Code of Arbitration

System where monetary disputes are resolved by impartial panel
- ❖ Decisions are in writing, are binding, and cannot be appealed
  - Not mandatory for harassment or discrimination claims
- ❖ Six year statute of limitations

For disputes between members, Arbitration is mandatory

For disputes with public customers, Arbitration is voluntary
- ❖ Pre-dispute arbitration agreements are allowed; do not limit awards
- ❖ If accepted, a majority of arbitration panel will consist of those not associated with securities industry

For disputes not exceeding $25,000, Simplified Arbitration is offered
- ❖ No hearing held, document submission only
- ❖ One single arbitrator

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STC™

Session Three

Bonds

- Fundamentals
- Corporate Bonds
- U.S. Government Securities

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Terminology

Bonds are a kind of “fixed income investment”

Elements:
- ❖ Par Value
- ❖ Maturity or Due Date
- ❖ Interest Rate

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Bond Calculations

Interest payments and bond prices are stated as percentages of par

- 1% or 1 point for a bond =
- An $^1/_8$ of a point for a bond =

For example:

- Ms. Jones owns a 5% bond, which means she receives per year in interest. She paid a price of 92 $^1/_2$ for the bond, or

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Discounts and Premiums

When market interest rates change, the market price of a bond changes in the opposite direction

- Inverse relationship

Example: At time of issue, ABC sets their coupon at the current market rate and the bond's price is par

Over time as interest rates change the bond will trade at a discount or premium to par

	Market Rate	**Coupon on ABC's bond**	**Market price of ABC bond**
At issuance:	7%	7%	
Later:	9%	7%	
Still later:	5%	7%	

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Bond Yields

Nominal Yield:
- Same as coupon; fixed

Current Yield:
- Annual Interest ÷ Current Market Price

Yield-to-Maturity or Basis:
- Investor's total overall yield
- Measured to bond's maturity

When quoting yield, 1% represents 100 basis points

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Current Yield Calculation

Annual Interest ÷ Current Market Price

Nominal Yield	Bond Price	Calculation	Current Yield
8%	$1,000		
9%	$1,125		
6 ½%	$812.50		

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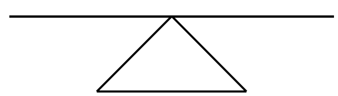
Yield Relationships

Par



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Price versus Yield Example

Example 1		Multiple choices
Y.T.M.:	7.75%	1. 8.00%
Price:	102	2. 7.65%
Coupon:	?	3. 7.75%

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Price versus Yield Example

Example 2		Multiple choices
Current Yield:	8.45%	1. 100
Y.T.M:	8.25%	2. 103 $^{7}/_{8}$
Price:	?	3. 98 $^{1}/_{2}$

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Price versus Yield Example

Example 3		Multiple choices
Coupon:	6%	1. 5.85%
Price:	95$^{1}/_{2}$	2. 6.00%
Y.T.M:	?	3. 6.47%
		4. 6.25%

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Largest Price Fluctuation

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

Maturity?	Longest or Shortest	
Coupon rate?	Highest or Lowest	
Duration?	Longest or Shortest	

Duration: The measure, expressed in years, of a fixed-income security's price sensitivity to changes in interest rates. The greater the duration, the greater percentage volatility.

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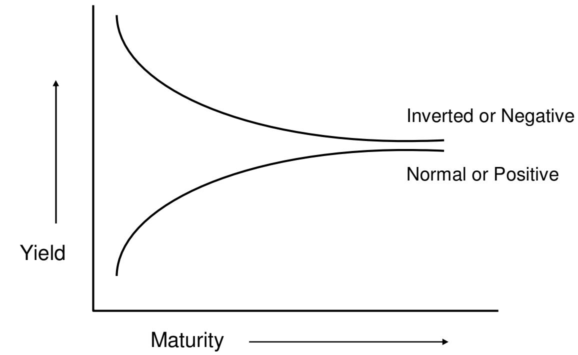
Yield versus Maturity



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Credit Ratings

Who pays for a bond to be rated?

