Uniform Investment Adviser Law Exam

Series 65 | 10th Edition

Securities Class Notes

Financial Education

KAPLAN UNIVERSITY SCHOOL OF PROFESSIONAL AND CONTINUING EDUCATION

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Series 65

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SERIES 65 UNIFORM INVESTMENT ADVISER LAW EXAM CLASS NOTES, 10TH EDITION

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Contents

Orientation

Thank you for choosing Kaplan *Financial* Education for your Series 65 exam preparation. This class will apply adult learning principles to give you the tools you'll need to pass your exam on the first attempt.

This book will save you time by covering the main points presented in class and serving as a reference when you review for the exam. Extra space is provided for your notes.

We recommend that you complete all practice questions in the Class Notes as well as those in *Series 65 License Exam Manual* before you take the Series 65 exam. You should then take the exam within two weeks of taking the class after completing as many of the questions in the Securities-ProTM QBank as you can.

This course may qualify for CE credit in your state. For information on filing for CE credit, please visit www.kfeducation.com.

The Series 65 exam has 140 multiple-choice questions (10 of which are "pre-test" questions that are not scored) and a time limit of three hours. You must correctly answer at least 72% (94 correct) of the questions on the exam to pass. Good luck!

Test Topic	# of Questions	% of Exam
Economic Factors and Business Information	20	15%
Investment Vehicles	32	25%
Investment Recommendations and Strategies	39	30%
Legal and Regulatory Guidelines	39	30%
Total	130	100%

Kaplan Financial Education Series 65 Live Classroom Study Schedule	
Topics covered in your class Day One: Federal Securities Regulations State Regulation Under the Uniform Securities Act Federal and State Regulation of Investment Advisers and Their Representatives Types and Characteristics of Fixed Income (Debt) Securities and Methods Used to Determine the Value of Fixed Income Securities	Topics covered in your class Day Two: Types and Characteristics of Pooled Investments Including Methods Used to Determine Their Value Types and Characteristics of Derivative Securities Alternative Investments Basic Economic Factors and Financial Reporting Methods of Quantitative Analysis Type of Client Client Profile Portfolio Management Styles, Strategies, and Techniques Tax Considerations Trading Securities Performance Measures Retirement Plans, Including ERISA Issues and Educational Funding Programs
Day One Homework	**Day Two Homework**
Complete two 40-question exams in your SecuritiesPro Qbank that cover topics presented during your Day One lecture	Complete two 40-question exams in your SecuritiesPro Qbank that cover topics presented during your Day Two lecture
Watch the following Class Videos: Types and Characteristics of Equity Securities Including Methods Used to Determine Their Value Fixed Income Securities (Series 65 Portion) Types and Characteristics of Cash and Cash Equivalents	Watch the following Class Videos: Insurance-Based Products Economic Factors and SEC Reporting (Series 65 Portion) Types of Risk
Content covered in actual classroom may vary. The topics listed above are guidelines only.	

WARM-UP TEST

1. Which of the following is NOT required in a preliminary prospectus?
   A. Written statement in red that the prospectus may be subject to change and amendment and that a final prospectus will be issued
   B. Purpose for which the funds being raised will be used
   C. Final offering price
   D. Financial status and history of the company

2. If a nonexempt issuer wanted to register simultaneously with the state and the SEC, which method would be used?
   A. Notice filing
   B. Coordination
   C. Qualification
   D. Registration

3. Under which of the following circumstances does the SEC allow an investment adviser to charge performance-based fees?
   A. The client initially has a specified minimum amount of assets under management or a specified minimum net worth.
   B. Compensation paid in this way is for gains reduced by losses over a minimum period of 1 year.
   C. The client understands the proposed compensation and believes that it is a fair method of compensation.
   D. Both A and B are correct.

4. Which of the following statements regarding the antifraud provisions of the Uniform Securities Act (USA) is TRUE?
   A. Exempt securities are not subject to the antifraud provisions of the USA.
   B. The only securities exempt from those provisions are those issued by national governments or political subdivisions of countries that maintain diplomatic relations with the United States.
   C. The only securities exempt from those provisions are those that are properly registered under blue-sky laws.
   D. No securities are exempt from the antifraud provisions of the act.

5. Which of the following securities are exempt from the registration and disclosure provisions of the Securities Act of 1933?
   I. Any interest in a railroad equipment trust certificate
   II. Municipal bonds
   III. US government securities
   IV. Commercial paper maturing in nine months or less
   A. I and II
   B. I and III
   C. II and IV
   D. I, II, III, and IV

6. The Investment Advisers Act of 1940 requires delivery of a brochure containing information about the adviser's background and business practices in which of the following situations?
   I. The service provided is an individual supervisory service.
   II. The client is an investment company.
   III. The contract is for an impersonal advisory service requiring payment of less than $500.
   IV. The client is an individual with net worth of more than $1 million.
   A. I and II
   B. I and IV
   C. II and III
   D. III and IV

7. Which of the following are regulated or mandated by the Securities Exchange Act of 1934?
   I. Full and fair disclosure in the registration of new offerings
   II. Creation of the SEC
   III. Manipulation of the market
   IV. Margin requirements on securities
   A. I, II and III
   B. I and IV
   C. II and III
   D. II, III, and IV

8. Which of the following securities are exempt from the registration requirements of the Uniform Securities Act?
   I. Investment contract issued in connection with an employee pension plan
   II. Securities issued by St. Paul's Catholic Church in Tempe, Arizona
   III. Securities issued by a regulated public utility
   IV. Securities issued by the provincial government of Ontario, Canada
   A. I and II
   B. I and III
   C. II and IV
   D. I, II, III, and IV

9. Which of the following persons would NOT be considered an investment adviser under the Investment Advisers Act of 1940?
   A. A person who advertises and is in the business of providing investment services but does not charge a separate fee
   B. A person who provides investment advice to individual retirement plan participants in defined contribution plans, and is not compensated by them but is paid a fee by the corporate sponsor
   C. A teacher who explains investment programs to retirees on a volunteer basis
   D. An agent of a registered broker-dealer who also has a separate financial planning business

10. In which of the following circumstances is a person most likely to be considered an investment adviser?
   A. A pension consultant who bills by the hour for the advice he provides on the merits of specific investment managers
   B. A sports representative or agent who successfully negotiates contracts and endorsements for athletes, then suggests that the athlete place his new-found wealth in the trust department of a major commercial bank
   C. A financial planner who only gives general investment advice not related to securities and then offers discounts to clients who subscribe to a newsletter he publishes on fly fishing
   D. A teacher who gives better grades to the 10 most successful students who invest an imaginary $100,000 portfolio employing both the investment techniques and specific securities recommendations outlined in the course

11. Which of the following must an investment adviser representative consider before recommending a municipal security to a customer?
   A. Customer's state of residence
   B. Customer's tax status
   C. Municipal security's rating
   D. All of the above

12. All of the following statements regarding government agency securities are true EXCEPT
    A. they may be backed by the federal government
    B. they are often considered riskier than corporate securities
    C. interest paid is always subject to federal income tax
    D. they are authorized by Congress

13. A corporation calls in its debt when interest rates are
    A. rising
    B. declining
    C. volatile
    D. stable

14. Interest on a California general obligation bond purchased by a resident of San Francisco is exempt from
    A. federal income tax only
    B. state income tax only
    C. capital gains taxes only
    D. state and federal income taxes

15. An investor in the 25% marginal income tax bracket owns a municipal bond with an 8% coupon. If the CPI is 3%, what is the investor's inflation-adjusted after-tax return?
    A. 3%
    B. 5%
    C. 5.76%
    D. 6%

16. Which of the following are NOT considered money market instruments?
    I. ADRs
    II. Commercial paper
    III. Corporate bonds
    IV. Negotiable CDs
    A. I and III
    B. I and IV
    C. II and III
    D. II and IV

17. Which of the following has the least exposure to inflation risk?
    A. Preferred stock
    B. Cash
    C. Common stock
    D. Fixed annuity

18. If an elderly widow with no independent income other than Social Security payments wishes to invest the proceeds from her recently deceased husband's life insurance, which of the following would be the most suitable recommendation?
    A. High-quality dividend paying preferred stocks
    B. Call options
    C. Municipal bonds with short-term maturities
    D. An oil and gas exploration program that is going to strike

19. The statistical measurement that indicates how much an investment's returns have fluctuated, compared to its average return, over a given period of time is known as
    A. beta
    B. standard deviation
    C. R-squared
    D. convexity

20. To assess the performance of a small cap stock fund you compare its results against
    A. the Dow Jones Industrial Average
    B. the S&P 100
    C. the S&P 500
    D. the Russell 2000

WARM-UP TEST ANSWER SHEET

Name: _____ Date: _____ Score: _____

1.	_____	11.	_____
2.	_____	12.	_____
3.	_____	13.	_____
4.	_____	14.	_____
5.	_____	15.	_____
6.	_____	16.	_____
7.	_____	17.	_____
8.	_____	18.	_____
9.	_____	19.	_____
10.	_____	20.	_____

Unit 1

Laws, Regulations, and Guidelines, Including Prohibition on Unethical Business Practices

Session One

Federal Securities Regulations

BENCHMARK SURVEY

It is important to Kaplan that we provide you with the best licensing exam preparation possible. Your feedback is important to us. We will be asking you to evaluate both your class and your instructor. The evaluation process is done online to protect your privacy and to give you the freedom to be open in your response.

1. During the last day of class, you will receive the initial survey through your email.

2. If you do not respond to the first survey, you will receive a reminder email three business days after class.

3. A second survey will allow you to provide additional feedback regarding your success on the exam.

Thank you for taking part in this important process.

ABOUT THE SERIES 65 EXAM

- 130* questions
- 3-hour time frame
- 72% to pass

ABOUT THE SERIES 66 EXAM

- 100* questions
- 2½-hour time frame
- 73% to pass

* Both tests have 10 additional un-scored, pre-test questions

SECURITIES ACT OF 1933

A. APPLIES TO NEW ISSUES UNLESS SECURITY OR TRANSACTION IS EXEMPT

1. Examples of exempt securities
   - a. U.S. government and agency securities
   - b. State and local municipal bonds
   - c. Commercial paper—maximum 270-day (nine-month) maturity
   - d. Bank securities (not bank holding companies)
   - e. Intrastate offerings under Rule 147 (80% rule—100% residents, resale rule)
2. Example of exempt transactions—private placements under Regulation D
   - a. Rule 501—accredited investor
     - 1.) Institutional investors
     - 2.) Employee benefit plans over $5 million
     - 3.) Insiders of the issuer
     - 4.) Individual with individual or joint (with spouse) net worth greater than $1 million (excluding the net equity of primary residence) or earnings over $200,000/individual or $300,000/joint for the past two years and expected this year
   - b. File Form D within 15 days of the sale
3. Non-exempt securities
   - a. Requires filing registration statement with the SEC

b. Requires use of a prospectus

1.) Preliminary prospectus ("red herring") may be used while registration is pending (during "cooling off" period)

a.) No price or effective date, only expected price range

b.) No orders or deposits of money until effective date

2.) No highlighting or other alterations of prospectus is allowed

c. Examples of non-exempt securities

1.) Corporate stocks and bonds

2.) Options

3.) Investment company shares

4. Rule 482—Omitting Prospectus

a. Legal name for the typical mutual fund advertisement/tombstone ad

SECURITIES EXCHANGE ACT OF 1934

A. CREATED THE SEC

1. Objectives—Regulate the industry (people) and the secondary trading marketplaces

a. Exchanges

b. OTC

B. ANTIFRAUD PROVISIONS

C. PROVIDED FOR REGISTRATION OF STOCK EXCHANGES AND BROKER-DEALERS (AND ASSOCIATED PERSONS)

D. GRANTS THE FRB AUTHORITY TO REGULATE CREDIT (REG T)

1. Margin accounts

2. No credit on new issues and options

E. DEFINED CONTROL PERSON—OFFICER, DIRECTOR, MORE THAN 10% SHAREHOLDER, AND IMMEDIATE FAMILY

F. DEFINED DISCRETIONARY ACCOUNT

1. Select the asset and/or the action and/or the amount
2. Written authorization prior to first trade

G. ASSOCIATED PERSON—ANYONE ASSOCIATED WITH A BD, INCLUDING SILENT PARTNERS AND OUTSIDE DIRECTORS, BUT NOT CLERICAL PERSONNEL

INVESTMENT COMPANY ACT OF 1940

A. INVESTMENT COMPANY REGISTRATION UNDER THE ACT

1. Three categories of investment companies
   - a. Face-amount certificate company
   - b. Unit investment trust
   - c. Management companies
     - 1.) Open-end and closed-end
2. Requirements for investment company registration with SEC
   - a. Private capitalization of $100,000
   - b. Clearly defined investment objective
   - c. Annual financial reports to SEC
     - 1.) Semiannual to shareholders

B. SHAREHOLDERS' RIGHT TO VOTE

1. Changing nature of business
2. Changing investment objective or policies
3. Changing investment adviser

C. STRUCTURE OF INVESTMENT COMPANIES

1. Board of directors
   a. No felonies or securities-related misdemeanors
   b. Minimum 40% non-interested
2. Investment adviser to manage portfolio for a fee
   a. Two-year initial contract, renewable annually
   b. Maximum 60-day termination
   c. Must be in writing

D. GENERAL RESTRICTIONS ON INVESTMENT COMPANY MANAGEMENT

1. Purchase on margin
2. Selling short
3. Speculative options
4. Joint trading account
5. Purchasing greater than 3% of the voting shares of another investment company

E. 12B-1 FEES FOR SALES AND PROMOTIONAL EXPENSES

1. Initial approval: Whole board, independent board, and shareholders
2. Annual renewal and quarterly review: Whole board and independent board
3. Termination: Independent board or shareholders
4. No higher than .25% if using the term no-load

INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988

A. USING INFORMATION NOT AVAILABLE TO THE PUBLIC TO PROFIT OR AVOID A LOSS

B. LIABILITIES AND PENALTIES

1. Up to greater of $1 million or 300% profit made/loss avoided (civil penalty)
2. 20-year jail term (criminal penalty)
3. Both tipper and tippee may be held liable
   a. Registered representative and broker-dealer may be liable
4. Bounty to informant

C. MISAPPROPRIATION THEORY

1. Insiders who violate insider trading rules may be liable to contemporaneous traders who did not have insider information for losses sustained
2. Called private rights of action
3. Penalties and statute of limitations
   a. Lawsuits may be initiated up to five years after violation
   b. Damages as much as the profits made or the losses avoided

NATIONAL SECURITIES MARKETS IMPROVEMENT ACT OF 1996 (NSMIA)

A. PREEMPTIVE AUTHORITY OF SEC

B. DUAL REGISTRATION REQUIREMENTS—ELIMINATED FOR CERTAIN SECURITIES AND INVESTMENT ADVISERS

C. CREATED FEDERAL COVERED CLASS OF ADVISERS AND SECURITIES—ADVISERS MANAGING $100 MILLION OR MORE MAY REGISTER FEDERALLY (SEC)

TEST PREP 1

An exemption from the standard registration requirements of the Securities Act of 1933 would apply in the sale of each of the following EXCEPT

A. bonds issued by the government of Canada
B. common stock under the provisions of Regulation D
C. bonds issued by the city of Baton Rouge
D. preferred stock under the provisions of Rule 147

TEST PREP 2

Under the Securities Exchange Act of 1934, the SEC is granted the power to regulate the activities of

I. commercial banks
II. the Federal Reserve Board
III. broker-dealers
IV. stock exchanges

A. I and II
B. I and IV
C. II and III
D. III and IV

Test Prep Answers

1. A

2. D

Session Two

State Regulation Under the Uniform Securities Act (USA)

ORIGINS OF THE UNIFORM SECURITIES ACT (USA)

A. PURPOSE

1. To unify state laws and protect investors

B. USA AS MODEL LEGISLATION

1. First drafted in the mid-1950s
2. Template or guide that each state uses in drafting state securities laws
3. The exam tests on the template, not individual states' versions

DEFINITIONS—THE ADMINISTRATOR

Official or agency that administers state securities laws

A. FUNCTIONS OF THE ADMINISTRATOR

1. Inspects registrants (BDs and IAs)
2. Investigates complaints
3. Subpoenas evidence
4. Establishes registration, testing, and fees
5. Denies, suspends, or revokes registration

B. JURISDICTION

1. The Administrator has power over any offer to buy or sell that:
   a. originated in the Administrator's state;
   b. was directed to the Administrator's state; or
   c. was accepted in the Administrator's state.
2. However, the Administrator does not have jurisdiction merely because a check was mailed or certificates were sent from the Administrator's state.

DEFINITIONS

A. PERSON

1. In securities law, a *person* is an entity capable of issuing, dealing in, or investing in securities, such as the following:

   a. Individuals—natural person

   b. Businesses (corporations, partnerships, associations)

   c. Governmental units (state, counties, school districts, or political subdivisions) and many others (see LEM)

2. Learn what is NOT a person:

   a. Minors

   b. Deceased individuals

   c. Those declared mentally incompetent

B. SECURITY

1. General definition—four prongs:

   a. An investment of money is made in

   b. A common enterprise where

   c. A profit is anticipated

   d. Through efforts of third-party management

   This is the Howey decision of the U.S. Supreme Court.

C. TYPES OF SECURITIES

1. Anything you would commonly think of, including:

   a. stock;

   b. bonds, debentures, and notes;

   c. options;

d. certificate of deposit for a security (ADR, ADS); or

e. variable contracts issued by insurance companies (life/annuity).

Check your LEM for the complete list.

D. NOT SECURITIES

1. Insurance

a. Fixed insurance policies

b. Fixed annuities

2. Retirement plans (IRA, Keogh)

3. Collectibles (art, stamps)

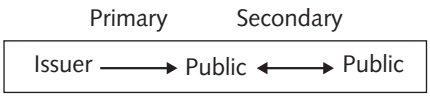
4. Commodity futures and actual commodities (precious metals, grains)

5. Condominium used as personal residence (e.g., not resort rentals)

6. Currency

E. ISSUER—PERSON WHO ISSUES OR PROPOSES TO ISSUE A SECURITY: PRIMARY TRANSACTION

F. NON-ISSUER—PERSON OTHER THAN ISSUER: SECONDARY TRANSACTION



G. BROKER-DEALER

1. Person with a place of business in this state engaged in business of effecting securities transactions for accounts of others (broker) or for own account (dealer)

2. Definition excludes the following persons:

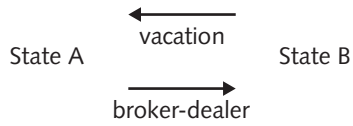
a. Agents (state term for registered representative)

b. Issuer

c. Bank or trust company

d. Person with no office in state who limits clients to issuers of the security, other broker-dealers, or institutional investors

e. Person with no office in state who directs offers to existing clients who are not residents of the state



H. INSTITUTIONAL INVESTORS

1. Banks (including savings institutions and trust companies)

2. Employee benefit plans (e.g., pension or profit sharing plans with assets of at least $1 million)

3. Insurance companies

4. Investment companies (as defined in the Investment Company Act of 1940)

I. AGENT (SUPERVISED PERSON) (A NATURAL PERSON)

1. Individual representing a **broker-dealer** in effecting or attempting to effect purchases or sales of securities must register as agents.

a. Excluded from the definition

1.) Clerical and administrative personnel

2.) Board member or capital contribution only (silent partner)

b. Client moves—agent cannot be registered in new state if the broker-dealer is not.

2. Individuals representing an **issuer** in effecting or attempting to effect purchases or sales of securities must register as agents EXCEPT

a. "Agent" does not include an individual who represents an **issuer** in effecting transactions

1.) which are exempted under the USA (exempt transactions);

2.) in securities issued by one of the five specified exempt issuers (see 2.3.2.2.1 in the LEM);

3.) in federal covered securities; or

4.) with employees of the issuer and no compensation is received.

J. INVESTMENT ADVISER (SESSION 3)

1. A person in the *business* of giving *advice* on securities for *compensation*

2. Registers with state OR SEC

K. INVESTMENT ADVISER REPRESENTATIVE (SESSION 3)

1. *Individual* representing an investment adviser

2. Registers on the state level only

L. OFFER

1. Attempt to solicit purchase

2. Attempt to dispose of security or interest in security for value

3. Sale of rights, warrants, or convertible security is an offer of the underlying stock

M. SALE

1. Transfer for value

a. Bonus of warrants or stock

2. Gifts of assessable stock

3. Sale does not include:

a. gifts of non-assessable stock;

b. stock dividend or stock split (if no payment);

c. bona fide pledge or loan (in short sale—loan of securities); or

d. act resulting from approved merger or business reorganization.

LICENSING AND REGISTRATION REQUIREMENTS OF PERSONS

	Broker-Dealer	Agents/IAR	Investment Adviser
Minimum net cap or net worth	Net capital	No	Net worth
Surety bond	Custody/Discretion	Discretion (agent only)	Custody/Discretion
Examination (audits)	Yes	No	Yes
Filing (fees)	Yes	Yes	Yes
Transferable	No	No	No

A. REGISTRATION PROCEDURES

1. Application

a. Background and history

b. Convictions (10 years; felonies and securities-related misdemeanors)

c. Financial condition (broker-dealers and investment advisers)

d. Consent to service of process = power of attorney

1.) From applicant to Administrator

2.) Must accompany new applications for broker-dealers, agents, investment advisers, and investment adviser representatives

3.) Permanent part of record

4.) Allows Administrator to receive legal papers

5.) Approval for investigation

2. Registration effective date

a. Not until granted registration by state—noon of 30th day

b. Not solely on passing exam

3. Termination procedures

a. Agent—notification to Administrator by both agent and broker-dealer

b. IAR—with state IA, IA notifies Administrator

c. IAR—with federal covered IA, IAR notifies Administrator

d. Effective 30 days after receipt of application to withdraw, but Administrator retains jurisdiction for one year

4. Broker-dealers (Form BD) and investment advisers (Form ADV)

a. Form of organization

b. Method of business

c. Registration of broker-dealer or investment adviser automatically registers individual (agent or IAR) who is partner, officer, or director with those functions

d. Expires December 31 unless renewed (also applies to agent and investment adviser representative)

e. Successor firms

1.) Merger, acquisition, or sale

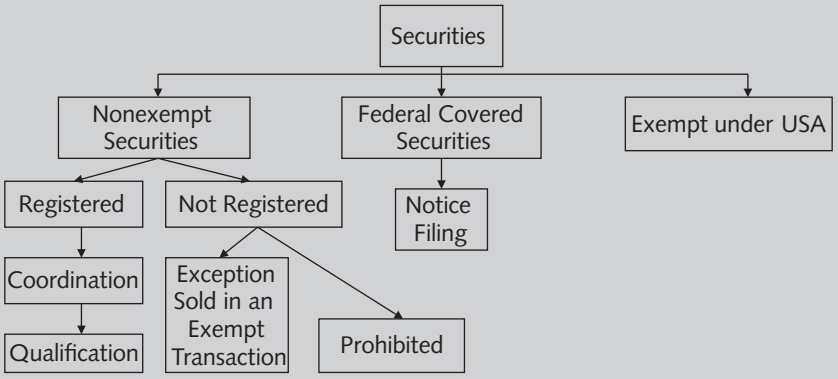
2.) New application filed, effective for remainder of year

3.) No additional filing fees

REGISTRATION OF SECURITIES UNDER THE USA

No person can lawfully offer or sell any security in state unless:

- the security is registered under the USA;
- the security or transaction is exempt from registration under the USA (exempt security or exempt transaction); or
- the security is a federal covered security.



A. EXEMPT SHORT-TERM NOTES/DEBT OBLIGATIONS

1. Promissory notes (commercial paper)

a. Maximum maturity—nine months (270 days) or less

b. Minimum $50,000 denomination

c. Three highest ratings

B. SECURITIES ISSUED BY EXEMPT ISSUERS

1. US government and agencies

2. Municipalities

3. Canadian government (federal and political subdivisions but not corporations)

4. Foreign national governments with diplomatic relations (issued or guaranteed by)

5. Banks, savings institutions, and trust companies

6. Insurance companies (stocks and bonds, not variable contracts)

7. Regulated public utility companies and common carriers

8. Charitable, religious, and nonprofit organizations

C. OTHER EXEMPT SECURITIES—FEDERAL COVERED SECURITIES

1. Exchange-listed securities

2. Nasdaq traded security

3. Investment companies registered under the Investment Company Act

4. Securities or transactions exempted under the Securities Act of 1933 (e.g., Regulation D private placements)

D. METHODS OF SECURITIES REGISTRATION AND NOTICE FILINGS

1. Notice filing

a. Administrator may require SEC filed documents

b. Quantity of securities being sold in the state (fee)

> For federal covered securities, generally investment company securities registered under the Investment Company Act of 1940

2. Coordination

a. Coordination of a state registration with federal registration

b. Registration by coordination is accomplished by filing a registration statement with the Administrator containing:

1.) three copies of latest prospectus filed with the SEC;

2.) copies of articles of indenture, articles of incorporation, and agreements among underwriters (if required by the Administrator); and

3.) amendments to prospectus filed with the SEC.

c. Effective at the same time as federal registration if:

1.) registration is on file for specified period (10–20 days);

2.) a statement of the maximum and minimum offering prices and underwriting discounts has been on file for two business days; and

3.) no stop order exists.

