

# *Series 53 Update*

*November 2009*

The following changes/updates are effective relevant to the Series 53 Examination. There are also some review questions attached to this document.

- The MSRB annual fee has increased from \$300 to \$500.
- A syndicate manager is required to pay a member firm any sales credit designated by a customer no later than 10 days (reduced from 30 days) following the date the issuer delivers the securities to the syndicate.
- Final settlement of the syndicate account must be made no later than 30 days (reduced from 60 days) following the date the issuer delivers the securities to the syndicate.
- The MSRB has rescinded Rule G-36 and moved all the delivery requirements of official statements, advance refunding documents, and filing of forms to a revised G-32. Listed below is a summary of the changes.
  - All underwriters are now required to submit official statements (OSs) and advance refunding documents (ARDs) in connection with primary offerings through the MSRB's Electronic Municipal Market Access system, which is known as EMMA. These documents must be submitted to EMMA in an electronic format (PDF). In addition, Form G-32 now replaces both Form G-36 and Form G-36 (ARD), and must also be submitted by the managing underwriter within one business day after receiving the OS from the issuer, and within five business days after receiving the ARD from the issuer.
  - The MSRB has established EMMA as the primary market disclosure service for official statements, other related primary market documents, and information. EMMA can receive documents from issuers and underwriters and provides access free of charge to the public. The EMMA system also contains information related to the continuing disclosure requirements submitted by municipal issuers and secondary market transactions submitted by municipal securities dealers. EMMA receives transactional information from the MSRB's Real-Time Transaction Reporting System (RTRS).
  - If documents have been submitted to EMMA, and these documents have been amended by the issuer during the primary offering or new issue disclosure period (defined as 25 days after delivery of the securities from the issuer to the underwriter), the underwriter is required within one business day to submit the amendment to EMMA and revise Form G-32.
  - Dealers selling municipal securities in the primary market (except for municipal fund securities) are required to provide no later than the settlement date either a copy of the OS or notify them of the availability of an OS through EMMA. Dealers are required to provide a written OS to any customer who requests one.

The following information provides some additional content related to the examination.

## Fair Dealing Rule

**Auction Rate Securities** Auction Rate Securities are securities with a variable interest or dividend rate that is set periodically through a single price or “Dutch Auction” process. Auction rate securities are long-term securities that are marketed as short-term investments. Based on submitted bids from holders and prospective buyers, the net clearing rate set by the auction agent will be the lowest rate that matches supply and demand. After the deadline for submission of orders, the auction agent assembles all the orders from lowest to highest bid and determines the net clearing rate. The net clearing rate is the lowest rate bid sufficient to cover all the securities exposed for sale.

These securities are usually sold as an alternative to other short-term money-market instruments. A municipal securities representative must disclose to a client that if the auction fails the client may not have immediate access to their funds. The rep also has a duty to disclose to clients any material facts relating to the specific features of the auction rate securities and the customer’s need for liquid investments when recommending this type of product.

**Variable Rate Demand Obligations (VRDOs)** Another type of long-term security which is marketed as a short-term investment is a VRDO. A variable rate demand obligation (VRDO) will adjust its interest rate at specified intervals (daily, weekly, monthly) and, in many cases, allows the owner to sell or put the security back to the issuer or a third party on the date that a new rate is established. A bank may issue a letter of credit (LOC) that provides the credit enhancement and short-term liquidity. A municipal securities dealer is required to disclose the identity and the credit rating of the firm that is providing the credit enhancement and any other relevant information. The investor will receive the par value plus accrued interest.

It is important to understand the difference between a VRDO and auction rate municipal securities. Although they are both long-term securities with short-term trading features only VRDOs have a put feature that permits the holder to sell the securities back to the issuer or third party. Auction rate securities (ARS) do not have this feature and if the auction fails the investor may not have immediate access to their funds. In addition, ARS use an auction process to reset the interest rate on the securities whereas the reset interest rate on a VRDO is set by the dealer at a rate that allows the security to be sold at par value.

**Insured Bonds** There are a number of insurance companies or groups that currently insure new issues of municipal bonds. When a policy is in effect, the insurer agrees to pay all interest and principal if, for any reason, the issuer fails to pay these costs. The issuer will pay a fee to the insurer, but the cost is offset by the issuer’s ability to pay a lower coupon. Concerning insured municipal bonds, the dealer is required to provide a description of any bond insurance that relates to the credit rating of the issue as well as information about the credit rating of the insurance company. There is no guarantee that an insured bond will have a triple A rating.