What's the concern?

	S & P / Fitch	**Moody's**
	AAA	Aaa
	AA	Aa
	A	A
	BBB	Baa
	BB	Ba
	B	B
Further differentiation:	+ or -	1, 2, 3

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Retirement of Debt

Put Features
- Allows bondholder to redeem (put) bond back to issuer on a date prior to stated maturity

Open Market Purchases
- Bonds likely trading at a discount
- Issuer has available funds with no better use

Call Features
- Allows issuer to redeem bonds prior to maturity

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Call Feature

Factors which make callable bonds marketable to investors:

- ❖ Higher yield – lower price
- ❖ Call protection – length of time during which a security cannot be redeemed by issuer
- ❖ Call premium – amount over par the issuer must pay an investor for redeeming the security early

From where does the money come?

- ❖ Sinking fund
- ❖ "Refunding" issue
  - Sale of a new bond to redeem an old bond
  - Done when interest rates have declined

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Pre-refunding

Hypothetical:

- ❖ An issuer floated 20-year 10% bonds five years ago. The bonds had seven years of call protection. Today, rates are at 6%, but are expected to rise. What can the issuer do?

Escrow account established for new bond proceeds

- ❖ Managed by trustee
- ❖ Amount deposited is sufficient to pay debt service

Advantages to issuer:

- ❖ Captures lower interest rate
- ❖ Pre-refunded bond no longer issuers liability
- ❖ Defeasance – eliminate restrictive covenants

Pre-refunded bonds continue to trade until the call date

- ❖ Considered AAA rated

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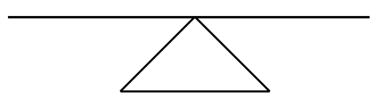
Yield-to-Call

The investor's yield if the bond is called **<u>at par</u>**

Par


For Callable Bonds always quote <u>the lower</u> of yield-to-call or yield-to-maturity

- ❖ Bonds selling at a discount use:
- ❖ Bonds selling at a premium use:
- ❖ Pre-refunded bonds always use

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Corporate Bonds

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Corporate Bond Overview

- Securities Act of 1933
- Trust Indenture Act of 1939 (applies to corp. debt only)
  - Trustee
    - Appointed by issuer to act in bondholder's best interest
  - Indenture- written contract which contains covenants (promises)
    - Open-End - allows new bonds to be issued using same collateral at same priority, or
    - Closed-End
- Interest received is fully taxable

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Two Types of Corporate Bonds

Secured
- Backed by physical assets or collateral owned by issuer
  - Mortgage Bond
  - Equipment Trust Bond
  - Collateral Trust Bond

Unsecured (Debentures)
- Backed by issuer's full faith and credit

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Convertible Debentures

Allows investor to get stock growth with safety of principal
- Conversion price a premium at issue
- Lower coupon rate
- Bond price is influenced by stock price

Bond holders may convert the par value of the bond into common shares at a given conversion price
- What is the conversion ratio?

XYZ Corporation 6% Debenture Market Price $1,100 - Convertible at $20

Par ÷ Conversion Price

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Conversion Parity

Parity means equivalent market values

Price of Convertible Bond = Aggregate Market Value of Common Stock

Example 1)
Given: Bond is convertible at $50 and the market price of the common stock is $60 per share
- Find: Parity price of bond
  - First find conversion ratio:
  - Then find the value of those shares:

An arbitrage opportunity exists if the bond is available at a discount to parity

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Conversion Parity

Example 2)

- ❖ Given: Bond convertible at $25 and the bond is priced at 120
- ❖ Find: Parity price of stock
  - First find conversion ratio:
  - Knowing the value of all shares, now find the value of each share:

An arbitrage opportunity exists if the stock is selling at a premium to parity

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Anti-Dilutive Feature

If an issuer of convertible securities ever splits their stock or issues a stock dividend, a covenant in the indenture would require the issuer to adjust the terms of the convertibles.

