluated annually</li> </ul>

RRs serving in the military are exempt from the two-year inactive status limitation that normally applies to registration reinstatement and both elements of continuing education are put on hold.

# MSRB Investor Education

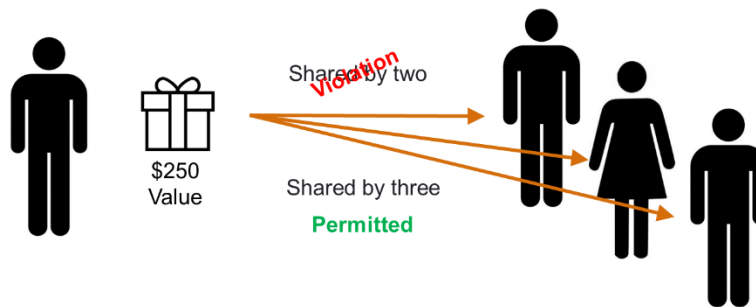
Annually, MSRB member firms must disclose the following to their customers:

- The MSRB's website address
- That they are registered with the MSRB and the SEC
- A statement regarding the availability of a brochure (the Investor Brochure) on the MSRB's website which describes the protections available to customers and the process by which a company may be filled with the appropriate regulatory authority

## The Gift Limit

Gifts that RRs make to employees who can direct business of their employer back to the RR's firm are limited to \$100 per person, per year

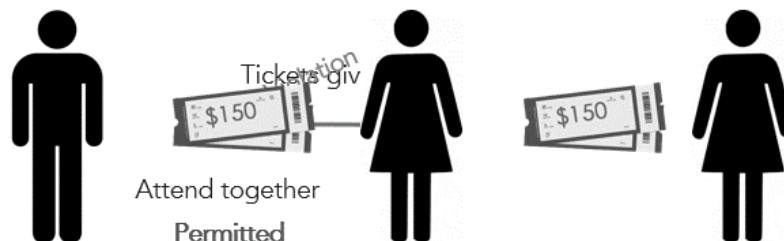
- MSRB approval is NOT required
- MSRB does consider the dollar value and number of intended recipients



## The Gift Limit

Rule also applies to gifts and gratuities from mutual fund distributors or wholesalers to B/D salespersons

- Limit may be exceeded for events involving family relationships (e.g., wedding, birth of child)
- *If attended by the gift giver*, an occasional meal, sporting event, or theater production is exempt as an entertainment/business expense
- Gifts are value based on the greater of their cost or market value



# Other Compensation Related Rules

<b>TRAINING AND EDUCATION EXCEPTION</b>	<ul style="list-style-type: none"><li>▪ Permits training program offerors (product distributors) to pay or reimburse for meetings which are attended by RRs and serve an educational purpose if:<ul style="list-style-type: none"><li>• RRs have their broker-dealer's permission to attend</li><li>• Attendance is not attached to a sales target</li><li>• Location is appropriate</li><li>• Payments and reimbursements are limited to the RRs (not guests)</li></ul></li></ul>
<b>IN-HOUSE INCENTIVES</b>	<ul style="list-style-type: none"><li>▪ Non-cash incentives are permitted as long as they're based on total sales, not on the sale of a specific product</li><li>▪ Must be paid by the employing dealer, not the product sponsor</li></ul>



# Chapter 7 – MSRB Primary and Secondary Market Rules

## Fair Dealings (G-17)

According to the MSRB's fair dealing rules, a municipal securities broker or dealer may not engage in any deceptive, dishonest, or unfair practices.

Either at or before the sale, all material information should be disclosed to a customer concerning the transaction, including a description of the security.

This obligation to disclose applies even if the dealer is acting as an order taker and not recommending the security.

