Securities Training Corporation

Securities Industry Essentials (SIE)

Learning Guide / Workbook

v14

How to Use This Learning Guide

As the instructor presents the material through the On-Demand lecture, use this Learning Guide to take notes, answer questions, and complete activities. Once the On-Demand program is complete, this Learning Guide can be used as an ongoing resource.

Breakdown of the SIE Exam

- 75 multiple choice questions plus 10 unscored items (85 total)
- 1 hour and 45 minutes to complete the SIE Examination
- Minimum required passing score is 70%

Function	# of Questions
1. Knowledge of Capital Markets (Covered in Chapters 1, 2, 11, and 19)	12 (16% of exam)
2. Understanding Products and their Risks (Covered in Chapters 3, 4, 5, 7, 8, 9, 10, and 20)	33 (44% of exam)
3. Understanding Trading, Customer Accounts and Prohibited Activities (Covered in Chapters 6, 12, 13, 14, 15, and 16)	23 (31% of exam)
4. Overview of the Regulatory Framework (Covered in Chapters 17 and 18)	7 (9% of exam)

Chapter 1 – Overview of Market Participants and Market Structure

Key Topics

1	2	3	4	5
TYPES OF ISSUERS	HOW FIRMS FUNCTION	TYPES OF INVESTORS	PRIMARY VS. SECONDARY MARKETS	CLEARING AND SETTLEMENT
Learn about the different types of issuers and the securities they issue	Learn the differences in how brokers, dealers, and investment advisers function.	Learn about the differences in retail, accredited, and institutional investors.	Learn what differentiates the primary vs. the secondary market.	Learn how trades clear and settle between firms.

Types of Issuers

Issuers are legal entities that raise capital by issuing securities. These include:

- Corporations
- U.S. Treasury and government agencies
- State and local governments
- Banks
- Foreign governments

Types of securities that may be issued:

- Equity – used by corporations
    - Represents ownership
- Debt (i.e., notes and bonds)
    - Represents an issuer's promise to pay

How Broker-Dealers Function

Broker
- Firm acts as a conduit or agent
- Finds another party willing to take the other side of the trade
- Collects commission for the service
- No risk to the firm

Agency

Broker

Commission

How Broker-Dealers Function

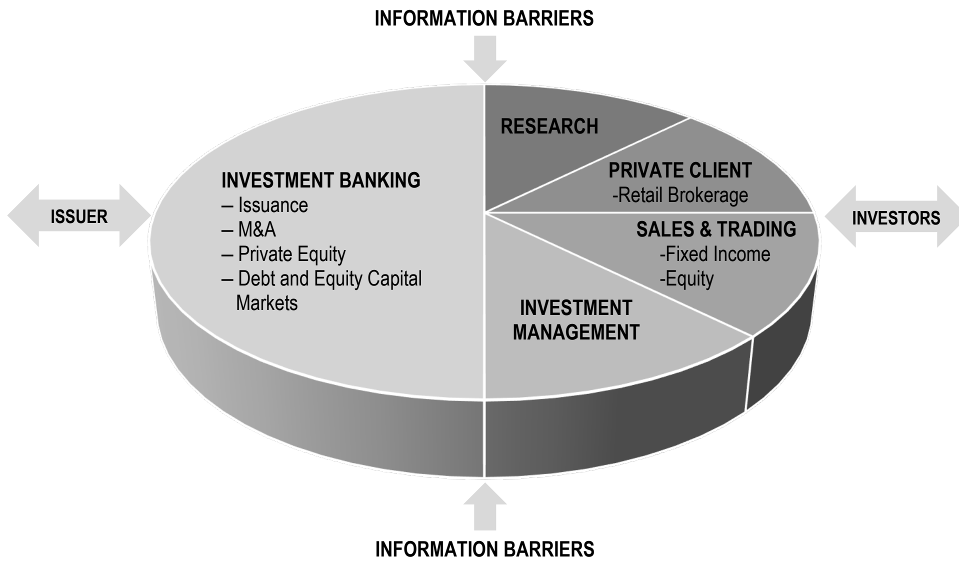
Dealer
- Firm acts as a principal
- Firm takes the other side of the trade
- Entitled to markup/markdown
- Inventory/risk

Principal

Dealer

Markup/markdown

The Structure of a Securities Firm



Market Maker and Its Quote

A market maker is a broker-dealer that chooses to display quotes to buy or sell a specific amount of securities at specific prices
- Quotes are firm for at least 100 shares

Bid	Ask (Offer)
17.05	17.15

The difference of $0.10 is the **Spread**

Bid represents a client's selling (liquidation) price ▪ This is the price at which the MM will buy	**Ask** or **offer** represents a client's purchase price ▪ This is the price at which the MM will sell

Investment Adviser (IA) and Municipal Advisor (MA)

Investment Adviser (IA)

- An IA is a firm that charges customers a fee for managing their securities portfolios
  - The fee is based on the assets under management (AUM)
  - An IA is considered a large or institutional customer of a broker-dealer

Municipal Advisor (MA)

- An MA is a person or firm who advises municipalities on bond offerings and must be registered with the SEC
  - An MA typically advises issuers (e.g., state, county, or city) regarding the structure and timing of a new offering

Activity

Match each description to the appropriate term:

BROKER	Represents ownership in a corporation
DEBT	Maintains an inventory of securities
INVESTMENT ADVISER	Charges a fee
MARKET MAKER	Receives a commission
EQUITY	Issuer is borrowing money

Institutional and Retail Investors

Institutional Investors

- Investors are typically defined based on the amount of assets they have invested
- Customers with a large amount of assets are referred to as *"institutional investors,"* such as:
  - Banks
  - Insurance companies
  - Investment companies
  - Corporations, partnerships, individual investors with a certain amount of money invested
  - Registered investment advisers
  - Public and private pension plans
  - Hedge Funds

Retail Investors

- Individual investors who are not defined as institutional investors are considered "retail investors"

Accredited Investors and QIBs

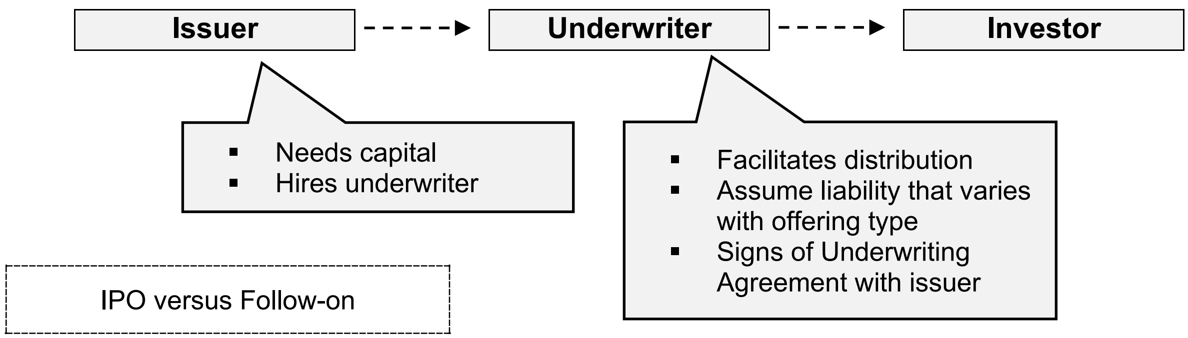
Accredited Investors

- There are other terms used for certain investors, but they are based on regulatory definitions
  - Accredited investors are institutional investors as well as individuals who have met a financial test:
    - Net Worth of $1,000,000 excluding their primary residence
      OR
    - Annual Income of $200,000 in each of the last two years ($300,000 married couples)

Qualified Institutional Buyers (QIBs)

- Buyer must own and invest a minimum of $100 million of securities
- Cannot be a natural person (human)

The Primary Market



Secondary Markets

Trading markets that facilitate the exchange of existing financial instruments among investors

NYSE and other traditional centralized exchanges:

- Provide a specific location for trade execution
- Trading is normally monitored by a specialist or designated market maker (DMM)
- Exchanges include:
  - NYSE MKT (formerly American Stock Exchange)
  - Boston Stock Exchange
  - Chicago Stock Exchange
  - Pacific Stock Exchange

Dealer-to-Dealer Markets

Nasdaq	▪ Non-physical; phone and computer network ▪ Negotiated market ▪ Unlimited number of “market makers” ▪ Classified as a securities exchange
Non-Exchange Issues (OTC)	▪ Often low priced and thinly traded ▪ Two systems which offer real-time quotations: • OTCBB (Bulletin Board) – Must be reporting companies • OTC Pink Markets – May be non-reporting companies
Market Makers	▪ Stand ready to buy or sell at least 100 shares at their quoted prices • Subject to SRO Rules
Traders	▪ Execute trades for their firm or their firms’ clients ▪ Do not maintain an inventory

Other Secondary Market Terms

Third Market
- Listed securities traded OTC
- Trades included in NYSE volume totals

Fourth Market
- Transactions between institutions
- Most true fourth market trades are internal crosses set up by money managers

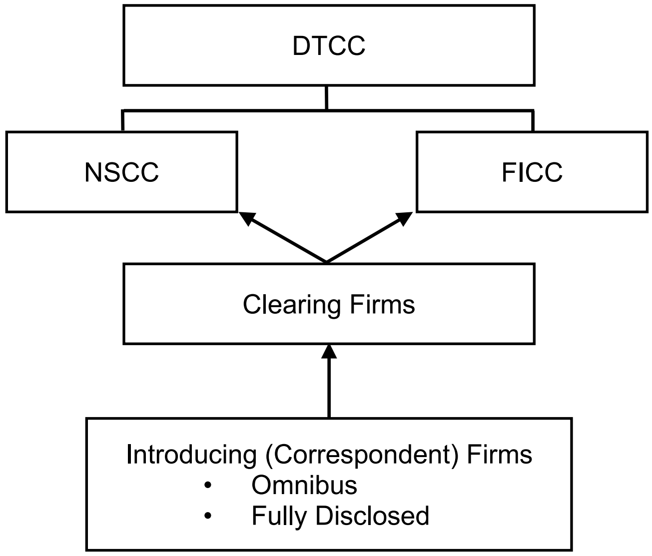
Dark Pools
- Provides liquidity for large institutional investors and high-frequency traders
- Quotes are not disseminated to the public
- Limits impact on the market

Activity

Read each statement and fill in the blanks.

1. To be considered an accredited investor, an individual must have a net worth of _________________ or annual income of $_______________.
2. A qualified institutional buyer cannot be a ______________________ and must own and invest a minimum of ___________________.
3. An issuer may hire an _________________ to assist in selling its securities publicly to raise capital.
4. The _______________ market is where issuers raise money by selling securities to the public.
5. The _________________ market is where the trading of existing securities between investors occurs.
6. ________________ is considered a registered exchange with an unlimited number of market makers.
7. ______________________ stand ready to buy or sell securities at their quoted prices, while _______________ execute trades for the firm or the firm’s clients.
8. A transaction executed directly between two institutions is considered a _______________ market trade.

Clearing and Settlement



Fully Disclosed versus Omnibus

Introducing firms process trades through clearing firms in one of two ways:

1. Fully Disclosed Accounts	2. Omnibus Accounts
▪ Specific information about each individual client is given to the clearing firm ▪ Clearing firm is responsible for: • Maintaining client assets • Establishing a separate account for each client • Sending confirmations, statements and checks – Contact information for introducing firm is included	▪ A single account is set up at the clearing firm ▪ Specific client information is maintained by the introducing firm ▪ Recordkeeping responsibilities rest with the introducing firm

DTCC and the OCC

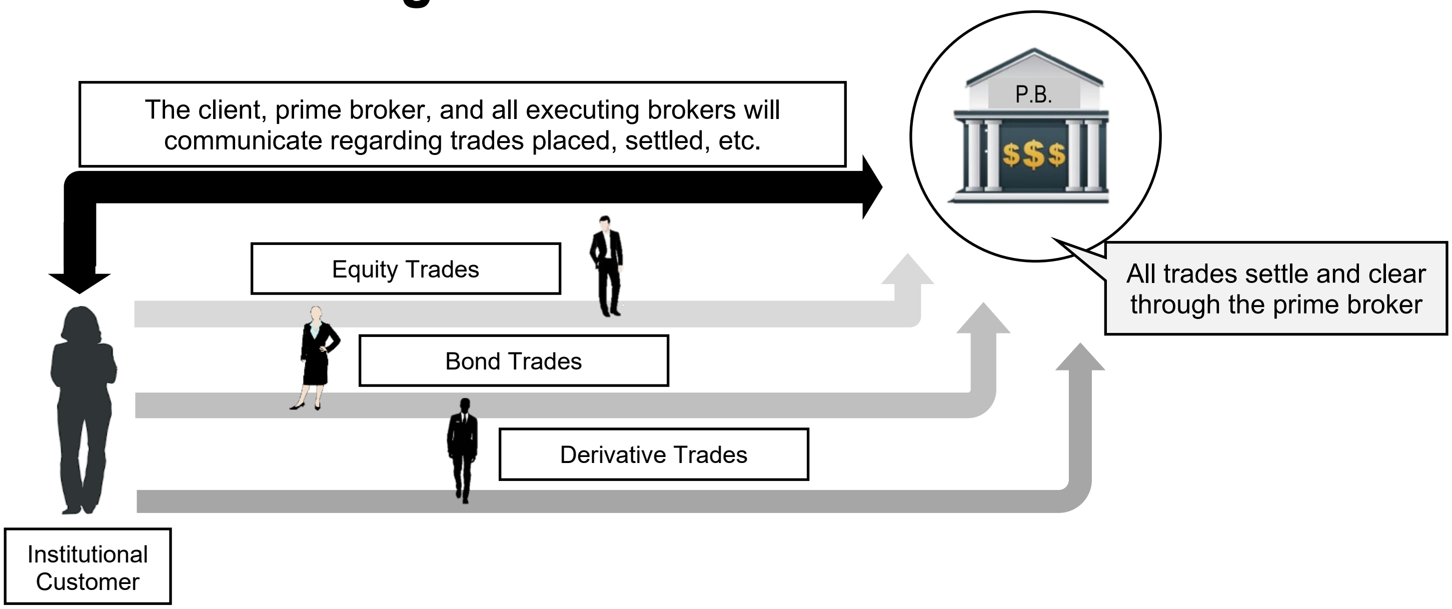
Depository Trust & Clearing Corp.	Options Clearing Corp.
▪ Provides clearing, settlement, and information services for its members • Is parent of the National Securities Clearing Corporation (NSCC) ▪ Guarantees settlement ▪ Removes counterparty risk ▪ Transactions among members are completed through computerized bookkeeping entries	▪ Issues and guarantees option contracts ▪ Regulates exchange-traded options (listed options) • Acts as the third party in all option transactions (i.e., the buyer for all sellers and the seller for all buyers) ▪ Deals directly with broker-dealers, not customers ▪ Trade settlement between broker-dealers and the OCC is next business day

Prime Brokerage Accounts

Prime Brokerage

- When a primary B/D provides a large client (e.g., hedge fund) with the ability to clear all trades through a centralized firm with executions occurring with multiple B/Ds
  - Prevents a single firm from determining the client's strategy
- The prime broker offers specialized services such as custody, securities lending, margin financing, clearing processing, operational support, research and customized reporting

Prime Brokerage



Question

As it relates to the methods of clearing and settlement, which of these statements is/are TRUE? Circle all that apply.

I. The clearing firm must maintain all client information for a fully disclosed account

II. Specific client information is held by the clearing firm in an omnibus account

III. The executing firms are subject to counterparty risk when clearing trades through the DTCC

IV. The Options Clearing Corporation only works with broker-dealers

Activity

Read each characteristic and determine the entity or type of account to which it applies.

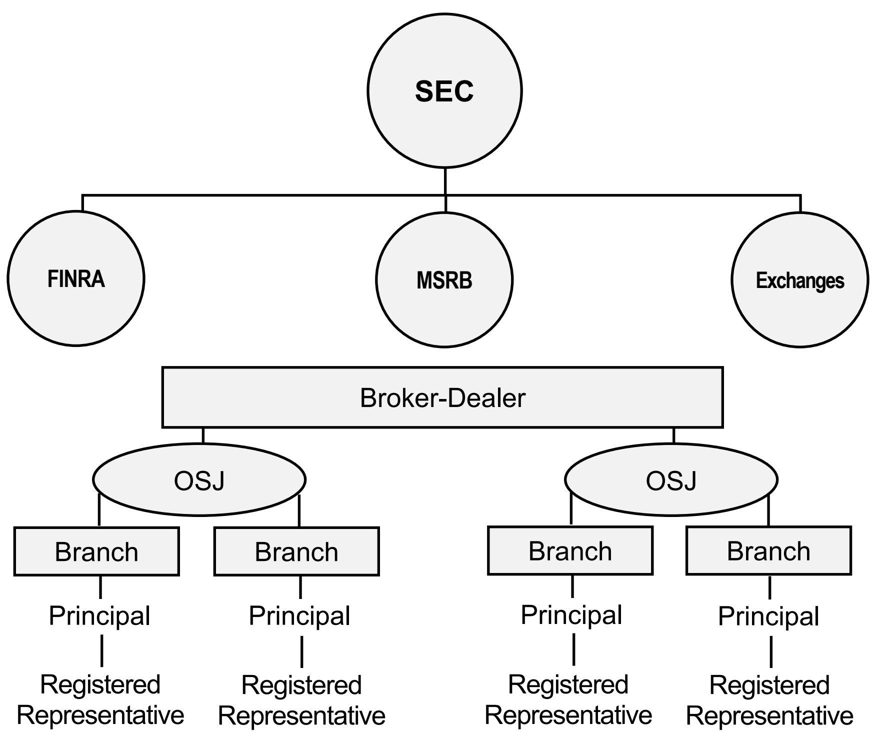
THE BUYER FOR ALL SELLERS AND THE SELLER FOR ALL BUYERS	
TRADES FROM MULTIPLE FIRMS CLEAR AND SETTLE THROUGH ONE FIRM	
CLEARING FIRM IS RESPONSIBLE FOR INDIVIDUAL CLIENT INFORMATION	
INTRODUCING FIRM IS RESPONSIBLE FOR INDIVIDUAL CLIENT INFORMATION	

Chapter 2 – Overview of Regulation

Key Topics

1	2	3	4	5
HOW FIRMS ARE REGULATED	FEDERAL RESERVE BOARD	FUNDAMENTAL FEDERAL ACTS	THE SECURITIES INVESTORS PROTECTION CORPORATION	SELF-REGULATORY ORGANIZATIONS
Learn about the supervisory structure within a broker-dealer.	Learn the methods used by the FRB to influence monetary policy.	Learn about the various laws that shape the financial services industry.	Learn how the SIPC protects customers of broker-dealers.	Learn about FINRA, the MSRB, and the CBOE.

Regulatory / Supervisory Overview



Federal Reserve Board (FRB)

The "Fed" is an independent agency of the U.S. government that functions as the U.S. central bank:

- Responsible for controlling monetary policy
  - Money supply
  - Interest rates
- Goal is to create maximum employment and stable prices
- Tools include:
  - Open market operations
  - Discount rate
  - Reserve requirements
  - Regulation T

Other Regulators

Federal Deposit Insurance Corporation (FDIC)	State (Blue-Sky) Regulators	North American Securities Administrators Association (NASAA)
▪ Acts as a banking regulator ▪ Insures banking depositors for up $250,000	▪ State Administrator (sometimes called Commissioner) • Enforces the Uniform Securities Act (USA) • The USA is a model law, not the actual law of any state	▪ Responsible for creating the provisions and updating the USA ▪ Focuses on protecting investors from fraud

Activity

Read each statement and determine which individual or regulation applies:

RESPONSIBLE FOR SUPERVISING REGISTERED REPRESENTATIVES	
CONTROLS THE MONEY SUPPLY AND INTEREST RATES	
INSURES BANK DEPOSITORS	
ENFORCE THE UNIFORM SECURITIES ACT	

The Securities Act of 1933

Scope of the law
- To provide for "full disclosure"
- Prospectus must precede or accompany any solicitation of a new issue (no marking or highlighting)
- SEC "no approval clause"

Requires SEC registration of new issues
- Registration exemptions are provided to issuers of certain securities and specific types of transactions

Liability
- Unconditional for issuers regarding information to investors
- Conditional for the underwriters that are required to perform:
  - Reasonable investigation
  - "Due diligence"

Securities Exchange Act of 1934

Scope of the law:
- To regulate the secondary market
- Created the SEC to enforce federal securities laws
- The SEC utilized self-regulatory organizations (SROs)

Specific provisions of the Act:
- Margin requirements (Regulation T)
- Registration requirements for B/Ds and RRs
- Trading regulations
- Insider regulations

Investment Advisers Act of 1940

An IA is defined as any person (firm) that meets the A-B-C Test:

Advice – Provides advice about securities, including asset allocation

Business – As a regular business

Compensation – Receives compensation for the advice

The IA definition includes firms that manage wrap accounts (i.e., they collect a single fee for providing advice and executing transactions)

Investment Advisers Act of 1940

The following persons are excluded from the IA definition:
- Broker-dealers that receive commissions only
- Banks, savings institutions, and trust companies
- Specific professionals who give incidental advice:
  - Lawyers, Accountants, Teachers, Engineers (L,A,T,E)
- Publishers of newspapers and periodicals
  - No timed or tailored advice is provided

Securities Investors Protection Act (SIPA)

Created the Securities Investors Protection Corporation (SIPC)
- Non-profit membership corporation (not government agency)
- Protects Separate Customers (not accounts) if B/D bankruptcy occurs
  - Separate customers include IRAs, as well as joint and custodial accounts
  - Separate coverage provided for accounts that are held at different firms

Coverage:
- Cash and street name securities: $_______________
  - Will only cover cash up to: $_______________
  - If limits are exceeded, customer becomes a: ________________________

Not covered:
- Fraud (covered by fidelity bond), futures contracts, commodities, and fixed annuities

Securities specifically identifiable to a customer are distributed back to customer without limit

SIPC Coverage Examples

For SIPC purposes, the following are examples of separate accounts that are held by Mary and Joe with the same B/D:

1.	Mary has a brokerage account in her name	Mary has SIPC coverage up to $_____________
2.	Joe has two brokerage accounts, each in his own name	For SIPC, Joe's accounts ______________ and he is protected by SIPC only up to a total of $_____________
3.	Joe and Mary are married and have a joint brokerage account which is separate from the individual account that they maintain with the firm	An additional maximum of $____________ of SIPC coverage protection is available for the joint account
4.	Joe has a Roth IRA and a traditional IRA with the brokerage firm	Joe is protected for up to $____________ for his Roth IRA and for up to $____________ for his traditional IRA.

Other Federal Laws

Penny Stock Reform Act of 1990	▪ Regulates solicited sales of penny stocks (i.e., unlisted equities priced below $5.00 per share) ▪ Firms must establish suitability, approval, and disclosure procedures
Insider Trading and Securities Fraud Enforcement Act 1988	▪ Insiders include corporate officers and directors; owners of more than 10% of a company's common equity ▪ The use of material, non-public information is prohibited ▪ Both tippers and tippees may be in violation
Investment Company Act of 1940	▪ Identifies three types of investment companies: 1. Management Companies 2. Unit Investment Trusts 3. Face Amount Certificate Companies
Telephone Consumer Protection Act of 1991	▪ Call time frame: 8:00 a.m. to 9:00 p.m. local time ▪ Firms maintain "Do Not Call" lists
USA PATRIOT Act of 2001	▪ Establishes the basis for a firm's anti-money laundering (AML) regulations ▪ Requires the filing of reports based on financial transactions

Activity

Match each Act to the appropriate situation:

SECURITIES ACT OF 1933	Uses an A-B-C test to determine whether an entity is subject to its rules
SECURITIES EXCHANGE ACT OF 1934	Limits unsolicited phone calls during specific hours of the day
INVESTMENT ADVISERS ACT OF 1940	Responsible for implementing AML rules
USA PATRIOT ACT OF 2001	Established full and fair disclosure rules for new offerings
TELEPHONE CONSUMER PROTECTION ACT OF 1991	Requires registration of registered representatives and broker-dealers

Financial Industry Regulatory Authority (FINRA)

The primary self-regulatory organization (SRO) for the securities industry

Conduct Rules	Uniform Practice Code (UPC)	Code of Procedure (COP)	Code of Arbitration
▪ Governs the interaction between customers and firms	▪ Standardizes the procedures for doing business in financial markets	▪ Establishes the process used to discipline any person who violates FINRA rules	▪ Provides the method for resolving disputes (typically monetary) between members, including those that involve public customers

Municipal Securities Rulemaking Board

The MSRB formulates and interprets the rules that apply to:
- Broker-dealers and salespersons engages in municipal business and
- Municipal advertising

MSRB rules do not apply to municipal issuers

Since the MSRB has no enforcement power, its rules are enforced by a separate regulatory agency:

For broker-dealers:	**For bank dealers:**
▪ FINRA or ▪ SEC	▪ Comptroller of the currency ▪ FRB or ▪ FDIC

Chicago Board Options Exchange (CBOE)

CBOE functions as the:
- Self-regulatory organization mainly for the options market
- A trading venue for:
  - Equity options
  - Index options
  - Yield-based options
  - ETFs

Regulated by the SEC

Question

Which of the following statements regarding the SRO is/are TRUE? Circle all that apply.

I. FINRA's Uniform Practice Code determines the discipline for those violating its rules

II. The MSRB formulates and interprets its rules, but does not enforce them

III. The CBOE provides a trading venue for ETFs

IV. FINRA is responsible for enforcing MSRB rules

Chapter 3 – Equity Securities

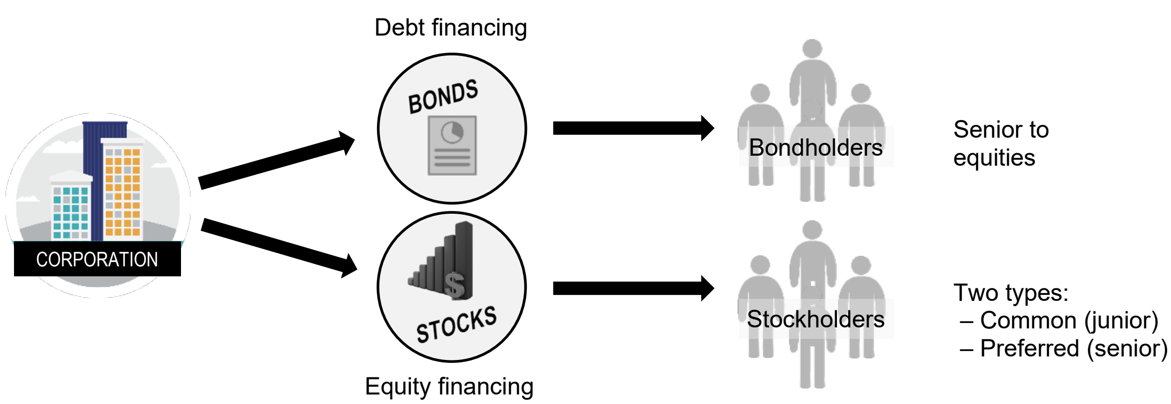
Key Topics

1	2	3	4	5
CORPORATE STRUCTURE	CHARACTERISTICS OF COMMON STOCK	CLASSIFICATIONS OF STOCK	TYPES OF PREFERRED STOCK	RIGHTS VS. WARRANTS
Learn about the securities that corporations issue to raise capital.	Learn about the benefits of owning common stock and the limits on restricted stock.	Learn about the different classifications of stock and what they offer.	Learn about the different types of preferred stock and what makes them marketable.	Learn about the differences between rights and warrants.

Corporations

- File Articles of Incorporation
  - Also referred to as a Certificate of Incorporation or Corporate Charter
- Solicit individuals to serve as members of the Board of Directors
  - Board member responsibilities include:
    - Overseeing the management team
    - Corporate governance
    - Declaring dividends

How Corporations Raise Money



Issuing Stock

The Corporate Charter determines the number of shares that are authorized and can be issued

	Initial Public Offering
Authorized	1,000,000,000
Issued	10,000,000
Outstanding	10,000,000

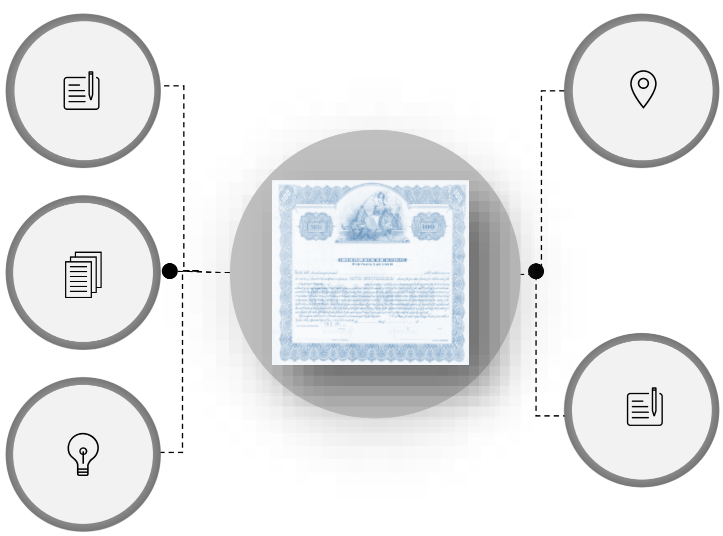
Shares Repurchased by Corporation

If a corporation chooses to repurchase some of its outstanding shares, they become Treasury stock

	Initial Public Offering	After Share Repurchase
Authorized	1,000,000,000	1,000,000,000
Issued	10,000,000	10,000,000
Treasury		(2,000,000)
Outstanding	10,000,000	8,000,000

Treasury stock does not receive dividends and has no voting rights.