- ❖ Adjustment of Conversion Prices and Ratios

Stock Split

	Conv. Price	Conv. Ratio	Price x Ratio
Original:	$100		
After 2:1 Split:			

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Anti-Dilutive Feature - Example

Stock Dividend

A corporation has issued debentures convertible at $50. The stock pays a 10% stock dividend. According to the non-dilutive feature of the bond indenture, the new conversion price would be:

1. $19.23
2. $20.83
3. $45.00
4. $45.45

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Income (Adjustment) Bond

Generally, issued by corporations after reorganization

- ❖ Issuer promises principal at maturity
- ❖ No promise of interest payment unless income is sufficient
- ❖ Generally sold at deep discount
- ❖ Trade flat (without accrued interest)

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Euro, Eurodollar, and Yankee Bonds

Eurodollars:

- U.S. dollar denominated deposits in foreign banks

Eurodollar Bond:

- Bond issued outside the United States
- Pays interest and principal in U.S. dollars
- Exempt from SEC registration
- May trade in the U.S. in the secondary market after 40 days

Yankee Bond:

- Foreign bonds issued in the the United States
- Pays interest and principal in U.S. dollars
- Must be SEC registered
- May trade in the U.S. market immediately

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Zero Coupon Bond

Pays no periodic interest

- Issued at deep discount, but matures at face value (par)
- Taxes paid on earnings reported but not received ("phantom interest")
- Investor's carrying value (cost basis) must be accreted yearly
- Trade flat (without accrued interest)
- Has no reinvestment risk
- Attractive for those planning for a specific investment goal (e.g. college funding or retirement), but not for those who desire current cash flow

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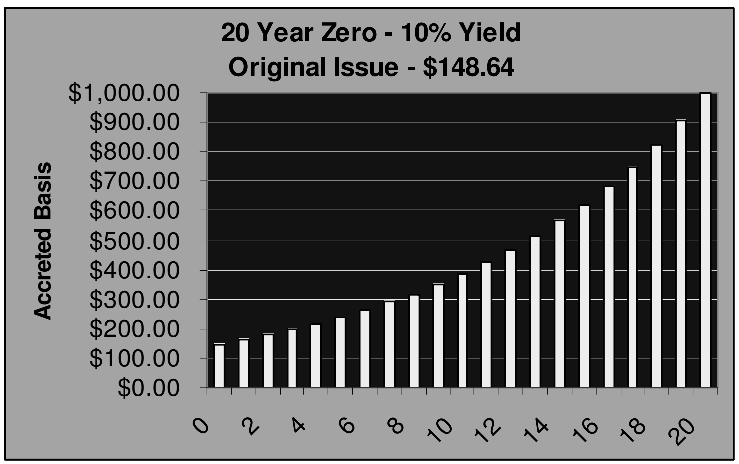
Constant Yield Method



Accrued Interest

Interest that is due on a bond since the last interest payment was made

The buyer pays the seller the market price of the bond plus the accrued interest

The calculation begins with the number of days since the last coupon:

- Start counting at:
- Count up to:

Corporates, Municipals and Government Agencies	U.S. Government T-Notes and T-Bonds
days in month and days in year	days in month and days in year

Calculation: Annual Interest $ X $\frac{\text{\# of accrued days}}{\text{360 or 365}}$

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Accrued Interest - Example

Given: An XYZ corporate bond, $1,000 par value, 8½% coupon, has a due date of 5/15/18 and is sold on Monday, September 10 for regular way settlement

1/1 ——— 12/31

Days of Accrued Interest:

Mos:	Days:	If T-Note/T-Bond:	
May	______	May	______
June	______	June	______
July	______	July	______
Aug.	______	Aug.	______
Sept.	______	Sept.	______
Total:	______	**Total:**	______

Amount of Accrued Interest:

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U.S. Government Securities

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Overview of U.S. Treasuries

Characteristics:
- ❖ No credit risk
- ❖ Highly liquid

Exempt from:
- ❖ Both state (Blue Sky) and federal ('33 Act) registration
- ❖ Trust Indenture Act of 1939
- ❖ Federal Reserve's Reg. T

Interest received:
- Exempt from both:
- But subject to:

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Two Types of Government Securities