3. Qualification

   a. Primarily for intrastate issues (but can be used for any registration)

   b. Any information the Administrator requests

   c. Effective when declared so by the Administrator

4. General registration provisions

   a. Filing fees

   b. Effective for one year from effective date—If underwriters or the issuer are still attempting to distribute unsold shares, effectiveness of registration may be extended until all shares are sold.

      1.) May be amended after effective date to increase offering size if price and commissions remain unchanged

   c. Administrator may require issuer to file quarterly reports

   d. Registration statement may be filed by:

      1.) the issuer;

      2.) a broker-dealer; or

      3.) an interested party, usually a selling stockholder.

POWER OF THE ADMINISTRATOR TO DENY, SUSPEND, OR REVOKE THE REGISTRATION OF A SECURITY

A. IT MUST BE IN THE PUBLIC INTEREST, AND

1. registration statement is inaccurate, misleading, or incomplete;

2. officer of the issuer has been convicted of a securities-related crime (10 years);

3. security is subject to court injunction;

4. offering is deemed fraudulent;

5. offering expenses or promoter's fees are excessive or unreasonable; or

6. registration has been revoked by the Administrator of another state.

B. ORDER OF THE ADMINISTRATOR

1. Appropriate prior notice
2. Opportunity given for a hearing
3. Written findings of fact and conclusions of law

EXEMPT TRANSACTIONS

A. PREORGANIZATION CERTIFICATES

1. Before incorporation (promise of seed money)
2. Maximum of 10 subscribers and no funds paid in

B. PRIVATE PLACEMENTS

1. Restricted to 10 offers in any 12 consecutive months other than to institutional clients
2. No immediate resale except for institutions
3. No compensation paid on sales to noninstitutional (retail) buyers

C. ISSUER TRANSACTIONS [BETWEEN ISSUERS AND UNDERWRITERS (GOING PUBLIC)]

D. WITH FINANCIAL INSTITUTIONS (SOPHISTICATED/PROFESSIONAL INVESTOR)

1. Investment companies
2. Insurance companies
3. Banks and trust companies
4. Employee benefit plans with not less than $1 million in assets (pension or profit sharing trusts)
5. Broker-dealers
6. Investment advisers
7. Individuals meeting the SEC definition of accredited investor are **not** considered institutional investors for the purpose of this exemption

E. NONISSUER TRANSACTIONS (SECONDARY TRANSACTIONS)

1. Unsolicited nonissuer transactions effected through broker-dealer; Administrator may request proof

2. Isolated nonissuer transactions

F. FIDUCIARY TRANSACTIONS

1. Include those made by an executor, administrator, trustee in *bankruptcy*, sheriff, etc.

UNETHICAL PRACTICES OF BROKER-DEALERS AND AGENTS

A. MISLEADING OR UNTRUE STATEMENTS

(For a complete listing, see the above heading in your LEM)

1. Repeating rumors

2. Promising certain services with no intent to deliver

B. NOT STATING (OMITTING) MATERIAL INFORMATION

1. Material facts are those used in making investment decisions.

C. USE OF MATERIAL INSIDE INFORMATION

1. Received after stop or limit order placed?

D. UNSUITABLE RECOMMENDATIONS

E. FAILURE TO DISCLOSURE OF CONFLICTS OF INTEREST

1. Proprietary products

2. Incentives from program sponsors (trips, etc.)

3. Financial interest in recommended security (sister is CEO)

4. Favorable research report after bringing company public

F. FAILURE TO MAKE DISCLOSURE OF FEES

1. Typically disclosed when a customer account is opened
    a. Must be up-to-date
2. Fee changes
    a. Typically at least 30 days in advance
        1.) Methods used include email, postal mail, or website
3. Disclosure method used
    a. Chart
    b. List
    c. Table
    d. Narrative
4. NASAA Model Fee Disclosure Schedule
    a. Template to be used
5. Typical fees include:
    a. issuance of a stock certificate;
    b. account transfer;
    c. wiring funds;
    d. margin account interest;
    e. annual account fee; or
    f. safekeeping of certificates.
6. Not included are:
    a. commissions;
    b. markups and markdowns; or
    c. advisory fees (all of these belong in other documents).

G. UNIQUE SITUATIONS

1. Exercising discretion without authority
   a. Ability to select asset, action, or amount
   b. Time or price is not discretion
      1.) Day order
2. Commingling
3. Sharing customer profits or losses
   a. Written consent of client and employing BD
4. Borrowing customer funds or securities or lending money to clients (unless a lending institution or an affiliate)
5. Written complaints—contact supervisor
6. Larger than ordinary commissions without disclosure
7. Soliciting sales or purchases in unregistered, nonexempt securities unless in an exempt transaction
8. Guaranteeing results—minimize losses or assure profit
   a. Agent agrees to buy back at original price (or with a bonus)
   b. *Guaranteed security*—Payment of principal and interest or dividends (not capital gain), promised by a third party (e.g., parent company for a subsidiary's debt)
9. Splitting commissions, unless with appropriately registered personnel of same or affiliated firms—the Administrator can make an exception

POWER OF THE ADMINISTRATOR TO DENY, SUSPEND, OR REVOKE A LICENSE

A. IT MUST BE IN THE PUBLIC INTEREST AND ONE OF THE FOLLOWING MUST HAVE OCCURRED:

1. Filing false or misleading application

2. Any felony or securities-related misdemeanor conviction within the last 10 years

3. Willful violation of the USA's ethical trade practices

4. Court injunction/administrative order

5. Disciplinary action by other securities authorities within the last 10 years

6. Dishonest, unethical practice

7. Insolvency

   a. In case of agents, if liabilities exceed assets or agent cannot meet obligations as they mature

   b. In case of a broker-dealer or investment adviser, a formal finding of insolvency is required

8. The applicant is not qualified on the basis of such factors as training, experience, and knowledge of the securities business.

   a. The Administrator may not deny solely on the basis of lack of experience if the applicant is qualified by training, knowledge, or both.

9. Firm's failure to supervise employees

10. Failure to pay filing fees

B. CANCELLATION OF REGISTRATION (NON-PUNITIVE)

1. Out Of Business (Mail Returned–No Forwarding Address)

2. Legally Declared Mentally Incompetent

3. Deceased

PROCEDURES AND PENALTIES

A. ADMINISTRATOR

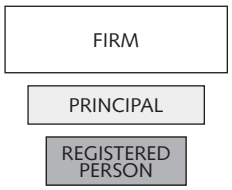
1. Enforcement of all antifraud provisions

2. Must give notice of action to be taken

   a. Must give opportunity for hearings

   b. Must provide written findings

3. Summary orders to postpone or suspend until final determination is reached
   a. No prior notice or hearing
   b. Must hold hearing within 15 days of written request
4. Issue cease and desist order for suspected improper activity
   a. With or without a prior hearing
   b. If cease and desist order is ignored, can apply to courts for an injunction
5. May proceed against firm if principal is disqualified
6. May not proceed against firm if only agent or IAR is disqualified



7. May investigate and subpoena in any state where registered, whether or not the firm has an office in the state
8. 60-day appeal of order—Appeal does not act as a stay unless ruled otherwise by the court.

B. CRIMINAL PENALTIES

1. Willful violation of the USA
2. Fines to $5,000, jail up to three years, or both
3. Statute of limitations is five years for fraudulent activity

C. CIVIL LIABILITIES

1. Unlawful sale
   a. Must be within two years of discovery or three years of violation, whichever occurs first
   b. Rights of buyer
      1.) Recover money plus reasonable interest (or state's legal rate) minus income received during period
      2.) Court costs and attorney fees, but not damages

2. Right of rescission—30 days' notice: If buyer receives offer of rescission and fails to accept or reject within 30 days, may not sue

3. Rights of advisory client: Recovery of advisory fees, losses on recommendations, court plus legal fees minus income received

COMMUNICATIONS WITH CLIENTS AND PROSPECTS

A. SOCIAL MEDIA INCLUDING EMAILS AND TEXT MESSAGES

1. Regulatory concerns

   a. Content, not method of delivery

   b. Compliance same as in written communications

   c. Agent's use of personal tools for business use

   d. Supervision of recordkeeping and training

B. ADVERTISING

1. Can't be deceptive or misleading

2. Highlighting or excerpting a prospectus

3. Broker-dealer's website is advertising

   a. Distinguish between what is and is not a recommendation

      1.) Libraries of research reports, news and quotes, screening tools, etc. are not recommendations.

      2.) Targeted email or pop-up, list of specific securities to reach client's goals, buy recommendations from a specific sector, etc. are recommendations.

C. SOCIAL MEDIA FOR AGENTS

1. Personal devices

2. Obtaining proper approvals

   a. Tweets (after first) probably not—LinkedIn, probably yes

3. Linking to third-party sites

   a. Entanglement and adoption

D. SUPERVISORY ACTIONS TO BE TAKEN BY THE BROKER-DEALER

1. Policies and procedures in place for training and education
2. Applies to both supervisory personnel and agents
3. Initial and annual training recommended
4. Monitoring

TEST PREP 1

A customer living in one state receives a phone call from an agent in another state. A transaction between the two occurs in a third state. According to the USA, under whose jurisdiction does the transaction fall?

A. Administrator of the state in which the customer lives
B. Administrator of the state in which the agent is registered
C. Administrator of the state in which the transaction took place
D. Administrator of all three states involved

TEST PREP 2

Which of the following would NOT be excluded from the USA's definition of broker-dealer?

A. A broker-dealer with no office in this state, properly registered in another state, and that deals with residents of that state who are vacationing in this state
B. A broker-dealer with no office in the state, properly registered in another state, and that deals only with institutional investors in this state
C. A broker-dealer with no office in this state, properly registered in another state, and whose only business is underwriting new issues of corporations domiciled in this state
D. A broker-dealer with no office in this state, properly registered in another state, and that deals with fewer than 6 individual clients in this state

TEST PREP 3

A sale or offer to sell would NOT include

A. a purported gift of nonassessable stock
B. any security given or delivered with, or as a bonus on account of, any purchase of securities
C. a stock dividend that requires only a nominal payment by the shareholder
D. a sale or offer of a warrant or right to purchase or subscribe to another security of the same or another issuer

TEST PREP 4

Which of the following statements regarding registration of securities professionals under the Uniform Securities Act are TRUE?

I. A successor firm is exempt from paying registration fees until the renewal date.
II. A successor firm is exempt from filing a consent to service of process until the renewal date.
III. The Administrator may require minimum financial standards for state-registered investment advisors who exercise discretion in client accounts.
IV. When an agent with a registered broker-dealer terminates the association, both the agent and the broker-dealer must notify the Administrator.

A. I and II
B. I and IV
C. II and III
D. I, III, and IV

TEST PREP 5

For which of the following new issues would a notice filing be most appropriate?

A. Bank stock
B. Intrastate offering
C. Open-end investment company shares
D. Railroad equipment trust certificate

TEST PREP 6

Which of the following transactions would be exempt under the Uniform Securities Act?

I. The sale of a non-Nasdaq stock by an executor of an estate
II. The gift of U.S. Treasury bonds from a father to his minor child
III. Preorganization certificates subscribed to by 18 institutional investors for which no payment has been made
IV. An unsolicited order from an individual client to purchase a nonexempt unregistered security

A. I and II
B. I and IV
C. II and III
D. III and IV

TEST PREP 7

Business practices prohibited under the Uniform Securities Act include

I. failure to state material facts
II. trading on inside information
III. forwarding a complaint letter to the agent's supervisor
IV. splitting commissions with an agent of an affiliated broker-dealer

A. I and II
B. I, II and III
C. III and IV
D. I, II, III and IV

TEST PREP 8

Nonpunitive termination of a securities professional's registration can be done through

I. cancellation
II. suspension
III. revocation
IV. withdrawal

A. I and III
B. I and IV
C. II and III
D. II and IV

TEST PREP 9

An agent with a broker-dealer making a recommendation to a client would have to disclose

A. whether acting in the capacity of a broker or a dealer
B. the amount of the commission to be charged on the transaction
C. any incentives offered by the issuer to the agent
D. the expiration date of the agent's license

TEST PREP 10

Which of the following would NOT be subject to the recordkeeping requirements of the Uniform Securities Act?

A. Emails sent to family members who are not clients
B. Emails sent to family members who are clients
C. Text messages to clients
D. Changes to the broker-dealer's website

Test Prep Answers

1. D
2. D
3. A
4. D
5. C
6. B
7. A
8. B
9. C
10. A

Session Three

Federal and State Regulation of Investment Advisers and Their Representatives

INVESTMENT ADVISERS ACT OF 1940/UNIFORM SECURITIES ACT

A. DEFINITION OF INVESTMENT ADVISER UNDER THE 1940 ACT/USA – 3 PRONG TEST

1. Gives advice on securities
2. As part of a regular business
3. For which compensation is received
4. Frequently referred to as IA on the exam

B. RELEASE IA-1092 (1987) EXPANDED THOSE INCLUDED IN THE DEFINITION

1. Financial planners
   a. Person who advises clients to select from among a variety of financial products
   b. Person who recommends mixture of securities, insurance products, and real estate—a *comprehensive* financial plan
   c. Compensated for investment advice
2. Pension consultants
   a. Advise employee benefit plans on funding, alternative investments, performance evaluation, and adviser selection
3. Sports and entertainment representatives
   a. Provide entertainers and sports figures with contract negotiation, tax planning, budget, and money management (including investment recommendations)

C. EXCLUSIONS FROM DEFINITION

1. Banks, savings institutions, and trust companies
   a. Bank owned subsidiary giving advice is not excluded

2. Professionals providing incidental advice

a. Lawyers, accountants, teachers, engineers (LATE) if advice is incidental to their profession or practice

b. Subject to registration if they charge specific fees for investment advice

3. Broker-dealers, if no special compensation

a. Advice solely incidental to their business

b. Wrap fee programs will lose this exclusion

4. Publishers (general and regular circulation)

a. "Market event" driven loses exclusion

5a. Persons advising solely on government securities (IA of 1940)

5b. Investment adviser representatives (USA)

D. EXEMPT FROM SEC REGISTRATION AS INVESTMENT ADVISERS

1. Intrastate advisers—clients and offices in single state

a. No advice on listed securities on national exchanges

b. No clients are "private funds"

c. Register with the state

2. Foreign private advisers

a. AUM in the United States of less than $25 million

b. Fewer than 15 U.S. clients

c. No investment company clients

d. Does not hold itself out as an IA

e. No place of business in the United States

3. Adviser to "private funds"

   a. Issuer is not proposing a public offering of its securities, and its outstanding securities are:

      1.) owned by a maximum of 100 investors; or

      2.) exclusively *qualified*, $5 million/$25 million (individuals/entity)

   b. Adviser's AUM in the United States of less than $150 million

   c. Generally an ERA and subject to anti-fraud rules

4. Only clients are insurance companies

E. EXEMPT FROM STATE REGISTRATION AS INVESTMENT ADVISERS

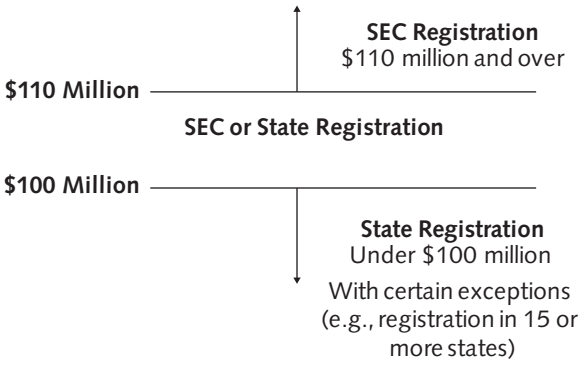
1. De minimis: No place of business in the state and fewer than six retail (individual) clients in preceding 12 months

2. No place of business in the state and deals only with institutions, broker-dealers, or other investment advisers

3. Private fund adviser: Same as SEC, except fund with <101 investors: $1 million with IA or $2 million net worth

4. Federal covered adviser

F. FEDERAL COVERED ADVISERS



1. Buffer of $20 million

   a. Once SEC registered, can remain with $90 million

2. Manager of registered investment company (any size)

3. Pension consultant ($200 million is eligible)

4. If registration would be required in 15 or more states

5. Federal covered advisers need not register with states; however, they may be required to pay filing fees.

G. INVESTMENT ADVISER REPRESENTATIVES: INDIVIDUALS SUPERVISED BY INVESTMENT ADVISERS

1. Partners, officers, or directors (with active role)

2. Employees and associates making recommendations, managing accounts, and soliciting advisory services, but not clerical and administrative personnel

3. If with a state-registered adviser, registers as an IAR unless meeting de minimis requirements

4. If with a federal covered adviser, only registers in those states where maintaining a place of business

5. Relationship of financial professionals

   a. Broker-dealers earn commissions or mark-ups by effecting **transactions** in securities for themselves or their clients.

   b. Investment advisers are compensated for giving advice.

   c. When client accepts IA's advice, the client or IA directs the trade to a BD for execution.

Broker Dealer	Investment Adviser
■ Primary business function is executing transactions in securities ■ Compensation is earned in the form of commissions and markups (markdowns)	■ Primary business function is giving advice ■ Compensation is earned in the form of fees or other charges, generally based on the amount of assets managed
Agents	**IARs**
■ Individuals employed by brokers/dealers to handle their customer orders to buy or sell securities ■ Separate function from an IAR (although many in large firms wear both hats)	■ Individuals employed by investment advisers to give advice to their clients ■ After an IAR advises a client about a specific security, the next step is to contact the broker-dealer where that client maintains a brokerage account to give the buy/sell order to an agent

H. INVESTMENT COUNSEL

Principal business is the giving of investment advice
Investment supervisory services = giving continuous advice on the basis of individual client needs

I. INITIAL REGISTRATION PROCEDURES

1. File Form ADV Part 1A—information includes:

a. business name;

b. past five years' business and current affiliations of control persons;

c. educational background;

d. nature of business;

e. balance sheet certified by public accountant;

f. scope of authority over client funds;

g. compensation arrangement;

h. criminal record;

i. portion of business devoted to providing investment advice;

j. registration of an investment adviser automatically registers, as an IAR, any individual who is a partner, officer, or director involved in the advisory business; and

k. Form ADV Part 1B (state covered advisers only).

2. Pay filing fee

a. Effective noon of the 30th day for USA

b. Effective within 45 days for SEC

3. Other required filings

a. Update Form ADV annually

1.) Within 90 days of fiscal year's end

2.) Show assets under management (AUM) to verify continued SEC registration; must have at least $90 million in AUM

3.) Pay appropriate renewal fees

b. Change in management, state of location, or form of business requires the IA to file an amended Form ADV promptly.

4. Withdrawal on ADV-W

a. Effective 30th day for USA

b. Effective 60th day for SEC

J. INVESTMENT ADVISER BROCHURE RULES

1. Brochure is Form ADV Part 2A (describes the firm) and Supplement, Form ADV Part 2B (personnel).

a. Updated annually at time of updating amendment

b. Contains required "disclaimer"

2. Deliver to a client or prospective client the current brochure before or at the time of entry into an investment advisory contract with that client.

a. Delivered 48 hours before, or at time of contract, with five business days' right to rescind without penalty (USA)

3. Deliver to each client, annually within 120 days after the end of the fiscal year, if there are material changes in the brochure since last annual updating amendment:

a. A *free* current brochure

b. A summary of material changes to the brochure including an offer to provide a copy of the updated brochure and information on how a client may obtain the brochure

c. May be delivered electronically

d. If no material changes, no brochure or summary

4. Must include balance sheet if investment adviser requires prepayment of fees of more than $1,200 ($500 USA), 6 months or more in advance, or **custody** (USA)

5. Disclosure of material legal or disciplinary action within past 10 years, including fines of $2,500 or more

   a. Prompt amendment required for material changes

6. Exemptions—investment adviser does not have to deliver brochure if the advisory clients are limited to the following:

   a. Investment companies

   b. Impersonal advice (subscriptions)—cost under $500

K. WRAP FEE BROCHURE

1. Charge a fixed fee for portfolio management, advice, and execution

2. Wrap fee brochure based on Appendix 1 of Form ADV Part 2A must be provided in lieu of standard brochure and must disclose that wrap fee may cost more than purchasing services separately

3. Must identify whether any of its related persons is a portfolio manager in the wrap fee program and, if so, describe the associated conflicts

L. INVESTMENT ADVISER CONTRACTS

1. The following are required disclosures under the Investment Advisers Act of 1940 and the North American Securities Administrators Association's (NASAA) Model Rule on Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers:

   a. Services to be provided

   b. Duration of the contract

   c. Advisory fee

   d. Formula for computing advisory fee

   e. Amount of prepaid fee returned if contract is terminated

   f. Whether discretion is granted

   g. Assignment only with consent

   h. Notification to clients of changes in advisory partnerships

i. Written requirement

1.) Required under USA

2.) Not required under Investment Advisers Act of 1940

3.) Required under Investment Advisers Act of 1940

M. COMPENSATION RESTRICTIONS

1. Generally no performance-based compensation

2. Performance-based compensation is allowed if:

a. it is for a *qualified client*

1.) Any person with a specified minimum amount of assets under management or net worth of a specified minimum amount (for individuals, spouse counts too)

2.) Executive officers or IARs of the adviser

b. NASAA requires disclosure of:

1.) incentive for greater risk taking;

2.) compensation may be on unrealized gains; and

3.) why the index used was chosen.

3. No waiving of fees/refunding for underperformance

4. No profit-sharing arrangement; no rebating commissions on mutual funds

N. DIRECTED TRANSACTIONS

1. Adviser directs client to broker-dealer with reasonable charges for services performed

2. Client directs investment adviser to use specific broker-dealer

3. Disclosure required

USA (State)		SEC (Federal)
Less than $25 million (small advisers)		$110 million or more (large advisers)
Mid-size advisers $25 million, but not $100 million	Some exceptions permit SEC registration (15 states) With $100 million, but not $110 million, can choose State or Federal	
Filing fee to state		Filing fee to state/SEC
Fewer than 6 clients within a year	De minimis	Fewer than 15 clients within a year (foreign)
Brochure = all relevant information on ADV 2A and 2B		Brochure = all relevant information on ADV 2A and 2B
ADV: 30 days	Registration effective	ADV: 45 days
ADV-W: 30 days	Withdrawal	ADV-W: 60 days

ETHICAL BUSINESS PRACTICES OF INVESTMENT ADVISERS

A. FIDUCIARY RESPONSIBILITY

1. Have reasonable and independent basis for investment advice

2. Act in clients' best interest.

a. Suitability (usually unsuitable—blanket recommendations)

b. Clients' interests come first

3. Best execution: Does not always require lowest commissions; must consider all services being rendered

4. Recognize limitations of own capabilities

5. Avoid conflicts of interest

a. Disclose ownership in recommended securities

b. Disclose gifts or incentives associated with recommended product

c. Advisers must notify clients if they are a representative of a broker-dealer and will recommend purchase of products through that broker-dealer to receive a commission

d. Disclose if recommending products of only the broker-dealer or insurance company with whom they are associated

e. Disclose that client may execute through other broker-dealers

f. Disclose amount of compensation when:

1.) the transaction is through a broker-dealer with whom the adviser is associated;

2.) compensation is received from an issuer; or

3.) compensation is received for the sale of nonsecurities products.

g. Disclose personal trades if:

1.) inconsistent with advice given to client; or

2.) investment adviser benefits from client acting on recommendation.

6. No market manipulation

a. Matched orders

b. Wash trades

c. Painting the tape

7. No unauthorized disclosure of confidential client information is allowed unless:

a. the client has consented;

b. the information is required by a court or the IRS; or

c. the account is joint with spouse.

8. No front running

B. DISCLOSURE OF CAPACITY

1. Acting as principal or agent in purchase or sale of recommended securities

   a. Written disclosure to client before completion of the transaction

   b. Client's consent before completion of the transaction

2. **Agency cross transaction:** Representing both sides of a trade involving an advisory client

   a. Client executes a written consent prospectively authorizing these transactions

   b. Written disclosure to client before completion of the transaction

   c. Can't recommend the trade to both parties

C. DISCLOSURE OF FINANCIAL IMPAIRMENT

1. Disclosure is required if the adviser:

   a. has discretion;

   b. has custody over customer funds or securities;

   c. requires prepayment of more than $500 in fees, six or more months in advance (state); or

   d. requires prepayment of more than $1,200 in fees, six or more months in advance (federal).

D. INVESTMENT ADVISER ADVERTISING

1. Advertisements include any notice, circular, letter, website or other written communication addressed to more than one person, or any report, chart, or formula used in making investment decisions.

