Securities Industry Essentials (SIE)

General Knowledge Examination

Study Manual – 1st Edition

To access your online materials, logon to **MY.STCUSA.com**

Visit **www.STCUSA.com** for more information and supplemental online products.

When reviewing the online PDF Study Manual, a **keyword search** can be performed by holding down the “Control” key and clicking on the “F” key (Ctrl + F) or, for Mac users, the “Command” key and ”F” key (Cmd + F).

STC Customer Service 800 782-1223 ⬩ info@stcusa.com

Copyright © Securities Training Corporation®. ALL RIGHTS RESERVED.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of Securities Training Corporation.

This copyrighted material was designed for your personal use only and is sold under the agreement that this course material, or any part thereof, will not be sold, shared, or distributed, by any means whatsoever, to another individual without the prior written, or as required by law or by any regulatory authority, consent of Securities Training Corporation; 123 William St, New York, NY 10038.

DISCLAIMER *STC students are provided with both a print and online study manual. If discrepancies are discovered between these two manuals, please consider the online study manual to be the most current since it's updated in real-time.*

G122

Table of Contents

Introduction

About the Securities Industry Essentials (SIE) Examination 1
Course Materials 1
Study Manual and Exam Breakdown 2
Final Examinations 2
Registering for the Examination 2
Standardized Test-Taking Tips 3
Test-Taking Pitfalls 4
Study Calendars 5

Chapter 1 – Overview of Market Participants and Market Structure

Market Participants 7
What's an Issuer? 7
What's a Broker-Dealer? 8
What's a Market Maker? 9
What's a Trader? 9
What's an Investment Adviser? 9
Types of Investors 10
Retail Investors 10
Accredited Investors 10
Institutional Investors 11
Market Structure 11
Primary Market 11
Secondary Market 12
Other Execution Methods and Venues 13
Clearing and Settlement – An Overview 14
The Depository Trust & Clearing Corporation (DTCC) 14
Processing the Trade – Clearing and Introducing Firms 14
Introducing Firms – Fully Disclosed Versus Omnibus Accounts 15
Other Customers of Clearing Firms 16
Clearing Options Contracts 17

Other Entities That Keep Markets Running Smoothly ... 18
Conclusion ... 18
Chapter 1 Summary ... 19
Create a Chapter 1 Custom Exam ... 19

Chapter 2 – Overview of Regulation

Regulation ... 21
Federal Regulation ... 21
Other Federal Regulators ... 21
SRO Regulation ... 22
State (Blue-Sky) Regulation ... 22
Firm (In-House) Rules ... 23
Why Take the SIE Exam? ... 23
Federal Regulation – The Acts ... 24
The Securities Act of 1933 ... 24
The Securities Exchange Act of 1934 ... 24
The Maloney Act of 1938 ... 24
The Investment Advisers Act of 1940 ... 25
The Securities Investor Protection Act of 1970 (SIPA) ... 25
The Employee Retirement Income Security Act of 1974 (ERISA) ... 27
The Securities Acts Amendments of 1975 ... 27
The Insider Trading and Securities Fraud Enforcement Act of 1988 ... 27
The Penny Stock Reform Act of 1990 ... 27
The Federal Telephone Consumer Protection Act of 1991 ... 28
The USA PATRIOT Act of 2001 ... 28
Self-Regulatory Organizations ... 30
FINRA ... 30
The Municipal Securities Rulemaking Board (MSRB) ... 30
The Chicago Board Options Exchange (CBOE) ... 31
Firm Specific Rules ... 31
Internal Compliance ... 31
The Importance of Understanding Regulation ... 32
Conclusion ... 32
Chapter 2 Summary ... 32
Create a Chapter 2 Custom Exam ... 32

Chapter 3 – Equity Securities

The Corporation – Equity Securities 34
Corporate Organization 34
Raising Capital – Financing the Corporation 34
Different Types of Equity Securities 35
Common Stock 35
Rights of Common Shareholders 36
Rule 144 38
Classification of Stocks 39
Blue-Chip Stocks 39
Growth Stocks 39
Defensive Stocks 40
Income Stocks 40
Cyclical Stocks 40
American Depositary Receipts (ADRs) 40
Preferred Stock 41
Cumulative Preferred Stock 41
Non-Cumulative Preferred Stock 41
Participating Preferred Stock 42
Callable Preferred Stock 42
Convertible Preferred Stock 42
Common versus Preferred Stock 43
Rights and Warrants – Derivative Securities 43
Preemptive Rights 43
Warrants 44
Miscellaneous Equity Rules 45
FINRA Rule 2261 – Disclosure of Financial Condition 45
FINRA Rule 2262 – Disclosure of Control Relationship with Issuer 45
SEC Rule 10b-18 – Purchases of Certain Equity Securities by the Issuer 45
Conclusion 46
Chapter 3 Summary 46
Create a Chapter 3 Custom Exam 47

Chapter 4 – An Introduction to Debt Instruments

Introduction to Debt Instruments....49
- Basic Bond Characteristics 49

Why Bond Prices Fluctuate from Par....52
- Discounts and Premiums 52

Bond Pricing 53

Prices and Yields: An Inverse Relationship 54
- Calculating Bond Yields 55

Redeeming Bonds Prior to Maturity....55
- Call Provisions 55
- Convertible Bonds.... 56
- Conclusion 59
- Chapter 4 Summary.... 59
- Create a Chapter 4 Custom Exam 59

Chapter 5 – Types of Debt Instruments

Types of Debt Instruments....61
- Treasury Securities 61
- Treasury Notes (T-Notes) and Treasury Bonds (T-Bonds) 62
- Treasury Inflation-Protected Securities (TIPS).... 62

Non-Interest-Bearing Securities....62
- Treasury Bills (T-Bills) 63

Stripped Securities....63
- Treasury STRIPS.... 64
- Cash Management Bills (CMBs) 64

U.S. Treasury Securities Auctions – The Primary Market....64

Agency Securities 65
- Federal Agencies 65
- Government-Sponsored Enterprises.... 65

Mortgage-Backed Securities....66
- Pass-Through Certificates.... 66
- Federal Home Loan Mortgage Corporation (FHLMC) 66
- Federal National Mortgage Association (FNMA).... 66
- Government National Mortgage Association (GNMA).... 67

Municipal Bonds 67

Types of Municipal Bonds 68
General Obligation (GO) Bonds 68
Revenue Bonds 68
Types of Revenue Bonds 69
Municipal Notes 71
Ratings for Municipal Notes 72
Other Municipal Securities 72
Auction Rate Securities 72
Variable Rate Demand Obligations (VRDOs) 72
The Primary Market for Municipal Bonds 73
Issuing GO Bonds 73
Issuing Revenue Bonds 73
New Issue Underwritings 73
Forming a Municipal Syndicate 74
Corporate Bonds 75
Types of Corporate Bonds 75
Secured Bonds 75
Unsecured Bonds 76
Other Types of Corporate Bonds 77
Income Bonds 77
Eurodollar Bonds, Yankee Bonds, and Eurobonds 77
The Money-Market 77
Types of Money-Market Securities 78
Bond Taxation Summary 80
Conclusion 80
Chapter 5 Summary 81
Create a Chapter 5 Custom Exam 81

Chapter 6 – Investment Returns

Return on Equity Investments 83
Dividends 83
Calculating Current Yield (Dividend Yield) 86
Return on Bond Investments 86
Prices and Yields – An Inverse Relationship 86
Calculating Bond Yields 87

Call Provisions ... 90
Cost Basis, Capital Events, and Return of Capital ... 90
Measuring Return ... 91
Total Return ... 91
Averages and Indexes ... 92
Conclusion ... 93
Chapter 6 Summary ... 94
Create a Chapter 6 Custom Exam ... 94

Chapter 7 – Packaged Products

Types of Investment Companies ... 96
Open-End Management Companies (Mutual Funds) ... 96
Additional Disclosure: The Statement of Additional Information (SAI) ... 99
The Organization of a Mutual Fund ... 99
Categories of Mutual Funds ... 100
Buying and Selling Mutual Fund Shares ... 102
Net Asset Value ... 102
Fees and Charges ... 104
Classes of Shares ... 105
Methods of Reducing Sales Charges ... 106
Dollar Cost Averaging (DCA) ... 109
Redeeming Shares ... 109
Systematic Withdrawal Plans ... 109
Prohibited Sales Practices ... 110
Other Types of Investment Companies ... 110
Face-Amount Certificate Companies ... 110
Unit Investment Trusts ... 111
Closed-End Investment Companies ... 111
Conclusion ... 112
Chapter 7 Summary ... 113
Create a Chapter 7 Custom Exam ... 113

Chapter 8 – Variable Contracts and Municipal Fund Securities

Annuities ... 115
Fixed versus Variable Annuities ... 115

Variable Annuities ... 116
The Life of a Variable Annuity ... 117
Accumulation Period ... 117
Annuity Period ... 118
Annuity Charges and Expenses ... 120
Qualified Annuities ... 121
Equity-Indexed Contracts (EICs) ... 121
Variable Annuities—Suitability and Compliance Issues ... 122
Municipal Fund Securities ... 123
Local Government Investment Pools ... 123
Section 529 College Savings Plans ... 124
Section 529A Plans ... 126
Conclusion ... 126
Chapter 8 Summary ... 127
Create a Chapter 8 Custom Exam ... 127

Chapter 9 – Alternative Investments

Other Types of Investment Companies ... 129
Exchange-Traded Funds (ETFs) ... 129
Exchange-Traded Notes (ETNs) ... 130
Other Types of Packaged Products ... 131
Hedge Funds ... 131
Private Equity Funds ... 131
Real Estate Investment Trusts (REITs) ... 132
Regulation ... 132
Investment Attributes ... 132
Direct Participation Programs (DPPs) ... 133
Advantages of Limited Partnerships ... 134
Disadvantages of Limited Partnerships ... 134
General Partners ... 135
Limited Partners ... 135
DPP Offering Practices ... 135
Tax Treatment of Individual Partners ... 136
Types of Limited Partnerships ... 136
Risk Summary ... 137

Conclusion 138
Chapter 9 Summary 139
Create a Chapter 9 Custom Exam 139

Chapter 10 – Options

Options 141
Equity Options – Terminology 141
Buyers and Sellers 141
Types of Options 142
Components of an Option 142
Intrinsic Value and Time Value 143
Breakeven 146
Speculation versus Hedging 146
Option Events 147
Options Clearing Corporation (OCC) 149
Options Disclosure Document 149
Index Options 149
Hedging with Options 149
Covered and Uncovered Option Positions 150
Summary of Profit and Loss Potential for Various Positions 151
Conclusion 151
Chapter 10 Summary 151
Create a Chapter 10 Custom Exam 152

Chapter 11 – Offerings

Capital Formation 154
Offering Securities to Investors 154
The Role of an Underwriter/Investment Banker 155
Underwriting Commitments 155
Market-Out Clause 157
Shelf Registration 157
Distribution of Securities 157
Syndicate 157
Selling Group 157
Determining the Public Offering Price (POP) 158

Underwriting Spread 158
Securities Act of 1933 – Registration 159
The Registration Process 160
The Pre-Registration (Pre-Filing) Period 160
The Cooling-Off Period 161
The Post-Effective Period 162
Disclosure Requirements 162
Aftermarket Prospectus Delivery Requirement 162
Types of Prospectuses 163
Exempt Securities 164
Exempt Offerings 165
Regulation D 165
Rule 144 166
Rule 144A 167
Rule 145 167
Rule 147 and 147A 168
The Primary Market for Municipal Bonds 168
Issuing General Obligation (GO) Bonds 169
Issuing Revenue Bonds 169
New Issue Underwritings 169
Forming a Syndicate 170
Underwriting Documentation 170
Notice of Sale 170
Legal Opinion 170
Official Statement 170
Official Statement Summary 171
New Issue Confirmations 172
Conclusion 172
Chapter 11 Summary 173
Create a Chapter 11 Custom Exam 173

Chapter 12 – Orders and Trading Strategies

Trade Capacity – How Broker-Dealers Act 175
Fair Prices and Commissions – The 5% Markup Policy 176
Discretionary Order/Discretion Not Exercised 178

Types of Transactions 178
Types of Orders 179
Market Orders 179
Limit Orders.................... 179
Stop (Loss) Orders.................... 180
Stop-Limit Order.................... 181
Order Qualifiers.................... 182
Conclusion 183
Chapter 12 Summary 183
Create a Chapter 12 Custom Exam 183

Chapter 13 – Settlement and Corporate Actions

Trading, Clearing, and Settlement 185
Settlement Dates.................... 185
Customer Payment Versus Settlement 186
Settlement Methods 187
Delivery of Physical Securities....................188
Paper Settlement 188
Corporate Actions 189
Corporate Actions in Equities.................... 189
Other Corporate Actions 191
Forwarding Official Communications 192
Conclusion 194
Chapter 13 Summary 194
Create a Chapter 13 Custom Exam 194

Chapter 14 – Customer Accounts

Account Types and Characteristics 196
Cash Accounts.................... 196
Margin Accounts 196
Options Accounts.................... 197
Discretionary Accounts 198
Fee-Based versus Commission Based Accounts 199
Educational Accounts.................... 200
Customer Account Registrations 201

Individual Account ... 201
Joint Account ... 201
Corporate/Institutional Accounts ... 202
Partnership Accounts ... 202
Trust Accounts ... 202
Custodial Accounts ... 203
Retirement Accounts ... 204
Traditional Individual Retirement Accounts (IRAs) ... 204
Roth IRAs ... 206
Qualified Retirement Plans ... 207
Employee Retirement Income Security Act (ERISA) ... 207
Taxation of Retirement Plans ... 208
Types of Plans ... 208
Conclusion ... 210
Chapter 14 Summary ... 210
Create a Chapter 14 Custom Exam ... 211

Chapter 15 – Compliance Considerations

New Account Documentation ... 213
Required Information ... 213
SEC Recordkeeping Requirements ... 214
Know Your Customer and Suitability ... 215
Suitability ... 215
Regulation Best Interest (Reg BI) ... 217
Anti-Money Laundering and the USA PATRIOT Act ... 218
FinCEN's Required Reports ... 218
Mandatory AML Compliance Programs ... 220
SEC Regulation SP ... 221
Privacy of Consumer Financial Information ... 221
Identity Theft Prevention—FTC Red Flags Rule ... 223
Client Notifications ... 223
Regulation of Communications ... 225
Correspondence ... 225
Institutional Communications ... 225
Retail Communications ... 226

Telemarketing — An Alternative Communication Method........226
National Do Not Call List........228
Safekeeping of Customer Funds and Securities........228
The Customer Protection Rule........228
Customer Free Credit Balances........229
FINRA Rules........229
Fidelity Bonds........229
Business Continuity Plan (BCP)........229
Books and Records........230
Conclusion........231
Chapter 15 Summary........231
Create a Chapter 15 Custom Exam........231

Chapter 16 – Prohibited Activities

Manipulation........233
Misrepresentations........233
Regulation M........233
Market Rumors........234
Front-Running........235
Trading Ahead of a Research Report........235
Excessive Trading Activity (Churning)........236
Marking-the-Close/Marking-the-Opening........236
Backing Away........236
Free Riding........237
Prohibited Trading Practices and Other Trading Rules........237
Anti-Intimidation/Coordination Interpretation........237
Payments to Influence the Market Price........238
Best Execution........238
Time of Trade Disclosures (MSRB Rule G-47)........238
Interpositioning........239
Trading Ahead of Customer Orders (Limit Order Protection Rule)........239
Quoting a Security in Multiple Mediums........239
Mutual Fund Trading Rules........240
Insider Trading........240
Other Prohibited Activities........242

The New Issue Rule 242
Sharing in Accounts and Guarantees 245
Borrowing and Lending Practices with Customers 245
Financial Exploitation of Specified Adults – FINRA Rule 2165 246
Accounts at Other Broker-Dealers and Financial Institutions 248
Payments to Unregistered Person 249
Forgery 249
Books and Records 249
Recordkeeping Formats 249
Conclusion 250
Chapter 16 Summary 251
Create a Chapter 16 Custom Exam 251

Chapter 17 – SRO Requirements for Associated Persons

SIE Exam – The First Step to Registration 253
Associated Persons 253
Activities of Non-Registered Persons 254
Registered Representative Designations 255
Principal Designations 256
Supervision of Registered Representatives 257
Registration of Representatives and Principals 258
Form U4 and the Central Registration Depository 258
Statutory Disqualification 259
Background Check 260
Fingerprinting Requirement 260
State Registration (Blue-Sky Rules) 261
Continuing Education 261
Regulatory Element 261
Firm Element 262
Conclusion 262
Chapter 17 Summary 263
Create a Chapter 17 Custom Exam 263

Chapter 18 – Employee Conduct and Reportable Events

Employee Conduct 265

Registration of Representatives and Form U4 ... 265
The Central Registration Depository ... 267
Updating Form U4 ... 267
Form U5 ... 267
Complaints ... 269
Red Flags ... 270
Personal Activities of Employees ... 271
Outside Business Activities ... 271
Private Securities Transactions ... 272
Influencing or Rewarding Employees of Others (The Gift Limit) ... 272
MSRB Political Contribution Rule (G-37) ... 274
Conclusion ... 275
Chapter 18 Summary ... 276
Create a Chapter 18 Custom Exam ... 276

Chapter 19 – Economic Factors

Economics ... 278
Measuring National Output ... 278
Inflation ... 278
Deflation ... 280
Measurements of Economic Activity ... 280
The Business Cycle ... 280
Business Cycle Indicators ... 281
The Effect of the Business Cycle on Securities Markets ... 282
Classifications of Common Stocks ... 283
Influencing the Economy – Monetary and Fiscal Policy ... 285
Keynesian Theory ... 285
Monetary Theory ... 285
Tools of the Federal Reserve Board ... 287
Reserve Requirements ... 287
Discount Window ... 287
Federal Funds ... 288
Open Market Operations ... 288
Margin Requirements ... 289
Moral Suasion ... 290

Effects of the FRB's Activities 290
International Economic Factors 291
Exchange Rates 291
Balance of Payments 291
Financial Statements 291
The Balance Sheet 292
Components of the Balance Sheet – Assets 293
The Liabilities Section 293
The Stockholders' Equity Section 293
The Income Statement 294
Components of the Income Statement 294
Conclusion 295
Chapter 19 Summary 295
Create a Chapter 19 Custom Exam 295

Chapter 20 – Investment Risks

Investment Risks 297
Systematic (Non-Diversifiable) Risk 297
Unsystematic (Diversifiable) Risk 299
Attempting to Control Risk Through Diversification 301
Buy-and-Hold 301
Portfolio Rebalancing 301
Indexing 302
Active Strategies 302
Sector Rotation 302
Dollar Cost Averaging 303
Hedging 303
Equity Options 303
Index Options 303
Currency Options 304
Conclusion 304
Chapter 20 Summary 304
Create a Chapter 20 Custom Exam 305

About the Securities Industry Essentials (SIE) Examination

The SIE Exam is an introductory-level exam that assesses a candidate's knowledge of basic securities industry information including concepts fundamental to working in the industry, such as types of products and their risks; the structure of the securities industry markets, regulatory agencies and their functions; and prohibited practices.

The SIE Exam is a 75 multiple-choice question exam with an additional 10 experimental questions included. These experimental questions don't count for or against a person's score. Candidates are given 1.75 hours to complete the exam and the minimum required passing score is 70%. The questions are divided into the following four sections:

Sections		Number of Questions	Corresponding STC Study Manual Chapter
1	Knowledge of Capital Markets	12	1, 2, 11, 19
2	Understanding Products and Their Risks	33	3, 4, 5, 7, 8, 9, 10, 20
3	Understanding Trading, Customer Accounts, and Prohibited Activities	23	6, 12, 13, 14, 15, 16
4	Overview of Regulatory Framework	7	17, 18
	Total:	**75**	

- The SIE Exam is open to any person who is age 18 or older, including students and prospective candidates who are interested in demonstrating basic industry knowledge to potential employers.
- Association with a firm is not required, and individuals are permitted to take the exam before or after associating with a firm.
- Essentials exam results are valid for four years.

Before candidates test, we recommend that they visit our website at www.stcusa.com to see if there have been any changes or supplemental materials created for this exam.

Course Materials

STC's Securities Industry Essentials (SIE) Examination Training Program consists of the following materials:

1. 20-chapter study manual
2. Final examinations with explanations

Copyright © Securities Training Corporation. All Rights Reserved.

Study Manual and Exam Breakdown

The study manual, which represents the first phase of your exam preparation, consists of 20 chapters that cover the topics tested on the SIE Examination. After reading each chapter, STC strongly suggests that students go to their *my.stcusa.com* dashboard and create a 10-question Custom Exam that contains only questions pertaining to the chapter just completed.

The Custom Exam may be taken with or without the explanations shown after each question is answered. Students shouldn't proceed to the next chapter until they fully understand the explanation for any questions that were answered incorrectly.

Final Examinations

The final examinations and corresponding explanations represent the most important part of your test preparation. These examinations will assist you in applying the information that you learned in the study manual to questions that are posed in the multiple-choice format and used in the SIE Exam.

An examination should first be taken with the SHOW EXPLANATIONS turned on. As you read a question, try to answer it. However, whether your answer is correct or incorrect, read the entire explanation. You may find it helpful to highlight or take notes on any facts you didn't know for use in future studying.

Studying each explanation is a crucial step to passing the SIE Examination. By concentrating only on the correct response and disregarding the explanation, you run the risk of memorizing answers without fully understanding the underlying concepts.

After completing all of the examinations with SHOW EXPLANATIONS switched on, and if time permits based on the calendar you're following, begin the process over again by retaking each examination without the explanations shown. If taking the test for the second time, you should strive to achieve a score of 85% or better to show maximum retention of the material.

Registering for the Examination

In order to take an examination, a candidate will need to make a test appointment. Please use the following information to schedule an appointment and/or to learn more about examination centers:

Prometric Exam Centers
www.prometric.com/finra
(800)578-6273 (toll free)

 Copyright © Securities Training Corporation. All Rights Reserved.

Prometric's website will provide the most up-to-date information regarding "Test Center Security" and "Test Break Policies." The exam center will provide candidates with:

- A four-function calculator
- Two dry erase boards
- A dry-erase pen

For more information related to scheduling an exam, as well as what to expect on both the day of your exam and after, please use the following link that is provided by FINRA:

www.finra.org/industy/qualification-exams
(800)999.6647 (toll free)

The following link provides a tutorial on the exam format:

www.finra.org/sites/default/files/external_apps/proctor_tutorial.swf.html

Standardized Test-Taking Tips

As with any standardized test, you may be able to increase your score by employing good test-taking techniques. An efficient technique will ensure an overall understanding of the question while helping to avoid careless errors. It will also help you to stay alert throughout the entire exam. Here is a step-by-step approach that may work well for you.

Step 1: Read the question the first time through without trying to answer it. Merely form an understanding of what the question is about.

Step 2: Carefully read the four choices. Remember that a multiple-choice examination actually gives you the answer. Your job is to recognize the correct choice from among the other distractions. By keeping these choices in mind when you reread the question, you will be able to efficiently pinpoint the important information and filter out extraneous material.

Step 3: Reread the question slowly. Stop at the end of each sentence and absorb the information. You may have to exaggerate this in the beginning as you get used to applying the deep concentration you need to assure that you recognize all important facts and catch misleading words or phrases (e.g., not, except).

Step 4: Make sure that you fully understand what the question is asking. You cannot possibly answer a question correctly before you know what it's looking for. You may have to look back to the question for additional facts before you are ready to actually choose your answer.

Step 5: Read each choice a second time. As you read a choice, decide whether it's a possible answer or not. Eliminate the incorrect choices. If you can eliminate three of the four choices, you have your answer. If you only eliminate one or two, this will help you narrow it down to your best choices. Reconsider the remaining choices by comparing their differences and decide which answer is more correct. Once you have made your decision, DO NOT LOOK BACK!

Copyright © Securities Training Corporation. All Rights Reserved.

NOTE: For Roman numeral questions, do any elimination before trying to answer the question. The answer will usually include only two or four choices.

It's very important that you practice your technique so that you become proficient by the time you sit for the examination. The best place to do this is on the final examinations. Not only will this practice build your technique, but it will also help you to identify any problem areas you may have. A list of common test-taking problems follows.

Test-Taking Pitfalls

Reading the Question Too Fast Half the battle of passing a standardized examination is determining what the question is asking. Regardless of how many times you read a question, you cannot absorb the information if you read the question too quickly. One technique that will help to slow you down while you are studying is to use your answer sheet to expose only one line of the question at a time. This way you will not be tempted to read on to the end of the question and will concentrate on what you are presently reading. While this technique cannot be used on the computerized exam, the practice should be helpful.

Changing Answers Going back and changing an answer means that you are second-guessing yourself. If you employ a good test-taking strategy, there's nothing you will gain from going back to a question a second time. If you think you may obtain the information you need from another question, please remember that this exam is written by expert test writers and they're not going to give anything away.

Formulating an Answer Too Quickly When you are ready to answer a question, make sure to consider all four choices given. Don't formulate an answer on your own and merely look for that choice while disregarding the others. Remember that there will often be more than one correct choice and while your choice may be right, it may not be the best response.

Making Careless Errors You must not have any preconceived notions when reading a test question. Always read what's written, not what you expect to see. By keeping an open mind, reading the questions slowly and at least two times through, you should be able to avoid these types of errors.

Copyright © Securities Training Corporation. All Rights Reserved.

Study Calendars

STC provides sample study calendars which are designed to help students in organizing their time and allowing for a manageable amount of daily study. Remember, these calendars are simply suggestions for how you may plan your studies. Feel free to make any modifications that you deem appropriate.

The calendars are available for download on your student dashboard on www.my.stcusa.com.

- Click on the link to "Calendars and Crunch Time Facts" that appears below the Securities Industry Essentials (SIE) Exam course title
- Choose the calendar that best fits your needs

EXAM PREP

SIE Securities Industry Essentials (SIE) Exam
Securities Industry Essentials (SIE) Exam
EXAM INFO CALENDARS & CRUNCH TIME FACTS
ADD CALENDAR
VIEW MY SCORES

Study Manual	Securities Industry Essentials (SIE) Exam Study Manual	Not Started	VIEW
On Demands Expires: 12-01-23	SIE On-Demand Lecture-1st Edition (MP4)	4.76%	VIEW
On Demands Expires: 12-01-23	SIE Virtual Class Recording	Not Started	VIEW

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 1 – Overview of Market Participants and Market Structure

- *Types of Issuers*
- *How Firms Function*
- *Types of Investors*
- *Primary vs. Secondary Markets*
- *Clearing and Settlement*

Copyright © Securities Training Corporation. All Rights Reserved.

This chapter begins with an examination of the different market participants and the roles they play. The chapter then reviews the market structure of the securities industry, including the process by which securities are created and subsequently traded. Finally, the chapter will focus on ensuring that SIE Examination candidates become comfortable with some of the terminology that will be encountered throughout this study manual. As will become evident, finance has a language of its own. Good luck in your studies!

Market Participants

The process of matching investors who have money with issuers that need money is one of the primary purposes of the securities industry. Ultimately, the securities marketplaces and its participants provide the bridge between those with capital (money) to invest and those that need the capital for financing purposes.

What's an Issuer?

An issuer is defined as a legal entity that sells securities in order to finance its operations. Issuers include businesses that need capital to grow and prosper, as well governments that typically borrow funds as a means of paying their bills or building infrastructure. Issuers include, but are not limited to:

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

There are two primary methods that issuers use to raise capital—issuing debt securities (bonds) and issuing equity securities (stocks). Let's briefly define each security type.

Debt Securities Both corporations and various government borrowers raise funds through the issuance of publicly traded loans, which are referred to as *bonds, notes,* or *debt instruments.* A bond is a security that represents the amount of indebtedness (principal) that the issuer owes to the investor. Investors who purchase bonds are considered *creditors* of the issuer and essentially lend their funds to the issuer for a specified period (until maturity).

The issuer is required to repay the principal balance of the bond at a future date and will typically make interest payments over the life of the loan. If the issuer misses an interest or principal payment, it's considered to be in *default*.

Equity Securities Traditionally, corporations raise capital through the issuance of stock (equity). If an investor purchases the stock, she has an ownership interest in the underlying business and, if the company is profitable, may be entitled to a portion of the profits (through a dividend distribution).

Copyright © Securities Training Corporation. All Rights Reserved.

The ownership interest typically doesn't have a maturity date and the payment of any dividends is voluntary for the issuer. Both stocks and bonds will be covered in greater detail later in this manual.

Financial firms are the bridges that connect issuers and investors. These firms generally fall into one of two broad categories—*broker-dealers* or *investment advisers*. Let's examine the distinction between these two types of financial firms.

What's a Broker-Dealer?

The term broker-dealer refers to the two capacities in which a firm may operate. A *broker* is defined as any person that engages in the business of effecting *agency* transactions in securities for the account of others. Essentially, brokers match up buyers and sellers and earn a commission for their efforts. As a comparison, think of how a real estate agent is employed by a real estate broker and acts on behalf of customers to earn commissions.

A *dealer* is defined as any person that engages in the business of buying and selling securities for its own account. Firms acting as dealers engage in *principal* transactions in which they buy securities directly from their clients and hold them in inventory, or they sell securities to clients from their inventory. For executing these trades, dealers are entitled to either a markup or markdown. Now, consider the similarity to a car dealer that buys for or sells from its inventory and will either markdown the car cost when buying or markup the car cost when selling. Since firms are continuously executing trades as either a broker or a dealer, it's convenient to simply refer to them as broker-dealers. Additional details of the capacities in which broker-dealers operate will be provided in Chapter 12.

Broker-Dealer Departments Many brokerage firms (broker-dealers) are divided into several distinct departments. SIE Examination candidates are expected to have a general idea of the responsibilities of the employees who work in each of these areas.

Investment Banking (IB) Investment banking is the area that works directly with the issuers to arrange and structure their securities offerings. For example, this department may advise an issuer that intends to raise funds through an issuance of stocks, bonds, or a combination of both. Remember, investment bankers are often referred to as the *underwriters* of securities. IB may also assist companies that seek to merge with or acquire other companies (M&A) or those that need to restructure due to a bankruptcy.

Research The analysts in a firm's research department study both the markets and individual issuers in order to issue recommendations. The typical recommendations are to buy, sell, or hold.

Sales Financial professionals who work in the sales area typically market individual stocks or bonds, but also packaged products (e.g., mutual funds) to both retail investors and institutions. Historically, sales personnel have been referred to as stock or bond brokers. However, for the SIE Examination, these salespersons will likely be referred to as *registered representatives (RRs)* or *investment adviser representatives (IARs)*.

 Copyright © Securities Training Corporation. All Rights Reserved.

Trading Trading professionals handle the execution of trades for both the firm's clients and the firm's own (proprietary) account. These trades may occur either in electronic marketplaces, such as Nasdaq, or hybrid marketplaces, such as the New York Stock Exchange (NYSE).

Operations The operations area ensures that all of the paperwork, funds, and securities transfers that are associated with a trade (or processing) are handled efficiently and according to specific industry standards. Operations personnel perform functions such as generating customer statements, confirmations, and tax records, as well as assisting in the transfer of securities and/or funds. These personnel are also responsible for ensuring that all firm and client assets are organized properly and safeguarded.

What's a Market Maker?

When a broker-dealer chooses to display quotes into a trading system to indicate its readiness to buy and/or sell securities at specific prices, the firm is referred to as a *market maker*. In most cases, a market maker is required to make regular bids and offers and meet specific capital requirements.