## Sophisticated Municipal Market Professional (D-15)

An SMMP is defined as an institutional customer that:

1. The dealer has a reasonable basis to believe is capable of evaluating investment risks and market value independently
2. Affirmatively indicates that it's exercising judgment in evaluating the dealer's recommendations

As a part of the reasonable basis required by part 1 above, the dealer should consider the amount and type of municipal securities owned or under management by the institutional customer

SMMPs may affirm part 2 above either orally or in writing and may provide this affirmation on a trade-by-trade basis, on a type of municipal basis, or for all trades executed in their accounts

*Institutional customers* are considered banks, insurance companies, S&Ls, registered investment companies, registered investment advisers, or other entities with total assets of at least \$50 million

# MSRB Rule G-32

Addresses the requirements in connection with primary offerings, such as:

<ul style="list-style-type: none"> <li>▪ Submission of official statements to the MSRB by underwriters</li> </ul>	<ul style="list-style-type: none"> <li>▪ Preparation of official statements by financial advisors</li> </ul>	<ul style="list-style-type: none"> <li>▪ Customer disclosure requirements</li> </ul>
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An underwriter is required to either submit a final official statement to the EMMA system or disclose that no final official statement is being prepared

If no final official statement is being prepared, a preliminary official statement should be submitted (if prepared)

# MSRB Rule G-32

If financial advisors have prepared a final official statement on behalf of an issuer, they:

- Must make it available to the managing underwriter (but not the public) promptly after it's been approved for distribution by the issuer
- May provide an electronic, printable form

When it comes to disclosure, NOTICE equals ACCESS and ACCESS equals DELIVERY

# MSRB Rule G-32 – Official Statements

Underwriters are responsible for delivering the following to the MSRB:

- A copy of the final official statement and a copy of Form G-32 (OS) by no later than one business day after receiving the official statement from the issuer
- If the issuer advance refunds an outstanding issue, a copy of the advance refunding document and Form G-32 (ARD) within five business days of delivery of the securities from the issuer to the underwriter

Rule G-32 requires underwriters to electronically submit official statements, advance refunding documents, and related primary market documents to EMMA.

# Official Statements and Customers

Responsibilities for underwriters and dealers regarding the delivery of official statements:

<b>Customers:</b>	<ul style="list-style-type: none"> <li>At or prior to settlement, a copy of the final official statement must be provided to customers</li> <li>If a final official statement will not be prepared, the dealer must notify the customer of this fact and may provide a preliminary O.S.</li> </ul>
<b>Filing with EMMA:</b>	<ul style="list-style-type: none"> <li>This customer obligation is considered to be met if the O.S. has been filed with EMMA and instructions are provided for obtaining it</li> </ul>
<b>New Issue Disclosure:</b>	<ul style="list-style-type: none"> <li>New issue disclosure period ends 25 days after final delivery of securities by the issuer</li> </ul>
<b>Amendments:</b>	<ul style="list-style-type: none"> <li>Underwriters are required to submit any amendments to the O.S. to the MSRB within one business day</li> </ul>

## CUSIP Numbers

**CUSIP** numbers are nine-digit alphanumeric codes that are used to identify securities. Each maturity of a municipal security offering will be assigned a **CUSIP** number.

Prior to the distribution of a new issue, the syndicate manager must *apply for* a CUSIP number

- For competitive offerings – immediately after the award of an issue and it must be obtained by the time of the first trade
- For negotiated offerings – prior to awarding the bond issue

By the initial trade, the syndicate manager is also required to apply for the new securities to be depository-eligible

- Exemptions:
  - Bonds with maturities of less than 60 days
  - Non-depository eligible securities

If alteration is made to bonds in the secondary market, a new CUSIP must be applied for and obtained for distinguishing purposes (e.g., part of an issue is refunded or insured)

# Activities of Financial Advisors (G-23)

Financial advisors (FAs) provide issuers with advice about the timing, structure, and terms of a new bond issue

Requires a written agreement with the issuer

- Must be signed at or prior to engagement
- Must state functions and compensation

An FA cannot simultaneously be a syndicate member for that issue or resign as an FA to become a syndicate member

There's no prohibition against an underwriter providing advice to an issuer regarding the structuring of its offering

MSRB Rule G-23 prohibits brokers from acting as FAs on an issue of municipal securities and subsequently acting as underwriters on the same issue.