2. Identification

   a. Name of firm

   b. Name of preparer if material is prepared outside the firm

   c. Date of first use

   d. Identification of information not current

3. Past performance
    a. Can be used if the following disclaimer and disclosure are included:
        1.) No assurance of future results
        2.) Includes all gains and losses over a minimum of one year
4. Testimonials prohibited
    a. "Like" on Facebook or endorse on LinkedIn
5. Offers of free service permissible (no obligations)
6. Other advertising prohibitions
    a. Implying extensive research facilities when not a fact
    b. Misleading or inconsistent clauses and caveats; hedge clauses
    c. Implying approval by regulators
    d. Use of abbreviation *RIA* or *IAR*
    e. Use of titles not earned (MBA, JD, CPA, CFP)
    f. Lack of disclosure of outside data sources
    g. Charts and formulas—explain limitations/difficulties

E. NET WORTH REQUIREMENT FOR INVESTMENT ADVISERS

1. Discretion only, no custody of funds/securities—$10,000
2. Custody of funds/securities—$35,000, unless having custody solely due to:
    a. direct fee deduction; or
    b. advising pooled investment vehicles subject to an annual audit.
3. Notify Administrator when below required net worth by end of next business day
4. File a financial report with Administrator within one business day of notice, including a statement of the number of client accounts

F. CUSTODY OF CUSTOMER FUNDS AND SECURITIES

1. Definition

a. Holds customer cash or securities

b. Authority to disburse funds from bank account without client's consent

c. Automatic fee payments considered custody

d. If custody only because of (c.), IA is not required to meet the USA's net worth or bonding requirements for advisers with custody

2. Rules

a. USA requires notification to the Administrator, unless state law prohibits custody

b. Must be segregated and marked to identify ownership

c. Written notice to client of location and notification of changes

d. Complete and accurate records of deposits and account activity

e. Quarterly itemized statement to customer

f. Use a qualified custodian; if not

1.) Annual surprise independent audit

g. If not keeping custody, NASAA requires certificates and funds inadvertently sent *returned* within three business days (third-party checks *forwarded* to third party within three business days)

G. PAYMENT FOR CLIENT SOLICITORS UNDER INVESTMENT ADVISERS ACT OF 1940

1. Must have written agreement (disclose conflicts of interest)

a. Description of activities and compensation

b. Agreement to provide adviser's brochure and solicitor's disclosure document to customer (disclose if higher cost will result)

c. The IA receives acknowledgment from client that both documents have been received

2. Third-party solicitors for covered advisers are not required to be registered as an IAR (employees of the IA who solicit are)

H. SOLICITORS FOR STATE-REGISTERED ADVISERS WHO ARE ASSOCIATED WITH OR EMPLOYEES OF THE IA MUST BE REGISTERED (IAR).

I. REPORTING REQUIREMENTS UNDER STATE/FEDERAL LAWS

1. Maintain required books and records (including electronic communications) for five years

   a. Kept at the principal office for two years

   b. May be kept in normally accepted manner (microfiche, digital, etc.) provided records can be read and copied

2. Advisers performing investment supervisory services must keep separate records for each client

J. ADDITIONAL PROHIBITIONS UNDER NASAA'S MODEL RULE ON UNETHICAL BUSINESS PRACTICES OF INVESTMENT ADVISERS, INVESTMENT ADVISER REPRESENTATIVES, AND FEDERAL COVERED ADVISERS

1. The policy permits IAs oral authorization for discretionary accounts for 10 business days after initial trade

2. Charging the customer an unreasonable fee: NASAA says that charges must be competitive

3. Entering into or renewing an advisory contract unless in writing

4. Use of third-party reports without disclosure

5. Improper use of waivers

6. Failing to disclose conflicts of interest

K. SEC AUTHORITY UNDER THE ACT OF 1940

1. May subpoena, seek court injunctions, refer evidence for criminal proceedings, hold hearings, and issue rules and orders

2. Appeal of SEC order must be within 60 days; appeal to U.S. Court of Appeals by written petition

3. Criminal penalties—federal level ($10,000 fine, five years' imprisonment, or both)

4. May suspend up to 12 months

COMPENSATION

A. ANY ECONOMIC BENEFIT—RECEIVED FROM ANY SOURCE

B. SOFT DOLLARS

1. Noncash compensation from broker-dealers for directed business

2. Allowable soft-dollar payments under safe harbor provision of Section 28(e) of Securities Exchange Act of 1934

   a. Research reports

   b. Software

   c. Services for benefit of clients

   d. Seminar registration fees

3. Soft-dollar payments not protected by Section 28(e)

   a. Reimbursement for travel expenses to seminars

   b. Furniture, equipment, or non-customer-related services

   c. Rent

CYBER SECURITY AND DATA PROTECTION

A. NASAA 2014 PILOT SURVEY

1. Cyber preparedness

   a. Threats and vulnerabilities

2. Cybersecurity compliance program

   a. Written policies, procedures, or training programs

1.) Safeguarding client information

2.) Red flags for identity theft

3. Cybersecurity and social media

a. Written policies, procedures, or training programs

1.) Social media for business purposes

4. Cyber incidents

a. If there have been any, has the firm "plugged the gap"

5. Cyber disposal

a. Procedures for disposing storage devices

6. Cybersecurity safeguards

a. Encryption

b. Anti-virus and anti-malware

c. Email security

1.) Authentication

B. METHODS FOR PROTECTING THE FIRM AND ITS CUSTOMERS

1. Strong methods of authentication

2. Antivirus software installed on electronic devices used to access client information

a. How often are updates downloaded to antivirus software?

3. Where is data backed-up and is it encrypted?

4. Does your firm allow remote access to servers or workstations via a virtual private network (VPN) or similar technology?

5. Does your firm use free Cloud services such as iCloud, Dropbox, or Google Drive, to store personal and confidential client information?

6. Does your firm utilize your firm's website to use or access client information data?

7. Does your firm's website include a client portal?

8. Protecting against ransomware

   a. Malware for data kidnapping

      1.) Attacker encrypts the victim's data

      2.) Demands payment for the decryption key

   b. Use a layered approach

      1.) Anti-virus

      2.) Web filtering

      3.) Firewalls

   c. Back-up data

      1.) Often

      2.) Keep old uninfected files available

      3.) Offline

C. REGULATION S-P—FIRMS MUST ADOPT POLICIES AND PROCEDURES TO ADDRESS THE PROTECTION OF NONPUBLIC PERSONAL INFORMATION.

1. Initial and annual notice to *customers*

   a. Customers have an ongoing relationship

2. Initial notice only to *consumers*

   a. Consumers obtain a product or service and have no further contact with the firm

3. Opt-out methods must be easy

   a. Writing a letter is not, an email is

TEST PREP 1

In response to an evolving marketplace, the SEC, through Release IA-1092, expanded the definition of investment adviser to include

I. broker-dealers offering wrap fee programs
II. financial planners
III. life insurance agents
IV. pension consultants

A. I and II
B. I and III
C. II and IV
D. III and IV

TEST PREP 2

Both federal and state law provide for exclusions from the definition of investment adviser. Which of the following persons is specifically excluded under the Uniform Securities Act but NOT the Investment Advisers Act of 1940?

A. Banks
B. Broker-dealers not receiving any special compensation
C. Economists
D. Investment adviser representatives

TEST PREP 3

To be in compliance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, a federal covered adviser

I. is permitted to use Form ADV Part 1A in lieu of a separate brochure
II. must disclose on Form ADV Part 1A the form of organization of the business entity
III. managing individual accounts may not have less than $90 million in assets under management
IV. whose principal office has moved must file an amendment noting that change within 90 days of the end of the investment adviser's fiscal year

A. I and II
B. I and IV
C. II and III
D. III and IV

TEST PREP 4

The Investment Advisers Act of 1940 mandates that contracts between investment advisers and their clients

I. be in writing
II. provide that no assignment of the contract may take place without prompt notification to the client
III. disclose the method of compensation
IV. state whether early termination of the contract will result in a partial refund of prepaid fees

A. I and II
B. I and IV
C. II and III
D. III and IV

TEST PREP 5

Which of the following would be prohibited under the Investment Advisers Act of 1940?

A. Disclosing the most intimate details of a client's portfolio when requested as part of an IRS audit
B. Disclosing that you are recommending a security for which you will be compensated as an agent of the sponsoring broker-dealer
C. Recommending both sides of an agency cross-transaction to advisory clients and saving the clients substantial commissions
D. Failing to disclose a financial impairment to an advisory client for whom you do not have discretion or custody or from whom you have not collected substantial prepayment of fees

TEST PREP 6

An investment adviser has devised a charting system and wishes to advertise this fact to obtain additional clients. For the adviser to do this, the USA would require which of the following?

A. Past performance since inception of the system must be shown
B. Disclosure of the length of time the charting system has been employed
C. If the system is indeed foolproof, verification of that fact
D. A statement as to the limitations of and difficulties involved in using this system

TEST PREP 7

A major concern of broker-dealers today is ensuring the safety of customer data. Recommended methods for doing so include

I. Encrypting files
II. Customer passwords
III. Biometric authentication
A. I and II
B. I and III
C. II and III
D. I, II and III

Test Prep Answers

1. C
2. D
3. C
4. D
5. C
6. D
7. D

Unit 2

Investment Vehicle Characteristics

Session Four

Equity Securities

A. COMMON STOCK

1. Benefits of common stock ownership

a. Capital growth

1.) Hedge against inflation; historically high real returns

b. Income

1.) Dividends, if declared by the board of directors

a.) Cash

b.) Stock

c. Easily transferrable (liquidity)

2. Risks of common stock ownership

a. Risk of price fluctuations in the overall market

b. Risk of business decline or failure due to poor management decisions or inability to meet debt obligations

1.) Could lead to a reduced or eliminated dividend

2.) Reduced earnings = lower market price

B. PREFERRED STOCK

1. Characteristics

a. Equity security with a fixed (stated) dividend

b. Purchased for income purposes

2. Benefits of preferred stock ownership
    a. Preference over common
        1.) Dividends
        2.) Liquidation
3. Risks of preferred stock
    a. Because dividend is fixed, there is inflation risk and interest rate risk.
    b. Dividends are not guaranteed.

C. VALUATION METHODS

1. Technical analysis
    a. Analyst **charts** a stock's market **price** and **volume** over a period of **time**
        1.) Determine trends
        2.) Support and resistance
        3.) Moving averages
    b. Used to minimize timing risk
    c. Major technical theories include:
        1.) Short interest
        2.) Odd-lot
        3.) Advance/decline
2. Fundamental analysis
    a. Looks at the company's financial statements (Session 11)
    b. Stock's price should reflect earnings or dividend growth or decline
    c. Used to minimize business risk

3. Dividend Models

a. Dividend Discount Model (DDM)

1.) Present value of future dividends using discounted cash flow (DCF) computation (Session 5)

b. Dividend Growth Model (DGM)

1.) Assumes growth of dividends

TEST PREP 1

A technical analyst looking to smooth out the daily volatility of a stock's performance would probably use

A. support and resistance
B. the odd-lot theory
C. moving averages
D. the advance/decline line

TEST PREP 2

An analyst is attempting to determine a reasonable value for a particular common stock. When comparing the result used by the two dividend models, it would be true to state that

A. using the dividend discount model will result in a higher valuation than using the dividend growth model
B. using the dividend growth model will result in a higher valuation than using the dividend discount model
C. the valuation will be approximately the same, whichever model is used
D. the dividend models can only be used with preferred stock

Test Prep Answers

1. B

2. C

Session Five

Fixed Income Securities

FIXED INCOME SECURITIES

A. DEBT FINANCING – PRIMARILY BONDS

1. Par (face) value – $1,000 each bond
2. Par value × stated interest rate = annual interest
   a. Semi-annual interest payments
3. Principal paid off at maturity (10, 20, or more years)
   a. Priority of interest and repayment of principal
4. Bond pricing
   a. Quoted as percentage of par
   b. Par, premium, or discount

FIXED INCOME SECURITIES – YIELD RELATIONSHIPS

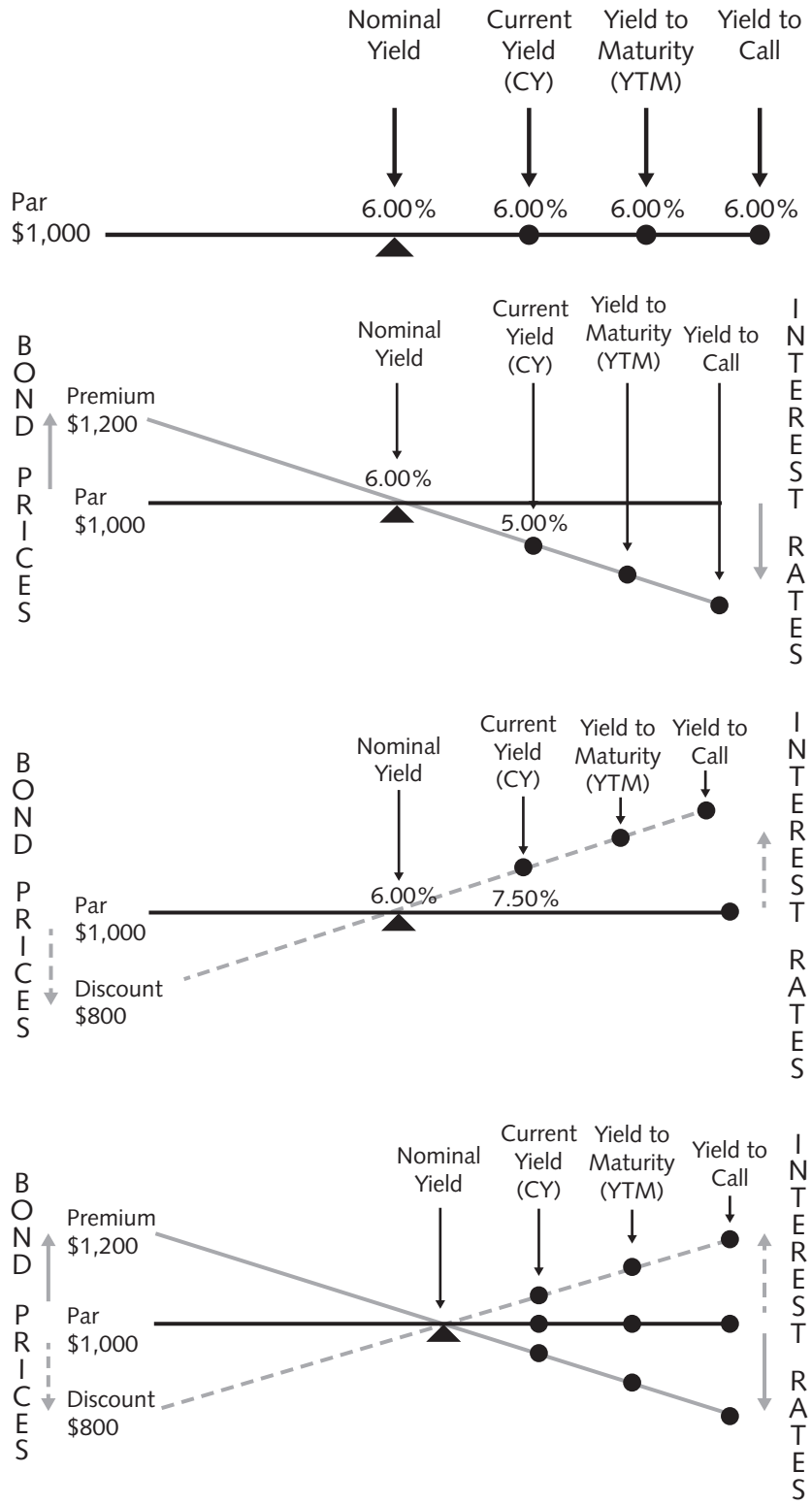
A. RELATIONSHIP OF YIELDS

1. Coupon, nominal, stated
   a. Fixed at issuance
2. Current yield
   a. Annual interest ÷ current market price
   b. Above coupon if at a discount
   c. Below coupon if at a premium
3. Yield to maturity
   a. Yield if held to maturity
      1.) Includes gain if bought at discount
      2.) Includes loss if bought at premium

4. Yield to call

a. Realized yield if bond is called

1.) Loss of premium more quickly lowers return



B. VALUATION FACTORS OF FIXED INCOME SECURITIES

1. Ratings and their effect on valuation

Moody's	Standard & Poors	Interpretation
Aaa	AAA	Highest grade
Aa	AA	High grade
A	A	Upper medium; medium grade; sound
Baa	BBB	Medium; good grade; some uncertainty
Ba	BB	Fair to good; lower medium; uncertainty
B	B	Fair; speculative features
Caa	C	Outright speculations; poor standing
Ca	CC	Outright speculations; marked weakness
C	D	Defaulted issue; highly speculative

2. Parity price of convertible bonds

a. Bond is convertible into fixed # of common shares

b. Price when bond and stock are at equal value

3. Duration

a. Measures volatility of bond prices by weighting the time the bond interest takes to pay for the bond

b. Longer duration means higher bond volatility

1.) Interest rates up, bond price down; interest rates down, price up based on duration

2.) Zero coupon bond's duration is maturity—most volatile

3.) If maturities are the same, lowest coupon has longest duration and highest coupon has shortest duration (least sensitive)

4.) If coupons are the same, latest maturity has longest duration and soonest maturity has shortest duration (least sensitive)

5.) Convexity is a more sophisticated measurement of sensitivity to interest rate changes

4. Discounted Cash Flow

a. Commonly used to value debt securities

b. Price will always reflect a yield equal to current market interest rates for comparable risk

1.) Take the income payments scheduled to be received over a given future period and adjust that for the time value of money

a.) Discount rate based on current market interest rates

2.) Take the future principal repayment—use the discount rate to compute the present value

3.) The value of the bond is the present value of its cash flow stream.

a.) The higher the discounted cash flow (the sum of present value of the income and principal) the higher the value of the bond

c. When used with equities, it is the dividend discount model

1.) Only dividends, no maturity value

TEST PREP 1

Which of the following bonds would probably be the most sensitive to a change in market interest rates?

A. 5% coupon, maturing in 20 years
B. 5% coupon, maturing in 15 years
C. 4% coupon, maturing in 1 year
D. 4% coupon, maturing in 20 years

TEST PREP 2

The *discount rate* used in a discounted cash flow computation is equal to the

A. rate on a 90-day T bill
B. current market interest rate for that level of risk
C. future value of the stream of payments over the life of the security
D. bank's prime lending rate

Test Prep Answers

1. D

2. B

FIXED INCOME SECURITIES (SERIES 65 ONLY)

A. U.S. GOVERNMENT SECURITIES

The safest issuer of debt in terms of default risk in the United States—interest tax-exempt at the state and local level

1. Active secondary trading (negotiable)
   - a. T-bills
   - b. T-Notes
   - c. T-Bonds
   - d. Treasury Inflation Protection Securities (TIPS)—offer inflation protection
     - 1.) Semiannual adjustment to principal based on CPI
2. Benefits of government issues include the following:
   - a. Safety
   - b. Liquidity
   - c. Best place to be when recession and deflation are predicted
3. Risks of government issues include the following:
   - a. Lower yields
   - b. Interest rate risk
     - 1.) Inverse relationship between interest rates and bond prices
   - c. Inflation risk (except TIPS)

B. GOVERNMENT AGENCY ISSUES

1. Government National Mortgage Association (GNMA or Ginnie Mae)
   - a. Only agency issue backed by the full faith and credit of the U.S. government
   - b. Pass-through certificate, monthly income

2. Federal National Mortgage Corporation (FNMA or Fannie Mae)
    a. Pass-through certificate, semi-annual income
3. Cash flow analysis on pass-through securities uses *average* maturities

C. TYPES OF CORPORATE BONDS

1. Secured
2. Unsecured
    a. Subordinated debt
3. High-yield bonds
4. Zero-coupon bonds
    a. Issued at a deep discount
    b. Appropriate for "target" investments
    c. No reinvestment risk
    d. High volatility
    e. Generates "phantom" income

D. BENEFITS

1. A predictable stream of income (interest payments made semiannually)
2. Repayment of principal at specified maturity date (bonds held to maturity have no interest rate risk as to principal)
3. Prior claim on issuer's assets
    a. Secured bonds have pledged assets.
    b. Debentures have priority over any equity.

E. RISKS OF CORPORATE BONDS

1. Default risk
    - a. Creditworthiness of issuer
        - 1.) High-quality versus low-quality debt
2. Interest rate risk
    - a. Common to all fixed income investments
3. Call risk
    - a. Call protection
4. Reinvestment risk
    - a. Interest payments and return of principal
5. Inflation (purchasing power) risk
    - a. Fixed payments lose buying power

F. MUNICIPAL BONDS

1. Issued by a form of government other than the federal government or agency of the federal government
    - a. Interest exempt from federal taxes
    - b. Exemption may also apply at state and local level
    - c. Capital gains subject to taxation
2. Types of municipal issues
    - a. General obligation (GO) bonds
        - 1.) Backed by full faith and credit (taxes)
            - a.) Issuer's authority to tax
    - b. Revenue bonds
        - 1.) Backed by specific revenue source, tolls, user fees

3. Benefits of municipal bonds

a. Low default risk

b. Tax-free income

1.) Attractive to those in high federal tax brackets

4. Risks of municipal bonds

a. Interest rate risk

b. Inflation risk

c. Possible exposure to the alternative minimum tax (AMT)

TEST PREP 3

If a client wants his income to keep pace with inflation, what would you recommend?

A. Preferred stocks
B. Investment grade corporate bonds
C. TIPs
D. GNMAs

TEST PREP 4

A bond dealer doing a cash flow analysis on a GNMA pass-through certificate would use the

A. average maturities
B. nearest maturities
C. longest maturities
D. average coupon

TEST PREP 5

What is the principal value of a TIPS bond after 2 years if the coupon is 5% and the inflation rate is 8%?

A. $1,100.00
B. $1,103.81
C. $1,160.00
D. $1,169.86

Test Prep Answers

3. C

4. A

5. D

Session Six

Cash Equivalents and Cash

A. MONEY MARKET INSTRUMENTS (CASH EQUIVALENTS)

1. Used to finance short-term cash requirements
2. Characteristics
   a. High-quality debt
   b. Short-term (one year or less to maturity)
   c. Issued at a discount, except CDs
3. **Issuers**
   a. Corporations—commercial paper
   b. Banks—negotiable (jumbo, $100,000 minimum) CDs
      1.) No prepayment penalty
      2.) Insured by FDIC (to $250,000)
   c. U.S. government—All T-bills as well as bonds and notes in the secondary market with one year or less remaining to maturity
4. Rates
   a. London Interbank Offered Rate (LIBOR) is the rate of interest at which banks borrow short-term funds from each other in London
5. Benefits of money market securities
   a. Safety
   b. Liquidity
6. Risks of money market securities
   a. Low yields
   b. Not suitable for long-term investors

B. CASH

1. Insured bank deposits

a. Demand Deposit Accounts (DDA)

b. Insured bank CDs

1.) First choice for capital preservation

2.) No interest rate risk

TEST PREP 1

All of the following instruments would likely be issued at a discount EXCEPT

A. T-bills
B. CDs
C. commercial paper
D. zero coupon bonds

TEST PREP 2

One of your clients has been relocated by her employer. She has $125,000 from the proceeds of the sale of her previous home. She is currently renting in her new location and, needing time to get familiar with the area, plans to purchase a new home within 9 months. You should probably recommend placing the funds into

A. common stock
B. preferred stock
C. U.S. Treasury bonds
D. an insured bank CD

Test Prep Answers

1. B

2. D

Session Seven

Pooled Investments

INVESTMENT COMPANY SECURITIES

There are three classifications of investment company securities under the Investment Company Act of 1940: face amount certificates, unit investment trusts, and management companies.