Common Stock Ownership Rights



Inspection of Books

Evidence of Ownership

Transfer of Ownership

Participation in Corporate Earnings

- Entitled to dividends if declared (not guaranteed)

Voting power, including:

- Election of board members
- Authorization of additional shares and stock splits (but NOT dividends)

Two Voting Methods

Statutory

- Beneficial **for large shareholders**
- One vote, per share, per issue

Cumulative

- Beneficial **for small shareholders**
- Allows shareholders to multiply the number of shares owned by the number of voting issues

Voting Methods

There are four candidates running for three seats on a corporation's board of directors. The following tables will compare statutory voting to cumulative voting for an investor who owns 300 shares:

Statutory Voting	
Candidate A	
Candidate B	
Candidate C	
Candidate D	
Total Votes	

Cumulative Voting	
Candidate A	
Candidate B	
Candidate C	
Candidate D	
Total Votes	

Question

As it relates to the corporate capitalization, which of these statements is/are TRUE?
Circle all that apply.

I. The number of outstanding shares is always equal to the number of issued shares.
II. Treasury stock is previously issued shares that are no longer outstanding.
III. Shareholders vote to authorize the payment of dividends.
IV. Cumulative voting is most beneficial for small shareholders.

Restricted Stock

When securities are purchased through a private placement, they are referred to as ***restricted* securities.**

Stop-transfer instructions are issued and a legend on the certificates indicates that the securities are unregistered.

Investment Letter or Lock-up Agreement

- Purchasers must sign the letter to acknowledge that the shares cannot be resold within a defined period.

Rule 144

Permits the sale of restricted and control stock

Restricted Stock	Control (Affiliated) Stock
Unregistered stock that is acquired through a private placement or as compensation for senior executives of an issuer ▪ Mandatory six-month holding period	Registered stock that is part of an issuer's public float and purchased in the open market by officers, directors, or greater than 10% shareholders of the issuer ▪ No minimum required holding period

When intending to sell, the SEC must be notified
- Form 144 filed at the time the sell order is place
- Securities may be sold over __________ through unsolicited broker's trades or to a dealer that is acting as principal
- If any shares from this filing remain unsold and the investor wants to sell them, an updated Form 144 must be filed

Maximum sale allowed is the greater of:
- _____% of the outstanding shares or the average weekly trading volume over the _____________________

Filing Form 144 is NOT required if selling no more than
5,000 shares **or** $50,000 of securities

Rule 144 – Maximum Sale

For example, ABC Inc. has 5,700,000 shares outstanding with recent trading volume as indicated below:

Week Ended	Volume Traded
2/28	62,000
2/21	60,000
2/14	56,000
2/7	58,000
1/31	58,000

Multiple Choices:
1. 57,000
2. 58,000
3. 58,800
4. 59,000

American Depositary Receipts (ADRs)

Characteristics:
- Priced in U.S. dollars
- Pay dividends in U.S. dollars
- Sponsored or Unsponsored

Sponsored	Unsponsored
Issued in cooperation with the foreign company	Issued without involvement of the foreign company
May trade on U.S. exchanges (Nasdaq or NYSE)	Generally trade in OTC market (OTCBB or OTC Pink Markets)

Question

What type of securities are acquired through a private placement?

____

____

What is the holding period for restricted stock and control stock?

____

____

How many shares can be sold when filing Form 144?

____

____

Activity

Match the stock with its correct description.

Blue Chip	Stock of companies whose value fluctuates with the business cycle (e.g., household appliances, automobiles)
Growth	Stock of companies that are resistant to recession (e.g., utilities, tobacco)
Income	Stock of strong, well-established, dividend paying companies
Defensive	Stock of companies that pay higher than average dividends in relation to market price
Cyclical	Facilitates the trading of foreign stock is U.S. markets
American Depositary Receipt (ADR)	Stock of companies with sales and earnings that are expanding faster than the economy; pay little (if any) dividends

Preferred Stock

- Designated to provide returns that are comparable to bonds
- Pays a stated dividend (not guaranteed)
  - Stated as a percentage of par
    - Par value is typically $100
- Dividends are paid to preferred shareholders before common shareholders
- There are multiple types of preferred stock

Types of Preferred Stock

Non-Cumulative
- Investor is only entitled to the current dividend; the investor is NOT entitled to unpaid dividend (dividends in arrears)

Cumulative
- Investor is entitled to unpaid dividends (those "in arrears") before common stock dividends may be paid

Callable
- Issuer has the ability to repurchase the stock
- Typically repurchased at a premium over par value

Participating
- Investor may receive additional dividends based on company profits

Convertible
- Investor may convert into a predetermined number of common shares

Example of Cumulative Preferred Stock

ABC Corp. intends to pay a dividend to its common stockholders in Year 3

Dividend paid to	Year 1	Year 2	Year 3
8% Preferred	$0	$2	
6% Cumulative Pfd.	$0	$2	
Common			

Convertible Preferred Stock

An investor bought 4%, $100 par convertible preferred stock at $110. The stock is convertible at $10 and the common stock's price has risen $12.

- What is the conversion ratio?

$$\frac{\text{Par}}{\text{Conversion Price}} = \frac{\$100}{\$10} =$$

- Based on the increased price of the common stock, at what price should the preferred stock be trading?

Market value of common x Conversion ratio = Price of Preferred

Since the price of the common stock has risen to $12,
the convertible preferred stock should be trading at $_______.

Activity

Read each characteristic and determine the type of preferred stock to which it applies

ALLOWS STOCKHOLDERS TO SHARE IN DIVIDENDS PAID TO COMMON STOCKHOLDERS	
PERMITS THE ISSUER TO REMOVE THE STOCK FROM THE MARKET	
MAKES UP FOR DIVIDENDS THAT WERE NOT PAID IN PREVIOUS YEARS	
CAN BE EXCHANGED FOR COMMON STOCK	

Preemptive Rights

Preemptive rights are:

- A shareholder's right to maintain percentage ownership; no dilution
  - Distributed through a rights offering
  - One right for each share owned
- Discounted
  - Shareholders exercise rights at a price that's below the current market value prior to a public offering
  - Immediate intrinsic value
- Short-term
  - Typically must be exercised within four to six weeks
- Tradable

Warrants

Attached to bonds or stock; act as "sweeteners"

Allow holders to purchase a specific number of the company's common shares

- Exercise price is above the current market value (premium)
- Long-term
  - May be exercised years after the original issuance

May be "detached" and traded separately

Rights	Issued to shareholders	Short-term	Immediate Discount
Warrants	Attached to a new issue	Long-term	Initial Premium

Miscellaneous Equity Rules

FINRA Rule 2261 – Disclosure of Financial Condition
- Upon request, a member firm must make its balance sheet available to customers in either physical or electronic form

FINRA Rule 2262 –Disclosure of Control Relationship with Issuer
- May be exercised years after the original issuance

SEC Rule 10b-18 – Issuer Purchasing its Own Stock
- For the issuer's purchases to not be considered manipulative, the following conditions must be met:
  - Only one broker-dealer used
  - Purchases made late in the day are prohibited
  - Purchase price is restricted
  - Single-day purchase amount is limited

Activity

Read each statement and determine whether it is TRUE/FALSE.

PREEMPTIVE RIGHTS HAVE IMMEDIATE INTRINSIC VALUE	
WARRANTS MUST BE EXERCISED WITHIN A SHORT PERIOD FROM ISSUANCE	
CUSTOMERS MUST BE MADE AWARE OF A BROKER-DEALER'S CONTROL RELATIONSHIP AFTER THE TRADE	
ONLY ONE BROKER-DEALER CAN BE USED WHEN AN ISSUER IS PURCHASING ITS OWN STOCK	

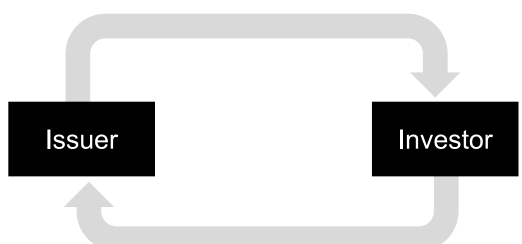
Chapter 4 – An Introduction to Debt Instruments

Key Topics

1	2	3	4	5
CHARACTERISTICS OF BONDS	BOND PRICING	PRICE VS. YIELDS	RETIREMENT OF DEBT	CONVERTIBLE BONDS
Learn about bonds and how they work, as well as the types of bonds and maturities.	Learn about how interest-rate risk and credit risk impact bond pricing.	Learn about the inverse relationship between prices and yields.	Learn about the conditions that impact the retirement of debt, such as callable bonds.	Learn about the benefits of convertible bonds.

Bond Basics: What are Bonds?

A bond represents a loan or debt obligation of an issuer (the borrower)



Question

For investors, what's the attraction to bonds?

Terminology

10%

- Interest rate; the fixed percentage of par
- It is set when the bond is issued
- Stated annually, and paid semi-annually

General Training

10% Debenture

Due 1/15/20XX

- The maturity or due date of the bond.
- This is the date for the return of principal and the last interest payment.

$1,000 Par

- Par value (face value or principal of the bond)
- This is the amount that the issuer agrees to pay its investors when the bond matures

Question

What other terms are used for interest rate?

____

____

Term and Serial Maturities

- Two of the ways that an issuer may structure its loan repayment or maturity are term and serial.
- For both types, bonds are issued on the same date and interest is paid each year.
- **Term maturity:** the entire bond offering matures on the same date.
- **Serial maturity:** the bond offering matures over several years (i.e., has a series of maturity dates).
  - **Level debt service:** Some serial maturities are structured so that principal and interest payments represent approximately equal annual payments over the life of the offering.

Activity

Read each description and then match it to the appropriate term.

Term	Description
BOND	Amount the issuer agrees to pay the investor when the bond matures
ISSUER	Entire bond offering matures on the same date
DEBT SERVICE	Interest payments and repayment of principal
FACE VALUE	Represents a loan or debt obligation of an issuer (the borrower)
FIXED COUPON RATE	Principal and interest payments represent approximately equal annual payments over the life of the offering
TERM BOND ISSUE	The rate of interest, which generally stays constant throughout the life of the bond
SERIAL BOND ISSUE	Responsible for interest payments and repayment of the principal at maturity (also known as debt service)
LEVEL DEBT SERVICE	Offering matures over several years (i.e., the issue has several maturity dates)

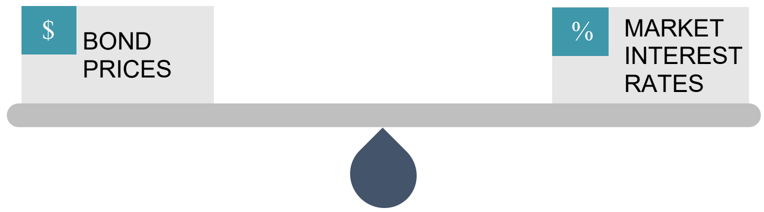
Zero-Coupon Bond

Issued	Issued at deep discount
Matures	Matures at face value (par)
Interest	The difference between the purchase price and par value
Carrying value	The investor’s carrying value (cost basis) must be accreted yearly
How it trades	Trades flat (without accrued interest)
Reinvestment risk	Not subject to reinvestment risk
Suitable for	Suitable for a person planning for a specific investment goal

Why Bond Prices Fluctuate from Par

- The par value of a bond can differ greatly from the price that investors pay to purchase the bond.
- Although most bonds are initially sold at par value, as time goes by, these same bonds will trade in the market at prices that are less than or more than par.
- A bond that’s sold for less than its par value is selling at a **discount.**
- A bond that’s sold for more than its par value is selling at a **premium.**

Interest-Rate Risk



INVERSE RELATIONSHIP

Interest-rate risk means that as market interest rates change, a bond's price will change in the opposite direction. They have an **inverse relationship**.

Activity

SCENARIO: A bond quoted at 94 ½ is trading at 94.5% of its $1,000 par value. Which of these statements are TRUE? Circle all that apply.

I. The purchase price of this bond is $945.00.
II. This bond is trading at a discount.
III. This bond is trading at a premium.
IV. Interest rates have risen since the bond was issued.

Credit Risk

- Credit risk is a recognition that an issuer may default and may not be able to meet its obligations to pay interest and principal to the bondholders.
- Issuers that are considered high credit risks must pay a higher rate of interest in order to induce investors to purchase their bonds.
- Securities issued by the U.S. government have the lowest possible credit risk.
- Credit risk is more difficult to evaluate when the bonds are issued by a corporation or a municipality.

Bonds with higher ratings have lower yields and higher prices.

Credit Rating Companies

- How can investors be sure they will get their interest payments and their principal back?
  - A bond's credit rating helps determine this
- Three credit rating companies are Standard and Poor's (S&P), Fitch Investors Service, and Moody's.

Credit Ratings

	S&P/Fitch	Moody's
Investment Grade	AAA	Aaa
	AA	Aa
	A	A
	BBB	Baa
Speculative Grade	BB	Ba
	B	B
	+ or -	1, 2, 3

Question

Who do you think pays for the rating?

As it relates to bond ratings, what's the concern?

Coupon Rates and Bond Pricing

A bond's price and interest rate are usually stated as a percentage of its par value

A bond with a price of:

- 100 is selling at 100% of its par value, or $1,000.
- 90 is selling at a discount equal to 90% of its par value, or $900.
- 110 is selling at a premium which is equivalent to 110% of its par value, or $1,100.

For corporate and municipal bonds, a bond's price may also be expressed in terms of points.

- Each point is equal to 1% of the bond's par value, or $10.
- Corporate and municipal bonds trade in increments of ⅛ of a point, or $1.25.
- For pricing purposes, convert fractions to decimals.

EXAMPLE
⅛ becomes .125 and ⅝ becomes .625.
Therefore, a bond quoted at 93 ⅝ can be converted to 93.625% of par, or $936.25.

Activity

What is the dollar value of each bond?

TIP: Don't forget to rewrite each fraction and make them decimals. The next step is par ($1,000) multiplied by the percentage of par and fraction.

Rate or Price	Rewritten as a Decimal	Dollar Value
5 ¼		
92 ½		
6 ⅝		
109 ⅜		

Pricing of Government Securities

Government bonds such as T-Notes, T-Bonds, and Agency Securities trade in increments of $^1/_{32}$ of a point.

	Quotation	Fractional	Decimal	Dollar Price
$1,000	**87.24**			
$10,000	**106.04**			

T-bills are quoted on a discount yield basis, not dollar. In a T-bill dealer's quotation, the bid's higher yield represents a lower price, while the ask's lower yield is a higher price.

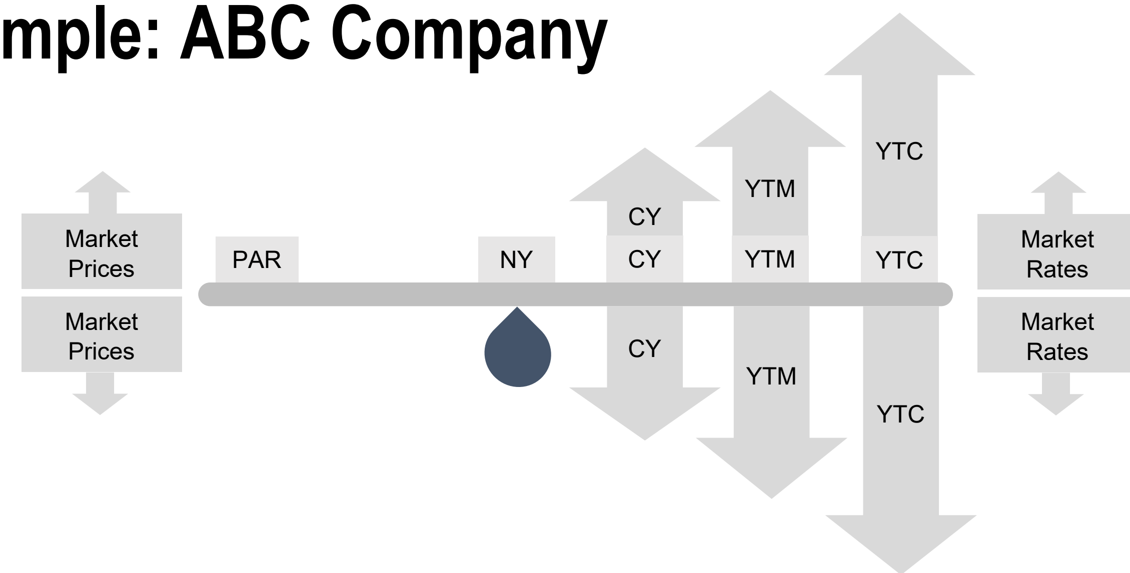
Bond Yields

NY	CY	YTM
▪ Nominal Yield (NY) ▪ Same as coupon ▪ Fixed	▪ Current Yield ▪ Annual interest divided by the current market price	▪ Yield-to-maturity ▪ Same as basis and yield ▪ Includes the reinvestment of annual interest and the gain or loss over the life of the bond ▪ Measured to the bond's maturity

1.00% = 100 basis points

.01% = 1 basis point

Example: ABC Company



Activity

Which statements are TRUE? Circle all that apply.

I. A bond's current yield is also referred to as its basis.
II. If interest rates are rising, bond prices are falling.
III. When bond yields are falling, bond prices are falling.
IV. If a bond is trading at par, its coupon rate, current yield, and yield-to-maturity are the same.

Retiring Debt Prior to Maturity

When a bond reaches its maturity date, the bondholder will redeem it to the issuer and receive the bond's par value plus the last interest payment.

The issuer's obligation to the bondholder has ended and the debt is considered retired.

Some bonds are redeemed *before* they mature.

Call Provision	Allows the issuer to redeem bonds prior to maturity – either in-whole or partial (lottery call) ▪ Catastrophe calls may be enacted if the project is destroyed ▪ If called, the investor receives the full return of principal plus any accrued interest ▪ Used when interest rates are falling ▪ Benefits include higher yield, call protection, call premium
Put Provision	Gives the bondholder the right to redeem (or put back) the bond on a date prior to maturity (opposite of a call provision) ▪ Used when interest rates are rising ▪ Allows bondholders to redeem their bonds at values greater than market value as interest rates rise

Activity

Which of these statements are TRUE? Circle all that apply.

I. Issuer's will likely call bonds when interest rates are low.
II. Issuers will make tender offers for their bonds when interest rates are low.
III. Bondholders will exercise put options when interest rates are high.
IV. An issuer may call its bonds during call protection periods.

Convertible Debentures and Conversion Parity

- A convertible bond gives an investor the ability to convert the par value of his bond into a predetermined number of shares of the company's common stock.
- Convertible bonds provide investors with safety of principal and potential stock growth.
- They also allow the issuer to pay a lower coupon rate.
- The conversion price is set at a premium at issuance and the bond's price is influenced by the underlying stock's price.
- The price at which the bond can be converted is referred to as the conversion price and is set at the time that the bond is issued.

The number of shares the investor will receive at conversion

$$\text{Conversion Ratio} = \frac{\text{Par Value of Bond}}{\text{Conversion Price}}$$

The price at which the bond can be converted; set at issue

Example: XYZ Corporation

XYZ Corporation
6% Debentures
Market price $1,100 and Convertible at $20.

$$\text{Conversion ratio} = \frac{\text{Par value of bond}}{\text{Conversion price}} = \frac{\$1{,}000}{\$20} = 50 \text{ shares}$$

What is conversion parity?

- Conversion parity means equivalent market values.
- Parity exists when the price of a convertible bond is equal to the aggregate market value of the common stock into which it can be converted.

Activity

A bond is purchased at $1,100 and convertible at $40. The market price of the common stock is now $45 per share. What is the parity price of the bond?

1. Find the conversion ratio:________________________________
2. Find the value of those shares: ________________________________
3. If converted, what is the stock's basis? ________________________________
4. When does an arbitrage opportunity exist?________________________________
5. Which is how much?________________________________

Chapter 5 – Types of Debt Instruments

Key Topics

1	2	3	4	5
U.S. TREASURY AND GOVERNMENT AGENCY SECURITIES Learn about the types of Treasury securities and how they are priced.	MUNICIPAL GO AND REVENUE BONDS Learn about municipal bonds and their issuers.	THE UNDERWRITING PROCESS Learn about the underwriting process for municipal bonds.	TYPES OF CORPORATE BONDS Learn about the types of corporate bonds.	MONEY MARKETS Learn about money market instruments and repurchase agreements.

U.S. Treasury Debt Overview

Characteristics	Taxation of Interest
▪ Issued directly by the U.S. Government ▪ Highly liquid; no credit risk	▪ Interest taxable at federal level ▪ Interest exempt at state and local levels

T-Bills, T-Notes, and T-Bonds

Treasury securities are considered marketable securities since they are traded in the secondary market after issuance.

The three most prevalent types of these marketable issues are:
- T-Bills
- T-Notes
- T-Bonds

T-Bonds and **T-Notes** are interest-bearing securities that have all the attributes of traditional fixed-income investments.

Each pays a fixed rate of interest semi-annually and investors receive the face value at maturity.

Comparing T-Bills, T-Notes, and T-Bonds

	T-Bills	T-Notes	T-Bonds
Maturities	Up to 1 year	2-10 years	Greater than 10 years
Denominations	All in $100 multiples		
Forms of Issuance	Book entry		
Interest	▪ Discount securities ▪ Trades flat	▪ Stated annually, paid semi-annually ▪ Accrued Interest: Actual/365	
How They are Initially Sold	Weekly auction	Periodic auction	

Pricing of Government Securities

Government bonds such as T-Notes, T-Bonds, and Agency Securities trade in increments of $^1/_{32}$ of a point.

However, T-Bills are quoted on a discount yield basis, not dollar

- In a T-Bill dealers' quotation, the bid's higher yield represents a lower price; the ask's lower yield is a higher price

Bid	Ask
2.94%	2.90%

TIPS

How can Treasury investors protect themselves from inflation?

- Acquire protection by investing in Treasury Inflation-Protected Securities (TIPS).

Offer a stated coupon with interest paid semi-annually	Adjust principal for inflation and deflation, based on CPI

TIPS Example

Principal	Coupon Rate	Annual Payment
$1,000	4%	$40.00
CPI increases by 1% (inflation)		
$1,010	4%	$40.40

T-STRIPS

- Issued at a discount and mature at face value
- Forms of zero-coupon debt created from T-Notes and T-Bonds
- Issued with a variety of maturities

T-STRIPS are non-interest bearing

Bidding at the Auction

What are auctions? ▪ The government sells Treasuries through auctions conducted by the U.S. Treasury
Competitive Bids ▪ Placed by large financial institutions ▪ Indicate both quantity and price
Non-Competitive Bids ▪ Placed by the public ▪ Indicate quantity only ▪ Are filled first ▪ Bidder agrees to pay the lowest price (highest yield) of the accepted competitive bids
T-Bills ▪ Settle on the Thursday following the auction

Activity

Read each characteristic and then circle which type (or types) of treasury debt to which it applies.

MORE THAN 10-YEAR MATURITY	T-Bills	T-Notes	T-Bonds
INTEREST IS FEDERALLY TAXABLE	T-Bills	T-Notes	T-Bonds
SOLD AT WEEKLY AUCTION	T-Bills	T-Notes	T-Bonds
DISCOUNTED SECURITY	T-Bills	T-Notes	T-Bonds
2 – 10-YEAR MATURITY	T-Bills	T-Notes	T-Bonds
BOOK-ENTRY ISSUANCE	T-Bills	T-Notes	T-Bonds
INTEREST PAID SEMI-ANNUALLY	T-Bills	T-Notes	T-Bonds

Question

Which of these statements are TRUE with regards to Treasury auctions? Circle all that apply.

I. Non-competitive bids are filled first.
II. Competitive bids determine price.
III. Non-competitive bids submit quantity and price/yield.
IV. The lowest accepted price/highest yield clears the auction.

Agency Securities

- Debt instruments issued and/or guaranteed by federal agencies and GSEs
- Exempt from state and federal registration
- Quoted in 32nds
- Accrue interest based on 30 days in the month/360 days in the year
- Issued in book-entry form

Two types:

FARMING LOANS	MORTGAGE-BACKED SECURITIES
▪ Federal Farm Credit Bank (FFCB) • Provides agricultural loans to farmers • Subject to federal tax, but exempt from state and local taxes	Mortgage-backed securities represent an interest in a pool of mortgages. ▪ Monthly payments consist of interest and principal ▪ Interest portion is fully taxable ▪ Subject to prepayment risk Agencies that issue mortgage-backed securities include: ▪ GNMA or Ginnie Mae ▪ FNMA or Fannie Mae ▪ FHLMC or Freddie Mac

> The most common security issued by government agencies is a mortgage-backed pass-through certificate. Pass-throughs provide excellent credit quality and a slightly higher yield than Treasuries; they are often used to supplement retirement income.

Activity

Read each statement and fill in the blanks.

1. Although agency securities are not direct obligations of the U.S. government, their credit risk is still considered ________.
2. Agency securities are ______________ from state and federal registration.
3. The Federal Farm Credit Bank (FFCB) is an example of a _____________________________________ entity.
4. Ginnie Mae, Fannie Mae, and Freddie Mac are examples of ______________________ securities.
5. Mortgage-backed securities represent an interest in a _________ of mortgages.
6. _________________________ is unique to mortgage-backed securities.
7. Agency ____________________ provide excellent credit quality and a slightly higher yield than Treasuries.

Municipal Bonds and Their Issuers

States and Political Subdivisions	Public Agencies and Authorities	Territories
▪ Cities ▪ Counties ▪ School districts	▪ Transit systems ▪ Housing authorities ▪ Water, sewer, and electric systems	▪ Puerto Rico ▪ Guam ▪ U.S. Virgin Islands

Types of Municipal Bonds

GENERAL OBLIGATION (GO) BONDS (Issued by states, counties, cities, or territories)	Purpose ▪ Issued for general purposes to meet any need of the issuer Sources for payment of debt service ▪ Taxes ▪ Issuer's full faith and credit State level ▪ Sales taxes, income taxes Local level ▪ Ad Valorem (property taxes) • Assessed value x millage rate = tax bill (1 mill = .001) ▪ Parking/licensing fees
REVENUE BONDS (Often issued by authorities)	Purpose ▪ Issued to fund a specific project Sources for payment of debt service ▪ Revenue (user fees) from a specific project Typical projects ▪ Toll roads, bridges, stadiums, airports Considered ▪ Self-supporting debt

Activity

Fill in the table.

Characteristic	GO Bonds	Revenue Bonds
Purpose		
Sources for payment		
Risk		
Yield		
Voter approval?		
Subject to debt limitations?		

Types of Revenue Bonds

Type	Source for Paying Debt Service
Transportation Revenue	Use tolls and user fees
Special Tax	Excise taxes on purchases, such as gasoline, tobacco, and liquor
Special Assessment	Assessments on the benefitting properties; used for sidewalks, sewers, etc.
Double Barreled	Two sources - project revenue and tax dollars (from GO bonds)
Moral Obligation	If project revenue is insufficient, the state legislature is morally (but not legally) obligated for the shortfall
Private Activity	A bond in which more than 10% of the proceeds will benefit a private entity (e.g., a sports team)
Industrial Development Bond (IDB)	Issued by a municipality and secured by a lease agreement with a corporate user of the facility

Municipal Notes

Municipal notes, or Tax-Free Anticipation Notes, are short-term issues that are normally issued to assist in financing a project or getting it started, or to assist a municipality in managing its cash flow

Types include:

- Tax Anticipation Notes (TANs)
- Revenue Anticipation Notes (RANs)
- Bond Anticipation Notes (BANs)
- Grant Anticipation Notes (GANs)

Ratings for Municipal Notes

	S&P	Moody's
Investment Grade	SP 1+ SP 1 SP 2	MIG 1 MIG 2 MIG 3
Speculative Grade	SP 3	SG

Municipal Bond Underwriting

Role of the Underwriter	**The Underwriting Process**
▪ The underwriter acts as a vital link between the issuer and the investing public by assisting the issuer in pricing the securities, structuring the financing, and preparing a disclosure document (referred to as the official statement).	▪ Although exempt, the underwriting process for municipal securities follows many of the same guidelines that are used for corporate underwritings.
Selecting an Underwriter ▪ Negotiated Sale - both issuer and underwriter "negotiate" terms of the deal ▪ Competitive Sale - issuer invites underwriters to submit sealed bids	**Forming a Syndicate** ▪ A syndicate is formed when a Manager invites other B/Ds to participate and share in liability by sending a Syndicate Letter. ▪ The Syndicate Letter addresses: • Size and type of offering • Percentage required to participate • Responsibility for unsold commitments of other members of the group

Question

Which of the following statements are TRUE with regards to underwritings? Circle all that apply.