# Underwriters and the Fair Dealing Rule (G-17)

As it primarily relates to negotiated offerings, underwriters are required to disclose both actual and potential conflicts of interest to an issuer, including:

- When their interests are different than those of the issuer
- The fact that a fiduciary relationship doesn't exist between the underwriter and the issuer
- The underwriter's obligation to purchase the issuer's securities at a fair and reasonable price must be balanced with its obligation to sell them to investors at fair and reasonable prices

Disclosure is required at the initiation of the issuer-underwriter relationship

The written disclosure must be sent to an issuer official who's able to legally bind the issuer to the underwriter

# Underwriters and the Fair Dealing Rule

The underwriter must attempt to receive written acknowledgement of receipt of the disclosures	If no written receipt is received, the underwriter must document the reason that the written acknowledgement was not received	Retail Order Period <ul style="list-style-type: none"> <li>▪ The definition of a retail order is determined by the issuer</li> <li>▪ During the retail order period, the underwriter agrees to only accept orders from retail customers</li> </ul>
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# Retail Order Disclosures

A dealer that submits a retail order to the senior syndicate manager is required to provide the following information concerning the order:

- Whether the order is from a customer that meets the issuer's eligibility criteria for participation in the retail order period
- Whether the order is one for which a customer is already conditionally committed
- Whether the broker, dealer, or municipal securities dealer has received more than one order from such retail customer for a security for which the same CUSIP number has been assigned
- Any identifying information required by the issuer (or the senior syndicate manager on the issuer's behalf) in connection with the retail order (not customers' names or Social Security numbers)
- The par amount of the order

## Primary Offering Practices (G-11)

Definitions of terms:

<b>Accumulation Account</b>	Temporary holding account for securities pending deposit into an investment trust
<b>Date of Sale</b>	<p>For competitive offerings:</p> <ul style="list-style-type: none"> <li>▪ The date on which all bids for the purchase of securities are due to the issuer</li> </ul> <p>For negotiated offerings:</p> <ul style="list-style-type: none"> <li>▪ The date on which the contract to purchase securities from an issuer is executed</li> </ul>
<b>Order Period</b>	Time that a syndicate states that orders for the purchase of the securities will be solicited

# Primary Offering Practices

Definitions of terms:

<b>Related Portfolio</b>	A portfolio that's controlled by a municipal securities dealer
<b>Underwriting Period</b>	<p>Begins with whichever is first:</p> <ul style="list-style-type: none"> <li>▪ The time of receipt of the first order, or</li> <li>▪ The time that the bonds are purchased from the issuer</li> </ul> <p>Ends with whichever is last:</p> <ul style="list-style-type: none"> <li>▪ The time that the issuer sends securities to the syndicate, or</li> <li>▪ The time that the syndicate no longer maintains an unsold balance</li> </ul>

## Syndicate Manager (G-11)

### 1 Responsibilities:

- Maintain books and records related to syndicate operations
- Preserve records such as:
  - Settlement date with issuer
  - Allotment of securities and sale prices
  - Names of syndicate members and their percentage of liability

### 2 Disclosures from manager to syndicate members:

- Allocation of bonds within 24 hours from date of sale
- Priority provision (in writing), whether it may be changed, and basis for any change
- Whether orders may be confirmed prior to end of order period
- All designations paid within 10 business days from date of sale

## Syndicate Members

### Disclosures from syndicate members to manager:

- For whom securities are being purchased, including:
  - Dealer's account
  - Account of a related portfolio
  - An accumulation account
  - Municipal securities investment trust
  - Identity of customer entering a group order

# Syndicate Settlement

At or prior to settlement, the manager sends a syndicate summary statement showing:

- Manager's fees
- Identity of related portfolio, municipal investment trust, or accumulation account to which securities are allocated
- Identity of persons submitting group orders
- Aggregate par value, prices, and maturity dates of all securities sold from syndicate accounts
- Any miscellaneous expense, if not in excess of others

Manager must disclose to syndicate members all information regarding payments on designated orders within 10 business days of date of sale (when bids are submitted or the contract with issuer is executed)

Any sales credits owed must be distributed within 10 calendar days following the date securities are delivered to the syndicate

Final settlement occurs within 30 calendar days of the date the securities are delivered by the issuer to the syndicate

# Political Contribution Rule (G-37)

Addresses political contributions made by:

- Municipal finance professionals (MFPs)
- Municipal dealers, or
- Political action committee controlled by B/D to influence negotiated business (especially underwritings)

Limitation on contributions of an MFP:

- \$250 per election to a candidate **for whom an MFP may vote** (allows \$250 to primary and \$250 to general election)
- Donations made to defray campaign costs:
  - Are a violation if total contributions exceed \$250 when made before election
  - Are not a violation if made after candidate loses, regardless of amount

MSRB Rule G-37 defines an MFP as "any associated person who is primarily engaged in municipal securities representative activities, other than sales activities with natural persons."  
This also includes persons who solicit states regarding their 529 plans.

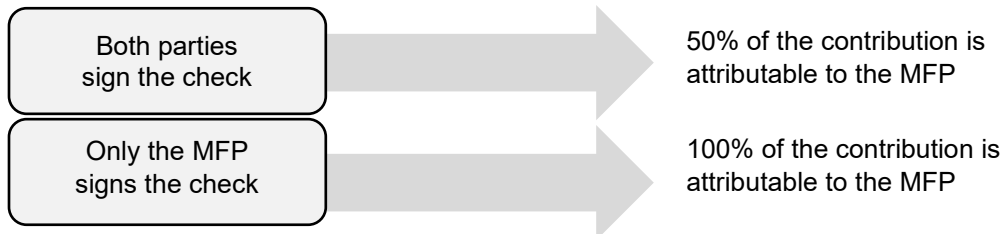
# Political Contribution Rule (G-37)

Violations result in:

- Two-year negotiated underwriting ban with specific issuer, which follows to another firm if the MFP leaves

If a person is hired in an MFP role and she made a contribution that violates the rule, there's a two-year look-back period

If a contribution is made from a joint checking account (MFP and spouse) and:



If contribution is from a non-MFP spouse's personal account, no limit applies

## Suitability (G-19)

Recommendations must be based on information obtained from the customer and used to create her investment profile, which includes:

- Age
- Other Investments
- Financial situation and needs
- Tax status
- Investment objectives and experience
- Liquidity needs
- Risk tolerance
- Time horizon

Broker-dealers have a suitability obligation to each of their customers

## Suitability (G-19)

Under MSRB's three main suitability obligations, a member firm and its registered representatives must have a reasonable basis to believe that ...

The Reasonable Basis Obligation	The Customer-Specific Obligation	The Quantitative Obligation
A recommendation is suitable for at least some investors	A recommendation is suitable for a particular customer based on the customer's investment profile (this provision does not apply to institutional customers)	A series of recommended transactions, even if suitable for a customer, are not excessive when the customer's investment profile is taken into consideration



## Time of Trade Disclosure (G-47)

A firm is required to disclose to a customer (either orally or in writing) all “material” information that’s known about a transaction at or prior to the time of the trade

- Applies whether recommended or unsolicited; primary or secondary market transaction
- Material information is that which is considered important or significant to an investor when making an investment decision
- A good source of information for the firm to review is EMMA
- Disclosure must include a complete description of the security and its potential risks, and also applies to electronic trading systems
- Firm must create policies and procedures to disseminate all material information to RRs

Since SMMPs have timely access to material information, they are not subject to this rule

## Disclosure of Control Relationships (G-22)

Exists if a broker-dealer controls an issuer or a person who has influence over the debt service of the issuer’s securities

