CHAPTER TWO

Product Knowledge: Municipal Fund Securities

(16 questions, 27% of the exam)

A **municipal fund security** is a fund of securities that is issued by a state or municipality. Investments in a municipal fund may consist of a wide variety of securities, including corporate stocks and bonds and government securities of every stripe. It is not to be confused with a **municipal bond fund**, which is a mutual fund consisting entirely of municipal bonds. A municipal fund security is distinguished from the typical investment company by its issuer.

Because it is issued by a state or local government, it is exempt from the rules of the Investment Company Act of 1940. Thus, a municipal fund security is not required to:

- Prepare a prospectus
- Register with the SEC
- Calculate and post an NAV

Municipal fund securities are also exempt from federal taxes, often state and local taxes as well.

2.1. HISTORICAL BACKGROUND

The term "municipal fund securities" did not exist until recently. In 1999 the MSRB became aware that dealers were selling trust funds held by state or local government entities. It reviewed two types of municipal programs, local government pools and higher education savings plan trusts, and asked the SEC for an opinion as to whether these trusts might constitute municipal securities, and if so, be subject to MSRB rules. It wasn't until 2000 that the MSRB adopted rules that applied to municipal fund securities.

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2.1.1. MSRB RULE D-12

MSRB Rule D-12 defines two kinds of municipal fund securities. The MSRB has regulatory responsibility for **local government pools** and **higher education trusts** when they meet the following three conditions:

- A dealer is conducting transactions in the trusts.
- The trusts, in fact, constitute municipal securities.
- The trusts are issued by an issuer that would be considered an investment company, except for its exemption under the Investment Company Act.

Though local government pools and education trusts have features more akin to investment company securities, they are regulated today as municipal securities by the MSRB, because they are issued by municipalities.

LGIPs have been around since the early 1970s. Section 529 college savings plans are a more recent development.

2.2. LOCAL GOVERNMENT INVESTMENT POOLS (LGIPs)

Local government investment pools (LGIPs) are trusts established by state and local governments that offer municipal entities a place to invest their money. Government entities use their surplus cash to purchase interests in a trust, which invests the assets in a large portfolio of securities, according to the trust's investment objectives and state laws. Only municipal governments and their instrumentalities may invest in these trusts. LGIPs are not open to investment by the public.

The purpose of LGIPs is to encourage the efficient management of the cash reserves of government entities, who otherwise have limited investment options. LGIPs offer an investment alternative that minimizes the risk of principal loss while offering daily liquidity and a competitive rate of return. By pooling their funds, government participants benefit from economies of scale, diversification, professional portfolio management, and liquidity.

Example: The state of Virginia offers public entities of Virginia the opportunity to participate in a professionally managed, AAA-rated LGIP. Under the Virginia statutes, the LGIP offers a competitive return with minimal risk of principal loss. The LGIP also offers liquidity and the benefits of large-scale institutional investment management.

2.2.1. LGIP PARTICIPANTS

Towns, villages, counties, cities, school districts, sewer districts, commissions, and committees may all be authorized to combine their resources in the pooled investment.

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However, not all of these entities may always participate in every LGIP. Instead, participants are often limited to a specific type of municipal entity within a certain jurisdiction. For instance, the pool may be limited to school districts within the state or to cities and townships within a single county. With some LGIPs, state monies and state retirement funds are added to the assets of the other participants to achieve economies of scale.

Some municipal entities may be required to invest in an LGIP. They are often referred to as "mandatory participants." Others, referred to as "voluntary participants," may be eligible to invest in an LGIP but can also invest elsewhere.

> **Example:** Under Washington State law, various local entities are eligible to participate in its LGIP, including cities and towns, counties, state agencies, federally recognized tribes, four-year universities, and others.

2.2.2. AUTHORIZATION AND ADMINISTRATION

LGIPs are authorized by state law. As a result, their characteristics will vary from state to state. They can differ in the financial instruments available under state law and in their stated investment objectives. Other differences may include legal structure and procedures for depositing and withdrawing money. Each pool has its own process for establishing a customer account, such as the documents they require and the participant's required banking information. Information sources for evaluating pools also may vary.

LGIPs are usually administered by the state treasurer or an authorized state advisory board. Alternatively, LGIPs may be governed under intergovernmental agreements, known as "joint powers" agreements. **Joint powers agreements** operate independently of state governments and are typically overseen by a board of trustees composed of municipal public officials.

The securities owned by the trust are most often managed by private investment management firms. However, asset management may also be handled internally by government employees. Occasionally, an LGIP will hire municipal securities dealers to market the LGIP to potential government participants.