I. Syndicates are created so that multiple firms share in the liability of a bond offering.
II. Voter approval is normally required when issuing GO bonds.
III. Feasibility studies are used when issuing revenue bonds.
IV. The issuer and underwriter work out the offering terms in a competitive sale.

Corporate Bonds

- Corporations that issue bonds use the proceeds from the offering for many purposes — from building facilities and purchasing equipment to expanding their businesses.
- The advantage is that the corporation does not give up any control or portion of its profits.
- The disadvantage is that the corporation is required to repay the money that was borrowed plus interest.
- Although buying corporate bonds puts an investor's capital at less risk than purchasing stock of the same company, bonds typically don't offer the same potential for capital appreciation as common stocks.

Types of Corporate Bonds

Corporate bonds are divided into two major categories – **secured** and **unsecured**.

Although all debt is issued by a corporation is backed by the issuer's full faith and credit, secured bonds are additionally backed by specific corporate assets.

Secured Bonds

Mortgage Bonds	▪ Secured by a first or second mortgage on real property ▪ Bondholders are given a lien on the property as additional security for the loan Collateral: real estate (land, buildings)
Equipment Trust Certificates	▪ Secured by a specific piece of equipment owned by the company and used in its business ▪ Trustee holds legal title to the equipment until the bonds are paid off ▪ Usually issued by transportation companies and backed by the company's rolling stock Collateral: planes, trains, trucks
Collateral Trust Bonds	▪ Secured by third-party securities owned by the issuer ▪ Securities (stocks and/or bonds of other issuers) are placed in escrow as collateral for the bonds. Collateral: securities (stocks, bonds) of other companies

Unsecured Bonds

When corporate bonds are backed by only the corporation's full faith and credit, they are referred to as **debentures**. If the issuer defaults, the owners of these bonds have the same claim on the company's assets as any other general creditor.

Occasionally, companies issue unsecured bonds that have a junior claim on their assets (compared to its other outstanding unsecured bonds). These bonds are referred to as **subordinated debentures**.

- In case of default, the owner's claims are subordinate to those of the other bondholders. Therefore, the owners of subordinated debentures will be paid after all of the other bondholders, but still before the stockholders.

Liquidation Proceedings

1. Secured creditors, including secured bonds
2. Administrative expense claims (taxes, current wages, lawyer and accountant fees)
3. General creditors (debentures)
4. Subordinated creditors (subordinated debentures)
5. Preferred stockholders
6. Common stockholders

Other Types of Corporate Bonds

Income Bonds	Eurodollar Bonds	Yankee Bonds	Eurobonds
▪ Normally issued by companies in reorganization (bankruptcy) ▪ Issuer promises to repay the principal amount at maturity, but NOT interest unless it has sufficient earnings	▪ Pay their principal and interest in U.S. dollars, but are issued outside of the U.S. (primarily in Europe) ▪ Issuers include foreign corporations, foreign governments, and international agencies, such as the World Bank	▪ Allow foreign entities to borrow money in the U.S. marketplace. ▪ Registered with the SEC and sold primarily in the U.S.	▪ Sold in one country, but denominated in the currency of another ▪ Issuer, currency, and primary market may all be different

Question

Which of these statements are TRUE with regards to corporate bonds? Circle all that apply.

I. Buying corporate bonds puts an investor's capital at less risk than purchasing stock.
II. With corporate bonds, the corporation gives up control as well as a portion of profits.
III. Interest must be paid on bonds before dividends are paid on stock.
IV. The corporation is required to repay the money that was borrowed plus interest.

Activity

Match each description to the appropriate term.

INCOME	Bond issued in the U.S. by a foreign entity
EURODOLLAR	Corporate bond backed only by corporation's full faith and credit
YANKEE	Issuer makes no promise of interest payments
UNSECURED	Bond issued outside of the U.S., but pays debt service in U.S. dollars
COLLATERAL TRUST	Secured by third-party securities that are owned by the issuer

Money Market Instruments

Characteristics	▪ Short-term debt instruments (one year or less to maturity) ▪ Provide safety of principal and liquidity ▪ Suitable for investors who seek safety when intending to make a purchase in the near future or while evaluating different investment options
Principal Types	▪ T-Bills – short-term Treasury debt ▪ Banker's Acceptances (BAs) – facilitate foreign trade (import/ export) ▪ Commercial Paper – unsecured corporate debt ▪ Negotiable Certificates of Deposit (CDs) – unsecured bank debt ($100,000 minimum) • Federal Deposit Insurance Corporation (FDIC) insures up to $250,000 ▪ Repurchase Agreements (Repos) – a dealer selling securities to another dealer with the agreement to repurchase

Activity

Match each description to the appropriate term.

BANKER'S ACCEPTANCE	Treasury debt
REPO	Unsecured corporate debt
CD	Unsecured bank debt
COMMERCIAL PAPER	Used for foreign trade
T-BILL	Involves two transactions

Chapter 6 – Investment Returns

Key Topics

1	2	3	4	5
RETURN ON INVESTMENTS	PRICE VERSUS YIELD	COST BASIS AND CAPITAL EVENTS	MEASURING RETURN	AVERAGES AND INDEXES
Learn about the different return calculations for both equity and debt investments.	Learn about the relationships of price versus yield based on a bond's price.	Learn about the impact cost basis has on capital gains and losses.	Learn about how to calculate different returns, such as total return and risk-adjusted return.	Learn about the different benchmarks used to measure investment return.

Dividend Dates

Declaration Date
- Date on which the dividend is announced

Payment Date
- Date on which the dividend (cash or stock) is distributed

Record Date
- Date on which a person must own the stock to receive dividend (owner of record)
- For a buyer to receive the dividend, transaction must settle on, or before, record date

Ex-Dividend Date
- ______ business day(s) before the record date
- Stock begins to sell without its dividend (i.e., at a reduced price)
- Regular-way settlement is assumed

Dividend Dates

MAY						
Sun.	Mon.	Tues.	Wed.	Thurs.	Fri.	Sat.
1	2	3	4	5	6	7
8	9	10	11	$\boxed{12}$ Record	13	14

Trade Date	Settlement	Entitled to Dividend?
May 9		
May 10		
May 11		
May 11 (cash)		

Due Bills

MAY						
Sun.	Mon.	Tues.	Wed.	Thurs.	Fri.	Sat.
1	2	3	4	5	6	7
8	9	10	11	$\boxed{12}$ Record	13	14

If the seller *fails to deliver* the securities by the record date (May 12):

- The seller remains the stockholder of record and will receive the dividend
- The buyer is entitled to the dividend if a trade is executed prior to the ex-date (May 11)
- A *due bill* must accompany the delivery of the stock ensuring the dividend as a receivable for the buyer

Activity

Scenario: A corporation has declared a cash dividend on June 1, payable on July 25 to stockholders of record on Thursday, July 12. Which of these states is/are TRUE? Circle all that apply.

I. The stock trades ex-dividend on Wednesday, July 11.

II. The seller is entitled to the dividend on a trade executed on Tuesday, July 10.

III. If securities are not delivered by July 12, a due bill must accompany the delivery.

IV. A cash trade can be done as late as July 25 in order for the buyer to receive the dividend.

Stock Dividends

The Impact of Stock Dividends	If a company chooses to pay a dividend to its shareholders in the form of additional shares of stock, there is: ▪ No economic gain or loss for holders ▪ No change to issuer's capitalization ▪ No change to holder's percentage of equity ownership
The Tax Treatment of Stock Dividends	▪ Additional shares received are generally not taxed as income ▪ Investor's total basis is unchanged, but basis per share is adjusted

Example – Stock Dividend

Investor owns 100 shares of XYZ at $60 per share.
XYZ Company declares a 10% stock dividend.

Before the dividend:	• Shares = 100 shares • Basis per share = $60	Investor's total position: $6,000
After the dividend:	• Shares = 110 • Basis per share = $54.54	Investor's total position: $6,000

Calculating Current Yield for Equities

Also referred to as dividend yield

- Measures the annual income from dividends compared to the stock's current market price (not the investor's original purchase price)
- It is based on the annualized dividend

A stock is currently trading at $40 per share and has paid a quarterly dividend of $0.30.
The current yield for this stock is:

$$\frac{\text{Annual Dividend}}{\text{Current Market Price}} = \frac{4 \times \$0.30}{\$40} = \frac{\$1.20}{\$40} = 3.00\%$$

Activity

Read each statement and determine whether it is TRUE or FALSE.

A STOCK DIVIDEND CHANGES THE OVERALL VALUE OF THE PORTFOLIO	
THE COST BASIS OF SHARES IS REDUCED AFTER A STOCK DIVIDEND	
A STOCK DIVIDEND IS TAXABLE IN THE YEAR IT'S PAID	
IF A CASH DIVIDEND REMAINS THE SAME, THE CURRENT YIELD ON THE STOCK WILL INCREASE AFTER A STOCK DIVIDEND IS PAID	

Return on Bond Investments

Bond prices are primarily influenced by fluctuations in market interest rates

- There is an inverse relationship between bond prices and market interest rates
- Bond yields and market interest rates move in the same direction

In order to calculate various returns on bonds, an investor must understand how to determine:

- The interest payable each year
- The market price of the bond

Nominal and Current Yield on Bonds

Nominal Yield (NY):

- Same as coupon; fixed

Current Yield (CY):

- Uses the annual interest payments
- Based on current market price, NOT owners' original purchase price

Current Yield Calculations

$$\frac{\text{Annual Interest}}{\text{Current Market Price}}$$

Nominal Yield	Bond Price	Calculation	Current Yield
8%	$1,000		
9%	$1,125		
6 ½%	$812.50		

Yield-to-Maturity (YTM)

Also referred to as the *Basis* or simply *the yield* of a bond:

- Investor's total overall yield includes:
  - Semiannual interest payments
  - Interest earned from reinvesting the interest (compounding or time value)
  - Any gain/loss on the difference between the current value and par value

Both basis and basis points are measurements of yield

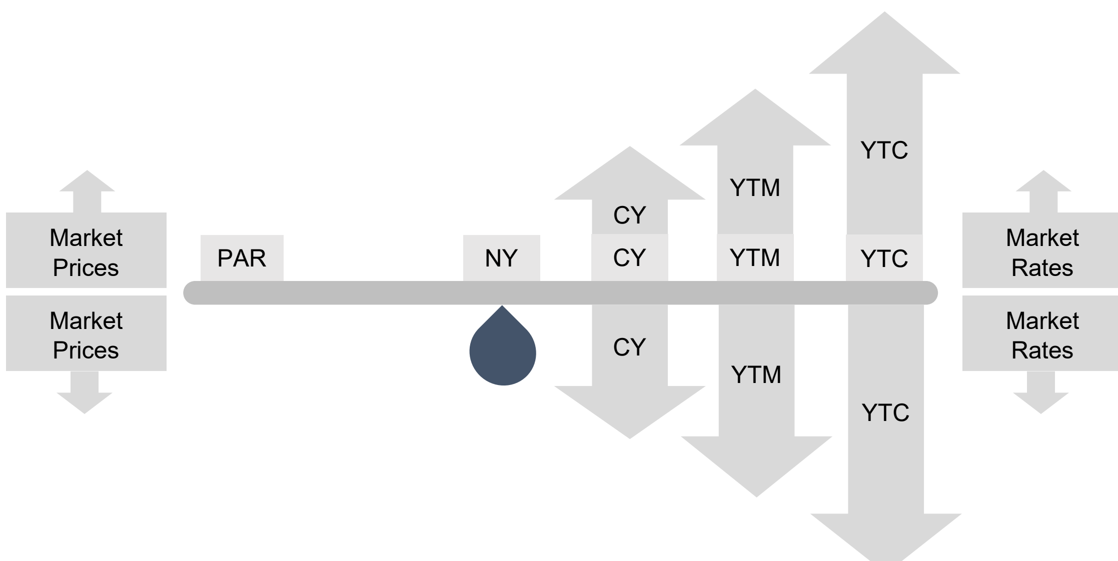
- Each basis point is .01%; there are 100 basis points in every 1%
- If a bond's YTM is 4.60%, it is trading at a 4.60 basis
- If another bond is trading at a yield of 4.75%, it is trading 15 basis points higher

Activity

Read each statement and fill in the blanks.

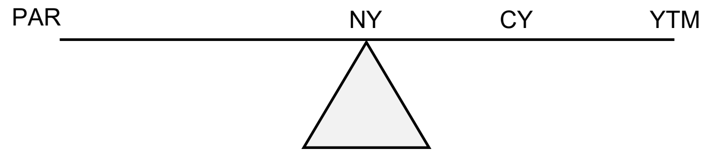
1. A bond's nominal yield is also referred to as its ________________.
2. To calculate a bond's current yield, an investor must use its ____________ interest payment.
3. To calculate a bond's current yield, the __________________________ of the bond is used, not the investor's ____________________.
4. A bond's yield-to-maturity is also referred to as its __________ or _________.
5. 1.20% is equal to ______ basis points.
6. If interest rates are increasing, bond yields are _______________ and bond prices are ____________.

Price Versus Yield Relationships



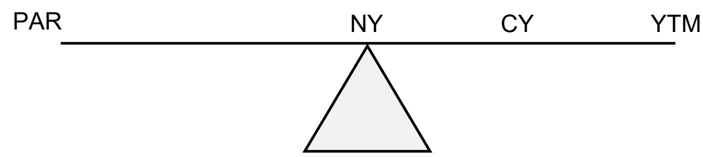
Price versus Yield Example

YTM: 7.75%	1. 8.00%
Price: 102	2. 7.75%
Coupon: _______	3. 7.65%



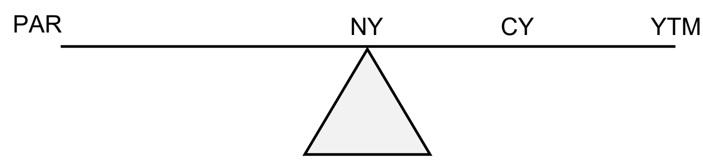
Price versus Yield Example

Current Yield: 8.45%	1. 98 1/2
YTM: 8/25%	2. 100
Price: _______	3. 103 7/8%



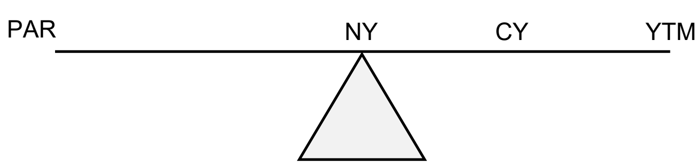
Price Versus Yield Example

Coupon: 6.00%	1. 5.85%
Price: 95.50	2. 6.00%
YTM: _______	3. 6.25%
	4. 6.47%



Yield-to-Call (YTC)

An investor’s yield if a bond is called at par



For Callable Bonds, always quote the lower of the YTC or YTM (referred to as the yield-to-worst)

- When bonds are callable at par and:
  - Selling at a discount, use: ___________
  - Selling at a premium, use: ___________

Cost Basis and Capital Events

Cost Basis	▪ Represents the total amount paid to acquire a security ▪ Typically includes commissions and other fees paid
Capital Gains	▪ The result of the sale or redemption of an asset if the proceeds exceed the basis (Holding period is measured from trade date to trade date) • Short-term: Assets that are held for one year or less – Taxed at: • Long-term: Assets that are held for greater than one year – Taxed at:
Capital Losses	▪ The result of the sale of an asset if the proceeds are less than that basis ▪ As it relates to holding period, short-term and long-term losses are defined the same as capital gains

A return of capital is when the investor receives some of the original investment back

Question

As it relates to cost basis and capital events, which of these statements is/are TRUE?
Circle all that apply.

I. Cost basis is equal to the amount paid for a security less commissions.
II. The sale of a security held for more than one year results in a long-term capital gain or loss.
III. The holding period of a security is measured from trade date to trade date.
IV. Any amount of the original investment received by an investor is considered a return of capital.

Total Return

Applies equally to bond and stock investments by including:

- all cash flows from interest or dividends
- *plus* any appreciation in value
- (or *minus* any depreciation)

$$\text{Total Return} = \frac{(\text{End Value} - \text{Beginning Value}) + \text{Investment Income}}{\text{Beginning Value}}$$

Total Return Example

An investor purchased ABC preferred stock two years ago for $25 per share. Over this time, she has received $5 in dividends and the stock is currently trading for $30 per share. What is the investor's total return on her investment?

$$\text{Total Return} = \frac{(\text{End Value} - \text{Beginning Value}) + \text{Investment Income}}{\text{Beginning Value}}$$

$$\text{Total Return} = \frac{(\$30 - \$25) + \$5}{\$25} = \frac{\$5 + \$5}{\$25} = \frac{\$10}{\$25} = 40\%$$

Measuring Other Investment Returns

Real Return (Inflation-Adjusted)	Rate of Return – Inflation
Risk-Adjusted Return	Rate of Return – Risk-Free Return
Risk-Free Return	Rate of return generally found on a U.S. Treasury bill

Question

Scenario: A security has a 6% rate of return, when the inflation rate is 1.5%, and T-bills are yielding 2%.

What is the real return?

What is risk-adjusted return?

Averages and Indexes

Investment returns are often compared against a benchmark of a group of securities

Narrow-based indexes focus on market segments, while broad-based indexes attempt to include the entire market, such as:

Standard & Poor's 500 Index – comprised mostly of NYSE stocks ▪ 400 industrial ▪ 20 transportation ▪ 40 utility ▪ 40 financial	Dow Jones Composite – broken down into three averages: ▪ Dow Jones Industrial – 30 stocks (most widely quoted) ▪ Dow Jones Transportation – 20 stocks ▪ Dow Jones Utility – 15 stocks

Other Averages and Indexes

Equity Indexes:

- Wilshire Associates Equity Index – Largest index; 5,000 stocks
- Russell 2000 – Focuses on small capitalized stocks
- Nasdaq Composite Index – Based on all Nasdaq listed securities
- Nasdaq 100 – The 100 largest companies listed on Nasdaq

The largest index is the Wilshire Associates Equity Index, while one of the smallest is the Dow Jones Industrial Average

Bond Indexes

- Barclay's Capital and other B/Ds have created indexes based on existing bonds in the market

Tracking Performance:

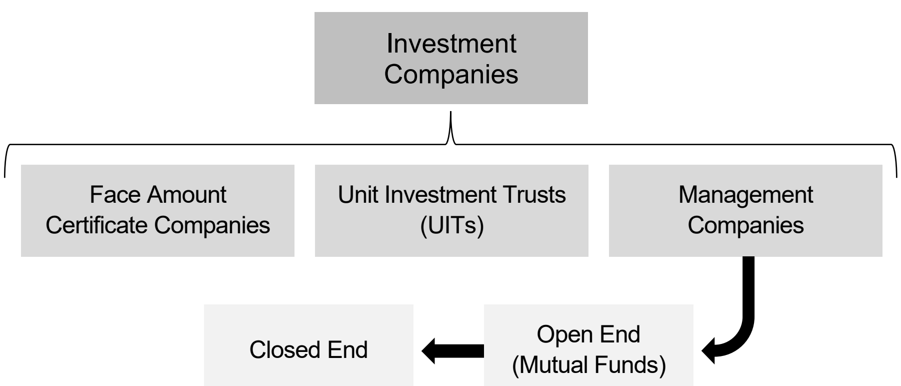
- An investor must track how his investments are performing relative to a benchmark or index (e.g., if his investment is up 5%, but the S&P 500 is up 10%)

Chapter 7 – Packaged Products

Key Topics

1	2	3	4	5
TYPES OF INVESTMENT COMPANIES	THE ORGANIZATION OF A MUTUAL FUND	CATEGORIES OF MUTUAL FUNDS	BUYING AND SELLING MUTUAL FUND SHARES	OTHER TYPES OF INVESTMENT COMPANIES
Learn about the different types of investment companies, with focus on mutual funds.	Learn about the responsibilities of the different service organizations connected to mutual funds.	Learn about the different types of funds and the contents of their portfolios.	Learn about the costs associated with purchases and sales of mutual fund shares.	Learn about unit investment trusts, face amount certificates, and closed-end funds.

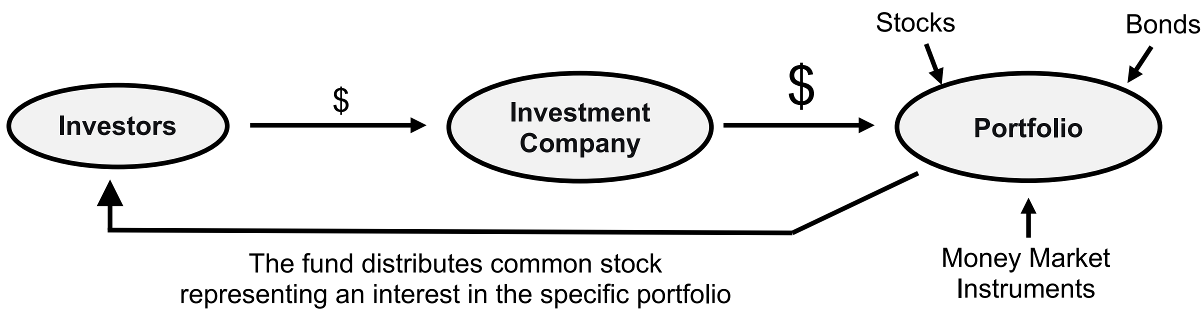
Types of Investment Companies



Investment Companies

A corporation (sometimes a trust) that invests the pooled funds of investors; typically into a diversified portfolio of securities

- Allows investors to acquire an interest in a large number of securities
- Mutual fund benefits include:
  - Professional management
  - Diversification
  - Liquidity
  - Convenience and cost
  - Exchanges at net asset value (NAV)



Diversified versus Non-Diversified

Diversified qualifications:

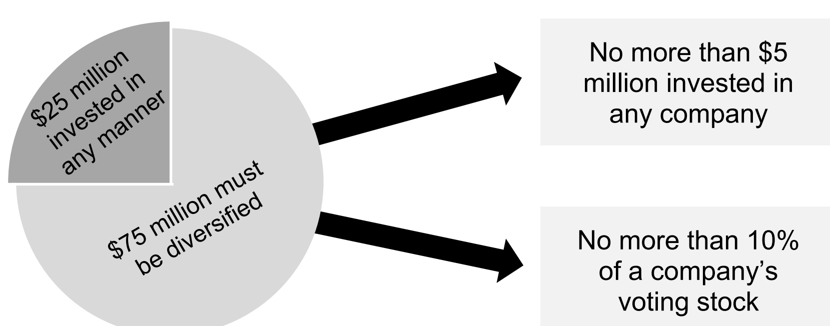
- 75% of total assets must be specifically structured so that:
  - No more than 5% is invested in any one company, and
  - No more than 10% of a company's voting stock is owned
- The other 25% may be invested in any manner

If the value of a position grows to above 5%, the mutual fund may still represent itself as diversified

Non-Diversified

- Assets may be invested in any manner

Diversifying a $100 Million Fund



Prospectus Contents

A prospectus must precede or accompany any solicitation and include the following details:

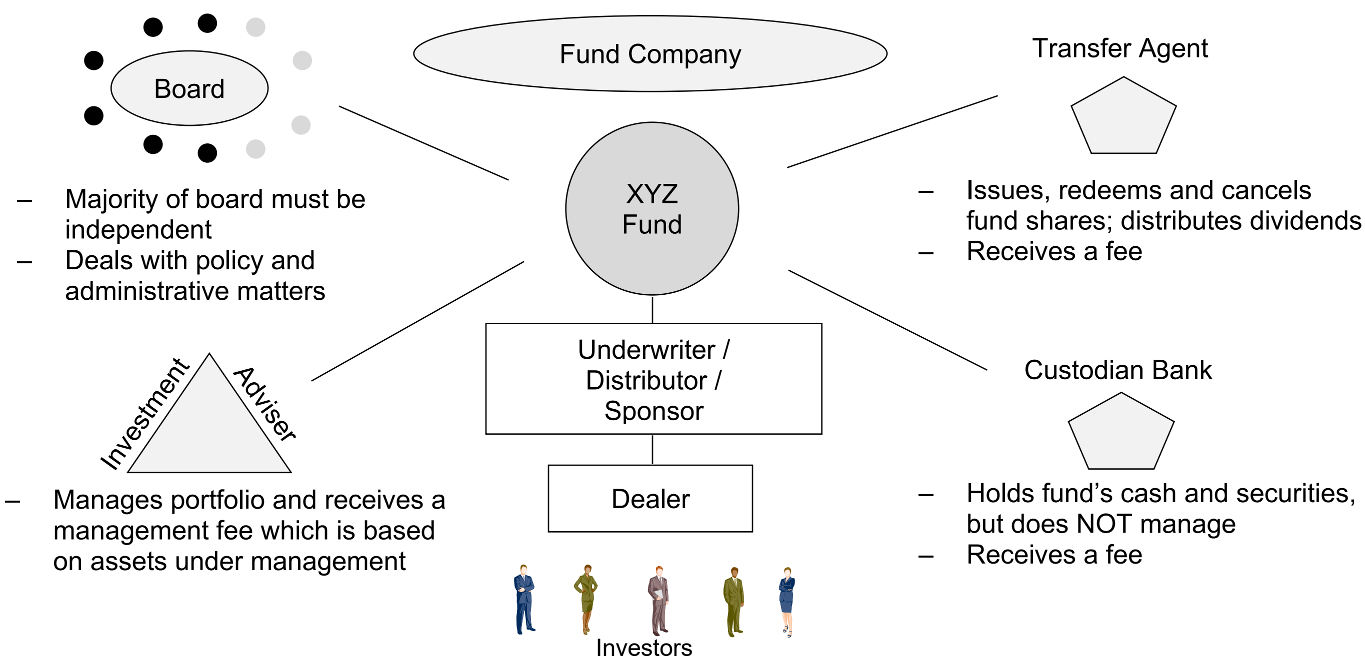
- Investment Objective
- Risk disclosure
- Performance information
- Sales charge disclosure
- Operating expenses disclosure
- Share class comparison table
- Breakpoint table
- Exchange privileges

Activity

Fill in the blank with the correct answers.

1. An individual's interest in a specific mutual fund is represented by ______________________.
2. ______________________ provides an investor with the ability to invest a small amount and obtain an interest a large number of securities.
3. A diversified fund is not permitted to invest more than ______ in any one company and cannot control more than _______ of any one company's voting securities.
4. For a diversified fund, no less than ________ of a fund's assets must be diversified, while the remaining ________ can be invested in any manner.
5. A ____________________ must precede or accompany any solicitation of mutual fund shares.

Mutual Fund Structure



Board of Directors

- Investment Company Act of 1940 requires that a majority of the board be independent (disinterested)
- Elected by, and responsible to, shareholders
- Deals with policy and administrative matters
- Hires outside companies for services
- Sets the fund's objective, but does not manage the portfolio

Investment Adviser

- Also referred to as the fund manager
- Registered with the SEC under IA Act of 1940
- Manages based on the objectives as stated by the Board of Directors
  - Invests the assets of the fund's portfolio
  - Provides analysis and research
  - Implements appropriate diversification
- Earns a management fee
  - Expressed as a percentage of assets
  - Generally the largest fund expense

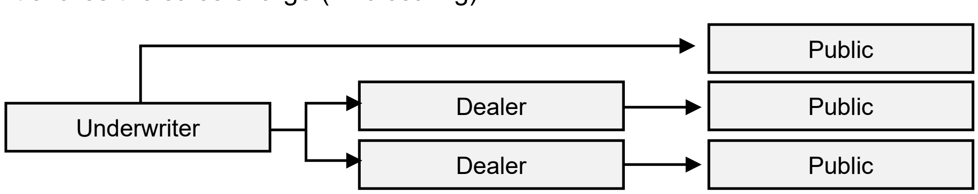
Transfer Agent and Custodian Bank

Transfer Agent	▪ Computes the net asset value ▪ Keeps track of share ownership; issues, redeem, and cancels the fund's shares ▪ Sends customer confirmations and fund distributions ▪ Receives a fee for its services
Custodian Bank	▪ Maintains custody of the fund's total assets (i.e., provides safekeeping) ▪ Responsible for both payable and receivable functions ▪ Receives a custodial fee for its services ▪ Does not manage the portfolio

Principal Underwriter

Underwriter (often referred to as sponsor/wholesaler/distributor)

- Appointed by the board
- Receives a portion of the sales charge for marketing and selling the fund shares to the public; may also receive a distribution fee
- Able to buy shares at the NAV and sell directly to investors or market the shares through independent dealers with whom it shares the sales charge (wholesaling)

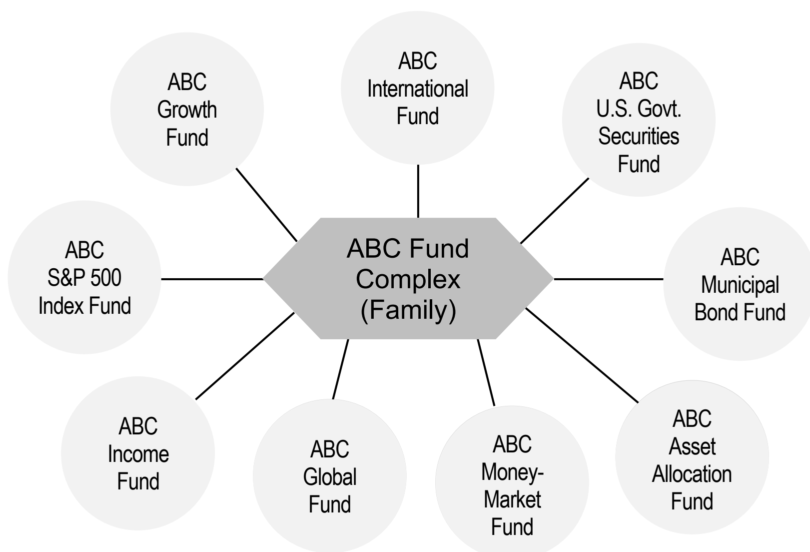


Activity

Match each entity to the appropriate description.