- Relationship must be disclosed orally prior to effecting a trade
- Written disclosure must be provided at, or before, settlement

For discretionary trades:

- Relationship must be disclosed to client
- Client must specifically authorize the transaction

## Accounts for Member Firm Employees (G-28)

The MSRB has created specific guidelines for employees of MSRB member firms opening accounts that will engage in municipal transactions at another member firm

Carrying firm must:

- Provide prior written notification to employer
- Provide duplicate confirmations
- Follow any special instructions

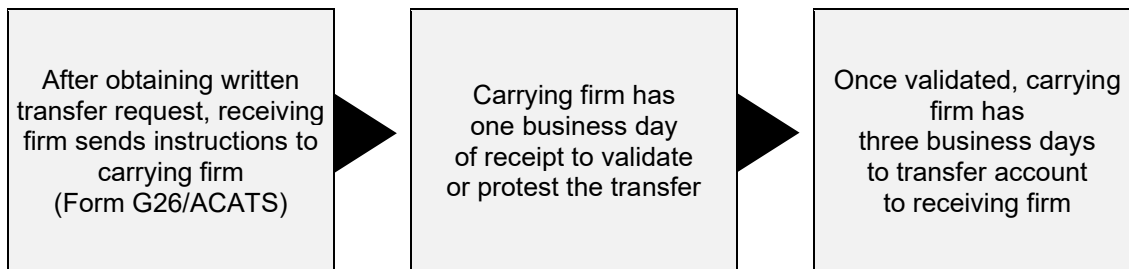
These guidelines also apply to accounts of spouses and minor children (UGMA and trust accounts)

## Improper Use of Assets (G-25)

Guarantees against loss are prohibited	Sharing in the profits and losses is prohibited unless
If in writing, exceptions are made for: <ul style="list-style-type: none"> <li>Put options</li> <li>Repurchase agreements</li> </ul>	A joint account is formed with the client and the sharing profits and losses is in direct proportion to each person's contribution

## Customer Account Transfers (G-26)

The following guidelines apply when a client wants to transfer his account from his current firm (carrying firm) to another firm (receiving firm)



## Advertising (G-21)

Defined as any notice, circular, research report, market letter, or promotional literature that's designed for public dissemination, including abstracts/summaries of official statements

- Definition does NOT include firm offering lists, final or preliminary official statements, or legal opinions

A form letter is written communication that's directed to 25 or more persons within a 90-day period

- It must be truthful and not misleading
- Principal pre-approval is required
- Retained for four years

# Advertising (G-21)

<b>Professional Advertising</b> <ul style="list-style-type: none"> <li>Includes any advertisement concerning the facilities, services, or skills of a broker-dealer or bank dealer</li> <li>The advertising may not publish any document that's materially false or misleading concerning the capabilities or services of the municipal dealer</li> </ul>	<b>New Issue Advertising</b> <ul style="list-style-type: none"> <li>If the date of sale is shown, the ad:             <ul style="list-style-type: none"> <li>May show initial reoffering prices or yields even if they may have changed</li> <li>Should indicate which maturities are available at the end of the presale period</li> </ul> </li> <li>Language should indicate that bonds may no longer be available or may be available at a price or yield that's different than what's shown</li> </ul>
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## Social Media

Interactive Content	Supervision of Interactive Content
<ul style="list-style-type: none"> <li>Refers to content which is posted or disseminated for direct, real-time interaction (e.g., chatting or messaging)             <ul style="list-style-type: none"> <li>Any posting or dissemination of content to an interactive social networking site, which may be defined as advertising, is supervised in a manner that's similar to correspondence (i.e., it must be reviewed and supervised, but not preapproved)</li> <li>Static content posted for an extended period is not interactive, is considered retail communication, and may be subject to pre-approval</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>A principal must approve any social media site an RR intends to use for business communications (not sites for strictly personal use)</li> <li>Social media cannot be used if it automatically deletes and erases content</li> <li>Records must be maintained for any business communication, including those made through personal devices</li> <li>Suitability rules apply to recommendations made through social media, and recommendations made by a RR must be pre-approved</li> </ul>