A market maker's *quote* is two-sided since it indicates the price at which it's willing to buy a security from (bid), or sell a security to (ask/offer), other market participants. For example:

Bid	Ask	Size
17.05	17.08	10 x 20
Price at which the firm will buy	Price at which the firm will sell	

In the example above, the firm is willing to buy 1,000 shares (10 round lots of 100 shares) at 17.05 and/or sell 2,000 shares (20 round lots of 100 shares) at 17.08. Generally, if no size is indicated, a market maker must be prepared to buy or sell a minimum unit of trading (100 shares) at the quoted prices.

What's a Trader?

Other firms and individuals that simply choose to trade securities for the firm's benefit (proprietary trading) or for the benefit of the firm's clients (without the interest in making markets) are referred to as *traders*. These traders are under no obligation to enter quotes into a marketplace; instead, they execute trades against the quotes of market making firms.

What's an Investment Adviser?

Many financial firms act as investment advisers, rather than functioning as broker-dealers. So, what's the difference between a broker-dealer and an investment adviser? Essentially, it comes down to how each is compensated for the services it provides. Broker-dealers earn compensation (e.g., commissions) for executing transactions, while investment advisers charge *fees* for providing advice to their clients. These fees are often based on a percentage of assets under management (AUM) and are charged regardless of whether any trades occurred in their clients' accounts.

Copyright © Securities Training Corporation. All Rights Reserved.

Investment advisers come in all shapes and sizes. Some manage hundreds of millions of dollars for mutual funds, while others have small practices and work exclusively with individual investors.

Municipal Advisors A municipal advisor is a specialized type of advisor that provides advice either to or on behalf of a municipal entity, such as a state, county or city. An advisor's client is typically the issuer, not the investor. These financial professionals provide advice related to the structure, timing, and terms of a municipal finance offering. The municipal advisor definition is broad and includes financial advisors, third-party marketers, placement agents, solicitors, finders, and swap advisors that engage in municipal advisory activities. For example, let's assume that a town intends to issue bonds to raise funds for the construction of a new gymnasium. If the mayor and members of the town council lack the necessary financial or securities knowledge, they may hire a municipal advisor to act as an intermediary between the town and the underwriter.

Types of Investors

As mentioned earlier, broker dealers connect issuers and investors in primary offerings, but are also involved in the trading of the issued securities. Investment advisers also often assist investors in building a balanced portfolio through a process that's referred to as asset allocation. Now let's examine some of the different types of investors.

Retail Investors

Many investors who directly buy stocks or bonds from broker dealers are retail investors. Essentially, this term means "regular individuals" who have limited assets and income. These investors may hold assets in one person's name (a single account) or perhaps together with their spouse or a friend (a joint account). Other forms of retail ownership include various retirement accounts, such as IRAs, or custodial accounts that are established for children.

The primary focus of securities regulation (to be described in Chapter 2) is on protecting these retail investors. Many professionals define a retail investor as a person who doesn't meet the definition of an institutional investor (described below).

Accredited Investors

The Securities and Exchange Commission (the primary regulator for the securities industry) categorizes certain investors who, by the nature of their income or assets, are viewed as more sophisticated and/or able to assume greater risk.

These investors are referred to as accredited investors and include the following:

- Financial institutions (e.g., banks), large tax-exempt pension plans, and private business development companies
- Directors, executive officers, or general partners of the issuer

Copyright © Securities Training Corporation. All Rights Reserved.

- Individuals who meet either one of the following two criteria:
  - Have a net worth of at least $1,000,000 (excluding their primary residence) or
  - Have gross annual income of at least $200,000 (or $300,000 combined with a spouse) for each of the past two years, with the anticipation that this level of income will continue

Institutional Investors

Institutional investors are typically large entities that pool their money to purchase securities. Institutional investors include banks, insurance companies, pension plans, endowments, and hedge funds. The SEC refers to certain institutions as *qualified institutional buyers (QIBS);* however, to be considered QIBs, the buyers must satisfy the following three-part test:

1. First, only certain types of investors are eligible, including:
   - Insurance companies
   - Registered investment companies
   - Registered investment advisers
   - Small business development companies
   - Private and public pension plans
   - Certain bank trust funds
   - Corporations, partnerships, business trusts, and certain non-profit organizations
2. The buyer must be purchasing for its own account or for the account of another QIB.
3. The buyer must own and invest at least $100 million of securities of issuers that are not affiliated with the buyer.

Under no circumstances is an individual (even one who meets the standard of being an accredited individual investor) considered to be a QIB. *Remember, QIBS are not humans, they're entities (e.g., firms).*

By specifically defining both institutional and non-institutional (retail) investors, securities regulators are able to create rules which are applicable to only one type of investor.

Market Structure

The way that the securities market is structured involves the issuance of the securities in one market (the primary market) and the trading of the securities in another market (the secondary market). This next section will examine these two markets.

Primary Market

Let's start with the premise that a new start-up company needs money for its expansion goals and will be issuing shares of its stock.

Copyright © Securities Training Corporation. All Rights Reserved.

Since the company is unaware of the nuances of raising capital, it works with the investment banking department of a brokerage firm. The investment banker will assume the role of the underwriter by agreeing (for a fee) to market the shares to the ultimate investors. These investors could include insurance companies, investment companies, pension funds, as well as individuals throughout the country. As the securities are sold to investors, most or all of the proceeds received will go to the issuer. Since this issuance marks the beginning of the shares' existence, this is referred to as the *primary market*.

The primary market is regulated by the SEC under the Securities Act of 1933. The process by which issuers offer their securities will be covered in detail in Chapter 11.

Secondary Market

After the primary distribution of the issuer's shares, the investors that purchased the shares from the issuer will inevitably want to sell them. The market that brings together these buyers and sellers is referred to as the *secondary market*. In the secondary market, the funds are no longer directed to the issuer; instead, the securities and the funds pass between investors. Let's examine some of the markets in which these securities trade.

Exchange Market Traditionally, stock markets were broken down into two categories—physical trading venues, such as the NYSE, and over-the-counter (OTC) marketplaces. Exchanges offer a centralized trading venue that functions as an open outcry auction market. The auctioneer who controls trading in a given stock is referred to as a designated market maker (DMM). Over time, many modern exchanges began to shift to hybrid trading methodologies in which trading would occur on a face-to-face basis on a physical floor as well as through electronic linkages.

Today, the distinction between physical and electronic markets is less important since many stock exchanges have eliminated their physical trading floors. Nasdaq, which is one of the world's largest stock markets, has always been an electronic trading venue, but is still classified by the regulators as an exchange. Any equity securities that meet the standards for trading on a national exchange (e.g., NYSE and Nasdaq) are referred to as *listed securities*.

Nasdaq The National Association of Securities Dealers Automated Quotation System (Nasdaq) is perhaps the most recognized equity dealer-to-dealer network (described below). Although it wasn't always the case, the SEC classifies Nasdaq as a securities exchange. The Nasdaq system provides quotes on select securities that have been properly registered and meet specific listing criteria, such as aggregate issuer assets, the number of shareholders, and the number of outstanding shares.

Dealer-to-Dealer Market When stocks don't qualify for listing on either a physical or electronic exchange, they're considered to be trading over-the-counter (OTC) and the stocks are referred to as *OTC equities* or unlisted securities. In OTC markets, trades occur in non-physical dealer-to-dealer networks that connect participants through phones or, more likely, computers. The OTC Pink Market (a platform that was created by the OTC Markets Group) is a network that provides dealers with quotes on these securities. The OTC Pink Market is not registered as an exchange with the SEC and typically doesn't have the same level of trading activity as the NYSE and Nasdaq.

 Copyright © Securities Training Corporation. All Rights Reserved.

Non-Equities Unlike equity securities, corporate, municipal, and U.S. government bonds don't have organized exchanges. Although some corporate bonds (e.g., convertible bonds) can be bought and sold on certain stock exchanges, most bonds are traded in the OTC market through various dealer-to-dealer networks.

Other Execution Methods and Venues

In recent years, market participants have created alternatives to the NYSE and Nasdaq for trading listed securities. Many broker-dealers have abandoned their market making operations on the traditional exchanges and directed orders to high frequency trading firms. Other broker-dealers have found alternative trading venues which compete with the NYSE and Nasdaq for trading volume.

The Third Market Electronic, internet-based trading doesn't require that orders be sent to the physical trading floor because alternative markets have emerged. The *third market* refers to exchange-listed securities being traded over-the-counter or away from traditional exchanges. While some of the trading in listed stocks still occurs on their primary exchanges, third-market volume has grown in the last several years. In a manner that's similar to traditional exchanges, the third market brings together investors and also accommodates after-hours trading.

The Fourth Market The fourth market refers to direct institution-to-institution trading and doesn't involve the public markets or exchanges. While some of this trading involves different portfolio managers contacting one another by phone, most true fourth-market trades are internal crosses set up by broker-dealers that execute trades for institutional accounts. These proprietary trading systems (PTSs) are established to facilitate the institution-to-institution trading are often considered a part of the fourth market.

Essentially, the third market involves transactions between dealer-brokers and large institutions, while the fourth market only involves transactions between large institutions. The activities of these markets have little or no influence on the workings of the typical stock trading by an average investor.

Electronic Communication Networks (ECNs) ECNs are market centers (i.e., exchanges) that allow for both the quoting and trading of exchange-listed securities. The objective of an ECN is to provide an electronic system for bringing buyers and sellers together (matching). These systems allow subscribers to disseminate information about orders, execute transactions both during the trading day and after-hours, and buy and sell anonymously. ECNs charge subscribers a fee for using their systems and act in only an agency (broker) capacity.

Dark Pools A dark pool is a system that provides liquidity for large institutional investors and high-frequency traders, but it doesn't disseminate quotes. The name is derived from the fact that the details of the quotes are concealed from the public. The system may be operated by broker-dealers or exchanges, and it allows these specific investors to buy and sell large blocks of stock anonymously. The objective is to allow these investors to trade with the least amount of market impact and with low transaction costs. Some dark pools provide order matching systems and may also allow participants to negotiate prices.

Copyright © Securities Training Corporation. All Rights Reserved.

Clearing and Settlement – An Overview

What happens after a trade occurs? At this point, the buyer and seller must agree on the terms of the transaction (*clear the trade*). Ultimately, the buyer is expected to pay for the security, and the seller is expected to deliver the security. This simultaneous payment and delivery process between the two parties is referred to as *settlement*. The modern securities clearing process is a complicated one that involves many parties that are tied together by various computer and communications systems. In a well-developed capital market, such as the one here in the U.S., the majority of trades are processed electronically with very few paper securities transactions occurring.

The Depository Trust & Clearing Corporation (DTCC)

The Depository Trust & Clearing Corporation is a securities depository and a national clearinghouse for the settlement of transactions in equities, corporate, municipal, and U.S. government bonds, mortgage-backed securities, money-market instruments, and over-the-counter derivatives. The DTCC also has significantly expanded its ability to process transactions in mutual funds and insurance products. The DTCC's function is to automate and centralize the clearing and settlement of trades among its (owners) members. Most major financial institutions in the U.S. are members of the DTCC system. The primary goal of the system is to eliminate physical securities in order to increase the speed and reduce the cost of clearing and settling trades.

The National Securities Clearing Corporation (NSCC) and the Fixed Income Clearing Corporation (FICC) are both subsidiaries of the DTCC. The NSCC clears equity trades for both U.S. and foreign issuers, while the FICC clears bond trades.

Ownership The DTCC is a non-profit, industry-owned corporation. Its owners include broker-dealers, investment banks, commercial banks, and mutual fund companies. The DTCC and its subsidiaries are regulated by the SEC and the depository is also a member of the U.S. Federal Reserve System.

Processing the Trade – Clearing and Introducing Firms

The clearing process will often involve two different types of firms—*clearing firms* and *introducing firms*. Due to the cost and complexity of creating and maintaining a fully functional trade processing area, many smaller broker-dealers (introducing firms) choose to hand off all or part of their trade processing and clearing functions to larger broker-dealers (clearing or carrying firms). The costs of clearing include a significant investment in hardware, software, and personnel.

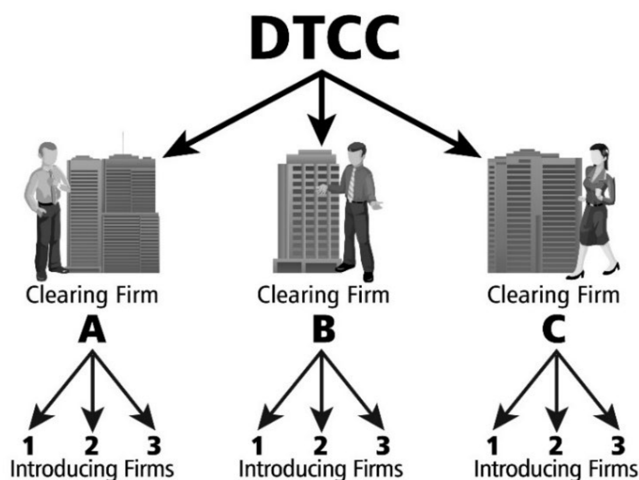
Let's take a look at the difference between the responsibilities of these two firms.

Clearing Firms One step below the DTCC on the trade processing hierarchy are the clearing firms (also referred to as *full-service firms*). These substantial broker-dealers perform order execution, clearing, and settlement functions. Clearing firms interface with the DTCC directly for both their own transactions as well as those of any other broker-dealers that choose to clear through them.

 Copyright © Securities Training Corporation. All Rights Reserved.

Introducing Firms Introducing firms neither process customer transactions nor do they operate their own clearing operations. Instead, they contract with clearing firms to perform these services. While customers of an introducing firm consider that firm to be their broker-dealer, customer funds and securities are actually physically held at the clearing firm, from which they generally also receive statements and confirmations.

The following diagram is an overview of the clearing process which involves both introducing and clearing firms:



Introducing Firms – Fully Disclosed Versus Omnibus Accounts

A clearing broker may provide introducing firms with back office and related recordkeeping functions on either a *fully disclosed* or *omnibus* basis. The differences between these two arrangements involve the level of detail the clearing firm will have regarding the customer as well as which entity will be responsible for providing trade details to the customer.

Introducing Firms – Fully Disclosed Accounts Many introducing firms operate through a clearing firm on a *fully disclosed basis*. This means that information about each of the individual customers of the introducing firm will be transmitted to the clearing firm and the clients' assets are held at the clearing firm. The clearing firm establishes separate accounts for each client and is responsible for all of the paperwork associated with the accounts, such as the delivery of confirmations and statements.

The paperwork will be identified as coming from the clearing firm, but it will contain additional identifying information so that the client can determine to which introducing firm the paperwork is related. For example, a client's statement may list ABC Clearing at the top of the document, but will also contain the name and contact information for XYZ Brokers, the introducing firm.

Copyright © Securities Training Corporation. All Rights Reserved.

Introducing Firms – Omnibus Accounts Not all of the relationships between introducing and clearing firms are fully disclosed. For example, ABC Bond Brokers, Inc. is a fixed-income broker-dealer that has a complete back-office operation for clearing its bond trades and holding customer positions. However, the firm will occasionally accept an order from a customer for common stock. Since the firm doesn't want to set up clearing operations to handle these infrequent accommodation transactions, it has arranged for DEF Clearing to execute and clear its customers' stock trades. ABC doesn't provide DEF Clearing with details regarding the individual clients. Instead, ABC uses a single *omnibus* account that's specifically designated by the clearing firm for customers of ABC Bond Brokers. In this type of arrangement, since the clearing firm doesn't have information on each individual customer, the recordkeeping responsibilities belong primarily to the ABC Bond Brokers, the introducing firm.

Other Customers of Clearing Firms

Although clearing firms have traditionally serviced smaller broker-dealers, these firms are not their only customers. Clearing firms also do extensive business with investment companies (mutual funds), investment advisers, and hedge funds. Investment companies will be described in Chapter 7.

Hedge Funds A hedge fund is a private, actively managed investment fund that uses sophisticated strategies in an attempt to generate returns that are higher than traditional stock or bond investments. These strategies could include:

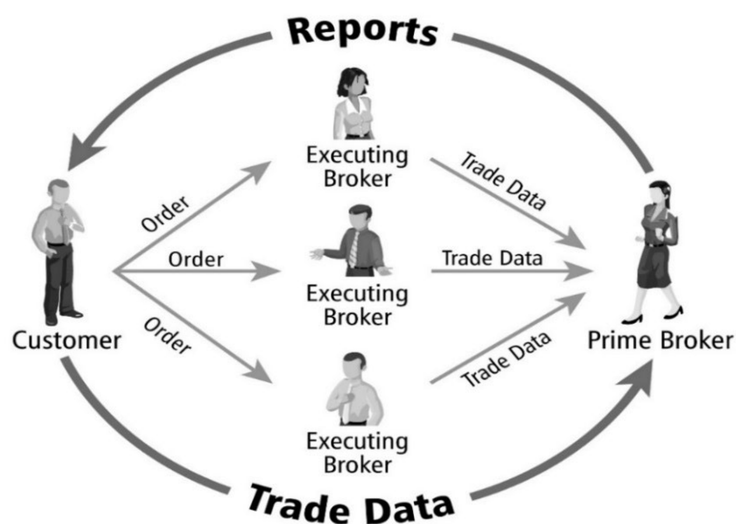
- Concentrated speculative investments on a given company or industry
- Arbitrage (a relational trade between two investments)
- Short selling (speculating on the downward movement of a company's stock)
- Currency or commodities trades
- Margin (the use of leverage)

Prime Brokerage Accounts One service that clearing firms typically offer is prime brokerage. The prime brokerage relationship consists of a bundled package of services that's offered to hedge funds, institutions, and high net worth individual clients. The clearing firm acts as a centralized location for holding all of the positions that were created by the various executing firms through which the client trades.

Prior to prime brokerage, clients were required to open a separate account at each executing broker-dealer. After trades were executed, each broker-dealer would then provide confirmations and statements to the client. The challenge for the client was the combining all of the information that it received from its various accounts to understand its overall position. In a prime-brokerage arrangement, the client chooses one firm as its prime broker to consolidate the bookkeeping process. Although the client may still use several broker-dealers for execution purposes (and as a source of research, allocations on IPOs, etc.), all of the trades are ultimately handled through its account at its prime broker. Therefore, the client receives one set of reports, rather than several.

Copyright © Securities Training Corporation. All Rights Reserved.

A simplified picture of this relationship follows:



Clearing Options Contracts

Options are derivative trading products that track the value of an individual stock, an index, or foreign currency. Options contracts can be purchased either on one of the options exchanges or in the over-the-counter market. Options contracts that are purchased on an exchange are referred to as listed options. Options contracts will be examined in Chapter 10.

Currently, listed options trade on the following exchanges:

- The Chicago Board Options Exchange (CBOE)
- The Boston Options Exchange (BOX)
- The NYSE Arca
- The Nasdaq PHLX (formerly the Philadelphia Stock Exchange)
- The International Securities Exchange (ISE)

A key feature of exchange-traded options is standardization, which means that the terms of the contracts are set and uniform. The DTCC doesn't clear options trades; instead, this is the job of the Options Clearing Corporation (OCC).

The Options Clearing Corporation (OCC) Listed options are issued and guaranteed by the Options Clearing Corporation much in the same way that the DTCC guarantees locked-in trades for its members. The OCC is regulated by the Securities and Exchange Commission and is owned proportionately by the exchanges where listed options trade.

The OCC acts as the third party in all option transactions. Broker-dealers deal directly with the OCC rather than with each other when settling trades. When customers buy or sell option contracts, their broker-dealers must settle the transactions with the OCC within one business day.

Copyright © Securities Training Corporation. All Rights Reserved.

Other Entities That Keep Markets Running Smoothly

In addition to DTCC, there are other types of financial institutions that help keep the equity, bond, and options markets operating smoothly. These intermediaries include custodians, transfer agents, registrars, and trustees. Each of these institutions are described in this final section.

Custodians Issuers typically use banks or other financial institutions to holds customers' securities for safekeeping. Although a custodian may hold assets in physical form, it's much more common for securities to be held in *book entry* (electronic) form.

Registrars and Transfer Agents Issuers that have publicly traded securities outstanding typically use banks or trust companies to keep track of the owners of their stocks and bonds. Typically, the firms that provide recordkeeping services act as both registrar and transfer agent.

A registrar's function is to maintain the ownership register of the issuer for each issue of its securities. The registrar records the name, address, and tax identification or Social Security number of each individual owner. These securities may be held in certificate form or by the investor's brokerage firm in street name (i.e., in the name of the broker-dealer).

The transfer agent is responsible for:

- The issuance and cancelation of certificates to reflect changes in ownership
- Maintaining a list of current shareholders who are eligible to receive additional shares after a stock split
- Acting as the company's paying agent for interest payments on bonds and for cash or stock dividends on equities
- Acting as proxy agent (sending voting materials) and mailing agent (mailing the company's financial reports to shareholders)
- Handling lost, destroyed, or stolen certificates

Securities Trustees For some types of investments, such as select bonds, loans, or trusts, a trustee is assigned to hold security interests that are created on trust for the benefit of various creditors (e.g., banks or bondholders). Some bond trustees also ensure that issuers abide by promises (covenants) that are found in a formalized agreement which is referred to as a *trust indenture.* Additionally, these trustees may represent investors in the event of default and/or bankruptcy.

Conclusion

This concludes the overview of the various market participants and their roles in the financial services industry as well as the structure of the securities markets. The next chapter will examine the regulatory framework in which issuers, financial firms, and investors transact business. Remember, this chapter was simply an overview. Later chapters will provide greater insight into the concepts that have been introduced in this first chapter.

 Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 1 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Understand the functions of a broker-dealer depending on the sector in which it operates:
  - Investment bankers in the primary market
  - Market makers in the secondary market
    - Distinguish between a firm acting as broker versus a dealer
- Compare and contrast the characteristics of different types of investors
  - Institutional, accredited, QIB, individual
- Understand the difference between the primary and secondary markets
- Identify the characteristics of:
  - Physical versus electronic market platforms
  - Regulated versus unregulated sectors of the market (NMS securities compared to OTC equities)
  - Third Market and Fourth Market
- Recognize the step-by-step transaction process from initiation to completion (and the unique terminology associated with each step)
- Understand the role of the DTCC in electronically handling the clearing, settlement, and custody of securities transactions
- Describe the distinction of roles between clearing and introducing firms
- Describe the roles of other participants in meeting the industry's recordkeeping and custody requirements

Create a Chapter 1 Custom Exam

Now that you've completed Chapter 1, log in to *my.stcusa.com*. From your Dashboard, select *Final Exams*, then scroll down and select *Create a Custom Exam*. Now, select *Chapter 1* and, at the bottom of the screen, enter 10 questions in the *Number of Questions* box, and then select *Build Exam*.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 2 – Overview of Regulation

- *How Firms are Regulated*
- *The Federal Reserve Board*
- *Fundamental Federal Acts*
- *The Securities Investors Protection Corporation*
- *Self-Regulatory Organizations*

Copyright © Securities Training Corporation. All Rights Reserved.

Passing the Securities Industry Essentials (SIE) Examination will be THE first step to achieving a career in the financial services industry. As this chapter will describe, financial services firms and their employees are subject to a significant number of federal, state, and industry regulations. This chapter will provide a broad overview of the securities industry's multi-layered regulatory structure.

Regulation

There are four tiers to regulation—federal laws, state laws, self-regulatory organization (SRO) rules and regulations, and firm-specific (in-house) policies and procedures. All of these different levels of regulation influence the activities of all persons who operate in the securities industry.

Federal Regulation

For broker-dealers, all of their capital raising, sales, trading, and operations activities are heavily regulated. The primary regulation comes from laws (also referred to as Acts) that have been passed by Congress. These Acts are enforced by the U.S. Securities and Exchange Commission (SEC), which is a part of the U.S. federal government.

The SEC The Securities and Exchange Commission is an independent, federal government agency that's responsible for protecting investors, maintaining fair and orderly securities trading markets, and facilitating capital formation in the primary market. The SEC is also charged with ensuring that Congress' demands are implemented.

Authority of the SEC The SEC has jurisdiction over securities transactions that are executed on an interstate basis (i.e., across state borders). The SEC may investigate potential securities law violations through its Division of Enforcement which prosecutes cases on behalf of the Commission. The SEC may also bring civil actions. If criminal activity is discovered by the Commission, the case falls under the jurisdiction of the Department of Justice (DOJ).

Other Federal Regulators

In addition to the SEC, other divisions of the federal government are involved in the securities markets. These include the Department of Treasury and the IRS, both of which are responsible for identifying and investigating illegal activities that have occurred (or may occur) within the financial markets (e.g., money laundering). In fact, the IRS also provides guidance to investors concerning the tax implications of holding, buying, and selling various types of securities.

The Federal Reserve Board (FRB) The Federal Reserve (the Fed) is an independent agency of the federal government that functions as the U.S. central bank. The Fed's Board of Governors, also referred to as the Federal Reserve Board (FRB), is responsible for controlling the nation's monetary policy (money supply and interest rates). The FRB's mandate is to create conditions which will result in maximum employment and stable prices.

Copyright © Securities Training Corporation. All Rights Reserved.

To do this, the FRB controls or sets the discount rate, reserve requirements, and margin requirements on securities purchases. In order to influence the rate that member banks charge each other on overnight loans (which is referred to as the fed funds rate), the Fed will buy and sell securities. These FRB tools will be examined in greater detail in Chapter 19.

Federal Deposit Insurance Corporation (FDIC) The Federal Deposit Insurance Corporation is an independent agency that was created by the Congress. The FDIC's role is to maintain stability and public confidence in the nation's financial system. The FDIC insures banking deposits and examines financial institutions for both safety and soundness in an effort to protect the nation's financial system. The current FDIC insurance coverage limit is $250,000 per depositor, per FDIC-insured bank.

SRO Regulation

Although the SEC is in charge of overall regulation, the creation and enforcement of day-to-day rules that brokerage firms must follow are often handled by self-regulatory organizations (SROs), including the Financial Industry Regulatory Authority (FINRA), the Municipal Securities Rulemaking Board (MSRB), and Chicago Board Options Exchange (CBOE), etc. The primary purpose of these different self-policing organizations is to promote fair and equitable trading practices. SRO rules require firms to use reasonable due diligence when dealing with customers. However, since SROs are not a part of the U.S. government, they lack the power to arrest or imprison any person who violates their rules.

Financial service firms (e.g., broker-dealers) are required to join an SRO and are referred to as *member firms*. The employees of these member firms are referred to as *associated persons.*

State (Blue-Sky) Regulation

Each state has the authority to impose additional requirements for issuers, broker-dealers and their agents (registered representatives), and investment advisers and their representatives. Typically, a state requires both broker-dealers and their agents to be registered in the state in order to transact business there. Additionally, issuers are generally required to register their securities prior to selling them in a given state. These rules, which are established under the Uniform Securities Act (USA), are referred to as the *blue-sky* laws due to the use of the term in a state court decision in the early 1900s.

North American Securities Administrators Association (NASAA) The provisions of the Uniform Securities Act (USA) are established by the North American Securities Administrators Association and enforced by the individual states. States typically enhance their securities regulations by imposing more stringent regulations than those that are written in the USA. Each state has its own securities regulations departments and the person is charge of is referred to as the Administrator or Commissioner. NASAA is the oldest international investor protection organization and its focus is protecting investors from fraud. NASAA's membership includes Administrators of the 50 states, the District of Columbia, the U.S. Virgin Islands, Puerto Rico, Canada, and Mexico.

Copyright © Securities Training Corporation. All Rights Reserved.

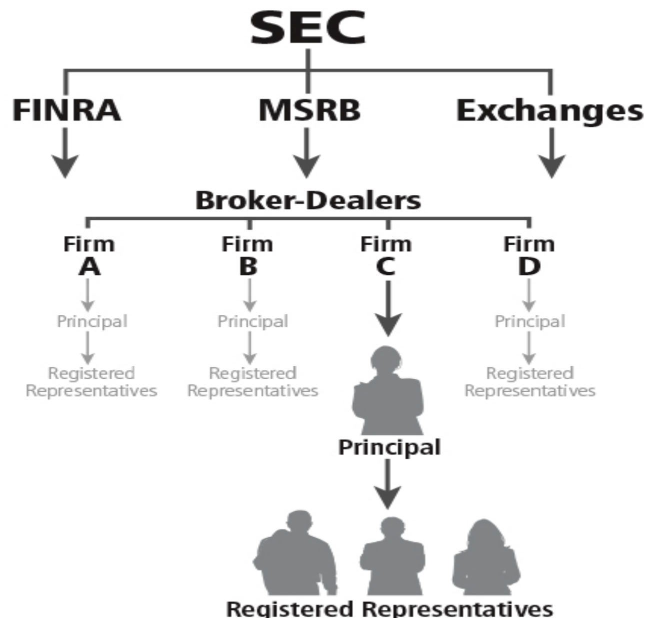
Firm (In-House) Rules

Member firms are required to establish and maintain a system to supervise the activities of their personnel. Firms must clearly outline their policies and procedures by creating internal Written Supervisory Procedures (WSP). A firm's WSP is essentially a manual that details the rules and identifies the person(s) responsible for their enforcement. Within a firm, there are three different categories of personnel—registered principals, registered representatives (RRs), and unregistered employees. The registered persons who manage and supervise RRs are referred to as principals. The unregistered employees are often administrative personnel, technology personnel, or other support staff.

Why Take the SIE Exam?

A person who is interested in the possibility of beginning a career in the securities industry will first need to pass the Securities Industry Essentials (SIE) Examination. However, many of these successful candidates will subsequently take jobs with broker-dealers or investment advisers which will require that they become registered as representatives of the firms (i.e., as registered representatives of broker-dealers or as investment adviser representatives of advisers.)

Once the SIE is completed, the candidate must take an additional exam, such as the Series 6, Series 7, or Series 79. Each representative will be assigned to a supervising principal who is responsible (and liable) for the representative's actions. As evidenced by the diagram below, an RR sits on the bottom of the regulatory pyramid.



Copyright © Securities Training Corporation. All Rights Reserved.

Federal Regulation – The Acts

Passing the SIE Exam requires an understanding of the regulatory environment in which securities are issued and traded. The following section is a brief description of some of the major federal legislations with which candidates will need to be familiar. Since the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940 are the most heavily tested regulations, they will be covered in greater detail in subsequent chapters.

The Securities Act of 1933

The Securities Act of 1933 was the first federal legislation to cover the securities industry and its main focus is the primary market. As mentioned in Chapter 1, the primary market refers to the market in which corporations and other issuers attempt to sell their securities (e.g., stocks and/or bonds) to the investing public. The Securities Act of 1933 demands that investors be provided with full and fair disclosure so that they're able to make informed investment decisions. The Act also provides specific rules for the conduct of both issuers and the investment bankers (underwriting firms).

The Securities Exchange Act of 1934

The Securities Exchange Act of 1934 establishes the rules for activities which are conducted in the secondary market. The two most recognized secondary markets are the New York Stock Exchange (NYSE) and Nasdaq. The Act of 1934 created the Securities and Exchange Commission (SEC) and gave it preeminent regulatory authority over domestic securities dealings in both the primary and secondary markets. Additionally, the Act of 1934 gave the Federal Reserve Board (FRB) regulatory oversight regarding the extension of credit (i.e., use of margin) in the securities industry. The margin requirements are established under the provisions of Regulation T. A margin account is created for investors who borrow money to purchase securities or to engage in the short selling of securities. Briefly, short selling is a trading strategy in which an investor borrows the shares that are sold. A short seller's belief is that the stock will decline in value (i.e., he's bearish) which will allow him to purchase the borrowed stock and deliver it back at a lower price. This type of trading will be covered in Chapter 12.