A. MANAGEMENT COMPANIES

1. Open end
   - a. Continuous public offering
   - b. Redeemable shares
2. Closed end
   - a. Defined number of shares
   - b. Trade on exchanges; OTC
   - c. Country funds

Open-end Company	Closed-end Company
Continuous primary offering	Shares fixed
Prospectus required	No prospectus after IPO
Must redeem shares	Shares not redeemable
Issues common stock only	Issues common stock, preferred and/or bonds
No secondary trading	Secondary (exchange/OTC)
Price by formula	Price by supply and demand
8½% maximum sales charge	Commissions

B. PRICING

1. Closed-end priced via supply and demand
   - a. Can be at a discount to or premium over NAV
2. Open-end priced via a formula:

   NAV per share = (assets – liabilities) ÷ number of shares

   - a. Forward pricing

3. 12b-1 fees

a. Used for marketing and promotion

b. Annual expense charged against fund's asset—reduces NAV

1.) Paid on a quarterly basis

c. The maximum 12b-1 fee for marketing and promotion is .75%

1.) No load funds are limited to .25%

4. Mutual fund share classes

a. Class A shares (*front-end load*)

1.) Investors pay sales charge on each purchase

b. Class B shares (*back-end load* [CDSC])

1.) Investors pay declining charge at redemption

2.) Higher 12b-1 fee than Class A

c. Class C shares (*level load*)

1.) Purchase at NAV with 1% CDSC for 1 year

2.) Higher 12b-1 fee than Class A

5. Reduction in Sales Charges (A shares)

a. Breakpoints

$ Invested	Sales Charge
$0 to $24,999	6.00%
$25,000 to $49,999	5.50%
$50,000 to $99,999	5.00%
$100,000 to $249,000	4.00%
$250,000 to $499,999	3.00%
$500,000 to $999,999	2.00%
$1,000,000+	0.00%

1.) Individuals and spouses

2.) Parent and dependent children

3.) Entity formed for a business purpose

b. Not an investment club

c. Breakpoint sale (violation under FINRA and NASAA)

1.) Selling beneath the breakpoint

C. BENEFITS OF INVESTMENT COMPANY SECURITIES

1. Diversification
2. Professional management
3. Liquidity
4. Low minimum initial investment

D. RISKS OF INVESTMENT COMPANY SECURITIES

1. Market risk for equity funds
2. Interest rate risk for bond funds
3. Fees and expenses
4. No control over manager's timing of purchases or sales

EXCHANGE-TRADED FUNDS (ETFs)

A. EXCHANGE-TRADED FUNDS (ETF)

1. Traded on exchanges or Nasdaq

a. Intra-day price fluctuations

b. Can be bought on margin and sold short

2. Typically tracks an index
    a. Possibly lower expense ratio than index fund
    b. Possibly more tax efficient than mutual fund
    c. Commissions to buy and sell

REAL ESTATE INVESTMENT TRUST (REIT)

A. REAL ESTATE INVESTMENT TRUSTS (REITs)

1. Tradable units in portfolio of real estate or mortgages
    a. Equity trusts—invest in portfolio of operating real estate
    b. Mortgage (debt) trusts—loan money for mortgages to owners of real estate or invest in (purchase) existing mortgages
        1.) Revenues generated primarily by the interest that they earn on the mortgage loan
    c. REITs are not "flow-through" vehicles like DPPs
        1.) Must distribute at least 90% of net income
        2.) Losses do not flow-through
    d. Historically exchange listed
        1.) Non-traded REITs require extra suitability

ALTERNATIVE POOLED INVESTMENTS

A. ETNS, LEVERAGED ETFS, AND INVERSE FUNDS

1. Generally for sophisticated investor
2. Stricter suitability requirements

B. EXCHANGE-TRADED NOTES (ETNS)

1. Also known as equity-linked notes (ELNs)
2. In spite of the name, are debt instruments
3. Return linked to market-index or benchmark
4. Credit risk—unsecured debt of issuer

C. LEVERAGED ETFS

1. Attempt to return a multiple of index
   a. 2x or 3x
   b. Losses multiplied as well

D. INVERSE FUNDS

1. Attempt to return opposite of index (e.g. benchmark falls 2%, fund increases 2%)
2. Can also be 2x or 3x leveraged
3. Inverse and leveraged—daily or weekly reset—not for long-term investors

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TEST PREP 1

All of the following are considered benefits of mutual funds EXCEPT

A. diversification
B. breakpoint sales
C. liquidity
D. the portfolio is professionally managed

TEST PREP 2

The price to purchase an ETF is determined by

A. the next computed NAV after receipt of the order
B. supply and demand
C. the seller
D. the formula described in the fund's prospectus

TEST PREP 3

A client needs money within the next 2 weeks and wishes to liquidate something from her portfolio. She would be least likely to accomplish this if she chose to sell her

A. long-term bond mutual fund
B. real estate investment trust (REIT)
C. rental apartment building
D. municipal bond unit investment trust

TEST PREP 4

An investor would be expected to use heightened suitability standards before recommending any of the following EXCEPT

A. ETNs
B. growth mutual funds
C. inverse funds
D. leveraged ETFs

Test Prep Answers

1. B
2. B
3. C
4. B

Session Eight

Insurance-Based Products

A. LIFE INSURANCE

1. Types of Life Insurance

a. Term life (TL) for a fixed term (e.g., 1, 5, 10, or 20 years)

1.) No cash value

2.) Renews with same face but higher premium

b. Whole life (WL)

1.) Fixed premium

2.) Guaranteed death benefit and cash value

c. Universal life (UL)

1.) Flexible premiums and face amount

2.) Cash value not guaranteed

3.) May be overfunded

d. Variable life (VL)

1.) Scheduled (fixed) premium

2.) Guaranteed death benefit

3.) Cash value not guaranteed

a.) Based on performance of separate account

Life Insurance Chart

Term	Whole Life	Variable Life	Universal Life
Low premium	Fixed premium	Fixed premium	Flexible premium
No cash value	Guaranteed cash value	No guaranteed cash value	No guaranteed cash value
Does not last past age 100	Guaranteed death benefit	Minimum guaranteed death benefit	Flexible death benefit
Suitable for young buyers with family responsibilities	Premium to general account	Separate account Performance Determines cash value	Premiums paid plus interest rates determine cash value

ANNUITIES

A. ANNUITIES

1. Fixed annuity
    - a. Amount of monthly income is guaranteed
    - b. Not a securities product
2. Variable annuity
    - a. Insurance product
        - 1.) Mortality guarantee (lifetime income)
    - b. Securities product
        - 1.) Separate account with sub-accounts
            - a.) Specifically for annuity
            - b.) Units are purchased versus shares of a mutual fund
        - 2.) Possible hedge against inflation
    - c. Separate account versus mutual fund
        - 1.) Tax deferral versus current taxation
            - a.) All growth within annuity is tax deferred
            - b.) Participate in the equities market with expenses generally higher than mutual fund with the same objective
    - d. Funding
        - 1.) Single premium deferred annuity (accumulation units)
        - 2.) Periodic payment deferred annuity (accumulation units)
        - 3.) Single premium immediate annuity (annuity units)

e. Distributions

1.) Random withdrawals

2.) Annuitize

a.) Straight life

b.) Life with period certain

c.) Joint life with last survivor

f. Taxation of Annuities

1.) Contributions not through employer-sponsored retirement plans are made with after-tax dollars

a.) Deposits are cost basis

b.) Growth (earnings) are tax deferred

c.) Everything above cost basis is taxed as ordinary income upon distribution

d.) Withdrawals are taxed LIFO

- If under 59½, 10% tax penalty on earnings

e.) Annuitize

- Exclusion ratio

Benefits	Disadvantages
Lifetime retirement income	Market risk
Tax-deferred growth	Expenses higher than mutual fund
Possible inflation hedge	Possible surrender charges
Section 1035 tax-free exchange	Tax penalty for early withdrawal

3. Index annuities

a. Cash values tied to the performance of an index

1.) Participate (generally with a "cap") in the gains but not the losses

b. Designed to reduce the purchasing power risk of fixed annuities without the market risk of a variable annuity

c. Not regulated as a security

1.) Any registered personnel selling this product must comply with suitability and disclosure requirements.

TEST PREP 1

Guaranteed cash value is a feature of which of the following life insurance policies?

A. Term
B. Universal
C. Variable
D. Whole

TEST PREP 2

All of the following are true regarding variable annuities EXCEPT

A. they may decline in value when the stock market falls
B. they have lower expenses than mutual funds
C. they may provide a lifetime income
D. they are eligible for a 1035 exchange for another annuity

TEST PREP 3

The investment return of a variable annuity comes from

A. the performance of the selected sub-accounts
B. the rate stated in the policy contract
C. computing the excess of the premiums received over the mortality experience
D. the insurance company's general account

TEST PREP 4

An equity index annuity has a participation rate of 80% with a cap of 12%. If the underlying index should return 14%, the account will be credited with

A. 9.6%
B. 11.2%
C. 12%
D. 14%

Test Prep Answers

1. D
2. B
3. A
4. B

Session Nine

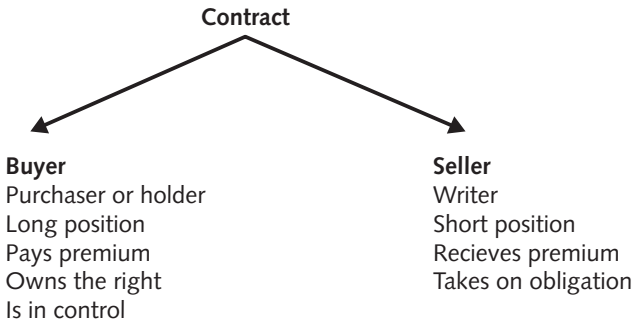
Derivative Investments

OPTION CONTRACTS

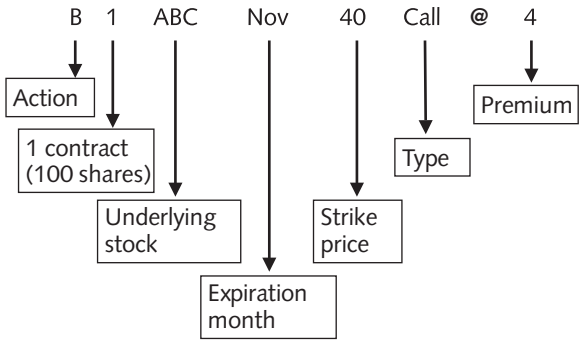
A. DEFINITION

A contract through which the seller gives the buyer the right, but not the obligation, to buy or sell a specified number of shares at a predetermined price within a set time period

B. PARTICIPANTS



C. THE OPTION CONTRACT



D. STANDARDIZED TERMS

1. Underlying asset
2. Expiration month
   a. LEAPS may be written for up to 39 months, all others a maximum of nine months
3. Exercise (strike) price

E. TYPES OF OPTIONS

1. Calls
   a. Owner has right to buy stock
   b. Seller has obligation to sell
2. Puts
   a. Owner has right to sell stock
   b. Seller has obligation to buy

F. BENEFITS OF USING OPTIONS

1. Buying options (long, holder)
   a. Leverage increases return percentage
   b. Less capital at risk
   c. Long put has less risk than short stock sale
   d. "Insurance" (hedging)
      1.) Use opposite strategy
      2.) Long stock position (or portfolio) strategy is bullish—risk is declining market—buy a put
      3.) Short stock position—strategy is bearish—risk is rising market—buy a call
2. Selling options (short, write)
   a. Income from the premium
   b. Partial hedge
      1.) Call hedges long stock position to extent of premium
      2.) Put hedges short stock position to extent of premium

G. RISKS OF USING OPTIONS

1. Long
   a. Guess wrong—lose most or entire premium paid
   b. Time decay—option expires
   c. Inability to exercise
      1.) European style—exercise only at expiration date (EE)
      2.) American style—exercise any time (AA)
2. Short
   a. Profit generally limited to premium received
   b. Uncovered call has unlimited risk

H. SUMMARY OF BASIC OPTION POSITIONS

	Buy	Sell
Call	Right to buy **Bullish** ↑	Obligation to sell **Bearish** ↓
Put	Right to sell **Bearish** ↓	Obligation to buy **Bullish** ↑

FORWARD AND FUTURES CONTRACTS

A. FORWARD CONTRACTS (COMMITMENTS)

1. Two-party contract
2. Nonliquid
3. Nonstandardized
4. Terms negotiated
   a. Quantity

b. Quality

c. Time

d. Place

e. Price

B. FUTURES CONTRACTS—EXCHANGE REGULATED

1. Quantity

2. Quality

3. Time

4. Place

5. Price

6. Producers (selling forwards or futures)

a. Decrease volatility

b. Limit future price risk

c. Lock in profit

7. Consumers (buying forwards or futures)

a. Decrease volatility

b. Lock in expenses

C. CUSTOMER FORWARD OR FUTURES POSITIONS

1. Long (buyer)

a. Obligated to ***take*** delivery

2. Short (seller)

a. Obligated to ***make*** delivery

> When investors trade futures contracts, they do not generally expect delivery of the commodity, but with forward contracts, investors generally do expect delivery of the commodity.

TEST PREP 1

A standardized option contract will always specify

A. the first day the option may be exercised
B. the last day the option may be exercised
C. the potential profit that may be realized upon exercise
D. the price at which the option may be exercised

TEST PREP 2

An investor has taken an option position that obligates her to buy 100 shares of the underlying security if the option is exercised. Her position is that of

A. a long call
B. a long put
C. a short call
D. a short put

TEST PREP 3

Your client owns 100 shares of XYZ purchased 3 years ago at $32 per share. It is December 21; XYZ is now trading at $52; and she believes the stock is about to enter a downtrend. What strategy could she use that would protect her gain and still allow her to take advantage of upside movement if her belief is incorrect?

A. Buy an XYZ March 50 call
B. Buy an XYZ March 50 put
C. Sell an XYZ March 50 call
D. Sell an XYZ March 50 put

TEST PREP 4

In January, the July soybean futures contract is being quoted at $5.00. Believing that soybean prices are going to increase, an investor purchases one July soybean futures contract. In May, the price of the July futures has increased to $5.50 and the investor decides to take the profit. Excluding transaction costs, with a contract size of 5,000 bushels, the investor has realized a

A. profit of $250
B. profit of $2,500
C. profit of $25,000
D. loss of $.50 per bushel

Test Prep Answers

1. D
2. D
3. B
4. B

Session Ten

Alternative Investments (ALTs)

DIRECT PARTICIPATION PROGRAMS (DPPs)

A. FLOW THROUGH OF INCOME AND EXPENSES

1. Previously called tax shelters; economic consequences of the businesses flow through to investors, not a corporation, thus no dividends.

B. USUALLY ORGANIZED AS LIMITED PARTNERSHIPS

1. Limited liability
   - a. At least one general partner (the active investor) and one limited partner (the passive investor)
   - b. Limited partners take no management role

C. INVESTMENT CONSIDERATIONS

1. Economic viability
   - a. Potential for profit must exist
2. Cash flow
   - a. Lease or rental payments
   - b. Sale of product (oil/gas)
3. Capital gains
   - a. Selling assets

D. BENEFITS

1. Passive losses flow through to investors
   - a. As with any new business, early years operate at a loss
   - b. Can offset passive income with passive losses
   - c. Loss limited to invested capital plus capital contributions committed for but not yet made
2. Tax credits

E. RISKS

1. Limited or no liquidity
   a. Nontransferable without general partner's consent

HEDGE FUNDS

A. INVESTMENT VEHICLES THAT USE SOPHISTICATED STRATEGIES

1. Leveraging through margin
2. Short selling
3. Arbitrage

B. NOT REQUIRED TO REGISTER WITH THE SEC

1. Advisers to the fund generally are registered

C. LIMITED LIQUIDITY

1. Usually issued as limited partnership interests
   a. Lock-up period

D. HIGH EXPENSES

1. Management generally receives a base + performance fee (2 + 20)
2. Management generally has a partnership interest ("skin in the game")

E. ACCREDITED (OR QUALIFIED) INVESTORS ONLY

ALTERNATIVE INVESTMENTS – INVESTMENT REAL ESTATE

A. ACTIVE RATHER THAN PASSIVE ROLE AS WITH REITs AND DPPs

1. Buying single family homes
   a. Repair and flip for gains
   b. Hold and rent for steady income

B. BENEFITS

1. Historical hedge against inflation
2. Rental income may be partially tax sheltered
3. Highly leveraged can lead to greater profits
4. Usually not correlated with stock market returns (Session 12)

C. RISKS

1. Not generally very liquid
2. Inability to find renters
3. High leverage in down market
4. Poor management skills

COMMODITIES, INCLUDING PRECIOUS METALS

A. TYPES OF COMMODITIES

1. Agricultural (corn)
2. Animal-based (pork bellies)
3. Natural resources (crude oil)
4. Industrial metals (copper)
5. Precious metals (gold)

B. BENEFITS OF INVESTING IN COMMODITIES

1. Potential hedge against inflation
2. Diversification
   a. Not correlated to stock market returns
3. Profit potential

C. RISKS OF COMMODITY INVESTING

1. Loss of principal
2. Volatility
3. Foreign market risk
   a. Currency and political
4. High spreads (precious metals)
5. Lack of income

TEST PREP 1

An investor in a DPP might enjoy each of these benefits EXCEPT

A. tax credits
B. potential capital gains
C. passive losses
D. liquidity

TEST PREP 2

Among the ways in which a hedge fund differs from a traditional mutual fund are that hedge funds

I. generally employ the use of leverage through margin
II. frequently take short positions
III. typically have lower operating expense ratios
IV. are generally not registered with the SEC

A. I and II
B. I, II, and IV
C. II and III
D. I, II, III, and IV

TEST PREP 3

One reason clients might wish to add gold to their portfolio is

A. to increase current income
B. as a possible hedge against inflation
C. because of gold's high correlation to the stock market
D. to increase the overall portfolio liquidity

Test Prep Answers

1. D
2. B
3. B

Unit 3

Economic Factors and Business Information

Session Eleven

Basic Economic Concepts and Financial Reporting

ECONOMICS AND ANALYSIS

A. FUNDAMENTALS OF COMPANIES

1. Quality of management
2. Market share
3. Product pipeline
4. Financial statements
   a. Balance sheet
   b. Income statement

B. COMPANY

Balance Sheet of ABC			
Assets		**Liabilities and Net Worth**	
Current Assets		**Current Liabilities**	
Cash	5,000,000	Accounts payable	5,000,000
Accounts receivable	15,000,000	Wages	4,000,000
Inventory	20,000,000	Taxes payable	1,000,000
Total current assets	40,000,000	Total current liabilities	10,000,000
		Long-term liabilities	
Fixed Assets		8% 20-year convert. @ $50	50,000,000
Buildings, furniture	40,000,000	Total liabilities	60,000,000
Land	15,000,000	**Net worth**	
Total fixed assets	55,000,000	Preferred stock $100 par	20,000,000
Intangibles (good will)	5,000,000	Common stock $1 par	1,000,000
Total assets	100,000,000	Capital in excess of par	4,000,000
		Retained earnings	15,000,000
		Total net worth	40,000,000
		Total liabilities and net worth	100,000,000

1. Financial statements
   a. Balance sheet
      1.) Assets = liabilities + net worth

2.) Assets – liabilities = net worth

Assets	Liabilities
	Net worth

2. Calculations used in balance sheet analysis

a. Book value

40MM	Net worth
– 20MM	Preferred stock
– 5MM	Intangibles (includes goodwill)
= 15MM	Book value
÷ 1MM	Number of common shares outstanding
= $15	Book value per common share

b. Liquidity (balance sheet)

1.) Working capital

Current assets – current liabilities
40,000,000 – 10,000,000

2.) Current ratio

Current assets / current liabilities
40,000,000 / 10,000,000

3.) Quick ratio (acid-test)

(Current assets – inventory) / current liabilities
(40,000,000 – 20,000,000) / 10,000,000

c. Capitalization

1.) Total capitalization

long-term debt + net worth (equity capital)
50,000,000 + 40,000,000

2.) Debt ratio

long-term debt ÷ total capitalization
50,000,000 ÷ 90,000,000

VALUATION RATIOS

A. PRICE-TO-EARNINGS RATIO (PE)

$$\frac{\text{CMV}}{\text{EPS}}$$

B. PRICE-TO-BOOK RATIO

$$\frac{\text{Market price of stock}}{\text{Book value per share}}$$

TEST PREP 1

Assets on a corporation's balance sheet would include

I. cash
II. inventory
III. net sales
IV. note payable secured by company vehicles

A. I and II
B. I and III
C. I, II, and IV
D. III and IV

TEST PREP 2

All of the following ratios are measures of the liquidity of a corporation EXCEPT

A. acid-test ratio
B. current ratio
C. debt/equity ratio
D. quick ratio

TEST PREP 3

When a company's debt-to-equity ratio is higher than typical for that industry, it might be said that the company is

A. about to increase their dividends
B. suitable for a conservative investor
C. highly profitable
D. highly leveraged

Test Prep Answers

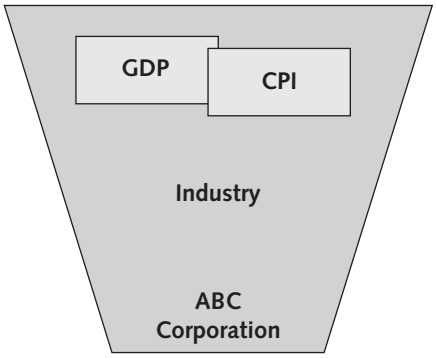
1. A
2. C
3. D

ECONOMIC FACTORS AND BUSINESS INFORMATION

The following is for Series 65 only.

A. TOP DOWN

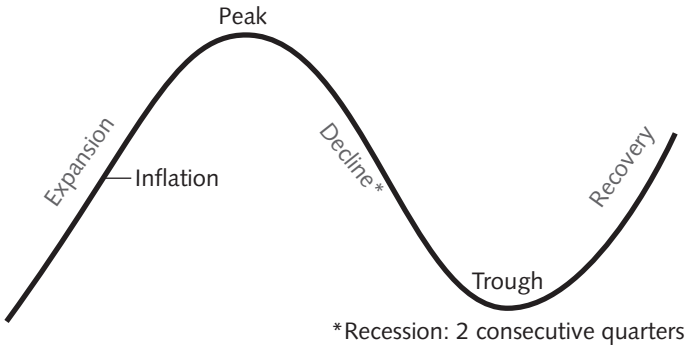
1. Economy
2. Industry
3. Company



B. ECONOMY

1. GDP
2. CPI
3. Economic indicators
   a. Leading
   b. Coincident
   c. Lagging

4. Business cycle



a. Sector rotation

1.) Follows the business cycle

2.) Sell those sectors that are peaking

3.) Buy those sectors that are expanding

C. INDUSTRY

1. Defensive (noncyclical)

2. Cyclical

3. Counter-cyclical

SEC FILINGS

A. FORM 8-K

1. Event driven

a. Sale of significant asset

b. Management change

c. Change of company name

d. Bankruptcy filing

e. Resignation of disgruntled board member

2. Relocation of a subsidiary would not trigger

3. Filed within four business days of event

B. FORM 10-K

1. Annual audited financial report

   a. Must use independent accountant

C. FORM 10-Q

1. Quarterly financial report

D. ANNUAL REPORT

1. Sent to stockholders—may use Form 10-K

TEST PREP 4

A company that is reporting high earnings during the expansion phase of the business cycle would probably be characterized as

A. countercyclical
B. cyclical
C. defensive
D. sector sensitive

TEST PREP 5

ABC Corporation has just uncovered a major accounting scandal with regard to the annual audited financial report it files with the SEC. What form will be filed to disclose this information?

A. FinCen Form 112
B. Form 8-K
C. Form 10-Q
D. Form 10-K

Test Prep Answers

4. B

5. B

Session Twelve

Methods of Quantitative Analysis

TIME VALUE OF MONEY

A. FUTURE VALUE

1. What will an investment made today at a given rate be worth at some point in the future?

2. Reflects compound rate of return

3. Factors taken into consideration

   a. Initial capital

   b. Time capital will remain invested

   c. Anticipated rate of return

   d. Unknown is ending (**future**) value of the initial capital if assumptions are met

> Example: If one invests $10,000 today at 8% interest, what will it be worth in 9 years?

B. PRESENT VALUE

1. How much needs to be invested today at a given rate to equal a specified value at a point in the future?

2. Factors taken into consideration

   a. Future goal

   b. Time to reach the goal

   c. Anticipated rate of return

   d. Unknown is today's (**present**) value—the required contribution to reach the goal

> Example: If one needed $25,000 in 12 years and was able to earn a 6% rate of return, how much would need to be invested today to reach that goal?

