Municipal bonds are issued by local governments such as cities, towns and counties, as well as by states and political subdivisions or agencies of states. The projects financed with municipal bonds can range from installing city streetlights to building new hospitals. A key feature of municipal bonds is that interest earned on them is generally exempt from federal income taxation and, in many states, interest earned on bonds issued in that state is exempt from state income taxation. The two most efficient methods of bringing municipal bonds to market are negotiated sales and competitive sales, with the method usually being invisible to the investor.

**NEGOTIATED SALES**

In negotiated sales, municipal bonds are issued under an exclusive agreement with the underwriter or underwriting syndicate, which is selected by the issuer through a proposal process. Issuers may choose the negotiated sales process when they have a large or more complex issue. In addition to the underwriter and issuer, several other parties are involved in a negotiated sale. They include:

- **Financial Advisor**—A financial advisor guides the issuer on matters pertinent to the bond issue, such as structure, timing, marketing, fairness of pricing, terms and bond ratings.

- **Bond Counsel**—The bond counsel is an attorney (or law firm) that is retained by the issuer to give a legal opinion stating that the issuer is authorized to issue the proposed securities. Most importantly, the bond counsel gives an unqualified opinion regarding all tax matters.

- **Underwriter’s Counsel and/or Blue Sky Counsel**—The underwriter’s counsel advises the underwriter on matters pertaining to the new issue, while the blue sky counsel opines on which states the issue can legally be offered for sale to the public.

Prior to pricing a negotiated issue, several events must take place to ensure a successful sale. First, a tentative sale date is set to alert prospective customers to the upcoming pricing. This date is tentative to allow the issuer and underwriter to select the optimum time to bring bonds to the market. Second, a tentative structure of the issue must be determined. This includes maturity structure, ratings, redemption provisions, security provisions, method of repayment and other factors that affect the issue’s marketability. A structure should be used that maximizes the interest of the broadest range of investors, from individuals to insurance companies and mutual funds. Finally, the preliminary official statement, a document published by the issuer that discloses material information on a new issue, must be made available to prospective buyers.

**PRICING A NEGOTIATED ISSUE**

When the issue is ready to be priced, the underwriter or underwriting syndicate discusses with the issuer and its financial advisor the proposed interest rates and spread (which is the fee paid to the underwriters to sell the bonds). Once the issuer gives its approval, the underwriter will release the pricing to its investor clients and allow them a certain time frame within which they can enter orders. During this order period, which can run from a minimum of one hour to five days, the underwriter closely monitors the incoming flow of orders. A well received pricing can become over-subscribed quickly, meaning there are more orders for bonds than the amount of bonds being issued. In this situation, the underwriter may recommend lowering the interest rates to the issuer. If interest in the issue is slow, meaning very few orders, the underwriter will usually advise raising the interest rates (to generate more orders) and possibly running a new order period. In a negotiated sale, the underwriter may recommend a combination of changes in interest rates and structure in order to achieve the best pricing and the maximum amount of investor interest in the issue.

After the underwriter and issuer agree on a final price and structure, the issuer awards the bonds to the underwriter who in turn will allocate the bonds to those customers who subscribed for bonds during the order period. Any unsold bonds will be offered for sale on a first-come, first-served basis.
**COMPETITIVE SALES**

Competitive sale is a method by which an underwriter or underwriting syndicate submits a bid for the purchase of a new issue of municipal securities at a given date and time, as determined by the official notice of sale. The securities are awarded to the underwriting syndicate presenting the best bid (lowest interest expense to the issuer). Issuers may choose the competitive sales process because they are required to by statute or because they believe it will allow them to achieve the lowest borrowing cost.

A financial advisor and bond counsel are involved in competitive sales also:

**Financial Advisor:** A financial advisor is responsible for announcing the date and time of sale, distributing the near-final official statement and notice of sale to prospective bidders, and submitting financial information to the rating agencies and municipal bond insurance companies.

**Bond Counsel:** Its role is identical to that in a negotiated sale.

**PRICING A COMPETITIVE ISSUE**

The pricing of a competitive sale is different from that of a negotiated sale in that the exact date and time of sale is set by the financial advisor and issuer. Prior to the sale, underwriters decide if they will bid on the issue and whether they will do so alone or from an underwriting syndicate in which two or more underwriters act together to submit a bid. In the hours prior to submission of the bid, the underwriter(s) discuss the scale they believe will award them the bonds. The scale is the interest rates that will be assigned for each year of maturity and the spread for which they are willing to work. Generally, the interest rates will be in ascending order from the earliest to longest maturities. The final bid is submitted to the financial advisor in the form of a sealed bid prior to, but no later than, the exact time specified. The bid must comply with all the specifications listed in the notice of sale, including interest rate restrictions and purchase price. The bid is usually for all of the issue, with partial bids not allowed.

The common methods of computing the interest expense to the issuer are net interest cost (NIC) and true interest cost (TIC), which serve as the basis of award in a competitive sale. The underwriting syndicate with the lowest NIC or TIC will be notified by the financial advisor that it has been awarded the issue.

After the award is received, the syndicate will run an order period for investor clients and syndicate members similar to that of a negotiated sale. One major difference compared to a negotiated sale is that the interest rates and structure are set and cannot be altered. At the end of the order period, allotments will be made and balances, if any, will be available on a first-come, first-served basis.

**PIPER JAFFRAY EXPERTISE**

Piper Jaffray is an active participant in both the negotiated and competitive sale new issue markets. The expertise of our municipal bond traders and public finance bankers allows us to provide an attractive supply of municipal bonds for our many retail and institutional clients. In 2004, Piper Jaffray was second in the nation in the number and par value of new issues $10 million and less and ranked among the top 15 municipal investment banks by par value. We underwrote 530 new municipal issues with a par amount of more than $7.6 billion.* The calendar of upcoming negotiated and competitive sales is available weekly from a Piper Jaffray financial advisor.

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Some issues may be subject to state and local taxes and/or the alternative minimum tax. Bond prices fluctuate as general interest rates change, so you may receive more or less than you paid if you sell prior to maturity. Any increase in principal value may be taxable. This information is not to be used as a primary basis of investment decisions. Please consult a Piper Jaffray financial advisor for more information. Piper Jaffray does not provide legal or tax advice.