The Maloney Act of 1938

The Maloney Act allowed for the creation of non-exchange SROs. Most securities transactions are not executed on a physical exchange; instead, they're conducted in other venues that were referred to as over-the-counter (OTC) markets. The National Association of Securities Dealers (NASD) was created in 1939 to act as the self-regulatory organization for the OTC market. In addition, in 1975, the scope of the Maloney Act enabled the creation of the Municipal Securities Rulemaking Board (MSRB). However, in 2007, the NYSE and NASD merged their member regulation and enforcement functions and created the Financial Industry Regulatory Authority (FINRA).

 Copyright © Securities Training Corporation. All Rights Reserved.

As SROs, FINRA and the MSRB are responsible for maintaining fair and orderly securities markets, promoting best execution and fair treatment of clients, and establishing rules and regulations that protect investors.

The Investment Advisers Act of 1940

The Investment Advisers Act regulates firms that are established as investment advisers (IAs). The Act both defines the term investment adviser and provides a number of exclusions from the IA definition. To meet the investment adviser definition, a firm must satisfy all three parts of an ABC Test which includes:

- Providing **A**dvice,
- Operating as a **B**usiness, and
- Receiving **C**ompensation for the advice

Examples of investment advisers include firms that manage mutual fund portfolios as well as firms that manage *wrap accounts* and collect a single fee to cover the costs related to investment advice along with the costs of transactions.

Exclusions from the IA definition are available to broker-dealers, specific types of professionals (lawyers, accountants, teachers, engineers), and publishers. For the professionals to be excluded, the investment advice being provided must be incidental to their actual profession. For example, if an accountant decides to hold himself out to the public as an investment adviser and charge a separate fee for that service, the exclusion will not apply.

The result of the Investment Company Act and the Investment Advisers Act is that a mutual fund must register with the SEC as an investment company and the firm that manages the assets of the mutual fund must register as an investment adviser.

The Securities Investor Protection Act of 1970 (SIPA)

The SIPA enabled the creation of the Securities Investor Protection Corporation (SIPC); an industry-funded, non-profit insurance entity. SIPC provides insurance coverage for the customers of brokerage firms in the event that the firms become insolvent (bankrupt); however, it doesn't protect the customers against market losses or employee misconduct.

SIPC covers securities that are registered in street name (i.e., customer securities being held in the name of the broker-dealer). Any broker-dealers that use the mails or other instruments of interstate commerce are required to be members of SIPC.

SIPC Coverage SIPC provides coverage for each separate customer (retail and institutional) to a maximum of $500,000, of which no more than $250,000 may be for cash holdings. If a customer maintains both a cash and a margin account with the same brokerage firm, the accounts are combined when determining SIPC coverage.

Copyright © Securities Training Corporation. All Rights Reserved.

A cash account is established if a customer doesn't borrow funds from a brokerage firm, while a margin account involves a customer borrowing funds to purchase securities. However, a customer who maintains a joint account with a spouse or a customer who has an IRA each have separate coverage for these accounts.

The following examples will clarify the rule:

Customer 1 has a cash account and a margin account with a broker-dealer. She has $300,000 of stock and $50,000 of cash in her cash account and her margin account has equity of $40,000. In this case, the cash account and the margin account will be combined for determining SIPC coverage. The customer will be protected for a total of $390,000. In a margin account, it's the equity balance, not the market value, that's subject to SIPC coverage.

Customer 2 has a cash account with $50,000 of securities and $320,000 of cash. He's protected for a total of $300,000 ($50,000 securities and $250,000 cash), since the maximum protection for cash is $250,000.

Customer 3 has a cash account with $180,000 of securities and $10,000 of cash and a joint account with her husband that contains $400,000 of securities. Her cash account is protected for a total of $190,000. Her securities are covered in full and, since her cash position is less than $250,000, it too is covered in full. The joint account is considered as a separate customer and receives full coverage.

Not Covered SIPC coverage doesn't apply to:

- Securities that are specifically identifiable as belonging to a customer (not in street name) since these types of securities are distributed to the customer without regard to the dollar limits
- Commodities accounts
- Other broker-dealers that have securities in the possession of a failed broker-dealer
- Personal accounts of senior officers of the firm

SIPC Procedures If a broker-dealer declares bankruptcy, a trustee is appointed by a federal court. The trustee is required to notify the broker-dealer's customers of the firm's insolvency and handle the orderly liquidation of the funds and securities that are in the broker-dealer's possession.

If a customer has a claim for securities that cannot be specifically identified as being in the possession of the broker-dealer, the dollar amount of the customer's claim will be based on the market value of the securities on the day that the court appoints a trustee. Securities that are in the possession of the failed broker-dealer will be distributed to customers. If there are insufficient securities in the possession of the failed broker-dealer, the securities on hand will be distributed to the claimants on a proportionate basis.

Customers who have claims that exceed the maximum dollar limits of SIPC coverage will rank with other general creditors for the balance of their claims. For example, a customer who has stock in the possession of a failed broker-dealer with a value of $525,000 will receive SIPC coverage of $500,000, but will be treated as a general creditor for the remaining $25,000.

Copyright © Securities Training Corporation. All Rights Reserved.

SIPC Disclosure When an account is opened, SIPC member firms must provide all new customers with written notification that they may obtain information about SIPC by contacting the insurer. The firm must provide customers with both SIPC's website address and a telephone number that may be used to obtain the referenced information. This information includes the SIPC brochure—a detailed document that explains coverage under the insurance program.

In addition, member firms must provide existing customers with this information in writing at least once per year. In situations in which both an introducing firm and a clearing firm service an account, either one of these firms may fulfill these requirements.

The Employee Retirement Income Security Act of 1974 (ERISA)

ERISA covers the administration of private, qualified retirement accounts, such as the popular 401(k) plans. ERISA provides standards for the funding, vesting, and eligibility of these plans, as well as the fiduciary responsibilities of pension fund trustees.

The Securities Acts Amendments of 1975

These Amendments created the Municipal Securities Rulemaking Board (MSRB) to act as the SRO for firms that transact business in municipal securities. Although the MSRB has no enforcement authority, it's responsible for formulating and interpreting the rules and regulations that are then enforced by other regulatory entities, such as FINRA or the SEC.

The Insider Trading and Securities Fraud Enforcement Act of 1988

The Insider Trading Act was created as a response to the scandals of the 1980s. Insider trading involves the illegal trading on the material, non-public information (i.e., information that's not available to the public that could affect the value of publicly traded securities). Both tippers (information givers) and tippees (information receivers) may be held liable for violations.

Although insider trading was prohibited by the Acts of 1933 and 1934, there were no specific penalties prescribed. For any individuals convicted of insider trading, the Act of 1988 established criminal penalties to include a fine as high as $5 million and/or up to 20 years imprisonment. At the civil level, the SEC may sue for up to three times the profit made or loss avoided (referred to as *treble damages*).

The Penny Stock Reform Act of 1990

The Penny Stock Reform Act regulates the solicited sales of certain low-priced securities to potential new customers. Penny stocks are defined as non-exchange-traded securities (i.e., OTC equities) that trade for less than $5 per share. Since penny stocks are often risky investments, the rules require firms to obtain a signed disclosure document from potential buyers which states that they understand the risks involved. Two of the primary risks of penny stock investments are their high volatility and low liquidity.

Copyright © Securities Training Corporation. All Rights Reserved.

The Federal Telephone Consumer Protection Act of 1991

The Telephone Consumer Protection Act was passed to address consumer complaints that related to the practice of cold calling. Due to the Act, any person with a profit motive who calls prospects must maintain a Do Not Call List and refrain from continuing to solicit business from any persons who request that their name be placed on that list. Solicitation calls may only be made from 8:00 a.m. to 9:00 p.m. local time of the called party.

The USA PATRIOT Act of 2001

The purpose of this Act is to deter and punish any terrorist acts that occur both in the U.S. and around the world, to enhance law enforcement investigatory tools, to establish a process for verifying the identity of potential customers, and to strengthen measures to prevent, detect and prosecute international money laundering and financing of terrorism. Additionally, the Act requires all appropriate elements of the financial services industry to report potential money laundering.

SIE candidates must be able to quickly pick out the relevant rules and regulations that apply to a situation. Since the information above is simply a quick snapshot of each law, more detailed information about them will be provided in later chapters.

The following page will provide a summary of all of the important Acts that may appear in exam questions.

Copyright © Securities Training Corporation. All Rights Reserved.

Federal Law Summary	
The Name of the Law	**Key Words or Relevant Points to Look for on the SIE Examination**
Securities Act of 1933	▪ IPO and new issue regulation ▪ Primary markets ▪ Issuer sales ▪ Full disclosure through a prospectus ▪ Red Herring ▪ No SEC approval
Securities Exchange Act of 1934	▪ Secondary market (trading markets) regulation ▪ Established antifraud rules and margin requirements (Reg. T) ▪ Created the SEC
Maloney Act of 1938	▪ Created the former SRO for Over-the-Counter (OTC) Markets (the NASD)
Investment Company Act of 1940	▪ More than 100 shareholders ▪ Minimum $100,000 in assets ▪ Annual reports to SEC; semiannual reports to shareholders
Investment Advisers Act of 1940	▪ ABC Test (Advice, Business, Compensation) ▪ Incidental advisers (lawyers, accountants, teachers, engineers) are excluded from the adviser definition
Securities Investor Protection Act of 1970 (SIPA)	▪ Protection against broker-dealer bankruptcy ▪ $500,000 coverage per separate customer ▪ $250,000 limitation on cash coverage ▪ Industry-funded; not part of U.S. Government
Insider Trading and Securities Fraud Enforcement Act of 1988	▪ Misuse of material, non-public information by any person ▪ SEC may sue for treble damages (three-times) ▪ $5,000,000 maximum fine and/or 20 years imprisonment ▪ Tippers and tippees may both be liable
Telephone Consumer Protection Act of 1991 (TCPA)	▪ Do Not Call Lists ▪ Call time limited to 8:00 a.m. to 9:00 p.m. (customer's time zone)
The USA PATRIOT Act of 2001	▪ Anti-Money Laundering ▪ Currency Transaction Reports (CTRs) for transactions exceeding $10,000 ▪ Suspicious Activity Report (SAR) for transactions equal to or exceeding $5,000 ▪ Customer Identification Program (CIP)
Penny Stock Reform Act of 1990	▪ Regulates solicited sales of penny stocks ▪ Stock priced below $5.00 per share ▪ Establishes significant disclosure rules

Copyright © Securities Training Corporation. All Rights Reserved.

Self-Regulatory Organizations

FINRA

As previously described, the Financial Industry Regulatory Authority (FINRA) is the primary SRO for the securities industry and is responsible for the content of the SIE Exam. Many of the rules on which candidates will be tested are FINRA rules and may be broken down into the following categories:

1. ***Conduct Rules*** These rules govern the interactions between customers and firms and cover areas such as compensation, communications, and sales practice violations. Many of these rules will be covered in Chapters 17 and 18.
2. ***Uniform Practice Code (UPC)*** UPC rules govern trading and the proper settlement of transactions. The goal of the Uniform Practice Code is to standardize the procedures for doing business in financial markets. Examples of UPC issues likely to be encountered on the examination include settlement and corporate actions which will be covered in Chapter 13.
3. ***Code of Procedure (COP)*** The COP covers the process used to discipline any person that violates FINRA rules. Remember, FINRA acts like a COP for the securities industry (using the COP).
4. ***Code of Arbitration*** The Code of Arbitration provides a process for resolving disputes between members, as well as those that involve public customers. Generally, arbitration is used to settle monetary disputes.

The table below summarizes the use of the Code of Procedure versus the Code of Arbitration:

	Code of Procedure	Code of Arbitration
Purpose	Determine disciplinary actions for rule violations	Provide for settlement of disputes
Parties	FINRA versus broker-dealers and/or registered representatives	Broker-dealers, RRs, customers
Possible Negative Outcomes	▪ Fine ▪ Censure ▪ Suspension ▪ Expulsion ▪ Other appropriate sanctions	Monetary or other compensation settlements
Appeal Process	Yes	No

The Municipal Securities Rulemaking Board (MSRB)

The Securities Acts Amendments of 1975 required dealers that participate in municipal securities transactions to be registered with the SEC and also created the Municipal Securities Rulemaking Board. The MSRB was established to function as an independent, self-regulatory organization and charged with primary rulemaking authority for the municipal securities industry.

 Copyright © Securities Training Corporation. All Rights Reserved.

The MSRB requires every broker or dealer that engages in municipal securities business to comply with its rules. The MSRB is mainly concerned with the standards of professional practice, including qualifications of broker-dealers, rules of fair practice, and recordkeeping. Interestingly, MSRB rules don't apply to the issuers of municipal securities.

Enforcement of MSRB Rules Although the MSRB formulates and interprets its rules, it has no enforcement power. Instead, the MSRB is controlled by the SEC and MSRB rules are enforced by either the SEC or another regulatory agency.

Type of Firm:	MSRB rules are enforced by:
Broker-dealers	▪ SEC or FINRA
Bank dealers	▪ Comptroller of the Currency for national banks ▪ Federal Reserve Board for non-national banks that are members of the FRB system ▪ Federal Deposit Insurance Corporation (FDIC) for non-national banks that are not members of the FRB system

The Chicago Board Options Exchange (CBOE)

The CBOE functions as a trading venue for options contracts in individual stocks, stock indexes, interest rates, as well as exchange-traded funds (ETF) and is also the SRO for the options market. The CBOE is the largest options market in the U.S. and is regulated by the Securities and Exchange Commission and owned by CBOE Global Markets. The specifics of option contracts will be covered in Chapter 10 and ETFs will be covered in Chapter 9.

Firm Specific Rules

Internal Compliance

Not all oversight is handled by the SEC or FINRA. Internal compliance professionals (many of whom are principals) oversee all employee and customer activities to ensure that both federal securities laws and industry rules are being followed. For example, a member firm's supervising principals routinely monitor both employee and client trading activity to uncover evidence of wrongdoing, such as insider trading.

Essentially, compliance works with sales professionals to develop policies and procedures which allow them to sell securities and to grow the firm's business in an ethical and compliant manner. Compliance professionals are responsible for creating their firms' house rules that form the basis of the previously described *Written Supervisory Procedures (WSPs*). These "in-house" rules are not tested on the SIE Exam since they vary from firm-to-firm. When preparing for the SIE Exam, an important distinction to remember is that a firm's internal rules may be more stringent and materially different from the minimum standards that are set by the SEC and SROs.

Copyright © Securities Training Corporation. All Rights Reserved.

The Importance of Understanding Regulation

There are two reasons for devoting such a significant amount of time to covering the different regulations. The first is to reinforce the importance of these regulations by providing a framework that will be helpful once a person begins her career in the financial services industry. The second is that the test itself is prepared by the major SROs—namely FINRA and the MSRB. In large part, passing the SIE Examination is a function of knowing the general and specific rules and regulations that govern the securities industry from the perspective of the SEC and the SROs that enforce these same rules and regulations.

Conclusion

This concludes the two overview chapters. Chapter 1 detailed the various market participants, while this chapter examined the regulatory framework in which these market participants operate. Now let's begin to examine the various securities products, with special emphasis placed on reviewing their risks and rewards.

Chapter 2 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Describe the roles of U.S. government agencies that influence the securities markets:
  - The SEC
  - The FRB ("the Fed")
  - The FDIC
- Compare and contrast the roles of the SEC and NASAA
- Describe the purpose for the SIE Exam, what passing the exam means, and potential next steps
- Compare and contrast the characteristics of:
  - The Securities Act of 1933 and the Securities Exchange Act of 1934
- Compare and contrast the characteristics of:
  - The Investment Company Act of 1940 and the Investment Advisers Act of 1940
- Understand the purpose of the Securities Investor Protection Act of 1970
  - Recognize and apply SIPC protection coverage provisions
- Compare and contrast the characteristics of:
  - The Code of Conduct and the Code of Arbitration
- Understand the Federal Law Summary Table
- Understand the unique characteristics of the MSRB as an SRO
- Recognize the responsibility firms have to establish a written supervisory procedures (WSP) manual

Create a Chapter 2 Custom Exam

Now that you've completed Chapter 2, log in to *my.stcusa.com* and create a 10-question custom exam.

 Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 3 – Equity Securities

- *Corporate Structure*
- *Characteristics of Common Stock*
- *Classifications of Common Stock*
- *Types of Preferred Stock*
- *Rights vs. Warrants*

Copyright © Securities Training Corporation. All Rights Reserved.

The goal of this chapter is to increase a person's knowledge of the following equity-related concepts: features of ownership (e.g., order of liquidation and limited liability), voting rights, convertibility, as well as control and restrictions (e.g., SEC Rule 144). The process of issuing and trading these securities will be covered in Chapter 11 of the study manual.

The Corporation – Equity Securities

Many businesses are organized as corporations. As a legal entity, a corporation may engage in many of the activities that a natural person is able to do. For example, it may buy property, obtain loans, sue, and be sued. Although a corporation is owned by its shareholders, the business is considered a separate person under the law and, therefore, an individual shareholder generally is not held personally responsible for the corporation's debts. If a business fails, the most a shareholder can lose is her original investment. In other words, shareholders have *limited liability*.

Corporate Organization

Corporations can vary in both size and complexity—ranging from large international conglomerates to small family businesses. However, the basic legal structure remains the same. The shareholders of the company elect a board of directors (BOD) and this board is responsible for overseeing the company and appointing its senior managers.

Raising Capital – Financing the Corporation

After being formed, it's inevitable that a corporation may need to raise additional capital (money) to fund its operations. As briefly mentioned in Chapter 1, there are two basic methods that corporations use to raise money—debt financing and equity financing. An issuer that sells bonds (debt) is borrowing money from the investors who buy the bonds. The funds are borrowed for a predetermined period and the company is required to make interest payments to the bondholders over the life of the bond. Bondholders are not considered owners and therefore they have no voting rights. For bond investors, their returns are limited to the interest that the corporation pays them for the use of their money.

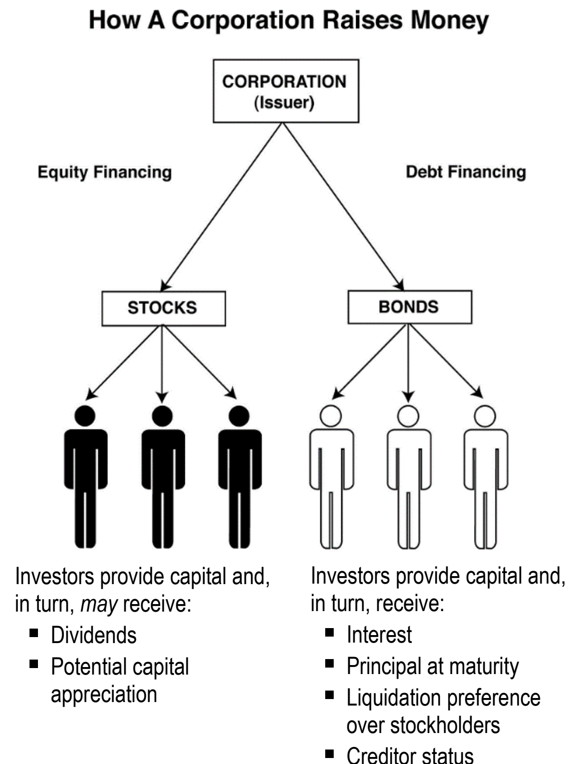
The other way for a corporation to raise money is to issue stock. Unlike bondholders, investors who purchase stock become part owners of the corporation. Since the investors are provided with an ownership interest in the corporation, these securities are referred to as equities. Stockholders don't receive guaranteed interest payments and there's no maturity date on their investments.

So, what's the upside for equity investors? If a company prospers, the shareholders can expect to share in its profits in the form of cash or stock distributions (dividends) and experience an increase in the value of their shares. However, if a company fails, the shareholders are more likely than other investors to lose their entire investment. This is due to the fact that, if the corporation is forced to liquidate its assets under Chapter 7 bankruptcy, bondholders and other creditors have a higher claim to the company's assets and will be paid first.

 Copyright © Securities Training Corporation. All Rights Reserved.

Different Types of Equity Securities

Common Stock There are two main types of stock that a corporation may issue—common and preferred. Common stock is the traditional form of equity and common stockholders are the last to be paid if the corporation declares bankruptcy. Common stockholders may receive dividends, but only after the corporation's bondholders (if any) have been paid their interest and the preferred stockholders (if any) have been paid their stated dividend.



Preferred Stock The second form of equity is preferred stock. In the capital structure, preferred stock is considered a *senior* security above the common stockholders, but it still ranks below the bondholders. The name *preferred* is derived from the fact that these owners have preference over common stockholders regarding payment of dividends. This preference also extends to a bankruptcy proceeding conducted under Chapter 7 or Chapter 11 of U.S. law. In both Chapter 7 and Chapter 11 bankruptcy proceedings, the corporation's secured creditors have the highest claim. Administrative claim holders are paid next, followed by unsecured creditors, then are preferred stockholders, and the last to receive payments are common stockholders.

Common Stock

Common stock is (1) the basic unit of corporate ownership, (2) the most widely issued type of stock, and (3) the first type of stock that a corporation issues. For bookkeeping purposes, common stock is usually issued with a par (face) value that's an arbitrary amount and is used for the company's financial statement. There's no relationship between the par value of an equity security and its market value. Let's analyze the progression of a company's shares from the time of incorporation to the point at which the corporation may choose to purchase its shares in the open market.

Copyright © Securities Training Corporation. All Rights Reserved.

Authorized Shares At the time of incorporation, a company is authorized to issue a certain number of shares. Once the original number of shares is set, it can be changed only by a majority vote of the stockholders and by revising the corporate charter (the documents that establishes the corporation). Most corporations issue fewer shares than what's authorized in order to keep a certain amount of stock available for future use.

Issued Shares Issued shares represent the number of shares that have been sold by the corporation. Any shares that haven't been sold or distributed are referred to as unissued shares.

Treasury Stock For various reasons, a corporation may ultimately repurchase some of its issued shares. When stock is issued and subsequently repurchased by the company, it's referred to as treasury stock. As long as the stock remains in the treasury, it has no voting rights and doesn't receive dividends. Treasury stock appears as an informational item on the corporation's balance sheet.

Outstanding Stock The term outstanding stock refers to the number of shares that have been issued to the public, *minus* any stock that has been repurchased by the company (treasury stock). Outstanding stock receives dividends and has voting rights. Many market professionals refer to a company's *market capitalization* to indicate its size, which is found by multiplying the current market price of the stock by the number of outstanding shares.

Issued Stock – Treasury Stock = *Outstanding Stock*

Example: Although ABC Corporation is authorized to issue 10,000,000 shares, it has only issued 4,500,000 million shares. Later, due to ABC having repurchased 500,000 shares of the stock for its treasury, ABC has 4,000,000 shares outstanding.

Rights of Common Shareholders

As specified in a corporation's charter and bylaws, all shareholders are provided with certain rights, which may include the following:

- Right of inspection
- Right to vote
- Right to receive dividends
- Right to evidence of ownership
- Right of transfer

Right of Inspection Stockholders have the right to inspect certain books and records of the company, including the stockholders' list and the minutes of stockholders' meetings. This right is usually exercised through the receipt of an audited annual report.

 Copyright © Securities Training Corporation. All Rights Reserved.

Right to Vote The ability to vote is typically associated with common stockholders. They may attend annual shareholder meetings and vote on important issues, including the election of members to the board of directors, whether the stock may be split, and whether the company is able to merge with or acquire another company. It's important to remember that shareholders vote on whether the corporation may execute a stock split, but NOT on whether the corporation should pay cash and/or stock dividends. Rather than allowing common stockholders to decide whether they deserve any form of distribution, all dividend decisions are made by the board of directors. The number of votes that are available to each shareholder is determined by the number of shares the person owns. For instance, if a person owns 100 shares, she's provided with 100 votes. If any shareholders are unable to vote in person, they can vote by proxy which involves allowing another person to cast their votes.

Corporations may issue different classes of common stock. Class A common shares allow the holders the ability to vote. However, Class B stock may be issued with no voting rights, limited voting rights, or super voting rights. Class A stock generally carries a higher value than any Class B stock that offers either no voting rights or limited voting rights.

Voting Methods The two different voting methods that may be used by a company are *statutory* and *cumulative*. With *statutory voting,* a shareholder is given one vote, per share owned, per voting issue. Therefore, the more shares a person owns, the greater her voting power. For that reason, statutory voting is considered to be beneficial for the larger, more substantial (majority) shareholders.

With *cumulative voting*, shareholders are able to multiply the number of shares that they own by the number of voting issues. The result of that calculation is the total number of votes that shareholders may cast in any manner that they choose. Cumulative voting tends to favor the smaller, less substantial (minority) shareholders.

> *Example: XYZ Corporation is holding an election for it board of directors. There are three seats available, but five potential candidates. With three seats available, this represents three voting issues. If shareholders are required to use statutory voting, an investor who owns 1,000 shares is able to cast a maximum of 1,000 votes to three of the five candidates. On the other hand, if cumulative voting is required, an investor who owns 1,000 shares is able to cast 3,000 votes in any manner that she chooses (1,000 shares x 3 voting issues), which is a significant benefit if she really favors one of the five candidates.*

The following diagram shows the difference between statutory and cumulative voting:

	Candidates				
	1	2	3	4	5
Statutory:	1,000 votes		1,000 votes		1,000 votes
Cumulative:		3,000 votes			

Copyright © Securities Training Corporation. All Rights Reserved.

Please note, the statutory voter could have chosen to cast votes for only two of the directors, but would still be limited to a maximum of 1,000 votes for each. The cumulative voter's 3,000 votes could have been cast in multiple ways (e.g., 1,500 votes for 2 candidates or 1,000 votes for 3 directors).

Right to Receive Dividends Although not guaranteed, companies will often pay out a portion of its profits to shareholders. The portion of a company's profit that's paid to common and preferred shareholders is referred to as a *dividend*. Dividend payouts and stock splits will be covered in detail in Chapter 13.

Right to Evidence of Ownership Shareholders have the right to receive one or more stock certificates as proof of ownership. The certificate states the name of the corporation, the name of the owner, and the number of shares that are owned by the stockholder. The certificate must also show the names of both the transfer agent and registrar and include the signature of an authorized corporate officer. As with a check, a stock certificate must be endorsed by the owner when it's sold to be considered in good deliverable form.

Right of Transfer Stockholders have the right to freely transfer their shares by selling them, giving them away, or bequeathing them to heirs. There are some cases in which shares are not freely transferable, such as when a person buys shares before the company's initial public offering (IPO) or acquires shares as part of their work compensation. These *restricted* shares often include a legend (warning) to indicate that the shares are ineligible for transfer.

Restricted Securities – Lock-Up Agreements and Legends For certain investors who own restricted securities, a lock-up agreement dictates the amount of time that pre-IPO investors (e.g., private placement buyers, management, venture capitalists, and other early investors) must wait before selling their shares after the company has gone public. Although these lock-up agreements will generally expire six months following the closing of the company's IPO, there's no statutory time limit. The lock-up is designed to prohibit management and venture capitalists that initially funded the company from immediately liquidating their shares for a profit once the issue goes public.

The lock-up period also restricts or limits the supply of shares being sold in the market. Shares that are subject to a lock-up agreement will have the restrictive legend printed across the face of the certificate to indicate that the securities haven't been registered with the SEC and are not eligible for resale unless the legend is removed. In many cases, the removal of the legend is accomplished under SEC Rule 144.

Rule 144

Rule 144 regulates the sale of *restricted* securities and *control* (affiliated) securities. Restricted securities are the unregistered securities that are typically acquired by investors through private placements. Control securities are registered securities that are acquired by control (affiliated) persons in the secondary market. Control persons may include officers, directors, or other insiders (those with more than 10% ownership) and their respective family members. Both restricted securities and control securities must be sold according to the provisions of Rule 144.

 Copyright © Securities Training Corporation. All Rights Reserved.

Holding Period For the *restricted securities* of a reporting company (one that's subject the reporting requirements of the Securities Exchange Act of 1934), the purchaser must generally hold the securities for *six months* before he can dispose of them. The six-month holding period starts from the time the securities were fully paid for (no margin) by the original purchaser. However, there is no holding period requirement that applies to control securities. In other words, securities that are acquired in the public market are not restricted and there's no mandatory holding period for an affiliate that purchases the securities. Despite the lack of a required holding period, the resale of an affiliate's control securities is subject to other conditions of the rule.

Notice of Sale Under Rule 144, a person that intends to sell either restricted or control securities must notify the SEC by filing Form 144 at the time the sell order is placed with the broker-dealer. Once notification is made, the SEC provides a 90-day period during which the securities may be sold. If the securities are not sold during this period, an amended notice must be filed. An exemption from the notice of sale requirement is available if the amount of the sale doesn't exceed 5,000 shares and the value of the securities doesn't exceed $50,000. In other words, if a person is not selling an excessive number of shares and the aggregate dollar value of the sale is insignificant, no filing with the SEC is required.

Volume Limitation Under Rule 144, the maximum amount of securities that a control person of an exchange-listed company may sell over any 90-day period is the *greater* of 1% of the total shares outstanding or the average weekly trading volume during the four weeks preceding the filing.

For example, an issuer has 7,000,000 shares outstanding and the average weekly trading volume for the past four weeks was 60,000 shares. Since 1% of the total shares outstanding is 70,000 shares and the four-week average is 60,000 shares, the holder can sell the greater of these two amounts, which is 70,000 shares.

Classification of Stocks

Specific stocks are often categorized based on the size (e.g., large-, mid-, or small-cap) or type of issuing company, assumed risk, expected return, or correlation to the business cycle. The following section lists some of the more common classifications.

Blue-Chip Stocks

Blue-chip stocks are high-grade issues of major companies that have long and unbroken records of earnings and dividend payments. The term is used to describe the common stock of large, well-established, stable, and mature companies that have great financial strength.

Growth Stocks

A growth stock is an issue of a company whose sales, earnings, and share of the market are expanding faster than the general economy and the industry average. Typically, this type of company is aggressive, research minded, and retains most of its earnings to finance expansion and, therefore, pays little or no cash dividends.

Copyright © Securities Training Corporation. All Rights Reserved.

Defensive Stocks

Defensive stocks are associated with companies that are resistant to a recession, including sectors of necessary services (utilities), production of consumer staples (tobacco, pharmaceuticals, soft drinks, and candy), and essentials (food). Essentially, defensive stocks are related to companies that perform well regardless of the current economic environment. It's important to distinguish between a defensive stock and a defense stock. A defense stock is issued by a company that's involved in the manufacture of materials that are used by the armed services to defend the country.

Income Stocks

Income stocks are issued by companies that pay higher-than-average dividends in relation to their market price. This type of stock is generally attractive to investors, particularly the elderly and retired, who are interested in current income as opposed to capital appreciation. Utility stocks are often placed in the income stock category

Cyclical Stocks

Cyclical stocks are associated with companies whose earnings fluctuate with the business cycle. When business conditions improve, the company's profitability is restored and the price of its common stock rises.

However, when conditions deteriorate, business for the company falls off sharply and its profits are diminished. This ultimately causes the stock's price to decline. Examples of companies whose stock is considered cyclical include household appliance, steel, construction, and automobile companies.

American Depositary Receipts (ADRs)

ADRs facilitate the trading of foreign stocks in the United States. An ADR represents a claim to foreign securities while the actual underlying shares are held by U.S. banks located overseas. ADRs trade in U.S. markets, either on an exchange or over-the-counter, and are priced and pay dividends in U.S. dollars, rather than in a foreign currency. ADR shareholders have dividend rights, but don't directly receive preemptive rights (to be covered shortly).