TRANSFER AGENT	Determines investments to meet the fund's objectives
BOARD OF DIRECTORS	Sets the fund's objectives and deals with administrative matters
CUSTODIAN BANK	Issues, redeems, and cancels the fund's shares
UNDERWRITER	Responsible for the safekeeping of the fund's assets
INVESTMENT ADVISER	Receives a portion of the sales charge for selling shares to the public

Mutual Fund Complex



Net Asset Value (NAV)

Accounting value of a fund's positions; marked-to-the-market at closing prices as of 4:00 p.m. ET

- NAV is synonymous with the bid price or redemption (liquidation) price for mutual fund shares
  - Investors who redeem their shares receive the next computed NAV (forward pricing)
- Public Offering Price (POP) is the NAV plus any applicable sales charges
  - Investors who purchase fund shares pay the next computed POP

$$\text{Calculating NAV Per Share} = \frac{(\text{Total Assets} - \text{Total Liabilities})}{\text{Number of Shares Outstanding}}$$

Calculating the Sales Charge

Difference between the NAV and POP is the sales charge

NAV (Bid)	POP (Ask)
9.20	10.00
Price at which a client redeems	Price at which a client buys

Sales charge is expressed as a percentage of the POP

$$\text{Calculating Sales Charge \%} = \frac{(\text{POP} - \text{NAV})}{\text{POP}} = \frac{(\$10.00 - 9.20)}{\$10.00} = \frac{\$0.80}{\$10.00} = 8\%$$

Calculating Public Offering Price

When given the NAV and sales charge percentage, use the following procedure to calculate the offering price:

Sales Charge	NAV	$\frac{\text{NAV}}{(100 - \text{Sales Charge \%})}$	Simplify	Resulting POP
5%	$69.80			
8.5%	$45.95			

Question

Scenario: A mutual fund has an NAV of $24.00 and a public offering price of $26.09.

What is the fund's sales charge percentage?
If the fund's shares could be purchased with a 5% sales charge, what would be the public offer price?

Sales Charges

Amount deducted from an investor's purchase

- Benefits the selling brokers
- Used to cover the costs of promotion and sales literature
  - Industry rules prohibit assessing charges in excess of ________% of the POP

<table>
<tr><td>Front-End Loads</td><td>▪ Total investment, less the sales charge, is directed to the portfolio</td><td></td></tr>
<tr><td>Back-End Loads (Contingent Deferred Sales Charges)</td><td>▪ Assessed at the time an investor redeems
▪ Percentage decreases as the holding period lengthens</td><td><table>
<tr><th>Holding Period</th><th>CDSC</th></tr>
<tr><td>1 year</td><td>5%</td></tr>
<tr><td>2 years</td><td>4%</td></tr>
<tr><td>3 years</td><td>3%</td></tr>
<tr><td>4 years</td><td>2%</td></tr>
<tr><td>5 years</td><td>1%</td></tr>
<tr><td>6 years +</td><td>0%</td></tr>
</table></td></tr>
<tr><td>12b-1 Fees</td><td>▪ Established under Section 12b-1 of the investment Company Act of 1940 (see next slide)</td><td></td></tr>
</table>

12b-1 Fees

An annual fee levied against the fund's assets

- Allows distribution costs to be borne by the fund, rather than from front-end charges

Used to finance promotion, advertising, commissions

- Includes continuing commissions or "trailers"
- If a written contract exists, it may be paid to RRs who are still employed with a firm or to retiring RRs based on existing assets

No-Load Funds

For a fund to be described as a no-load, it must have:

1. No front-end sales charge (load)	2. No deferred sales charge (back-end load)	3. No 12b-1 fee that exceeds .25% of the fund's average net assets per year

A no-load fund may have a redemption fee
(since the fee is not considered a sales charge)

Fees and Charges

Ongoing fees are NOT sales charges

- These fees may be based on a percentage of assets under management or on amounts redeemed early from a fund

Management (Advisory) Fee	▪ Paid to the investment advisor ▪ Asset-based; not tied to profits or losses ▪ Typically the largest of the fees
Administrative Fee	▪ Custodian bank payments ▪ Transfer agent costs
Redemption Fee	▪ Does not go to underwriter or dealer ▪ Remains behind in the fund, benefitting other owners

Mutual Fund Expense Ratio

Defined as the percentage of a fund's assets paid for operating expenses and managements fees, including 12b-1 and administrative fees, and all other asset-based costs incurred by the fund

- Calculated by dividing a fund's expenses by its average net assets (sales charges are not expenses)
- Will decline if:
  - Assets under management increase
  - Any fee or expense is reduced

The largest expense for a fund is typically the management fee

Classes of Shares

	A	B	C
Sales Charges	Front-end load	Contingent deferred sales charge assessed if shares are held for less than 6 to 8 years	A level load (ongoing fee of typically 1%) for as long as shares are held. Back-end load may be assessed for early redemption.
12b-1 Fees	Low or none	Higher than Class A shares	Higher than Class A shares; generally the same as Class B shares
Other Features	Breakpoints available for large purchases	Often convert to Class A shares after 6 to 8 years; no breakpoint available	No conversion to Class A shares

Activity

Read each statement and determine whether it is TRUE/FALSE.

A 12B-1 FEE IS AN ANNUAL FEE CHARGED AGAINST FUND ASSETS TO FINANCE ADVERTISING EXPENSES	
A NO-LOAD FUND CANNOT INCLUDE A 12B-1 FEE	
A REDEMPTION FEE IS AN ADDITIONAL SALES CHARGE ASSESSED ON CERTAIN SALES	
A MUTUAL FUND'S EXPENSE RATIO WILL DECLINE IF THE ASSETS UNDER MANAGEMENT INCREASE	

Methods to Decrease Sales Charge

Breakpoints

- When investing an amount at or above the breakpoint, the investor qualifies for the lower sales charge on the entire purchase
- Purchases of multiple funds within the same family or complex of funds are consolidated to determine the sales charge

Invested Amount	Sales Charge
Less than $50,000	5.75%
$50,000, but less than $100,000	4.50%
$100,000, but less than $250,000	3.50%
$250,000, but less than $500,000	2.50%
$500,000, but less than $1 million	2.00%
$1 million or more	None

Breakpoints – Example

A customer invests $60,000 in a mutual fund. The Fund's next calculated NAV is $19.61 and the maximum offering price is $21.32. The fund charges a 1% redemption fee. Using the previous breakpoint schedule, how many shares is the investor able to purchase?

Sales Charge	NAV	$\frac{\text{NAV}}{(100 - \text{Sales Charge \%})}$	Simplify	Resulting POP

Mutual funds allow the purchase of fractional shares

Letter of Intent (LOI)

Optional provision that allows investors to qualify for a breakpoint without initially depositing the entire amount required

- _____-month time period
- May be back dated ______ days
  - If backdated, the fund will re-compute the sales charges on previous purchases
- Non-binding on customer; a portion of share held in escrow in case of non-performance

Rights of Accumulation (ROA)

Right to add up all purchases made from same family of funds

- When a breakpoint is crossed, current and future purchases will have a lower sales charge

Rights of accumulation may be made available to any of the following:

- An individual purchaser
- A purchaser's immediate family members (i.e., spouse, dependent children)
- A fiduciary for a single fiduciary account
- A trustee for a single trust account
- Pension and profit-sharing plans that qualify under the Internal Revenue Code guidelines
- Other groups (e.g., investment clubs) provided they were not formed solely for the purpose of paying reduced sales charges

Dollar Cost Averaging (DCA)

A method of investing which involves making the same periodic investment regardless of share price over a fixed period

- Does not <u>guarantee</u> attainment of any specific investment goals
- Necessary disclosures:
  - No assurance of long-term growth
  - Prices are subject to change
  - Contributions must continue even when prices decline, otherwise losses could occur

Activity

Which statements are TRUE about reducing the cost of mutual fund shares? Circle all that apply.

I. Sales charges are based on the total investments within the same complex of funds.
II. A letter of intent allows purchases over a 15-month period to be consolidated to determine the sales charge.
III. The ability to reduce sales charges as the value of shares reaches a breakpoint is referred to as rights of accumulation.
IV. The use of dollar cost of averaging assures long-term growth.

Redeeming Mutual Fund Shares

The Redemption Process	▪ A mutual fund investor may redeem (sell) shares and receive the share's next calculated net asset value (minus any applicable contingent deferred sales charges or redemption fees) ▪ Funds are required to send investors the payment for their shares within *seven calendar days* of receiving the redemption notice
Redemption Fees	▪ Assessed against investors who redeem their shares after holding them for a short period (often one year or less) ▪ NOT a sales charge; it is returned to the fund's portfolio

Withdrawal Plans

Allows investors to receive regular, periodic payments from their accounts

- A minimum account value is required
- A variety of withdrawal methods are available, such as:
  - Fixed dollar amount
  - Fixed percentage
  - Fixed time
  - Fixed number of shares
- Payments are not guaranteed for the life of the investor

> Clients should not be advised to engage in a systematic purchase and withdrawal plan simultaneously

Sales Practice Violations

- Breakpoint sales
- Soliciting sales of shares at amounts just below a breakpoint
- Recommending purchases from different fund families due to the potential for higher sales charges
- Switching between different fund families due to the impact of new sales charges or holding periods
  - For switch recommendations, RRs may be responsible for justification of:
    - Tax ramifications (both exchanges and switches are taxable)
    - Potential sales charges on new purchase
- Excessive purchases of Class B shares
  - Salespersons should not recommend purchasing large quantities of B shares (since they do not qualify for breakpoints)

Activity

Which statements are TRUE about regarding redeeming shares and sales practice violations? Circle all that apply.

I. A redemption fee is assessed on all sales of mutual funds.

II. A client should not be engaged in a withdrawal plan while systematically purchasing shares.

III. Class B shares should not be recommended to an investor who is considering purchasing a large amount of shares.

IV. Switching from one fund to another within the same family is a tax-free exchange.

Other Types of Investment Companies

Face Amount Certificate Company (FAC)
- Issues debt certificates
- Issuer promises face value at maturity or surrender value if presented prior to maturity

Unit Investment Trust Company
- Supervised, not managed (no management fee)
- Portfolio generally remains fixed for the life of the trust
- Ownership usually referred to as shared of beneficial interest (SBI)

Closed-End Compared to Open-End

Closed-End (Publicly Traded)	Open-End (Mutual Fund)
Typically a one-time issuance of common shares ▪ Could issue preferred stock or bonds	Continually issue new shares ▪ Common shares ▪ Sold by prospectus
Shares may trade at a discount or premium to NAV with commission or mark-up added (supply and demand)	Shares are sold at the NAV + sales charge (if any)
Sponsor does not stand ready to redeem shares	Sponsor stands ready to redeem shares at the next calculated NAV (forward pricing)
Shares trade in the secondary market	Shares remain in the primary market
Shares may be sold short	Shares cannot be sold short

Activity

Read each description and indicate the type of investment company.

PORTFOLIO IS SUPERVISED, NOT MANAGED	
SHARES MAY TRADE AT A PRICE LESS THAN THE NAV	
A FIXED AMOUNT IS PAID AT A SPECIFIC DATE	
SHARES ALWAYS REMAIN IN THE PRIMARY MARKET	

Chapter 8 – Variable Contracts and Municipal Fund Securities

Key Topics

1	2	3	4
TYPES OF ANNUITITES Learn about the differences between fixed and variable annuities.	ANNUITY PHASES Learn about the accumulation and annuity phases.	QUALIFIED ANNUITIES AND EQUITY-INDEXED ANNUITIES (EIAs) Learn about qualified contracts and EIAs.	MUNICIPAL FUND SECURITIES Learn how individuals can save for college.

Types of Annuities

Annuities are products that are sponsored by insurance companies in which investment income grows tax-deferred; they may be fixed or variable

	Fixed	Variable
Investment risk:		
Is it a security?		
Account:		
Portfolio:		
Inflation hedge:		

The Separate Account

- An investment company product
    - Regulated under the Investment Company Act of 1940
    - Registered with the SEC
- Must be sold by prospectus
- Investments may be changed during accumulation phase

The Accumulation Phase – Phase 1

Also referred to as the Pay-In Period or Deposit Phase

- During this phase, account is valued in terms of "accumulation units"
  - Units are purchased after-tax, no deduction
  - Investment income is tax-deferred until withdrawn
- The purchase price is referred to as the accumulation unit value (AUV); similar to a mutual fund's NAV
  - Unit value is calculated at the end of the business day (using forward pricing that's similar to mutual funds)
- Accumulation units are invested in separate accounts

The Separate Account and its Subaccounts

S&P 500 Index Subaccount	International Subaccount	High-Yield Corporate Bond Subaccount
Value Subaccount	Biotech Subaccount	GNMA Subaccount
Aggressive Growth Subaccount	Global Subaccount	Special Situations Subaccount

Receiving Benefits – Withdrawals

While still in the accumulation phase …

- Annuitants may choose to take withdrawals from their annuity
  - Annuitants control the timing and amount of their withdrawals
  - Only the earnings portion is taxable

Death During Accumulation Phase

If the annuitant dies during the accumulation phase, the payout to the beneficiary will represent:

- The greater of:
  - The total contributions made or
  - The current value of the contract
- Amount above cost basis could be taxable

Activity

Read each characteristic and determine the type of annuity to which it applies.

MONEY IS DEPOSITED INTO THE GENERAL ACCOUNT	
THE INVESTOR DETERMINES WHERE THE MONEY IS DEPOSITED	
THE INVESTOR ASSUMES THE INVESTMENT RISK	
THE INSURANCE COMPANY ASSUMES THE INVESTMENT RISK	

Question

As it relates to the accumulation phase of an annuity, which of these statements is/are TRUE?
Circle all that apply.

I. Accumulation units are purchased after-tax and grow tax-deferred.
II. Withdrawals are first considered a part of cost basis and not taxable.
III. Death benefits are the greater of cost basis or the current value.
IV. Death benefits above cost basis are tax-free.

The Annuity Phase – Phase 2

Also referred to as the Pay-out, Withdrawal, or Annuitization Phase

- When receiving benefits at annuitization, accumulation units are converted into a fixed number of annuity units
- Unit value is based on:
    - Age and gender of the contract holder
    - Life expectancy
    - Payout option selected
    - Value of the separate account
- Payout is established by multiplying the fixed number of annuity units by the fluctuating value

Payout Options

Straight Life Annuity	▪ Annuitant receives payments for life • Highest possible payout with highest risk
Life Annuity with Period Certain	▪ Payments are made to annuitant for life or to beneficiary (in the case of annuitant's death) for specified minimum number of years
Joint and Last Survivor Annuity	▪ Payments are made for life so long as one annuitant is living
Unit Refund Life Annuity	▪ Annuitant receives an amount at least equal to his original investment • At death, any remaining amount is paid to a beneficiary

Annuity Charges and Expenses

Like mutual funds, annuities have charges and expenses that are not invested in the separate account, including:

- Sales charges – there is no maximum; they must be fair and reasonable
- Expenses – insurance companies deduct various expenses from the investment income, such as:
  - *Management fee* – adviser's fee for making investment decisions in the separate account
  - *Expense risk charges* – charged if expenses are greater than estimated
  - *Administrative expenses* – cost of issuing and servicing contracts
  - *Mortality risk charges* – a guarantee that annuitants will be paid for life even if they live beyond life expectancies

Qualified versus Non-Qualified Annuities

Qualified	Non-Qualified
▪ Offered to employees of tax-exempt organizations or public schools ▪ Deductible (pre-tax) contributions, which results in a zero-cost basis ▪ Contribution amount is limited	▪ Available to any person through either an insurance company or broker-dealer ▪ Non-deductible (after-tax) contributions, which establishes the basis ▪ Contribution amount is NOT limited

State and Local Governments offer their employees 457 plans, which have qualified features

Qualified versus Non-Qualified

A 62-year old retired individual had contributed $10,000 into an annuity. This year, she received a lump-sum payment from the annuity of $16,000. How is the distribution taxed?

	If Qualified	If Non-Qualified
Contribution:	$10,000	$10,000
Earnings:	$6,000	$6,000
Basis:		
Taxable:		

Equity Indexed Annuities (EIAs)

EIAs are similar to:

- Fixed annuities since they offer a guaranteed minimum return
- Variable annuities since they offer returns which vary (based on index performance)

Investor's return:

- If the index performs poorly, the investor will still earn the minimum guaranteed rate
- If the index performs above a preset level, the investor will earn a return that exceeds the minimum guaranteed rate
  - Some contracts are issued with a *participation* rate which limits the amount of the index's appreciation that the client will earn

Annuity Suitability Issues

Target Audience:	▪ Generally for investors within the age range of 30 to 55 ▪ Persons seeking tax-deferred growth or to offset inflation ▪ Persons who have maximized qualified plan contributions
Unsuitable for:	▪ Senior citizens or persons who are seeking immediate tax benefits ▪ Investors with short investment time horizons
Concerns with 1035 Exchanges:	▪ Customer must benefit from the new annuity ▪ Any benefits potentially lost in the exchange ▪ Whether the RR recommending the exchange has signed off and the application was approved by principal

Activity

Match each description to the appropriate term.

EQUITY INDEXED ANNUITY	Settlement option with the greatest risk
1035 EXCHANGE	Guarantees payments for life regardless of life expectancies
QUALIFIED ANNUITY	Distributions are fully taxable
MORTALITY RISK EXPENSES	Provides a potential return above a guaranteed minimum amount
STRAIGHT LIFE ANNUITY	Allows for movement from one annuity to another without a taxable event

Municipal Fund Securities

Local Government Investment Pools (LGIPs)	Prepaid Tuition Plans	529 Plans
▪ Created by state and local governments to provide municipal entities a place to invest funds ▪ Government entities purchase interest in the trust (LGIP) ▪ Provides safety and diversification ▪ Not open to the public	▪ A type of college savings plan ▪ Purchaser buys college tuition credits • Locks in tuition costs at current levels • Protects against future cost increases ▪ Not self-directed	▪ Primarily a type of college savings plan ▪ Account owner chooses a plan, but may alter the investment direction ▪ More detail on next slide

529 Plans

- Funded with after-tax dollars; investment grows tax-deferred
- Money invested in one state's plan may be used in another state
- To avoid gift tax, the maximum contribution is $16,000 per person, per year (doubled for married couples)
  - The plan allows for front-loading five years of contributions ($80,000 per person or $160,000 for married couples)
- A federal tax exemption is provided to the beneficiary for qualified withdrawals:
  - College tuition, books and supplies, room and board, a maximum withdrawal of $10,000 per year for tuition and books for grades K-12, and up to $10,000 (lifetime limit) to repay a qualified student loan or expenses related to certain apprenticeship programs

529 Plans and 529 ABLE Plans

529 plans may be direct-sold or adviser-sold:

DIRECT-SOLD	ADVISER-SOLD
▪ Involves no salespersons; instead, the plan is sold directly through the 529 savings plan's website or through the mail	▪ The plan is sold through a broker-dealer that has entered into a selling agreement with the primary distributor of the 529 plan

529 ABLE (529A) Plans (Achieving a Better Life Experience)

- Available to individuals who are disabled and are receiving Social Security disability, Medicaid, or private insurance payments
  - Maximum contribution is $16,000 per year (no front-loading)
  - Disability payments continue if account value does not exceed $100,000
  - Distributions are tax-free if used to pay qualified expenses

529 Plan

(Funded with after-tax contributions)

Question

As it relates to the college savings plans, which of these statements is/are TRUE?
Circle all that apply.

I. Local Government Investment Pools are investments for municipal entities.
II. A prepaid tuition plan allows individuals to decide how their money is invested.
III. A 529 plan allows investors to front load the plan with five years' worth of contributions.
IV. A 529 ABLE account permits a disabled person to continue receiving Medicare payments.

Chapter 9 – Alternative Investments

Key Topics

1	2	3
EXCHANGE-TRADED FUNDS AND EXCHANGE-TRADED NOTES Learn about the types of exchange-traded funds and exchange-traded notes.	HEDGE FUNDS AND REITS Learn about hedge funds and the characteristics of real estate investment trusts (REITs).	LIMITED PARTNERSHPS Learn about the characteristics and different types of limited partnerships.

ETFs Compared to Index Funds

Exchange-Traded Fund (ETF)	Index Fund
Portfolio consists of a basket of securities which mirror an index (Low expenses)	Portfolio consists of a basket of securities which mirror an index (Low expenses)
Shares trade in the secondary market; may be sold short	Shares are redeemed by the fund; cannot be sold short
Commission is paid on trade	Usually have no sales load
Intra-day pricing	Forward pricing; once daily
Leveraged and inverse ETFs exist	Do not allow leverage

Inverse and Leveraged ETFs

Inverse ETF

- Designed to perform in a manner that's inverse to the index it is tracking
  - If the index falls by 2% on the day, the ETF should rise by approximately 2%
  - Similar to short selling without unlimited risk

Leveraged ETF

- Constructed to deliver 2x or 3x the index it is tracking
  - May be leveraged inverse ETF
  - If the index rises by 1.5%, a 2x long ETF should rise by approximately 3%

The portfolios reset daily and, as a result, are designed for *short-term trading*; they take advantage of intraday swings in the index

Exchange-Traded Notes (ETNs)

ETNs are structured products and are issued as *unsecured* debt. They trade on exchanges, have low fees, and provide access to challenging areas of the market.

ETN → Linked to: → Performance of a market index or other benchmark

ETN Details:

- Backed by *only the full faith and credit of the issuer* (credit risk)
- Not principal protected, but return is linked to performance of an asset
- May be purchased on margin, sold short, and traded on exchange
- Issuer obligated to deliver *performance at maturity*

Activity

Read each statement and determine which security it describes.

LINKED TO THE PERFORMANCE OF A BENCHMARK, BUT NOT PRINCIPAL PROTECTED	
SIMILAR TO AN ETF, BUT ITS SHARES ARE FORWARD PRICED (ONCE PER DAY)	
SIMILAR TO AN INDEX FUND, BUT ITS SHARES TRADE IN THE MARKET AND CAN BE SOLD SHORT	
PERFORMS IN A DIRECTION THAT'S OPPOSITE ITS BENCHMARK	

Alternative Packaged Products

Hedge Funds	▪ Investment fund generally for wealthy investors ▪ Not considered a registered investment company ▪ Uses exotic strategies involving derivatives, leverage, and selling short ▪ May place restrictions on investors withdrawing money (lack of liquidity) ▪ Not required to publish NAV on a daily basis
Private Equity and Venture Capital Funds	▪ Similar to hedge funds in the method of raising capital through the sale of limited partnership units under the Regulation D exemption ▪ Typically available to accredited investors only ▪ Unregulated; limited trading opportunities

Real Estate Investment Trust (REIT)

A company that manages a portfolio of real estate investments in order to earn profits for its shareholders

Types of REITs	Tax Benefit	Characteristics
1. Mortgage/Debt: issue secured loans that are backed by real estate purchases 2. Equity: own and operate income-producing real estate 3. Hybrid: combination of mortgage and equity REITs	▪ No taxation on income if ______% of it is distributed • Doesn't pass through losses (unlike limited partnerships) • 20% of distributed income is tax-deductible	▪ Subject to registration requirements of the Securities Act of 1933 ▪ Shares trade in the secondary market and are marginable ▪ Distributions don't qualify for the dividend exclusion rule ▪ Attractive for investors seeking current income

Methods of Offering REITs

1. Registered, exchange-listed, and publicly traded
   - Liquid
2. Registered, but not exchange-listed (non-traded)
   - Often have a lack of liquidity
3. Unregistered; offered through a private placement
   - Illiquid

Activity

Which statements are TRUE regarding real estate investment trusts (REITs)? Circle all that apply.

I. Hybrid REITs invest in both mortgages and properties.

II. REITs are not taxed on income if they distribute a minimum of 90%.

III. Their shares are exempt from the registration requirements of the Securities Act of 1933.

IV. Shares are not traded in the secondary market and are redeemed by the issuer.

Advantages of Limited Partnerships

A limited partnership is a business venture that's designed to pass through both income and losses to investors

Flow-through of income (no double taxation) and expenses	▪ Income flows through as passive income ▪ A portion is taxed as ordinary income (20% is deductible)
Limited Liability	▪ Limited partners are only liable for the amount invested and any loans assumed (i.e., the amount they have at risk)

Disadvantages of Limited Partnerships

Illiquidity
- Typically not publicly traded
- General partner's approval may be required to sell

Lack of Control
- Limited partners have limited voting power and no managerial authority

Effects of Tax Law Changes

Increased Tax Complexity

Calls to Contribute Additional Funds

General and Limited Partners

General Partner
▪ Day-to-day manager with unlimited personal liability ▪ Must have at least a 1% interest ▪ Fiduciary toward limited partner ▪ Last at liquidation: • Secured Lender • General Creditor • Limited • General

Limited Partner
▪ Passive investor with limited liability ▪ Contributors of capital ▪ Have certain rights: • Lend money to the partnership, inspect books, and compete ▪ Ways to endanger "limited" status: • Negotiate contracts, hire/fire employees, or lend name

Offering Practices

Public Offering	Private Placement
▪ If a sponsor (GP) conducts a public offering of securities: • Registration is required under the Securities Act of 1933 • An underwriter is used to facilitate the offering • A prospectus is used as the disclosure document	▪ If a sponsor (GP) conducts a private placement of securities: • Securities qualify for an exemption from registration through Reg. D

Real Estate Programs

Category	Details
Raw Land	Speculation on land appreciation; no positive cash flow or depreciation
New Construction	Risks of overbuilding, cost overruns, long duration, etc.
Existing	Existing cash flow, but potential problematic tenant issues (e.g., long-term leases)
Low Income (Government Assisted)	Beneficial potential tax credits; little chance of appreciation; high maintenance costs

Oil and Gas Programs

Category	Details	Risk
Exploratory	High risk with high potential reward	
Developmental	Drilling near an existing field	
Balanced	Combination of exploratory and developmental	
Income	Purchase of existing wells; creates immediate cash flow	

DPPs – Risk Summary

Investors should be aware of the following risks of DPP investments:

- Management ability of the general partner(s)
- Illiquid nature and potential loss of capital
- Unpredictable income
- Potential future mandatory assessments
- Rising operating costs
- Changes in tax laws and government regulations
- Economic and environmental occurrences

Successfully investing is about managing risk, not avoiding it.

Investor Considerations

Investor Certification

- Registered representatives are required to certify they have informed their customers of all relevant facts and lack of marketability
- Investors must have sufficient net worth and income to absorb a loss of the entire investment

Discretionary Accounts

- Registered representatives are not permitted to exercise discretion involving client investments in DPPs

Activity

Read each statement and fill in the blanks.

1. Limited partnerships pass through ____________________________________.
2. The general partner must invest no less than _____________ in the partnership.
3. Limited partners ________________ have a fiduciary responsibility to the partnership.
4. Limited partnerships generally avoid registration by offering securities through ___________________________.
5. _________________ is considered the riskiest real estate program.
6. Overbuilding is a risk in a _____________________________ limited partnership.
7. The riskiest oil and gas program is an _________________________________ partnership.

Activity

Which statements are TRUE regarding limited partnership investments? Circle all that apply.

I. Partnerships may require limited partners to deposit additional funds.
II. Investors are not required to receive information regarding the risks of the investment.
III. Registered representatives can use discretion to purchase limited partnerships for customers.
IV. Customers must provide their RRs with written approval to purchase limited partnership interests.

Chapter 10 – Option Fundamentals

Key Topics

1	2	3	4	5
BUYERS AND SELLERS Learn about the role of options buyers and sellers.	CALLS AND PUTS Learn the difference between Calls and Puts, and what it means to be long or short those positions.	OPTIONS TERMINOLOGY Learn about options terminology.	THE OCC Learn about the role of the Options Clearing Corporation (OCC).	SPECULATION AND HEDGING Learn about how options can be used for purposes of either speculating or hedging.