Non-Marketable (Non-negotiable)
- ❖ Series EE Savings Bonds
  - Can only be bought from and sold back to the U.S. Government
  - No secondary market
  - No price fluctuation

Marketable (Negotiable)
- ❖ Treasuries

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U.S. Treasuries

T-Bills	T-Notes	T-Bonds
MATURITIES		
DENOMINATIONS		
FORM OF ISSUANCE		
INTEREST		
HOW THEY'RE INITIALLY SOLD		

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Bidding at the Auction

Two Types of Bids:

- ❖ Competitive Bids (large financial institutions)
  - Indicate both quantity and price
- ❖ Non-competitive Bids (the public)
  - Indicate quantity only
  - Bidder agrees to pay:
  - Filled first

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Auction Example

$100 million U.S. Government Bond Auction Due 06/01/XX Coupon 7.5%		
Bidder	**Bid**	**Fill**
Jerry and Others	$20 million NC	
Big Bank	$40 million at 99	
Foreign Country	$40 million at 98	
Government Dealer	$40 million at 97	

Known as single price or "Dutch" auction

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Pricing of Government Securities

T-Notes, T-Bonds and Agency Securities

- ❖ A percentage of par and fraction – $^{1}/_{32}$

Quotation	Rewritten	Decimal	Dollar Price
87.15			
106.25			

T-Bills:

- ❖ Quoted on a discount yield basis, not dollar
- ❖ In a T-bill dealer's quotation, the bid's <u>higher yield</u> represents a <u>lower price</u> and the asked's <u>lower yield</u> a <u>higher price</u>

Bid	Asked
2.94	2.90

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Other Government Securities

T-Strips and Receipts

- ❖ Coupon payments and principal sold separately as zero coupon securities (each discounted)
- ❖ T-Notes and T-Bonds can be stripped (not T-Bills)
- ❖ Wide range of maturities to choose from when shopping for a zero coupon
- ❖ Trade flat (without accrued interest)

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Other Government Securities

TIPS (Treasury Inflation Protected Securities)

- ❖ Stated coupon
- ❖ Principal is adjusted for inflation, based on the CPI
- ❖ Principal adjustments are taxed as ordinary income in the year the adjustments are made
- ❖ Adjusted principal paid at maturity

Principal	Coupon	Payment
$1,000	4%	$40.00
	CPI increases by 1%	
$1,010	4%	$40.40

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Government Agencies and Enterprises

Securities issued by U.S. Government Agencies and Government Sponsored Enterprises (GSEs)
- Created to reduce borrowing costs for certain sectors of the economy

- ❖ Mortgage
  - Government National Mortgage Assoc. (GNMA)
  - Federal National Mortgage Assoc. (FNMA)
  - Federal Home Loan Mortgage Corp. (FHLMC)
- ❖ Education – Student Loan Marketing Assoc. (SLMA)
- ❖ Farming / Agriculture – Federal Farm Credit Bank (FFCB)

Characteristics

- ❖ Registration:
- ❖ Quote:
- ❖ Accrued Interest:

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GNMA, FNMA, FHLMC Pass-Throughs

Represents an interest in a pool of mortgages

- ❖ Monthly payments represent interest and principal
- ❖ Interest portion is fully taxable

Subject to pre-payment risk

- ❖ GNMA pass-throughs are U.S. Government guaranteed, while FNMA and FHLMC are not

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Collateralized Mortgage Obligations

CMOs
- ❖ A mortgage-backed bond created by dividing mortgage pools (GNMA, FNMA, FHLMC, not SLMA) into various bond classes (tranches).
  - Helps to manage pre-payment risk
  - Interest is generally paid monthly (fully taxable), with principal paid sequentially
  - AAA rated and issued in $1,000 denominations
- ❖ Advertising:
  - Offer educational material
  - No comparison to any other investment
  - Filed with FINRA 10 business days prior to use