# Social Media and Third-Party Posts

## Third-party posts to a broker-dealer's social media

- Generally not considered a retail communication, but subject to recordkeeping rules
- Will be considered a retail communication if the broker-dealer:
  - Is involved in the preparation of the content (entanglement)
  - Has explicitly or implicitly endorsed or approved the content (adoption)

## Links to third-party websites

- Broker-dealers are **prohibited** from linking to third-party sites that contains false or misleading content
- In a personal communication, an RR can link or share content from the broker-dealer that doesn't relate to the firm's products or services
  - Not considered retail communication
  - For example, sharing a link to a charity event being sponsored by the firm

## Testimonial concerns

- Unsolicited third-party opinions to a site that are used by an RR for business are not considered testimonials
- If the RR shares or likes the comments, they're subject to FINRA's rules and may be considered testimonials
- Broker-dealers must disclose if more than \$100 is paid for a testimonial

# Quotations (G-13)

BDs are prohibited from disseminating a quotation unless the price represents a bona fide bid or offer for a security (or request for such)

Quotes must be:

- Firm unless qualified as informational (nominal)
- Reasonably based on current market value

If a dealer publishes a quote for bonds it does not own, it must be willing to honor the quote

If two firms form a joint account to sell bonds:

- Both members must maintain the same price
- They must state that they are working together jointly

# Best Execution (G-18)

When buying or selling municipal securities, a dealer is required to obtain the “best” price under prevailing market conditions

Factors include:

- The character of the market for the security (e.g., price, volatility, and relative liquidity)
- The size and type of transaction
- The number of markets checked
- The information reviewed to determine the current market for the subject security or similar securities
- The accessibility of quotation
- The terms and conditions of the customer’s inquiry or order (as communicated to the dealer), including any bids or offers, that result in the transaction

# Best Execution (G-18)

<b>Interpositioning</b>	<b>Execution of customer transactions</b>
<b>Definition of the market</b>	<b>Best execution and executing brokers</b>
<b>Securities with limited quotation or pricing information</b>	<b>Customer instructions</b>

# Broker’s Broker (G-43)

Defined as a dealer or separately operated and supervised division of a dealer that principally effects municipal transactions for other dealers

Provides liquidity for retail investors in municipal securities; acts as an intermediary between dealers

- Prices must be fair and equitable
- Must disclose the maximum commission that may be charged on a given transaction
- Plays a significant role in bid-wanted auctions

An alternative trading system (ATS) is NOT a broker’s broker if:

- It’s registered with the SEC under Regulation ATS
- It uses automated and electronic communication only
- All of its customers are SMMPs
- It discloses its procedures for bid-only auctions and complies with the MSRB’s conduct rules (G-43)

# Bid-Wanted Auctions

At commencement, seller is anonymous and doesn't specify a minimum price, but will ultimately select winning bid
Bids are submitted to a broker's broker working on seller's behalf
If a broker's broker allows customers or affiliates to place bids, written disclosure must be made
Only the seller and the winning bidder receive information about bid prices before the bid-wanted auction is completed

## Guidelines for Bid-Wanted Auctions

→	While there's no minimum number of bids required, there must be a cut-off time
→	Trade/price parameters must be set for bids
→	For bids that are outside of trade parameters, or if a broker's broker believes an error was made, bidders are contacted
→	If the high bid is outside of the parameters, the seller is contacted
→	Bids used for price discovery and "throw away" bids are prohibited
→	If the winning bid or next best bid (cover bid) are changed, seller must be notified
→	If bids of customers or affiliates of broker-dealers are the highest bid, disclosure must be made

## Prices and Commissions (G-30)

In a **principal transaction**, the most important factor is that the yield should be comparable to the yield on other securities of comparable quality, maturity, coupon rate, and block size that are available in the market.