An ADR may be sponsored or unsponsored. For a *sponsored* ADR, the company whose stock underlies the ADR pays a depositary bank to issue ADR shares in the U.S. This sponsorship permits the company to raise capital in the U.S. and list the ADR on either the NYSE or Nasdaq. Many of the largest ADRs are sponsored. For an *unsponsored* ADR, the company doesn't pay for the cost associated with trading in the U.S.; instead, a depositary bank issues the ADR. Unsponsored ADRs trade in the OTC market and are usually quoted on the OTC Link—an electronic exchange that executes trades in securities that are not eligible for NYSE or Nasdaq listing.

Copyright © Securities Training Corporation. All Rights Reserved.

Preferred Stock

Preferred stock is often issued by established companies that already have common stock outstanding. These shares are suitable for investors who are more interested in income than capital appreciation (i.e., the same type of investors who might otherwise purchase bonds). Unlike common shares, preferred shares generally lack voting rights.

Preferred stock is normally issued with a par (face) value of $100, which corresponds to its initial market price, and carries a specified dividend. For example, a 5% preferred stock is expected to pay an annual dividend of $5 (5% of the par value of $100). However, the dividend rate for preferred stock may also be stated as a dollar amount (e.g., $3 preferred stock is expected to pay a 3% annual dividend). A preferred stock's dividend rate generally represents the maximum amount that the preferred stockholders may receive. If a company is not doing well, its board of directors may choose to pay less than the full amount or may choose to pay nothing at all.

Corporations attempt to make their preferred stock marketable to specific investors by adding features to their shares. Let's examine the different types of preferred stock.

Cumulative Preferred Stock

What happens if a corporation fails to pay the full dividend on its preferred stock? If the preferred stock is *cumulative*, then all of the preferred dividends that are in arrears (owed) must be paid before the common stockholders receive dividends. Most preferred stock is cumulative.

Assume that Widget, Inc. has issued 5% preferred cumulative stock. Over the last three years, the widget market has been in turmoil due to the introduction of the gidget—a cheaper foreign-made substitute. As a result, Widget, Inc. has paid only the following dividends to its preferred stockholders:

	Dividends Paid	Dividends in Arrears
Year 1	$2	$3
Year 2	$2	$3
Year 3	$3	$2

In Year 4, the widget market rebounds after several gidgets spontaneously combust. Now Widget, Inc. has sufficient earnings to pay dividends to both its preferred and common stockholders. Before the common stockholders receive any dividend payments, the company must pay $13 to the preferred shareholders (the missing amounts of $3 for Year 1, $3 for Year 2, $2 for Year 3, and the full stated $5 for Year 4).

Non-Cumulative Preferred Stock

If preferred stock is *non-cumulative*, any missed dividend payments don't accumulate. Instead, only the current year's dividend must be paid before common stock dividends are paid.

Copyright © Securities Training Corporation. All Rights Reserved.

Now, assume that Widget, Inc. has issued 5% non-cumulative stock. Again, the widget market has been in turmoil for the last three years and, as a result, the company has paid only the following dividends:

	Dividends Paid
Year 1	$2
Year 2	$2
Year 3	$3

In Year 4, if the widget market rebounds, how much must Widget, Inc. pay to its non-cumulative preferred shareholders if it also wants to pay a common dividend? Only $5 since the preference is limited to the current year's dividend for non-cumulative preferred stock. Remember, non-cumulative preferred stock is not entitled to any missing or unpaid dividends.

Participating Preferred Stock

For preferred stock, the stated return is generally the maximum annual income that an investor can expect to receive. However, an investor who purchases *participating* preferred stock may receive a greater dividend if the company is doing well and its common dividends exceed a specified amount. For example, an investor owns a 5% preferred stock, with a potential 3% additional payout. This investor is entitled to the 5% dividend but could receive up to 8% if the common stock dividends reach a specified level.

Callable Preferred Stock

A company that issues *callable* preferred stock has the right to repurchase the stock (i.e., to call it back) at a specified price at some time in the future. In order to induce investors to buy the stock, the call price is typically higher than the stock's par value.

Convertible Preferred Stock

For investors who want greater potential for capital appreciation than preferred stocks typically provide, *convertible* preferred stock may be a suitable choice. The trade-off is a lower dividend rate than what's offered by other types of preferred stock. Investors who purchase convertible preferred stock are able to, at their discretion, convert the par value of the preferred stock into a predetermined number of common shares at a specified price—which is the stated conversion price.

To determine the conversion ratio (i.e., the number of shares to which an investor is entitled), the par value of the preferred stock ($100) is divided by its conversion price. For example, if the conversion price is $25, then the conversion ratio is 4-for-1 ($100 par value ÷ $25). In this case, the preferred stockholder will receive four shares of common stock for every one share of preferred stock.

A feature that an issuer may add to convertible preferred stock is to make the stock callable. The choice of whether to convert the stock or allow it to be called will generally depend on the relative value of the common stock received through conversion as compared to the call price. The preferred stock will typically trade at a value which reflects the best choice for the customer.

 Copyright © Securities Training Corporation. All Rights Reserved.

For example, a notice is published stating that RMO 5% convertible preferred stock will be called at $102 per share. The preferred is convertible into 2 shares of common stock and RMO's common stock is selling in the market at $55 per share. After the notice appears, the price of the preferred stock will most likely trade in the market at a price near $110.

Why is this the case? Since the convertible preferred stock has a conversion value of $110 ($55 per common share x 2 share conversion ratio), the market price of the preferred stock will reflect the increased value of the common stock. The call price of $102 doesn't reflect the common stock's increased value.

Common versus Preferred Stock

	Common Stock	Preferred Stock
Ownership stake in the company	✓	✓
More likely to receive regular dividend payments		✓
Higher priority in the event of bankruptcy		✓
Greater potential for capital appreciation	✓	
Typically has voting rights	✓	
Issued with a specific dividend rate		✓

Rights and Warrants – Derivative Securities

Derivative securities are special types of investments that track the value of common stock or another underlying asset. For example, imagine a security which provides the owner with the opportunity to buy 100 shares of ABC stock at $75 per share regardless of how high the stock may rise. This is precisely the position in which the buyer of a warrant will find herself. If ABC rises above $75, the warrant has value since the investor is entitled to buy the shares at a price that's below the current market price. On the other hand, if ABC declines in value to below $75, the warrant will have little value since ABC stock is able to be purchased in the market at a better price than what's available through the warrant.

The following section will examine two types of derivatives that are issued by a corporation—rights and warrants. Chapter 10 will examine options contracts—a different type of derivative that's often issued by a third party, such as the Options Clearing Corporation (OCC).

Preemptive Rights

An exclusive privilege for common stockholders is that they may be entitled to preemptive rights. If a corporation is seeking to raise more capital and intends to issue additional shares of stock, a *rights offering* may be conducted to provide current shareholders with the opportunity to buy the shares before they're offered to the public.

Copyright © Securities Training Corporation. All Rights Reserved.

By participating in the offering, the current shareholders are able to maintain their percentage of ownership in the company. If shareholders choose not to subscribe to the offering, their percentage of ownership and ability to control the company's future will be diluted by the new stock offering.

Rights Offering and Subscription Price In a rights offering, all existing common stockholders automatically receive one right for every one share they own. However, the number of rights required to buy one new share of stock, the price at which the shares may be acquired, and the available period for exercising the rights will vary. Typically, the offer is good for only a limited number of days and the preset purchase price is below the current market value of the stock. This preset exercise price is referred to as the *subscription price*.

> *For example, Widget Inc. has 1,000,000 shares of outstanding stock and plans to issue an additional 1,000,000 shares to the public. An investor who currently owns 100,000 shares (10% of the outstanding stock) will receive 100,000 rights. These rights will allow her to purchase 100,000 shares at a favorable price and maintain her 10% ownership in the company. If she doesn't exercise her rights within a certain period, the rights will expire.*

Investors who acquire rights have two viable options. First, the holder may choose to exercise the rights by tendering them to the issuer's transfer agent. Second, the rights may be freely transferred (traded) since they usually trade in the same market as the underlying stock.

Warrants

A warrant is another type of derivative on an equity security that may be issued by corporations. Like rights, warrants give the holders the ability to buy the issuer's common stock at a specified price (the subscription price) in the future.

However, unlike stock rights that have a relatively short life, warrants have a maturity that's often set years in the future. In fact, some warrants have a perpetual (endless) life.

Another way that warrants differ from stock rights is that a warrant's subscription price is usually set at a price that's higher than the current market price of the stock. Therefore, if a stock later increases in value (above the subscription price), the holder of the warrant will be in a position to realize a profit. Companies typically issue warrants in connection with an offering of stock or bonds. By including the warrants, investors are given an added incentive (i.e., as a sweetener) to purchase these issues. Warrants are usually able to be detached from the securities with which they were originally issued and may be sold separately.

Intrinsic Value If the stock's market price rises above the warrant's subscription price, then the warrant has intrinsic value. For example, if the warrant's subscription price is $30 and the stock's market price is $33, then the warrant has intrinsic value of $3 (i.e., the investor could acquire the stock for $30 and sell the shares at $33, for a 3-point gain). However, to reflect the possibility that the stock's price may increase further before the warrant expires, the actual value of the warrant may be even higher than the intrinsic value.

 Copyright © Securities Training Corporation. All Rights Reserved.

	Rights	Warrants
Issued to:	Existing common stockholders	Purchasers of the issuer's stocks or bonds
Subscription Price:	Below current market value	Above current market value
Maturity:	Short-term (30-45 days)	Long-term (Years, not days)

Miscellaneous Equity Rules

FINRA Rule 2261 – Disclosure of Financial Condition

If requested, a member firm is required to make available for inspection by a regular customer the information related to the firm's financial condition as disclosed in its most recent balance sheet. The balance sheet may be delivered to a customer in either physical or electronic form.

FINRA Rule 2262 – Disclosure of Control Relationship with Issuer

A brokerage firm that has a control relationship with the issuer of any security is required to disclose this fact to its customers. The disclosure must be provided either before or at the time of executing a transaction in the security. Two situations in which a control relationship exists are if the member firm is a publicly traded company or if it's a subsidiary of a publicly traded company. For example, a customer has an account at LRR Investments and is purchasing 1,000 shares of LRR Incorporated, which is listed on the NYSE. In this case, LRR Investments is required to disclose the existing control relationship between the two firms.

SEC Rule 10b-18 – Purchases of Certain Equity Securities by the Issuer

For a variety of reasons, an issuer of securities may be tempted to purchase its stock in an effort to increase the price. To minimize the possibility of manipulation, the SEC has created Rule 10b-18 which controls how an issuer or any affiliates may purchase its own stock in the secondary market. Some of the legitimate reasons for issuers to purchase their own stock in the open market include for stock buyback plans or for funding employee stock purchase plans.

Safe Harbors Under 10b-18 The SEC will not assume that an issuer is attempting to manipulate its stock price if the issuer adheres to the following conditions:

- *Only one broker-dealer is used to place bids and make purchases during any trading session.*
- *Purchases are not made during certain times of the day.* Issuers are prohibited from making a purchase that's the first reported transaction for that day and from making a purchase during the last 30 minutes of the normal trading day. If the issuer's stock is actively traded, the purchase prohibition changes to within the last 10 minutes of the trading day.

Copyright © Securities Training Corporation. All Rights Reserved.

- *The bid or purchase price of securities is limited to certain prices.* The price may not be higher than the highest independent bid or the last independent transaction price, whichever is higher. For example, if the last independent transaction was $23.53 and the current bid/ask spread is $23.50 – $23.60, the highest price at which the issuer may buy its stock is $23.53.
- *The amount of stock purchased on any single day is limited.* The total volume on any single day may not exceed 25% of the average daily trading volume (ADTV) for that security.

Conclusion

This concludes the introductory chapter on equity securities. Chapter 11 will examine the process of issuing these securities in the primary market which is regulated by the provisions of the Securities Act of 1933. Chapter 12 will cover the process by which securities are purchased and sold in the secondary market. The next chapter will provide an introduction to bonds.

Chapter 3 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Understand that *common stock*:
  - Is suitable for investors seeking growth
  - Has the most risk if a corporation declares bankruptcy
- Understand that common shareholders have the right to vote in corporate elections (e.g., board of directors, mergers), but not for cash or stock dividends
  - *Review the statutory versus cumulative voting example*
- Understand that treasury shares have been repurchased by the corporation and have no voting or dividend rights
- Define the terms *restricted stock* and *control stock* and understand their differences
- Understand that *preferred stock*:
  - Is suitable for investors seeking income
  - Has interest rate risk
  - Doesn't offer voting rights
  - Receives dividends before the common shares
- Calculate the required dividend to be paid on any cumulative preferred stock that's in arrears
- Understand the stability of convertible preferred stock prices during periods of fluctuating interest rates
- Recognize the differences between the pricing and maturities of rights and warrants
- Understand that *American Depositary Receipt (ADRs)*:
  - Provide U.S. investors with the ability to buy stock in a foreign company
  - Trade in U.S. markets, are valued in U.S. dollars, and pay dividends in U.S. dollars
  - May be sponsored (the ADRs trade on exchanges) or unsponsored (the ADRs trade in over-the-counter markets)
  - Have market risk and currency risk

 Copyright © Securities Training Corporation. All Rights Reserved.

Create a Chapter 3 Custom Exam

Now that you've completed Chapter 3, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 4 – An Introduction to Debt Instruments

- *Characteristics of Bonds*
- *Bond Pricing*
- *Price vs. Yields*
- *Retirement of Debt*
- *Convertible Bonds*

 Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 3 described equity issuance—a method that corporations use to raise capital by selling an ownership interest to investors. Corporations can also raise capital by issuing bonds. Unlike shareholders, investors who buy bonds don't become part owners of the company; instead, these investors become creditors. Essentially, think of purchasers of bonds as taking on the role of a bank by lending money to the issuer for a certain period. In return, the corporation agrees to pay these investors interest, as well as to repay the original amount of the loan when the bond matures.

Although bonds are categorized based on the entity that issues them, all of these debt instruments have certain fundamental traits in common. This chapter will examine these common characteristics, while the next chapter will cover specific details related to bonds that are issued by corporations, the U.S. Government, municipalities, and other borrowers.

Introduction to Debt Instruments

Basic Bond Characteristics

A bond is a contract between an issuer and an investor. As stated previously, the investor lends money to the issuer and the issuer (debtor) promises to repay *debt service*. Debt service represents the total of all interest payments over the bond's life and the final repayment of the loan value (principal) at maturity. The issuer must stand ready to make these payments since it will be in default if any are missed.

For an issuer, raising capital through debt is referred to as *leverage financing* since the issuer is borrowing against its net worth. When a corporation has more debt than equity outstanding, it's considered a leveraged issuer.

Let's examine some key terms that are used when describing bonds.

Par Value The par value of a bond (also referred to as the principal or face value) is the amount that the issuer agrees to pay the investor when the bond matures. An investor who buys a bond with a par value of $1,000 expects to receive $1,000 when the bond reaches maturity. Regardless of the amount an investor pays for a bond, if it's held to maturity, the issuer is obligated to pay the par value. Most bonds are issued in multiples of $1,000, but some (e.g., U.S. Treasury securities) may be issued in denominations as small as $100.

Coupon Rate Obviously, investors don't buy bonds just to receive their principal back at some future date. The issuer must also agree to pay investors interest on the loan until the bond matures. The rate of interest is generally fixed at the time the bond is issued and, with some exceptions, remains the same for the life of the bond. This fixed rate of interest is also referred to as the bond's *coupon rate.* The interest paid is calculated based on the bond's $1,000 par value, not the price paid for the bond. Ultimately, the primary reason that investors purchase bonds is to generate income represented by their bond's coupon rate.

Copyright © Securities Training Corporation. All Rights Reserved.

Generally, bonds with longer maturities offer higher coupons. Since the investor's money is at risk for a long period, the investor expects a higher rate of return than those offered by shorter-term investments. Short-term bonds are usually safer investments since buyers know that their money will be returned relatively quickly. For this safety, investors are willing to accept lower rates of interest. Of course, there are other factors that may affect the yield of bonds. If an issuer is considered a high credit risk, it must offer higher yields to attract investors than an issuer with a higher credit rating. The term yield is used in different ways. In some situations, yield may refer to the return on an investment; however, in the case of a debt instrument that's purchased at par value, it refers to the interest payments.

In order to determine the amount of interest that the investor will receive annually, the bond's par value ($1,000) is multiplied by its stated interest rate. For example, if a client purchases a 6% corporate bond, she will receive $60 per year ($1,000 x 6% = $60). Since bonds usually pay interest twice per year (semiannually), the investor will receive two $30 payments every year ($60 ÷ 2 = $30).

The bond's maturity date is important in determining when an investor will receive her interest payments. One of the payment dates will always be the month and day of maturity, while the other is six months from that date. Therefore, if the investor's 6% corporate bond matures on June 1, 2030, she will receive two payments per year—one every June 1 and the other every December 1.

Fixed or Variable Rates As previously mentioned, a bond's interest rate is set at the time of issuance and generally remains fixed for the life of the bond. However, in some cases, as interest rates move up or down, the coupon rate will be adjusted to reflect market conditions. These adjustable rate bonds are sometimes referred to as *variable or floating rate securities*.

Initial Interest Payment Traditionally, bonds pay interest on the 1st or 15th of the month to ease paperwork issues. However, *newly issued bonds* pay interest from the dated date (the date from which interest begins to accrue), which may not fall on the 1st or 15th. For this reason, the very first coupon on a newly issued bond may be for more or less than the traditional six-month period as the issuer tries to get synchronized with the 1st or 15th payment date. If the first coupon is for more than six months, it's referred to as a *long coupon;* if the first coupon is for less than six months, it's referred to as a *short coupon*.

Accrued Interest Since bond interest is paid semiannually, a bondholder who sells a bond between interest payments is usually entitled to the interest earned during the period when he still owned the bond. This accrued interest is the amount of interest that the seller is entitled to receive (from the buyer) and the amount that the buyer is required to pay (to the seller) for a bond being sold in the secondary market. For calculation purposes, corporate and municipal bonds use 30 days in every month and 360 days in the year, while U.S. government T-notes and T-bonds use actual days in every month and 365 days in the year.

Copyright © Securities Training Corporation. All Rights Reserved.

Zero-Coupon Bonds Zero-coupon bonds don't pay periodic interest. Instead, an investor purchases a zero-coupon at a deep discount from its par value, but redeems the bond for its full face value at maturity. The difference between the purchase price and the amount that the investor receives at maturity is considered the bond's interest. Usually, the longer the zero-coupon bond's maturity, the deeper its discount will be from par value.

Interest Bearing Bonds	Zero Coupon Bonds
Pay interest at regular intervals	Interest paid as a lump sum when bond matures
For investors who desire current income	For investors who desire a lump sum at some future date

Maturity Date This is the date on which the bondholder will receive the $1,000 return of principal from the issuer. The maturity or due date is identified on the face of the bond.

Serial versus Term Issues Corporations and other entities routinely issue millions of dollars worth of bonds at the same time. There are several ways that the issuer may structure its loan repayment. Two of the common forms are *term* and *serial*.

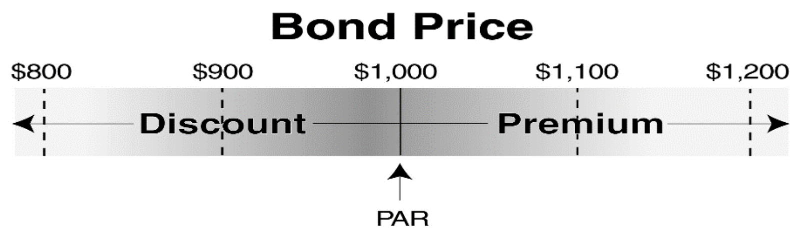
If all of the bonds in an offering are due to mature on the same date, it's referred to as a *term bond issue*. On the other hand, if parts of an offering will mature sequentially over several years, it's referred to as a *serial bond issue*. For example, an issuing corporation may sell $50 million par value of bonds with $10 million coming due each year over a five-year period. With serial issues, an investor could purchase a quantity of bonds that mature at the same time or, if she wants, she could purchase bonds with different maturities. A serial bond may be structured so that principal and interest payments represent approximately equal annual payments over the life of the offering, which is referred to as *level debt service*.

In some cases, an issuer may structure an offering so that some of it matures serially, with a large portion of the offering being paid off at the final maturity. This form is referred to as a *balloon maturity*.

Copyright © Securities Training Corporation. All Rights Reserved.

Why Bond Prices Fluctuate from Par

The par value of a bond can differ greatly from the price that investors pays to purchase the bond (i.e., the market price). Although most bonds are initially sold at par value, as time goes by, these bonds may trade in the market at prices that are less than or more than par. A bond that's sold for less than its par value is selling at a *discount*, while a bond that's sold for more than its par value is selling at a *premium*.



Discounts and Premiums

The reasons for these discounts or premiums typically relate to the changes in prevailing market interest rates (i.e., interest-rate risk) or concerns about the creditworthiness of the issuer (i.e., credit risk). Let's carefully analyze these two risk factors.

Interest-Rate Risk Investors who purchase bonds assume the risk that the bond's market value may decline if market interest rates rise. *Interest-rate risk* implies that as market rates increase, investors will not be interested in purchasing existing bonds at par since they're able to obtain higher yields by purchasing new bonds. Therefore, existing bonds will need to be offered at a discount (put on sale) in order to attract purchasers. Conversely, if interest rates fall after a bond has been issued, the bond will likely trade at a premium to par.

In general, when interest rates change, the prices of long-term bonds will fluctuate more than the prices of short-term bonds. In other words, bonds with longer maturities have more interest-rate risk than short-term bonds. However, please be careful not to confuse this with which rates are more volatile. Short-term interest rates change more often and more sharply (they're more volatile) than long-term rates. A more detailed description of interest-rate risk will be provided Chapter 20.

Credit Risk *Credit risk* is a recognition that an issuer may default and may not be able to meet its obligations to pay interest and principal to the bondholders. Not surprisingly, issuers that are considered high credit risks must pay a higher rate of interest in order to induce investors to purchase their bonds. Generally, if a company is perceived as becoming more risky, the prices of its bonds will fall; however, if a company is viewed as improving, its bond prices tend to rise.

 Copyright © Securities Training Corporation. All Rights Reserved.

Measuring Credit Risk Securities that are issued by the U.S. government have the lowest possible credit risk since the government's risk of defaulting is virtually zero. This is due to the fact they're backed by the full faith and credit and taxing authority of the U.S. government.

Credit risk is more difficult to evaluate when the bonds are issued by a corporation or a municipality. Most investors rely on an organization that specializes in analyzing the credit of bond issues. Some of the credit rating companies that provide bond ratings are *Moody's, Standard and Poor's (S&P),* and *Fitch Investors Service*. Each company evaluates the possibility that an issuer may default and assigns the issue a credit rating. Later, this rating may be raised or lowered depending on subsequent events. A lowered credit rating may cause a bond's market price to drop significantly.

Below are the ratings of Moody's, Standard and Poor's, and Fitch from the highest to the lowest:

		Moody's	S&P	Fitch
Investment Grade	Best Quality	Aaa	AAA	AAA
	High Quality	Aa	AA	AA
	Upper Medium	A	A	A
	Medium	Baa	BBB	BBB
Speculative Grade		Ba	BB	BB
		B	B	B
		Caa	CCC	CCC
		Ca	CC	CC
		C	C	C
			D	DDD
				DD
				D

For bonds issued by corporations, Moody's further subdivides each major rating category by using a 1, 2, or 3, with 1 being the highest. For example, Aa1 is higher than Aa2, however, Aaa3 is higher than Aa1.

Standard & Poor's uses a plus (+) and minus (-) to further distinguish between ratings. For example, A+ is better than A; however, A- is better than BBB+.

It's important to note that only relatively large issues are rated. This doesn't necessarily mean that an unrated issue is of poor quality; instead, it may suggest that an issue may be too small to apply for and be given a rating.

Bond Pricing

A bond's price is usually stated as a percentage of its par value. For example, a bond with a price of 100 is selling at 100% of its par value, or $1,000 (100% of $1,000). A bond with a price of 90 is selling at a discount equal to 90% of its par value, or $900. A bond with a price of 110 is selling at a premium which is equivalent to 110% of its par value, or $1,100.

Copyright © Securities Training Corporation. All Rights Reserved.

A bond's price may also be expressed in terms of *points*. Each point is equal to 1% of the bond's par value, or $10. Therefore, a quote of 99 points is equal to $990 (99 points x $10 per point = $990). A bond selling at 100 is selling for 100 points or $1,000. If the bond's price increases to 101, it's selling for $1,010 (101% of the par value).

Bond Price	Percentage of Par Value	Price in Dollars	
99	99%	$990	Discount
100	100%	$1,000	Par
101	101%	$1,010	Premium

Smaller Pricing Increments Of course bonds don't always trade in even point values; their prices will often include a fraction. Traditionally, corporate and municipal bonds trade in increments of 1/8 of a point, while Treasury notes and bonds trade in increments of 1/32 of a point. For pricing purposes, rather than working with a fraction, let's convert the fraction to a decimal by dividing the numerator by the denominator. For example, 1/8 becomes .125, 5/8 becomes .625, and 15/32 becomes .46875. Therefore, a bond quoted at 93 5/8 would be converted to 93.625% of par, or $936.25.

Following are some additional pricing examples:

Corporate and Municipal Bonds:
87 1/8 = 87.125 = $871.25
100 7/8 = 100.875 = $1,008.75
103 3/8 = 103.375 = $1,033.75

Treasury Notes and Bonds:
99.08 = 99 8/32 = 99.250 = $992.50
100.16 = 100 16/32 = 100.50 = $1,005.00
103.24 = 103 24/32 = 103.75 = $1,037.50

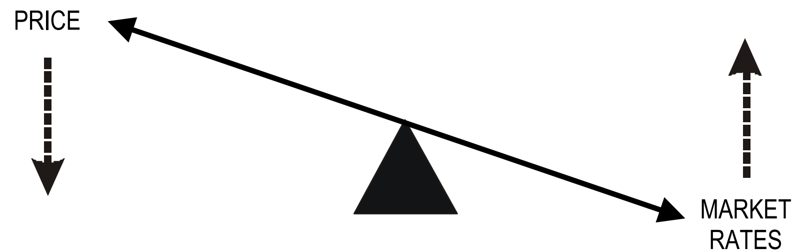
Note: Treasury bills trade on a yield basis.

Prices and Yields: An Inverse Relationship

A bond's coupon (interest rate) is generally fixed for its life. As market interest rates change, new bonds will be issued with either higher or lower coupon rates than what existing bonds pay. In order to be able to keep pace with current interest rates, the values (market prices) of existing bonds will adjust based on the relative coupon rates of existing and new issues.

As stated earlier, if interest rates rise, the value (price) of existing bonds will fall since the demand for existing bonds that offer lower interest rates will decline. If interest rates fall, the value (price) of existing bonds will rise since they're worth more than a new bond issued with a lower coupon. So essentially, there's an inverse relationship that exists between market interest rates and existing bond prices.

Copyright © Securities Training Corporation. All Rights Reserved.



To summarize, as interest rates increase, the prices of existing bonds decrease and, as interest rates decrease, the prices of existing bonds increase.

Calculating Bond Yields

As with any other investor, a bondholder is interested in determining her investment's return or yield. There are three different measures for determining a bond's yield—*nominal yield (or coupon), the current yield (annual interest ÷ current market price),* and *yield-to-maturity (effective return)*. These three measurements of return will be covered in detail in Chapter 6.

Redeeming Bonds Prior to Maturity

When a bond reaches its maturity date, the bondholder will redeem it to the issuer and receive the bond's par value *plus* her last interest payment. At this point, the issuer's obligation to the bondholder has ended and the debt is considered *retired.* However, some bonds are redeemed before they mature.

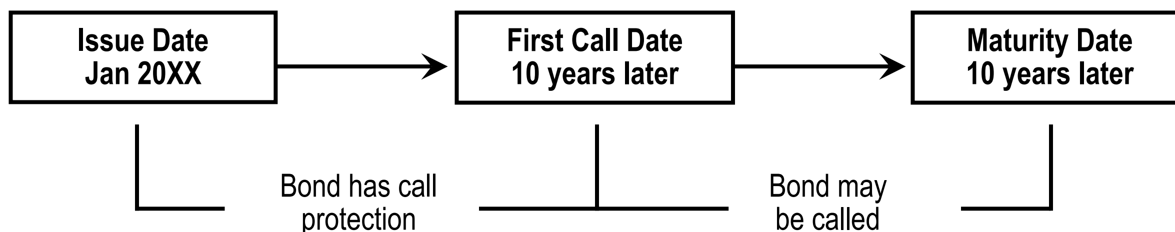
Call Provisions

A bond offering may include a *call provision* which allows the *issuer* to redeem its outstanding bonds before they reach maturity. If called, the investor receives the full return of principal plus any accrued interest. From the issuer's perspective, the benefit is that it's no longer required to make periodic interest payments once the bond issue has been called. One of the main reasons that issuers make bonds callable is to have the ability to take advantage of declining interest rates. In an effort to entice investors to buy callable bonds, their yields (coupons) are typically higher than those of non-callable bonds.

Call Protection and Call Premium Most callable bonds contain a restriction on how soon the bonds may be called—typically 5 to 10 years after the date of issuance. This is referred to as *call protection*. If the call protection period runs out and the bonds are subsequently called, the issuer is often required to pay the bondholders more than the par value in order to compensate them for the early redemption of the bonds. This additional amount is referred to as a *call premium*.

Copyright © Securities Training Corporation. All Rights Reserved.

For example, in January 20XX, an issuer sold bonds that mature in 20 years. Beginning 10 years after issuance, the bonds are callable at 102. If a bondholder buys one of these bonds and the issuer calls back after 10 years, she will receive $1,020 ($20 more than the bond's par value). The call protection gives the investor the assurance of knowing that her bond cannot be called for 10 years.



Call Types Some calls are *in-whole*, which means that the entire issue is being called at one time. Other calls are *partial (lottery calls)*, which means that some of the bonds will be retired early, but others will remain outstanding. Finally, some bonds may have *catastrophe call* provisions which are enacted only if a bond's underlying collateral is destroyed. For example, a bond is issued to generate funds which will be used to construct a bridge. If later, due to severe flooding, the bridge washes into the water, the issue may be called with the bondholders being paid back with insurance proceeds. Both partial and in-whole calls must be disclosed to a client prior to a bond's purchase and noted on the confirmation. However, due to the unlikelihood of occurrence, catastrophe calls are exempt from this rule.

Put Provisions Bonds may also be issued with a *put provision*, which is the opposite of a call provision. This feature gives the *bondholder* the right to redeem the bond on a specified date (or dates) prior to maturity. For bonds which offer the put feature, their yields are generally lower (and prices higher) since the bondholders are given the ability to redeem their bonds in the event that interest rates rise.

Convertible Bonds

In order to offer investors more of an incentive to buy its bonds, a corporation with a weak credit rating may issue convertible bonds. A convertible bond gives an investor the ability to convert the par value of his bond into predetermined number of shares of the company's common stock. For the purchaser, the tradeoff for this opportunity is that convertible issues traditionally offer lower coupons than similar non-convertible issues. If the bonds are converted, the debt becomes equity and the issuer's capital structure will be significantly altered.