Options Overview

An option is a contract between two parties

BUYER

- Long the option
- Pays the premium (DEBIT)
- Acquires a right/control

SELLER

- Short the option
- Receives the premium (CREDIT)
- Assumes an obligation

Types of Contracts

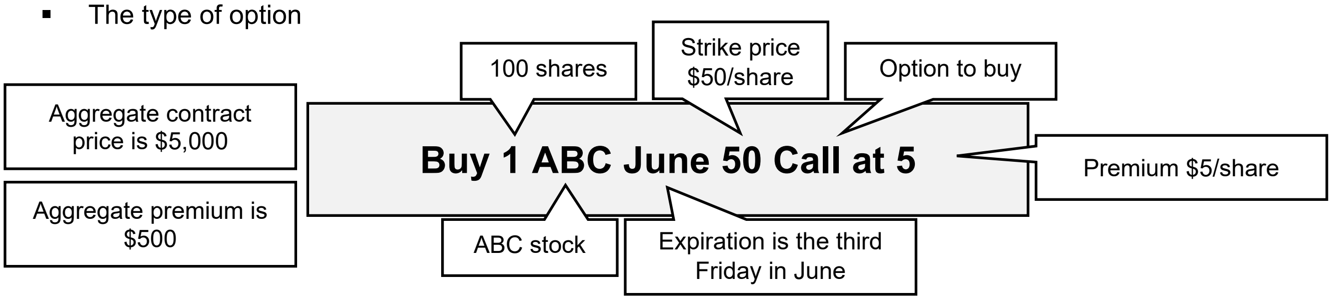
If an option is exercised…

	BUYER'S RIGHT	SELLER'S OBLIGATION
CALL	To buy stock	To sell stock
PUT	To sell stock	To buy stock

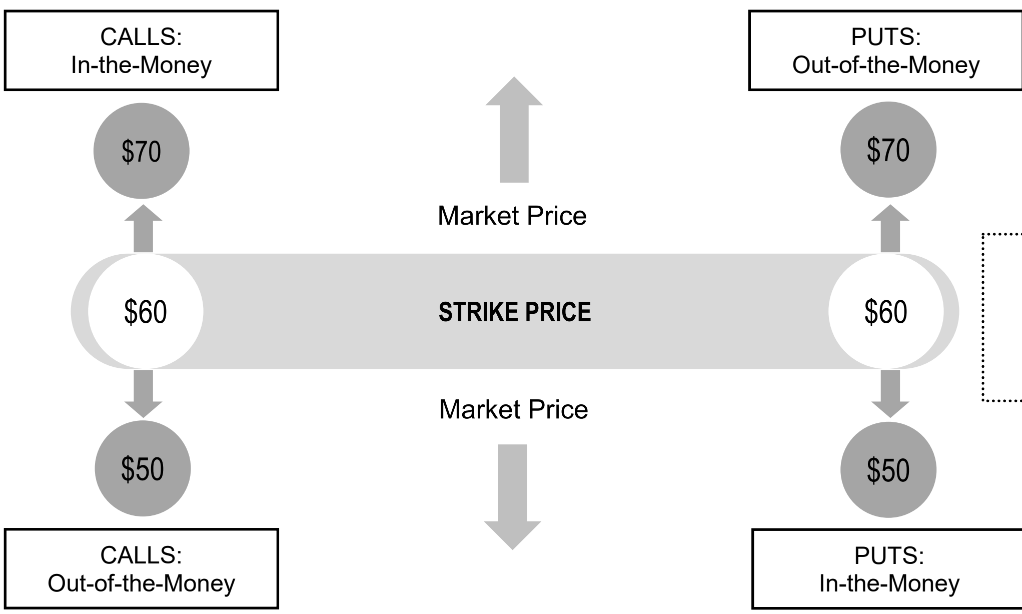
Standardized Components

An equity option is a contract to buy or sell a specific number of shares of a particular stock at a fixed price over a certain period and is described by:

- The name of the underlying security
- The expiration month of the contract
- The exercise (or strike) price
- The type of option

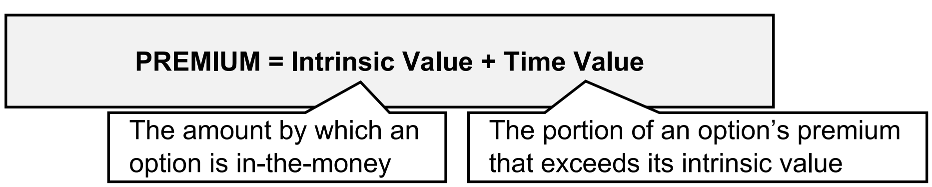


In-the-Money Versus Out-of-the-Money



Calls and Puts are At-the-Money if the option's strike price is equal to the stock's market price.

Terminology



A contract has intrinsic value if it's in-the-money.

- Its intrinsic value equals its in-the-money amount.
- It has **zero** intrinsic value if it's out-of-the-money or at-the-money.

Time value is based on:

- Time left until expiration
- Market volatility

The concept of <u>IN</u>trinsic value is tied to options that are <u>IN</u>-the-money.

Activity

Read each description and then match it to the appropriate term.

Term	Description
INTRINSIC VALUE	Owner has right to buy stock; seller has obligation to sell the stock at fixed price
TIME VALUE	Pays the option's premium; is long the option
OPTION	A contract entered into by two parties
CALL OPTION	The amount by which an option is in-the-money
PUT OPTION	Receives the option's premium; is short the option
BUYER	Owner has right to sell stock; seller has obligation to buy the stock at fixed price
SELLER	The portion of an option's premium that exceeds its intrinsic value

Activity

Fill in the table.

Option and Premium	Market Price	In, At or Out-of-the Money	Intrinsic Value	Time Value
ABC Jun 35 Call at 3	36	IN		
DEF Apr 60 Put at 7	54	IN		
RST Jul 35 Put at 1.50	35	AT		
XYZ Aug 110 Call at 2	109	OUT		

Basic Options: Long and Short Calls

	CALLS	
	BUYER, OWNER, LONG	**SELLER, WRITER, SHORT**
Rights	Buy stock at strike price	None
Obligations	None	Sell stock at strike price
Strategy	Bullish ↑	Bearish ↓
Breakeven	Strike price + premium	Strike price + premium
Maximum Gain	Unlimited	Premium
Maximum Loss	Premium	Unlimited

Creating a basic option position is considered speculative.

Breakeven – Long Call

When the current market value of XYZ stock is at 47:

Buy 1 XYZ Feb 45 Call at 3

Breakeven:

45 + 3 = 48

Debit (Cash Out)	Credit (Cash In)
3.00 45.00	
48.00	

Breakeven – Short Call

When the current market value of XYZ stock is at 47:

Sell 1 XYZ Feb 45 Call at 2.50

Breakeven:

45 + 2.50 = 47.50

Debit (Cash Out)	Credit (Cash In)
	2.50 45.00
	47.50

Basic Options: Long and Short Puts

	PUTS	
	BUYER, OWNER, LONG	**SELLER, WRITER, SHORT**
Rights	Sell stock at strike price	None
Obligations	None	Buy stock at strike price
Strategy	Bearish ↓	Bullish ↑
Breakeven	Strike price – premium	Strike price – premium
Maximum Gain	(Strike price – premium) x 100 shares	Premium
Maximum Loss	Premium	(Strike price – premium) x 100 shares

Creating a basic option position is considered speculative.

Breakeven – Long Put

When the current market value of ABC stock is at 92:

Buy 1 ABC Apr 95 Put at 3.50

Breakeven:

95 – 3.50 = 91.50

Debit (Cash Out)	Credit (Cash In)
3.50	95.00
	91.50

Breakeven – Short Put

When the current market value of DEF stock is at 32:

Sell 1 DEF Nov 35 Put at 4

Breakeven:

35 – 4 = 31

Debit (Cash Out)	Credit (Cash In)
35.00	4.00
31.00	

Question

Which of the following statements are TRUE with regards to Long and Short Call and Puts?

I. Buyers of Calls are bullish (i.e., they want the stock to rise).
II. Sellers of Calls are bearish (i.e., they want the stock to fall).
III. Breakeven for the seller of a call is the strike price minus the premium.
IV. Breakeven for the buyer of a put is the strike price plus the premium.
V. The maximum loss for a buyer of a call is the premium.
VI. The maximum loss for a buyer of a put is the premium.

Speculation Versus Hedging

Speculation	Hedging
▪ Options can be purchased or sold to generate a profit ▪ The investor has no existing position in the underlying security. ▪ Long Calls and Short Puts are bullish ▪ Long Puts and Short Calls are bearish	▪ Purchasing options to protect the movement of an underlying security ▪ Long puts protect long stock positions ▪ Long calls protect short stock positions

The Life of an Option

1. Expire Worthless	2. Exercised	3. Liquidated
If an option is at- or out-of-the-money on the expiration date, the holder of the contract has no incentive to exercise the contract. Also, since there would be no time remaining on the contract, the contract **expires worthless**. The expiration triggers: ▪ The maximum profit for a seller of a call or put ▪ The maximum loss for the buyer of a call or put	The investor who is long an option has the exclusive right to exercise the option at her own discretion. The two styles of exercise are: ▪ American Style – options may be exercised at any time up until expiration ▪ European Style – options may only be exercised on the day of expiration	Liquidating (closing out) an option position is essentially an alternative to exercising the option. The investor executes an opposite transaction on the same series of option. In other words, what was bought is sold or what was sold is bought.

Liquidate, Trade, or Close-Out

Opening Transaction	Closing Transaction
Opening Purchase (Long/Buyer)	Closing Sale
Opening Sale (Short/Seller)	Closing Purchase

NOTE:
Profit or loss is determined by the difference between the price paid for option and price received from sale.

Example: Exercise Versus Close-out

When ABC's current market value is 64, an investor buys:

1 ABC Dec 65 Call at 3

Later, ABC increases to **72**.
Now, the Dec 65 Calls are trading at **8**.

Scenario #1: Exercised, stock sold	
DEBIT (CASH OUT)	CREDIT (CASH IN)
300 6,500	7,200
6,800	7,200
	+400

Scenario #2: Closed out at new premium	
DEBIT (CASH OUT)	CREDIT (CASH IN)
300	800
300	800
	+500

Includes $100 of time value

The OCC and Options Trading

The Options Clearing Corporation:

- Issues and guarantees listed option contracts
- Eliminates counterparty risk by acting as the third party in all option transactions
  - Acts as the buyer for all sellers and the seller for all buyers
- Deals directly with broker-dealers, not customers
- Creates and requires the distribution of the Options Disclosure Document (Characteristics and Risks of Standardized Options)
- Regulates exchange-traded options

Trade settlement between broker-dealers and the OCC is next business day (i.e., T + 1).

Deadlines for Equity Options

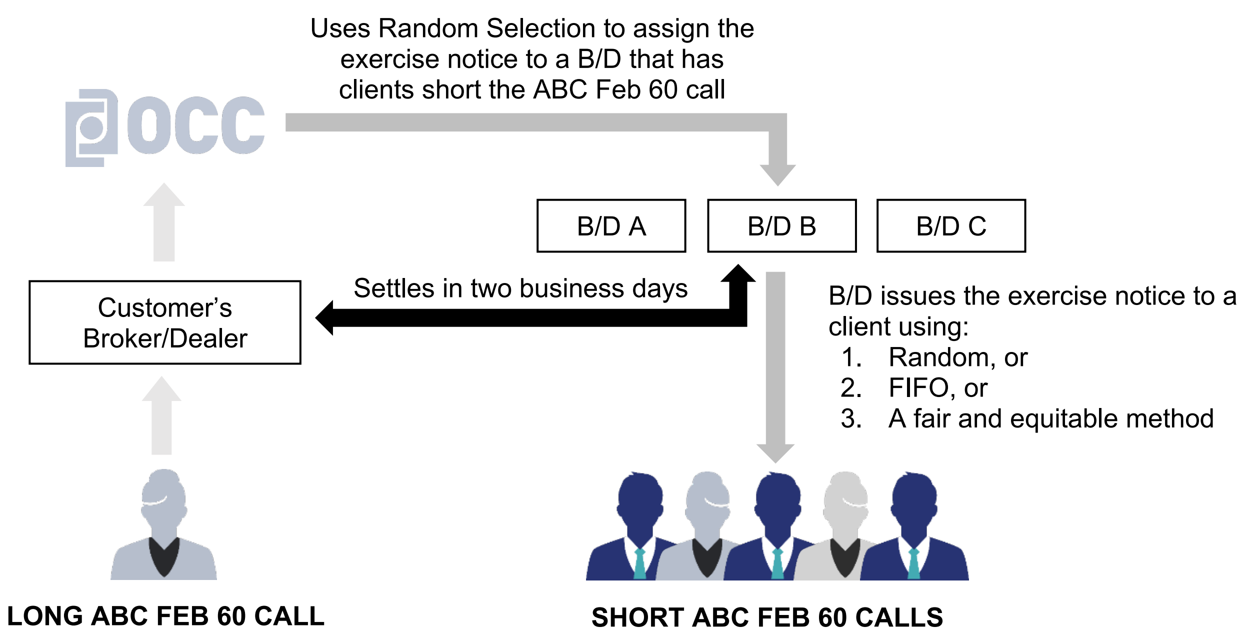
OCTOBER						
SUN	MON	TUES	WED	THURS	FRI	SAT
		1	2			
6	7	8	9			
13	14	15	16	17	18	19
20	21	22			25	26
27	28	29				

Trading ceases at 4:00 pm ET

Options expire at 11:59 pm ET

Buyer must submit exercise notice to her broker by no later than 5:30 pm ET

Exercising an Equity Option



Index Options

- Index options provide the opportunity to speculate on (or hedge against) the movement of the market, rather than movement of a specific stock.
- One of the more popular index options is the SPX, which tracks the S&P 500 Index.
- Unlike equity options, these options are cash settled.
  - The seller is obligated to deliver the cash difference between the closing index value and the strike price.

Question

Which of the following statements are TRUE with regards to options trading? Circle all that apply.

I. The OCC issues and guarantees all contracts and deals directly with broker-dealers, not customers.
II. Trade settlement between broker-dealers and the OCC is same business day.
III. Equity options expire at 11:59 pm ET on the third Friday of the expiration month.
IV. Index options provide the opportunity to hedge against the movement of the market, rather than movement of a specific stock.

Hedging Long and Short Positions

If investors have either long or short stock positions and want to hedge or protect against potential risk, they may **purchase options**.

To protect (or hedge) stock in a volatile market:

- When long stock: Buy a put
  - If the stock decreases, the gain on the put can offset the loss on the stock
- When short stock: Buy a call
  - If the stock increases, the gain on the call can offset the loss on the stock

Covered and Uncovered Positions

Covered Call: ▪ A call is written against stock that's already owned ▪ The sale of the call generates income, thereby increasing the yield on the underlying security ▪ Considered a conservative option strategy	**Uncovered Call:** ▪ A Call is written against stock that's not owned ▪ Considered the most speculative option position with unlimited potential risk
Covered Put: ▪ A put is written when the investor has a sufficient amount of cash to satisfy the obligation of being exercised against on the put	**Uncovered Put:** ▪ A Put is written without having sufficient cash to meet the obligation of being exercised against on the put ▪ There is significant risk if the underlying security falls

Chapter 11 – Offerings

Key Topics

1	2	3	4
PRIMARY MARKET AND UNDERWRITING COMITTMENTS	THE SECURITIES ACT OF 1933	EXEMPT SECURITIES AND TRANSACTIONS	MUNICIPAL OFFERINGS
Learn about the primary market and issues regarding underwritings.	Learn about the process of registration and various disclosure documents.	Learn about how to be exempt from registration and other related rules.	Learn about the process of underwriting municipal securities and available information sources.

Types of Financing Transactions

	Public Offerings ('33 Act)	Private Offerings (Reg. D)
Timing	Initial Public Offering (IPO) Subsequent Raises (Follow-on offerings)	Exempt offering that does not involve a public distribution
Proceeds	Primary and/or secondary	

A Private Investment in Public Equity (PIPE) is the private raising of capital by a company that's publicly traded

Underwriting Commitments

Types of Underwriting	Comments	Unsold shares are directed to:	Principal/Agent
Firm Commitment	Syndicate “takes down” the entire offering		
Best Efforts	Syndicate sells what it can		
Best Efforts All-or-None	Offering is cancelled if all shares are not sold		
Best Efforts Mini-Maxi	Offering is cancelled if a set minimum is not sold		
Stand-By	Syndicate agrees to buy any shares that are not bought through a rights offering		

Additional Underwriting Issues

Shelf Registration	▪ Gives certain issuers the flexibility of selling new issues on a delayed or continuous basis ▪ May be permitted for up to three years ▪ Issuer and underwriter can adjust the terms of the offering to reflect the market conditions at the time of the sale
Market-Out Clause	▪ Provides the underwriter with the ability to cancel the agreement ▪ Based on events that make marketing the issue difficult or impossible • Reasons are limited and disclosed in the clause

Question

As it relates to financing and underwriting issues, which of these statements is/are TRUE?
Circle all that apply.

I. Public offerings are only used for primary offerings

II. The underwriter in a firm commitment underwriting is acting as a principal

III. The underwriter in a best efforts underwriting is acting as an agent

IV. Shelf registration allows an underwriter the ability to offer securities once within a 3-year period

The Primary Market

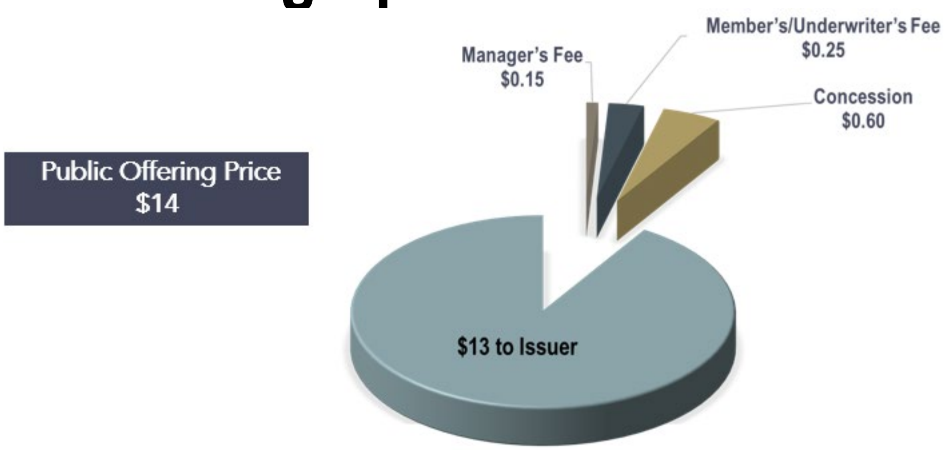
Issuer
- Needs capital
- Hires underwriter

Underwriting Manager (Investment banker)
- Facilitates distribution
- Assumes liability that varies with offering type
- Signs Underwriting Agreement with issuer

Syndicate Members
- B/Ds assisting in selling and sharing
- Signs Syndicate Agreement with manager

Selling Group
- B/Ds accepting no liability, assist in sales only
- Signs Selling Agreement with manager

The Underwriting Spread



Distribution of the Spread

Underwriter purchases from issuer at $13 and sells at the POP of $14

Manager's Fee	Member's U/W Fee	Concession
$.15	$.25	$.60

Example: 1,000 shares are sold to a customer at $14 per share

	Manager sells from its allocation	Member sells from its allocation	Selling Group sells
Customer pays:			
Issuer receives:			
Manager:			
Member:			
Selling group:			

Question

Check the participant(s) that may have liability for unsold portions of a new issue.

I. Managing underwriter
II. Syndicate member
III. Selling group

Activity

For a new offering, identify how the underwriting spread is distributed for sales that are credited to the different market participants.

	1	*2*	*3*
	The Managing Underwriter	**The Syndicate Member**	**The Selling Group**
Manager's Fees			
Member's Fee			
Concession			

Securities Act of 1933

Scope of the law

- To provide for "full and fair disclosure"
- Prospectus must precede or accompany any solicitation of a new issue (no marking or highlighting)
- SEC "no approval clause"

Requires SEC registration of new issues

- Registration exemptions are provided to issuers of certain securities and specific types of transactions

Liability

- Unconditional for issuers regarding information to investors
- Conditional for the underwriters that are required to perform:
  - Reasonable investigation
  - "Due diligence"

The Registration Process

Pre-Registration Period	Cooling-Off Period	Post Registration Period
▪ Document preparation and due diligence begins ▪ Registration statement is completed ▪ B/Ds and RRs may have no communication with the public	▪ File the registration statement with the SEC ▪ Issuer distributes preliminary prospectus (Red Herring) ▪ "Blue Sky" the issue ▪ Final due diligence meeting held	▪ Effective date ▪ Sales confirmed and Final Prospectus delivered ▪ Must contain the SEC no-approval clause

After-Market Prospectus Requirements

Distribution participants that sell securities in the after-market must provide purchasers with a copy of the prospectus for a specific period from the effective date.

For a non-listed IPO	90 Days
For a non-listed, follow-on offering	40 Days
For an IPO of a security to be exchange-listed (NYSE or Nasdaq)	25 Days
For an exchange-listed, follow-on offering	No Requirement

Types of Prospectuses

A prospectus is any communication, written or broadcast, that offers a security for sale

Statutory Prospectus	Condensed form of the registration statement that provides detailed information on the offering
Preliminary Prospectus	Also referred to as a Red Herring; used during the cooling off period ▪ Omits the offering price, underwriting and dealer discounts, and proceeds to the issuer ▪ Once final offering price is set, a final statutory prospectus is filed
Summary Prospectus	Short-form prospectus typically used for mutual fund offerings ▪ Investor must be informed of statutory prospectus
Free Writing Prospectus	Any communication that does not meet the standards of a statutory prospectus ▪ Includes a legend recommending that investors read the statutory prospectus • Examples: offering term sheets, e-mails, press releases, and marketing materials

Activity

Read each situation and determine the period in the registration process to which it applies.

BLUE SKY THE OFFERING	
NO COMMUNICATION WITH THE PUBLIC	
DELIVER RED HERRING TO PROSPECTIVE PURCHASERS	
SALES CONFIRMED AND PROSPECTUS DELIVERED	

Activity

Types of Prospectuses – Match the prospectus with its correct description.

SUMMARY PROSPECTUS	Condensed form of the registration statement with offering price and effective date
FREE WRITING PROSPECTUS	Short-form prospectus
RED HERRING	Preliminary prospectus
STATUTORY PROSPECTUS	Offering term sheets, e-mails, press releases, and marketing materials

Exempt Securities

The following securities are exempt from SEC registration:

- U.S. Government and Agency securities
- Municipal securities
- Securities issued by banks
- Securities issued by non-profit organizations
- Short-term corporate debt; maturities not exceeding 270 days
- Securities issued by Small Business Investment Companies

All remain subject to antifraud provisions of the Act

Exempt Transactions

Regulation D – Private Placement

- A sale of securities directly to "accredited" investors and/or to a limited number of non-accredited investors
- Unlimited number of accredited investors
  - Officers/directors of the issuer
  - Institutions
  - Individuals who have met a financial test:
    - Net Worth of:____________________________________
      OR
    - Annual Income of:_________________________________
      ____
- No more than ______ non-accredited investors

Regulation D – Private Placement

Purchaser Representative (no specific qualifications)

- Appointed by a non-accredited investor to evaluate the risks and merits of an offering
- May not be an officer, director, or greater than a 10% owner of issuer, unless related to the investor

Private placement memorandum (disclosure document)

- Not required if all investors are accredited
- Required for all investors if any non-accredited investors are included
- Includes the use of proceeds, suitability standards, and financials

Rule 144

Permits the sale of restricted and control stock

Restricted Stock	Unregistered stock that's acquired through a private placement or as compensation for senior executives of an issuer
Control Stock	Registered stock that's part of an issuer's public float and purchased in the open market by officers, directors, or greater than 10% shareholders of the issuer

If either restricted or control stock is being sold, the SEC must be notified

- Form 144 filed by the time the sell order is placed

Rule 144A

Provides an exemption for restricted securities that are sold to Qualified Institutional Buyers (QIBs)

- QIB is defined as an institution that has at least $100 million under management
- 144A securities may be equity or debt securities which are offered by domestic or foreign issuers
- However, if securities of the same class are listed on an exchange, they are ineligible for 144A exemption
- Typically used for corporate debt offerings

Remember, QIBs are institutions, NOT individuals
(i.e., a wealthy individual is not a QIB).

Rule 145

This rule regulates the reclassification of one security into a new security

Reclassifications are generally considered sales and subject to registration and prospectus requirements

SUBJECT TO RULE 145	▪ Substitutions of one security for another ▪ Securities that are a result of a merger/acquisition ▪ Securities issued after a transfer of assets from one corporation to another
NOT SUBJECT TO RULE 145	▪ Stock splits ▪ Reverse stock splits ▪ Changes in par value

Rule 147 and 147A

Intrastate Offering

Provides an exemption for the sale of securities to residents of one state if:

- The corporation has its principal place of business in the state and meets **any one of the following four requirements:**
    1. 80% of the assets located
    2. 80% of the revenues generated
    3. 80% of the proceeds used, or
    4. A majority of issuer's employees are based in the state
- Resales to non-residents are prohibited for **six months** from the end of the distribution

Activity

Identify whether the statement applies to Rule 147 or Reg. D. Read each statement and fill in the blanks.

___________ Investors must be residents of one state.

___________ Sales are limited to a maximum number of non-accredited investors.

___________ Non-residents cannot purchase stock for six months after the last sale of the offering.

___________ An offering memorandum is the disclosure document.

Activity

Match each description to the appropriate Rule.

RULE 144	Sales of restricted and control stock
RULE 144A	Reclassifications of securities
RULE 145	Qualified institutional buyers

Issuing G.O. and Revenue Bonds

Municipal debt issues are exempt from the registration and prospectus requirements

Issuing General Obligation (GO) Bonds	Issuing Revenue Bonds
▪ Usually requires voter approval ▪ Subject to debt limitations placed on the municipality which limits its ability to add debt above its debt ceiling	▪ Doesn't require voter approval since they're backed by fees that are paid for use of the facility or service ▪ A consultant is hired to produce a feasibility study

Selecting an Underwriter

There are two different methods that a municipality may use when selecting its underwriter

Competitive Sale	Negotiated Sale
▪ Notice of Sale advertises the offering to underwriters • The Notice is prepared by the issuer • Contains relevant details about the issue ▪ Issuer is inviting underwriters to submit sealed bids • Underwriting generally awarded to lowest bid	▪ Issuer appoints its managing underwriter ▪ Both issuer and underwriter "negotiate" terms of the deal

Municipal Advisor – typically employed by a municipality to assist in selecting an underwriter

Municipal Documents/Information

Official Statement	Used by municipal issuers as a disclosure document
Legal Opinion	Prepared by Bond Counsel which renders its opinions as to: ▪ Issuer's legal, valid, and enforceable obligation ▪ Tax exempt status of the issue
New Issue Confirmations	Provided to purchasers, along with a copy of the official statement, by no later than settlement date
Committee on Uniform Securities Identification Procedures	Underwriters are expected to apply for CUSIP numbers that are used to identify unique securities (e.g., by maturity)

Electronic Municipal Market Access (EMMA)

MSRB website used by issuers and underwriters to submit documents

Electronic Access

- Provides electronic public access to information about the municipal market
  - Trade activity
  - Market statistics

Documents

- Various documents:
  - Pre-sale documents
  - Official statements
  - Continuing disclosures

Plan Info

- Includes 529 plan information

Question

Circle the statement(s) that is/are TRUE regarding municipal documents?

I. When an official statement is prepared by an issuer, it must be provided to any purchaser of the new issue.
II. A legal opinion guarantees the payment of principal and interest on a bond.
III. The bond counsel for the issuer prepares the legal opinion.
IV. The MSRB requires the preparation of an official statement.

Chapter 12 – Orders and Trading Strategies

Key Topics

1	2	3	4
TRADE CAPACITY Learn about the two different ways that broker-dealers execute trades.	5% POLICY Learn about FINRA's guideline for the commissions, markups, and markdowns that firms charge.	TYPES OF TRANSACTIONS Learn about purchases, long sales, and short sales.	TYPES OF ORDERS Learn about how market orders, limit orders, and stop orders are used.

How Broker-Dealers Function

BROKER
- Remember, A – B – C
- **A**gency trades are executed by **B**rokers and they charge **C**ommissions
- Brokers don't assume risk

DEALER
- Remember, P – D – M
- **P**rincipal trades are executed by **D**ealers and they charge **M**arkups and/or **M**arkdowns
- Dealers assume risk

Markups and Markdowns

Market maker quotes are inter-dealer, but are adjusted when trading with retail customers
- Allows dealers to profit on trades with customers
- Price adjustments are built into the trade, but are generally disclosed on the confirmation

This quote shows the prices at which the market maker will buy from and sell to other dealers:

Bid	Ask
17.05	17.15

Factoring in a $.05 markdown or markup, the prices to retail clients will be as follows:

Price for Selling Client	Price for Buying Client
17.00	17.20

Fair Prices and Commissions

The Policy	▪ FINRA has established a 5% Policy • The policy is not a rule, but rather a guideline for commissions, markups, and markdowns – Certain transactions may justify a higher markup/markdown – Other transactions may justify a lower markup/markdown
The Factors That Influence the Charge	▪ Influential Factors • Type of security involved (equity or debt) • Availability of the security • Price • Amount of money involved • Pattern of markups • However, the type of client or whether the firm will profit is NOT relevant

The 5% Policy

The policy applies to proceeds transactions

- When a client directs a B/D to liquidate securities and use the proceeds to buy other securities
  - Markup is calculated based on one trade (as if done for cash)

The policy excludes:

- Trades involving securities sold by prospectus or offering circular (e.g., new issues, mutual funds, variable annuities)
- Exempt securities (e.g., U.S. government and municipal securities)

Activity

Read each statement and determine whether it is TRUE/FALSE.

