

Chapter Four

Municipal Securities

Introduction

The Municipal Securities Rule Making Board or the MSRB is the organization responsible for overseeing the municipal securities industry. The MSRB has no enforcement arm and its only function is to write rules and test questions. As a result, the Series 7 exam will contain a large number of questions relating to municipal securities.

Municipal bonds

State and local governments will issue municipal bonds in order to help the local governments meet their financial needs. Most municipal bonds are considered to be almost as safe as Treasury securities issued by the federal government. However, unlike the federal government, from time to time an issuer of municipal securities does default. The degree of safety varies from state to state and from municipality to municipality. Municipal securities may be issued by:

- ✓ States
- ✓ Territorial possessions of The US, such as Puerto Rico
- ✓ Legally constituted taxing authorities and their agencies
- ✓ Public authorities that supervise ports and mass transit

Types of Municipal Bonds

General Obligation Bond

General obligation bonds also known as “GO’s” are full faith and credit bonds. The bonds are backed by the full faith and credit of the issuer and by their ability to raise and levy taxes. In essence tax revenues back the bonds. GO’s will often be issued to fund projects that benefit the entire community and the financed projects generally do not produce revenue of any kind. General obligation bonds would be issued, for example, to fund a local park, a new school building, or a new police station. General obligation bonds that have been issued by the state are backed by income and sales taxes while GO’s that have been issued by local governments or municipalities are backed by property taxes.

Voter Approval

General obligation bonds are a drain on the tax revenue of the state or municipality that issues them. The amount of general obligation bonds that may be issued must be within certain debt limits and requires voter approval. The maximum amount of general obligation debt that may be issued is known as the statutory debt limit. State and municipal governments may not issue general obligation debt in excess of their statutory limit.

Property Taxes

General obligation bonds issued at the local level are mostly supported by property tax revenue received from property owners. A property owner's taxes are based on the assessed value of the property, not on its actual market value. Towns will periodically send an assessor to inspect properties and determine what the properties' assessed values are.

Example

A homeowner whose home has a market value of \$100,000 will not be taxed on the entire market value of the home. If the town uses a 75% assessment rate, the home's assessed value would be \$75,000.

Overlapping Debt

Taxpayers are subject to the taxing authority of various municipal authorities. Municipal debt that is issued by different municipal authorities that draws revenue from the same base of taxpayers is known as overlapping debt or coterminous debt.

Example:

The county water authority issued bonds that are supported by the property taxes levied in the county. The water authority's debt overlaps the towns' and county's other general obligation debt by drawing support from the same tax revenue. State issues are not included when determining overlapping debt because they are supported by other revenue sources such as state sales taxes and income taxes.

Revenue Bonds

A revenue bond is a municipal bond that has been issued to finance a revenue-producing project such as a toll bridge. The proceeds from the issuance of the bond will construct or repair the facility, and the debt payments will be supported by revenue generated by the facility. Municipal revenue bonds are exempt from The Trust Indenture Act of 1939, but all revenue bonds must have an indenture that spells out the following:

- ✓ Rate Covenant
- ✓ Maintenance Covenant
- ✓ Additional Bond Test
- ✓ Catastrophe Clause
- ✓ Call or Put Features
- ✓ Flow of Funds
- ✓ Outside Audit
- ✓ Insurance Covenant
- ✓ Sinking Fund

Industrial Development Bonds / Industrial Revenue Bonds

An industrial revenue bond or an Industrial development bond is a municipal bond issued for the benefit of a private corporation. The proceeds from the issuance of the bond will go towards building a facility or towards purchasing equipment for the corporation. The facility or equipment will then be leased back to the corporation and the lease payments will support the debt service on the bonds. Interest earned by some high-income earners on industrial development bonds may be subject to the investor's alternative minimum tax. States are limited as to the amount of industrial revenue bonds that may be issued, based on the population of the state.

Lease Rental Bonds

A lease back arrangement is created when a municipality issues a municipal bond to build a facility for an authority or agency such as a school district. The proceeds of the issue would be used to build the facility that is then leased to the agency and the lease payments will support the bond's debt service.

Special Tax Bonds

A special tax bond is issued to meet a specific goal. The bond's debt service is paid only by revenue generated from specific taxes. The debt service on special tax bonds is, in many cases, supported by "sin" taxes, such as taxes on alcohol, tobacco, gasoline, hotel and motel fees, and business licenses. Keep in mind that special tax bonds are revenue bonds not general obligation bonds.