Other key factors include:

- Size of the trade
- The fact that the firm is entitled to a profit
- The expense involved in effecting the transaction
- The total dollar amount of the transaction
- The service provided in effecting the transaction
- The availability of the securities in the market
- The rating, maturity, and call feature

# Prices and Commissions (G-30)

In an **agency transaction**, the commission must be fair and reasonable as determined by various factors, including:

- Availability of the security
- Value of firm-rendered services
- Expense incurred in executing the order
- The total dollar amount and price of the transaction
- Any other compensation received by firm in connection with the trade

## Mark-Up Policy

A dealer acting in a principal capacity in a transaction with a customer that's charging a mark-up or mark-down must mark-up or mark-down the transaction from the prevailing market price

- The prevailing market price is its contemporaneous cost or contemporaneous proceeds (a dealer's cost (proceeds) is contemporaneous when its inventory purchase and subsequent resale to a retail customer occur in close time proximity)

# Reports of Sales or Purchases (G-14)

Publishing reports about purchases or sales that did not occur is considered fraudulent, misleading, and deceptive

- B/Ds must have a reasonable basis to assume that a transaction took place

For trades reported during normal trade reporting hours (7:30 a.m. to 6:30 p.m.):	Report within 15 minutes
For trades executed outside of normal trade reporting hours:	Report within 15 minutes of RTRS opening
Bonds without CUSIP numbers, global securities, and municipal fund securities	Exempt from reporting

# Short System

Collects and disseminates information on short-term debt

For auction rate securities:	For variable rate demand obligations:
<ul style="list-style-type: none"> <li>▪ Report must be submitted to the MSRB (EMMA) by 6:30 p.m. ET on the day of the auction</li> <li>▪ Report includes auction dates, interest rates, and par values</li> </ul>	<ul style="list-style-type: none"> <li>▪ Report must be submitted to MSRB (EMMA) by 6:30 p.m. ET on the day the rate is reset</li> <li>▪ Remarketing information is provided by remarketing agent</li> </ul>

# Confirmation, Clearance, Settlement of Transactions (G-12 for Other MSRB Firms and G-15 for Customers)

Customer confirmations must be sent on or prior to the settlement date (T + 1)

- Mark-ups and Mark-downs must be disclosed based on prevailing market price
- EMMA disclosures – reference or hyperlink
- Lower of yield-to-maturity or yield-to-call

Retail trades that are settled through a clearing corporation (e.g., NSCC) don't need a comparison or interdealer confirmation

- Don't Know (DK) notice

Good delivery

Rejection and Reclamation

## Close-Out Procedures (G-12)

Results when a dealer doesn't deliver securities to another dealer for a purchase (Buy-in), or a dealer doesn't pay for a sale from another dealer (Sell-out). Close-outs must be completed no later than 10 calendar days after settlement.

<b>Buy-In</b>	
<ul style="list-style-type: none"> <li>▪ Close-out notice may be no earlier than the first business day following original settlement date</li> <li>▪ Close-out cannot occur earlier than the third business day after the notice was given</li> <li>▪ Purchaser may grant the seller one 10-calendar day extension, which makes it a maximum of 20 days</li> </ul>	
<b>Sell-Out</b>	
<ul style="list-style-type: none"> <li>▪ Close-out may be no earlier than the first business day following receipt by the seller of notice of rejection</li> <li>▪ Close-out cannot occur earlier than the first business day following the date the notice of close-out was given</li> </ul>	



# Reciprocal Dealings with Investment Companies (G-31)

Since a municipal bond fund would be a lucrative account for an MSRB member, the MSRB prohibits a firm from soliciting business from an investment company as compensation for selling the fund's shares

- In other words, a municipal securities dealer may NOT obtain the fund's business based on an agreement to only sell the fund's shares

# Maintenance of Books and Records (G-8 & G9)

MSRB G-8 provides guidance on what records need to be kept

MSRB Rule G-9 provides guidance on the retention requires of these records

- Four years, six years, or lifetime