Converting Bonds to Stock The price at which the bond can be converted is referred to as the *conversion price* and is set at the time that the bond is issued. To determine the *conversion ratio* (i.e., the number of shares the investor will receive at conversion), the par value of the bond ($1,000) is divided by the conversion price.

 Copyright © Securities Training Corporation. All Rights Reserved.

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

For example, if Widget Inc. issues 10% convertible bonds with a conversion price of $40, the conversion ratio is 25 shares for each bond. Put another way, the bondholder is able to exchange the bond and, in return, receive 25 shares of stock.

$$\textbf{Conversion Ratio} = \frac{\text{\$1,000 Par Value}}{\text{\$40 Conversion Price}} = \text{25 shares per bond}$$

The conversion ratio is the number of shares that an investor receives when surrendering a $1,000 face amount of bonds. When the conversion ratio is multiplied by the conversion price, the result will always equal $1,000. Therefore, a conversion is immediately profitable if the underlying stock is trading at a premium to the conversion price. Consider the examples below:

Conversion Price	Conversion Ratio	Price x Ratio
$10	100	$1,000
$20	50	$1,000
$40	25	$1,000
$50	20	$1,000
$100	10	$1,000

Whether it's worthwhile for investors to convert their bonds into stock depends largely on the price of the underlying stock compared to the market value of the bond.

For example, let's assume that Widget's bond is convertible at $40 and is trading in the market at 85. Also, Widget's common stock is currently trading at $35 per share. What's the best choice for the investor, selling the bond or converting the bond to stock and selling the stock?

If the bond is sold in the market, the investor will receive $850 (85% of par). On the other hand, if the bond is converted into 25 shares ($1,000 ÷ $40 = 25). The 25 shares could then be sold for $35 per share, which results in sales proceeds of $875 (25 shares x $35). Therefore, the best choice for the investor is to convert the bond into stock and sell the stock.

Copyright © Securities Training Corporation. All Rights Reserved.

Advantages and Disadvantages of Convertible Bonds Convertible bonds allow corporations to borrow money at a lower rate (lower coupon) since the convertible feature is attractive to investors. Investors are willing to accept the lower interest rate in exchange for the opportunity to convert the bonds into common stock. In addition, the investor has some downside protection because, even if the price of the stock falls, the convertible bond still has inherent value as a bond.

A disadvantage to convertible bonds is that if all of the bonds are converted into stock, then the number of outstanding shares may increase dramatically. From the issuer's point of view, conversion adjusts the mandatory debt obligation into equity and deleverages the corporation's balance sheet. This deleveraging is useful because it removes both the near-term and long-term debt service obligations. Remember, dividend payments to common shareholders are voluntary, while interest payments to bondholders are mandatory. Therefore, after conversion, the former bondholders are no longer owed money at maturity. The bonds are eliminated and will be replaced with an ownership interest.

Forced Conversion Most convertible issues are callable which provides the issuer with the ability to (at its option) redeem the bonds prior to maturity. However, if the call (redemption) price of the bond is less than the conversion value, the bondholder could be forced to either convert the bond immediately or accept less than its conversion value. This possibility, referred to as *forced conversion*, may be a disadvantage for investors.

For example, Rob owns a corporate bond that's convertible at $40. With the underlying stock currently selling at $45 per share, the corporation indicates that the bond will be called at 105 ($1,050) on the next call date. If Rob asks his RR what action to take, what should she tell him?

Step 1: Determine the conversion ratio:

$$\textbf{Conversion Ratio} = \frac{\text{Par Value of Bond}}{\text{Conversion Price}} = \frac{\$1,000}{\$40} = \text{25 shares}$$

Step 2: Figure out what Rob will receive after the bond is converted and the stock is sold:

Conversion Value = Number of shares x Price Per Share

Conversion Value = 25 shares x $45 = $1,125

Rob's RR should recommend that he convert the bond to stock since the shares are worth $1,125, while he would receive only $1,050 if he allowed the bond to be called.

 Copyright © Securities Training Corporation. All Rights Reserved.

Conversion is NOT Taxable If the owners of convertible bonds or convertible preferred stock convert those securities into the common stock of the corporation, the conversion is NOT a taxable event. When these securities are converted, the cost basis for the common stock received will be based on the cost basis of the original security. A taxable event arises only when the investor subsequently sells the acquired shares.

For example, an investor purchased a convertible RFQ corporate bond for $1,200 and converted the bond into 40 shares of common stock. The investor's overall cost basis is $1,200, while her cost basis per share is $30 ($1,200 ÷ 40 shares). If the stock was later sold for $32 per share, she would report a capital gain of $2 per share, or $80.

Conclusion

The next chapter will examine the characteristics of specific types of bonds, including corporate issues, U.S. Treasury and agency securities, and municipal issues. Additionally, the various methods of underwriting these securities will be described.

Chapter 4 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Understand and define the terms:
  - Debt service, par value, coupon rate or nominal yield, current yield, yield-to-maturity (YTM), yield-to-call (YTC), dated date (and when it's used), and accrued interest
- Recognize and understand the process used for calculating accrued interest for the different types of bonds (which use a 30-day month and a 360-day year versus actual days in a month and a 365-day year)
- Define and understand the difference between serial and term bonds
- Recognize and understand how interest rate risk and credit risk affect bond prices
- Recognize and understand the role of bond ratings companies and what their ratings signify
- Recognize and understand the term *points* and the trading units in which different bonds trade (i.e., 1/8 or 1/32 of a point)
- Define and understand the terms *call provision*, *call protection*, *call premium*, and *put provision*
- Recognize and understand the formula for conversion ratio and when it's used
- Recognize and understand the tax consequences of a conversion

Create a Chapter 4 Custom Exam

Now that you've completed Chapter 4, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 5 – Types of Debt Instruments

- *U.S. Treasury and Government Agency Securities*
- *Municipal GO and Revenue Bonds*
- *The Underwriting Process*
- *Types of Corporate Bonds*
- *Money Markets*

Copyright © Securities Training Corporation. All Rights Reserved.

The previous chapter examined some basic characteristics that are shared by debt securities. This chapter will cover the specific features of debt instruments that are issued by the U.S. Treasury and agencies, municipal governments, and corporate issuers. The securities differ in their relative safety profile and the tax status of their interest payments.

Types of Debt Instruments

Treasury Securities

According to the Securities Act of 1933, securities that are issued by the U.S. government (Treasuries) and any government agency are exempt from registration. Treasury securities are considered the safest type of fixed-income investment and are suitable for the most conservative investors. Since the securities are backed by the full faith and credit of the U.S. government, they have virtually no credit risk. This "no default" status is the benchmark against which the credit ratings of all other issuers are measured.

The U.S. government issues securities to finance its operations. The securities may be divided into two major groups:

1. Marketable (negotiable)
2. Non-marketable (non-negotiable)

Treasury securities are considered marketable securities since they're traded in the secondary market after issuance. On the other hand, U.S. savings bonds are considered non-negotiable since they're purchased from and redeemed back to the U.S. government. Of the two groups, marketable securities are much more likely to appear on the SIE Examination. Marketable instruments include the following:

- Treasury bills
- Treasury notes
- Treasury bonds
- Treasury Separate Trading of Registered Interest and Principal Securities (T-STRIPS)
- Treasury Inflation-Protected Securities (TIPS)
- Treasury Cash Management Bills (CMBs)

From this point on, when the word *Treasuries* is used, it will refer to marketable/negotiable securities only. The three most prevalent types of these marketable issues are T-bills, T-notes, and T-bonds. Let's begin our discussion with the interest-bearing Treasury securities and then move on to other instruments that are non-interest-bearing.

Copyright © Securities Training Corporation. All Rights Reserved.

Treasury Notes (T-Notes) and Treasury Bonds (T-Bonds)

Treasury bonds and Treasury notes are interest-bearing securities that have all the attributes of traditional fixed-income investments. Each pays a fixed rate of interest semiannually and the investors receive the face value at maturity. Treasury notes have initial maturities that range from 2 to 10 years, while Treasury bonds are issued with maturities of more than 10 years. T-notes and T-bonds are both issued in book-entry (electronic) form and in minimum denominations of $100. However, please note that most examples in this study manual will use a par value of $1,000.

The interest received on T-notes and T-bonds is taxed at the federal level, but exempt from state and local taxation. The main reason for purchasing Treasury securities is the safety that comes with a government-backed investment.

Treasury Inflation-Protected Securities (TIPS)

One of the primary concerns for bond investors is inflation. Since a bond investor may often need to wait years for his principal to be returned, inflation (a rise in prevailing prices) will diminish the purchasing power of the returned funds. So how is a Treasury investor able to protect herself? One answer may be to acquire protection by investing in Treasury Inflation-Protected Securities (TIPS). TIPS are interest-bearing, marketable securities.

The rate of interest on TIPS is fixed; however, the principal amount on which that interest is paid may vary based on the change in the Consumer Price Index (CPI). During a period of inflation (a rise in CPI), the principal value will increase. However, if deflation occurs (from a decline in CPI), the principal value of the instrument will decrease (but not below $1,000). TIPS are issued in book-entry form in $100 increments and are available in 5-, 10-, and 30-year terms. The interest received on TIPS is taxed at the federal level, but exempt from state and local taxation.

An investor purchased a 4% TIPS with an original principal value of $1,000. Due to inflation, if the principal is adjusted to $1,030, how much interest will she receive for her next semiannual payment?

TIPS pay a fixed rate of interest, but it's based on an inflation-adjusted principal. In this example, the 4% coupon rate is multiplied by the adjusted principal of $1,030, for an annual interest amount of $41.20. However, the investor's next semiannual payment is $20.60 ($41.20 ÷ 2).

Non-Interest-Bearing Securities

T-bonds, T-notes and TIPS are all interest-bearing instruments. This next section will describe the various forms of Treasuries that are non-interest bearing. These securities are issued at a discount and mature at face value.

Copyright © Securities Training Corporation. All Rights Reserved.

Treasury Bills (T-Bills)

Treasury bills are short-term securities that mature in one year or less. Currently, an investor may purchase T-bills with maturities of one month (4 weeks), three months (13 weeks), six months (26 weeks), and one year (52 weeks). T-bills are issued in book-entry form only and are sold in minimum denominations of $100 (and in multiples of $100 thereafter).

T-bills are always sold at a discount from their face value and, unlike Treasury bonds and notes, T-bills don't make semiannual interest payments. The difference between a T-bill's purchase price and its face value at maturity represents the investor's interest. Consequently, T-bills are referred to as *discount securities* or *non-interest-bearing securities*.

Prices T-bills are quoted on a *discounted yield basis*, not as a percentage of their par value. The yield represents the percentage discount from the face value of the security. An example of a T-bill quotation is shown below:

Bid	Asked	Ask Yld
1.12	1.11	1.13

Remember, due to the inverse relationship between price and yield, the higher the yield, the lower the price, and the lower the yield, the higher the price. Therefore, despite the fact that the bid (1.12 discount yield) is numerically higher than the asked (1.11 discount yield), the bid (higher yield) will represent a lower price.

Along with the bid and asked quotation, the column titled *asks yield* signifies the *bond* or *coupon equivalent yield.* The bond equivalent yield allows investors to compare the yields available on T-bills with the yields available on notes, bonds, and other interest-bearing securities. The bond equivalent yield takes into account the fact that the interest being earned is on the amount invested, not on the face amount. As a result, a T-bill's bond equivalent yield is always greater than its discount yield.

Stripped Securities

In the 1980s, several broker-dealers began stripping the interest payments and final principal payments from Treasury notes and bonds and then repackaging and reselling them as zero-coupon bonds. Although these stripped securities were not issued by the Treasury, their cash flows were very secure since the underlying securities are direct obligations of the U.S. government. Thereafter, a group of dealers began to issue generic stripped securities—referred to as Treasury Receipts (TRs). An important distinction is that Treasury Receipts are backed by Treasury securities that are owned by the issuing broker-dealer; they're not directly backed by the U.S. Treasury.

Copyright © Securities Training Corporation. All Rights Reserved.

Treasury STRIPS

In order to facilitate the stripping of securities, the Treasury created its Separate Trading of Registered Interest and Principal Securities (STRIPS) program. Dealers are able to purchase T-notes and T-bonds and separately resell the coupon and principal payments as zero-coupons (discounted securities) after requesting this treatment through a federal reserve bank. The difference between an investor's purchase price and the bond's face value is interest. STRIPS are backed by the full faith and credit of the U.S. Treasury and are quoted on a yield basis, not as a percentage of their par value.

Cash Management Bills (CMBs)

CMBs are unscheduled, short-term debt offerings that are used to smooth out Treasury cash flows. CMBs are issued at a discount, but will mature at their face amount. The duration of CMBs may be as short as one day.

U.S. Treasury Securities Auctions – The Primary Market

The government sells Treasuries through auctions that are conducted by the U.S. Treasury. These auctions vary in frequency depending on the securities being sold. This schedule is detailed in the chart below:

Summary of Treasury Auctions			
Treasury Type	**Frequency**	**Auction Date**	**Issue Date**
4-week bill	Weekly	Tuesday	Thursday
13- and 26-week	Weekly	Monday	Thursday
52-week bill	Every four weeks	Tuesday	Thursday
2-, 3-, and 5-year note	Monthly	Varies	End of month
10-year note	Quarterly	Feb., May, Aug., & Nov.	15th of the month
30-year bond	Quarterly	Feb., May, Aug., & Nov.	15th of the month

Competitive versus Non-Competitive Tenders When Treasury auctions are held, *securities firms* compete by submitting bids to buy Treasuries through an automated system. These bids are referred to as *competitive tenders* since they specify the price and/or yield at which the firm is willing to buy the Treasuries. (Competitive bids are similar to limit orders to buy stock at a specific price, but may not be filled).

However, if an *individual* wants to purchase Treasuries, she usually submits a *non-competitive tender.* (Non-competitive bids are similar to market orders placed to buy stock since they don't specify a price and are guaranteed to be filled.) Non-competitive bids are filled first; however, the bidders must agree to accept the yield and price as determined by the auction. All winners of the auction will ultimately pay the lowest price of the accepted competitive tenders. This single price auction process is referred to as a *Dutch auction*.

 Copyright © Securities Training Corporation. All Rights Reserved.

Agency Securities

Agency securities include debt instruments that are issued and/or guaranteed by federal agencies and by *government-sponsored enterprises* (GSEs). Although agency securities are not direct obligations of the U.S. government, their credit risk is still considered low. Investors are attracted to agency securities due to their perceived safety and the fact that their yields are slightly higher than the yields of corresponding U.S. Treasury securities.

The overriding presumption is that since the federal government created these entities, it will not allow a default on their obligations. Therefore, most agency debt is highly rated and many agency offerings have AAA ratings. Also, as with U.S. Treasury securities, agency debt is issued in book-entry form and quoted in fractions of 1/32nds of a point.

Federal Agencies

Since federal agencies are direct extensions of the U.S. government, the securities that they issue or guarantee are backed by the full faith and credit of the U.S. government. This category includes the Government National Mortgage Association (GNMA).

Government-Sponsored Enterprises

Government-sponsored enterprises (GSEs) are publicly chartered, but privately owned organizations. Congress allowed for their creation to provide low-cost loans for certain segments of the population. The enterprise issues securities through a selling group of dealers with the offering's proceeds provided to a bank (or other lender). The bank then lends the money to an individual who is seeking financing (e.g., homeowners or farmers).

Although GSE securities are not backed by the U.S. government, they are considered to have minimal default risk. Examples of GSEs include:

- Federal Farm Credit Banks (FFCBs)
- Federal Home Loan Banks (FHLBs)

Federal Farm Credit Banks (FFCBs) The Federal Farm Credit Banks provide funds for three separate entities—Banks for Cooperatives, Intermediate Credit Banks, and Federal Land Banks. These organizations make agricultural loans to farmers. Interest received on these obligations is subject to federal tax, but is exempt from state and local taxes.

Federal Home Loan Banks (FHLBs) The 12 Federal Home Loan Banks help provide liquidity for the savings and loan institutions that may need extra funds to meet seasonal demands for money. As with FFCB debt, interest received on these securities is subject to federal tax, but is exempt from state and local taxes.

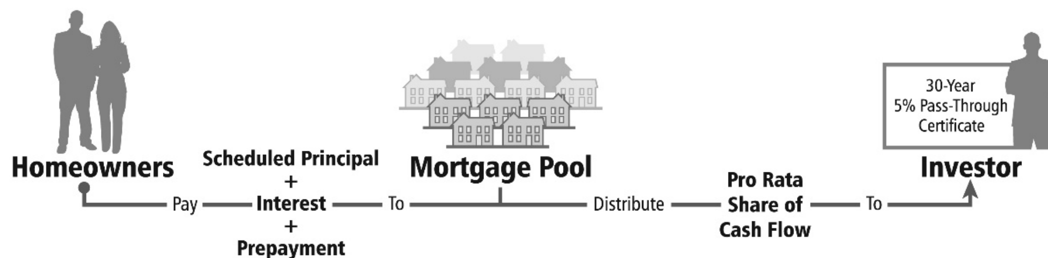
Copyright © Securities Training Corporation. All Rights Reserved.

Mortgage-Backed Securities

As the name implies, mortgage-backed securities are debt instruments that are secured by pools of home mortgages. The agencies that issue these securities include the *Government National Mortgage Association (GNMA* or *Ginnie Mae),* the *Federal National Mortgage Association (FNMA* or *Fannie Mae),* and the *Federal Home Loan Mortgage Corporation (FHLMC* or *Freddie Mac)*.

Pass-Through Certificates

The most common security issued by government agencies is a mortgage-backed *pass-through certificate*. The simplest method of creating a pass-through certificate is for an agency to purchase a pool of mortgages with similar interest rates and maturities. Interests in the pool are then sold to investors as pass-through certificates. Each certificate represents an undivided interest in the pool and the owners are entitled to share in the cash flow that's generated by the pooled mortgages. The picture below provides the basic idea of a mortgage-backed pass-through investment:



On a monthly basis, the homeowners in the pool make their mortgage payments and, after certain administrative charges are deducted, the bulk of these payments are passed through to investors every month. Each payment includes a portion of both interest and principal.

Federal Home Loan Mortgage Corporation (FHLMC)

The purpose of the Federal Home Loan Mortgage Corporation, or Freddie Mac, is to provide funds to federally insured savings institutions to finance new housing. Freddie Mac raises money for its operations by issuing mortgage-backed bonds, pass-through certificates, and guaranteed mortgage-backed certificates. These securities are not backed by the U.S. government; instead, they're backed by other agencies and the mortgages that are purchased by Freddie Mac. Interest earned on Freddie Mac securities is subject to federal, state, and local tax (i.e., it's fully taxable).

Federal National Mortgage Association (FNMA)

The Federal National Mortgage Association, or Fannie Mae, raises money to buy insured Federal Housing Administration (FHA), Veterans Administration (VA), and conventional residential mortgages from lenders such as banks and savings and loan associations. Rather than being backed by the U.S. government, FNMA issues are backed by its authority to borrow from the U.S. Treasury. Interest earned on FNMA securities is subject to federal, state, and local taxes (i.e., it's fully taxable).

Copyright © Securities Training Corporation. All Rights Reserved.

Government National Mortgage Association (GNMA)

Unlike FHLMC and FNMA, the Government National Mortgage Association, or Ginnie Mae, is a wholly-owned corporation that operates within the U.S. Department of Housing and Urban Development. Ginnie Mae's purpose is to provide financing for residential housing. Although Ginnie Mae securities are explicitly backed by the full faith and credit of the U.S. government, any interest earned on them is subject to federal, state, and local taxes.

GNMA issues mortgage-backed securities and participation certificates, but its most popular securities are modified pass-through certificates. A modified pass-through certificate is backed by a pool of FHA and/or VA residential mortgages. As the homeowners in the pool make their mortgage payments (consisting of principal and interest), a portion of those payments is passed through to the investors who purchased the certificates from GNMA. GNMA guarantees monthly payments to the owners of the certificates, even if it has not been collected from the homeowners.

The mortgages in the pool have maturities that range from 25 to 30 years. However, due to prepayments, foreclosures, and refinancings, the average life of the pool tends to be much shorter especially during periods of declining interest rates and the resulting *prepayment risk*.

Prepayment Risk In addition to the risks that are inherent in many fixed-income investments (e.g., interest-rate, credit, and liquidity risk), mortgage-backed securities are subject to a special type of risk which is referred to as *prepayment risk*. This is the risk that's tied to homeowners paying off their mortgages early. When interest rates fall, homeowners have an incentive to refinance and pay off their existing mortgages. This risk, and others, will be described in more detail in Chapter 20.

Municipal Bonds

Municipal bonds are issued by states, territories and possessions of the United States, as well as other political subdivisions (e.g., counties, cities, or school districts). Public agencies (e.g., authorities and commissions) also have the authority to issue municipal bonds. Unlike U.S. Treasury securities, these debt instruments carry some level of default risk since municipal bonds are not backed by the federal government.

For most investors, the primary advantage of municipal bonds is that the interest received is typically exempt from federal tax. Another advantage is that most states don't tax the interest from bonds that are issued within their state borders if they're purchased by their state residents. For this reason, investors tend to buy in-state bonds to avoid potential federal, state, and (in some cases) local taxes.

Copyright © Securities Training Corporation. All Rights Reserved.

Types of Municipal Bonds

There are primarily two types of municipal bonds—*general obligation bonds* (GOs) and *revenue bonds*. GO bonds may be issued to meet any and all needs of the issuer. In a sense, GO bonds are issued for general purposes. On the other hand, revenue bonds are typically issued to fund a specific project or facility, such as a bridge or toll road. For revenue bonds, the cash flows that are generated by the specific project (e.g., tolls, usage fees) are used to repay bondholders.

General Obligation (GO) Bonds

A general obligation bond is secured by the full faith, credit, and taxing power of the issuer. Therefore, only issuers that have the ability to levy and collect taxes may issue GO bonds. State or local governments are able to issue general obligation bonds based on their *statutory* or *constitutional powers*. However, prior to issuing general obligation bonds, issuers must obtain voter approval. Essentially, this voting requirement is due to the fact that taxpayer money is being used to pay debt service.

Authority to Issue A statutory power is a law that's passed by a state or local government which allows for the issuance of securities. The constitutional powers to issue general obligation bonds are derived from the state constitution. These statutory and constitutional powers may also limit the amount of debt that an issuer is able to incur. In other words, a GO bond issuer may be subject to a *debt ceiling*.

Backing State general obligation bonds are usually secured by income tax, sales tax, and other taxes that are collected at the state level. For local jurisdictions, such as counties and cities, the most common source of tax revenue is from levies on real property (ad valorem tax). School taxes are also assessed at the local level and are normally a significant portion of a person's real estate tax assessment. In addition, other *non-tax revenue* (e.g., parking fees, park and recreational expenses, and licensing fees) may be used to pay the debt service on GO bonds.

Revenue Bonds

Revenue bonds are issued for either projects or enterprise financings in which the issuer pledges to repay the bondholders using the revenues that are generated by the project or facility. Issuers of revenue bonds may be authorized political entities (e.g., state or local governments), an authority (e.g., the Port Authority of New York and New Jersey), or a commission that's created to issue bonds for purposes of building and operating a project.

Revenue bonds can be used to finance airports, water and sewer systems, bridges, turnpikes, hospitals, and many other facilities. Concessions, tolls, and user fees that are associated with the use of these facilities are used to make interest and principal payments on the bonds. Revenue bonds are generally considered riskier than GO bonds since the generated revenues may prove to be unreliable or insufficient to fund debt service.

Copyright © Securities Training Corporation. All Rights Reserved.

Another source of revenue originates from rental or lease payments. For example, a state may create a non-profit authority to issue revenue bonds in order to build a school. The local government that uses the school will lease the facility from the authority and the lease payments will be used by the issuer to pay interest and principal.

Revenue bonds may be issued when voter approval for general obligation bonds cannot be obtained. Also, revenue bonds may be issued to finance capital projects when statutory or constitutional debt limitations prevent a municipality from issuing general obligation bonds.

Types of Revenue Bonds

Revenue bonds are generally characterized by the project that the bond is financing or by the source(s) backing the bond. The following list represents some of the more common types of revenue issues.

Housing Revenue Bonds Housing bonds are issued by state or local housing finance agencies in an effort to help fund single family or multi-family housing and are normally for low or moderate income families. In some cases, the proceeds of the bond offering are lent to the real estate developers that are constructing the property.

Dormitory Bonds Dormitory bonds are issued to build housing for students at public universities and are repaid from a portion of students' tuition payments.

Health Care Revenue Bonds Health care bonds are used for the construction of non-profit hospitals and health care facilities.

Utility Revenue Bonds Utility bonds are issued to finance gas, water and sewer, and electric power systems that are owned by a governmental unit. The bonds are normally backed by the user fees that are charged to customers.

Transportation Bonds Transportation bonds are used to finance projects such as bridges, tunnels, toll roads, airports, and transit systems. User fees (e.g., tolls) are used to pay the debt service on these bonds.

Special Tax Bonds Special tax bonds are backed by special taxes (e.g., taxes on tobacco, gasoline, hotel/motel stay) for a specific project or purpose, but not by ad valorem (property) taxes. For example, highway bonds that are payable from an excise tax on gasoline are considered special tax bonds.

Special Assessment Bonds Special assessment bonds are payable only from a specific charge on those who directly benefit from the facilities. Examples include bonds that are issued to develop or improve water and sewer systems, sidewalks, and streets.

Copyright © Securities Training Corporation. All Rights Reserved.

Moral Obligation Bonds Moral obligation bonds are first secured by the revenues of a project; however, if revenues are insufficient to pay debt service requirements, the state (or a state agency) is morally obligated (but not legally required) to provide the needed funds. Prior to issuing the bonds as moral obligation bonds, the *legislative approval* of the state government must be obtained.

Lease Rental Bonds Lease rental offerings involve one municipal entity leasing a facility from another. For example, a state building authority may issue bonds to build a college dormitory and then the authority will lease the dorm to the college. The bonds issued by the building authority will be paid from the revenues that are generated through lease payments received from the college.

Private Activity Bonds If more than 10% of the bond's proceeds will be used to finance a project for use by a private entity (e.g., a corporation or professional sports team) and if more than 10% of the bond's proceeds will be secured by property used in the private entity's business, the bonds are referred to as private activity bonds.

Industrial Development Bonds (IDB) IDBs are a type of private activity bond that are issued by a municipality and secured by a lease agreement with a corporation. The purpose for the offering is to build a facility for a private company. The security's credit rating is based on the corporation's ability to make lease payments since the municipality doesn't back the bonds.

Taxable Municipal Bonds In certain cases, a municipality may not be able to issue bonds that are exempt from federal income tax. This may occur when the bonds are issued to finance projects that don't provide a significant benefit to the general public.

Some examples of situations in which a bond may lose its tax exemption include 1) an offering in which the proceeds are being used to build a sports facility or certain types of housing, or 2) an offering designed to allow an issuer to borrow funds in order to replenish its unfunded pension liabilities.

Double-Barreled Bonds Double-barreled bonds are backed by a specific revenue source (other than property taxes) as well as the full faith and credit of an issuer with taxing authority (a GO issuer). Essentially, debt service on the bonds will be paid by a combination of tax dollars and revenue dollars from the project being constructed.

 Copyright © Securities Training Corporation. All Rights Reserved.

The following chart summarizes the differences between GO and revenue bonds:

	General Obligation Bonds (GOs)	Revenue Bonds
Issuer:	States and local municipalities	States or local governments, an authority, or agency
Required for issuance:	Voter approval	Feasibility study (described later)
Source of the funds backing the bonds:	Taxes ▪ State GOs: Secured by income, sales, and other state-collected taxes ▪ Local GOs: Secured by property tax (ad valorem tax on assessed property value)	Collected revenues generated by a financed project ▪ Concessions ▪ Tolls ▪ User fees ▪ Rental or lease payments
Use of the funds:	Paying the general operating expenses of a municipality and for capital improvement projects (e.g., roads, parks, schools, and government buildings)	Construction of airports, water and sewer systems, bridges, toll roads/turnpikes, hospitals, etc.

Now that both GO and revenue bond issues have been examined, let's consider shorter term municipal instruments.

Municipal Notes

Municipal notes are short-term issues that are normally issued to assist in financing a project or to assist a municipality in managing its cash flow. Municipal notes are interest-bearing securities that ultimately pay interest at maturity.

Tax Anticipation Notes (TANs) TANs are issued to finance current municipal operations in anticipation of future tax receipts from property taxes. Also, TANs are typically classified as general obligation securities.

Revenue Anticipation Notes (RANs) RANs are issued for the same purpose as TANs except that they're issued in anticipation of receiving revenues at a future date. Depending on the facility that's generating the revenue, it could be in the form of federal or state subsidies.

Tax and Revenue Anticipation Notes (TRANs) TRANs are created when TANs and RANs are issued together.

Bond Anticipation Notes (BANs) BANs are issued to obtain financing for projects that will eventually be financed through the sale of long-term bonds.

Grant Anticipation Notes (GANs) GANs are issued in expectation of receiving funds (grants) from the federal government.

Construction Loan Notes (CLNs) CLNs are issued by municipalities to provide funds for the construction of a project that will eventually be funded by a bond issue.

Copyright © Securities Training Corporation. All Rights Reserved.

Ratings for Municipal Notes

As described in Chapter 4, Moody's and Standard and Poor's issue ratings for fixed-income securities. Both organizations also have a rating system that's specific to municipal notes.

Moody's has four rating categories for municipal notes and variable rate demand obligations (VRDOs) – which are described below. The first three ratings are considered Moody's Investment Grade (MIG) ratings, with the fourth considered a speculative grade. VRDOs receive ratings based on a variation of the MIG scale—the Variable Municipal Investment Grade (VMIG) system.

MIG 1 (VMIG 1): Superior credit quality
MIG 2 (VMIG 2): Strong credit quality
MIG 3 (VMIG 3): Acceptable credit quality
SG: Speculative grade credit quality

Standard and Poor's has the following four rating categories for municipal notes:

SP-1+: Very strong capacity to pay principal and interest
SP-1: Strong capacity to pay principal and interest
SP-2: Satisfactory capacity to pay principal and interest
SP-3: Speculative capacity to pay principal and interest

Other Municipal Securities

Auction Rate Securities

Auction rate securities (ARSs) are long-term investments that have a short-term twist—the interest rates or dividends that they pay are reset at frequent intervals through auctions. Investors who purchase ARSs are typically seeking a cash-like investment that pays a higher yield than what's available from money-market mutual funds or certificates of deposit. Generally, there are two types of ARSs, bonds with long-term maturities (20 to 30 years) and preferred shares with a cash dividend. Both the interest rate on the bonds and the dividend on the preferred shares will vary based on rates that are set through Dutch auctions for a specified short period that's usually measured in days—7, 14, 28, or 35. Auction rate bonds are issued by entities such as corporations, municipalities, student loan authorities, and museums, while auction rate preferred shares are issued by closed-end funds (which are described in Chapter 7).

Variable Rate Demand Obligations (VRDOs)

Another long-term security that's marketed as a short-term investment is a variable rate demand obligation (VRDO). A VRDO's interest rate is adjusted at specified intervals (daily, weekly, monthly) and, in many cases, this adjustment allows the owner to sell or put the security back to the issuer or a third party on the date that a new rate is established. If this is done, the investor will receive the par value plus accrued interest.

Copyright © Securities Training Corporation. All Rights Reserved.

Investors who are interested in short-term investments may also purchase other tax-free money-market instruments such as tax-exempt commercial paper and tax-free money-market funds. Tax-exempt commercial paper has a maximum maturity of 270 days and is normally backed by a bank line of credit.