Special Assessment Bonds

A special assessment bond will be issued in order to finance a project that benefits a specific geographic area or portion of a municipality. Sidewalks and reservoirs are examples of projects that may be financed through issuance of special assessment bonds. The homeowners in the area that benefit from the project will be subject to a special tax assessment. The assessment will then be used to support the debt service of the bonds. Homeowners that do not benefit from the project are not subject to the tax assessment.

Double Barreled Bonds

Double barreled bonds are bonds that have been issued to build or maintain a revenue-producing facility such as a bridge or a roadway. The initial debt service is supported by the user fees generated by the facility. However if the revenue generated by the facility is insufficient to support the bond's interest and principal payments, the payments will be supported by the general tax revenue of the state or municipality. The debt service on double barreled bonds is backed by two sources of revenue. Because the tax revenue of the state or municipality also backs them, revenue bonds are rated and trade like general obligation bonds.

Moral Obligation Bonds

A moral obligation bond is issued to build or maintain a revenue producing facility such as a park or tunnel. If the revenue generated by the facility is insufficient to cover the debt service, the state legislature may vote to allocate tax revenue to cover the short fall. A moral obligation bond does not require that the state cover any shortfall; it merely gives them the option to. Some reasons why a state may elect to cover a shortfall are:

- ✓ To keep a high credit rating on all municipal issues
- ✓ To ensure that interest rates on their municipal issues do not rise

New Housing Authority / Public Housing Authority

New Housing Authority and Public Housing Authority bonds are issued to build low-income housing. The initial debt service for the bonds is the rental income received from the project's tenants. Should the rental income be insufficient to cover the bond's debt service, the US Government will cover any shortfall. Because the payments are guaranteed by the federal government NHA / PHA bonds are considered to be the safest type of municipal bond. NHA / PHA bonds are not considered to be double barreled bonds because any shortfall will be covered by the federal government, not the state or municipal government.

Short Term Municipal Financing

States and municipalities, like other issuers, need to obtain short term financing to manage their cash flow and will sell both short term notes and tax-exempt commercial paper. Short term notes are sold in anticipation of receiving other revenue and are issued an MIG rating by Moody's investor service. The MIG ratings range from 1 to 4, with a rating of MIG 1 being the highest and a rating of MIG 4 being the lowest. The types of short term notes a state or municipality may issue are:

- ✓ Tax Anticipation Notes (TANs)
- ✓ Revenue Anticipation Notes (RANs)
- ✓ Bond Anticipation Notes (BANs)
- ✓ Tax and Revenue Anticipation notes (TRANS)

Municipal tax-exempt commercial paper matures in 270 days or less and will usually be backed by a line of credit at a bank.

Issuing Municipal Securities

Prior to issuing any bonds, a municipal issuer must authorize the issuance of the bonds through a bond resolution and obtain a preliminary legal opinion. The bond resolution authorizes the sale of the bonds and describes the issuer's obligations to the bondholders. The preliminary legal opinion helps to determine how the bonds may be offered.

Selecting an Underwriter

Municipal officials cannot effectively tend to their duties and try to find investors to purchase the municipality's debt. As a result, municipal issuers will select an underwriter or a syndicate of underwriters to sell the bonds for them. There are two ways that the issuer may select an underwriter. An underwriter may be selected either through a negotiation with the issuer or through a competitive bidding process. Most revenue bonds are awarded to the underwriter through negotiation. In a negotiated underwriting, the issuer will select the underwriter and negotiate the best terms directly with them. Most general obligation bonds are awarded through competitive bidding. In competitive bidding the issuer will invite underwriters to bid on the terms of the issue by publishing an official notice of sale in the Daily Bond Buyer. The underwriter or syndicate, submitting the bid with the lowest net interest cost, or NIC, to the issuer, will be awarded the issue. The official notice of sale will include:

- ✓ Description of the Issuer
- ✓ Description of the Issue
- ✓ Dated Date
- ✓ Maturity Structure
- ✓ Date and Place of Sale. Including The Time of Sale
- ✓ Denomination of Bonds
- ✓ Call or Put Provisions
- ✓ Sealed Bid or Other Bidding Provisions
- ✓ Amount of Good Faith Deposit Required to Accompany all Bids
- ✓ Name of bond Council
- ✓ Paying Agent and Trustee
- ✓ Expenses Allocated to issuer or purchaser
- ✓ Terms of Delivery
- ✓ Criteria for Awarding The Issue
- ✓ Right of Rejection

Interested parties will submit bids based on their ability to market the bonds on behalf of the issuer. The underwriter is trying to provide the issuer with a competitive rate on their bonds while still being able to earn a profit by selling the bonds to investors.