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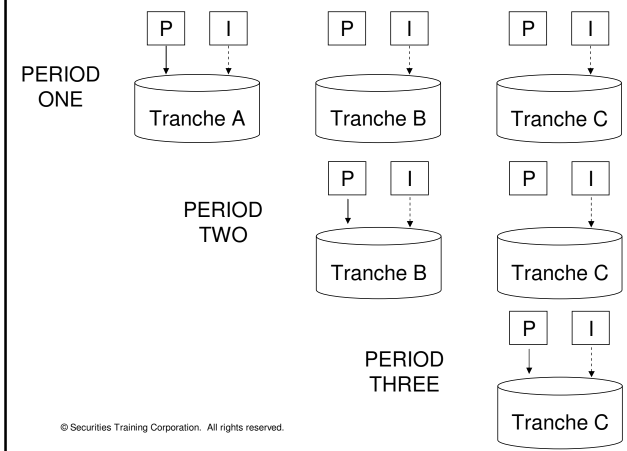
CMOs – Sequential Pay



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Other CMO Tranches

Planned Amortization Class or PAC Tranche
- ❖ Provides the most predictable cash flow and maturity

Support or Companion Tranche
- ❖ Provides the least predictable cash flow and maturity

Z-Tranche
- ❖ Last tranche to receive payments

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Money Market Instruments

Characteristics:
- ❖ Short-term debt instruments (one year or less to maturity)
- ❖ Safety of principal and liquidity
- ❖ Provide investors with a stable alternative pending an investment decision

Principal Types:
- ❖ T-Bills
- ❖ Banker's Acceptances – Facilitate foreign trade (import / export)
- ❖ Commercial Paper – Unsecured corporate debt
- ❖ Negotiable Certificates of Deposit (CDs) – Unsecured bank debt ($100,000 minimum)
- ❖ Repurchase Agreements (Repos) – A dealer selling securities to another dealer with the agreement to repurchase

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Long-Term CDs

Long-Term CDs or Brokered CDs are not money market instruments

- Maturities range from 2 to 20 years
- May be callable
- FDIC insurance may not apply
- Investors may experience a loss of principal if sold prior to maturity
- May have limited liquidity

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Session Four

- Municipal Bonds
- Municipal Securities Rulemaking Board (MSRB)

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Municipal - Overview

Issuers:

- States and their political subdivisions
  - Cities
  - Counties
  - School districts
- Public agencies and authorities
- Territories and possessions
  - Puerto Rico, U.S.V.I, Guam, American Samoa

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Municipal Exemptions

Exempt from:
- ❖ Both state (Blue Sky) and federal ('33 Act) registration
- ❖ Trust Indenture Act of 1939
- ❖ Federal Reserve's Reg. T

Interest Exemption:
- ❖ Interest received is exempt from tax
  - But may be subject to State and Local tax
- ❖ Territories and Possessions
  - Interest is "triple tax exempt"
- ❖ Note: Capital gains are taxable

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Yield Calculations

Ms. Jones 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: $\frac{\text{Tax-Free Yield}}{(100\% - \text{Tax Bracket }\%)}$

Ann Investor purchased a 7.5% corporate bond and is in the 35% tax bracket. What amount will Ann be able to keep after taxes have been paid?

Net Yield Formula: Taxable Yield x (100% - Tax Bracket %)

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Two Types of Municipals

	General Obligation	Revenue
Source for Payment of Debt Service:		

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Two Types of Municipals

	General Obligation	Revenue
Risk?		
Yield?		
Voter approval?		
Subject to debt limitations?		

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Analyzing Municipal Bonds

G.O. Bond analysis is based upon the municipality's tax revenues and liabilities outstanding

- Factors analyzed:
  - Property values
  - Current debt, including overlapping* (coterminous) debt
  - Tax delinquencies
  - Unfunded pension liabilities
  - Per capita income
  - Population growth

* Overlapping debt: situation where multiple authorities in a given geographic area have the ability to tax the same residents

Revenue Bond analysis will examine revenue, operating costs and competition from similar projects

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Types of Revenue Bonds

Type:	Source of Debt Service:
Housing	Rent
Transportation	Tolls, user fees
Special Tax	Excise taxes on purchases such as gasoline, tobacco, and liquor
Special Assessment	Assessments on the benefited properties; used for sidewalks, sewers, etc.