A MARKUP IS APPLIED TO THE ASK PRICE WHEN A MARKET MAKER SELLS TO A CUSTOMER	
TOTAL PRICE PAID BY CUSTOMERS IS THE ASK PRICE	
FINRA'S 5% POLICY ALLOWS A BROKER-DEALER TO CHARGE ENOUGH TO MAKE A PROFIT	
THE 5% POLICY APPLIES WHEN A CUSTOMER SELLS A SECURITY AND USES THE PROCEEDS TO PURCHASE ANOTHER SECURITY	

Discretionary Orders

For Discretionary Accounts:
When discretion is granted to a registered representative, it must be documented when used ▪ If the trading decision was made by the representative without consent to the specific trade, the order ticket must state that it was *discretionary* ▪ If the trade was executed with the client's consent, the order ticket will state *discretion not exercised*

For Non-Discretionary Accounts:
Any order ticket must indicate solicited or unsolicited ▪ If a trade was recommended by the agent and accepted by the customer, the order ticket is marked *solicited* ▪ If a trade is placed by a customer without the representative's recommendation, the order ticket is marked *unsolicited*

Types of Transactions

When an order is placed, it must be identified as either a:

Purchase	Trade may be paid in full or purchased on margin
Long Sale	Sale of securities that are owned by the customer
Short Position Created By:	Sale of securities that are not owned by the customer ▪ Customer borrows from the firm and sells ▪ Must deposit the appropriate amount of margin to borrow securities ▪ Risk is on the upside and unlimited Covered and uncovered options (i.e., the sale of call or put options) ▪ If covered, no margin is required and risk is generally limited ▪ If uncovered, margin is required and risk may be significant

Activity

Which of the following must be documented on an order ticket? Circle all that apply.

I. The order ticket must indicate if discretion was not exercised for orders executed in a discretionary account.
II. A trade recommended by an RR and accepted by a customer can be marked unsolicited.
III. A sale of securities that are not owned by a customer is documented as being sold short.
IV. All sales of options must be done in margin account.

Types of Orders

Market Order	▪ Customer <u>wants</u> to buy or sell ▪ Customer specifies the security and size of the order only ▪ Order is immediately executed at the best price available

Limit Order	▪ Customer only wants to buy or sell at a set price or better
	▪ Customer specifies the security, size, and price
	▪ Order is only executed if the limit price is able to be met
	  • Buy limit: at preset price or lower
	  • Sell limit: at preset price or higher

Buy Limit Order

An investor is interested in ABC stock, which is currently trading at 30.75. Rather than placing a market order, she enters a buy limit order

- Buy 1,000 ABC at $30

Sell Limit Order

ABC is currently trading at $29.40 and an investor who is long the stock is willing to sell her shares. Rather than placing a market order, she enters a sell limit order

- Sell 1,000 ABC at $30

Activity

Match each type of order with the appropriate description.

MARKET	A buy or sell order that may not be executed
SELL LIMIT	An order that will only be executed at a specific price or lower
LIMIT	A buy or sell order that will be immediately executed
BUY LIMIT	An order that will only be executed at a specific price or higher

Stop Orders

May be used to limit a loss or protect a gain

Does not guarantee a specific price when buying or selling

If Long Stock (BULLISH)	▪ Hope – Stock rises in value ▪ Fear – Stock falls in value ▪ Need – Limit downside risk (enter sell stop order below current market value)
If Short Stock (BEARISH)	▪ Hope – Stock falls in value ▪ Fear – Stock rises in value ▪ Need – Limit upside risk (enter buy stop order above current market value)

Stop and Stop Limit Orders

Both stop and stop limit orders are "triggered" (activated) when a trade occurs at, or through, the stop price

- Sell stop orders will activate at the stop price or lower
- Buy stop orders will activate at the stop price or higher

Once a Stop Order is Activated	→	It Becomes a Market Order (Immediate Execution)
Once a Stop Limit Order is Activated	→	It Becomes a Limit Order (Uncertain Execution)

Limit and stop limit orders may not provide protection since it's possible that they may not be executed

Activity

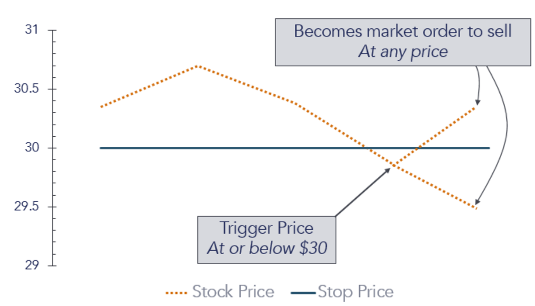
Read each statement and indicate to which order it applies.

CAN BE USED TO HEDGE A LONG POSITION	
ONCE ACTIVATED, IT MAY NOT BE EXECUTED	
ONCE ACTIVATED, IT WILL BE IMMEDIATELY EXECUTED	
CAN BE USED TO HEDGE A SHORT POSITION	

Sell Stop Order

An investor's long position in RST has risen in value; however, he's afraid of a potential decline. To limit downside risk, he enters a sell stop order

- Sell 1,000 RST at $30 stop



Sell Stop Order Example

An investor bought 1,000 shares of DEF at $34

- The stock starts trading at lower prices
- Afraid of a large loss, she enters an order:

  Sell 1,000 DEF at 30 stop
- Today's transactions:

  30.35…30.70…30.38…29.87…29.85

  Trigger Price?________ Execution Price?________

A stop order (which becomes a market order once triggered) can be executed at a price that's above or below the stop price

Buy Stop Order

An investor's short position in ABC has fallen in value; however, he's afraid of a potential increase. To limit upside risk, he enters a buy stop order

- Buy 1,000 ABC at $30 stop

Buy Stop Order Example

An investor is short 1,000 shares of DEF at $26

- The stock starts trading at higher prices
- Afraid of a large loss, he enters an order:

  Buy 1,000 DEF at 30 stop
- Today's transactions:

  29.75…29.60…29.70…30.12…30.15

  Trigger Price?________ Execution Price?________

A stop order (which becomes a market order once triggered) can be executed at a price that's above or below the stop price

Order Qualifiers

Different qualifiers can be used to influence when and if an order is executed

Two of the more popular are:

1. Day Order – unless otherwise indicated, all orders are day orders and are cancelled at day's end if not executed
2. Good-'Til-Cancelled (GTC) or Open Order – stays on the book until it expires, is executed, or is cancelled
    - May be placed for one week, one month, or other specified period
    - Entering firm should periodically check with the exchange on which the order was entered
    - May be adjusted for distributions on the security or partial execution

Activity

Which of the following is/are TRUE regarding stop and other order qualifiers? Circle all that apply.

I. A day order that's not executed on a specific day will be carried over to the next day.
II. A buy stop at $17 will be triggered if the stock trades at or below $17.
III. A sell stop at $37 will be triggered if the stock trades at or below $37.
IV. A GTC order is adjusted if the underlying stock is the subject of a stock dividend.

Chapter 13 – Settlement and Corporate Actions

Key Topics

1	2	3	4
TRANSACTION SETTLEMENT	SECURITIES DELIVERY	COPRORATE ACTIONS	FORWARDING OFFICIAL COMMUNICATIONS
Learn about the different methods of settlement based on the securities involved.	Learn about what constitutes good delivery for stock and bond transactions.	Learn about the different corporate actions, including stock splits and tender offers.	Learn about how communications are delivered to objecting vs. non-objecting beneficial owners.

The Trading Process

1. **Order entry** – Order ticket details regarding how a trade is to be executed
2. **Execution** – Occurrence of a trade in a market center
3. **Clearing** – Executing firms agree to the details of a trade; any unrecognized trades may result in a DK (Don't Know) notice
4. **Settlement** – The day on which the customer's name is placed on or taken off the issuer's books
5. **Custody** – Safeguarding of client and firm assets

Settlement Dates

Unless a specific exception is made, settlement (completion of the transaction between the firms involved) will occur as follows:

- Corporate and Municipal Securities
    - Two business days after the trade date (T + 2)
- U.S. Government Securities and Option Trades
    - Next business day after the trade date (T + 1)
- Cash Settlement for any security
    - Same day as the trade date (both sides must agree)
- Seller's Option
    - Negotiated settlement; not earlier than two business days after the trade
- When Issued
    - As determined by the National Uniform Practice Committee

Regulation T Payment Date

According to the Federal Reserve, Regulation T payment must be obtained for transactions in *either cash or margin accounts* within two business days of settlement (S + 2 or T + 4)

Exempt securities:

- Municipal
- U.S. Government

For both of these securities, payment is generally due on settlement date

Option trades requires customers to make payment on the fourth business day after the trade (T + 4)

Activity

Match each settlement to the appropriate description.

T + 2	A negotiated settlement; not earlier than two business days after the trade
T + 1	Settlement date for transactions involving U.S. government securities and options
REG. T PAYMENT DATE	Settlement date for transactions involving corporate and municipal securities
SAME DAY	Two business days after regular-way settlement (i.e., S + 2 or T + 4)
SELLER'S OPTION	Settlement for any securities using cash settlement

Depository Trust & Clearing Corporation

The DTCC provides clearing, settlement, and information services for depository-eligible securities through its subsidiaries, including:

- National Securities Clearing Corporation (NSCC) – central counterparty for clearing, settling and guaranteeing U.S. equity trades
- Depository Trust Company (DTC) – provides custody and safekeeping services for securities

Transactions among members are completed through computerized bookkeeping entries

- Referred to as book-entry settlement
- No physical delivery of securities

Good Delivery

A member firm's transfer agent makes the final determination as to whether a security is in good deliverable form and may be transferred to the new owner

Good Delivery Requirements	Units of Delivery
▪ Properly registered ▪ Properly endorsed certificate ▪ Signed stock power if the stock certificate is sent unsigned ▪ CUSIP numbers may be used to identify and clear	▪ Stock transactions must be delivered in multiples of 100 shares ▪ Bond transactions must be in $1,000 units or multiples thereof – 100 units adding to $1,000 are permissible

Restricted securities are not considered good delivery

Activity

Which statements are TRUE regarding clearing trades and good delivery of securities?
Circle all that apply.

I. Book entry requires physical delivery of securities.
II. A stock power can be used in lieu of a signed certificate.
III. Stock transactions must be delivered in multiples of 100 shares.
IV. Restricted securities can be used for good delivery.

Corporate Actions Department

Responsible for handling the following corporate actions:

- Stock splits
- Rights offerings
- Proxies
- Tender offers
- Mergers and spinoffs
- Exchange offers
- Stock buybacks

Cost Basis and Capital Events

The Purpose of a Stock Split or Stock Dividend	Company's attempt to improve marketability of its stock ▪ No economic gain or loss for holders ▪ No change to issuer's capitalization ▪ No change to holder's percentage of equity ownership
The Two Types of Stock Splits	▪ Forward (e.g., 2:1 or 3:2) – more shares, lower price ▪ Reverse (e.g., 1:5) – fewer shares, higher price • For both types, dividends per share are adjusted proportionately
Tax Treatment	▪ Additional shares received are generally not taxed as income ▪ Investor's total basis is unchanged, but basis per share is adjusted

Example – Forward Stock Split

Investor owns 100 shares of XYZ at $180 per share. XYZ Company executes a 3:2 split.

Before the split:
- Shares = 100 shares
- Basis per share = $180

Investor's total position:
$18,000

After the split:
- Shares = 150
- Basis per share = $120

Investor's total position:
$18,000

Example – Reverse Stock Split

Investor owns 1,000 shares of XYZ at $10 per share. XYZ Company executes a 1:4 split.

Before the split:	• Shares = 1,000 shares • Basis per share = $10	Investor's total position: $10,000
After the split:	• Shares = 250 • Basis per share = $40	Investor's total position: $10,000

Activity

Read each statement and determine whether it is TRUE or FALSE.

A FORWARD OR REVERSE SPLIT CHANGES THE TOTAL VALUE OF SECURITIES IN THE PORTFOLIO	
AFTER A 1 FOR 5 STOCK SPLIT, AN INVESTOR WHO OWNED 500 SHARES WILL NOW OWN 100 SHARES	
AFTER A 3 FOR 2 STOCK SPLIT, AN INVESTOR WHO OWNED 200 SHARES WILL NOW OWN 300 SHARES	
AFTER A 5 FOR 4 STOCK SPLIT, 100 SHARES AT $50 PER SHARE WILL EQUAL 125 SHARES AT $40 PER SHARE	

Tender Offers

A tender offer indicates the intent to buy shares from the owner at a fixed price

- The offer may be made by the issuer or a third party
- The offer is typically made to acquire a company or a controlling position and seat on the board of directors
- The offer may be for all of the shares or a specific percentage

Shares may only be tendered if an investor is long the stock or its equivalent, such as:

- A convertible security (conversion NOT required)
- A right or warrant (exercise NOT required)
- A call option (ONLY if exercised)

Other Corporate Actions

Preemptive Rights
- Provide existing shareholders with opportunity to purchase additional shares directly from the company
- The subscription price is set below the current market

Mergers and Acquisitions
- Merger – the combination of two companies
- Acquisition – one company purchasing and assuming control of another

Spinoffs
- A company may choose to spinoff a specific business unit to existing shareholders
- Shareholders receive new shares of the business unit

Forwarding Official Communications

Beneficial Owners – Investors whose securities are held in their name and recorded on the firm's books	
Non-Objecting Beneficial Owner (NOBO)	**Objecting Beneficial Owner (OBO)**
▪ Owners who allow issuers to contact and send communications to them directly	▪ Owners who will not release personal information to issuers. ▪ Instead, all communications must be sent through the OBO's broker-dealer

Proxies
- A voting power of attorney; must be immediately forwarded to customers
- By signing, the beneficial owner allows another person to vote on his behalf

Forms 10-K (annual) and 10-Q (quarterly)
- Financial information that must be forwarded to all stockholders

Charging for Services

Charging Issuers	▪ Member firms may charge issuers for forwarding materials to beneficial owners ▪ Rates are subject to FINRA rules
Charging Customers	▪ Member firms may charge customers reasonable costs/fees, but cannot discriminate between customers ▪ Services include: • Safekeeping of securities • Collection of dividends and interest • Exchange or transfer of securities ▪ However, charges for forwarding proxies or other financial information is the responsibility of the issuer

Activity

Read each corporate action and indicate what it's called.

A COMBINATION OF TWO COMPANIES	
AN INTENT TO PURCHASE SHARES OF ANOTHER OWNER	
SHAREHOLDERS RECEIVE NEW SHARES OF A BUSINESS UNIT OF A COMPANY	
ONE COMPANY ASSUMES CONTROL OF ANOTHER COMPANY	

Activity

Which statements are TRUE regarding the delivery of official communications? Circle all that apply.

I. For OBOs, all communications must come from the OBO's broker-dealer.
II. NOBOs don't allow issuers to contact them directly.
III. A broker-dealer may charge an issuer when forwarding proxies to shareholders.
IV. A broker-dealer may charge customer a fee when transferring their securities.

Chapter 14 – Customer Accounts

Key Topics

1	2	3
ACCOUNT TYPES AND CHARACTERISTICS Learn about the basics of cash accounts, margin accounts, and option accounts.	CUSTOMER ACCOUNT REGISTRATIONS Learn about individual accounts, joint accounts, and other unique forms.	RETIREMENT ACCOUNTS Learn about both Traditional and Roth IRAs, as well as ERISA rules for qualified plans.

Types of Accounts

Cash Account
- Buyer pays full amount of trade

Margin Account
- Long – client borrows funds from the broker-dealer to purchase securities
- Short – client borrows securities from the broker dealer to sell short

Options Account

Opening a Margin Account

Margin	▪ Increases customer purchasing power ▪ Increases risk of large losses due to adverse market changes • Subject to the FRB's Regulation T deposit requirement of 50%
Credit Agreement	▪ The terms of the loan ▪ Discloses interest amount, how computed, and when charged
Hypothecation (Pledge) Agreement	▪ Customer hypothecates securities to B/D as collateral ▪ B/D borrows money from a bank to replace the loan that was made to the customer

Additional Margin Documents

Loan Consent Agreement (generally used for short sales)
- *Not mandatory for opening account*
- If signed, B/D is able to lend the customer's securities to others

Margin Disclosure Document – must be provided to all customers opening a margin account and indicates:
- A customer can lose more money than deposited
- The firm can force the sale of securities or assets in the account
- The firm can sell securities from the account without notifying the customer
- The customer has no control over which assets are sold to meet a margin call
- The in-house maintenance requirement can be changed without prior written notification to the client
- The client is not entitled to an extension for a maintenance call

Activity

Read each statement and determine which document it describes.

INDICATES THAT THE BROKER-DEALER IS PERMITTED TO USE SECURITIES IN THE MARGIN ACCOUNT TO SECURE A LOAN	
DISCLOSES THE INTEREST RATE, HOW IT'S COMPUTED, AND WHEN IT'S CHARGED	
STATES THAT SECURITIES CAN BE SOLD FROM THE ACCOUNT TO MEET A MARGIN CALL	
STATES THAT A BROKER-DEALER IS PERMITTED TO LEND SECURITIES IN A MARGIN ACCOUNT TO OTHERS	

Opening an Options Account

Due to the high risk in option accounts, option trading may not be suitable for all clients

Firms must gather client information through Option Account Agreement, including:
- Names of those with trading authority
- Financial status, objectives, experience
    - Data need not be verified

If the client does not provide requested information, a note is made on the agreement

A copy is sent to the client for his eventual signature (verification) along with the OCC's options disclosure document (ODD)

Discretionary Accounts

If a client is to authorize another person to make investment decisions in her account or deposit and/or withdraw funds, the following forms/steps are required:

- An authorization form signed by the client and the person granted authorization (Power of Attorney)
  - Principal must approve the account in writing prior to its opening
  - Each order must be reviewed and approved promptly by a principal (not in advance)
  - Activity must be monitored for potential churning

Limited Trading Authorization

- Allows for execution of trades

Full Trading Authorization

- Allows for execution of trades, withdrawal of cash and securities, check writing privileges

Power of Attorney
Grants a person other than the account owner with the authority to act on the owner's behalf without the owner's prior knowledge.

Not Held Orders

- Allows client to provide oral authorization for trade execution
- Avoids the need for discretionary authority if RR decisions are limited to time and/or price of execution
- Client specifies whether to buy or sell, the quantity, and the security
  - "Sell 1,000 shares of XYZ whenever you think the time and price is right"
- Not held orders are only good for one day; if longer, written authorization is required

The Three "A"s
For Not Held orders, the customer specifies the **A**ction, the **A**mount, and the **A**sset.

Activity

Which statements are TRUE regarding options and discretionary accounts? Circle all that apply.

I. Due to the high risk in options trading, a customer is required to provide any information requested for the account to be approved.
II. A principal must approve a discretionary order before it is executed.
III. Full trading authority allows cash and securities to be withdrawn from a discretionary account.
IV. If a customer specifies the security, the quantity, and whether to buy or sell, the broker can determine when to execute the trade on that day.

Fee-Based Accounts

Advisory and custodial fees, along with transaction costs, are wrapped into one comprehensive annual fee

- Traditional accounts charge on a per transaction basis assessing a commission on each trade

- Fee-based accounts roll all of the costs for services into one fee
  - Wrap accounts are a type of fee-based account

Suitability considerations:

- Are the services appropriate given client's needs?
- Are the fees reasonable given the client's trading history?
  - Unsuitable for clients who trade infrequently (Buy and Hold)
  - Designed primarily for active traders

Education Savings Plans

Coverdell Education Savings Account (CESA)	529 Plan
▪ A trust or custodial account that's created for the purpose of paying the qualified education expenses of a designated beneficiary • Maximum contribution: $2,000 annually per child up to age 18 • Contribution is non-deductible, but earnings are tax-free if used for qualified education expenses (contribution eligibility is subject to income limits) • CESAs may be used to pay for private education on any level (i.e., kindergarten through college) • Funds must be used by the child's 30th birthday or transferred to a relative's CESA	▪ A plan that is generally operated by a state and designed to meet the costs of both college and K-12 education ▪ Allows for much larger contributions than what CESAs allow ▪ Covered in greater detail in Chapter 8

Question

For which type of investor is a fee-based account unsuitable?___________________________________

____

How much and for how long can contributions be made to a CESA? ______________________________

____

Which educational savings plan is primarily designed for higher education?_________________________

____

Customer Account Registrations

INDIVIDUAL	FIDUCIARY
JOINT	CORPORATE
CUSTODIAL (MINOR)	PARTNERSHIP

Individual Account

- Opened by, and for, one person
- Only the account owner can dictate trades
  - Third party authorization may be granted to another person
- Numbered or Nominee accounts are permitted
  - The account may be opened under a number or code name
  - Provides privacy for the individual
  - Customer Identification Procedures (CIP) requires firms to maintain records of the beneficial owners

Joint Accounts

- New account information is obtained for each owner
- Any owner may initiate activity
- When signatures are required, all owners must sign
- Checks are made payable to all parties

JOINT TENANTS WITH RIGHTS OF SURVIVORSHIP (JTWROS)
▪ Common for spouses ▪ Each tenant has equal ownership ▪ If one owner dies, ownership passes equally to surviving tenant(s) without probate

JOINT TENANCY IN COMMON (JTIC)
▪ Each tenant owns a specified amount ▪ If one owner dies, decedent's portion is transferred to her estate ▪ Common for business partners

Trust Accounts

Trust – a legal arrangement in which an individual (creator) gives fiduciary control of property to a person or institution (trustee) for the benefit of beneficiaries

Revocable – also referred to as living or inter vivos trusts
- A person has the ability to revoke or change any terms in the trust
- Does not reduce estate taxes, but avoids probate if funded prior to donor's death

Irrevocable
- Cannot be changed after being signed
- Will reduce estate taxes and avoid probate

Accounts for Minors – UGMA/UTMA

Custodial Account – Uses a standard new account form titled "custodian for minor"

ONE MINOR (Legal Owner)	▪ Responsible for taxes; minor's Social Security number ▪ If child dies without a will, state law determines asset distribution
ONE CUSTODIAN (Any Adult)	▪ Has authority to initiate activity (prudent investments) ▪ Under the Uniform Prudent Investor Act (UPIA), a custodian may delegate investment functions to a third party
GIFTS	▪ Irrevocable; may be cash and/or securities ▪ Covered options and penny stock transactions may be permitted ▪ No margin (i.e., no uncovered options, short sales, commodities) ▪ No limit on number of donors or on the value of gifts ▪ Taxes may be due from donors if gifts exceed $16,000 per year

Other Forms of Registration

FIDUCIARY	▪ A fiduciary is defined as a person or organization that owes to another the duties of good faith and trust ▪ Documentation is often filed with a court in order to get court approval of the actions of the fiduciary
CORPORATE	▪ Always examine Corporate Resolution ▪ To open an option or margin account, the Corporate Charter must also be examined
PARTNERSHIP	▪ Partnership agreement specifies persons authorized to execute trades ▪ Information must be collected on each managing partner

Activity

Match each type of account to the appropriate description.

REVOCABLE	Only the account owner can dictate trades
UTMA	If a tenant dies, the decedent’s portion is transferred to her estate
INDIVIDUAL	If a tenant dies, ownership passes equally to the surviving tenants
JTWROS	The terms of the trust account can be changed
JTIC	There is only one custodian and gifts are irrevocable

The SECURE Act

Effective January 1, 2020, the Setting Every Community Up for Retirement Enhancement (SECURE) Act was passed to enhance and increase access to retirement savings plans. The Act introduces the following provisions:

Increase of Age for Required Minimum Distribution (RMD)

- For individuals who turn age 70 ½ after Dec. 31, 2019, the RMD is now set at age 72.
  - If an individual turned age 70 ½ in 2019, he must take his RMD for 2019 by April 1, 2020 and each year thereafter

Contributions to a Traditional IRA After Age 70 ½

- Provided an individual has earned income, he’s able to contribute to a Traditional IRA regardless of his age

Penalty-Free Withdrawals for Birth or Adoption

- An individual may take a penalty-free withdrawal of up to $5,000 from an IRA or employer-sponsored retirement plan for expenses associated with the birth or adoption of a child

Section 529 College Savings Plans

- An individual is now permitted to withdraw up to $10,000 on a tax-free basis (a qualified withdrawal) to repay a qualified student loan as well as expenses for certain apprenticeship programs. This is a lifetime limit.

401(k) Plans for Part-Time Employees

- Employers that maintain 401(k) plans must have a dual eligibility requirement under which employees are be eligible if they complete either:
  1. A one-year of service requirement (with the existing 1,000-hour requirement) or
  2. Three consecutive years of service during which the employees complete at least 500 hours of service

Traditional and Roth IRAs

	Traditional	Roth
Similarities	100% of earned income, up to a maximum of $6,000	100% of earned income, up to a maximum of $6,000
	Spousal option: extra $6,000	Spousal option: extra $6,000
	Age 50 or older: extra $1,000	Age 50 or older: extra $1,000
Differences	May be a deductible contribution	Contribution is NEVER deductible
	Contribution is always allowed	Higher income individuals may not contribute
	Required Minimum Distribution (RMD) by Apr. 1 of the year after owner reaches age 72 (tax penalty for failure)	No withdrawal requirement
	Withdrawals are subject to tax	Qualifying withdrawals are tax-free

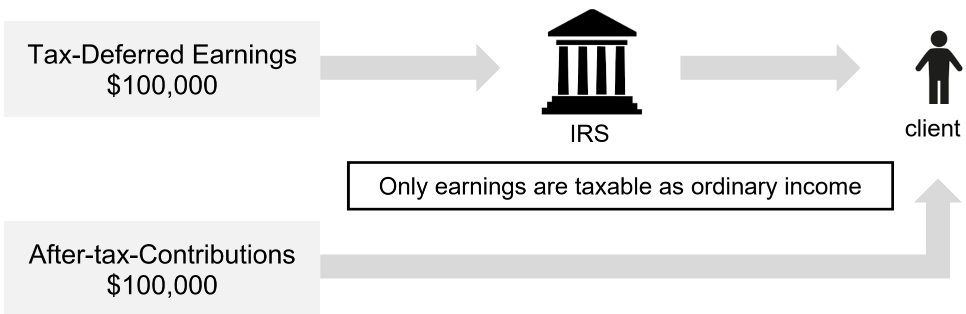
Traditional and Roth IRAs

For both Traditional and Roth:

- Early withdrawal penalty:
  - Before age 59 ½ and 10% of taxable amount
    - In a Roth IRA, the first contribution must have been made at least five years prior
  - Exceptions: death, disability, qualified higher education expenses, up to $5,000 for expenses associated with the birth or adoption of a child, or qualified first-time homebuyer distributions ($10,000 lifetime limit)
- Rollovers and Transfers (no penalty)
  - Rollover:
    - Owner receives proceeds
    - Once per year (rolling 12 months); completed within 60 days
  - Trustee-to-Trustee Transfer:
    - Owner does not have access to the funds
    - May be more than one per year

Taxation of Traditional IRAs

(Funded with after-tax contributions)



Activity

Read each statement and determine whether it is TRUE/FALSE.

IF AN INDIVIDUAL HAS EARNED INCOME, HE CAN CONTRIBUTE TO A TRADITIONAL IRA	
REQUIRED MINIMUM DISTRIBUTIONS MUST BE MADE FROM A ROTH IRA AFTER THE OWNER REACHES AGE 72	
EARNINGS CAN BE WITHDRAWN FROM A TRADITIONAL AND ROTH IRA WITHOUT PENALTY FOR FIRST-TIME HOMEBUYERS	
QUALIFYING DISTRIBUTIONS FROM A ROTH IRA ARE TAX-FREE	

ERISA

Employee Retirement Income Security Act of 1974 was created to prevent misuse and mismanagement of pension plan funds

- Rules apply to private sector defined benefit and defined contribution plans
- Determines qualified status
  - Employer and employee contributions are tax-deductible
  - Earnings are typically tax-deferred
- Plans must not be discriminatory and offered to all employees who:
  - Are age 21 or older
  - Have at least one year of full-time service (1,000 hours)
- An approved vesting schedule must be followed
  - Specifies the percentage of the employer's contributions to which the employee is entitled when withdrawing from the plan
  - Employees are 100% vested in their own contributions

Taxation of Retirement Plans

Tax status of contributions:
- Pre-tax contributions have a zero-cost basis **(taxable at withdrawal)**
- After-tax contributions are part of cost basis **(tax-free at withdrawal)**

Retirement plans never generate capital gains or losses

Earnings typically grow **tax-deferred**

Tax status of distributions:
- Any portion representing pre-tax contributions is **taxable as ordinary income**
- Any portion representing after-tax contributions is a return of capital and **not taxed**
  - Earnings are typically taxed as ordinary income
- Subject to required minimum distributions (RMD)

401(k) and Profit-Sharing Plans

401(k) PLANS
- Employees may elect to contribute (generally pre-tax)
  - 401(k) plans generally have a zero-cost basis since they are funded with pre-tax contributions, with earnings that grow tax-deferred
  - Contributions are subject to a maximum annual amount
- Employers may match contributions but are not required to do so
  - Matching may be based on a profit-sharing plan
- Employers that maintain 401(k) plans must have a dual eligibility requirement under which employees are eligible if they satisfy either:
  - A one-year of service requirement (or 1,000 hours) or
  - Three consecutive years during with the employee provided at least 500 hours of service

PROFIT-SHARING PLANS
- Contributions are discretionary, decided by the board of directors
- Contributions are subject to maximum annual amounts
- Allocation of contributions to employees is based on a predetermined formula

Activity

Which statements are TRUE regarding ERISA and distributions from retirement plans? Circle all that apply.

