Ways to Buy Municipal Bonds

When considering whether to buy or sell a municipal bond, investors can ask themselves the following questions to help determine which of several investment methods may work best.

- ☐ How comfortable are you with making investment decisions?
- ☐ Do you want personal contact and the ability to ask questions of a professional?
- ☐ Do you want to have an advisor pursue an agreed-upon strategy and execute on your behalf?
- ☐ Do you wish to manage your own account?
- ☐ What fee structure do you prefer, taking into consideration the frequency of your trades?

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Depending on investment needs, desired level of involvement investors want in the purchase process and what type of fee structure is appropriate, investors have a choice in how to participate in the municipal bond market:

1. Use the services of a broker-dealer or a bank department that is a municipal securities dealer;
2. Hire an investment manager who can locate and trade bonds on your specific instructions or general authority;
3. Engage in direct online trading through a self-managed account; or
4. Buy or sell shares in a municipal bond mutual fund or exchange traded fund (ETF).

Investors seeking fixed income over a time period and the full return of principal, and who trade infrequently, might consider a broker-dealer charging mark-ups or commissions. Investors who wish to trade bonds frequently might consider an account that does not charge on a per-transaction basis. An investor seeking a wide range of bond exposure (sectors, maturities, credits) but who has limited funds (a typical minimum denomination to buy a single bond is $5,000) might consider a mutual fund or ETF. To make an informed decision, consider some of the attributes of each of these methods.

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Use a Full Service Broker-Dealer

A full-service broker-dealer[1] or a bank department that is a municipal securities dealer facilitates transactions on behalf of investors and has access to the expertise of its employees. At a full-service broker-dealer, a broker who primarily deals with individual investors is called a private client broker. A private client broker may also have the title "financial consultant" or "financial adviser." Purchases and sales of municipal bonds though a broker-dealer are preceded by a discussion with the investor, and the investor must give an explicit order to buy or sell securities in a brokerage account.

Remember that in full-service broker-dealer accounts, once you receive disclosure and suitable recommendations, you are responsible for the decisions to buy or sell.

Broker-dealers have established legal duties to investors. For instance, a broker-dealer is required to disclose to investors all material information about any municipal security it sells and must offer a fair and reasonable price when an investor is buying or selling a municipal security. Also, a broker-dealer must only recommend securities that are suitable for the investor's investment needs and risk tolerance. Remember that in full-service broker-dealer accounts, once you receive disclosure and suitable recommendations, you are responsible for the decisions to buy or sell. Broker-dealers are not required to meet fiduciary standards.[2]

While a broker-dealer generally has the best access to newly issued bonds because it typically participates in the initial offering of bonds to the market, investors should understand that the broker-dealer is also required to deal fairly with the state and local government entities that issue the bonds, as well as with investors.

Brokerage Fees

Full-service broker-dealers often charge a fee, called a "mark-up" when they buy bonds on behalf of investors and a "mark-down" when they sell bonds for investors. Mark-downs are usually smaller than mark-ups for several reasons. First, an investor who wants to sell a bond usually has fewer questions than an investor who is considering whether to buy a bond. Second, the ongoing operating costs of receiving and paying interest to the investor, or processing possible bond calls, will no longer be borne by the broker whose client is selling the bond.

Mark-ups and mark-downs are included in the total price shown on an investor's trade confirmation. But, for certain transactions, broker-dealers must also separately disclose on the confirmation the amount of the mark-up or mark-down charged. Additionally, some broker-dealers voluntarily disclose the amount of the mark-up or mark-down charged, even when not required to do so by MSRB rules. You should always feel free to ask your financial professional how much your purchase or sale was marked up or down if you don't fully understand the cost of your transaction.

Mark-ups and mark-downs are charged when the broker itself acts as a principal in the trade. The broker is "one side of the trade." The bond comes out of or goes into the broker's inventory, however briefly.

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1 Information about both a broker and a broker-dealer firm is available at: http://brokercheck.finra.org.

2 See 15 U.S. Code § 80b–6.

A registered investment adviser can be ***affiliated*** *with a broker-dealer or* ***independent investment adviser.*** *A broker-dealer can register its employees both ways to allow you, the investor, to choose which kind of relationship you want. If you engage one firm to serve as custodian (hold your securities), but require it to take orders about your account from an independent investment adviser you have selected, that is a separately managed account.*

In some cases, investors want a broker to act as agent in facilitating a purchase or sale of a municipal bond that is not in the broker's own inventory. In these types of purchases and sales (called as-agent trades), the broker does not act as the "other side" of the trade but helps find a buyer or seller for a bond. In such cases, there is still a fee charged for that service, but it is called a commission. Commissions are separately shown on a trade confirmation.

Full-service broker-dealers may also charge fees associated with the delivery of trade confirmations or other trade processing fees.