## Inactive Status due to Military Duty

A registered person who voluntarily joins the military or is called into active duty falls into a category called special inactive. The Central Registration Depository indicates this category. The regulators provide registration relief to registered personnel whether they return to their previous employer or seek registration with another broker-dealer.

Registered representatives called into active military service are exempt from the two-year inactive status limitation normally applied to registration reinstatement. During the period of active military service, individuals are NOT permitted to function as registered representatives by contacting customers; however, they may continue to receive compensation based on securities transactions.

The MSRB applies relief of the examination requirements when a person is either in a special inactive status (serving in the military while still registered), or if a person on active military duty left the industry and ceased to be registered. If the person does not register within 90 days of the completion of active duty, she must register within two years, minus the time between termination and engaging in active service. For example, if a person terminates her registration and six months later joins the military she must register within 18 months of the completion of military duty. Both the Regulatory and Firm Elements of Continuing Education are also deferred during active duty. The time element applied to registered persons for continuing education is tolled (taken away) during the period of active military service. Therefore the requirement to sit for regulatory continuing education based on the second anniversary of initial registration and each three years thereafter is halted while the person is in active military service and resumes once the individual's special inactive status ends.

# Questions

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1. Mr. Jones is a small business owner who has purchased Treasury Bills and other short-term securities during times when he has excess funds available in the business. He likes the aspects of liquidity and safety. A friend has told him he can get higher rates from Auction Rate Securities. He wants to know why you have not recommended this investment to him. Which TWO of the following would you cite as your reasons?
  - I. Auction Rate Securities are long-term investments.
  - II. Interest or dividend rates are reset at established intervals based on a "Dutch" auction.
  - III. If the auction fails, the client may not have immediate access to their funds.
  - IV. The interest or dividend rate is set as the lowest rate to match supply and demand at the auction.
  - a. I and III
  - b. I and IV
  - c. II and III
  - d. II and IV
  
2. All of the following are TRUE concerning both Auction Rate Securities and Variable Rate Demand Obligations EXCEPT:
  - a. Interest rates are set at specified intervals
  - b. They are often issued by municipalities
  - c. They are long-term securities with short-term trading features
  - d. They have a put feature allowing the holder to redeem the security at par
  
3. In January an investor receives a bonus from her employer. She will need to have access to the funds in April. An RR should NOT recommend which of the following municipal securities?
  - a. A variable rate demand obligation
  - b. An auction rate security
  - c. A tax anticipation note
  - d. A bond anticipation note
  
4. Auction Rate Security is a type of investment that has the interest or dividend rate reset periodically. The term "net clearing rate" refers to which of the following?
  - a. The average rate of all submitted bid
  - b. The highest rate to match supply and demand
  - c. The lowest rate to match supply and demand
  - d. The lowest rate of all submitted bids
  
5. Which TWO of the following choices are required disclosures to a customer buying municipals bonds?
  - I. A description of any bond insurance that relates to the credit rating of the issue
  - II. A statement attesting to the fact that the bond insurance will guarantee a triple A rating for the issue
  - III. Information on the auction process, including the duration of the interest-rate reset period for Auction Rate Securities
  - IV. A description of the features of Auction Rate Securities available from other dealers
  - a. I and III
  - b. I and IV
  - c. II and III
  - d. II and IV

6. The registration status of a registered person who either volunteers or is called up for U.S. military service is:
  - a. U4 reserve status
  - b. Special inactive status
  - c. Temporarily terminated
  - d. Designated military exclusion
  
7. Chris works at a municipal securities dealer. He has just been called up for active military duty. What is his continuing education status?
  - a. He must participate before he leaves for active duty.
  - b. CE requirements are deferred until his active duty ends.
  - c. He must participate in CE, unless his active duty is overseas.
  - d. A CE proctor will be brought to a designated U.S. military base for delivery of the program.
  
8. When does the tolling of registration expiration provisions terminate for persons previously registered with a member, who start active military duty?
  - a. 60 days following the completion of active military service
  - b. 90 days following the completion of active military service
  - c. 1 year following the completion of active military service
  - d. 2 years following the completion of active military service
  
9. Dale is an MFP who is actively involved in state and local politics. As the branch manager supervising Dale, which of the following activities would you most likely prohibit concerning an issuer official?
  - a. Appearing at a fundraising event
  - b. Hosting a fundraising event
  - c. Soliciting votes
  - d. Giving a speech
  