I. ERISA requires plans to allow all employees who are at least age 21 and have one year of full-time service to be eligible to contribute to a plan.
II. Distributions from retirement plans as a result of appreciation of securities are taxed as capital gains.
III. An employee must be vested to receive the benefits of the employer's matching contributions in a 401(k) plan.
IV. Contributions to profit-sharing plans are decided by the board of directors.

Chapter 15 – Compliance Considerations

Key Topics

1	2	3	4
OPENING AND UPDATING CLIENT ACCOUNTS	USA PATRIOT ACT AND ANTI-MONEY LAUNDERING RULES	REGULATION SP AND CUSTOMER STATEMENTS	COMMUNICATION RULES AND PROTECTING THE CUSTOMER
Learn about FINRA and SEC rules for opening customer accounts.	Learn about the Customer Identification Program and FinCEN reports.	Learn about how client information is protected and delivery of statements.	Learn about broker-dealer communications and how customer interests are protected.

FINRA Rules for Opening Cash Accounts

Required Information:

- Name of customer
  - Numbered or coded account is acceptable
- Address
  - Cannot open with P.O. box only (military P.O. box is acceptable)
- Whether of legal age
- Registered representative(s) of record
- Signature of supervising principal

Copy of the above information must be provided to clients at least every 36 months

Customers are NOT required to sign their new account forms.

Additional Information

Prior to settlement of the initial transaction, a reasonable effort must be made to obtain the following customer information (this does not apply to institutional accounts):

Tax I.D./ Social Security number	Occupation as well as name and address of employer	Whether associated with another member firm

If a client refuses to provide any requested information, the RR should document the refusal

Recordkeeping Requirements

According to SEC Rule 17a-3 broker-dealers are required to maintain the following records:

- Name and tax ID number
- Address, telephone number and date of birth
- Employment status and whether associated with another broker-dealer
- Information to assist in determining suitability
  - Income
  - Net Worth (excluding principal residence)
  - Risk Tolerance
  - Objectives

Updating Client Information

Failure to update client information on a timely basis may result in the execution of unsuitable transactions or regulatory issues

- If a client moves to a new state, both the firm and the RR must be registered in that state in order to continue conducting business with the client
- Changes in the financial background of a client (for better or worse) must be documented
  - A different pattern of transactions may indicate a change
- Objectives are typically adjusted as customers age

FINRA rules require firms to send a copy of updated changes to a customer within 30 days or at the time the next statement is mailed.

Suitability

The Basics of Suitability	Institutional Suitability
Suitability is based on the client's profile when an account is opened ▪ Applies to recommended transactions and investment strategy ▪ Suitability is not determined by gains and losses ▪ RRs may not place their own interests ahead of the client's, such as: • Recommending one product over another to generate a larger commission	Institutional suitability – The extent of the obligations is based on: ▪ Those servicing the account having a reasonable belief that the client is capable of evaluating investment risks ▪ The institutional client affirmatively stating that it's exercising independent judgement

FINRA's Suitability Rules

Under FINRA's three main suitability obligations, a member firm and its registered representatives must have a reasonable basis to believe that:

The Reasonable Basis Obligation	The Customer-Specific Obligation	The Quantitative Obligation
A recommendation is suitable for at least some investors	A recommendation is suitable for a particular customer based on the customer's investment profile (this provision does not apply to institutional customers)	A series of recommended transactions, even if suitable for a customer, are not excessive when the customer's investment profile is taken into consideration

Activity

Match the information to the FINRA rule.

REQUIRED

REASONABLE EFFORT

Name and address
Social Security number
Name and address of employer
Signature of principal
Whether client is of legal age

Activity

Read each statement and determine whether it is TRUE/FALSE.

THE SEC REQUIRES A BROKER-DEALER TO MAINTAIN THE CUSTOMER'S SOCIAL SECURITY NUMBER AND DATE OF BIRTH	
ONLY A BROKER-DEALER MUST BE REGISTERED IN THE CLIENT'S STATE OF RESIDENCY, NOT THE REGISTERED REPRESENTATIVE	
SUITABILITY IS NOT BASED ON GAINS AND LOSSES	
SUITABLE RECOMMENDATIONS ARE NEVER CONSIDERED EXCESSIVE	

USA PATRIOT Act

Customer Identification Procedure (CIP)

- B/Ds must verify the identity of each customer within a reasonable period of time from the account opening
- Why?

Three stages of money laundering:

1. Placement	2. Layering	3. Integration
Illegal cash is placed in the broker-dealer's business	A series of transactions are executed which are meant to avoid detection (e.g., structuring)	Proceeds from the previous transactions are put back into the stream of commerce

FinCEN's Reports

Under the Bank Secrecy Act (BSA), certain reports are sent to the Financial Crimes Enforcement Network (FinCEN), which is a bureau of the U.S. Department of Treasury

Bank Secrecy Act Transaction Report (BCTR)

- Filed for all cash transactions executed by a single customer during one business day that exceed $10,000 (also filed for structured transactions)
- Filed within 15 business days

A violation could result in a 20-year prison term and the greater of a $500,000 fine per transaction or twice the amount of the funds involved.

Suspicious Activity Report (SAR)

- Filed whenever a transaction (or group of transactions) equals or exceeds $5,000 and the firm is suspicious
- Filed within 30 business days
- Suspicious activity should also be reported to a principal

AML Compliance Program

A member firm must establish an AML program to detect money laundering schemes and suspicious transactions

- Program requirements include:
  - Appointing an AML compliance officer
    - AML officer must be identified to FINRA and be knowledgeable about the Bank Secrecy Act (BSA)
- Creating written procedures, including training for personnel
- An independent audit function to test the program's effectiveness
- However, there's NO requirement to file reports with a regulator

Customer Identification Program

Required Identifying Information	▪ Name ▪ Legal address (residence or business) ▪ Date of birth ▪ Identification number (which may be different for U.S. persons compared to non-U.S. persons)
Identification Number for U.S. Persons	▪ Taxpayer ID or ▪ Social Security number
Identification Number for Non-U.S. Persons	▪ One or more of the following: • Taxpayer ID • Passport number • Alien ID Card number • Any other government-issued document establishing residence and identity
Office of Foreign Assets Control (OFAC)	▪ An OFAC list is maintained to identify the names of terrorists and/or criminals ▪ If a client's name appears on the OFAC List, transactions are blocked and law enforcement is notified ▪ Also known as the Specially Designated Nationals of SDN list

Activity

Which statements are TRUE regarding the USA PATRIOT Act and AML rules? Circle all that apply.

I. Broker-dealers must verify the identity of a customer prior to opening an account.

II. An SAR is filed for all cash transactions equaling or exceeding $5,000, even if it is not suspicious.

III. The Bank Secrecy Act requires that a report be filed for all cash transactions that exceed $10,000 during one business day.

IV. All transactions must be blocked if a customer's name appears on the OFAC list.

Protecting Client Information

Privacy

Firms may not disclose client information unless:
- Ordered by a court or government entity or
- Client provides written permission
  - A person does not have the right to know the content of his spouse's account

Regulation SP
- Created rules for protecting the privacy of clients' confidential information
- Clients provided with "privacy notice" at the opening of account and annually thereafter
- Requires disclosure of information that's shared and with whom it's shared
- Requires a reasonable "opt-out" provision

Identity Theft Prevention

Federal Trade Commission's (FTC) Red Flag Rules
- Financial institutions must create and implement policies and procedures to detect and address identity theft
- Intent is to protect the client's assets

Use of Stockholder Information for Solicitation
- Firms are prohibited from using client information for solicitation purposes
- Permitted if specifically directed to do so and it is for the benefit of the corporation

Customer Statements and the Holding of Mail

Account Statements
- Sent by broker-dealers at least quarterly
- For active accounts, sent monthly

Holding customer mail
- Firm must receive written customer instructions
- Instructions must include the time period during which the mail will be held
    - If the requested time *exceeds three consecutive months*, customer instructions must include a valid reason
- Whether the customer's instructions still apply must be verified at reasonable intervals

Trade Confirmations

Sent on, or before, settlement of the transaction

Confirmation Information
▪ Execution details: • Name of customer • Buy/sell • Price and quantity ▪ Trade and settlement dates ▪ Firm capacity (agent or principal) ▪ For bonds, dollar price and yield information ▪ Name of contra party or a statement of the availability of the information upon written request

Definition of Communications

Correspondence	Retail Communication	Institutional Communication
▪ Written or electronic communication that a member firm distributes or makes available to 25 or fewer *retail investors* (prospective or existing) within any 30-calendar-day period ▪ Subject to review and supervision	▪ Written or electronic communication that a member firm distributes or makes available to more than 25 *retail investors* within any 30-calendar-day period ▪ Often subject to preapproval and filing	▪ Written or electronic communication that a member firm distributes or makes available *only to institutional investors* (NOT to any retail investors) ▪ Subject to review and supervision

Activity

Read each statement and fill in the blanks.

1. ____________________________ establishes rules to protect the privacy of clients' confidential information.
2. A privacy notice must be provided to clients when _______________________________ and ____________________________.
3. The FTC's ___________________________ requires financial institutions to create policies to detect identity theft.
4. Account statements are sent _______________________ for inactive accounts, but _______________________ for active accounts.
5. Customer mail can be held for _________________________ at the broker-dealer.
6. ______________________________ must be sent on, or before, settlement of a transaction.
7. _________________________ is communication that's distributed to 25 or fewer retail investors within a 30-calendar-day period.
8. Retail communications are sent to _______________________ retail investors within a _______________________.

Telephone Consumer Protection Act

Telemarketing calls may be made on any day, but only from **8:00 a.m. to 9:00 p.m.** local time of the person being called (residential only)

Exclusions:	The time-of-day restriction doesn't apply if the person: ▪ Has made any unsolicited inquiry of the firm ▪ Has engaged in a transaction with the firm within 18 months
Information Provided:	The caller must provide: ▪ Both his name and his employing firm's name ▪ The firm's phone number or address ▪ The purpose for the call
Do-Not-Call List:	If requested, a client must be placed on the firm's "Do Not Call List" within 30 days and will remain there indefinitely ▪ Before placing a call, a firm must review the FTC's National Do-Not-Call Registry

Transmitting unsolicited advertisements to fax machines is prohibited.

Customer Protection Rule

On a *daily basis*, broker-dealers are required to obtain and maintain physical possession or **control** of all fully paid and **excess margin securities** belonging to **customers**

Control	Excess Margin Securities	Customers
▪ Good control locations include an SEC-approved depository (domestic or foreign) such as the DTC or in-transit between the offices of a broker-dealer	▪ The value of margined securities that exceeds 140% of a customer's debit balance	▪ Any person for whom the B/D holds funds or securities or any omnibus account that is maintained by a B/D on behalf of its customers ▪ Excludes B/Ds, general partners, directors, principal officers, or subordinated lenders

Customer Free Credit Balances

A free credit balance represents customer proceeds resulting from sales, dividends, or interest payments that have not been withdrawn or invested

- A statement must be sent to customers at least quarterly
- The statement must indicate the total amount due and that it's payable on demand
- If statements are sent more frequently than quarterly, a notice of free credit balance must be included

Fidelity Bond

Broker-dealers must obtain a fidelity bond as insurance coverage against losses as a result of:

- Fraudulent trading, loss of securities, or forgery
- NOT errors and omissions or B/D bankruptcy

If the bond is substantially modified, terminated, or cancelled, FINRA must be notified immediately.

Business Continuity Plan (BCP)

A written plan identifying procedures to be followed due to an emergency or significant business disruption must be made available to FINRA promptly on request

A BCP must address each of these points

Regulatory reporting	Communication with regulators (e.g., SEC and FINRA)	Communications between firms and clients and between firms and employees
Emergency contact information of two persons (one must be a member of senior management and a registered principal	Alternative locations for employees to continue working	Ensuring that mission-critical systems (computers) continue to process transactions promptly

Retention of Books and Records

Lifetime	Six Years	Three Years
Corporate and partnership documents	Blotters (records of original entry), ledgers, new account forms, powers of attorney, municipal complaints*	Order tickets, confirmations, statements, Forms U4 and U5, employee records, all forms of communication, trial balances

* FINRA requires complaints to be maintained for four years

All records must be maintained in an easily accessible place ***for the first two years.***

Activity

Which statements are TRUE regarding requirements to protect customers? Circle all that apply.

I. Telemarketing calls can only be made between the hours of 9:00 a.m. and 8:00 p.m. local time.
II. Free credit balance represent customer proceeds that have not been withdrawn or reinvested.
III. The fidelity bond protects customers in the event of a broker-dealer's bankruptcy.
IV. The Business Continuity Plan is not required to be filed with FINRA unless requested.

Chapter 16 – Prohibited Activities

Key Topics

1	2	3	4	5
MANIPULATIVE AND DECEPTIVE PRACTICES	REGULATION M	INSIDER TRADING	NEW ISSUE RULE	BOOKS AND RECORDS
Learn about prohibited practices such as front-running, trading ahead, backing away, freeriding, and the spreading of rumors.	Learn about the regulation that's designed to prevent manipulation surrounding new offerings.	Learn about the aspects of insider trading, who are considered tippers and tippees, the policies, penalties, and bounties associated with violations.	Learn about the New Issue Rule, the restricted persons, preconditions for sale, and general exemptions.	Learn about recordkeeping requirements for broker-dealers.

The Securities Exchange Act of 1934

The 1934 Act prohibits manipulative and deceptive practices in the sale of securities. Rule 10b-5 includes specific anti-manipulation provisions which states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange

a) *To employ any device, scheme, or artifice to defraud*
b) *To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or*
c) *To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person*

In connection with the purchase or sale of any security:

- Rule 10b-1 – Stipulates that antifraud rules also apply to exempt securities
- Rule 10b-3 – Stipulates that broker-dealers are prohibited from engaging in fraudulent practices

Prohibited Trading Practices

Market rumors	Front-running	Marking-the-Close/Opening	Churning
▪ Spreading false or misleading information to influence the price of stocks and/or bonds	▪ RRs executing trades for proprietary accounts (or those for which they have discretion) ahead of a customer's block order (a market moving order)	▪ Effecting trades near the opening or close of trading in an attempt to influence a stock's closing price up or down	▪ Excessive trading in a client's account for the purpose of generating additional fees and commissions

Prohibited Trading Practices

Interpositioning	Trading Ahead of Customer Orders	Quoting a Security in Multiple Mediums
Refers to the insertion of a third party between a customer and the best market. ▪ Prohibited if detrimental to the customer, but acceptable if advantageous.	Occurs when, after accepting and while holding a customer order, the dealer executes an order for the same security, same price, on the same side of the market for its own account. ▪ The obligation is to fill the customer's order first. ▪ An exception exists if executed by a different department at the same firm if information barriers exist.	Refers to displaying quotes on the same security in multiple markets. ▪ Permitted if quotes are at the same price.

Regulation M Overview

Regulation M (or Reg. M) was created to prohibit manipulative conduct by persons (distribution participants) that have an interest in the outcome of an offering. Some of the rules under Reg M include:

1	2	3
▪ Limits bids and purchases by distribution participants (underwriters and selling group members) ▪ Prevents *conditioning* the market by restricting trading for a specific period	▪ Allows for passive market making ▪ Permits distribution participants to execute unsolicited trades to maintain marketability of the security	▪ Permits stabilization of the new issue to protect its price from falling substantially

Trading Ahead of a Research Report

If a firm has knowledge of material, non-public information regarding the contents of a research report, it may NOT establish, increase, decrease, or liquidate an inventory position in a security or its derivative.

- Executing proprietary orders is prohibited until the information is released publicly.
  - Applies to equity, debt and derivatives.
  - Covers exchange and non-exchange listed securities.
- Information barriers must exist between trading and research departments.
  - Barriers prevent the flow of information between the departments

A Market Maker's Quote

A market maker that publishes a quote is obligated to buy or sell at its stated bid or offer and up to the size quoted.

Bid	Ask
10.00	10.05

The market maker must buy at 10.00 and sell at 10.05

Failure to do so is considered *backing away* (a violation).

Activity

Match each description to the appropriate term.

MARKET RUMORS	A market maker's failure to buy or sell at its stated bid or offer
FRONT-RUNNING	Excessive trading in a client's account to generate additional fees and commissions
CHURNING	Establishing, increasing, decreasing or liquidating a security based on having knowledge of an unexecuted block order
TRADING AHEAD	Spreading false or misleading information to influence the price of stocks and/or bonds
BACKING AWAY	RRs executing orders for proprietary accounts (or those in which you have discretion) ahead of a the release of a research report

Question

Which of the following statements are TRUE with regards to Regulation M? Circle all that apply.

I. It permits bids and purchases by distribution participants.
II. It allows for passive market making.
III. It permits stabilization of a new issue to protect its price from falling substantially.
IV. It was created to prohibit manipulative conduct by persons that have an interest in the outcome of an offering.

Regulation T Payment Date

The Reg. T payment must be obtained for purchases that are made in either cash or margin accounts within two business days of settlement (S+2)	Before settlement, a customer can request that the broker-dealer transfer a trade from a cash account to a margin account	If no payment is made, the position is closed out (securities sold) on the third business day following settlement	The result of non-payment is that the account is frozen for 90 days (all payments must be made in advance)

An investor who buys a stock and subsequently sells it, but fails to meet the Regulation T requirement, is guilty of *freeriding.*

Anti-Intimidation/Coordination Interpretation

The following actions are prohibited:

- Coordinating price quotes, transactions, or trade reports with other market makers
- Threatening, harassing, or intimidating other market makers
- Retaliating against or discouraging the competitive activities of another market maker

Trading Rules

Best Execution	FINRA and MSRB rules require a dealer to use reasonable diligence to obtain best execution for their customers. Factors include: ▪ The character of the market for the security ▪ The size and type of the transaction and number of markets checked ▪ The ease of obtaining a quote and the terms of the order
MSRB Time of Trade Disclosure	According to the MSRB, dealers are required to provide customers with all material information that is known or reasonably available at or prior to time of trade. ▪ These requirements apply for both solicited and unsolicited trades, trades that occur in the primary or secondary market, or for agency or principal trades.

Insider Trading

Insider trading involves the purchase or sale of securities using material, non-public information about an issuer to make a profit or avoid a loss.

1. TIPPERS AND TIPPEES	2. PROCEDURES
▪ Refers to inside information passed from one party (tipper) to another (tippee) who then trades on that information ▪ If trading occurs, both parties would be in violation	Broker-dealers must have written policies designed to prevent insider trading. These must include: ▪ A system to monitor an employee's personal trading ▪ The establishment of information barriers to prevent access to confidential information ▪ Trading restrictions or monitoring of certain securities on which the firm has access to inside information ▪ Restricted list – distributed to employees ▪ Watch list – only known to legal and compliance
3. INSIDER TRADING PENALTIES	**4. BOUNTIES**
▪ Civil – The SEC may demand disgorgement of profits and the payment of treble damages (three times the damage) ▪ Criminal – An individual may be subject to a maximum fine of $5 million, and/or up to 20 years in prison	Eligible whistleblowers are entitled to an award of between 10% and 30% of the monetary sanctions collected in actions brought by the SEC and other regulatory authorities.

The New Issue Rule

FINRA prohibits member firms from selling **equity IPOs** to accounts in which **restricted persons** have beneficial interest

Restricted Persons	▪ Member firms and any member firm employees
	▪ Immediate family members of member firm employees if:
	    • There is material support (25% of the person's income), or
	    • Sharing of a household, or
	    • The purchase is made through the family member's firm
	▪ Finders and fiduciaries
	▪ Portfolio managers purchasing for their own account

Preconditions of Sale	▪ Verification that the account is eligible to purchase the IPO
	    • May be a written statement or electronic communication
	    • May not be an oral statement
	▪ Re-verification of eligibility every 12 months

General Exemptions	▪ An account that includes restricted persons, provided their combined ownership does not exceed 10% (de minimis) ▪ Issuer-directed sales that allow restricted persons to purchase if the associated person or associated person's immediate family is an employee or director of the issuer ▪ Portfolio managers purchasing for the mutual fund ▪ A broker-dealer purchasing for its own account after making a bona fide public offering

Sharing in Accounts and Guarantees

Sharing in profits and losses in a client's account is prohibited unless a joint account is established with the client and:

- The employee has the written permission of both the client and the broker-dealer, and
- The sharing is proportionate to the employee's investment
  - An arrangement with a family member is exempt from the proportionate sharing requirement.

Investment advisory accounts permit sharing in profits and losses if:

- Prior written consent between the firm and customer
- Firm is in compliance with SEC regulations

Guarantees – employees may neither guarantee against losses nor reimburse a customer for losses in any way.

Borrowing and Lending

Borrowing and Lending **without Notification**	Borrowing and Lending **with Notification**
▪ RRs borrowing from or lending to customers is acceptable without firm notification if the customer: • Is an immediate family member, or • Is a financial institution regularly engaged in the business of providing loans	▪ RRs must provide written notification to their firms and obtain prior written approval if: • The customer and RR are both registered with the same firm, or • A personal relationship exists, or • A business relationship exists outside of the brokerage firm.

Financial Exploitation Rules

Definition	**Procedures**
Financial exploitation rules apply to specified adults who are most likely to be exploited including: ▪ Persons age 65 or older ▪ Any persons 18 or older believed to have a mental or physical impairment jeopardizing their ability to protect their own interests	If a concern arises, a firm may place a temporary hold on the account ▪ The customer's designated trusted contact person should be notified • Information regarding the trusted contact person should be obtained when an account is opened (at least a reasonable effort should be made)

Temporary Holds

DISBURSEMENT OF FUNDS	Temporary holds apply to the: ▪ Disbursement of funds or securities ▪ Execution of securities transactions ▪ Transfer of assets from one account to another at the same firm
INTERNAL REVIEW	When a hold is placed, an immediate internal review of the reasons must occur.
ORAL OR WRITTEN NOTIFICATION	No later than two business days after the hold is placed, the firm must provide oral or written notification of the hold to all parties who are authorized to transact business in the account and the trusted contact person.

Activity

Read each statement and fill in the blanks.

1. Clients who buy or sell a stock without paying the Regulation T requirement commit a ___________________ violation.
2. Coordinating price quotes and transactions, delaying reporting of trades, and sharing information about customer orders are examples of ____.
3. _______________________ refers to the insertion of a third party between a customer and the best market.
4. _______________________ involves the purchase or sale of securities using material, non-public information about an issuer to make a profit or avoid a loss.
5. The __________________________ prohibits member firms from selling equity IPOs to accounts in which a restricted person has a beneficial interest (more than 10%).
6. Financial exploitation rules apply to ___________________________ who are most likely to be exploited.

Outside Brokerage Accounts

Employee Requirements	Before a member firm employee can open an account with another firm, the employee must: ▪ Obtain the employer's prior written consent ▪ Provide written notification of his association to the executing firm ▪ Satisfy the previous two provisions within 30 days of employment if opened prior to employment
Executing Broker-Dealer Requirements	▪ The executing firm must send duplicate confirmations and statements if requested by the employing firm. ▪ This applies to accounts for the employee's spouse, dependent children, or an account in which the person controls or has a beneficial interest.
Exemptions	▪ Requirements of this rule do not apply to transactions involving mutual funds, variable contracts, unit investment trusts, or 529 plans.

Compensation Rules and Forgery

Payments to unregistered persons

- Generally, firms and RRs are prohibited from paying compensation to any individual or firm who is not FINRA registered.
  - This includes paying referral fees.
  - Retiring representatives may continue to receive commissions on existing accounts if a bona fide contract is created

Forgery

- Signing another person's name without authorization
- May result in criminal prosecution

Broker-Dealer Books and Records

Prior to utilizing any form of electronic storage media, a B/D must notify its self-regulatory organization (SRO).

If the electronic storage media to be used is other than CD-ROM, the B/D must give its SRO 90-days' advance notice.

Electronic storage media must have tamper-evident features or the ability to record all changes that are made to its contents.

Question

Which of the following statements are TRUE with regards to Regulation M? Circle all that apply.

I. Sharing in profits and losses in a client's account is always prohibited.

II. Borrowing money from or lending money to a client is acceptable without firm notification if the customer is an immediate family member.

III. If signs of diminished capacity are identified, the firm should move ahead with the disbursement of funds while contacting the customer's designated trusted contact person.

IV. Generally, firms and RRs are prohibited from paying compensation to any individual or firm who is not FINRA registered.

Chapter 17 – SRO Requirements for Associated Persons

Key Topics

1	2	3
SIE AND EMPLOYEES OF MEMBER FIRMS	REGISTERED REPRESENTATIVES AND PRINCIPALS	REGISTRATION AND CONTINUING EDUCATION
Learn about both associated and non-registered persons of FINRA member firms.	Learn about the different roles of registered personnel.	Learn about how client information is protected and delivery of statements.

Securities Industry Essentials (SIE)

Implemented to ensure that industry professionals have a broad understanding of fundamental concepts and rules of the securities industry

Centerpiece of Exam Restructuring	▪ Reduction in the number of exams ▪ Prerequisite for all remaining representative level qualifications
Eligibility	▪ Must be age 18 or older ▪ No need to be sponsored or associated with a FINRA member broker-dealer ▪ Valid for four years

In addition to the SIE Exam, associated persons of the firm will have to pass an appropriate industry-specific exam that relates to their registration category

Associated Persons

Defined as employees of FINRA member firms (broker-dealers) and include all of the following:

- Officers, directors, partners, or branch managers
- Employees (unless the employee's function is solely and exclusively clerical or ministerial)
- Person engaged in investment banking or securities business

Certain associated persons are required to be registered as either representatives or principals

Non-Registered Persons

Customer contact is limited to	▪ Extending invitations to firm-sponsored events ▪ Inquiring as to whether a prospective customer wants to speak with a registered person ▪ Inquiring as to whether a customer is interested in receiving investment literature
Customer orders cannot be accepted	▪ Orders can only be accepted and entered by registered persons ▪ If an RR is unavailable, a non-registered person can transcribe an order as long as an RR confirms the order with the customer before it's entered

Commissions or finder's fees cannot be paid to non-registered persons

Registered Representatives

Securities Industry Essentials (SIE) Exam is the centerpiece for becoming registered with the following qualification exams:

- Series 6
- Series 7
- Series 22
- Series 52
- Series 57
- Series 79
- Series 86/87
- Series 99

Firm Supervision – Principals

Principals are the individuals who are responsible for managing specific areas of a member firm

Focus/Activity	Required Registration
General Securities Sales Supervisor	Series 9/10
General Securities Principal	Series 24
Investment Companies and Variable Contracts Products Principal	Series 26
Financial and Operations Principal	Series 27
Municipal Fund Securities Limited Principal	Series 51
Municipal Securities Principal	Series 53

Examinations

Failing an Examination	▪ After failing a qualification exam (or the SIE Exam) on the first and/or second attempt, a person must wait 30 days before retesting ▪ If the qualification exam (or the SIE Exam) is failed a third time, a 180-day waiting period applies between all subsequent attempts
Exam Confidentiality	FINRA considers it a violation to: ▪ Remove any part of the exam from a test center ▪ Reproduce parts of an exam ▪ Disclose parts of an exam to another person ▪ Receive parts of an exam from another person ▪ Compromise past or present exams in any way

Activity

Which statements are TRUE regarding associated persons of a member firm? Circle all that apply.

I. The SIE must be taken by all employees.
II. Orders can only be accepted and entered by registered personnel.
III. Registered representatives will be required to sit for two exams.
IV. An individual who fails an exam on the second attempt is required to wait 30 days before retesting.

Written Supervisory Procedures

To provide adequate supervision, a firm must establish, maintain, and enforce written supervisory procedures, which include the following:

- Clear identification of a person's supervisory responsibilities and the date assigned
- Procedures for each business line and applicable securities laws for which each supervisor is responsible
- Approving customer accounts and reviewing them periodically in an effort to detect and prevent abuses
- Verifying the good character, qualifications, and experience of all persons being certified for registration and monitor their good standing on a continuing basis

Each registered representative is assigned to a specific supervisor/principal

Registration Requirements

Person must be sponsored by a broker-dealer and must file both Form U4 and a fingerprint card with the Central Registration Depository (CRD)

Some items contained on Form U4:

- Name (nickname/alias) and address
- Personal data and identifying information
- Information regarding any past violations (not limited to the past 10 years)

Statutory Disqualification (SD)

Grounds for statutory disqualification:

- Conviction within the last 10 years of any felony or securities-related misdemeanor
- Denial or revocation of registration by the SEC or CFTC
- Expulsion or suspension from membership with any SRO (U.S. or foreign)
- Omitting a material fact in any application or report to an SRO
- Maintaining a business relationship with a banned person

Eligibility proceeding:

- FINRA offers firms an Eligibility Proceeding process in order to request permission to either hire or continue to employ an SD person. If permitted, heightened supervisory requirements must be established.