The official notice of sale does not include:

- ✓ The Yield to Maturity or YTM
- ✓ The Bond's Rating
- ✓ The Name of the Underwriter
- ✓ The Amount of Accrued Interest

The municipal issuer prepares a bond contract for the benefit of the underwriter and issuer. The bonds contract includes:

- ✓ Bond Resolution
- ✓ Trust Indenture (If any)
- ✓ Applicable State and Federal Laws
- ✓ Any Other documentation regarding the issuer

These documents make up the bond contract and the issuer is required to adhere to all of the terms and conditions laid out in the various documents.

Creating a Syndicate

Most municipal issues are sold to raise a substantial amount of money. In order to assist with the marketing of the issue and to spread the risk of underwriting the securities, several investment banks will form a syndicate. The syndicate is a group of underwriters responsible for selling the issue. Firms participating in a syndicate, formed to submit a bid in a competitive underwriting, must sign the syndicate letter or syndicate agreement. The syndicate letter will disclose all fees and expenses including clearing expenses. Syndicate participants in a negotiated underwriting must sign the syndicate letter or syndicate contract. The syndicate agreement will contain:

- ✓ Each Members participation in the offering (member's commitment)
- ✓ Method of Allocating Bonds
- ✓ Name of Managing Underwriter
- ✓ Management Fee and Spread
- ✓ Member Expenses and Amount of Good Faith Deposit
- ✓ Liability for Unsold Bonds
- ✓ Type of Syndicate Account, Eastern or Western

Syndicate Accounts

Each syndicate member is responsible for selling the bonds that have been allocated to them based on their participation. A syndicate member may also be responsible for selling additional bonds if another syndicate member is unable to sell their entire allocation of bonds. There are two types of syndicate accounts: an eastern account also known as an undivided account, and a western account also known as a divided account. In an eastern account, if any bonds remain unsold, all of the underwriters must assist in selling the remaining bonds in accordance with their commitment level, regardless of which syndicate member was unable to sell them.

Example:

Let's assume that there are 3 investment banks participating in a syndicate to underwrite \$10,000,000 worth of municipal bonds. The syndicate account is an eastern account and the investment banks' commitment levels are as follows:

Investment Bank	Commitment Percentage	Dollar Value of Bonds
A	40%	\$4,000,000
B	30%	\$3,000,000
C	30%	\$3,000,000

If investment bank "B" were only able to sell \$2,000,000 of their allocation, the remaining \$1,000,000 of bonds would have to be sold by all syndicate members based upon their commitment levels. The remaining bonds would be allocated as follows:

Investment Bank	Commitment Percentage	Dollar Value of Bonds
A	40%	\$400,000
B	30%	\$300,000
C	30%	\$300,000

Even though investment bank “B” was responsible for the \$1,000,000 of unsold bonds, they would only be required to sell 30% of the remaining bonds or \$300,000 worth and the other syndicate members must sell the remaining bonds in line with their participation.

In a western account or a divided account, any unsold bonds are the responsibility of the syndicate member who was unable to sell their allocation. If, in the above example, the syndicate account was a western account, syndicate member “B “ would have to sell all \$1,000,000 worth of bonds that they failed to sell originally

Submitting The Syndicate Bid

Syndicate members will engage in a series of meetings in order to determine the terms and conditions of their bid. The syndicate members must determine:

- ✓ The Underwriter’s Spread
- ✓ The Re-Offering Yield
- ✓ The Prices and Yields to be Submitted To the Issuer

If all syndicate members cannot agree unanimously, on one or more conditions, they must agree to accept the decision of the majority of the syndicate members. Only one bid may be submitted for each syndicate and it will be submitted by the lead or managing underwriter.

Determining The Re Offering Yield

The Syndicate must determine the re offering yield that will be offered to the investing public. This is known as writing the scale. Most general obligation municipal bonds are issued with a serial maturity that matures over a period of years. The longer-term maturities carry higher yields than the bonds that mature earlier. When the syndicate has determined the prices and yields, they will submit the bid to the issuer, along with the required good faith deposit. All competitive underwritings are done on a firm commitment basis and the winning syndicate is required to purchase all of the bonds from the issuer, even if they can’t sell them to investors.

Awarding The Issue

Once all bids have been submitted, the issuer and the bond council will meet to determine which syndicate will be awarded the issue. The bid with the lowest net interest cost or NIC will usually win the issue. The NIC takes into consideration the actual dollar amount of interest that will be paid over the life of the issue. Additionally, if the issuer received a premium for the bonds, the amount of the premium will be deducted from the net interest cost. If, however, the issuer sold the bonds at a discount, the amount of the discount will be added to the overall net interest cost. An alternative calculation used to award the issue would be based on the True interest cost of the issue or the TIC. The TIC takes into consideration the time value of the money. Regardless of which method is used to award the issue, the syndicate with the best bid is awarded the issue. The issuer keeps their good faith deposit and returns the others. The manager of unsuccessful syndicates must return the good faith deposits to syndicate members within two business days. The syndicate that submits the second best bid is known as the cover bid and will be awarded the issue, in the event the winning syndicate cannot meet their obligations to the issuer. The manager of the winning syndicate will open a syndicate account once the issue has been awarded and the manager is responsible for its operation and must keep accurate books and records for all account activities.