C. RULE OF 72

1. Approximate formula for doubling of investment

2. 72 ÷ return percentage = years to double

3. 72 ÷ number of years = percentage return needed to double

> EXAMPLE: If you can earn 4%, divide 72 by 4 = 18 years' time to double your money
>
> EXAMPLE: If you have 3 years, divide 72 by 3 = 24% earnings needed to double your money

D. NET PRESENT VALUE (NPV)

1. Subtract cost of the investment from the present value of the future returns (DCF)

2. Positive NPV is desirable

   a. Cost of bond is $940; if present value is $990

   b. NPV is +$50 — make the investment

   c. If present value is $900, NPV is –$40 = No

E. INTERNAL RATE OF RETURN (IRR)

1. The discount rate that results in a net present value of zero for a series of future cash flows

   a. In our $25k example above, IRR = 6%

   b. Rate of return needed to get from PV to FV

2. Yield to maturity of a bond reflects IRR

3. Expressed as a percentage, not dollar amounts

DESCRIPTIVE STATISTICS

A. MEASURES OF CENTRAL TENDENCY

1. Mean

   a. Arithmetic mean—simple average

   b. Geometric mean—always lower (unless all returns equal)

2. Median

3. Mode

4. Range/mid-range

B. BETA (β)

1. Measure of stock's co-movement relative to benchmark

2. Measures **systematic risk**: risk associated with the market in general, not the total risk that pertains to a specific security

   $\beta = 1$ ... Average risk investment

   $\beta > 1$ ... Above Average risk investment

   $\beta < 1$ ... Below Average risk investment

   $\beta = 0$ ... Riskless investment

C. STANDARD DEVIATION (σ)

1. Measures the volatility of an investment compared with past returns

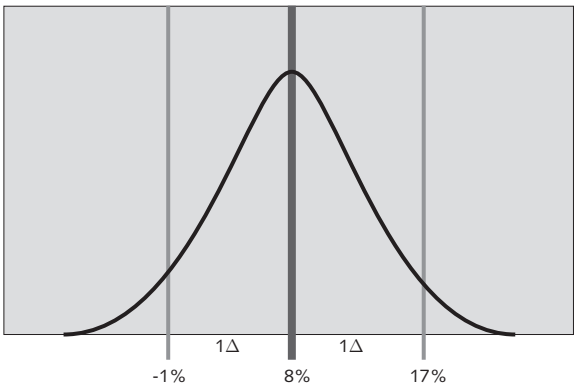
2. Standard deviation measures a security's dispersion of returns versus its historical performance (mean)

3. Systematic risk = beta

4. Standard deviation measures total risk (systematic risk and unsystematic risk)

5. Used in computing Capital Market Line

6. Volatility within 1 σ ⅔ of the time; within 2 σ 95% of the time



66.7% of the time

D. ALPHA (α)

1. Compare the actual return in excess of the risk-free rate to the expected return

a. If higher, positive alpha

b. If lower, negative alpha

c. If the same, zero alpha

> Alpha Example:
>
> The Risk-free rate (RF) is 3%. Stock A has a beta of 1.0; Stock B has a beta of 1.4. Stock A has a return of 13%; Stock B has a return of 19%. What is Stock B's alpha?
>
> Solution:
>
> Expected return = (Market – RFR)(Beta)
>
> Expected return = (13% – 3%)(1.4) = 14%
>
> Actual return over RFR = 19% – 3% = 16%
>
> Alpha = 16% – 14% = +2% (positive alpha)

TEST PREP 1

Your 50-year-old client has a 401(k) with a value of $100,000. What is the approximate annual rate of growth the account will have to experience so that at your client's retirement at age 70, the account will be worth $400,000?

A. 7.2%
B. 14.4%
C. 25.0%
D. 50.0%

TEST PREP 2

When viewing the historical performance of KAPCO Common stock over the past 5 years, an IAR sees the following returns:

Year 5: 10%; Year 4: –4%; Year 3: 8%; Year 2: 3%; Year 1: 8%.

Based on this information, it would be accurate to state that the

A. mode is higher than the mean
B. mean is higher than the median
C. range is 5
D. stock has a beta in excess of 1.0

TEST PREP 3

Determining volatility based on a security's historic returns is the purpose of computing its

A. beta coefficient
B. alpha
C. book value
D. standard deviation

Test Prep Answers

1. A

2. A

3. D

Session Thirteen

Types of Risk

TYPES OF RISK

A. SYSTEMATIC RISK

1. Risk that overall market conditions will affect individual securities adversely regardless of specific company's circumstances

    a. Cannot be diversified away

2. Examples of systematic risks

    a. Market risk

        1.) Usually measured by beta

    b. Interest rate risk

        1.) As interest rates go up, fixed income prices go down and vice versa

        2.) Long term versus short term

            a.) Long term debt more volatile (longer duration)

        3.) Low coupon versus high coupon

            a.) Low coupon debt more volatile (longer duration)

    c. Inflation (purchasing power) risk

        1.) Erosion of the buying power of the local currency unit

        2.) Greatest impact on fixed dollar investments

        3.) TIPS offer protection

B. UNSYSTEMATIC RISK

1. Risk that a business will fail or perform poorly as a result of specific characteristics of the company or industry in which it operates

    a. **Can** be diversified away

2. Examples of unsystematic risk

    a. Business Risk

1.) Loss of investment due to specific failure of the business
- Labor problems
- Poor management decisions
- Lawsuits

b. Credit (default) Risk

1.) Minimize through higher ratings

2.) Applies to debt securities, not equity

3.) Sometimes referred to as financial risk when too much leverage employed

c. Regulatory Risk

1.) Vulnerability to adverse changes in regulations (EPA, FDA, EEOC, etc.)

d. Legislative or Political Risk

1.) Vulnerability to adverse legislation (tax laws)

e. Sovereign Risk

1.) Risk that a government could default on its debt (sovereign debt) or other obligations

f. Liquidity Risk (marketability)

1.) Speed or ease of converting an investment into cash

2.) Virtually nonexistent with listed/Nasdaq securities and mutual funds

C. OPPORTUNITY COST

1. Rate given up on one investment to invest in another

2. Involves both systematic and unsystematic risk

D. LIQUIDATION PRIORITY—CAPITAL STRUCTURE

1. Secured debt

2. General creditors (including debentures)

3. Subordinated debt

4. Preferred stockholders

5. Common stockholders

TEST PREP 1

Historically, which of the following has been the least vulnerable to inflation risk?

A. Bonds
B. Common stock
C. Fixed annuities
D. Preferred stock

TEST PREP 2

An investor currently owns $100,000 of U.S. Treasury bonds maturing in 12 years. The most significant risk facing this client is

A. credit risk
B. interest rate risk
C. legislative risk
D. liquidity risk

Test Prep Answers

1. B

2. B

Unit 4

Client Investment Recommendations and Strategies

Session Fourteen

Type of Client

TYPE OF CLIENT

A. NEW ACCOUNT AGREEMENT

1. Basic customer information
   a. Name, of legal age, employment
2. Customer identification program (CIP)
   a. From USA Patriot Act – anti-terrorism
   b. DOB, physical address and TIN
3. Financial information and objectives

B. SUITABILITY—APPLIES TO ALL

1. Understanding of customer objectives required
2. Adviser acts in fiduciary capacity

C. DIFFERENT CLIENT ACCOUNTS

1. Individual—one beneficial owner
   a. Includes a sole-proprietorship
2. Joint—two or more legal persons with control
   a. A minor cannot open a joint account with an adult; must be of legal age to sign joint account agreement.
   b. JTWROS—equal ownership, passes to survivor
   c. Tenants in Common—can be unequal, passes to estate
   d. Tenancy by the entirety
      1.) Limited to spouses
      2.) Permission of spouse needed before sale or gift of interest
      3.) Primarily for real estate

e. Checks must be made out in the names of all owners.

f. Distribution of money or certificate must be endorsed by all owners—may be sent to one address.

g. Any owner whose name is on the account has control over the assets (except tenancy in the entirety).

h. Transfer on death (TOD) is okay for all except TIC (avoids probate on first to die, but not estate tax).

3. Business accounts

a. Sole proprietorship

1.) Unlimited liability

2.) Suitability of the individual

3.) Simplest business to form and dissolve

b. Partnerships

1.) An unincorporated association of two or more people

2.) Income and losses flow through

a.) If formed as a limited partnership, management (and liability) is assigned to the general partner. Limited partners are passive and liability is limited to their investment plus any funds committed to.

3.) Easy to form and easy to dissolve

4.) Suitability is combined/collective objectives of all of the partners

c. Limited liability company (LLC)

1.) Limited liability, taxed like a partnership

2.) Unlimited number of members (rather than shareholders)

3.) Easy to form, easy to dissolve

4.) Suitability similar to partnerships

d. S corporations

1.) Limited liability, taxed like a partnership

2.) Limited to 100 shareholders

3.) Suitability similar to partnerships

e. C corporations

1.) Shareholders' risk limited to investment

2.) Corporation is taxable entity

3.) Best for raising large amounts of capital

4.) Suitability of the entity, not the shareholders

FIDUCIARY ACCOUNTS—TRUSTS AND ESTATES

A. ALL TRUSTS

1. Trustee follows the terms of the trust

a. Adhere to Uniform Prudent Investor Act (UPIA)

B. LIVING TRUSTS

1. Grantor/settlor transfers assets (corpus) to trustee/trust while the grantor/settlor is alive

2. Can be revocable or irrevocable

a. Revocable living trusts (grantor trust)

1.) Grantor can be trustee, beneficiary, or both

2.) Income or corpus can go to grantor(s) or beneficiaries

3.) Terms of trust may be altered; grantor may amend or revoke the trust

4.) Grantor is responsible for tax on trust income

5.) Assets remain in grantor's taxable estate

b. Irrevocable living trust

1.) Trustee and beneficiary cannot be the grantor

2.) Terms of the trust cannot be altered

3.) Grantor may avoid income and estate tax. Income is taxed to the beneficiaries if distributed, otherwise to the trust

4.) Irrevocable Life Insurance Trust (ILIT) is a popular example

C. MAY BE A SIMPLE TRUST OR A COMPLEX TRUST

1. Simple trust must distribute DNI each year.

a. Income from dividends and interest

b. Rents

c. Realized capital gains not reinvested in the corpus

d. Less: trust expenses

2. Simple trust may not distribute corpus

3. Complex trust may retain income

4. Complex trust may distribute corpus

5. 39.6% tax bracket reached at $12,400 (2016) of undistributed income

D. TESTAMENTARY TRUST

1. Settlor retains control over assets until death

2. Trust is irrevocable (can't change things after death)

a. Property passes into the trust by way of the will and must go through the probate court process

b. Does not reduce grantor's income or estate tax liability

3. Trustee is responsible for managing the trust until termination

E. ESTATE—CUSTODIAL ACCOUNT DIRECTED BY AN EXECUTOR OR ADMINISTRATOR (INTESTATE) ON BEHALF OF BENEFICIARIES

1. Fiduciary relationship
2. Suitability in accordance with UPIA

F. MISCELLANEOUS

1. Per stirpes—assets pass to descendants of deceased beneficiary
2. Per capita—assets are divided among surviving beneficiaries only
3. Intestate—if the deceased died intestate (without a will), the personal representative is an administrator (state appointed), rather than an executor.

TEST PREP 1

Which of the following business structures has a statutory limit to the number of investors?

A. C-corporation
B. LLC
C. Partnership
D. S-corporation

TEST PREP 2

Flow-through of income and loss is a characteristic of all of the following EXCEPT

A. Partnership
B. LLC
C. C-corporation
D. S-corporation

TEST PREP 3

Which of the following statements are CORRECT?

I. Complex trusts must distribute income on an annual basis.
II. Simple trusts must distribute income on an annual basis.
III. The grantor has the ability to change the beneficiary of a revocable trust.
IV. The grantor has the ability to change the beneficiary of an irrevocable trust.

A. I and III
B. I and IV
C. II and III
D. II and IV

TEST PREP 4

All of the following would be included in the DNI of a trust EXCEPT

A. dividends
B. rental income
C. capital gains reinvested in the corpus
D. interest

Test Prep Answers

1. D
2. C
3. C
4. C

Session Fifteen

Client Profile

CLIENT PROFILE

A. CLIENT PROFILES

1. Financial status
    - a. What is on a family balance sheet?
    - b. Shows what is available for lump sum investment
    - c. What is on a family income statement?
        - 1.) Determine cash flow
        - 2.) Shows what is available for periodic investing
2. Life insurance
    - a. Capital needs analysis
        - 1.) Used to calculate life insurance needs
            - a.) Assets and liabilities
            - b.) Future earnings
            - c.) Inflation
        - 2.) Market volatility is not a consideration
3. Nonfinancial considerations
    - a. Attitudes
    - b. Demographics
    - c. Experience
    - d. Values
4. Elements of risk tolerance
    - a. Liquidity requirements
    - b. Investment time horizon—short/long

c. Current investment holdings

d. Attitude toward volatility

5. Type of client

a. Individual/business/trust/institution

6. Client characteristics

a. Conservative (low risk)

b. Aggressive (high risk)

7. Behavioral finance

a. Behavioral biases can cause investors to make financial decisions that are irrational. Examples of those biases include:

1.) Overconfidence (investors overestimate their ability)

2.) Conservatism (hard to change prior beliefs, even with new information)

3.) Herd behavior (market drop – panic selling)

B. FINANCIAL GOALS

1. Preservation of capital

a. Client cannot afford loss of principal

b. Appropriate investments include insured bank CDs and money market funds

c. Client risks loss of purchasing power

2. Current income

a. Government, agency, municipal, corporate bonds

b. Preferred stocks

c. Common stocks

1.) Public Utilities

- **d.** Bond funds
- **e.** Equity income funds

3. Capital appreciation

- **a.** Common stock
- **b.** Equity mutual funds or growth ETFs

4. Speculation

- **a.** Options
- **b.** High-yield bonds
- **c.** Commodities

5. Diversification

- **a.** Asset allocation
  - **1.)** Foreign stock funds
  - **2.)** Tangible assets for inflation protection

6. Passive investing

- **a.** Index funds; ETFs
  - **1.)** Low cost

7. College tuition

- **a.** Zero-coupon bonds (STRIPS) maturing when tuition is due
- **b.** Coverdell ESA, Section 529 plans

8. Retirement planning

- **a.** Social Security
- **b.** Pensions/401(k)
- **c.** Annuity, IRA, etc.

9. Tax planning
   a. Tax deferral
   b. Tax-free income
10. Time horizon
   a. Helps determine suitability of recommendations
   b. Social Security
   c. Disability insurance

TEST PREP 1

A family balance sheet would reveal all of the following EXCEPT

A. cash in the bank
B. salary
C. value of 401(k) plan holdings
D. credit card debt

TEST PREP 2

It is axiomatic that investors with a long time horizon should

A. maintain a high percentage of their assets in cash equivalents
B. allocate a higher portion of their portfolio to equities than if they had a short time horizon
C. allocate a smaller portion of their portfolio to equities than if they had a short time horizon
D. stay out of the stock market and invest in gold

TEST PREP 3

You would most likely recommend a money market mutual fund to a client whose objective is

A. capital growth
B. capital preservation
C. liberal income
D. limited liability

Test Prep Answers

1. B
2. B
3. B

Session Sixteen

Portfolio Management Styles, Strategies, and Techniques

ASSET ALLOCATION

A. SPREADING PORTFOLIO FUNDS AMONG DIFFERENT ASSET CLASSES

1. Cash and cash equivalents
2. Fixed-income investments
3. Equities
   a. Domestic
   b. Foreign
4. Tangible assets
   a. Real estate
   b. Precious metals

B. STRATEGIC ASSET ALLOCATION—LONG TERM

1. Passive investment strategy
2. Percentages determined based on client
   a. 60% equity/40% debt—very common
   b. 70% debt/30% equity—retiree
3. Periodic rebalancing
4. Buy and hold
5. Frequently use index funds or ETFs
6. Low investor costs

C. TACTICAL ASSET ALLOCATION—SHORT TERM

1. Active management strategy
2. Undervalued purchased/overvalued sold
3. Current market conditions

4. Market timing
5. High investor costs
    a. Trading costs (commissions)
    b. Capital gains taxes

GROWTH PORTFOLIOS

A. EARNINGS GROW FASTER THAN SIMILAR COMPANIES/OVERALL MARKET

1. Generally high P/E's
2. Looking for earnings momentum
3. Low dividend payout ratio
4. Likely to trade at higher end of 52-week trading range

VALUE PORTFOLIOS

A. UNDERVALUED OR OUT-OF-FAVOR SECURITIES

1. Generally low P/E ratios
2. Higher dividend payout ratio
3. Focus on financial statements
    a. Hidden value may include "rainy day" fund
4. Likely to trade at the lower end of 52-week trading range

OTHER PORTFOLIO MANAGEMENT STYLES

A. MARKET CAPITALIZATION

Categorization by Market Capitalization

Name	Size	Benchmark
Micro Cap	$50 million–$300 million	N/A
Small Cap	>$300 million–$2 billion	Russell 2000
Mid Cap	>$2 billion–$10 billion	S&P 400
Large Cap	>$10 billion	S&P 500

market capitalization = (CMV / share) × number of shares outstanding

B. CONTRARIAN

1. Buys when others are selling; sells when others are buying

C. CAPITAL ASSET PRICING MODEL (CAPM)

1. Used to determine the required rate of return

   a. Must be compensated for time value

      1.) Use risk-free rate

   b. Must be compensated for systematic risk

      1.) Compare beta to market return

   c. Formula—Risk-free rate (RF) plus (market return [MR] minus RF) times beta (β)

      Example: RF = 4%, MR = 12%, β = .8

      4% + (12% – 4%) × .8 = 4% + 6.4% = 10.4% required rate of return

D. MODERN PORTFOLIO THEORY

1. Diversify by using securities with a low or negative correlation, thereby reducing portfolio volatility

2. Correlation

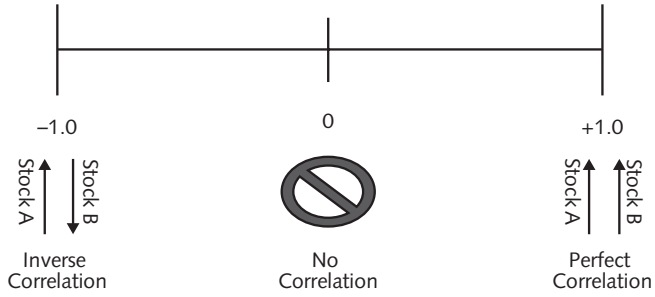
   a. Positive correlation: Two securities' prices move in a similar direction

b. Negative correlation: Prices of two securities move in opposite direction

1.) Adds diversification to portfolio

c. Perfect correlation: Parallel movement (index funds)

d. Zero correlation: No discernable pattern



E. EFFICIENT MARKET HYPOTHESIS (EMH)

1. All investors have equal access to the same market information

2. Can't beat the market; just throw darts

3. Three forms of EMH

a. Weak—information everyone knows (price and volume), technical analysis

b. Semi-strong form—information available with some effort (e.g., company financials, economic factors); fundamental analysis

c. Strong form—information available to insiders; still no benefit

F. MONTE CARLO SIMULATION

1. Runs hundreds or thousands of trials based on varying factors such as:

a. rates of return on investments;

b. inflation rates; and

c. interest rates.

2. Measures probabilities of meeting specific objectives and goals under varying conditions and circumstances

STRATEGIES

A. BUY AND HOLD

1. Can be used with many different styles (results in lower maintenance costs)
2. Lower capital gains taxes

B. INDEXING

1. Low transaction costs
2. Lower management fees

C. DIVERSIFICATION

1. Between asset categories
2. Within the asset category

D. SECTOR ROTATING

1. Business cycle

E. INCOME STRATEGIES

1. Barbells
2. Bullets
3. Ladders

FUNDING TECHNIQUES

A. DOLLAR COST AVERAGING

$ Invested	Price/Share	No. of Shares
$100	$5	20
$100	$4	25
$100	$2	50
$100	$10	10

total $ invested ÷ no. of shares = average cost per share

$400 ÷ 105 = $3.81

total share prices ÷ no. of investment periods = average price per trade

21 ÷ 4 = $5.25

B. INCOME REINVESTMENT

1. Mutual fund dividend and capital gains distributions
2. Dividend reinvestment plans (DRIPs)
   a. Offered from issuers to shareholders
   b. Sometimes discounted
   c. Reduced or no commissions
   d. Can usually invest additional sums
3. Interest on interest (e.g., savings accounts)
4. Taxation
   a. Currently taxable
   b. Form 1099 required

TEST PREP 1

A portfolio manager makes investment decisions based on market signals. This manager is probably using which portfolio management style?

A. Buy and hold
B. Passive
C. Strategic
D. Tactical

TEST PREP 2

Using the following information, which stock most likely would be included in a growth portfolio?

A. ABC with dividends of $2.25 per share, a current market price of $50, and a 52-week price range of 48–75
B. DEF with dividends of $.50 per share, a current market price of $9, and a 52-week price range of 8.80–19
C. GHI with dividends of $.25 per share, a current market price of $22, and a 52-week price range of 14.45–22.10
D. JKL with dividends of $1.05 per share, a current market price of $22, and a 52-week price range of 20–40

TEST PREP 3

According to Modern Portfolio Theory (MPT), which of the following securities would most likely reduce the volatility of your client's portfolio?

A. ABC with a correlation coefficient of +.89
B. DEF with a correlation coefficient of +.35
C. GHI with a correlation coefficient of +.02
D. JKL with a correlation coefficient of -.65

TEST PREP 4

A 35-year-old couple is actively looking to purchase their first home within the next 6 months. Their investible assets are $150,000. Which of the following asset allocations would appear to be most suitable for them at this time?

A. 100% equity
B. 90% equity, 10% cash
C. 50% cash, 35% equity, 15% bonds
D. 60% bonds, 20% equity, 20% cash

Test Prep Answers

1. D
2. C
3. D
4. C

Session Seventeen

Taxation

INDIVIDUAL TAX STRUCTURE

A. TAX ON INCOME—PROGRESSIVE

1. Rate increases as income increases

a. What is taxed as income?

1.) Earned income

a.) Ordinary income rates

2.) Passive income

a.) Ordinary income rates

b.) Can offset passive loss (DPPs)

3.) Portfolio income

a.) Qualifying dividends at 15%–20%

b.) Non-qualifying dividends - ordinary income

c.) Bond interest—ordinary income rates

d.) Municipal bonds—interest is tax free on federal; sometimes state as well

4.) AMT (alternative minimum tax)

a.) Uses preference items

b.) Owed if greater than regular tax

5.) Taxation of reinvestments

a.) Dividends from mutual finds or DRIPS taxed in year of payment

b.) Capital gains distributions (generally long-term) taxed in year of payment

c.) Interest received on an interest on interest (savings) account taxed in year of crediting to account

d.) Form 1099 is sent

B. CAPITAL GAINS AND LOSSES

1. Proceeds minus cost basis
2. Stock splits and stock dividends change cost basis (adjusted and taxed when sold)
3. Short term versus long term
   a. Short term is 12 months or less
      1.) Taxed at ordinary income rates
   b. Longterm is more than 12 months
      1.) Maximum tax of 15% (20%)
4. Deducting ***net*** capital losses
   a. Capital losses offset capital gains with no limit
   b. Net capital losses—maximum $3,000 per year deductible against ordinary income
   c. Balance may be carried forward indefinitely

Example: Deducting losses

Net gains:	$12,000
Net losses:	<$17,000>
Net total:	<$5,000>

Current-year deduction: $3,000 (maximum)

Carry remaining loss forward to next year: $2,000

   d. 30-day wash sale rule
      1.) Substantially identical securities—rights, calls, warrants, convertibles
5. Sale versus several purchases
   a. FIFO (IRS default)
   b. Identified cost
   c. Averaging (mutual funds)

Example: Investor sold at $15 per share

Share purchased	Purchase Price
100	$10
100	$16
100	$12

C. OTHER TAX ISSUES

1. Gifts of securities

a. Donor's original cost basis (cost and holding period) passes to recipient (the donee)

2. Inherited securities—cost basis to heirs is market value on date of death

a. Stepped-up basis

3. Estate tax

a. Gross estate includes:

1.) cash, securities, real estate;

2.) insurance (if policy owned by the insured);

3.) property in revocable trusts, IRAs, annuities, business interests; and

4.) all other assets owned by or in which the deceased has an ownership interest.

a.) Assets valued as of date of death or alternative valuation date (six months later)

b. Subtract deductions from the gross estate including the following:

1.) Mortgages and other debts

2.) Estate administrative expenses

3.) Property passing to qualified charities

4.) Property passing to a surviving spouse

a.) If U.S. citizen spousal deduction is unlimited

c. Result is taxable estate

1.) Calculate estate tax (maximum rate = 40%)

2.) Apply uniform credit (equivalent to $5,450,000 of assets in 2016)

3.) The estate tax is due nine months after death on IRS Form 706

4. Gift tax

a. Donor liability

b. $14,000 exclusion (2016)

1.) $28,000 for married couple

2.) Unlimited gift between spouses

3.) Non-citizen spouse limited to $148,000 per year (2016)

4.) Form 709 used to file gift tax returns

5.) Gift and estate tax rates are progressive

5. Taxation of foreign securities

a. Typically 15% withholding from dividends and interest

1.) Recoverable by tax credit

6. Trusts

a. Tax brackets are significantly lower for trusts than they are for individuals (Form 1041)

BUSINESS TAXATION

A. BUSINESS TAXATION

1. Sole proprietor

a. Taxed on Schedule C of Form 1040

2. Partnership

a. Partnership files Form 1065 information return

1.) Due March 15

2.) Partners receive Schedule K-1

3. LLC

a. Single member LLC files like a sole proprietorship

b. Multiple member files like a partnership

4. S-Corporation

a. Filed on Form 1120S

b. Due 15th day of 3rd month after year-end

c. Schedule K-1 to shareholders

5. C-Corporations

a. Filed on Form 1120

b. Due 15th day of 4th month after year-end, e.g. April 15 for calendar year reporting corporation.

c. No forms to shareholders—corporation pays tax

6. Corporate dividend exclusion rule—70%

TEST PREP 1

All of the following would be taxed at ordinary income tax rates EXCEPT

I. alimony payments received
II. a year-end cash bonus
III. net long-term capital gains
IV. qualifying dividends

A. I and II
B. I and IV
C. II and III
D. III and IV

TEST PREP 2

Which of the following statements is NOT true?