The Primary Market for Municipal Bonds

Like U.S. government and government agency securities, municipal securities are exempt from the registration and prospectus requirements of the Securities Act of 1933. Although exempt, the underwriting process for municipal securities follows many of the same guidelines that are used for corporate underwritings. The Municipal Securities Rulemaking Board (MSRB)—the SRO for firms that deal in municipal securities—formulates the rules and regulations that relate to municipal underwritings.

Issuing GO Bonds

Since GO bond issues are backed by taxes, the following two requirements must be satisfied:

1. **Voter Approval** The issuance of general obligation bonds usually requires voter approval since it's the funds that are generated by taxing citizens that are used to pay the debt service. For a general obligation bond, the indenture (written contract) will typically include the statutes which permit the issuer to levy taxes.
2. **Debt Ceiling Limitations** A GO issue is generally subject to debt limitations that are placed on the municipality by a voter referendum or by statutes. A municipality is not permitted to issue bonds in excess of its debt limitation since doing so would exceed its *debt ceiling*.

Issuing Revenue Bonds

Since revenue bonds are backed by the user fees that are generated by a project or facility (and not by taxes), voter approval is not required. However, there are special procedures to be followed and requirements to be met prior to issuing revenue bonds. One of these procedures is conducting a *feasibility study*.

Feasibility Study A municipality must hire a consulting engineer to study the project and present a report to identify whether the project will be able to bring in the necessary revenues. This report examines the need for the proposed project and whether the project is a sound economic investment. An accounting firm is usually retained to help determine whether the revenues will be sufficient to cover expenses and debt service.

New Issue Underwritings

Once a municipal issuer has determined that there's a need for a bond issue and has followed the preliminary steps required to offer a bond (e.g., obtaining voter approval for a GO issue or completing a feasibility study for a revenue issue), it may continue the process of issuance. At this point, the municipality will typically seek the assistance of an underwriter (investment banker).

Copyright © Securities Training Corporation. All Rights Reserved.

Role of the Underwriter A municipal underwriter plays an important role in the process of offering securities. The underwriter acts as a vital link between the issuer and the investing public by assisting the issuer in pricing the securities, structuring the financing, and preparing a disclosure document (referred to as the official statement).

Selecting an Underwriter In some cases, the issuer will simply appoint its underwriter by using a process that's referred to as a *negotiated sale*. Another method involves requesting that interested underwriters submit proposals through a bidding process that's referred to as a *competitive sale*.

Negotiated Sale With a negotiated sale, an issuer brings its issue to market by selecting the lead underwriter or senior manager that will sell the issue to the public. Essentially, the issuer requests the assistance of the firm with which it wants to work. The size of the issue, the coupon rate, possible call provisions, and other details are generally decided during the issuer's negotiation with the underwriter.

Competitive Sale Rather than selecting its underwriter, an issuer may invite interested underwriters to compete against one another by submitting bids for the issue. The syndicate that submits the best bid is awarded the bonds. Normally, the best bid is the one that presents the issuer with the lowest interest cost over the life of the issue.

The following summarizes the primary method that different issuers use for underwriting purposes:

- U.S. government securities – Auction process
- Municipal general obligation bonds – Competitive sale
- Municipal revenue bonds – Negotiated sale
- Corporate bonds – Negotiated sale

Forming a Municipal Syndicate

Traditionally, several broker-dealers will combine to form an underwriting syndicate and one firm will act as the syndicate manager (lead underwriter). The syndicate is essentially a group of underwriters that share the liability and risk for selling the issue. Although the syndicate's composition may change, it's usually comprised of firms that have worked together in the past. Municipal issues are typically sold on a firm-commitment basis, which means that the selected/ winning syndicate is fully responsible for selling the entire offering. The underwriting process will be described in more detail in Chapter 11.

Copyright © Securities Training Corporation. All Rights Reserved.

Corporate Bonds

Corporations that issue bonds use the proceeds from the offering for a variety of purposes—from building facilities and purchasing equipment to expanding their businesses. The advantage to issuing bonds over issuing stock is that the corporation is not giving up any control of the company or any portion of its profits. However, the disadvantage is that the corporation is required to repay the money that was borrowed plus interest.

If a corporation has common and preferred stock outstanding and issues bonds, it's required to pay the interest on its outstanding bonds before it pays dividends to its stockholders. Also, if the company goes bankrupt, bondholders and other creditors must be satisfied before the stockholders can make a claim to any of the company's remaining assets. Although buying corporate bonds puts an investor's capital at less risk than purchasing stock of the same company, bonds typically don't offer the same potential for capital appreciation as common stocks.

Types of Corporate Bonds

Corporate bonds are divided into two major categories—*secured* and *unsecured*. Although all debt that's issued by a corporation is backed by the issuer's full faith and credit, secured bonds are additionally backed by specific corporate assets.

Secured Bonds

With secured bonds, if the issuer falls into bankruptcy, the trustee will take possession of the assets, liquidate them, and then distribute the proceeds to the bondholders. Therefore, if the company defaults, secured bondholders have a higher degree of protection.

The following are the different types of secured bonds that companies issue:

Mortgage Bonds Mortgage bonds are secured by a first or second mortgage on real property; therefore, bondholders are given a lien on the property as additional security for the loan.

Equipment Trust Certificates These are bonds secured by a specific piece of equipment that's owned by the company and used in its business. The trustee holds legal title to the equipment until the bonds are paid off. These bonds are usually issued by transportation companies and backed by the company's rolling stock (i.e., assets that move), such as railroad cars, airplanes, and trucks.

Collateral Trust Bonds Collateral trust bonds are secured by third-party securities that are owned by the issuer. The securities (stocks and/or bonds of other issuers) are placed in escrow as collateral for the bonds.

Copyright © Securities Training Corporation. All Rights Reserved.

Type of Secured Bond	Collateral
Mortgage	Real Estate
Equipment Trust	Equipment
Collateral Trust	Stocks or Bonds

Asset-Backed Securities (ABS) Many loans that are held by financial institutions (banks and finance companies) are not permanently held by the lender; instead, some are securitized and offered to investors. This securitization is done with credit card receivables, home equity, as well as automobile and student loans.

In the process of securitizing the loans, the lender sells its receivables to a trust that creates a security which represents an interest in the trust and is backed by the subject receivables. In many cases, the investor receives a monthly payment that reflects both interest and principal amortization.

The benefits of investing in these securities includes a higher yield or return as compared U.S. Treasury securities, high credit quality since they're secured, and a relatively predictable cash flow. Asset backed securities are subject to interest-rate risk, credit risk, and prepayment risk due to being backed by payments that are made to the lender.

Unsecured Bonds

When corporate bonds are backed by only the corporation's full faith and credit, they're referred to as *debentures*. If the issuer defaults, the owners of these bonds have the same claim on the company's assets as any other general creditor (i.e., before stockholders, but after secured bondholders).

Occasionally, companies issue unsecured bonds that have a junior claim on their assets compared to its other outstanding unsecured bonds. These bonds are referred to as *subordinated debentures*. In case of default, the owner's claims are subordinate to those of the other bondholders. If the company defaults, the owners of subordinated debentures will be paid after all of the other bondholders, but still before the stockholders.

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

Copyright © Securities Training Corporation. All Rights Reserved.

High-Yield (Junk) Bonds Corporate bonds that are rated below investment grade (below BBB by S&P or below Baa by Moody's) are referred to as *high-yield* or *junk bonds*. The lower rating indicates that bond analysts are uncertain about the issuer's ability to make timely interest payments and to repay the principal. In other words, these bonds carry a higher-than-normal credit risk and typically pay higher coupons in order to compensate investors for the added degree of risk.

Guaranteed Bonds A guaranteed bond is one that, along with its primary form of collateral, is secured by a guarantee of another corporation. The other corporation promises that it will pay interest and principal if necessary. A typical example is a parent company that guarantees a bond that's issued by a subsidiary company.

Other Types of Corporate Bonds

Income Bonds

Income bonds are normally issued by companies in reorganization (bankruptcy). The issuer promises to repay the principal amount at maturity, but does NOT promise to pay interest unless it has sufficient earnings. Since interest payments are not promised, income bonds *trade flat* (without accrued interest), sell at a deep discount (well below par), and are considered speculative investments.

Eurodollar Bonds, Yankee Bonds, and Eurobonds

A *Eurodollar* is a dollar-denominated deposit that's made outside of the United States. *Eurodollar bonds* pay their principal and interest in U.S. dollars, but are issued outside of the U.S. (primarily in Europe). The issuers of Eurodollar bonds include foreign corporations, foreign governments, and international agencies, such as the World Bank.

Another common type of bond that's denominated in U.S. dollars is a *Yankee bond*. Yankee bonds allow foreign entities to borrow money in the U.S. marketplace. These bonds are registered with the SEC and sold primarily in the U.S.

A *Eurobond* is sold in one country, but denominated in the currency of another. The issuer, currency, and primary market may all be different. For example, a Russian manufacturer could sell bonds that are denominated in Swiss francs in London. This type of bond, which is referred to as a foreign pay bond, can be greatly affected by interest-rate movements in the country in which it's denominated.

The Money-Market

Debt securities with maturities of more than one year are often referred to as *funded debt,* while short-term debt instruments with one year or less to maturity are referred to as *money-market securities*. There are a significant number of securities that trade in the money market with issuers, including the U.S. government (e.g., T-bills), government agencies, banks, and corporations. There's also a diverse group of participants that utilize the money market, including the Federal Reserve Board, banks, securities dealers, and corporations.

Copyright © Securities Training Corporation. All Rights Reserved.

Money-market transactions provide an avenue for both acquiring money (borrowing) and investing (lending) excess funds for short periods. Typically, the investment period ranges from overnight to a few months, but may be as long as one year.

Types of Money-Market Securities

Examples of money-market securities and related instruments include:

- Commercial paper
- Bankers' acceptances
- Negotiable certificates of deposit
- Federal funds
- Money-market mutual funds
- Repurchase agreements (Repos)

Money-market instruments are a separate asset class and referred to as *cash equivalents*. Since cash equivalents are investments of high quality and safety, they're considered to be nearly the same as cash.

Commercial Paper When corporations need long-term financing, they issue bonds. Short-term needs are met by the issuance of commercial paper. Commercial paper is short-term, unsecured corporate debt which typically matures in 270 days or less. Due to its short maturity, commercial paper is exempt from the registration and prospectus requirements of the Securities Act of 1933. Similar to T-bills, commercial paper is usually issued at a discount; however, some issues are interest bearing. The standard minimum denomination is $100,000.

Since commercial paper is typically issued by corporations with high credit ratings, it's considered very safe. Standard & Poor's, Fitch, and Moody's issue credit ratings for commercial paper. S&P will assign ratings from A1 (highest) to A3, and Fitch will assign ratings from F1+ (highest) to F3. The highest rating that Moody's will assign to commercial paper is P-1 (also called Prime 1) with intermediate ratings of P-2 and P-3. Speculative commercial paper receives a rating of NP (not prime).

Bankers' Acceptances (BAs) Bankers' acceptances are instruments that are used to facilitate foreign trade. For example, let's assume that an American food company is importing French snails. The American company may wish to pay for the snails after delivery and, therefore, it issues a time draft (i.e., a check that's payable on a future date) which is secured by a letter of credit from a U.S. bank as payment. The French company exporting the snails is able to hold the draft until its due date and receive the full amount or may cash it immediately at a bank for a discounted amount. At that point, the bank has the draft guaranteed by the issuing bank and it becomes a banker's acceptance. BAs are actively traded and considered quite safe since they're secured both by the issuing bank and by the goods that were originally purchased by the importer.

Repurchase Agreements (Repos) In a repurchase agreement (repo), a dealer sells securities (usually T-bills) to another dealer and agrees to repurchase them at both a specific time and price (a higher price). Essentially, the first dealer is borrowing money from the second dealer and securing the loan with securities (a collateralized loan). In return for making the loan, the second dealer (the lender) receives the difference between the purchase price and the resale price of the securities.

 Copyright © Securities Training Corporation. All Rights Reserved.

If a dealer purchases securities and agrees to sell them back to the other dealer at a specific date and price, this is referred to as a *reverse repo* or *matched sale*. In this situation, the first dealer lends money (with securities as collateral) to the second dealer and earns the difference in sales prices. Many corporations, financial institutions, and dealers engage in repos and reverse repos. These types of transactions are typically short-term, with most being overnight transactions.

Negotiable Certificates of Deposit (CDs) Banks and savings and loans issue certificates of deposit, which are time deposits that carry fixed rates of interest and mature after a specified period. Although most CDs mature in one year or less, they essentially have a minimum maturity of seven days with no maximum maturity. Holders of CDs are penalized if they redeem them prior to their stated maturity.

Negotiable CDs have a minimum denomination of $100,000, but often trade in denominations of $1,000,000 or more (also referred to as jumbo CDs). There's an active secondary market in these securities. CDs of up to $250,000 are currently insured by the Federal Deposit Insurance Corporation (FDIC).

Long-Term CDs Long-term or *brokered CDs* generally have maturities that range from two to 20 years and are not considered to be money-market securities. These long-term CDs may have additional risks that are not associated with traditional bank-issued CDs, including:

- Either limited or potentially no liquidity
- The possibility of experiencing a loss of principal if the CD is sold prior to maturity
- The potential existence of call features that limit capital appreciation and subject the investor to reinvestment risk
- The possibility of no FDIC insurance

Federal Funds (Fed Funds) The monies borrowed overnight on a bank-to-bank basis are referred to as *fed funds*. This interbank borrowing is usually done to allow a bank to meet the reserve requirement which is set by the Federal Reserve. One bank with excess reserves may lend them to another bank that's in need of reserves. This allows the bank with excess reserves to earn interest on funds that would otherwise remain idle.

The rate charged on these overnight loans is referred to as the *fed funds rate*. The rate fluctuates on a daily basis and is a leading indicator of interest-rate trends since it reflects the availability of funds in the system. Although the Federal Reserve doesn't set the fed funds rate, it will attempt to influence the rate through its purchases and sales of government securities in the secondary market.

Other short-term interest rates tend to follow changes in the fed funds rate. A bank charges the *prime rate* when providing loans to corporations that are among the bank's best credit-rated customers. Other corporations may be charged a higher rate, but the rate will be based on the prime rate. The *London Interbank Offered Rate (LIBOR)* is the average rate that banks charge each other on loans for London deposits of Eurodollars.

Copyright © Securities Training Corporation. All Rights Reserved.

Bond Taxation Summary

As this chapter comes to a conclusion, the following chart should be useful in identifying the tax implications of the interest for each type of bond:

Security	Federally Taxable	State/Local Taxable
T-Bill	Yes	No
T-Note/T-Bond	Yes	No
TIPS	Yes	No
STRIPS	Yes	No
Government National Mortgage Association (GNMA)	Yes	Yes
Federal National Mortgage Association (FNMA)	Yes	Yes
Federal Home Loan Mortgage Corporation (FHLMC)	Yes	Yes
Federal Farm Credit Banks (FFCBs)	Yes	No
Federal Home Loan Banks (FHLBs)	Yes	No
Student Loan Marketing Association (SLMA)	Yes	Varies
Municipal Bonds	No	Varies*
Territory/Possession Bonds	No	No
Corporate Bonds	Yes	Yes

* In most states, taxpayers don't pay state and local tax on bonds issued by municipal entities that are located in the states in which they reside.

Conclusion

This concludes the discussion on the types of debt instruments. The next chapter will examine the various measurements of return for both equity and debt investors.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 5 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Recognize and understand the types of U.S. government direct obligations
- Recognize and understand non-interest-bearing securities
- Recognize the characteristics of the U.S. Treasury security auction market
- Recognize and understand government/sponsored agency securities
  - Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC), Federal Farm Credit Bank (FFCB), and Federal Home Loan Bank (FHLB)
- Understand the characteristics of mortgage-backed securities (MBS)
  - Understand the impact of prepayment risk on MBS
- Identify and understand the two types of municipal bonds
  - General obligation (GO) bonds
  - Revenue bonds (including the different forms)
- Understand the characteristics and ratings for municipal notes
- Understand the characteristics of municipal auction rate securities (ARS)
- Understand the characteristics of variable rate demand obligations (VRDO)
- Understand the primary market for municipal bonds
  - The issuance of GO bonds
  - The issuance of revenue bonds
- Understand the new issue underwritings process and components of the underwriting spread
- Understand the process of forming an underwriting syndicate
- Recognize and understand the types of corporate bonds
  - Secured bonds, unsecured bonds (debentures), income bonds
  - Eurodollar bonds (and Eurodollars), Yankee bonds, Eurobonds
  - Money market securities
- Understand the tax implications for bond interest

Create a Chapter 5 Custom Exam

Now that you've completed Chapter 5, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 6 –
Investment Returns

- *Return on Investments*
- *Price versus Yield*
- *Cost Basis and Capital Events*
- *Measuring Return*
- *Averages and Indexes*

Copyright © Securities Training Corporation. All Rights Reserved.

Most individuals who invest their money expect a profit or a positive return. This chapter will cover the various methods that investors use to measure the performance of their stock and/or bond investments. These returns may come in the form of periodic dividends that are paid on equities or interest that's paid on bonds. Another form of return is any change in value (either appreciation or depreciation) that may occur between the purchase and sale of a given investment. The end of the chapter will examine the use of benchmarks, which many investors use to gauge the relative performance of their investments.

Return on Equity Investments

Chapter 3 described that buying a corporation's equity securities makes the investor a part owner of the corporation. In some cases, corporations may choose to allow its shareholders to participate in its earning by paying out dividends. Dividend payments are voluntary, unlike bond interest payments which are mandatory.

Dividends

Common stock doesn't receive a specific annual dividend; instead, the board of directors decides what dividends (if any) the company is able to pay to its common shareholders. Dividends are paid on a per-share basis. As it relates to dividends, there are three important dates that are set by the paying corporation:

- ***Declaration date***: The declaration date is the date on which the dividend is authorized. If a company's board declares a $.10 dividend, its stockholders as of a specific date will receive $.10 for each share that they own.
- ***Payment date***: The payment date is the date on which the declared dividend will be paid. Dividends are usually paid quarterly and are taxable in the year in which they're paid/received.
- ***Record date***: The record date is the date on which an investor must officially own the stock to be entitled to receive the dividend.

For example, on December 1, the board of Widgets, Inc. declares a dividend of $1 per share that's payable on January 3 to shareholders of record on December 15. Any person who is on Widget Corporation's records as a shareholder as of December 15 will receive the $1-per-share dividend on January 3.

Copyright © Securities Training Corporation. All Rights Reserved.

Declaration Date
Board of Directors
Declares Dividend

Record Date
Last Possible Day
to Own Shares and
Receive Dividend

Shareholders
R. Jones
T. Smith
S. Johnson

Payment Date
Dividend Sent
to Shareholders

Jan. 3
Twenty-Five Dollars and — $25.50
Pay to: R. Jones

December 1 **December 15** **January 3**

Ex-Dividend Rule Although a corporation's board of directors sets the declaration, payment, and record date, the ex-dividend date is set by the SRO for the market on which the stock trades
(e.g., FINRA). The ex-dividend date represents the date on which a stock begins to trade without its dividend. A stock will typically trade ex-dividend one business day prior to the record date (i.e., record date minus one business day). So ultimately, an individual who purchases a stock for regular-way settlement (trade date + 2 business days, or T + 2) either on or after the ex-dividend date will not be entitled to the quarterly cash dividend since he will not own the stock by the record date.

The following example is used to explain the concept:

MAY 20XX						
S	**M**	**T**	**W**	**Th**	**F**	**S**
1	2	3	4	5	6	7
8	9	10	11 (Ex-Dividend Date)	12 (Record Date)	13	14

For example, on Monday, April 25, the board of directors of XYZ Corporation declares a $.60 dividend which will be paid on Friday, May 27, to all stockholders of record on May 12. The stock will trade ex-dividend on Wednesday, May 11 (one business day prior to the record date). Assuming a two-business-day settlement, any trade that's executed on May 11 will not settle until May 13 (the day after the record date). Therefore, investors who purchase XYZ stock on or after May 11 will not be entitled to the dividend.

Copyright © Securities Training Corporation. All Rights Reserved.

The ex-dividend date represents the first day that a stock begins to trade without its dividend. Therefore, on the ex-dividend date, the stock's price will be reduced by an amount equal to the dividend to be paid. For example, if a stock paying a $.50 dividend closes at $20 per share on the day before the ex-date, it will open at a price of $19.50 on the ex-dividend date. For any dividend that's in a fractional amount, the reduction must cover the full dividend (i.e., a dividend of $0.12 $^{1}/_{2}$ results in a reduction of $0.13).

Due Bills If a trade is executed prior to the ex-dividend date, the buyer is entitled to the dividend. However, if the seller fails to deliver the securities by the record date, the seller will remain as the shareholder of record for the dividend payment. The seller will receive the dividend, but not be entitled to it. Therefore, good delivery rules require a due bill to accompany the stock which creates a liability for the seller and a receivable for the buyer.

Using the calendar from the previous example with a record date of Thursday, May 12, if an investor purchases stock on Tuesday, May 10, the transaction will settle in two business days—Thursday, May 12. The buyer will receive the dividend because the transfer agent will be made aware of the name of the new owner in time to change the shareholder's record for the upcoming dividend. Because the stock trades ex-dividend on Wednesday, May 11, from that date forward, the buyer will be able to purchase the stock at a price that doesn't include the dividend. A due bill will be required only if the buyer purchases the stock before the ex-date, but the seller delivers the security after the record date.

Using Cash Settlement A buyer may still obtain the dividend after the normal ex-date by purchasing the security and using a cash (same day) settlement on a date up to, and including, the record date. In the preceding example, if the investor buys for cash as late as Thursday, May 12, she's entitled to the dividend. In this case, the price of the stock is adjusted to reflect buyer's receipt of the dividend. For a cash settlement trade, the ex-dividend date is the business day following the record date.

Stock Dividends Rather than making a cash distribution, a company may elect to pay a dividend to its shareholders in the form of additional shares of stock.

For example, an investor bought 100 shares of Widget, Inc. for $80 per share; therefore, his cost basis is $8,000. If Widget, Inc. declares a 10% stock dividend the investor will be entitled to an additional 10 shares (100 x 10%). Unlike ordinary cash dividends, stock dividends are not taxable until the shares are subsequently sold. Ultimately, the investor will be holding an increased number of shares, but at a reduced price per share. Although this form of distribution is not taxable, the IRS requires the investor to adjust her cost basis on the stock as follows:

- *Original cost basis = $80.00 per share ($8,000 ÷ 100 original shares)*
- *Adjusted Cost basis = $72.72 per share ($8,000 ÷ 110 current shares)*

Copyright © Securities Training Corporation. All Rights Reserved.

Calculating Current Yield (Dividend Yield)

For stock, the current yield is its annual return based on its annual dividend and current price (as opposed to its original price or face value). The formula for calculating a stock's current yield is its *annualized* dividend divided by its current market price.

For example, if XYZ stock is trading at $50 per share and the stock has a quarterly dividend of $0.25, its current yield is 2%. Since dividends are typically paid quarterly, the $0.25 dividend must be multiplied by four to determine the annualized dividend income.

$$\frac{\$0.25 \times 4}{\$50} = \frac{\$1.00}{\$50} = 2\%$$

Return on Bond Investments

As described in Chapter 4, when an issuer sells bonds, it's obligated to make consistent interest payments to the bondholders that are allowing it to borrow their money. This fixed rate of interest is also referred to as the bond's coupon rate. Remember, regardless of whether a bond is purchased at a premium, par, or discount price, its interest rate is always based on its par value of $1,000. The basic formula for determining the dollar amount of interest paid each year is the bond's coupon rate multiplied by its par value.

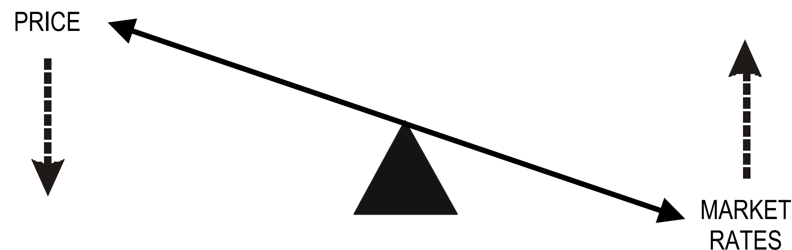
Example 1: If a client purchases a 6% corporate bond and pays $875, she will receive $60 per year ($1,000 x 6% = $60).

Example 2: If a client purchases an 8% corporate bond and pays $1,000, she will receive $80 per year ($1,000 x 8% = $80).

Example 3: If a client purchases a 9% corporate bond and pays $1,100, she will receive $90 per year ($1,000 x 9% = $90).

Prices and Yields – An Inverse Relationship

As previously mentioned, a bond's coupon (interest rate) is generally fixed for its life. Therefore, as market interest rates change, new bonds will be issued with either higher or lower coupon rates than what existing bonds pay. To keep pace with current interest rates, the value of existing bonds will need to change. As interest rates rise, the value (price) of existing bonds will fall since the demand for existing bonds that offer lower interest rates will decline. On the other hand, if interest rates fall, the value (price) of existing bonds will rise since they're worth more than new bonds being issued with lower coupons.



Copyright © Securities Training Corporation. All Rights Reserved.

To summarize, as interest rates increase, the prices of existing bonds decrease and, as interest rates decrease, the prices of existing bonds increase.

Understanding this fundamental inverse relationship between market interest rates and existing bond prices is the first step in determining what an investor actually earns. The simple discussion regarding the amount of interest a bondholder receives by multiplying the par value by the coupon rate may be insufficient. Since investors will likely purchase bonds in the secondary market at a price other than par value, when they're considering their actual return on investment, they will need to account for the price difference and subsequent return of par at maturity.

Calculating Bond Yields

As with any other investors, bondholders are interested in determining their investment's return or yield. There are three different measures for determining a bond's yield—*nominal yield, current yield,* and *yield-to-maturity*.

Nominal Yield A bond's nominal yield is the same as its coupon rate. If a bondholder purchases a 6% bond, her nominal yield is 6% *regardless of the price she paid.* Nominal yield is the simplest measurement of return; however, since it fails to account for the fact that the bond may have been purchased at a premium or discount, it's simply a place to begin the yield discussion.

Current Yield Current yield essentially measures what a bond investor receives each year based on her (potential) purchase price. While the nominal yield is based on a bond's par value, current yield is based on the bond's *current market price*.

Current yield is calculated by dividing the bond's annual interest payment by the bond's current market price.

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

Since a bond's nominal yield is fixed, if an investor purchases a 10% bond, she will receive $100 per year ($1,000 x 10%). However, the determination of her current yield will be very different depending on the price she pays.

Price Paid	Annual Interest	Current Yield Calculation	Current Yield
$900 (discount)	$100	$100 ÷ $900	11.11%
$1,000 (par)	$100	$100 ÷ $1,000	10%
$1,100 (premium)	$100	$100 ÷ $1,100	9.09%

Copyright © Securities Training Corporation. All Rights Reserved.

Determining and analyzing a bond's current yield allows an investor to gain a better understanding of what she's earning on the bond. However, current yield fails to take into consideration the payment at maturity. If an investor buys a bond at a price other than par, the difference between the price paid (premium or discount) and the par value paid at maturity must be factored in to determine the bond's overall yield.

Yield-to-Maturity (YTM) Yield-to-maturity takes into account *everything* that an investor receives on a bond from the time she purchases it until the bond ultimately matures. This includes the bond's interest payments *plus* the difference between what the investor paid for the bond and what she receives at maturity (par).

An investor who purchases a bond at par will get her money back at maturity. An investor who purchases a bond at a discount will have a profit since she paid less for the bond than its par value. An investor who purchases a bond at a premium will have a loss since she paid more than the bond's par value.

> *Note: The calculation of YTM is complex and not required to be calculated for exam purposes. Instead, the goal should be to gain an understanding of the concept.*

Basis A bond's yield-to-maturity is also referred to simply as its *yield* or its *basis*. Therefore, a 7.44% yield-to-maturity, a 7.44% yield, and a 7.44 basis are synonymous.

The term basis is derived from one method of expressing yield. One *basis point* is equal to 1/100 of 1% and, for that reason, a 1% difference in yield equals 100 basis points. The term basis points may be used to compare the yields of two different bonds. For example, if Bond A is trading at a 4.55 basis and Bond B is trading at a 4.95 basis, then Bond B is trading 40 basis points higher than Bond A. If an investor purchased Bond B with a 4.95 basis, it would provide a pick-up yield of 40 basis points over Bond A.

YTM Example 1 An investor purchases a 10% bond for $900 (at a discount). If the bond matures in 10 years, the bond's yield-to-maturity will include:

1. The bond's semiannual interest payments for the next 10 years, *plus*
2. The $100 gain that she will receive when the bond matures ($1,000 par value – $900 market price), *plus*
3. The interest earned from reinvesting the semiannual coupon payments

Since the investor purchased this bond at a discount, the bond's yield-to-maturity will be greater than both its nominal yield and current yield.

YTM Example 2 Now let's assume that the investor purchases the same 10-year, 10% bond for $1,100 (at a premium). In this case, the yield-to-maturity will include:

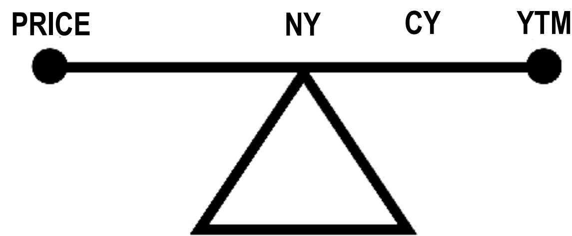
1. The bond's semiannual interest payments for the next 10 years, *minus*
2. The $100 loss that she will incur when the bond matures ($1,100 market value – $1,000 par value), *plus*
3. Interest earned from reinvesting the semiannual coupon payments

 Copyright © Securities Training Corporation. All Rights Reserved.

Since the investor purchased the bond at a premium, the yield-to-maturity will be less than both its nominal yield and current yield. If she had purchased the bond at par, then its yield-to-maturity would be the same as its nominal yield and current yield.

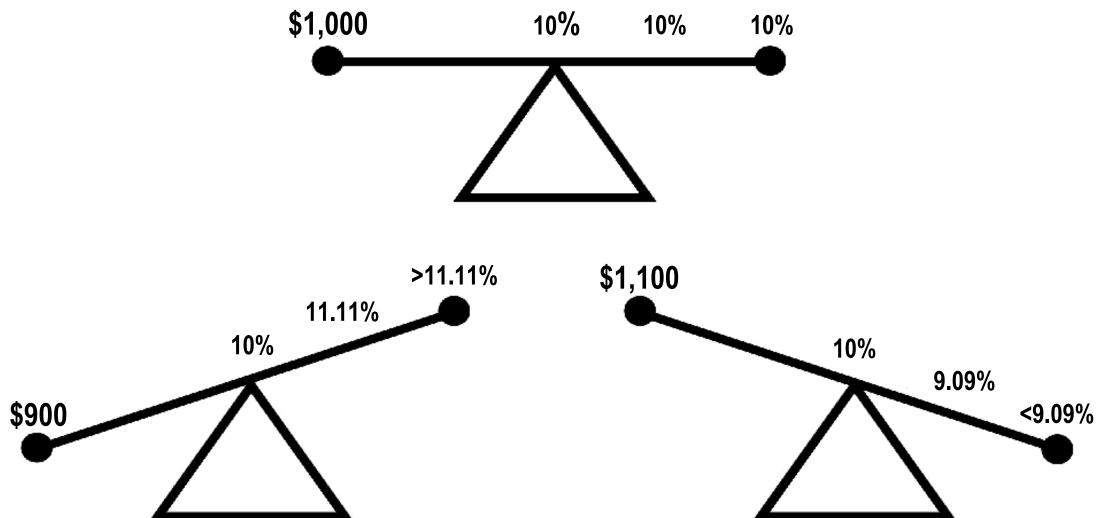
Dollar Price	Nominal Yield	Current Yield	Yield-to-Maturity
$900 (discount)	10%	11.11%	Greater than 11.11%
$1,000 (par)	10%	10%	10%
$1,100 (premium)	10%	9.09%	Less than 9.09%

Using a see-saw or teeter-totter diagram is probably the easiest way to visualize the relationship between bond yields. The bond's price will be placed on the left, with the yields placed to the right. In the diagram below, since the nominal yield is fixed, it's always placed at the top of the triangle. The yield-to-maturity is always placed at the far end, while the current yield will always be placed in between the nominal yield and the yield-to-maturity.