Underwriter's Compensation

The difference between the price the underwriters pay for the bonds and the price at which they resell the bonds to the public is known as the spread. The syndicate members divide up the spread according to their different roles and in accordance with their participation in the issue. The Spread consist of:

- ✓ Management Fee
- ✓ Underwriting Fee
- ✓ Additional Takedown
- ✓ Selling Concession

The Management Fee

The syndicate manager receives a per bond fee for their role as syndicate manager. They receive this fee on all bonds regardless of who sells them.

The Underwriting Fee

The Underwriting fee is the part of the spread that is used to cover underwriting expenses. If any surplus remains after paying all expenses the syndicate members will split the fee based on their commitment to the underwriting.

The Total Takedown

The total takedown is what syndicate members can earn on sales of the bonds to their customers. The total takedown consists if the additional takedown and the selling concession.

The Selling Concession

The selling concession may be earned on sales of bonds made by dealers who are not syndicate members. Selling group members may purchase bonds directly from a syndicate member and earn the selling concession on sales to their customers.

\$1,000 Price to Investor
Selling Concession \$9.00
Additional Takedown \$5.00
Underwriting Fee \$4.00
Management Fee \$2.00
\$980 Proceeds to Issuer

Take Note: The total takedown in this example is \$14 per bond. Syndicate members will purchase the bonds from the syndicate account at \$986 and may earn \$14 per bond.

Order Period

The order period is the time set by the syndicate manager, during which orders will be solicited for the bonds. All orders will be filled based upon the order priority agreed to in the syndicate letter and without regard to when the order was received. The order allocation priority is very important, especially when the issue is in high demand and there are more orders than bonds available to fill the orders.

Allocation Municipal Bond Orders

The syndicate manager must establish a method for allocating bonds based upon the priority of orders received by the syndicate. The MSRB requires that this be done in writing and it is usually detailed in the syndicate agreement along with the details regarding the sending of confirmations. The method under which the orders will be allocated may not be left to the syndicate manager's discretion. However there may be circumstances under which the syndicate manager may make exceptions so long as these circumstances are detailed in the syndicate agreement. The syndicate manager must demonstrate their reasons for deviating from the agreed order, if they take an exception to the agreed allocation process.

There are several types of orders that may be received by the syndicate and they are:

- ✓ Pre Sale Orders
- ✓ Syndicate or Group Net Orders
- ✓ Designated Orders
- ✓ Member Orders
- ✓ Member Related Orders

Pre Sale Orders

Pre Sale orders are entered by institutional investors, who agree to purchase the bonds, prior to the bond's pricing and terms being finalized. Pre sale orders are given the highest priority when allocating bonds to customers. The total spread, less the management fee, is deposited in the syndicate account and is divided up among the syndicate members based on their participation. If after all pre sale orders are filled any bonds remain they will be allocated to the syndicate orders.

Syndicate Orders / Group Net Orders

A syndicate order is one where the sales credit for the order is shared by members of the syndicate, based on their participation. A member may designate their orders as syndicate orders to give them a better chance of being filled. The entire sales credit, less the management fee, is deposited in the syndicate account. After all syndicate orders are filled, any remaining bonds will be distributed to designated orders.

Designated Orders

A designated order is usually submitted by a syndicate member, for the account of a large institution. With a designated order, the large institution will "designate" which syndicate members and which agents at the syndicate members receive the sales credit. If any bonds remain, the next orders to be filled are the member orders.

Member Orders

Member orders are orders submitted by syndicate members for their own customers. The syndicate member receives all of the sales credit. Member orders are traditionally smaller orders for individual accounts. If there are any bonds remaining, the last type of order to be filled is member related orders.

Member Related Orders

The last type of order to get filled is a member related order. A member related order is entered for the benefit of an entity sponsored or controlled by the member such as a proprietary mutual fund or UIT.

All municipal securities dealers submitting an order to a syndicate, or to a member of a syndicate, must disclose the capacity in which it is acting in filling the order. The member must also disclose if the order is for the dealer's account or for an account that it

controls or sponsors. Syndicate members are also required to state the name of the person for whom the order was entered, as well as the total par value of each maturity.