2.2.3. LGIP REGULATION AND DISCLOSURE

While LGIPs are similar to mutual funds, they are not subject to regulation under the Investment Company Act. In particular, they are not required to register with the SEC, prepare a prospectus, or calculate net asset value on a daily basis. Municipal securities dealers that market LGIPs are also exempt from the Investment Company Act, but they must comply with MSRB rules.

Most LGIP participants invest directly through government personnel without the assistance of a municipal securities dealer. MSRB disclosure rules do not apply for LGIPs when state employees market their pools to participants without outside assistance. If municipal securities dealers market LGIPs, the LGIP is exempt from the regulations contained within the Investment Company Act, but the dealers must comply with MSRB rules.

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MSRB Rule G-32, for example, requires municipal securities dealers/underwriters to provide investors with an official statement drafted by the issuer, which provides information about the issuer and its securities and any other information necessary for evaluating the investment. Dealers must provide investors with this official statement by the settlement of the transaction. When managed by government personnel, however, LGIP issuers do not have to provide this information to customers.

When an LGIP is managed by a private investment management firm and a municipal securities dealer has been hired to market the product, MSRB disclosure rules *do* apply. In this instance, the issuer must provide the dealer with a copy of an official statement and other information material to evaluating the offering. The municipal securities dealer, in turn, must deliver the official statement to participants it has solicited by the date of settlement. The issuer must also deliver the official statement to the MSRB, which will post the information on its public website.

	Subject to Investment Company Act Regulations?	**Subject to MSRB rules?**	**Example**
A *government employee* sells and markets LGIP	Issuer exempt from Investment Company Act regulations	Government employees who sell and market the fund are exempt from MSRB rules	Government official is not required to provide a participant with an official statement
A *municipal securities broker or dealer* sells and markets LGIP	Issuer exempt from Investment Company Act regulations	Municipal broker or dealer must follow MSRB rules	Municipal brokers and dealers are required to provide customers with an official statement by the confirmation of the transaction

2.2.3.1. LGIPs and Net Asset Value

LGIPs are different from mutual funds in that they are not regulated under the Investment Company Act of 1940. Further, LGIPs are exempt from **SEC Rule 2a-7**, which requires a stable net asset value (NAV) for money market mutual funds. However, many states operate in a Rule 2a-7 manner, because it allows them to avoid additional reporting requirements imposed by the Governmental Accounting Standards Board for those LGIPs operating outside Rule 2a-7.

2.2.4. INVESTMENT OBJECTIVES

LGIPs generally are formed to meet a specific investment objective. In most cases, LGIPs

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invest to protect the investors' principal and provide them with cash liquidity. These pools invest in short-term securities to avoid credit, liquidity, and interest rate risks. Like money market mutual funds, these LGIPs try to maintain a constant NAV of $1. These are often referred to as **stable NAV LGIPs**.

Other LGIPs have the objective of maximizing returns within the constraints of safe, liquid investment options. In doing so, these **variable NAV LGIPs** introduce greater risk to the investor. These pools do not have the goal of maintaining a constant NAV of $1. The value of shares in these LGIPs will fluctuate depending upon the value of the underlying investments.

LGIPs may also be designed to help issuers of municipal bonds meet their yield restrictions under the Internal Revenue Code. LGIPs are not only restricted in the kinds of securities they may invest in, but they are strongly discouraged from earning excessive yields. This will be discussed in further detail later in the chapter.

> **Example:** California created a short-term LGIP called CalTRUST that observes state law investment requirements and additional investment guidelines adopted by the LGIP's board of trustees. CalTRUST's investment portfolio is composed of municipal bonds, asset-backed securities, money market funds, commercial paper, U.S. Treasury notes, and other high-quality, fixed-income securities. The objectives of the fund include preserving the principal, meeting the daily liquidity needs of its participants, and maximizing yield. CalTRUST is a variable NAV pool, because it includes the goal of maximizing yield and does not contain the explicit investment goal of keeping NAV at $1 per share.

2.2.5. LGIP OPERATIONS AND FEES

Whatever the investment strategy, LGIPs typically maintain a minimum level of liquidity to allow participants to redeem their shares and withdraw funds when necessary. Participants may redeem their shares at any time, although there may be short waiting periods. Many municipalities and state agencies expect money to be available for withdrawals for payrolls or other operating expenses.

LGIPs often allow participants to invest and withdraw funds by writing a check or through a wire transfer. This allows funds to be invested and withdrawn on a daily basis, adding to an LGIP's value as a cash management tool. Interest is earned daily.

LGIPs may invest only in securities allowed under state law, and these are often low-risk securities. Still, LGIPs are subject to investment risk, because their value can decline over time. Moreover, despite being offered by the state, they are not usually insured or guaranteed by a government.

When LGIPs are administered by a management firm, the firm may assess sales fees and commissions for its services. It may also collect management and administrative fees out of the assets in the fund. These fees will lower an investor's total returns.

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