Getting a Fair Price

MSRB Rule G-30 requires brokers and municipal securities dealers to charge fair and reasonable prices. For principal transactions, the "all-in" price, including mark-up or mark-down, must be fair and reasonable. For agency transactions, the financial entity must try to get a fair price related to prevailing market conditions and must charge a fair commission. MSRB Rule G-18 requires a dealer to use reasonable diligence to determine the best market for a bond and execute in that market so that the resulting price to the customer is as favorable as possible under prevailing market conditions.[3]

An important factor in determining whether the aggregate price to the customer is fair and reasonable is that the yield should be comparable to the yield on other securities of comparable quality, maturity, coupon rate and block size then available in the market. Reviewing the trading history of a bond on the MSRB's Electronic Municipal Market Access (EMMA®) website can provide an indication of what the yield should be. In the event there are no trades in the specific security, EMMA's Price. Discovery Tool helps users find comparable securities. If the yield you are receiving seems out of line with comparable trades, ask questions.

Hire an Investment Manager

A registered investment adviser (RIA) manages accounts and makes purchases and sales in accordance with an investor's agreed-upon strategy, without getting individual approval for each transaction. RIAs have a special obligation to investors, called fiduciary duty. An RIA must put your interests first in advising you and managing your account. When you hire an RIA, you should get written information that explains both the investment policy that applies to your account and the investment process used by the RIA. RIAs often combine purchases for several clients by trading in larger blocks to obtain a better price.

RIAs usually charge a management fee to account holders. Some advisers charge an annual percentage of an investor's assets, while others may charge a fixed fee for advice. RIAs may also charge fees associated with the delivery of trade confirmations or other trade processing fees to account holders.

An RIA works for a company or partnership that is an investment manager. An RIA sells advice, rather than selling securities. An RIA may be affiliated with a broker-dealer. Some RIAs may charge an additional fee for financial planning. The amount of an

[3] On December 5, 2014, the SEC approved MSRB Rule G-18 and the related amendments with an effective date of December 7, 2015. The new effective date of MSRB Rule G-18 is March 21, 2016.

adviser's fees can affect the yield on your investments, including municipal securities, depending on the interest rate environment and the associated interest earnings.[4]

Engage in Direct Online Trading Through a Self-Managed Account

Some investors may prefer a self-managed account, also known as direct online trading, without the assistance of a private client broker. This is an account held with a broker-dealer, and generally charges the same commissions, mark-ups and mark-downs associated with a regular brokerage account with a broker-dealer. The firm has the same obligations to investors as any broker-dealer, but it may fulfill them differently. For example, disclosure about a particular bond might be electronic-only without any discussion with a private client broker. A self-managed account requires the investor to understand the pros and cons of each transaction.

Interest rate changes have a different effect on the owners of municipal bond mutual funds than on the direct owners of municipal bonds.

Municipal Bond Mutual Fund

Another way investors can choose to participate in the municipal market is to buy shares in a mutual fund that is fully or partially invested in municipal bonds. A mutual fund salesperson is directly employed by a mutual fund (a registered investment company) or a group of affiliated funds. The mutual fund salesperson aids investors in buying or selling mutual fund shares. Private client brokers may also sell mutual fund shares or they may be recommended by an RIA. Full-time professional investment managers select and monitor the credit quality of the bonds held in a municipal bond mutual fund. Typically, participating in a mutual fund provides a naturally diversified municipal bond portfolio at a lower cost than purchasing individual bonds. Investors generally receive the tax-exempt interest from such funds.

Although a municipal bond mutual fund provides built-in diversity in municipal bond investing, you do not own those bonds directly. Instead, you own an equity share of the fund. This is important because interest rate changes have a different effect on the owners of municipal bond mutual funds than on the direct owners of municipal bonds. Many investors who buy individual municipal bonds intend to, and do, hold them to maturity, although the market value of bonds varies between purchase and maturity. But the managers of mutual funds are seeking to maintain a stable or increasing share price. If rising interest rates cause the market value of bonds in the mutual fund portfolio to fall, some of those bonds will be sold — at a loss — both to limit further losses and to pay for share withdrawals. As a mutual fund shareholder, you are exposed to potential fluctuations in the mutual fund's value.

For an explanation of sales charges, deferred sales charges, and various kinds of shareholder and operating fees associated with mutual funds see http://www.sec.gov/answers/mffees.htm.

Municipal Bond Exchange Traded Fund

Municipal Bond Exchange Traded Funds (ETFs) are mutual funds that trade on a stock exchange. Most municipal bond ETFs are designed to track an underlying index. When an investor buys or sells shares of a municipal bond ETF, the transaction occurs between investors (buyers and sellers)

[4] See http://www.sec.gov/investor/alerts/ib_fees_expenses.pdf to learn more about how fees and expenses affect your investment portfolio.

over the exchange. In contrast, when an investor buys or sells shares in a municipal bond mutual fund, the transaction occurs directly from the mutual fund company. Municipal bond ETFs trade during market hours like a stock. Municipal bond mutual funds can only be bought or sold once a day. Because municipal bond ETFs trade like a stock, their share price can differ from the underlying net asset value (NAV) of the ETF. This can add another level of volatility into the price of a municipal bond ETF that does not exist with a municipal bond mutual fund.

For an explanation of sales charges, deferred sales charges, and various kinds of shareholder and operating fees, associated with mutual funds see http://www.sec.gov/answers/mffees.htm.

Regardless of the method in which you participate in the municipal bond market, consider your investment needs and ask your financial professional for written information about how fees are charged and which fees apply to your account.