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Types of Revenue Bonds

Type:	Source of Debt Service:
Moral Obligation	If project revenue is insufficient, state legislature is morally, but not, obligated for shortfall
Double Barreled	Two sources: • Project Revenue • Tax Dollars (G.O.)
Industrial Development Revenue (IDR)	Lease agreements (payments) with a corporate user of the facility • The credit rating is only as good as the • May be subject to the AMT

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Covenants from Issuer (Revenue)

Rate: Pledge to maintain user fees at a level sufficient to meet debt service and other obligations

Maintenance and Operation: Pledge to maintain project in good working order and to contribute to a fund for that purpose

Insurance: Pledge to carry insurance on the property

Catastrophe Call: Allows issuer the ability to call a bond due to the destruction of the revenue source backing the bond

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Covenants from Issuer (Revenue)

Additional Issue: Open versus closed-end indenture

Non-Discrimination: Pledge not to grant special rates to any one person or group

Flow (Allocation) of Funds: Establishes the priority for payment of debt service

- Will debt service be paid by:
  - Net Revenue (always assumed), or
  - Gross Revenue

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Net versus Gross Revenue

Net Revenue Pledge Bond

From: Gross Revenue
First comes: Maintenance and Operating
Leaving: Net Revenue
From which we pay: Debt Service

Gross Revenue Pledge Bond

From: Gross Revenue
First comes: Debt Service
From what's left we pay: Maintenance and Operating

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

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Municipal Notes

Tax-Free Anticipation Notes

- Short-term, interim financing
- Get a project started
- Help in managing cash flows
  - Tax Anticipation Notes (TAN)
  - Revenue Anticipation Notes (RAN)
  - Bond Anticipation Notes (BAN)
  - Grant Anticipation Notes (GAN)

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Ratings for Municipal Notes

S & P	Moody's
SP-1	MIG 1
SP-2	MIG 2
SP-3	MIG 3
	MIG 4

MIG = Moody's Investment Grade

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Other Types of Securities

Variable Rate Demand Obligation (VRDO):
- ❖ Debt security offering a variable rate of interest that is adjusted at specified intervals (such as daily, weekly, or monthly)
- ❖ Holders can redeem for par plus accrued interest at any time that rates are reset

Auction Rate Securities:
- ❖ Long-term bonds (municipal or corporate) with a variable interest rate that is periodically set through a "Dutch Auction"
- ❖ The auction sets the lowest interest rate at which all the securities being offered for sale will clear the market ("net clearing rate")
- ❖ Interest rate reset periods range from 7, 28, or 35 days

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Municipal Documents

Official Statement
- ❖ Contains most detailed disclosures regarding:
  - Issuer
  - Purpose
- ❖ Preparation is <u>NOT</u> required, since the MSRB has <u>no control</u> over issuers
- ❖ If prepared, MSRB requires B/Ds to distribute it

Legal Opinion
- ❖ Written by the Bond Counsel prior to sale
- ❖ The counsel renders opinions as to:
  - Issuer's legal, valid and enforceable obligation
  - Tax exempt status of the issue
- ❖ "Unqualified" opinion is better than a "qualified" opinion

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Municipal Documents

Indenture (a.k.a. Bond Resolution)
- ❖ A contract which addresses the legal protections afforded the bondholders and terms of the issue, such as:
  - Coupons
  - Maturity
  - Call provisions
  - Covenants

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Selecting an Underwriter

With a <u>Negotiated Sale</u>
- ❖ Issuer appoints their underwriter
- ❖ Both issuer and underwriter "negotiate" terms of the deal
- ❖ Usually used for Revenue Bonds

With a <u>Competitive Sale</u>
- ❖ Issuer advertises bonds by publishing a "Notice of Sale" in the Bond Buyer
- ❖ Issuer is inviting underwriters to submit sealed bids
- ❖ Usually used for General Obligation Bonds