To determine the relationship of yields on a discount or premium bond, just imagine the slope of the line and remember the order in which yields are plotted.

For illustration purposes, the following diagrams will use the yields shown on the previous page:



Copyright © Securities Training Corporation. All Rights Reserved.

To summarize:

- If an investor purchases a bond at par, the nominal yield, current yield, and yield-to-maturity will all be equal.
- If an investor purchases a bond at a discount, the highest yield will be the yield-to-maturity, followed by the current yield, with the nominal yield as the lowest.
- If an investor purchases a bond at a premium, the highest yield will be the nominal yield, followed by the current yield, with the yield-to-maturity as the lowest.

Call Provisions

Some bonds may include a *call provision* which allows the issuer to redeem (call) the outstanding bonds before they reach their final maturity. If called, the issuer is often required to pay the bondholders more than the par value to compensate them for the early redemption of the bonds.

This additional amount is referred to as a *call premium*. This event obviously impacts the bondholder's return since he's receiving more than par and receiving it prior to the bond's expected maturity.

Yield-to-Call (YTC) The yield-to-call represents a bond's yield if it's called prior to maturity. For callable bonds, there's uncertainty as to whether the bond will be called. For that reason, when the bond's yield is quoted to an investor, both the yield-to-call and yield-to-maturity must be calculated. Regulations stipulate that the yield being disclosed to investors must be the lower of the two yields. This conservative return estimate is referred to as providing the bond's *yield-to-worst*. If a bond is trading at a discount, the yield-to-call is higher than the yield-to-maturity; however, if a bond is trading at a premium (and callable at par), the yield-to-maturity is higher than the yield-to-call.

Cost Basis, Capital Events, and Return of Capital

So far, the primary focus has been on the effect of interest and dividend payments for investors. But what happens if the value of investors' underlying investment rises or falls? If the investor has not yet sold, there's no taxable event. In other words, these *unrealized* capital gains or losses (paper profits or losses) have no impact on the investor's tax situation. On the other hand, if the gains or losses are realized, they must be reported on the investor's tax filing.

Cost Basis The term cost basis refers to the total amount that an investor has paid to purchase a security. The calculation typically includes the commissions or other fees which are paid to the brokerage firm when the securities are purchased. Some securities make distributions that can be reinvested to purchase additional securities. The investor's total cost basis will increase since he's required to pay tax on the distribution.

Copyright © Securities Training Corporation. All Rights Reserved.

Investors often need assistance in determining their basis in a security. For example, if a person inherits securities, the beneficiary's basis is the market value of the securities on the date of the original owner's death (or the net asset value on the date of death if it's mutual fund shares being received). By receiving the market value at the time of death, the beneficiary has a higher (i.e., stepped up) cost basis, which reduces his potential capital gain. Brokerage firms assist investors with calculating cost basis by sending an IRS Form 1099 which provides useful tax related information.

Capital Gains Capital gains are generated when an investment is sold for a greater value than its cost basis. If the investment had been held for one year or less prior to its sale, the gain is considered short-term and is taxed at the same rate as the investor's ordinary income rate (marginal tax rate). However, if the investment had been held for more than one year prior to its sale, the gain is considered long-term and is taxed at a lower rate. Currently, the maximum rate at which long-term gains are taxed is 20%.

Capital Losses Capital losses are generated when an investment is sold for lower value than its cost basis. As with capital gains, if an investment had been held for one year or less prior to its sale, the loss is considered short-term. If the asset had been held for more than one year prior to its sale, the loss is considered long-term. Capital losses are used as reductions against capital gains.

Return of Capital A return of capital occurs when an investor receives a portion of her original investment back. Since this payment is not considered either income or a capital gain, it's not a taxable event. Any return of capital will lower an investor's cost basis since she now has less money at risk.

Measuring Return

Many investors will measure their investment return in relation to the amount of risk they assume, while others measure return against a predetermined benchmark. This section will examine some of the more popular measurements of return.

Total Return

The total return calculation takes into account all of the cash flow received from dividends and/or interest, *plus* any appreciation or depreciation in the value of the investment. This return is expressed as a percentage and is usually calculated over a period of one year. The total return on an investment is calculated as follows:

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

Example: An investor purchases 1,000 shares of VPN at $25 per share. VPN pays an $0.80 annual dividend. After one year, the stock's market value has declined to $23 per share. What's the investor's total return?

Copyright © Securities Training Corporation. All Rights Reserved.

In this example, the investor's total purchase was $25,000; however, after one year, the value of the stock had declined to $23,000. During the year, the company paid a dividend of $0.80 per share; therefore, the investor received $800 (1,000 x $0.80). The investor's total return calculation is shown below:

$$\frac{[(\$23{,}000 - \$25{,}000) + \$800]}{\$25{,}000} = \frac{(\$1{,}200)}{\$25{,}000} = -4.8\%$$

The investor has a loss of 4.8%.

Inflation-Adjusted Rate of Return Inflation-adjusted rate of return, also referred to as the real interest rate, measures the true yield of a fixed-income payment after removing the effects of inflation.

Inflation-Adjusted Return = Actual Return – Rate of Inflation

ABC Corporation's bond has a nominal yield of 8%. If the rate of inflation is 3%, what's the bond's inflation-adjusted rate of return? Based on the formula shown above, the inflation-adjusted rate of return is 5% (8% – 3%).

Risk-Free Return Risk-free return is the return on an investment that has no risk. The rate of return on a U.S. Treasury bill (T-bill) is most often used to represent the risk-free return rate. However, in some cases, the rate of return on a 10-year U.S. Treasury note is used as an alternative.

Risk-Adjusted Return Risk-adjusted return measures how much an investment returns in relation to the risk that was assumed to attain it. For exam purposes, calculating the risk-adjusted return is unnecessary, but having a basic understanding of the concept and its components is important.

Averages and Indexes

Investors often compare their performance to a given benchmark. The benchmark could be an average or index that monitors the performance of a group of securities. Some indexes are intended to reflect the entire market and are referred to as broad-based, while others measure only a segment of the market (or particular industry) and are referred to as narrow-based.

The Dow Jones Averages The Dow Jones Composite Average consists of 65 stocks and is broken down into the following three subaverages:

- Dow Jones Industrial Average, which consists of 30 stocks
- Dow Jones Transportation Average, which consists of 20 stocks
- Dow Jones Utility Average, which consists of 15 stocks

Of the three subaverages, the Dow Jones Industrial Average (DJIA) is the most commonly quoted measure of the stock market. The DJIA contains 30 of the leading blue-chip companies that represent the backbone of industry in the United States. Included in this average are companies such as Apple, General Electric, IBM, and Microsoft.

Copyright © Securities Training Corporation. All Rights Reserved.

The Standard & Poor's 500 Index The S&P 500 Index contains stocks that are listed on the NYSE and Nasdaq. Compared to the Dow Jones Averages, the S&P 500 provides a broader measure of the market and consists of approximately:

- 400 industrial stocks
- 20 transportation stocks
- 40 financial stocks
- 40 utility stocks

The New York Stock Exchange Composite Index The NYSE Composite Index contains all of the common stocks that are listed on the New York Stock Exchange. The index is further divided into four sub-indexes for industrial, transportation, financial, and utility issues.

The Wilshire Associates Equity Index The Wilshire Associates Equity Index consists of stocks that trade on the New York Stock Exchange and Nasdaq. The Wilshire Index represents the dollar value of all the stocks and is considered the broadest of all indexes and averages.

Other Equity Indices The Major Market Index consists of 20 well-known, highly capitalized stocks. The Nasdaq Composite Index consists of all Nasdaq listed securities, and the Nasdaq 100 consists of 100 of the largest companies that are listed on Nasdaq. The Russel Index follows 2,000 small-cap company stocks and is considered the benchmark for the small-cap component of the market.

Debt or Bond Indices In addition to equity indices, there are also benchmarks for debt securities. For example, Barclays Capital and other brokerage firms have created a number of indices that are based on various types of debt securities in the market. There are also municipal bonds indices that are created by *The Bond Buyer*—a financial publication that specializes in the municipal market.

Tracking Performance One of the most important things for an investor to track is how his investments are performing relative to a benchmark or index. For instance, what if his equity portfolio had increased 5% over the last 12 months, but the S&P 500 Index was up 10% over that same period. In this case, the investor should likely examine the individual stocks in his portfolio to determine the appropriate alteration(s).

Conclusion

This concludes the examination of investment returns. The next few chapters will cover several popular packaged products, such as mutual funds, exchange-traded funds, and annuities.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 6 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Recognize and understand the difference between the ex-dividend date and the record date
- Explain what happens to a stock's price on the ex-dividend date
- Understand the impact and tax treatment of stock dividends
- Recognize and understand what a bond's coupon rate represents for its semi-annual interest payments
- Recognize and understand the relationship between bond prices and bond yields
  - Understand what happens to bond prices if interest rates rise
  - Understand what happens to bond prices if interest rates fall
- Recognize and understand the difference between a bond's nominal yield, current yield, and yield-to-maturity
- Identify the relationship of the three yields if a bond is trading at a discount
- Identify the relationship of the three yields if a bond is trading at a premium
- Define and understand the term basis points
- Define *cost basis*
- Understand the relationship between cost basis, sales proceeds, and capital gains or losses
- Understand the process for determining an investment's total return
- Understand the process for calculating an investment's current yield
- Recognize and understand the difference between narrow-based and broad-based indexes
- Compare and contrast the characteristics of the S&P 500 Index and the Dow Jones Industrial Average

Create a Chapter 6 Custom Exam

Now that you've completed Chapter 6, log in to *my.stcusa.com* and create a 10-question custom exam.

 Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 7 – Packaged Products

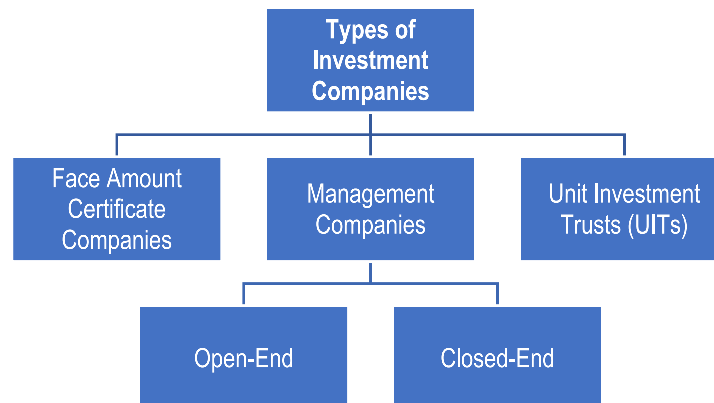
- *Types of Investment Companies*
- *The Organization of a Mutual Fund*
- *Categories of Mutual Funds*
- *Buying and Selling Mutual Fund Shares*
- *Other Types of Investment Companies*

Copyright © Securities Training Corporation. All Rights Reserved.

This chapter will examine different packaged products such as mutual funds, closed-end funds, and unit investment trusts (UITs). Although each of these investments has different characteristics, they have one element in common—each provide investors with an efficient way to quickly buy or sell a group of underlying stocks and/or bonds. SIE candidates should place special emphasis on the mechanics of buying and selling these products as well as the appropriate client disclosures.

Types of Investment Companies

An investment company pools funds from numerous investors and purchases securities that are held in a portfolio for the benefit of those investors. The method by which investment companies are organized and operated is governed by the Investment Company Act of 1940. The Act of 1940 identifies three different types of investment companies—*face-amount certificate companies, unit investment trusts (UITs),* and *management companies*. The Act further divides management companies into open-end and closed-end companies. Open-end management companies are more commonly referred to as *mutual funds*.



Open-End Management Companies (Mutual Funds)

Open-end management companies are by far the most popular type of investment company. The basic idea is that, for a cost, a mutual fund provides a means for investors with similar goals (e.g., long-term growth) to pool their money and invest in a portfolio of securities. As with other companies, this investment pool elects a board of directors (BOD). A mutual fund's BOD will hire an expert (i.e., an investment adviser) to perform the security selection and trading functions.

 Copyright © Securities Training Corporation. All Rights Reserved.

Some of the advantages offered by mutual funds include the following:

Diversification Essentially, the diversification in a mutual fund is exemplified by the adage, "don't put all your eggs in one basket." Diversification allows investors to reduce their risk by spreading their money among many different investments.

Diversified versus Non-Diversified A management company may be either diversified or non-diversified. In order to qualify as a diversified company, the portfolio must be invested in the following specific manner:

- At least 75% of the assets must be invested in a diversified manner with:
  a. No more than 5% of the invested assets may be invested in any one company.
  b. No more than 10% of the voting stock of any one company may be owned.

A diversified company must meet these standards at the time of initial investment; however, subsequent market fluctuations or consolidations will not nullify the company's status as diversified.

A non-diversified investment company usually invests in one specific asset category or industry, and in a few securities within each category/industry. The risk with non-diversification is that bad news from just one or two companies in a particular industry can hurt the prices of all stocks in that industry.

Professional Management Most retail investors don't have the time or expertise to manage their own investments adequately and cannot afford to hire their own professional manager. By investing in mutual funds, the investors receive the services of professional managers for much less than they would need to pay individually. These money managers must be registered as investment advisers under the Investment Advisers Act of 1940. Note, an investment adviser (IA) is the management company, while investment adviser representatives (IARs) are the individuals who work for the IA.

Liquidity Liquidity is defined as the ability to sell an asset at a reasonable price within a short period. Mutual funds are extremely liquid investments; however, unlike standard stocks, mutual fund shares are not traded throughout the day. Instead, mutual fund shares are issued by, and subsequently redeemed back to, the fund itself.

Exchanges at Net Asset Value Another benefit of investing in mutual funds is that shareholders may exchange the shares they own in one fund for shares of another fund at the net asset value (the fundamental value of the shares) as long as both funds are in the same family (brand name). If the exchange is made within the same fund family, an additional sales charge will not be assessed.

Convenience A person who wants to invest monthly may arrange to have the funds automatically deducted from their checking accounts. Investors are also able to have income dividends and capital gains reinvested automatically.

Copyright © Securities Training Corporation. All Rights Reserved.

Recordkeeping Mutual funds provide a number of services that make investing easy. The fund takes care of most of the recordkeeping and ensures that shareholders receive regular reports that show their purchases, redemptions, and end-of-the-year tax summaries (Form 1099-DIV). Mutual funds also must send detailed financial reports to their shareholders at least twice per year. These *semiannual and annual reports* provide the shareholders with the most current information about the fund's finances and holdings as of a particular date.

SEC Registration The Investment Company Act of 1940 requires every investment company that has *more than 100 shareholders* to register with the Securities and Exchange Commissions (SEC). Also, a fund must have a *minimum net worth of $100,000* in order to offer its shares to the public.

The Prospectus A fund's prospectus is the primary disclosure document for potential investors and includes the following information:

- Investment objectives
- Investment policies and restrictions
- Principal risks of investing in the fund
- Performance information (whether the fund made money)
- The fund's managers
- Operating expenses (the costs that are deducted from the fund's assets on an ongoing basis)
- Sales charges (what investors pay a salesperson when buying shares)
- Classes of shares the fund offers
- How the fund's NAV is calculated
- How investors redeem or purchase shares
- Exchange privileges (whether the investor can exchange shares in one fund for shares of another fund)

Prospectus Delivery Requirement Any offer to sell a fund's shares must either be preceded by or accompanied by the current prospectus since mutual fund purchases are primary issuances. The delivery may be made in physical or electronic form. Dealers must have systems in place to ensure that clients receive this document before any purchase orders are processed. Also, registered representatives are not permitted to alter, mark, or highlight a prospectus in any way.

Mutual Fund Terminology Since mutual fund disclosure documents use specialized language, a list of substitute terms is provided below:

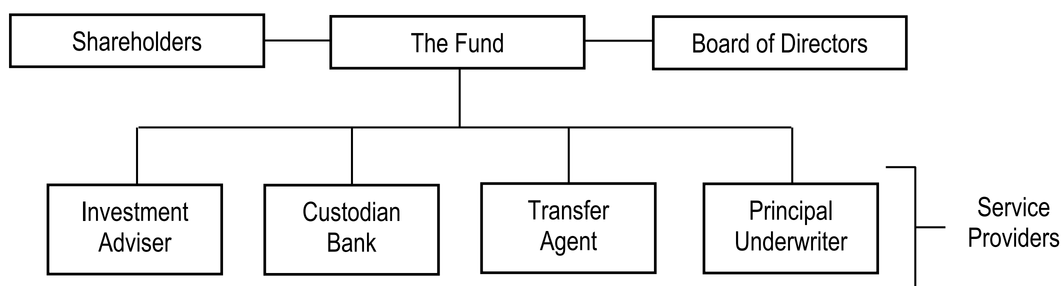
- The sales charge is also referred to as the s*ales load.*
- The net asset value (NAV) is also referred to as the *bid* or *redemption price.*
- The public offering price (POP) is also referred to as the *net asset value plus the sales charge* (if any).

Copyright © Securities Training Corporation. All Rights Reserved.

Additional Disclosure: The Statement of Additional Information (SAI)

The Statement of Additional Information provides more detailed information than the prospectus about a fund and its investment policies and risks. Unlike the prospectus, the SAI is *not* required to be given to any person who simply expresses an interest in purchasing the fund's shares. However, the fund is required to provide a copy of the SAI to any person who requests it.

Structure of a Mutual Fund



The Organization of a Mutual Fund

Although most mutual funds are organized as corporations, some are established as trusts. In many ways, the structure of a mutual fund resembles a regular corporation. A fund has a *board of directors* that's responsible for administering the fund for the benefit of the *shareholders*. The fund's shareholders are the persons who invest their money in the fund.

Board of Directors The board of directors of a mutual fund is elected by its shareholders. The board's main functions are to protect the shareholders' interests and to be responsible for:

- Establishing the fund's investment policy (any fundamental changes in the policy must be approved by shareholders)
- Determining when the fund will pay dividends and capital gains distributions
- Appointing the fund's principal officers that run the fund on a day-to-day basis (e.g., the investment adviser that manages the fund's portfolio)
- Selecting the fund's custodian, transfer agent, and principal underwriter

Investment Adviser The fund's investment adviser manages the fund's portfolio in accordance with its investment objectives and the policies established by its board of directors. IAs research and analyze financial and economic trends and decide which securities the fund should buy or sell in order to maximize performance. For these services, the investment adviser is paid a management fee which is based on the assets under management (AUM), but not based on performance.

Copyright © Securities Training Corporation. All Rights Reserved.

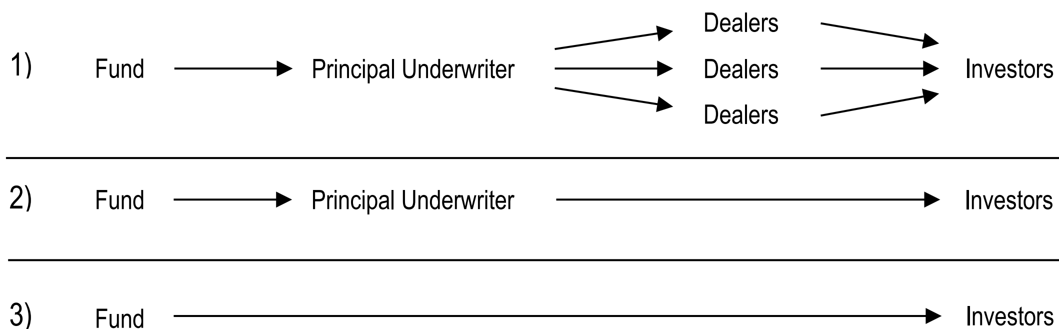
Custodian Bank In order to prevent the theft or loss of a fund's assets, the Investment Company Act requires the fund to appoint a qualified bank as its custodian that will maintain its assets. The custodian is responsible for safeguarding the fund's cash and securities and collecting dividend and interest payments from these securities. However, the custodian neither guarantees the fund's shareholders against investment losses, nor does it sell shares to the public. A fund's custodian may also serve as its transfer agent.

Transfer Agent The fund's transfer agent performs a number of recordkeeping functions, such as issuing new shares and canceling the shares that investors redeem. Today, most of these securities functions are done electronically without physical certificates changing hands.

The transfer agent also distributes capital gains and dividends to the fund's shareholders and forwards the required documents to shareholders, including statements and annual reports.

Principal Underwriter Most funds use a *principal underwriter* (also referred to as the sponsor, wholesaler, or distributor) to sell their shares to the public. An underwriter may sell shares directly to the public or it may employ intermediaries (dealers) such as a discount or full-service brokerage firm. Many funds use a network of dealers to market their funds to investors. The dealers are essentially brokerage firms that have a written contract with the underwriter and are compensated for selling the fund's shares to investors. All FINRA member firms must use the same pricing and may not sell fund shares at a discount to non-member firms.

Three Distribution Methods



Categories of Mutual Funds

Aggressive Growth Funds These funds invest in small companies and often participate in the initial public offerings of these companies' shares. The stocks of these companies can be very volatile, but historically they have also produced high returns for long-term investors.

Growth Funds Capital appreciation is the main objective of a growth fund. The advisers of these funds invest in stocks that they believe will show above-average growth in share price.

Copyright © Securities Training Corporation. All Rights Reserved.

Specialized or Sector Funds Some funds concentrate their investments to stocks in a particular industry (e.g., high tech stocks or pharmaceuticals) or in a particular geographic location. Although specialized funds are riskier than more diversified funds, they allow fund managers the opportunity to take advantage of unusual situations.

International and Global Funds Mutual funds that focus on foreign securities are often the easiest way for U.S. investors to invest abroad. *International funds* invest primarily in the securities of countries other than the United States. They include funds that invest in a single country and regional funds that invest in a particular geographic region (e.g., Europe or the Pacific Basin). On the other hand, *global funds* invest all around the world, both in the U.S. and abroad.

Equity Income Funds Equity income funds invest in companies that pay high dividends in relation to their market prices. These funds usually hold positions in mature companies that have less potential for capital appreciation, but are also less likely to decline in value than growth companies.

Growth and Income Funds These funds have both capital appreciation and current income as their investment objectives. Growth and income funds invest in companies that are expected to show more growth than a typical equity income stock and higher dividends than most growth stocks. However, the trade-off is that they usually offer less capital appreciation than pure growth funds, and lower dividends than income funds.

Bond Funds The main objectives of bond funds are current income and preservation of capital. Since the portfolio consists of bonds only, many of these funds are susceptible to the same risks as direct investments in bonds, including credit risk, call risk, reinvestment risk, and interest-rate risk.

Index Funds Index funds have become increasingly popular in recent years. An index fund creates a portfolio that mirrors the composition of a particular benchmark stock or bond index, such as the S&P 500 Index. The fund attempts to produce the same return as the index; therefore, investors cannot expect the fund's returns to outperform the relevant benchmark. Since index mutual funds are passively, rather than actively managed, they typically have lower management fees.

Value Funds These funds invest in "out-of-favor" companies that are considered undervalued and are often in the process of restructuring. Due to the nature of their investments, value funds are most suitable for investors with long time horizons.

Balanced Funds Balanced funds maintain some percentage of their assets in stocks, bonds, and money-market instruments (cash equivalents). Although the percentages will vary from time to time as market conditions change, a portion of the portfolio will always be invested in each type of security.

Asset Allocation Funds Similar to balanced funds, these funds also invest in stocks, bonds, and money-market instruments. Fund managers determine the percentage of the fund's assets to invest in each category based on market conditions.

Copyright © Securities Training Corporation. All Rights Reserved.

Money-Market Funds Money-market funds invest in short-term debt (money-market) instruments that typically have maturities of less than one year. The two principal benefits for investors in money-market funds are liquidity and safety.

Buying and Selling Mutual Fund Shares

Mutual fund shares are purchased at their public offering price (POP) and redeemed (sold) at their intrinsic net asset value (NAV). The difference between these two values is the *sales charge or load*.

Net Asset Value + Sales Charge = Public Offering Price

The equation above represents the process that's used to determine the purchase price of the shares of a traditional front-end load fund (Class A shares). In this case, the investor pays an up-front sales charge that's added to the NAV at the time of purchase.

Fractional shares may be purchased if the amount being deposited is not sufficient to purchase an even number of whole shares. If a client intends to sell (redeem) shares, he receives the next calculated NAV. Other share classes and pricing methods exist and will be described later in this chapter.

Net Asset Value

The NAV of a mutual fund (or any other investment company) is determined by dividing its total net assets (securities valued at their current market price, plus cash, minus total liabilities) by the total number of shares outstanding.

$$\text{Net Asset Value} = \frac{\text{Total Net Assets}}{\text{Number of Outstanding Shares}}$$

The net asset value of a fund must be computed at least once per day. A fund's prospectus discloses the cutoff time that's used for share purchases and redemptions and explains how its NAV is calculated. The NAV is normally computed daily as of the close of trading on the New York Stock Exchange (4:00 p.m. Eastern Time).

End of Day Pricing Orders to buy and sell fund shares are based on the next computed price. This is referred to as *forward pricing* since purchases and redemptions are based on the next calculated price. For example, if an individual places an order to purchase shares at 11:00 a.m., the purchase price will not be known until the net asset value is computed after the close of business on that day.

 Copyright © Securities Training Corporation. All Rights Reserved.

If a client places an order at 4:10 p.m. on Wednesday (after the close); it will not be executed until the close of business on Thursday. This is an important distinction between mutual funds and other types of funds, such as closed-end funds or ETFs. (ETFs will be discussed in the next chapter.) Shares of closed-end funds and ETFs trade throughout the day like individual stocks and bonds.

Settlement of Transactions Mutual fund transactions typically settle on the same day as the purchase/redemption. Unlike stocks, the ex-dividend date for a mutual fund is actually determined by the fund or its principal underwriter. Typically, a mutual fund's ex-dividend date is the business day following the record date.

Sales Charges—Front-End Loads When investors purchase mutual fund shares with an associated front-end load (Class A shares), they pay the *public offering price (POP),* which consists of the NAV plus a sales charge. Under FINRA rules, the maximum sales charge permitted is 8.5%; however, breakpoints (reduced sales charges) are often available to investors who purchase a significant amount of Class A shares. A mutual fund's sales charge is expressed as a percentage of the POP and is calculated using the following formula:

$$\text{Sales Charge \%} = \frac{\text{POP} - \text{NAV}}{\text{POP}}$$

For example, if the XYZ fund has an NAV of $17.25 and a POP of $18.40, the sales charge percentage is 6.25% (the difference in values of $1.15 ÷ $18.40).

Back-End Loads and Contingent Deferred Sales Charges(CDSC) Rather than assessing a sales charge at the time of purchase, some funds allow investors to buy shares at the NAV and will then assess a sales charge when the investors redeem their shares. Usually, the longer the investor owns the shares, the greater the decrease will be in the back-end load. Due to the decreasing charge, this form of load is referred to as a contingent deferred sales charge (CDSC). In fact, if the investor holds the shares long enough, there may be no sales charge imposed at the time of redemption.

The following is a hypothetical example of a contingent deferred sales charge scale:

Years Since the Purchase was Made	CDSC as a Percentage of the Dollar Amount Invested
0 – 1	4.0%
1 – 2	3.0%
2 – 3	2.0%
3 – 4	1.0%
Greater than 4	None

Copyright © Securities Training Corporation. All Rights Reserved.

Confirmation Disclosure If customers purchase investment company shares that assess a deferred sales charge at redemption, FINRA rules require that they be provided with a written disclosure which includes the following statement: "On selling shares, an investor may pay a sales charge. For details on the charge and other fees, see the prospectus." Although no sales charge is assessed at the time that Class B shares are purchased, RRs may not attempt to sell them as the equivalent of a no-load.

No-Load Funds Not all mutual funds assess sales charges. When a mutual fund sells its shares to the public at their net asset value (i.e., with no sales charge), it's referred to as a no-load fund. In other words, this fund's net asset value and public offering price are equal. Most no-load funds are purchased directly from the fund's distributor without any compensation being paid to the salespersons.

To be marketed as a no load fund, this type of fund may not assess a front-end load, a deferred sales load, or a 12b-1 fee (described next) that exceeds .25% (or 25 basis points) of the fund's average annual net assets.

Fees and Charges

Prior to purchasing mutual fund shares, investors must review the total cost of fund ownership since, in addition to sales loads, funds assess annual fees that are based on the NAV of their holdings including 12b-1 fees, service fees, and administrative fees.

12b-1 Charges (Distribution Fees) In a 12b-1 arrangement, mutual funds may pay for distribution expenses through deductions from the portfolio's assets. These 12b-1 charges are used to pay the costs of distributing the fund's shares to the public and will cover expenses such as sales concessions and the costs associated with advertising and the printing of the prospectus.

A 12b-1 fee is an ongoing asset-based charge that's deducted from the customer's account on a quarterly basis. Typically, 12b-1 fees range between .25% and 1%, but the maximum 12b-1 fee is an annualized 1% of the fund's assets.

Service Fees Service fees are charges that are deducted under a 12b-1 plan and used to pay for personal services or the maintenance of shareholder accounts. Trailing commissions (trailers) are an example of a service fee. These ongoing trailer fees are paid to RRs as compensation for continuing to service their clients' accounts.

Administrative Charges Administrative charges are deducted from the net assets of an investment company and used to pay various costs including the payments that are made to custodian banks and/or transfer agents.

Fee Disclosure In the front of its prospectus, a mutual fund is required to disclose all of its fees using a standardized table.

Copyright © Securities Training Corporation. All Rights Reserved.

Expense Ratio The expense ratio is defined as the percentage of a fund's assets that are used to pay operating costs and is calculated by dividing the fund's total expenses by the average net assets in the portfolio. The expense ratio includes the management fee, administrative fees, and 12b-1 fees, but doesn't include sales charges.

$$\text{Expense Ratio} = \frac{\text{Total Expenses}}{\text{Average Net Assets}}$$

Expense ratios typically range between .20% and 2% of a fund's average net assets and must be disclosed in the fund's prospectus. The expense ratio varies based on the type of fund and the share class that's selected by the investor. No-load funds typically have lower expense ratios, since their 12b-1 fees are limited to 25 basis points per year.

Classes of Shares

Today, most funds offer investors the choice of multiple classes of shares, usually referred to as Class A, Class B, Class C, etc. The differences in classes are the ways in which the sales charges and distribution charges are assessed. Investors may choose between shares with front-end loads and varying 12b-1 fees (marketing fees), back-end loads with higher 12b-1 fees, or some other combination.