Background Checks and Fingerprinting

Background Checks	FINRA requires firms to perform a search of reasonably available public records ▪ Verify the accuracy of the information on the Form U4 ▪ If registered previously, review the most recent Form U5 • Provides information regarding the reason for termination from previous firm
Fingerprinting	▪ Required for all applicants who are registering with new firm, even if it had been done with a previous firm ▪ Industry requirement extends to the Operations Area • As a general rule, all persons who come into contact with funds, securities, or the firm's books and records must be fingerprinted

State Registration (Blue Sky Law)

State Registration

Registration and examination requirements may also apply on the state level; however, it is dependent on the activities performed by the registered person

- If required, the person is tested on the Uniform Securities Act (a model law) through an exam that is created by the North American Securities Administrators Association (NASAA)

NASAA Exams

NASAA created the following three exams:

1. Series 63
2. Series 65
3. Series 66

Continuing Education

Regulatory Element

- Applies to all registered personnel; no grandfathering
- Due on second anniversary and every three years thereafter
  - Must be completed within 120 days of notice
  - If not completed, registration becomes inactive

Firm Element

- On-going training directed by the firm
- Based on needs assessment
- Training plan must be re-evaluated annually

RRs serving in the military are exempt from the two-year inactive status limitation that normally applies to registration reinstatement and both elements of continuing education are put on hold.

Activity

Read each statement and determine which document or phrase applies.

DESCRIBES THE RESPONSIBILITIES THAT A FIRM MUST FOLLOW TO CONDUCT BUSINESS	
THE RESULT OF BEING CONVICTED OF A FELONY WITHIN THE PREVIOUS 10 YEARS	
DOCUMENT THAT MUST BE FILED WITH CRD FOR A PERSON TO BECOME REGISTERED	
MUST BE COMPLETED ON A PERSON'S SECOND REGISTRATION ANNIVERSARY AND EVERY THREE YEARS THEREAFTER	

Activity

Which statements are TRUE regarding the registration process? Circle all that apply.

I. If allowed through an Eligibility Proceeding, a statutory disqualified person may be hired by a member firm.

II. Form U5 provides the reasons for the termination of a previously registered person.

III. Only registered representatives are subject to fingerprinting requirements.

IV. An RR who is serving in the military is still subject to the continuing education requirements.

Chapter 18 – Employee Conduct and Reportable Events

Key Topics

1	2	3	4
FORMS U4, U5, AND U6 Learn about required disclosures and information available on BrokerCheck.	FINRA AND MSRB INVESTOR EDUCATION Learn about how the SROs provide information to investors.	CUSTOMER COMPLAINTS AND REPORTING REQUIREMENTS Learn about how complaints and Red Flag issues are handled.	REQUIRED DISCLOSURES Learn about the various disclosures that associated persons must make to firms and the Political Contribution Rule.

Registration Requirements for the RR

As described in Chapter 17, a person's registration is initiated by filing Form U4 (the Uniform Application for Securities Industry Registration or Transfer)

Form U4 Disclosures	▪ Personal information, including residential and business history ▪ Information related to violations of laws or SRO rules
Disclosure Reporting Page (DRP)	▪ If a registrant answers "YES" to any legal or disciplinary questions, additional information is required on the DRP
Predispute Arbitration Agreement	▪ By signing Form U4, an applicant agrees to resolve disputes with his employer, other associated persons, or customers through arbitration

Applicants who file false, incomplete, or misleading information will have their registration revoked

Arbitration Disclosures

Before arbitration begins, firms are required to make the following disclosures to clients:

- The right to sue or to a jury trial is waived with arbitration
- Certain claims are not required to be arbitrated, including those related to:
  - Discrimination or sexual harassment
  - Disputes arising under a whistleblower statute
- Arbitration awards are generally final and binding
- The ability to obtain documents may be more limited
- Decisions made by arbitrators don't require explanation
- Arbitration panels may consist of either industry or public arbitrators

Form U5 and Form U6

FORM U5	If registration is terminated, Form U5 must be filed within 30 days ▪ Copy provided to the RR ▪ Changes to Form U5 must be made within 30 days ▪ FINRA must be notified of written complaints that are received after the representative leaves the firm ▪ Re-qualification is required if registration is terminated for more than two years (FINRA maintains jurisdiction for those two years)
FORM U6	Form U6 is used to report: ▪ Disciplinary actions against representatives and firms, and ▪ Final arbitration awards against representatives and firms

Activity

Match the information to the appropriate Form.

FORM U4
FORM U5
FORM U6

Reasons for representative's termination
Arbitration rewards
Business history of associated person
Predispute Arbitration Clause
Disciplinary actions against RRs and firms

BrokerCheck

This system allows investors to check the background and disciplinary history of their existing or prospective firm or RR, including:

- The RR's current employing firm, the last 10 years of employment history, and all approved registrations
- Any felonies, certain misdemeanors and civil proceedings, and investment-related violations
- Pending customer-initiated arbitrations and civil proceedings involving investment-related activities
- Written customer complaints filed within the last 24 months alleging sales practice violations of $5,000 or more
- Terminations of employment after allegations involving violations of rules, fraud, theft, or failure to supervise

FINRA Investor Education and Expungement

FINRA's Investor Education
FINRA's Investor Education rule requires firms to provide customers with the following information on an annual basis: ▪ FINRA's BrokerCheck hotline number ▪ FINRA's website address   • A statement that an investor brochure is available which describes BrokerCheck

Expungement
Expungement is the process by which customer dispute information is removed from an RR's CRD record ▪ The claim must be factually impossible or erroneous ▪ The registered person could not have been involved in the investment-related sales practice violation ▪ The claim, allegation, or information is false

MSRB Investor Education

Annually, MSRB member firms must disclose the following to their customers:

- The MSRB's website address
- That they are registered with the MSRB and the SEC
- A statement regarding the availability of a brochure (the Investor Brochure) on the MSRB's website which describes the protections available to customers and the process by which a complaint may be filed with the appropriate regulatory authority

Customer Complaint

Defined as a grievance that's delivered in any written form, including letters, e-mails, IMs, or text messages

- Complaints must be forwarded to a supervisor for review/investigation
- Complaint files, including copies, are maintained in an OSJ along with a report to indicate the action taken to resolve the complaint
- Records are retained for four years
- Quarterly reports are sent to FINRA (not the SEC) to provide statistical and summary complaint information

Reporting Requirements

FINRA requires firms to file information relating to certain customer complaints and other incidents involving RRs by no later than within 30 days of discovery. These events include:

▪ Being subject to a customer complaint involving allegations of theft, misappropriation of funds or securities, or forgery	▪ Having been indicted or convicted of, or pleaded guilty or no contest to, any felony or misdemeanor involving securities violations
▪ Violating securities laws or regulations of the government, SRO, financial business or professional organization	▪ Being the subject of a suspension, termination, withholding of commissions, or fines in excess of $2,500
▪ Having been named as a defendant by a regulator alleging violation of any securities, insurance, or commodities regulation	▪ Being a defendant or respondent in an award or settlement of more than $15,000

Red Flags

Red Flags	SEC rules emphasize that firms must exhibit reasonable supervision and require supervisors to look for red flag situations • A Red Flag situation arises if there is any indication of real or potential violations of securities rules
Red Flag Discovery	If an issue is discovered, the following steps must be taken: 1. *Investigate the situation* – make a reasonable effort to ascertain all relevant facts 2. *Document the investigation* – records must be written 3. *Pursue the investigation to a conclusion* – the matter should be brought to some resolution, which may be that no violation occurred

Activity

Which statements are TRUE regarding information available on BrokerCheck and the process of addressing complaints? Circle all that apply.

I. BrokerCheck provides information on a registered person's background and disciplinary history.
II. Expungement is the process of removing complaints from a registrant's history.
III. An Investor Brochure describes the process by which FINRA handles complaints against individuals.
IV. FINRA requires customer complaints to be retained for four years.

Outside Business Activities

These outside activities include a registered person serving on a company's board of directors, writing articles for a financial publication on a part-time basis, or bartending on the weekends; however, it does not include volunteer/charity work or hobbies

Requirements

Written Notice
- A registered person must provide prior written notice to her employer to be involved in outside activities if:
  - She is being compensated or has a reasonable expectation of being compensated

Update Form U4
- Although firm approval is NOT required, the RR must update her Form U4 and the information is disclosed through BrokerCheck

Private Securities Transactions

These are securities transactions that are executed by an associated person outside of her association with a member firm, including both public and private offerings

There are different requirements based on whether compensation will be received

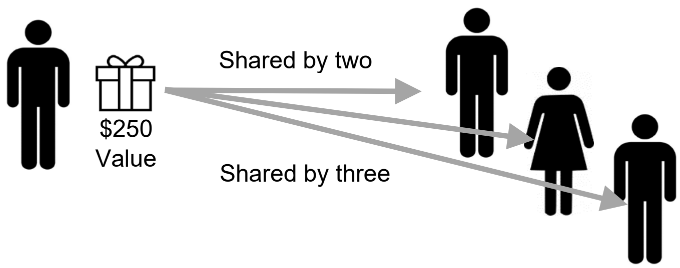
If compensation is to be received:
An RR must obtain his employing firm's written permission and the firm must record the transactions on its books • Compensation includes commissions, finder's fees, tax benefits, securities, or the right to receive securities

If NO compensation is to be received:
An RR must provide his employing firm with written notice which details the trade and must obtain his firm's written acknowledgement of receipt

The Gift Limit

Gifts that RRs make to employees who can direct business of their employer back to the RR's firm are limited to $100 per person, per year

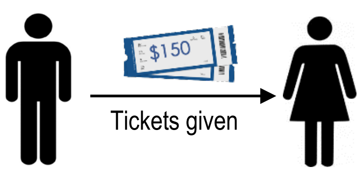
- FINRA approval is NOT required
- FINRA does consider the dollar value and number of intended recipients

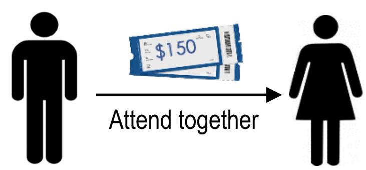


The Gift Limit

Rule also applies to gifts and gratuities from mutual fund distributors or wholesalers to B/D salespersons

- Limit may be exceeded for events involving family relationships (e.g., wedding, birth of child)
- If attended by the gift giver, an occasional meal, sporting event, or theater production is exempt as an entertainment/business expense
- Gifts are value based on the greater of their cost or market value





Other Compensation Related Rules

TRAINING AND EDUCATION EXCEPTION	Permits training program offerors (product distributors) to pay or reimburse for meetings which are attended by RRs and serve an educational purpose, if: ▪ RRs have their broker-dealer's permission to attend ▪ Attendance is not attached to a sales target ▪ Location is appropriate ▪ Payments and reimbursements are limited to the RRs (not guests)
IN-HOUSE INCENTIVES	▪ Non-cash incentives are permitted as long as they're based on total sales, not on the sale of a specific product

Political Contribution Rule – MSRB Rule G-37

This rule addresses political contributions that are made by municipal finance professionals (MFPs) to persons who can direct municipal debt underwriting business

- MFPs include associated persons of a broker-dealer who are primarily engaged in the following activities related to municipal securities:
  - Underwriting
  - Sales
  - Financial advisory or consulting services
  - Research or investment advice
- RRs who recommend municipal securities to retail customers are excluded

MSRB Rule G-37
is the "No Pay to Play Rule"

Rule G-37 – Maximum Contributions and Penalties

The rule places a limitation on contributions (which could include any gift, subscription, loan, advance, or deposit)

MFP Can Vote for Candidate
An MFP may contribute $250 per candidate, per election cycle, to candidates for whom he may vote

MFP Cannot Vote for Candidate
An MFP may make NO contribution to candidates for whom he may NOT vote

If a violation occurs, a two-year ban is imposed on negotiated underwriting business with the issuer.

Activity

Read each statement and determine whether it is TRUE/FALSE.

PRIOR WRITTEN NOTICE MUST BE PROVIDED IF AN RR IS BEING COMPENSATED FOR A PART-TIME JOB	
FIRMS ARE NOT REQUIRED TO MAINTAIN RECORDS OF COMPENSATION THAT RRs RECEIVE FOR TRANSACTIONS EXECUTED OUTSIDE OF THEIR FIRM	
A GIFT VALUED AT $175 AND GIVEN TO TWO RRs IS ACCPETABLE	
A TRIP TO A LUXURY RESORT AWARDED TO THE RR WHO SELLS THE MOST SHARES OF THE FIRM'S PROPRIETARY MUTUAL FUND IS ACCEPTABLE	

Activity

Which statements are TRUE regarding the MSRB's political contribution rules? Circle all that apply.

I. The rules apply to all municipal registered representatives.
II. A $100 contribution to a candidate for whom an MFP cannot vote is acceptable.
III. A $250 contribution to a candidate for whom an MFP can vote is acceptable.
IV. A violation results in a two-year ban on negotiated underwriting business.

Chapter 19 – Economic Factors

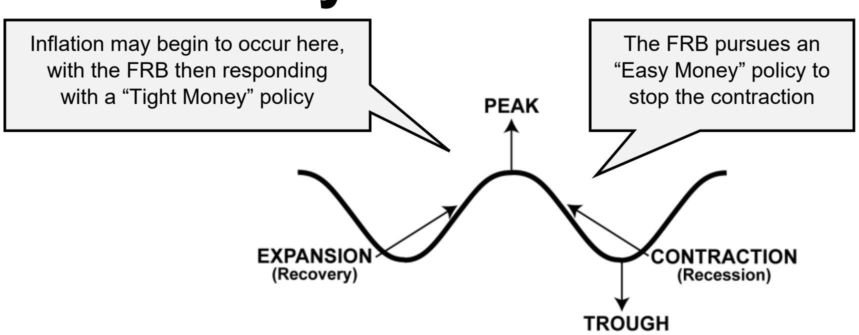
Key Topics

1	2	3	4
MEASURING THE ECONOMIC CLIMATE	KEY INTEREST RATES AND STOCK CLASSIFICATION	MONETARY AND FISCAL POLICY	INTERNATIONAL ACTIVITIES AND FUNDAMENTAL TOOLS
Learn about economic terms, indicators, and the business cycle.	Learn about the primary interest rates and classifications of stock.	Learn about how the U.S. government and FRB attempt to influence the economy.	Learn about the balance of trade and the contents of balance sheets and income statements.

Economic Terms

Gross Domestic Product (GDP)	Measurement of the output of goods and services produced within the U.S. (disregards origin of producer) ▪ Key measure of aggregate economic activity
Consumer Price Index (CPI)	Measures the change in prices of goods purchased by a typical consumer ▪ Key measure of inflation
Inflation	"Too much money chasing too few goods" ▪ Leads to a rise in prices of goods and services ▪ High inflation usually accompanies high interest rates
Deflation	A general decline in prices, often caused by a reduction in the supply of money or credit ▪ Interest rates trend downward

The Business Cycle



Economic Indicators

Leading Economic Indicators	Coincident Economic Indicators	Lagging Economic Indicators
▪ Building permits, private housing units ▪ Manufacturers' new orders, consumer goods, non-defense capital goods ▪ S & P 500 Index ▪ Initial claims for unemployment insurance ▪ Interest rate spreads, 10-year T-bonds less federal funds	▪ The Index of Industrial Production ▪ Employees on non-agricultural payrolls ▪ Personal income less transfer payments	▪ Change in the Consumer Price Index for services ▪ Average prime rate charged by banks ▪ Average duration of unemployment

Activity

Match each term to the appropriate description.

CONSUMER PRICE INDEX	Personal income
FRB EMPLOYS A TIGHT MONEY POLICY	During periods of contraction
FRB EMPLOYS AN EASY MONEY POLICY	Key measure of inflation
LEADING INDICATOR	Prime rate
COINCIDENT INDICATOR	S&P 500 Index
LAGGING INDICATOR	As the peak is approached in the business cycle

Measuring Interest Rates

Prime Rate
- The rate charged by commercial banks to their best corporate clients

Discount Rate
- The rate charged by the FRB when a member bank borrows from it

Federal Funds Rate
- The rate charged on an overnight loan of reserves between member banks

Call Money Rate
- The rate charged by commercial banks on collateralized loans to broker-dealers

Classifications of Stock

Cyclical	Defensive
Performance tends to run parallel to changes in the economy ▪ Includes machine tool companies, construction firms, transportation and automotive ▪ These tend to do well during the expansion phase of the business cycle	Have smaller reactions to changes in the economy ▪ Examples include utility, tobacco, alcohol, cosmetic, pharmaceutical and food companies ▪ These tend to do better during contraction
Growth	**Value**
Companies whose sales and earnings are growing at a faster rate than the economy ▪ They reinvest most of their earnings and pay little or no dividends ▪ Tend to be riskier than other stocks, but offer greater potential for appreciation	Stocks that trade at lower prices relative to the issuing company's fundamentals ▪ The risk is that investors may ignore these companies ▪ Investors who buy value stocks are considered contrarians

Market Capitalization of Stocks

Large-Cap: More than $10 billion
Mid-Cap: Between $2 billion and $10 billion
Small-Cap: Between $300 million and $2 billion
Micro-Cap: Between $50 million and $300 million
Nano-Cap: Below $50 million

Activity

Read each statement and determine whether it is TRUE/FALSE.

THE FEDERAL RESERVE BOARD SETS THE FEDERAL FUNDS RATE	
A VALUE STOCK IS ONE THAT IS OFTEN OVERLOOKED BY INVESTORS	
DEFENSIVE STOCKS TEND TO PERFORM WELL DURING PERIODS OF CONTRACTION	
A MICRO-CAP STOCK IS CONSIDERED LESS RISKY THAN A SMALL-CAP STOCK	

Monetary and Fiscal Policy

	Keynesian	Monetarist
Principally attempt to influence		
Type of policy		
Responsible for implementation		

Tools of the Fed

The following “tools” are listed from the least to the most used

Regulation T	Extension of credit by broker-dealers
Discount Rate	The only rate that’s directly controlled by the Fed
Reserve Requirement	Amount of money that a bank must maintain based on a percentage of deposits
Federal Open Market Committee (FOMC)	Trades U.S. Treasuries through “primary government dealers”

Actions of the FOMC

To increase money supply and ease credit → The FOMC will → BUY SECURITIES and Engage in Repos

- This will cause deposits and reserves to ________________________

To decrease money supply and tighten credit → The FOMC will → SELL SECURITIES and Engage in Reverse Repos

- This will cause deposits and reserves to ________________________

The goal of these actions is to influence the fed funds rate

International Economic Factors

Interest Rates

- An inverse relationship exists between the U.S. dollar and foreign currencies
- Rising interest rates in U.S. will normally be accompanied by a strengthening of the dollar in relation to other currencies

Balance of Trade

- System of recording all of a country's economic transactions with the rest of the world over a specific period
    - Favorable balance of trade:
        - A decline in the dollar (relative to other currencies)
        - When the U.S. exports more than it imports
    - Unfavorable balance of trade
        - An increase in the dollar (relative to other currencies)
        - When the U.S. imports more than it exports

Foreign Exchange

Companies that receive revenue and incur costs in foreign currencies will have exchange-rate risk

Costs	Revenues
A U.S. company that manufactures overseas will have higher costs if the U.S. dollar falls (FC rises) and lower costs if the U.S. dollar rises (FC falls)	A U.S. company that has sales overseas will have higher revenue if the U.S. dollar falls (FC rises) and lower revenue if the U.S. dollar rises (FC falls)

Activity

Fill in the blank with the correct answers.

1. The Federal Reserve Board changes and provides lending through the ________________________________.
2. ________________________ is the rate used by the Federal Reserve Board to control the extension of credit by broker-dealers.
3. The Federal Open Market Committee will increase the money supply when it ____________________, which should ________________________ deposits and reserves.
4. The __________________________________ dictates the amount that member banks must keep on deposit.
5. _____________________________________ in the U.S. generally leads to a strong dollar.
6. The balance of trade tends to become more favorable with a _____________ dollar relative to foreign currencies.

The Balance Sheet

Current Assets • Cash • Marketable Securities • Accounts Receivable • Inventory	**Current Liabilities** • Accounts Payable • Dividends Payable • Interest Payable
Fixed Assets • Land • Buildings • Equipment	**Long-Term Liabilities** • Notes and Bonds
Intangibles • Goodwill • Patents • Trademarks	**Shareholders' Equity** • Preferred Stock and Common Stock • Retained Earnings • Paid-In Capital or Capital Surplus

Total Assets = Total Liabilities + Shareholders' Equity

The Income Statement

Revenue (Sales)
−Cost of Goods Sold
Gross Profit
−Operating Expenses (SG&A, D&A)
Operating Income
+ Other Income or Expenses
Earnings Before Interest and Taxes (EBIT)
−Interest
Taxable Income
−Taxes
Net Income or Loss

Activity

Which statements are TRUE regarding balance sheets and income statements? Circle all that apply.

I. The balance sheet equation is total assets = total liabilities + shareholders' equity.
II. Accounts receivable is considered a current liability.
III. Paid-in capital is part of shareholders' equity.
IV. In order to determine a company's earnings per share, its income statement must be examined.

Chapter 20 – Investment Risks

Key Topics

1
SYSTEMATIC RISKS
Learn about the systematic (non-diversifiable) risks.

2
UNSYSTEMATIC RISKS
Learn about the risks that can be offset through diversification.

3
PORTFOLIO STRATEGIES
Learn about passive and active portfolio strategies.

4
HEDGING
Learn about how hedging can protect different positions in a portfolio.

Systematic Risks

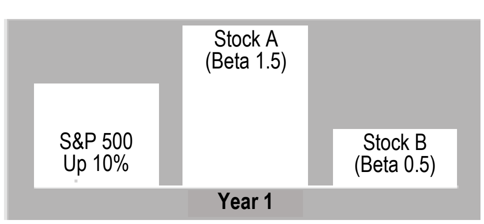
Systematic risks are those that affect the value of all securities and cannot be avoided through diversification, including:

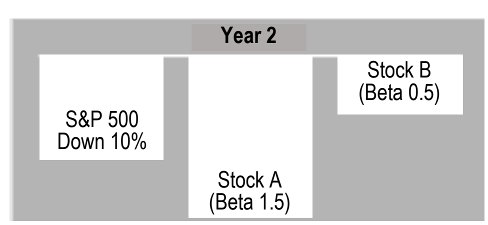
Market Risk	Risk inherent in all securities due to market fluctuation
Interest-Rate Risk	Risk that the value of a fixed income investment (bond) will decline due to a rise in interest rates
Inflation Risk	Risk that an asset or the purchasing power of income may decline over time, due to the shrinking value of the country's currency ▪ To find a bond's real interest rate, the formula is: Nominal Yield – Inflation Rate
Event Risk	Risk that a significant event will cause a substantial decline in the market

Measuring Systematic Risk

Beta measures the volatility of an asset (typically an equity) relative to the entire market

- A stock's beta is compared to the beta of the S&P 500, which is always 1.00
- If a stock's beta is more than 1, it's expected to outperform when the market is up and underperform when the market is down
- If a stock's beta is less than 1, it's expected to underperform when the market is up and outperform when the market is down

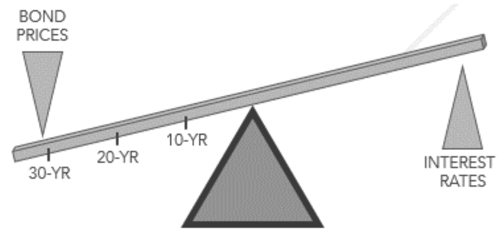




The Impact of Interest-Rate Risk

Fixed income investors (bondholders) are most affected by interest-rate risk

- Rising interest rates result in falling bond prices
  - Cannot be avoided by diversifying
  - Long-term debt is more vulnerable than short-term debt
  - Duration is used to measure the change in a bond's price based on a given change in interest rates
    - Measured in terms of years; the higher the duration, the higher the risk



- Equities of highly leveraged companies (e.g., utilities) and preferred stocks are susceptible to interest-rate risk

The Impact of Inflation Risk

Inflation risk, also referred to as purchasing power risk, is most detrimental to investments that offer fixed payments

- Inflation leads to increasing interest rates, thereby causing fixed payment securities to fall in value
- Rising prices diminishes the purchasing power of these same securities
- Common stock, variable annuities, real estate, and precious metals tend to perform better during times of inflation

What is Inflation? Inflation occurs when there's a continual increase in consumer prices or decline in a currency's purchasing power, caused by an increase of currency and credit beyond the availability of goods and services.

Activity

Match each term to the appropriate description.

RISING INTEREST RATES	Investment underperforms a rising market and outperforms a falling market
FALLING INTEREST RATES	Investment outperforms a rising market and underperforms a falling market
REAL INTEREST RATE	Bond prices are increasing
HIGH BETA	Purchasing power is diminished
LOW BETA	Factors in the rate of inflation when determining return

Unsystematic Risks

These risks are unique to a specific security and can managed through diversification

BUSINESS RISK	▪ Risk that a company may perform poorly causing a decline in the value of the stock
REGULATORY RISK	▪ Risk that new regulations may have a negative impact on an investment's value
POLITICAL RISK	▪ Risk that political event outside of the U.S. could adversely affect the domestic markets
LIQUIDITY RISK	▪ Stemming from a lack of marketability, this is risk that an investment cannot be bought or sold quickly enough to prevent or minimize a loss

Additional Risks

CAPTIAL RISK	CREDIT RISK	CURRENCY RISK	LEGISLATIVE RISK
▪ Risk of investors losing their invested capital (lower for bonds)	▪ Risk that a bond may not repay its obligation	▪ Risk of loss when converting an investment that's made in a foreign currency into U.S. dollars	▪ Risk that new laws may have a negative impact on an investment's value (e.g., tax code changes)

Additional Risks

OPPORTUNITY RISK	REINVESTMENT RISK	PREPAYMENT RISK
▪ Risk of passing on the opportunity of making a higher return on another investment	▪ Risk that interest rates will fall and semiannual coupons will be reinvested at a lower rate	▪ Risk that mortgages will be paid off early due to lower interest rates, resulting in reinvestment in lower yielding investments

Activity

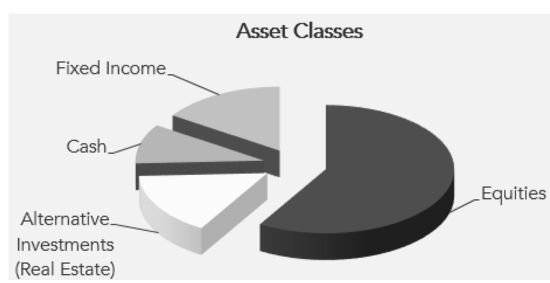
Read each statement and determine which type of risk it describes.

THE COST OF IMPORTING GOODS IS INCREASING	
MORTGAGE-BACKED SECURITIES ARE MATURING EARLY	
NEW LEADERSHIP ASSUMES CONTROL IN A FOREIGN COUNTRY	
CONGRESS HAS MADE CHANGES TO THE TAX CODE	

Asset Allocation

Asset allocation focuses on a portfolio constructed of various asset classes

An optimal portfolio (one producing the greatest return for a given amount of risk) is based on a client's goals, expected return, and risk tolerance



Passive (Strategic) Asset Allocation

Assumes that markets are efficient and creating an optimal portfolio requires allocating assets based on a client's risk tolerance and investment objectives

Buy-and-Hold (do nothing)	Indexing	Systematic Rebalancing
▪ Minimizes transaction costs and tax consequences ▪ However, the asset mix of the portfolio may drift over time	▪ Maintaining investments in companies that are part of major stock (or bond) indexes ▪ Infrequent rebalancing	▪ Involves buying and selling assets on a periodic basis ▪ More frequent rebalancing keeps the portfolio closer to its strategic allocation ▪ May result in higher transaction costs as well as tax consequences

Tactical (Active) Asset Allocation

Assumes that markets are inefficient

Involves altering the asset mix in anticipation of changing economic conditions/events (market timing)

- **Sector Rotation** is one example
  - Money is moved from one industry or sector to another in an attempt to beat the market
  - A portfolio manager who employs a sector rotation strategy will try to anticipate the next turn in the business cycle and shift assets into the sectors that will benefit

Dollar Cost Averaging

Involves making the same periodic investment regardless of share price over a fixed period of time

- Investors will purchase more shares when price is low and fewer shares when price is high
- Advantage:
  - Results in the average cost of shares being less than their average price

> With dollar cost averaging, the good news is that:
> - When share prices are up, the previously purchased shares are worth more
> - When shares prices are down, the investor will be able to purchase more shares at a lower price

Hedging Risk

Options are popular investments to use as a hedge (protection):

- Equity options can protect individual stocks
- Index options can protect an entire portfolio
- Currency options can protect against exchange-rate risk
  - To hedge the U.S. dollar, investors must take the opposite position on the currency option

If an investor *anticipates an increase*, in the underlying asset's value, *but fears a decrease*, he should:

If an investor *anticipates a decrease*, in the underlying asset's value, *but fears an increase*, he should:

Activity

Which statements are TRUE regarding different types of portfolio strategies? Circle all that apply.

I. A buy-and-hold strategy may result in portfolio drift.
II. Indexing is utilized to take advantage of market inefficiencies.
III. Sector rotation will try to anticipate the next move in the business cycle.
IV. Dollar cost averaging results in realized profits on the investment.