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Notice of Sale Contents

Bidding Procedures: Date, time and place to return bids

Dated Date: For a new issue, date on which interest begins to accrue

Maturity Structure: Term:
- Entire issue matures on one date
- Mandatory sinking funds are common
- Quoted on a dollar basis (% of par)

Serial:
- Issue has series of maturity dates
- Provides issuer with level debt service
- Quoted on a yield basis

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Notice of Sale Contents

Call Provisions (if any)

Bond Insurance (if any): Company guarantees payment of principal and interest if issuer defaults
- ❖ FGIC, MBIA, or AMBAC
  - Improves credit rating of the issue

Legal Opinion: Identifies the Bond Counsel providing the opinion

Good Faith Deposit: Must accompany bid

Right of Rejection: Issuer's ability to reject any or all bids

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Syndicate Practice

Formation of Syndicate
- ❖ Manager invites other B/Ds to participate and share liability
- ❖ Sends prospective firms a <u>Syndicate Letter</u> to provide information about the issue (also referred to as <u>Agreement Among Underwriters</u>):

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Syndicate Practice

Preparing 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 upon interest cost
  - Net Interest Cost (NIC)
    or
  - True Interest Cost (TIC) -Canadian method
- ❖ Winning syndicate bid (lowest overall cost to issuer) takes bonds as a firm commitment

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Priority of Orders

1)	**P**re-Sale	Contingent order, taken before the bonds have been priced
2)	**G**roup Net	Benefits the entire syndicate by percentage of liability
3)	**D**esignated	Profit designated to two or more members, but not all
4)	**M**ember	Profit to only one member

With justification, manager may change priority

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Priority of Orders

Example: $62 million offering with the following orders on the manager's desk

Pre-Sale:	$32 million
Member:	$20 million
Group Net:	$20 million
Designated:	$30 million

How many of the designated orders will be filled?

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Syndicate Liability for Unsold Bonds

Eastern Account

- ❖ Undivided Syndicate
- ❖ Each member takes some of the unsold bonds (same percentage as original allocation)

Western Account

- ❖ Divided Syndicate
- ❖ Members only responsible for their individual allocation

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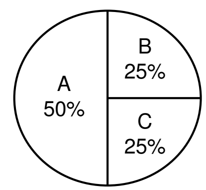
Syndicate Liability for Unsold Bonds

A three-member syndicate



$100,000,000 Issue

Reallocation of: $ ______

Member	Sales	If Western Style	If Eastern Style
A	$50 million		
B	$ 5 million		
C	$25 million		

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Components of the Spread

The manager of an underwriting syndicate receives $^{1}/_{4}$ point per bond. The syndicate member's compensation is $^{3}/_{4}$ point for each bond they sell, and a selling group's concession is $^{1}/_{2}$ point for each bond they sell. (Hint: the total spread for the example is 1%)

Manager's Fee	Additional Takedown	Concession

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Components of the Spread

	Total Takedown $^{3}/_{4}$	
Mgr. Fee	Additional Takedown	Concession
$^{1}/_{4}$ or $2.50	$^{1}/_{4}$ or $2.50	$^{1}/_{2}$ 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			
Sell. Group			

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Municipal Information

For the Primary Market: Bond Buyer

Indexes:

20 Bond: - G.O.s with year maturities
- Average rating AA or Aa2

11 Bond: - 11 of the above 20
- Average rating AA+ or Aa1

25 Revenue: - Revenues with year maturities
- Average rating A+ or A1

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Bond Buyer Information

Statistics

- ❖ Visible Supply
  - Total par value of both issues expected to reach the market within next days
  - Compiled daily
- ❖ Placement Ratio
  - Par value sold (placed) versus total par value that was available for sale
  - Compiled weekly

2005	No. New Accounts	Total Amt. New Accts. ($000s)	Sales from New Accts. ($000s)	Placement Ratio (%)
6/15	20	1,729,781	1,588,601	91.8
6/8	17	476,595	432,585	90.8
6/1	23	952,278	843,508	88.6