A. Estate taxes are filed on Form 706.
B. Estates may be valued at date of death or nine months later.
C. Gift taxes are filed on Form 709.
D. Heirs receive stock with a stepped-up basis.

TEST PREP 3

A business entity reports an operating loss for the year. The loss will not be of any tax benefit to the owners of the business if the entity is organized as

A. an LLC
B. a C corporation
C. an S corporation
D. a sole proprietorship

TEST PREP 4

Investors in which of the following would not receive a Schedule K-1?

A. S-Corporation
B. C-Corporation
C. Limited partnership
D. LLC

Test Prep Answers

1. D
2. B
3. B
4. B

Session Eighteen

Trading Securities

TYPES OF ACCOUNTS

Customers can have cash or margin account.

A. CASH

1. Payment in full (no borrowing) within specified time
2. Retirement and custodial accounts may only be cash

B. MARGIN

A margin account uses leverage. It allows an investor to use some cash and some credit to purchase securities. The Federal Reserve Board regulates the extension of credit in the securities industry.

1. Customer meets initial margin call; broker-dealer lends the balance
2. Considered a leveraged position
3. Greater returns or losses on percentage basis
   a. Marginable securities—securities are used as collateral for loan
   b. Drop in market value could lead to maintenance call for more money (House then SRO)
4. Account forms
   a. Credit agreement
   b. Hypothecation agreement
   c. Consent to loan agreement
      1.) Optional
5. Extension of credit—Regulation T—50% initial requirement
6. Short sales—must be in a short margin account
   a. Selling short is bearish strategy
   b. Deliver stock borrowed from the broker-dealer

c. Return borrowed stock to close out (cover) position

1.) Purchase at lower price = profit

2.) Purchase higher price = loss (potentially unlimited)

7. Mixed margin account—long and short positions

a. Equity = Long CMV + short credit balance – long debit balance – short CMV

8. Maintenance margin (call)—call for additional funds when equity in the account becomes deficient

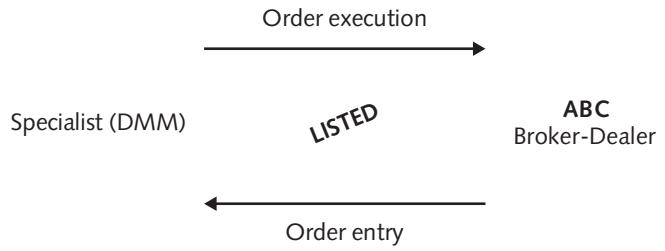
9. House (firm) versus SRO

MARKETS AND THEIR PARTICIPANTS

A. EXCHANGES (LISTED)

1. Physical location

2. Auction market

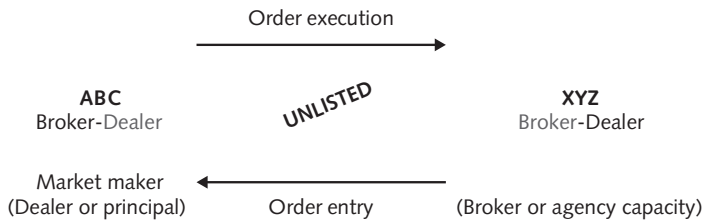


B. OVER-THE-COUNTER (OTC) UNLISTED

1. Between broker-dealers (not on exchange)

2. Corporate stocks/bonds, municipal, and government

3. Negotiated market



C. ROLES OF THE BROKER-DEALER

1. Market makers (dealers)

a. Broker-dealer with position (inventory) in security

1.) Maintain bid and ask minimum of 100 shares

a.) Firm quote

2.) Parties provide liquidity as available contra parties

3.) Inside quotes (inside market)

	Bid	Ask/offer
MMA	17.50	17.95
MMB	17.58	17.99
MMC	17.62	18.01

b. Dealer or principal—markup or markdown

2. Brokers

a. Broker-dealer acting in agency capacity

1.) Calls market maker (dealer/principal)

2.) Purchases/sells at inside market

3.) Charges commission, not mark-up

a.) Commission always disclosed on trade confirmation

3. Confirmations

a. Detailed description of transaction

b. Disclose capacity of firm (broker or dealer)

c. Disclosure if market maker

d. Disclosure of control relationship

e. Sent by completion of trade

TRADING CONCEPTS

A. TYPES OF ORDERS

1. Market orders—executed immediately at best available price

a. Time priority applies

2. Limit orders—stated prices at which customers are willing to buy or sell

a. Guaranteed price, not fill

1.) Buy limit order

a.) Entered below CMV

2.) Sell limit order

a.) Entered above CMV

3.) Time priority applies

> **Example: Market and Limit Orders**
>
> Market order: *Buy (or sell) 1000 shares XYZ @ market*
>
> Instruction: Execute at any (best) available price
>
> Sell limit: *Sell 1000 shares XYZ @ 35 (cmv = 33)*
>
> Instruction: Execute at $35 or better (higher)
>
> Buy limit: *Buy 1000 shares XYZ @ 30 (cmv = 33)*
>
> Instruction: Execute at $30 or better (lower)

3. Stop orders ("stop loss")

a. Buy stop

1.) Can protect short position in rising market

2.) Entered above CMV

3.) Becomes a market order when triggered

b. Sell stop

1.) Can protect long position in falling market

2.) Entered below CMV

3.) Becomes a market order when triggered

4.) Can accelerate a decline in a falling market

Example: Buy stop

An investor sells 100 ABC short at $33 but does not want to be at risk of losing money if the stock goes **up**.

Buy stop: *Buy 100 shares ABC @ 35 stop*

Instruction: Triggered at $35 or better (higher)

Becomes a market order

Buy stops are always placed above CMV

B 100 ABC @ 35 STOP

33	34.75	34.90	34.80	35	?
↓ Order entered				↓ Trigger elect	↓ Market Order

Example: Sell stop

An investor buys 100 ABC at $33 but does not want to be at risk of losing money if the stock goes **down**.

Sell stop: *Sell 100 shares ABC @ 30 Stop*

Instruction: Triggered at $30 or better (lower)

Becomes a market order

Sell stops are always placed below CMV

S 100 ABC @ 30 STOP

33	30.75	30.25	30.10	30	?
↓ Order entered				↓ Trigger elect	↓ Market Order

4. Stop limit orders—become limit orders when triggered

a. Trigger—first trade at or through stop price

b. Like any other limit order, execution is not guaranteed

Example: Sell stop limit order

An investor wants to sell the stock if it falls to $25 but wants at least $24

S 100 ABC @ 25 STOP LIMIT 24

26	25.90	25	23.90	23.95	24ob
↓ Order entered		↓ Trigger elect			↓ Execution 24 or higher

5. Time
   a. Day
   b. Good until canceled
6. Block trade—10,000 shares or more

HIGH FREQUENCY TRADING

A. PROPRIETARY TRADING USING HIGH SPEED SYSTEMS TO MONITOR AND SUBMIT LARGE NUMBER OF ORDERS TO THE MARKETS

1. Use algorithms to maximize speed.
2. Computers take advantage of minute discrepancies in price.

B. BENEFITS OF HFT

1. Increased liquidity, especially very active stocks
2. Arbitrage increases market efficiency
3. Lower costs for institutional purchasers

C. NEGATIVES OF HFT

1. Phony trades can lead to market manipulation.
2. It's unfair to small investors who don't have such quick access to information.
3. "Snowballing" effect (Aug 24, 2015—DJI drops over 1,000 points in minutes)

DARK POOLS

A. KNOWN AS DARK POOLS OF LIQUIDITY

1. Used by institutional traders
2. Execute large block trades without impact to public quotes or prices
3. Fund managers use to keep from revealing strategies
4. Market transparency "darkened"

TEST PREP 1

When the equity in a client's margin account begins to decline, the first demand for additional funds is usually a

A. house call
B. maintenance call
C. margin call
D. restricted call

TEST PREP 2

A market maker in an over-the-counter stock

A. buys at the bid price
B. sells at the bid price
C. buys at the offer price
D. sells at the offer price plus commission

TEST PREP 3

A short investor enters an order marked, "Buy DMF at 25.50 stop". Which of the following would trigger the order?

A. If the market price goes below 25.50
B. If the market price goes to or above 25.50
C. The order does not need to be triggered, but it must be executed at 25.50
D. This order cannot be executed

TEST PREP 4

All of the following statements regarding an investor with a short stock position are true EXCEPT

A. the position could be protected through the purchase of a long call on the stock
B. the position could be protected through the entry of a buy stop order on the stock
C. the position could be protected through the entry of a buy limit order on the stock
D. investors who sell short are exposing themselves to a potentially unlimited loss

Test Prep Answers

1. A
2. A
3. B
4. C

Session Nineteen

Performance Measures

MEASURING INVESTMENT RETURN

A. TOTAL RETURN

Income ± Gains or Losses = Total Return

Total Return ÷ Investment = Total Return %

Example: An investor purchased a stock at $50 and sold it for $59 after holding it for one year. During that year, the stock paid a $.25 quarterly dividend. What was the investor's total return?

B. HOLDING PERIOD RETURN

Total Return as calculated regardless of the holding period

Example: An investor purchased a stock at $50 and sold it for $59 after a two-year holding period. During those two years, the stock paid a $.25 quarterly dividend. What was the investor's holding period return?

C. ANNUALIZED RETURN

(1 year or 12 months) ÷ Holding Period) × the Holding Period Return

Example: An investor purchased a stock for $20 and sold it three months later for $21. What is the annualized return?

D. AFTER-TAX RETURN/YIELD

Pre-tax return × (1.00-marginal tax rate); or

Pre-tax return – marginal tax rate

Example: An investor owns a security with an annual taxable return of 10%. If the investor is in the 30% tax bracket, what is the after-tax return?

E. INFLATION-ADJUSTED RETURN

Unadjusted rate of return – inflation rate (CPI)

Example: An investor owns a security that has provided a return of 8% for the year. If the inflation rate of that period was 3%, what is the investor's real rate of return?

F. EXPECTED RETURN

Example: An investor is told that there is a 20% chance that an investment will return 10%; a 30% chance that it will return 2%, and a 50% chance that it will return 6%. Based on this information, what is the expected return?

20% chance of 10% → 20 × 10%

30% chance of 2% → 30 × 2%

50% chance of 6% → 50 × 6%

G. SHARPE RATIO—MEASURES RISK ADJUSTED RETURN

$$\frac{\text{Actual return} - \text{Risk-free return (T-bills)}}{\text{Standard deviation}} = \text{Sharpe ratio}$$

1. Measures amount of return per unit of risk taken
2. Higher Sharpe ratio is better

H. TIME-WEIGHTED RETURNS

1. Used to evaluate the performance of portfolio managers
2. Does not reflect cash in or out of the account

I. DOLLAR-WEIGHTED RETURNS

1. Used to evaluate the individual's account performance
2. Reflects that investor's cash flow in and out of account

J. CURRENT RETURN AND YIELD TO MATURITY

BENCHMARK PORTFOLIOS

A. DOW JONES INDUSTRIAL AVERAGE (DJIA)

1. 30 large-cap stocks
2. Price weighted

B. STANDARD AND POOR'S 500 (S&P 500)

1. 500 large-cap stocks

2. Market value or cap weighted

3. Standard benchmark for large-cap equity

C. NYSE COMPOSITE INDEX (NYSE COMPOSITE)

1. All NYSE-listed stocks

2. Market value or cap weighted

D. STANDARD AND POOR'S 400

1. 400 Mid-cap stocks

2. Market value or cap weighted

3. Standard benchmark for mid-cap equity

E. RUSSELL 2000® INDEX

1. 2,000 small-cap stocks

2. Market value or cap weighted

3. Standard benchmark for small-cap equity

F. EAFE

1. Europe, Australasia, and Far East

2. Market value or cap weighted

3. Standard benchmark for foreign equity

G. THE WILSHIRE 5000

1. Broadest indicator of U.S. equities market

2. Approximately 3,600 securities

TEST PREP 1

An investor purchases 100 shares of KAPL common stock on June 1, 2015, at $20 per share. On December 1, 2015, the stock is sold at $21 per share. Which of the following statements are CORRECT?

I. The annualized return is 7%.
II. The annualized return is 10%.
III. The holding period return is 3.5%.
IV. The holding period return is 5%.
A. I and III
B. I and IV
C. II and III
D. II and IV

TEST PREP 2

Which of the following benchmarks would be the most appropriate for a portfolio manager who concentrates on large-cap stocks?

A. Nasdaq 100
B. S&P 400
C. S&P 500
D. Russell® 2000

Test Prep Answers

1. D

2. C

Session Twenty

Retirement Plans Including ERISA Issues and Educational Funding Programs

RETIREMENT PLANS

Qualified Plans	Nonqualified Plans
Contributions currently tax deductible	Contributions not deductible
Approved by IRS	IRS approval not required
Cannot discriminate	Can discriminate (executives)
Tax on accumulation deferred	Accumulation may be tax deferred
All withdrawals taxed	Excess over cost base taxed
Plan operates as trust	Trust not required

NONQUALIFIED PLANS

A. INDIVIDUAL—ANNUITIES

B. BUSINESS

1. Deferred compensation
   a. Retain key employees
   b. May discriminate
2. Payroll deduction

INDIVIDUAL PLANS

A. TRADITIONAL IRAS

1. Contribution limit
   a. 100% of earned income up to an allowable amount (plus catch-up for individuals age 50 and older)
2. Spousal IRA: Additional contribution with same limits may be made for spouse with little or no earned income
3. Contributions may or may not be deductible
   a. Covered by employer-sponsored plan
   b. Above certain income limits

4. Contribution deadline is April 15 of the year following the contribution year

5. Earnings grow tax deferred

6. Tax penalties

a. Excess contribution = 6%

b. Premature distributions: before age 59½ = 10% of taxable amount, with the following exceptions:

1.) Death

2.) Disability

3.) Qualified education expenses

4.) Medical expenses over certain limits

5.) First-time purchase of primary residence ($10,000)

6.) Health insurance for unemployed

7.) Equal payments for life expectancy—Rule 72t

c. Insufficient distribution = 50%: Distribution must begin April 1 of the year after turning age 70½

7. Nonallowable/Inappropriate investments: Tangibles, Insurance, Municipal bonds

a. U.S. gold and silver coins (*American Eagles*) are allowed.

b. Real estate is allowed

1.) Neither contributor or lineal family may derive immediate benefit (spouse, parents, children, or grandchildren).

8. Rollover

a. Rollover of 100% of the amount distributed must occur within 60 days of the distribution or the remainder will be taxed.

> **Example:** Trustee of qualified plan sends cash distribution to participant who then sends the money to the trustee of his IRA.

b. Trustee to trustee transfer—no tax

c. Direct Rollover

1.). Plan to plan, or plan to IRA—no tax

9. Taxation upon distribution

a. Ordinary income

b. Proportionate if some contributions were after tax

B. ROTH IRA

1. Same contribution limits as a traditional IRA

a. May have both—limit is not doubled

2. Contributions not allowed for those exceeding earnings limits

3. Contributions never tax deductible

4. Earnings may be withdrawn tax-free if a qualified distribution account:

a. has been established for five years; and

b. one of the following conditions applies:

1.) Age 59½

2.) Death or disability

3.) First-time home purchase

5. No required minimum distributions at age 70½

6. Contributions may be made after age 70½

7. Minor may be named as a beneficiary

QUALIFIED PLANS (EMPLOYER SPONSORED)

A. KEOGH (HR-10)—SELF EMPLOYED, NONINCORPORATED

B. 403(B) PLANS (TAX SHELTERED ANNUITIES [TSAs])

1. Available for employees of 403(b) organizations (i.e., public schools) and 501(c)(3) organizations (i.e., qualified nonprofits such as churches and hospitals)

2. Funded through pretax salary reductions

3. Employer may make contributions

C. DEFINED BENEFIT PLAN (TRADITIONAL PENSION PLAN)

1. Provides defined benefit at retirement based on the following:

   a. Age

   b. Years of service

   c. Earnings

2. Sponsor (employer) bears investment risk

D. DEFINED CONTRIBUTION PLANS

1. Money purchase pension plan

   a. Annual employer contribution is fixed.

   b. Employee bears investment risk.

2. Profit-sharing plan—employer contribution may be decreased or skipped on the basis of corporate profits

3. 401(k) plan

   a. Reduces income tax for employees who contribute, but not FICA and FUTA

   b. Top-heavy testing for key employees (not highly compensated employees)

   c. Safe harbor plan avoids testing if contributing with immediate vesting, whether non-elective or matching

   d. Distribution may be rolled over into traditional IRA or into a Roth IRA

   e. Self-employed may use solo 401(k) to maximize contributions

f. Participants may borrow

1.) Pay back with interest through payroll deduction

EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)

A. ELIGIBILITY

B. FUNDING

C. REPORTING

D. BENEFICIARY

E. FIDUCIARY RESPONSIBILITY

1. No self-dealing

2. No acting with parties with adverse interests

3. No compensation on personal transactions

F. PARTY IN INTEREST

1. Any fiduciary of the plan

2. The employer

3. An employee organization whose members are covered by the plan (unions)

4. Service providers (e.g., legal, accounting, trustee/custodial, recordkeeping)

5. A "control" person of any of the above

6. Lineal descendent of above (besides #3)

G. INVESTMENT POLICY STATEMENT—SECTION 404(A)

1. Recommended, not required, plan document detailing acceptable investments and investment strategies

a. Investment objectives and policies

b. Investment selection criteria (but not actual investments)

c. Monitoring procedures and performance

d. Determination for meeting future cash flow needs

2. Not the same as the DOL's Summary Plan Description (SPD)

H. SAFE HARBOR PROVISIONS (LIABILITY OF THE TRUSTEE)—SECTION 404(C)

1. Investment selection

   a. At least three investment alternatives

2. Independent control

   a. Employees choose their own investments

3. Communication

   a. Information available upon request

      1.) Prospectuses and financial statements

      2.) Risk and return characteristics of investments

I. PROHIBITED TRANSACTIONS

1. Parties in interest (e.g., lending money to the plan)

2. Fiduciary self-dealing (e.g., acting on both sides of a transaction involving the plan)

J. VESTING

EDUCATIONAL FUNDING PLANS

A. EDUCATIONAL IRA/COVERDELL ESA

1. After-tax contribution, but grows tax-deferred

2. Contributions may be made by anyone, including the beneficiary, but the total annual maximum contribution per child is $2,000

3. Contributions may be made until the child's 18th birthday

4. Contributors must fall under certain earnings limits

5. Earnings withdrawn for qualified education expenses before beneficiary is age 30 are tax-free; otherwise tax + 10% tax penalty

B. SECTION 529 PLANS (QUALIFIED TUITION PLANS [QTPs])—COLLEGE SAVINGS PLANS

1. After-tax contributions

2. No age limit for contributions or withdrawals

3. Earnings accumulate tax deferred and are tax-free when withdrawn for postsecondary qualified education expenses

4. No earnings limitations on contributors

   a. States may offer state income tax-free withdrawals or deductions for contributions or tax credits

5. Non-qualified withdrawals subject earnings to tax plus a 10% tax penalty

6. Prepaid tuition plans

7. College savings plans

   a. States set maximum contribution limits—no federal limits

      1.) Subject to gift tax rules

         a.) Five-year multiple gift tax exclusion

      2.) Donor retains control

8. May be rolled over to another state's plan

   a. Once per 12 months

9. These are municipal fund securities and require delivery of an official statement or offering circular (not a prospectus)

10. Treated as parental assets when student applies for financial aid—better for student than if their asset

CUSTODIAL ACCOUNTS

A. CUSTODIAL ACCOUNTS

1. Rules
    - a. One child—beneficial owner
    - b. One custodian
        - 1.) Adult
        - 2.) Not necessarily the donor
        - 3.) Fiduciary capacity
    - c. Irrevocable
        - 1.) No limit as to gift size
        - 2.) Withdrawn only for benefit of minor
    - d. Donor/custodian no management fee
    - e. Names on account
        - 1.) Custodian
        - 2.) Minor—name and Social Security number
        - 3.) State where account is held
2. Taxation
    - a. Minor's Social Security number
3. Types
    - a. Uniform Gift to Minors Act (UGMA)
        - 1.) Assets registered to individual at any age of majority
    - b. Uniform Transfers to Minors Act (UTMA)
        - 1.) Designate age for the transfer of the assets

2.) Maximum 25 years of age

3.) Offer greater investment choices

a.) Real estate

UGMA	UTMA
1 custodian, 1 minor	1 custodian, 1 minor
Irrevocable, indefeasible	Irrevocable, indefeasible
No margin No short sales No uncovered options	No margin No short sales No uncovered options
Unlimited contribution	Unlimited contribution
Donor/custodian need not be the same person or related	Donor/custodian need not be the same person or related
Age of majority	Up to age 25
Limited investment options	Broader investment options

TEST PREP 1

In which of the following cases would an individual be subject to IRS tax penalties?

A. John, age 54, earns $4,500 and contributes $4,500 to his IRA.
B. Allen, age 62, retires and performs an IRA rollover with the funds in his company retirement plan.
C. Susan, age 56, is no longer employed as a result of permanent disability and elects to begin monthly withdrawals from her IRA.
D. Mary, age 55, earns $35,000 and withdraws $19,000 from her IRA to use as a down payment on her first purchase of a primary residence.

TEST PREP 2

Which of the following actions taken by the administrator of a qualified retirement plan would NOT be a violation of ERISA's rules on fiduciary responsibility?

A. Borrowing money from the plan at the prime rate +3%, collateralized by U.S. Treasury securities
B. Lending money to the plan at the prime rate –3%
C. Delegating responsibility for management of the plan's portfolio to an outside, third-party, federal covered investment adviser
D. Maintaining a brokerage account in joint name with the plan

TEST PREP 3

Many parents prefer to use a Section 529 plan over a Coverdell ESA to finance their child's education plans because

I. contribution limits are higher
II. funds may be withdrawn tax-free if used for qualified pre- or post-secondary education expenses
III. there are no earnings limitations
IV. 529 contributions are tax deductible

A. I and II
B. I and III
C. I, II, and III
D. III and IV

TEST PREP 4

For which of the following purposes could the custodian of an UGMA account, who has set up the account for his son, withdraw assets from the same account?

A. To pay off an old debt from his student days
B. To pay a medical expense for his son
C. To pay for a family trip to the seashore
D. To fund some important changes in his small business

Test Prep Answers

1. D
2. C
3. B
4. B

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Enrichment Video Presentations

Series 65

Equity Securities

SECURITIES AND CORPORATE CAPITALIZATION

A. ISSUE STOCK

1. Ownership (equity)
2. Limited liability

B. ISSUE DEBT

1. Bonds, notes
2. Holder of note or bond is creditor of corporation

COMMON STOCK

A. CHARACTERISTICS

1. Most junior security
2. Offers residual claim to assets if company goes out of business
3. Easily transferred

B. OBJECTIVES

1. Capital appreciation
2. Dividend income

C. VOTING RIGHTS

1. Board of directors
2. Other crucial corporate decisions
   a. Mergers and acquisitions
   b. Recapitalizing the company

D. PREEMPTIVE RIGHTS—SUBSCRIPTION RIGHTS OR STOCK RIGHTS

1. Right to maintain percentage ownership

2. Short term

3. Exercise if below market or sell (treat as security)

E. WARRANTS

1. Certificate granting owner the right to purchase securities from the issuer at a specified price

   a. Long term

   b. Issued with an exercise price higher than current market value

2. Often offered as a sweetener with other offerings such as bonds or preferred stock to make them more marketable

3. Rights and warrants are considered derivatives because their value is *derived* from the underlying security

PREFERRED STOCK

A. PREFERRED TO DIVIDENDS AND LIQUIDATION

1. Dividends

   a. Preferred dividend must be satisfied prior to a common dividend being paid.

      1.) Percentage of par or dollar amount

      2.) Dividends not guaranteed

2. Liquidation

   a. If company declares bankruptcy, preferred stock is senior to common stock, but behind all debt.

B. OBJECTIVE

1. Income

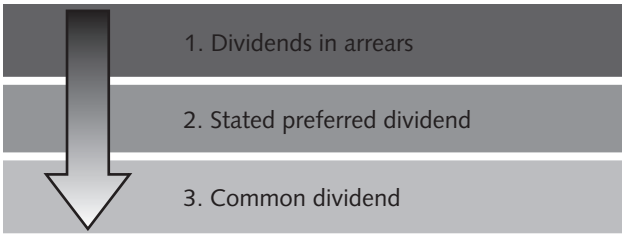
   a. Although preferred stock is an equity security, market prices fluctuate similar to debt securities (interest rate sensitive).

   b. Most important consideration to investors is the continued ability of the corporation to pay the stated dividend.