10. All of the following statements are TRUE concerning Variable Rate Demand Obligations (VRDOs) EXCEPT:
  - a. Once the bank provides the credit enhancement, the security will be rated triple A
  - b. A bank will usually provide a letter of credit to provide short-term liquidity
  - c. The municipal dealer is required to disclose the identity of the firm that is providing the credit enhancement
  - d. The municipal dealer is required to disclose the credit rating of the firm that is providing the credit enhancement

# Explanations

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1. (A) Although auction rate securities are usually sold as an alternative to other short-term securities, they are long-term securities. An RR must disclose to a client that, if the auction fails, the client may not have immediate access to her funds. The RR also has a duty to disclose to clients any material fact relating to the specific features of the auction rate securities and the customer's need for a liquid investment when recommending this type of product. The fact that the interest or dividend rate is reset at specified intervals is a material fact, but would not be a reason to avoid recommending the investment. The same reasoning applies to the fact that the rate is set at the lowest rate that matches supply and demand. These investments may not be suitable for investors who have a need for liquidity.
2. (D) Although they are both long-term securities with short-term trading features, only VRDOs have a put feature that permits the holder to sell the securities back to the issuer or third party. Auction rate securities (ARSs) do not have this feature, and if the auction fails the investor may not have immediate access to their funds. In addition, ARSs use an auction process to reset the interest rate on the securities, whereas the reset interest rate on a VRDO is set by the dealer at a rate that allows the securities to be sold at par value.
3. (B) VRDOs and ARS are both are long-term securities with short-term trading features. VRDOs have a put feature that permits the holder to sell the securities back to the issuer or third party. Auction rate securities (ARS) do not have this feature and if the auction fails the investor may not have immediate access to their funds. TANs and BANs are short-term municipal notes and if their maturities extend beyond April, these securities could be easily sold in the secondary market.
4. (C) Based on submitted bids from holders and prospective buyers, the net clearing rate set by the auction agent will be the lowest rate that matches supply and demand. After the deadline for submission of orders, the auction agent assembles all the orders from lowest to highest bid and determines the net clearing rate. The net clearing rate is the lowest rate bid sufficient to cover all the securities exposed for sale.
5. (A) According to the MSRB fair dealing rules, a municipal securities broker or dealer may not engage in a deceptive, dishonest, or unfair practice. All material information should be disclosed to a customer concerning the transaction including a description of the security at or before the sale. Concerning insured municipal bonds, the dealer is required to provide a description of any bond insurance that relates to the credit rating of the issue as well as information about the credit rating of the insurance company. There is no guarantee that an insured bond will have a triple A rating. Concerning Auction Rate Securities, the dealer is required to provide information on the auction process, including the duration of the interest-rate reset period, and the possibility of a failed auction. In this situation, the customer should understand the illiquid nature of these securities. There is no requirement for a dealer to provide a description of the features of Auction Rate Securities available from other dealers.
6. (B) A registered person who voluntarily joins the military or is called into active duty falls into a category called special inactive. The Central Registration Depository indicates this category.

7. **(B)** Both the Regulatory and Firm Elements of Continuing Education are deferred during active duty. The time element applied to registered persons for continuing education is tolled (taken away) during the period of active military service. Therefore the requirement to sit for regulatory continuing education based on the second anniversary of initial registration and each three years thereafter is halted while the person is in active military service and resumes once the individual's special inactive status ends.
8. **(B)** If a person does not reregister with a member within 90 days following the completion of military service, the time in which a person must become registered without becoming subject to the two-year registration expiration provision, will consist of the standard two years, reduced by the period between the person's termination of registration and beginning of active service in the U.S. Armed Forces.
9. **(B)** The MSRB does not restrict MFPs from engaging in political activities to express their personal views provided they do not solicit contributions or exceed the contribution limits. Activities such as appearing at a fundraising event, soliciting votes (not contributions), giving a speech, writing books, displaying a sign on their property, or having a bumper sticker on their car would generally be permitted activities. Hosting a fundraising event may be considered soliciting contributions, or the expenses incurred to host the event may be considered a contribution, making this choice the most likely prohibited activity.
10. **(A)** A type of long-term security that is marketed as a short-term investment is a variable rate demand obligation (VRDO). A VRDO will adjust its interest rate at specified intervals (daily, weekly, monthly) and, in many cases, has a put feature that allows the owner to sell (put) the security back to the issuer or a third party on the date that a new rate is established. A bank may issue a letter of credit (LOC) that provides the credit enhancement and short-term liquidity. A municipal securities dealer is required to disclose the identity and the credit rating of the firm that is providing the credit enhancement and any other relevant information. The credit enhancement will cause the ratings of the security to increase, but there is no guarantee it will receive a triple A rating.