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Municipal Securities Rulemaking Board (MSRB)

and Municipal Taxation

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MSRB Overview

- The MSRB formulates and interprets rules
- MSRB rules regulate:
  - Broker-dealers and salespersons engaged in municipal business, and
  - Municipal advertising
- MSRB rules do not apply to municipal issuers
- Since the MSRB has <u>no enforcement power</u>, rules are enforced by a separate regulatory agency

For broker-dealers:	For bank dealers:
- FINRA or - SEC	- Comptroller of the Currency - FRB or - FDIC

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Municipal Securities Representative

Requirements:

- Conduct day-to-day firm business
- Must pass the Series 7 or 52 during the first 180 calendar days after joining the firm
- <u>Minimum 90-day</u> apprenticeship period
- As an apprentice, individuals may not deal with customers (only other municipal professionals) or be compensated by commission (only salary)

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Municipal Securities Principal

Role of the Principal

- Must promptly review and approve in writing:
  - All new accounts
  - All municipal transactions
  - All municipal correspondence
  - Summaries / abstracts of an Official Statement
  - All complaints
- Regarding complaints:
  - Must be in writing and signed by the customer
  - "Investor Brochure" delivered to customer
  - Resolution and complaints maintained for six years

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Financial Advisory Relationship

Agreement between a broker-dealer and an issuer to provide financial advice for a fee. Requirements are in place if the financial advisor now wishes to underwrite a bond issue for that issuer.

- ❖ For a Competitive Sale:
  - Obtain issuer's written permission
- ❖ For a Negotiated Sale:
  - Terminate the relationship
  - Obtain issuer's written permission
  - Disclose to issuer all anticipated compensation
  - Disclose previous relationship to customers

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Control Relationship

A broker-dealer employs (controls) a person who has influence as to an issuer's debt service

If the broker-dealer wishes to trade that issuer's bonds for or with a customer the broker-dealer must:

- ❖ Disclose relationship, at least orally, before the trade
- ❖ Disclose relationship in writing at or prior to settlement
- ❖ And if for a discretionary account, obtain the customer's specific, written permission

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Political Contributions

Contributions made by municipal finance professionals (MFP) to candidates or a PAC could potentially aid in attaining business, therefore a conflict exists

- ❖ A violation would occur if:
  - A municipal securities professional makes a political contribution in excess of (per election) to a candidate for whom they may vote, or
  - Makes any contribution to a candidate for whom they may not vote
- ❖ If a violation occurs, there is a two year ban on business with the issuer (no negotiated deals, however this does not include competitive)

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Municipal Discounts and Premiums

Original Issue Discount (O.I.D.)

- ❖ Basis must be accreted * at a rate which will bring basis to par at maturity
- ❖ Held to maturity produces:
- ❖ Sale prior to maturity could produce:

Secondary Market Discount

- ❖ When the bond is sold or redeemed, the accreted market discount is taxed as:

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Municipal Discounts and Premiums

Premiums

- Basis must be amortized * at a rate which will bring basis to par at maturity
- Held to maturity produces:
- Sale prior to maturity could produce:

* IRS requires the “constant yield method” for accretion and/or amortization. However, not calculated for test. Test will only ask for straight-line.

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Example 1 of 3

An investor purchased a municipal bond at a discount. If the investor holds the bond to maturity, any gain will be considered:

I. Tax-free interest if the bond is an OID
II. A capital gain if the bond is an OID
III. Ordinary income if the bond is not an OID
IV. Tax-free income if the bond is not an OID

1) I and III only
2) I and IV only
3) II and III only
4) II and IV only

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Example 2 of 3

A municipal bond that was issued at par is purchased in the secondary market at a price of 90. What would be the tax consequence if the bond was held to maturity?

1) $100 capital gain
2) $100 capital loss
3) $100 tax-free interest
4) $100 ordinary income

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Example 3 of 3

An investor purchases a $100m face value municipal bond with a 5-year maturity at 105. After two years, the bond is sold at 95. For tax purposes, the investor has a:

1) $ 2,000 loss
2) $ 4,000 loss
3) $ 8,000 loss
4) $10,000 loss

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