C. TYPES

1. Straight (noncumulative)
2. Cumulative
   a. Stockholders entitled to dividends in arrears
3. Callable
   a. Can be called back by the issuer as of a specified date and specified price
4. Convertible
   a. Issued at a lower stated dividend than nonconvertible
   b. Least appropriate choice if purchasing for income

D. PRIORITY OF DIVIDEND PAYOUT



AMERICAN DEPOSITARY RECEIPTS (ADRS)

A. FACILITATE U.S. CITIZENS OWNING FOREIGN SHARES

B. DEPOSITORY BANK IS REGISTERED OWNER OF FOREIGN SHARES

C. ISSUED BY DOMESTIC BANKS

D. DIVIDENDS ARE NET OF FOREIGN WITHHOLDING TAX

E. HOLDER BEARS FOREIGN CURRENCY RISK

FOREIGN SECURITIES MARKETS

Foreign securities markets offer investors the ability to diversify their investments among various currencies, geographic areas, and industries.

A. RISKS OF INVESTING IN FOREIGN MARKETS

1. Emerging markets (lesser developed)
    - a. Low levels of GDP
    - b. Rapid growth potential
    - c. Risks
        - 1.) Questionable market liquidity
        - 2.) Potential restrictions on currency conversion
        - 3.) High volatility
        - 4.) High transaction costs
        - 5.) Lower regulatory standards
        - 6.) Political (country)
2. Developed markets
    - a. Large levels of equity capitalization
    - b. Low commission rates
    - c. Fewer currency conversion restrictions
    - d. Highly liquid
    - e. Risks
        - 1.) Country risk (lower than emerging)
            - a.) Political, economic policies
        - 2.) Currency risk
        - 3.) Withholding, fees and taxes on dividends and capital gains

Series 65

Debt Securities

DEBT SECURITIES

A. DEBT FINANCING—BONDS

1. Par value—$1,000 = 100 points
2. One point = $10
3. Par value × stated rate = annual interest
   a. Interest is paid semiannually
4. Principal paid at maturity (5, 10, 15, 20+ years)

B. TRACKING CORPORATE BONDS

1. Quoted as a percentage of par
   a. Premium
   b. Discount

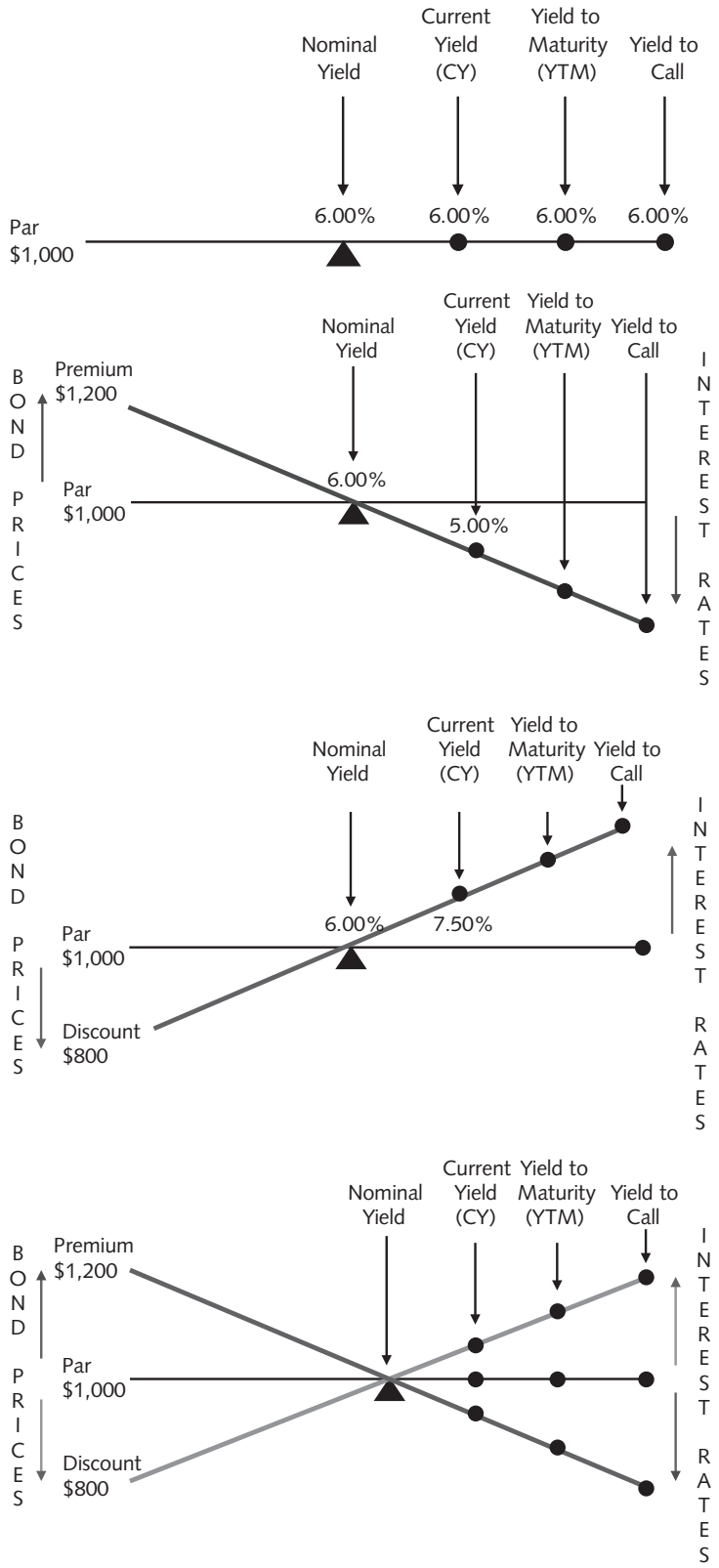
RELATIONSHIP OF YIELDS

A. YIELDS

1. Stated, nominal, coupon
   a. The interest rate paid by the bond (semi-annually)
2. Current yield
   a. Annual interest ÷ current market value
3. Yield to maturity
   a. Yield achieved if the bond is held to maturity

4. Yield to call

a. Yield achieved if the bond is called prior to maturity



CHARACTERISTICS OF CORPORATE BONDS

A. SECURED BONDS

1. Mortgage bond
2. Collateral trust certificate
3. Equipment trust certificate

B. UNSECURED BONDS

1. Debentures
2. Subordinated debentures

C. CONVERTIBLE BONDS

1. Can be exchanged for common stock
2. Example: $1,000 par; conversion price $40

$1,000 / $40 = 25 shares of common stock

3. Parity
   a. Two securities positions valued equally

      If the CMV of common stock is $50 per share, what is parity of the bond?
      $50 × 25 shares = $1,250

D. ZERO-COUPON BONDS

1. All interest paid at maturity
2. Interest taxed annually

E. REDEMPTION

1. Principal and last interest payment returned upon maturity

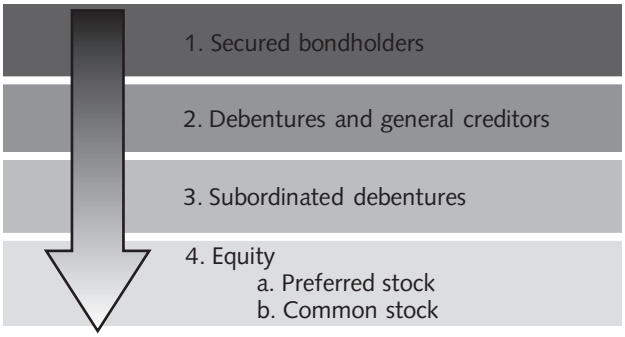
F. TAXATION

1. Interest is taxed at federal, state, and local levels
2. Difference upon sale is a capital gain or loss

G. RATINGS—MEASURE DEFAULT RISK

Moody's	Standard & Poor's	Interpretation
Aaa	AAA	Highest grade
Aa	AA	High grade
A	A	Upper medium; medium grade; sound
Baa	BBB	Medium; good grade; some uncertainty
Ba	BB	Fair to good; lower medium; uncertainty
B	B	Fair; speculative features
Caa	C	Outright speculations; poor standing
Ca	CC	Outright speculations; marked weakness
C	D	Defaulted issue; highly speculative

H. LIQUIDATION PRIORITY



GOVERNMENT SECURITIES

A. U.S. GOVERNMENT SECURITIES

The largest issuer of debt in the United States and the safest in terms of default risk – interest tax-exempt at the state and local level

1. Active secondary trading

a. Negotiable (marketable)

1.) T-bills

a.) 4 to 52 weeks

b.) Issued at discount

2.) Notes and bonds

a.) Maturities
- Notes—2 to 10 years
  - Semiannual interest; federally taxable
- Bonds—over 10 years
  - Semiannual interest; federally taxable

b.) Quotes—percentage of par + 32nds
- 1/32 = .3125

Example: 96.08 = 968 / 32 = $962.50

3.) Treasury Inflation Protection Securities (TIPS)—offer inflation protection

a.) Semiannual adjustment to principal based on CPI

b.) TIPS Example

Coupon is 8%, inflation is 6%. What is the principal value in 3 years?

2. Benefits of government issues include:

a. safety, and

b. liquidity.

3. Risks of government issues include:
   a. lower yields,
   b. interest rate risk, and
   c. inflation risk (except TIPS).

GOVERNMENT AGENCY ISSUES

A. GOVERNMENT AGENCY ISSUES

1. Government National Mortgage Association (GNMA or Ginnie Mae)
   a. Only agency issue backed by the full faith and credit of the U.S. government
   b. Minimum $25,000 pass-through certificates
   c. Monthly check of principal and interest
   d. Taxed at the federal, state, and local levels
2. Federal National Mortgage Corporation (FNMA or Fannie Mae)—publicly held corporation
   a. Semiannual checks of principal and interest
   b. Taxed at all levels
3. Federal Home Loan Banks (FHLB)—lends to savings and loan associations
   a. Interest tax exempt at state and local level
4. Federal Farm Credit Banks—lends money to farmers
   a. Interest tax exempt at state and local level
5. Benefits of agency issues include:
   a. very high safety and
   b. higher income than Treasuries.

6. Risks of agency issues include:

a. interest rate risk,

b. inflation risk, and

c. pre-payment risk (pass-through certificates).

MUNICIPAL BONDS

A. MUNICIPAL BONDS

1. Issued by a form of government other than the federal government or agency of the federal government

a. Interest exempt from federal taxes

b. Exemption may also apply at state and local level

c. Capital gains subject to taxation

2. Types of municipal issues

a. General obligation (GO) bonds

1.) Backed by full faith and credit (taxes)

a.) Issuer's authority to tax

b. Revenue bonds

1.) Backed by specific revenue source, tolls, user fees

3. Tax-equivalent yield

Example: 6% muni bond, 40% tax bracket

$$\frac{\text{Muni \%}}{1-\text{TB}} = \frac{6\%}{1-.40} = \frac{6\%}{.60} = \text{Tax-equivalent yield}$$

4. Tax-free equivalent yield

Example: 10% corp bond, 40% tax bracket

$$\text{Corp \%} \times (1-\text{TB}) = 10\% \times .60 = \text{Tax-free equivalent yield}$$

5. Benefits of municipal bonds
   a. Low default risk
   b. Tax-free income
      1.) Attractive to those in high tax brackets
6. Risks of municipal bonds
   a. Interest rate risk
   b. Inflation risk
   c. Possible exposure to the alternative minimum tax (AMT)

MONEY MARKET INSTRUMENTS

A. MONEY MARKET INSTRUMENTS

1. Used to finance short-term cash requirements
2. Characteristics
   a. High-quality debt
   b. Short-term (one year or less to maturity)
      1.) 30-year bond with one year left could qualify
3. Issuers
   a. Corporate—commercial paper
   b. Financial institutions—negotiable (Jumbo, $100k minimum) certificates of deposit
   c. U.S. government—all T-bills as well as bonds and notes in the secondary market with one year or less remaining to maturity
4. Rates
   a. London Interbank Offered Rate (LIBOR) is the rate of interest at which banks borrow short-term funds from each other in London.

5. Benefits of money market securities
    a. Safety
    b. Liquidity
6. Risks of money market securities
    a. Low yields
    b. Not suitable for long-term investors

Series 65

Investment Company Securities

INVESTMENT COMPANY SECURITIES

A. REGULATED UNDER THE INVESTMENT COMPANY ACT OF 1940

1. Three classifications of investment companies
   - a. Face amount certificate companies (FACC)
   - b. Unit investment trusts (UIT)
   - c. Management investment companies
     - 1.) Open end (mutual fund)
     - 2.) Closed end

B. OPEN END COMPANY SHARES

1. Front-end load (Class A shares)
   - a. Sales charge paid at purchase
   - b. 8.5% of POP or less
   - c. Lower expense ratio—12b-1 fees max of .25%
   - d. Suitable for large investments, long time horizons
2. Back-end load (Class B shares)
   - a. Shares purchased at NAV
   - b. CDSC (contingent deferred sales charge)
   - c. Higher expense ratio—12b-1 fees up to .75% deducted from account every quarter
   - d. Converts to "A shares" after CDSC expires
   - e. Suitable for smaller investments, long time horizons
3. Level load (Class C shares)
   - a. 1-year CDSC

b. 12b-1 fee deducted from account every quarter .75% of average net assets or less

c. Short-term investor, 1–5 years

C. BREAKPOINTS

a. A level of investing that reduces the sales charge as a percentage

b. Available to "A" shares

D. LETTER OF INTENT

1. Allows 13 months to reach breakpoint

2. May be backdated up to 90 days

3. If not reached, corresponding sales charge applies

4. Only new money invested applies toward breakpoint

5. Can include accounts for dependent children (minors)

E. RIGHTS OF ACCUMULATION

1. Allows amount in account to apply toward breakpoint

2. No time limits

3. Can include accounts held at other broker-dealers

F. COMBINATION PRIVILEGE

1. Purchases of other funds in the same family apply toward a breakpoint

2. Can include accounts at other broker-dealers

G. CONVERSION AND EXCHANGE PRIVILEGE

1. Shares of one fund may be exchanged for shares in another of the same family at NAV

2. Taxable event

H. AUTOMATIC REINVESTMENT AT NAV

1. Dividend and capital gains distributions reinvested in new shares at NAV
2. Taxable event
   a. Form 1099 issued for year of receipt
   b. Reinvestments increase cost basis

I. MAXIMUM SALES CHARGE 8.5%

1. Fund may levy the full 8.5% only if it offers.
   a. Breakpoints
   b. Rights of accumulation
2. All new funds now offer automatic reinvestment of dividends and capital gains at NAV.

FUND TYPES

A. GROWTH FUNDS

1. Capital appreciation primary
2. Income secondary
3. Small-, mid-, and large-cap funds

B. BALANCED FUNDS

1. Stocks for capital appreciation
2. Bonds for income
3. Primary objective: preservation of principal

C. ASSET ALLOCATION FUNDS

1. Switch percentage of holdings in each asset class according to performance of each group
   a. Stocks for growth

b. Bonds for income

c. Money markets for stability

D. MONEY MARKET FUNDS

1. No load

2. Management fee

3. Open end

4. Interest compounded daily

5. Maturity no more than 397 days

a. Banker's acceptances

b. Negotiable CDs

c. Commercial paper

d. Treasury bills

6. Not insured by any agency

Series 65

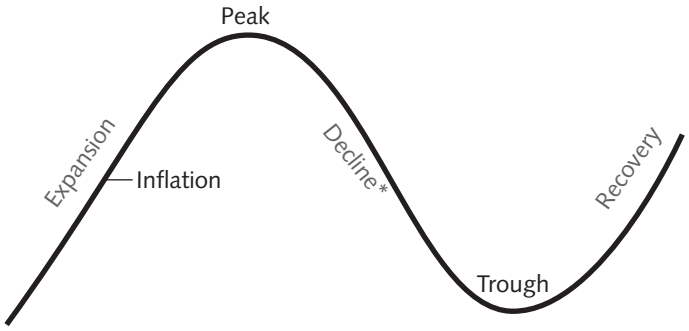
Economic Factors and Business Information

FUNDAMENTAL ANALYSIS

A. ECONOMY

1. Basic economic concepts

a. Business cycle



2. Economic indicators

a. Leading

1.) Building permits (housing starts)

2.) Manufacturers' new orders for nondefense capital goods, such as machine tools

3.) Stock market prices as measured by the S&P 500

4.) Money supply

5.) Average weekly initial claims for unemployment insurance

6.) Manufacturers' new orders for consumer (durable) goods

7.) Average weekly hours (manufacturing)

b. Coincident

1.) Measures current economy

a.) Nonagricultural employment

b.) Personal income

c.) Industrial production

d.) Manufacturing and trade sales in constant dollars

c. Lagging

1.) Duration of unemployment

2.) Prime rate

3.) Corporate profits

4.) Inventory

d. Sector rotation

1.) Follows the business cycle

2.) Sell those sectors that are peaking

3.) Buy those sectors that are expanding

3. Influences

a. Fiscal policy—Congress/President

1.) Enact tax laws

a.) Taxation

- Lower rates spur economy

2.) Government spending

a.) Spending cuts slow economy

b.) Keynesian economics—use government spending and tax policy

b. Monetary policy—Federal Reserve System

1.) Seeks to influence prices and economic activity through level of money supply

c. Balance of payments

1.) More net money coming into country (surplus—the country's financial account is credited)

2.) More net money going out of country (deficit—the country's financial account is debited)

3.) Balance of trade

a.) Exports versus imports—more exports = surplus, fewer exports = deficit

b.) United States buying more wine from Italy or selling more wheat to Italy

c.) Value of dollar relative to foreign currencies

4.) Dollar up

a.) Exports less competitive because product is more expensive

b.) Imports more competitive because product is less expensive

5.) Dollar down

a.) Exports more competitive because product is less expensive

b.) Imports less competitive because product is more expensive

B. INDUSTRY

1. Cyclical

a. Performance follows economic cycles

1.) Autos

2.) Steel

3.) Heavy equipment

4.) Capital goods

2. Defensive
    a. Minimal impact from economic changes
    b. Appeals to conservative investment styles
        1.) Food
        2.) Utilities—highest dividend payout ratio
        3.) Clothing
        4.) Drugs
        5.) Tobacco, liquor
3. Growth
    a. Technology
        1.) Obsolescence risk
    b. Lowest dividend payout
4. Sector rotation
    a. Cyclical
    b. Defensive
    c. Growth

C. COMPANY

ECONOMICS AND ANALYSIS

A. FUNDAMENTALS OF COMPANIES

1. Quality of management
2. Market share
3. Product pipeline

4. Financial statements

a. Balance sheet

b. Income statement

Balance Sheet of ABC			
Assets		**Liabilities and Net Worth**	
Current Assets		Current Liabilities	
Cash	5,000,000	Accounts payable	5,000,000
Accounts receivable	15,000,000	Wages	4,000,000
Inventory	20,000,000	Long-term debt payable	1,000,000
Total current assets	40,000,000	Total current liabilities	10,000,000
		Long term liabilities	
Fixed Assets		8% 20-year convert. @ $50	50,000,000
Buildings, furniture	40,000,000	Total liabilities	60,000,000
Land	15,000,000	**Net worth**	
Total fixed assets	55,000,000	Preferred stock $100 par	20,000,000
Intangibles (good will)	5,000,000	Common stock $1 par	1,000,000
Total assets	100,000,000	Capital in excess of par	4,000,000
		Retained earnings	15,000,000
		Total net worth	40,000,000
		Total liabilities and net worth	100,000,000

Income statement of ABC	
Sales	60,000,000
– Cost of goods sold (including 2,000,000 depreciation)	40,000,000
= Operating income	20,000,000
– Interest expense	4,000,000
= Pretax income	16,000,000
– Taxes	6,000,000
= Net income after taxes	10,000,000
– Preferred dividends	1,000,000
= Earnings available to common	9,000,000

B. CALCULATIONS USED IN BALANCE SHEET ANALYSIS

1. Book value

$40,000,000	Net worth
– $20,000,000	Preferred stock
– $5,000,000	Intangibles (includes goodwill)
= $15,000,000	Book value
÷ 1,000,000	Number of common shares outstanding
= $15	Book value per common share

2. Liquidity (balance sheet)

a. Working capital

current assets – current liabilities

$40,000,000 – $10,000,000 = $30,000,000

b. Current ratio

current assets/current liabilities

$40,000,000 / $10,000,000 = 4:1

c. Quick ratio (acid test)

(current assets – inventory)/current liabilities

($40,000,000 – $20,000,000) / $10,000,000 = 2:1

3. Capitalization

a. Total capitalization

long-term debt + net worth

$50,000,000 + $40,000,000 = $90,000,000

b. Debt-to-equity ratio

long-term debt/total capitalization

$50,000,000 / $90,000,000 = 55.56%

C. CALCULATIONS USED IN ANALYZING AN INCOME STATEMENT

1. $\text{Pretax margin} = \dfrac{\text{pretax income}}{\text{gross revenues}} = \dfrac{16{,}000{,}000}{60{,}000{,}000}$

2. $\text{EPS} = \dfrac{\text{earnings available to common}}{\text{number of common shares outstanding}}$

$\$9\ \text{EPS} = \dfrac{9{,}000{,}000}{1{,}000{,}000}$

3. Fully diluted earnings per share—assumes all bonds and preferred stock are converted into common stock

4. $\text{Dividend payout ratio} = \dfrac{\text{common dividends}}{\text{earnings per share}}$

	Company A (Growth)	Company B (Utility)	Company C (Large Cap)
EPS	$5.00	$3.00	$4.00
Dividends	$.50	$2.25	$1.60
Payout %	10%	75%	40%

D. CASH FLOW STATEMENT—USES INFORMATION FROM BALANCE SHEET AND INCOME STATEMENT

1. Cash flow from operations

net income + noncash expenses (e.g., depreciation, amortization)

2. Cash flow from financing

a. Issuing equity or debt securities

3. Cash flow from investments

a. Buying or selling securities or other non-operating assets

E. FOOTNOTES

1. Generally found at the end of the financial statements

a.) Possible litigation

b.) *Off-book* debt

c.) Relevant information not part of the financial detail

VALUATION RATIOS

A. PRICE-TO-EARNINGS RATIO (PE)

$$\frac{\text{CMV}}{\text{EPS}}$$

B. PRICE-TO-BOOK RATIO

$$\frac{\text{Market price of stock}}{\text{Book value per share}}$$

Class Notes

Class Exam

CLASS EXAM

1. Which of the following is the most suitable investment for the IRAs of a young couple with a combined annual income of $42,000?
   A. Stock in a growth fund
   B. Initial public offerings of small companies
   C. Options on large-cap common stock
   D. Partnership interests in an oil and gas drilling program

2. The Investment Company Act of 1940 includes several different types of entities in its definition of *investment company*. Among them is the management company which is further classified as either open-end or closed-end. Although there are a number of similarities between these two, one characteristic of an open-end investment company that distinguishes it from a closed-end investment company is that
   A. it may avoid taxation by distributing all of its net investment income to shareholders
   B. it may be either diversified or non-diversified
   C. there is a continuous public offering
   D. there are a wide variety of objectives available for investors to select from

3. In certain situations, a private placement requires an investor meet the definition of accredited investor. Under which of the following circumstances will an investor be considered accredited?
   A. $200,000 net worth or $200,000 annual income
   B. $200,000 net worth and $100,000 annual income
   C. $1 million of net worth, exclusive of primary residence, or $200,000 annual income
   D. $1 million net worth, exclusive of primary residence, and $100,000 annual income

4. Under the Uniform Securities Act, which of the following statements regarding a sale, an offer, or an offer and sale are TRUE?
   I. Any security given or delivered with or as a bonus for any purchase of securities is considered to have been offered and sold for value.
   II. A purported gift of assessable stock is considered to involve an offer and sale.
   III. Every sale or offer of a warrant or stock right to purchase or subscribe to another security is considered to include an offer of the other security.
   IV. A bona fide pledge is considered an offer and sale.
   A. I, II, and III
   B. I and III
   C. II and IV
   D. III and IV

5. Which of the following would qualify under the Section 28(e) safe harbor provisions for soft dollar compensation?
   A. Rent-free use of unused space in the broker-dealer's office
   B. Providing access to the broker-dealer's computerized accounting system allowing the investment adviser to prepare its financial statements
   C. Clearance and settlement services provided by the broker-dealer
   D. Reimbursement for travel expenses incurred to attend a seminar on the latest compliance trends for registered investment advisers

6. The Uniform Securities Act requires client consent for assignment of the investment advisory contract in all of the following situations EXCEPT
   A. the sole owner of the investment advisory firm pledges the firm as collateral for a bank loan
   B. the sole proprietor of an investment advisory firm sells the firm to another adviser
   C. the death of a partner holding a minority interest causes no change in the ownership interests of the remaining partners
   D. two investment advisory firms intend to merge, causing a change in the majority interest of the partners

7. Under the USA, an agent may file for a review of an Administrator's revocation order within how many days of revocation?
   A. 30
   B. 60
   C. 90
   D. 270

8. Securities issued by which of the following are exempt from the registration and advertising filing requirements of the USA?
   I. The United States or any territory
   II. A state or political subdivision of a state
   III. A common carrier (e.g., a railroad) regulated in respect to its rates and charges by the United States or a state
   IV. Banks and savings institutions
   A. I and III
   B. II and III
   C. II and IV
   D. I, II, III, and IV

9. Which of the following statements would justify an Administrator's denial of a security's registration?
   I. The order is in the public interest.
   II. The company has not been paying dividends.
   III. The underwriter's compensation is excessive.
   A. I and II
   B. I and III
   C. II and III
   D. I, II, and III

10. Which of the following statements regarding both traditional and Roth IRAs is TRUE?
   A. Contributions are deductible.
   B. Withdrawals at retirement are tax free.
   C. Earnings on investments are not taxed during the accumulation period.
   D. Distributions must begin the year after the year the owner reaches age 70½.

11. Which of the following are neither an offer nor a sale according to the Uniform Securities Act?
   I. Reclassification of the issuer's securities
   II. Bona fide pledge or loan
   III. Act incident to a judicially approved reorganization in which a security is issued in exchange for one or more outstanding shares
   IV. Stock dividend of stock other than the issuer's for which nothing of value was given
   A. I and II
   B. II and III
   C. III and IV
   D. I, II, III, and IV

12. Which of the following are NOT investment advisers according to SEC Release IA-1092?
   I. Broker-dealer who charges for investment advice
   II. Publisher of a financial newspaper
   III. Person who sells securities analysis
   IV. CPA who, as an incidental part of his practice, suggests that high-tax bracket clients invest in municipal bonds.
   A. I and II
   B. I and III
   C. II and IV
   D. III and IV

13. The term *investment adviser representative* includes which of the following?
    I. A receptionist for an adviser
    II. An employee of an investment adviser who solicits new business for the adviser
    III. A supervisor who oversees employees that manage client portfolios for an adviser
    IV. An investment advisory firm registered in the state of Texas
    A. I and III
    B. I and IV
    C. II and III
    D. II and IV

14. A customer placed an order with an agent to sell 100 shares of ABC to have cash for an urgent purchase the next day, and he instructed the agent to limit any losses. The agent did not have discretionary authority over the account. The agent waited to sell the shares, hoping to get a better price for the customer. The price of the shares went down, so the agent sold 50 ABC shares to limit the customer's losses. According to the Uniform Securities Act, this is
    A. a violation because the agent acted without discretionary authority
    B. permissible because the agent is obligated to get the best price for the customer
    C. a violation because the agent is required to execute sell transactions immediately after the order is placed
    D. permissible because the agent is not permitted to guarantee a price to a customer

15. Under the Uniform Securities Act, all of the following statements are true EXCEPT
    A. surety bonds are not required for investment advisers that do not have custody of customer securities
    B. Administrators may inspect an investment adviser's records held out of state without prior notice
    C. surety bonds are not required for investment advisers that exercise discretion over customer accounts
    D. Administrators may require minimum financial requirements for investment advisers whether or not they have custody of customer securities

16. Under the Uniform Securities Act, which of the following are cause for disciplinary review action by the state securities Administrator?
    I. Joe files an application for registration as an investment adviser and omits the fact that he was convicted of fraud 8 years ago.
    II. Teresa, a registered investment adviser, failed to disclose that she recently filed for bankruptcy protection.
    III. The ABC Advisory Group employs several representatives as independent contractors.
    IV. FINRA suspended Ed from conducting business in the securities industry for 6 months.
    A. I and II
    B. I, II, and IV
    C. II and IV
    D. III and IV

17. Under ERISA, a fiduciary must act in all of the following ways EXCEPT
    A. solely in the interest of plan participants and beneficiaries
    B. with care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character (prudent expert rule)
    C. in accordance with the governing plan documents unless they are not consistent with ERISA
    D. confining investments to only those most likely to achieve growth

18. A client places an order to buy 300 DWQ at 140 stop, but not over 144. This is
    A. a buy stop order
    B. a buy limit order
    C. a market not held order
    D. a buy stop limit order

19. A client owns U.S. Treasury bonds and wishes to liquidate the position. The client receives a quote of 102.19 from a bond dealer. This represents
    A. a premium
    B. a discount
    C. the bid price
    D. the ask price

20. If your customer wants to set aside $40,000 for when his child starts college but does not want to endanger the principal, you should recommend
    A. zero-coupon bonds backed by the U.S. Treasury
    B. corporate bonds with high rates of interest
    C. municipal bonds for their tax benefits
    D. common stock

21. What does a bond's yield to maturity (YTM) indicate?
    A. The annual interest the issuer pays on the bond
    B. The annual interest the issuer pays on a bond relative to its market price
    C. The annual interest rate an issuer pays on a bond relative to the annual dividend rate an issuer pays on its cumulative preferred stock
    D. The annualized impact of a bond's market discount or premium over its holding period return

22. Opening a margin account involves the submission of a number of documents, including a properly executed margin agreement. Under the NASAA Statement of Policy on Dishonest or Unethical Business Practices of Broker-dealers and Agents, those documents must be
    A. received prior to the initial trade in the account
    B. received promptly after the initial trade in the account
    C. properly notarized
    D. approved by a designated principal prior to the initial trade in the account

23. If your 60-year-old customer purchases a non-qualified variable annuity and withdraws some of her funds before the contract is annuitized, what are the consequences of this action?
    A. Ordinary income tax on earnings exceeding basis
    B. 10% penalty tax plus payment of ordinary income tax on all funds withdrawn
    C. 10% penalty tax plus payment of ordinary income tax on all funds withdrawn exceeding basis
    D. Capital gains tax on earnings exceeding basis

24. A 6% corporate bond trading at a yield to maturity of 5.8% is trading at
    A. a discount
    B. a premium
    C. par
    D. parity

25. Which of the following trades occur in the secondary market?
    I. Specialist (DMM) on the NYSE buying stock as principal
    II. Corporate bond syndicate selling new issues to the public
    III. An agent buying unlisted securities for a client
    IV. Insurance company buying corporate bonds directly from another insurance company
    A. I and III
    B. I, III, and IV
    C. II and III
    D. III and IV

26. Which of the following investment management styles would you recommend to a risk-averse client who believes in the added value that professional stock selection can offer but is seeking long-term capital gains?
    A. S&P 500 index fund manager
    B. An international index fund manager
    C. A small-cap growth fund manager
    D. A large-cap growth manager

27. When opening an account for a new customer, broker-dealers must maintain customer identification programs for the purpose of verifying the client's identity. This requirement was mandated by
    A. the Anti-Money Laundering Act of 2001
    B. the Dodd-Frank Act of 2010
    C. the Sarbanes-Oxley Act of 2002
    D. the USA PATRIOT Act of 2001

28. If an investor is pursuing an aggressive investment strategy, which of the following purchases is most suitable for him?
    A. AMF stock with a beta coefficient of 1.0
    B. DOH stock with a beta coefficient of .7
    C. GHI stock with a beta coefficient of 1.3
    D. Convertible bonds of MTN, a highly profitable large-cap company

29. An investor owns 300 shares of GHI common stock at a cost of $40 per share. GHI is currently selling for $53.76 per share. The investor is concerned that current economic conditions do not hold a promising outlook for GHI, but he is reluctant to sell at this time. Which of the following option positions would offer protection with no cash outlay?
    A. Buy 3 GHI 50 puts
    B. Buy 3 GHI 50 calls
    C. Sell 3 GHI 50 puts
    D. Sell 3 GHI 50 calls

30. A publicly traded corporation has filed for bankruptcy. In what order would the following list of interested parties receive payment?
    I. Holders of secured debt
    II. Holders of subordinated debentures
    III. General creditors
    IV. Preferred stockholders
    A. I, II, III, IV
    B. I, III, II, IV
    C. III, I, II, IV
    D. IV, I, II, III

31. Which of the following statements regarding dividends is TRUE?
    A. A corporation is required to pay a cash dividend to stockholders if the earnings are sufficient, especially if it is preferred stock.
    B. Dividends have a significant influence on the value of the corporation's stock.
    C. A growth company would be more likely to pay a cash dividend than a stock dividend.
    D. Because of its priority, the dividend on a company's preferred stock will always be higher than the dividend on its common stock.

32. Open- and closed-end investment companies have all of the following in common EXCEPT
    A. they compute their net asset values
    B. they actively manage their portfolios
    C. they have stated investment objectives
    D. their shares are traded in the secondary market

33. Securities issued by which of the following would be exempt from the registration requirements of the Uniform Securities Act?
    I. Nonprofit organization
    II. Exchange-listed security
    III. Federal savings and loan association
    IV. Federal credit union
    A. I and II
    B. II and IV
    C. III and IV
    D. I, II, III, and IV

34. If a firm executes a customer order and discloses on the confirmation both a commission and a markup, which of the following statements is TRUE?
    A. The total of the two may not exceed 5%.
    B. The firm is in violation of trading rules acting as both principal and agent in the same transaction.
    C. The firm is acting properly in its role as a market maker.
    D. The firm is engaging in a prohibited practice known as selling away.

35. According to the Investment Company Act of 1940, if an issuer is in the business of investing, reinvesting, trading, owning, or holding securities and owns or intends to own securities that exceed 40% of its assets, it is classified as

A. a face-amount certificate company
B. an unit investment trust
C. an investment company
D. an investment partnership

36. The residual right of common stockholders refers to their right to

A. vote in elections for the board of directors
B. examine the books of the corporation
C. receive all announced dividends
D. claim company assets in bankruptcy after creditors' interests have been satisfied

37. Stock prices in the over-the-counter market are determined by

A. the FINRA 5% markup policy
B. buyers bidding directly against each other for the securities at a central marketplace
C. negotiation between buyers and sellers
D. buyers and sellers bidding directly against each other in a double auction market

38. An investor with a long position in a stock, who then purchases a put option on that stock, may

I. participate in additional gains if the security continues to increase in price
II. avoid selling at a loss if the price of the stock drops below the strike price
III. protect a profit in the current stock position

A. I and II
B. I and III
C. II and III
D. I, II, and III

39. Which of the following statements is NOT true?

A. Members of a limited liability company (LLC) are not personally liable for debts that arise under the LLC.
B. Limited partners actively manage the investments in the partnership but are not liable for funds in excess of the amounts they have invested.
C. A sole proprietorship account is for tax and legal purposes, indistinguishable from the business owner.
D. An S corporation is a form of incorporation that is taxed as a partnership but in all other respects operates like a regular corporation.

40. One method used by some analysts to estimate the future value of a stock is the dividend growth model. This model would probably be most useful in the case of

A. a large-cap stock
B. a small-cap stock
C. an AAA corporate bond
D. a cumulative preferred stock

Class Notes

Answers and Rationales

WARM-UP TEST ANSWERS AND RATIONALES

1. **C.** A preliminary prospectus is printed before the final price is established, although it may indicate an expected price range that is subject to change. The red ink disclaimer of possible changes is required on the red herring's cover. Use of the proceeds, financial statements, and the business history of the company are required in the preliminary prospectus.

2. **B.** Coordination is the simultaneous (concurrent) registration of a public offering with the state and SEC.

3. **D.** The SEC permits performance-based fees if the following conditions are met: (1) the client has at least a specified minimum in assets under management or a net worth of a specified minimum, and (2) the compensation is based on gains and losses combined over at least a year's time. It is not necessary that the client understand what is going on because the SEC believes that someone with the required assets should have enough financial savvy to take the higher risk.

4. **D.** Neither exempt securities nor exempt transactions are exempt from the USA's antifraud provisions. The best way to look at this question is to ask yourself, "When would I be permitted to engage in fraudulent activity?"

5. **D.** All of the securities listed are exempt from the registration and disclosure provisions of the Securities Act of 1933.

6. **B.** A disclosure brochure is not required to be delivered if the client is a registered investment company or if the advisory service is of an impersonal nature and costs less than $500. A brochure is required when the service provided is an individual supervisory service, and the client's net worth has no bearing on brochure delivery requirements.

7. **D.** The Securities Exchange Act of 1934 created the SEC and addresses market manipulation and margin requirements on securities. The Securities Exchange Act of 1934 does not address full and fair disclosure on the registration of new offerings; the Securities Act of 1933 does.

8. **D.** All of the securities listed are exempt from registration under the Uniform Securities Act. There are many different exemptions, but all of them seem to carry a common thread. Either the issuer is someone above reproach (a government or a charity), or it is regulated by someone else (a public utility or a bank).

9. **C.** As a volunteer, the teacher is not in the business of providing investment advice and does not receive compensation for such advice. A person who places himself before the public through advertising as an investment adviser and who provides advice is an adviser. A person in the business of providing investment advice does not have to receive compensation directly from the beneficiary of the service to be considered an adviser. A financial planner is included in the definition of an investment adviser under Release IA-1092 of the Investment Advisers Act of 1940.

10. **A.** A consultant who advises pension funds on the merits of investment managers and their approaches to the market is specifically described as an investment adviser in Release IA-1092. Note that the sports representative in this case does not make specific investment recommendations. The recommendation that a person place funds in a commercial bank does not, of itself, constitute investment advice. The teacher is engaged in an educational exercise in which no compensation is received.

11. **D.** The customer's state of residence and tax status are essential when determining suitability for a municipal security. The security's rating is also critical because it measures the safety and quality of the bond.

12. **B.** Corporate securities are considered riskier than government agency issues. Agency issues have only a slight risk of default because they are backed by revenues from taxes, fees, and interest income. Agency issues include GNMAs, which are backed by the full faith and credit of the government. Some agency issues are exempt from state and local taxation, but they are not exempt from federal taxation. Congress authorizes these agencies to issue debt securities.

13. **B.** A corporation generally calls in its debt when interest rates are declining. It can then replace old, higher interest-rate debt with new, lower interest-rate issues.

14. **D.** A municipal bond is normally exempt from federal taxes as well as state taxes in the state in which it was issued. Interest from bonds is subject to, or exempt from, ordinary income tax, not capital gains.

15. **B.** The interest on the municipal bond is free of income tax. Therefore, the after-tax return is the same as the coupon, 8%. Subtracting the 3% CPI gives us an inflation-adjusted return of 5%

16. **A.** A money market instrument is a high-quality, short-term debt security with maturity of 1 year or less. ADRs (American depositary receipts) are equity, and corporate bonds are long-term debt instruments.

17. **C.** The returns on common stock have historically outperformed inflation, making them less vulnerable to loss of purchasing power among the choices presented.

18. **A.** High quality dividend paying preferred stocks will give her a reasonable income without great risk. Options are not income vehicles and are not income producing. Municipal bonds are not generally appropriate for low income clients because there would be little after-tax benefits. Oil and gas programs are speculative and not appropriate.

19. **B.** Standard deviation measures how much an investment's returns have fluctuated over a given period of time. The higher the investment's standard deviation, the higher the risk.

20. **D.** The appropriate benchmark for a small cap fund is the Russell 2000 because it is comprised of companies whose market capitalization puts them in the small-cap range ($300 million to $2 billion).

CLASS EXAM ANSWERS AND RATIONALES

1. **A.** The IRA for this couple should be established with an objective of long-term appreciation. IPOs of small companies and options on large-cap common stock are riskier investments and are generally considered inappropriate for IRAs. The DPP is inappropriate because tax losses in an IRA cannot be used to offset gains.

2. **C.** The reason open-end investment companies have that name is because of the nature of their continuous public offering of new shares. In simple terms, they are "open" while a closed-end investment company is limited to a fixed offering ("closed"). All of the other characteristics listed are common to both of these management investment companies.

3. **C.** Under Rule 501 of Regulation D, the SEC defines an accredited investor as an individual who either has a net worth of at least $1 million, excluding the value of the primary residence, or has had annual income of at least $200,000 ($300,000 joint return) in the last 2 years with the same or more expected this year.

4. **A.** The term sale does not include a bona fide pledge. It does include securities given as a bonus with a purchase and gifts of assessable stock because the owner of the assessable stock may be called upon to come up with additional money. Sales of rights or warrants are considered offers of the underlying security.

5. **C.** Section 28(e) of the Securities Exchange Act of 1934 provides a safe harbor for research and brokerage services provided in exchange for directed transactions. Clearance and settlement of trades is a qualifying brokerage service.

6. **C.** Written consent for assignment is required of clients whenever a change in a majority interest in an investment management partnership is involved. The death of a partner with a minority interest does not require consent for assignment. The sole owner of the advisory firm cannot pledge the firm as collateral without client consent. However, consent is required when there is a change in nonminority ownership through death. The merger of partnerships involves a change in majority interest, which requires consent.

7. **B.** An agent may appeal a final order of the state Administrator. A written petition must be filed with the appropriate court within 60 days of the entry of the Administrator's order, and the court may then affirm or set aside (vacate) the revocation order.

8. **D.** The Uniform Securities Act exempts from registration and disclosure requirements all of the securities listed. Banks, for example, are under the regulatory supervision of other government agencies. Regulated common carriers are exempt as is any security issued or guaranteed by the federal or local governmental units of the United States and Canada.

9. **B.** An Administrator's denial of a security's registration must be in the public interest. The underwriter's compensation may not be excessive.

10. **C.** The common factor for both traditional and Roth IRAs is that investment earnings are not taxed during the accumulation period. Traditional IRAs offer tax-deductible contributions but withdrawals are taxed. Roth IRAs do not offer tax-deductible contributions, but qualified withdrawals are tax free. Traditional IRAs require distributions to begin in the year after the year an owner reaches age 70½, but this is not true for Roth IRAs.

11. **D.** The Uniform Securities Act specifically excludes these four choices from the definition of offer and sale.

12. **C.** A publisher of a financial newspaper and a CPA who, as an incidental part of his practice, suggests investing in municipal bonds are not investment advisers.

13. **C.** An investment adviser representative is always an individual (natural) person. Employees who solicit business on behalf of investment advisers and those persons who supervise other employees are investment adviser representatives.

14. **A.** An agent may determine the price and timing of a transaction without discretionary authority. In this situation, the agent acted without authority when the amount of the security sold was changed. An agent is not necessarily required to execute a transaction immediately after an order is placed. While it is true that the agent cannot guarantee a price to a customer, the agent cannot take discretion to achieve a specific price without written authority from the client.

15. **C.** Surety bonds are required for investment advisers that exercise discretion over customer accounts as well as those that maintain custody. The Administrator may inspect an investment adviser's records held out of state without prior notice and require minimum financial requirements for investment advisers whether or not they have custody of securities.

16. **B.** Any conviction for a felony or securities-related misdemeanor that occurred within the previous 10 years must be disclosed. Failure to disclose a suspension by FINRA or a bankruptcy filing are causes for disciplinary action on the Administrator's part. Advisory groups may employ representatives as independent contractors.

17. **D.** Under ERISA, a fiduciary is not required to confine investments to only those most likely to achieve growth; other objectives, such as income and preservation of capital should be considered as well. The fiduciary is required to diversify investments so as to minimize the risk of losses, unless doing so is clearly not prudent under the circumstances.

18. **D.** The customer has specified a buy stop limit order. If the stock rises to the stop price of $140, the order is triggered and then becomes a buy limit order at 144, meaning an order to buy at $144 or lower. A market not held order allows the broker to submit a market order and is not held or committed to executing the order at a specific price.

19. **C.** When a client is selling securities, the quoted price represents the amount the dealer is bidding to buy them. It is true that the quoted price here is at a premium, but that doesn't answer the question as specifically.

20. **A.** Treasury STRIPS are guaranteed by the U.S. government, so there is virtually no chance of default. They are zero-coupon bonds and offer no current income, which is appropriate for a client who wants 100% return paid at a future date for college expenses.

21. **D.** YTM shows a reduction in annualized total return due to a premium paid or an increase in return from a discount. Choice A is incorrect because it describes the nominal (also called stated or coupon) or the annual interest that the issuer must pay to the bondholder. Choice B is incorrect because it describes a bond's current yield, which ignores gain or loss from premium or discount. Choice C is incorrect because yield to maturity does not compare an issuer's bond yields against its preferred stock yields. The YTM expresses an investor's total return from a bond considering both the coupon yield plus the par value at maturity.

22. **B.** The NASAA policy states that it is contrary to high standards of commercial honor and just and equitable principles of trade for any broker-dealer to execute any transaction in a margin account without securing from the customer a properly executed written margin agreement promptly after the initial transaction in the account.

23. **A.** Distributions from a nonqualified plan represent both a return of the original investment made in the plan with after-tax dollars (a nontaxable return of capital) and the income from that investment. The income was deferred from tax over the plan's life, so it is taxable as ordinary income once distributed. A 10% penalty tax applies only if distributions begin before age 59½.

24. **B.** If YTM is less than nominal yield, the bond must be trading at a premium.

25. **B.** The secondary market is the trading market. In the trading market, a trade can take place on a stock exchange, in the unlisted or OTC market, by trading listed securities in the OTC market, or in direct institution-to-institution trades via a service like INSTINET (the fourth market). New issues are considered to be sold in the primary market.

26. **D.** A large-cap growth manager is the most appropriate for the client because large capitalization stocks are generally less volatile and provide long-term capital growth. Index funds do not employ stock selection methods, they merely replicate the index.

27. **D.** As an effort to curb the flow of money for terrorist activities, among its other provisions, the USA PATRIOT Act of 2001 incorporated the customer identification program (CIP). Financial institutions must incorporate CIPs to verify the identity of individuals opening new accounts.

28. **C.** Beta coefficients greater than 1 signify that the stock will fluctuate more than the market as a whole. In general, the higher the beta, the greater the risk. Such risk-taking is appropriate for investors who seek aggressive investment strategies.

29. **D.** The only position that does not require any cash outlay is the sale of an option. In fact, the client would receive money from the sale (the premium). Selling calls offers some protection (to the extent of the premium received) for those with long positions while selling puts protects those who are short. The greatest protection would be offered by purchasing 3 GHI 50 puts, but that would cost money and the question specifically stated "no cash outlay"

30. **B.** The order in a liquidation is as follows: the IRS and other government agencies, secured debt holders, unsecured debt holders and general creditors, holders of subordinated bonds, preferred stockholders, and, finally, common stockholders.

31. **B.** Dividends play a large role in what someone is willing to pay for the stock. For example, the dividend discount model (DDM) values a stock as the discounted present value of future dividends. A company is not required to pay dividends. A growth company will tend not to pay cash dividends but rather use the money for expansion. The dividend on a company's preferred stock is fixed at issuance – it can never increase. If the company is successful, it may well happen that its common stock dividend will be higher than that on the preferred.

32. **D.** Shares of open-end companies do not trade in the secondary market. Both open-end and closed-end companies compute their net asset values, actively manage their portfolios, and have stated investment objectives.

33. **D.** All of the issuers listed are exempt from the registration provisions of the Uniform Securities Act.

34. **B.** A firm may not act as a broker and a dealer in the same transaction regardless of the amount of the markup. Additionally, the firm is not acting properly as a dealer by charging a commission and a markup, and the firm is not engaged in selling away. Selling away refers to the sale of securities outside an associated person's regular business.

35. **C.** By definition under the Investment Company Act of 1940, an investment company is in the business of investing, reinvesting, trading, owning, and holding securities and owns or intends to own securities that exceed 40% of its assets.

36. **D.** The residual right of common shareholders refers to their position in the event of bankruptcy. Common shareholders have rights to vote for the board of directors, to inspect the books of the company, and to receive dividends.

37. **C.** The OTC market is a negotiated market, not an auction market. Dealers one-on-one negotiate trades in an OTC stock. The FINRA 5% markup policy is a guide to use in determining the markup/markdown/commission on an OTC trade but not the price (and the FINRA rule has no application on this exam).

38. **D.** The purchase of a put allows the stockholder to lock in a sale price and thus protect a capital gain or avoid a loss. If the price continued to rise, the investor would not exercise the put but let the put option expire and sell the stock at the higher market price.

39. **B.** Limited partners are passive investors in a partnership whose liability is limited to the amount of funds they have invested plus any funds committed to, but not yet forwarded to the general partner. They do not manage the funds in the partnership; the general partner has that responsibility. Owners, called members, are not personally liable for the debts that arise under an LLC. The LLC is a separate legal entity from its owners. A sole proprietorship account is the business account of an individual business owner and is handled in much the same way as an individual account. An S corporation is taxed as a partnership, although it operates like a regular corporation.

40. **A.** The dividend growth model is a method to value the common stock of a company on the basis of assumed constant growth of dividends in the future. Therefore, it can only be applied to a corporation whose dividends might be expected to increase. It is far more likely that a large-cap stock will be paying dividends than a small-cap stock. Bonds don't pay any dividends and, in any event, their interest, just like the dividends on preferred stock, is fixed; there is no growth possible.

Notes

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