Although the specifics of the different classes that each fund sells may vary widely, most funds offer the following classes of shares:

Class A Shares Class A shares usually have front-end loads, but have small or nonexistent 12b-1 fees. In addition, investors who purchase large amounts of shares within the same fund family may be able to take advantage of reduced sales charges through the use of breakpoints or rights of accumulation (both of which are described below). The disadvantage of Class A shares is that not all of the investor's money is directed into the portfolio. For example, if an investor purchases $1,000 worth of Class A shares of a common stock fund that has a 5% sales charge, only $950 is invested in the fund. The $50 is deducted as a sales charge and benefits the selling brokers. This class of shares is most suitable for long-term investors. Although the front-end load may seem high, the continuous internal expenses of Class A shares tend to be lower than those for Class B or C shares.

Class B Shares Although Class B shares generally have no up-front sales charges, higher 12b-1 fees are usually assessed. Investors are subject to contingent deferred sales charges (CDSC) if the shares are redeemed before a certain period. These shares are most suitable for investors who intend to redeem their shares within five to seven years, especially if the back-end load decreases every year. Once the specified number of years has passed and the back-end charge is reduced to zero, most Class B shares will convert to Class A shares. Unlike Class A shares, Class B shares don't qualify for breakpoint (sales charge) discounts.

Copyright © Securities Training Corporation. All Rights Reserved.

Class C Shares Class C shares assess what's referred to as a level load, which means there's an ongoing fee (typically 1.0%) for as long as the investor holds the shares. As a result, this increases the expenses of the fund and diminishes returns. These shares are most suitable for investors who will hold their shares for a short period (more than one year, but less than three years). Although there's no front-end load, a back-end load may be assessed if shares are redeemed within one year. Class C shares typically have 12b-1 fees that are higher than those of Class A shares.

Other Share Classes Many fund families also offer additional classes of shares for employees of broker-dealers, institutional investors, retirement plans, or other special categories of investors. In its prospectus, a fund provider must fully disclose each of the share classes that it offers as well as the different sales charges and applicable 12b-1 fees.

Shares Class Summary

	Class A	Class B	Class C
Sales Charges:	Front-end load	Contingent deferred sales charge assessed if held less than 6 to 8 years	Have a level load, which is an ongoing fee (typically 1.0%)
12b-1 Fees:	Low or none	Higher than for Class A shares	Higher than for Class A shares
Other:	Breakpoints available for large purchases	Often convert to Class A shares after 6 to 8 years; no breakpoints available	Most suitable for short-term investors; no conversion to Class A shares

Methods of Reducing Sales Charges

Investors who purchase Class A shares have a variety of different methods to reduce their sales charges. Typically, these reduced sales charges apply to all purchases made within a *fund family.*

Fund Families The term fund families or fund complexes is used when defining a single investment company or mutual fund company that has many different types of mutual funds from which a customer may choose to purchase. A fund family is essentially a brand name that applies to several related individual mutual funds. A customer may be able to invest a large sum of money with one fund family, receive a sales breakpoint (reduced sales charge), diversify his assets, and be allowed to switch between mutual funds.

Breakpoints Mutual fund shares must be quoted at the maximum sales charge percentage that the fund charges. However, most mutual funds offer sales breakpoints on shares that are purchased with a front-end load. Breakpoints are dollar levels at which the sales charge is reduced (the mutual fund industry's version of a volume discount). A fund's breakpoints must be clearly stated in its prospectus.

Copyright © Securities Training Corporation. All Rights Reserved.

The following is an example of a breakpoint table:

Amount Deposited	Sales Charge As a Percentage of the Offering Price
Less than $25,000	5.0%
$25,000, but less than $50,000	4.25%
$50,000, but less than $100,000	3.75%
$100,000, but less than $250,000	3.25%
$250,000, but less than $500,000	2.75%
$500,000, but less than $1 million	2.0%
$1 million and more	0.0%

For example, a person who invests between $100,000 and $250,000 will pay a reduced percentage sales charge or load of 3.25%.

Determining the Offering Price for a Reduced Load Since breakpoints affect the purchase price of mutual fund shares, SIE candidates should be able to determine a fund's offering price based on the reduced sales charge percentage. This adjusted POP is calculated by using the following formula:

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

For example, if the XYZ Fund has an NAV of $10 and a person invests $100,000 into the fund, it will entitle him to a 3.25% breakpoint. What's the adjusted offering price for the investor?

$$\text{POP} = \frac{\$10.00}{(100\% - 3.25\%)} = \frac{\$10.00}{96.75\%} = \$10.34$$

At this price, the investor is able to purchase 9,671.18 shares ($100,000 ÷ $10.34).

Letter of Intent (LOI) A letter of intent qualifies an investor for a discount made available through breakpoints without initially depositing the entire amount required. The letter indicates the investor's intention to deposit the required funds over the next 13 months. The LOI may be backdated for 90 days to include prior purchases.

Copyright © Securities Training Corporation. All Rights Reserved.

Since letters of intent are non-binding, an investor will not be penalized for failing to make the additional purchases. However, this failure will result in a price adjustment that equals the higher sales charge that would have applied to the original purchase. Basically, if a person fails to invest the amount stated in the LOI, the fund will retroactively collect the higher fee.

Rights of Accumulation (ROAs) Rights of accumulation give investors the ability to receive cumulative quantity discounts when purchasing mutual fund shares. The reduced sales charge is based on the total investment made within a family of funds (fund complex) provided the shares are purchased in the same class. Rather than using the original purchase price, the current market value of the investment *plus* any additional investments is used to determine the applicable sales charge.

Availability of Breakpoints and Rights of Accumulation Breakpoints, letters of intent, and rights of accumulation may be made available to any of the following:

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

Letters of Intent	Rights of Accumulation
Investors receive the benefit of a breakpoint without immediately depositing all of the required funds.	The investor is able to add up all of the purchases made in the same fund complex. Once a breakpoint is reached, all future purchases are entitled to the reduced sales charge.

Before mutual fund shares are purchased by a client, an RR must inquire as to whether the client owns other mutual funds within the same fund family in a related account—even if the account is held by another broker-dealer.

For a fund to assess the maximum allowable sales charge of 8.5%, it must offer investors both breakpoints and rights of accumulation. If the fund omits either of these features, the maximum sales charge it's permitted to assess is lowered according to a set schedule.

Dividend Reinvestment Most mutual funds make dividends and capital gains distributions to their shareholders on an annual basis. Once a distribution is made, the investor must then choose to either receive the money or reinvest it. However, mutual funds make the choice easy by allowing investors to reinvest their dividends and other distributions, usually at the NAV, without paying a sales charge.

Copyright © Securities Training Corporation. All Rights Reserved.

Dollar Cost Averaging (DCA)

Dollar cost averaging is a popular method of investing in mutual funds in which a person invests a fixed-dollar amount at regular intervals, regardless of the market price of the shares. An investor who uses dollar cost averaging is ultimately buying more shares when the price is low and fewer shares when the price is high. Dollar cost averaging lessens the risk of investing a significant amount of money at the wrong time and is especially appropriate for long-term investors, such as those investing for retirement.

Redeeming Shares

An investor may redeem (sell) shares back to the fund on any business day. Since shares are redeemed at the NAV, a fund must calculate its NAV at least daily; however, some funds may do the pricing more frequently. The Investment Company Act of 1940 requires mutual funds to pay the redemption proceeds to their investors within seven calendar days.

Redemption Fees When mutual fund shares are redeemed, some funds deduct a small redemption fee from the amount that's paid to the investor. Redemption fees have a range of .5% to approximately 2% and are returned to the fund's portfolio. Ultimately, the fee, which is separate from any deferred charge that may apply, is designed to discourage investors from redeeming shares too quickly. Some funds waive redemption fees after the shares have been held for a specific period.

Systematic Withdrawal Plans

Many mutual funds offer investors the opportunity to withdraw funds systematically. If investors elect to begin a systematic withdrawal plan, they will receive regular payments, typically on a monthly or quarterly basis. Payments are first made from dividends and then capital gains; however, if these amounts are insufficient, the fund will redeem the investor's shares until the principal in the account is exhausted.

Investors who choose systematic withdrawal plans have three payout options—fixed-dollar, fixed-percentage, or fixed-time. With fixed-dollar payout plans, investors will receive the same amount of money with each payment. For example, a person who has $25,000 worth of shares could request that the fund send her $200 per month until all of the funds are exhausted.

Investors may also request that their fund liquidate a fixed-percentage of their shares at regular intervals
—for example, 1% each month or 3% each quarter (using a fixed-percentage payout plan). With this payout option, the exact dollar amount to be received by the client will vary based on the NAV of the shares at the time they're sold.

The third choice for investors is to have their holdings liquidated over a fixed-time (using a fixed-time payout plan). A client who chooses this method must provide the fund with an exact ending date. Once the date is set, the fund will liquidate the client's shares in amounts that will exhaust the account by the date specified by the client.

Copyright © Securities Training Corporation. All Rights Reserved.

Prohibited Sales Practices

FINRA has established rules that address different violations relating to the sale of investment company securities. Some of FINRA's concerns involve RRs who ignore the best interests of their clients and attempt to maximize their sales commissions by ignoring discounts that may be available to clients.

Breakpoint Sales RRs who induce clients to purchase shares at a level just below the dollar value at which a breakpoint is available are engaging in a prohibited practice that's referred to as a *breakpoint sale*. Instead, clients should be reminded that LOIs may be used if all of the funds are not currently available. Also, RRs should avoid allocating a client's investments into several different fund families. This practice may result in the client not receiving a breakpoint that would have been available if all the funds were allocated to a single family.

No Discounts on Class B Shares RRs should not recommend buying Class B shares to a client who intends to place a large order. The client should be directed toward Class A shares since only this share class qualifies for breakpoints.

Switching Shares When an RR recommends that a client sell the existing mutual fund shares that she owns of one fund family and invest the proceeds into *another fund family*, the RR's recommendation is referred to as *switching*. The concern is that the movement between different fund families will result in a new sales charge being assessed.

Exchanging Shares Most mutual funds offer investors the ability to sell shares of one fund and buy shares of another fund *within the same fund family* without sales charge implications. Unlike switching shares, exchanging shares doesn't create a sales practice issue. However, regardless of whether the investor is involved in switching or exchanging shares, the IRS considers them both the sale of one fund's shares and the purchase of another fund's shares. Any resulting gain or loss will represent a taxable event for the investor.

Other Types of Investment Companies

Although mutual funds are by far the most common type of investment company, let's examine some of the other varieties.

Face-Amount Certificate Companies

These types of investment companies are very rare today. A face-amount certificate company issues debt certificates that pay a predetermined rate of interest. Investors purchase these certificates in either periodic installments or by depositing a lump sum and then receive a fixed amount if they hold the certificates until maturity. However, investors who cash in their certificates early will receive a lesser amount—referred to as a *surrender value*.

Copyright © Securities Training Corporation. All Rights Reserved.

Unit Investment Trusts

Unit investment trusts (UITs) are formed under a legal document that's referred to as an *indenture* and have trustees rather than boards of directors. UITs invest in a fixed portfolio of income-producing securities, such as bonds or preferred stocks.

UITs issue only redeemable securities that are referred to as units or shares of beneficial interest (SBIs) that are generally sold in minimum denominations of $1,000. Investors are able to buy or sell SBIs in the secondary market. Each unit entitles the holder to an *undivided interest* in the UIT's portfolio that's proportionate to the amount of money invested.

UITs are supervised, but not managed, investment companies. In other words, UITs don't utilize the services of investment advisers to determine what securities to buy and sell. Since these trusts are not managed, they don't have associated management fees.

Closed-End Investment Companies

Closed-end investment companies are the other type of management company. Unlike open-end management companies (mutual funds), closed-end funds typically conduct a one-time issuance of common shares to the public. Although they may issue additional shares later, they don't continuously issue new shares or stand ready to redeem their shares for cash. Beyond issuing common shares, closed-end funds may also issue senior securities (i.e., preferred stock or bonds).

After a closed-end investment company issues its shares, these shares trade in the *secondary market.* Therefore, an investor who wants to purchase shares in a closed-end investment company will buy them on a traditional exchange (e.g., the NYSE or Nasdaq). As these securities trade in the secondary market, there's no prospectus delivery requirement. Additionally, the shares are able to be purchased on credit (i.e., they're marginable).

The price that an investor pays for shares is determined by supply and demand. Unlike mutual funds, closed-end funds may trade at prices that are at a discount or a premium to NAV. When closed-end funds are purchased or sold in the secondary market, the investors pay commissions rather than sales charges.

Copyright © Securities Training Corporation. All Rights Reserved.

Below are two summary tables which summarize investment companies:

Open-End Funds	Closed-End Funds
Continuously issue new shares	Issue a fixed number of shares
May issue only common shares	May issue common shares or senior securities, such as preferred stock and bonds
Sold at NAV + sales charge (if any)	Price is determined by market forces which result in shares selling at discounts or premiums to the NAV ▪ Commissions are paid on purchases and sales
Fund sponsor stands ready to redeem shares at the next calculated NAV	Fund sponsor doesn't stand ready to redeem shares
Shares don't trade in the secondary market	Shares are traded in the secondary market
Prospectus delivery is required	No prospectus delivery requirement

Comparison of Investment Companies

Product	Secondary Market Trading	Portfolio	Marginable
Mutual Fund	No	Adjustable	No
Closed-end Fund	Yes	Adjustable	Yes
UIT (redeemable)	Yes	Fixed	No

Conclusion

This concludes the examination of mutual funds and related packaged products that are subject to the Investment Company Act of 1940. The next chapter will describe some additional forms of bundled investments.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 7 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Recognize the three different types of investment companies
  - Management companies (open- and closed-end), UITs, face amount certificate companies
- Understand the characteristics of open-end investment companies (mutual funds)
- Understand the mutual fund registration and prospectus requirements
- Identify the functions of the various service providers within the mutual fund structure
  - BOD, investment adviser, custodian bank, transfer agent, underwriter, and dealers
- Recognize the major fund categories
  - Identify the types of securities held within each fund
  - Understand each fund's investment objective and risk level
- Understand mutual fund pricing and the associated terms
  - NAV, POP, forward pricing, sales charge, 12b-1 fees
- Calculate both the POP and sales charge percentage
  - Understand the concept of a no-load fund and recognize the differences between class A, B, C shares
    - *Review share class chart*
- Understand the different methods by which sales charge is reduced
- Define and understand mutual fund sales practices and violations
  - *Breakpoints, letters of intent,* and *rights of accumulation*
- Recognize different sales practice violations
  - *Breakpoint sales, large purchases of Class B shares, switching*
- Define and understand the characteristics of *dollar cost averaging*
- Understand how closed-end investment companies differ from open-end investment companies
  - *Review the comparison table*

Create a Chapter 7 Custom Exam

Now that you've completed Chapter 7, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 8 – Variable Contracts and Municipal Fund Securities

- *Types of Annuities*
- *Annuity Phases*
- *Qualified Annuities and Equity-Indexed Annuities (EIAs)*
- *Municipal Fund Securities*

Copyright © Securities Training Corporation. All Rights Reserved.

This chapter will examine the details regarding variable annuities, including the different types, their unique tax implications, as well as suitability considerations. Additionally, the last section of this chapter will describe municipal fund securities, such as local government investment pools (LGIPs), Section 529 educational plans, and 529 ABLE plans.

Annuities

An annuity is an agreement between a *contract owner* and an insurance company. The owner gives the insurance company a specific amount of money (either all at once or over time) and, in return, the company promises to provide a person (i.e., *the annuitant*) with income either immediately or at some point in the future. The contract owner may designate any person as the annuitant; however, the annuitant and the contract owner are usually the same person. Most annuitants choose to start receiving their income payments when they retire.

Annuities are typically considered long-term investments which many clients use to supplement their work-sponsored retirement plans and/or their IRAs. A significant benefit offered by annuities is that the growth in the accounts is tax-deferred. However, two drawbacks are that purchasers of these investments often have long holding periods and they may be subject to significant surrender charges and/or tax liabilities if assets are withdrawn too quickly. From an investor's perspective, it's important to understand the different features of the contracts.

The majority of annuities are *non-qualified*, which means that the contract owner invests money on an after-tax basis with the interest credited to the account accumulating on a tax-deferred basis. In other words, an annuitant is not required to pay taxes on the income or growth until she begins taking distributions or withdraws funds from the account. As is the case with retirement plans, these contracts don't generate capital events. If any portion of a withdrawal is subject to taxation, it's taxable at the same rate as the owner's ordinary income. Non-qualified annuities will form the basis of this examination of annuities.

Fixed versus Variable Annuities

There are two types of annuity contracts—*fixed* and *variable*. With a fixed contract, the investor receives a fixed rate of interest and the investment risk is assumed by the insurance company. For this reason, fixed contracts are not considered securities and are governed under state insurance law only. On the other hand, variable contracts offer returns that fluctuate and the investor assumes all of the investment risk. Variable contracts are considered securities and are subject to SEC, FINRA, and state insurance regulation. As is the case with all variable products, a prospectus must be delivered prior to completing the sale of any variable annuity.

Copyright © Securities Training Corporation. All Rights Reserved.

Variable Annuities

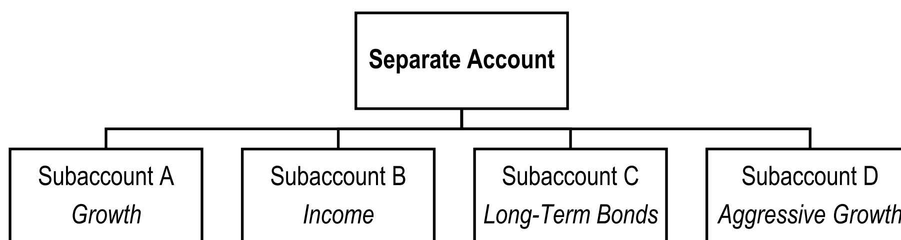
Variable annuities were created to provide investors with greater protection against inflation than what traditional, fixed annuities can offer. The contract owner is also given a level of control over how her contributions are invested—at least during the annuity's *accumulation phase* (the period during which she's depositing funds into the annuity). Although it's only insurance companies that issue variable annuities, these contracts are not considered forms of life insurance. A firm that offers variable annuities must be a broker-dealer that's registered with the SEC. Also, the registered representatives who sell variable annuities must obtain a state insurance license as well as either a Series 6 or Series 7 FINRA registration.

In a variable annuity, when a person decides to annuitize, she will begin to receive payouts from the annuity and, in turn, relinquish control of the principal value of the contract to the insurance company. Once the benefit payments start, the amount will vary from month-to-month depending on the performance of the investments in the *separate account* (described below). If these investments perform well, the payments to the annuitant may increase. Conversely, if they perform poorly, then the payments may decrease. For variable annuities, the insurance company doesn't guarantee a minimum rate of return. Variable annuities are not suitable for all investors. Before considering variable annuities, investors should exhaust all of their options in saving for retirement on a pre-tax basis—such as through IRAs or 401(k) plans.

The Separate Account The separate account feature is unique to variable products. As the name implies, the assets in an insurance company's separate account are segregated from the insurance company's general account (which is used for fixed annuities). All of the income and capital gains that are generated by the investments in the separate account are credited to the account. Also, any capital losses that are incurred by the separate account are then charged to the account; however, it's not affected by any other gains or losses that the insurance company incurs. If the insurance company becomes insolvent, its creditors may not make claims against the assets in the separate account, but they may make claims against the assets in the general account. The separate accounts of variable products are generally required to be registered as investment companies under the Investment Company Act of 1940.

Subaccounts For variable annuities, the separate accounts typically contain a variety of different underlying portfolios or subaccounts (which are similar to the fund choices that investment companies offer to their investors). The contract owners are able to allocate their payments among these different subaccounts based on their investment objectives. Additionally, contract owners are generally allowed to transfer their money from one subaccount to another as their investment goals change. However, to change from one subaccount to another, the owner needs to contact the insurance company that sponsors the contract.

Copyright © Securities Training Corporation. All Rights Reserved.



Each of the subaccounts typically corresponds to a different underlying mutual fund (or unit investment trust), such as a large-cap stock fund, a long-term bond fund, or a money-market fund. Another subaccount may have a fixed rate of return which is guaranteed by the insurance company. The value of the other underlying subaccounts will fluctuate based on changing market conditions.

In a variable annuity, a contract owner who invests in any subaccount (other than the fixed-rate subaccount), assumes all of the investment risk. An insurance company doesn't guarantee a minimum rate of return for most of its variable annuity subaccounts. As a result, market risk is the greatest risk that a variable annuity contract holder faces. Variable annuities are classified as securities; therefore, they must be registered with the SEC and sold by prospectus. The separate accounts and underlying subaccounts must also be registered with the SEC as investment companies.

The Life of a Variable Annuity

Most variable annuities involve two periods—the *accumulation* and the *annuity period*. In other words, there's a pay-in period as well as a pay-out period. The details of these two are summarized below.

Accumulation Period

The accumulation (pay-in) period of a variable annuity begins when a person first directs her contributions to the insurance company. During the accumulation period, the value of the annuitant's investment in the separate account is calculated by using an accounting measurement that's referred to as an *accumulation unit*. Essentially, the accumulation units are purchased at net asset value (NAV). The NAV of the subaccount units is calculated using the same method that's employed by mutual funds.

$$\textbf{NAV Per Unit} = \frac{\textbf{Total Net Assets}}{\textbf{Total Units Issued}}$$

The calculation is done at the end of every business day (usually at the close of trading on the exchanges). The actual price that annuitant's will pay for their units is the next calculated NAV. This approach is referred to as *forward pricing*. However, the value of the units will fluctuate along with the changing value of the underlying portfolios of the separate account. If the investments in the separate account perform well, then the units will increase in value; however, if the investments in the separate account perform poorly, then the units will decrease in value.

Copyright © Securities Training Corporation. All Rights Reserved.

With each investment, the insurance company first deducts the applicable commissions or other charges and then uses the remainder of the annuitant's investment (the net payment) to buy the accumulation units in the subaccounts that are selected.

Cash Surrender Annuitants may cancel (surrender) their variable annuities at any time during the accumulation period and receive the annuity's current value. Also, annuitants may instead choose to withdraw a part of their annuity's value at any time (a partial surrender). However, as described earlier, an annuitant may be required to pay surrender charges that are determined by how long she has held the annuity. The surrender will also result in the requirement to pay taxes on any increase in the value of her annuity.

For variable annuities, insurance companies don't guarantee a minimum cash surrender value. Therefore, if a person surrenders her annuity, she may receive less than the total amount that she has invested.

Loans Insurance companies generally allow their contract owners to borrow against the value of their annuity contracts during the accumulation period. As opposed to a withdrawal, the advantages of taking a loan include the fact that the borrower will avoid surrender charges, potential taxes, as well as potential early distribution penalties. Loans taken from annuities are typically required to be repaid within a specific period. However, if the loan is not repaid, it will be considered a distribution and potentially subject to taxation and early distribution penalties.

Death Benefits Although variable annuities are not life insurance policies, these contracts often have an associated death benefit. Therefore, at the time of purchase, the contract owner designates a person as her beneficiary to receive this benefit in the event of her death.

If the annuitant dies during the accumulation period, the beneficiary receives the greater of:

1. The sum of all of the contract owner's payments into the annuity, or
2. The value of the annuity on the day of the annuitant's death

> *For example, a person has paid a total of $50,000 into a variable annuity and designated his son as his beneficiary. If the annuitant dies one year later when the value of his annuity is $45,000, then the beneficiary receives $50,000.*

Because mutual funds lack the death benefit feature, this is one reason that clients may prefer to purchase annuity contracts despite the fact that they're relatively more expensive.

Annuity Period

The annuity (pay-out) period begins when an annuitant decides to receive income payments from the annuity. Prior to this point (during the accumulation period), the contract holder is permitted to surrender the annuity in exchange for its current value. However, once a person decides to annuitize, she may no longer surrender the annuity or freely withdraw money from it. Instead, she's receiving payments based on the performance of the assets in the separate account.

 Copyright © Securities Training Corporation. All Rights Reserved.

Annuity Units At annuitization, the insurance company converts all of the accumulation units into annuity units. Annuity units represent the accounting measurement that's used to determine the dollar amount of each payment that will be made to the annuitant.

The number of annuity units represented in each payment is fixed at this time. The value of each payment that's made to the annuitant is based on a fixed number of annuity units multiplied by a fluctuating value.

To calculate the annuitant's payment, the insurance company takes the following into consideration the:

- Annuitant's age and gender
- Settlement (payout) option selected
- Annuitant's life expectancy
- Assumed interest rate

Settlement Payout Options There are several methods for receiving payments from an annuity. An annuitant may choose from the options described below in order to receive benefit payments from the contract.

Straight-Life Annuity A straight-life annuity is a contract in which an annuitant receives monthly payments for as long as she lives, but this method makes no provision for a designated beneficiary. Therefore, no payments are made after the annuitant's death, even if only one payment had been made before the person's death. Remember, the contract's death benefit ceases once the holder makes the decision to annuitize. This payment option carries the most risk, but also provides the annuitant with the highest payout of all of the options.

Life Annuity with Period Certain A life annuity with period certain is an option that will provide monthly or other periodic payments to the annuitant for life. However, if the client dies prior to the end of the specified period, the payments will continue to be made in either a lump-sum or in installments to a designated beneficiary until the end of the period certain.

> *For example, an investor chooses a 15-year period certain life annuity, but dies after receiving payments for five years. The annuity company will continue to pay the named beneficiary for the remaining 10 years on the contract. However, if the investor had lived for 18 years, the annuity company's payment obligations would have continued up until his death. Since his death occurred three years after the end of the period certain, the annuity company is relieved of the obligation to make any payments to a beneficiary.*

Unit Refund Life Annuity Under a unit refund life annuity, periodic payments are made during the annuitant's lifetime. If the annuitant dies before an amount equal to the value of the annuity units is paid out, the remaining units will be paid to a designated beneficiary. This payment may be made either in a lump-sum or over a given period.

Copyright © Securities Training Corporation. All Rights Reserved.

Joint and Last Survivor Life Annuity A joint and last survivor life annuity is an option in which payments are made to two or more persons. If one person dies, the survivor continues to receive only her payments. However, upon the death of the last survivor, payments cease.

> *For example, a grandfather establishes an annuity that will provide lifetime payments to both his son and grandson. A joint and last survivor life annuity is the best payout option for the grandfather's needs because it provides lifetime income to both persons.*

Annuity Charges and Expenses

In an annuity, the entire contribution is not invested in the separate account since purchases are subject to various sales charges and fees. Registered representatives must explain each of these costs to their clients prior to effecting a sale.

Sales Charges The prospectus for a variable annuity must clearly disclose all of the charges and expenses that are associated with the annuity. Today, the majority of companies impose a form of *contingent deferred sales charge* (also referred to as a surrender charge or withdrawal charge) that's similar to what's assessed on Class B mutual fund shares.

Although FINRA rules specify a maximum sales charge of 8.5% for mutual fund sales, there's no statutory maximum sales charge on variable products. Instead, sales charges for variable annuities must be reasonable.

Expenses As to be expected, insurance companies that issue variable annuities have expenses. These expenses are deducted from the investment income that's generated in the separate account. Expenses include the costs of contract administration, investment management fees, and mortality risk charges.

Management Fee Each of the subaccounts will usually assess an investment management fee. This is the fee that the subaccount's investment adviser receives for managing the assets.

Expense Risk Charges When an insurance company issues a variable annuity, it usually guarantees that it will not raise its costs for administering the contract beyond a certain level (referred to as the expense guarantee). The expense risk charge compensates the company if the expenses incurred for administering the annuity turn out to be more than estimated.

Administrative Expenses Administrative expenses are associated with the costs of issuing and servicing variable annuity contracts including recordkeeping, providing contract owners with information, and processing both their payments and requests for surrenders and loans.

Mortality Risk Charges An insurance company may not refuse to meet the obligation of providing its annuitants with a lifetime income even if they live longer than expected. The pledge that the company makes is referred to as the *mortality guarantee*. There are two types of mortality risks that are associated with annuities.

Copyright © Securities Training Corporation. All Rights Reserved.

First, the insurance company may guarantee its annuitants that it will make payments to them for the rest of their lives. When calculating these payments, the company takes into account the annuitant's expected life span.

Second, most variable annuities also guarantee that if the contract owner dies during the annuity's accumulation phase, the company will return a certain amount of money (i.e., a death benefit) to the person who is designated as the beneficiary by the contract owner.

Qualified Annuities

Although any person may invest in a non-qualified annuity, a tax-deferred, *qualified annuity* is a special type that may only be established by non-profit organizations or public school systems for their employees. The employees may set aside a portion of their income on a pre-tax basis in order to fund the annuity. The employers may also contribute to the annuity on their employees' behalf. The amount contributed by the employees is excluded from their taxable income.

> *For example, a public school teacher who earns $35,000 per year has $2,000 withheld from his paycheck annually to purchase units in a tax-deferred annuity. This will result in his taxable income being only $33,000 per year.*

The money that the employees contribute into qualified annuities accumulates on a tax-deferred basis until the employees ultimately withdraw the funds. Since the contributions are made with pre-tax dollars, all of the payouts from the annuity are taxed as ordinary income.

Let's assume that during a person's working life he had contributed $100,000 into a tax-deferred annuity and the value of his investment has grown to $250,000. At retirement, if he withdraws the entire value of his annuity, he's required to pay ordinary income taxes on the entire amount. The entire amount is taxable because the annuitant has a zero cost basis (i.e., none of the invested funds have been taxed).

Equity-Indexed Contracts (EICs)

EICs are contracts that combine the features of both fixed and variable annuities; however, they're not required to be registered with the SEC as securities. An equity indexed contract offers clients a minimum guaranteed rate of return or *floor* (similar to a fixed contract), but also offers upside potential (similar to a variable contract).

The insurance company links the return of these types of contracts to an equity index, such as the S&P 500 Index. If the index performs poorly, the client will still earn the minimum guaranteed rate. On the other hand, if the index appreciates above a preset level, the investor will earn a return that exceeds the minimum guaranteed rate. Some contracts are issued with a participation rate which may limit the amount of the index's appreciation that the client will earn.

Copyright © Securities Training Corporation. All Rights Reserved.

For example, an EIC has a participation rate of 80% and the associated index's return is 10%. In this case, the investor will not share in the entire return of the index. Instead, the investor's return is capped at 8% (10 x 80%).

Although these contracts offer the benefit of tax-deferred growth, clients may lose money when surrendering the contract in the early years since expenses, CDSCs, and premature distribution penalties often apply. The market doesn't cause the value of these investments to decline; instead, it's the impact of fees being deducted.

Suitability As with variable annuities, equity-indexed annuities are not suitable for all investors, particularly older investors, who may need access to their money for medical or living expenses. EIAs should never be sold to short-term investors since the surrender period for an equity-indexed annuity may be as long as 15 years.

Variable Annuities—Suitability and Compliance Issues

Since variable contracts *don't* provide a known amount of retirement income, these contracts are best suited for investors who can deal with the fluctuation in value and payment stream and can understand the risks inherent with equity investments. An investor's hope is that the contract will continually grow at a rate that will provide a hedge against inflation risk.

Generally, variable annuities are not suitable for senior investors; instead, they're more appropriate for persons with long-term investment goals who don't anticipate needing access to their money for at least five to seven years. While variable annuity contracts have features that are similar to mutual funds, what makes them unique is that they provide tax-deferred growth. However, many annuities impose significant charges on investors who surrender their contracts early. If an annuitant withdraws funds prior to reaching the age of 59 $^1/_2$, he's required to pay taxes on any increases in the value of his annuity *plus* he's subject to a 10% tax penalty.

Under FINRA rules, prior to making a variable annuity recommendation, salespersons must make reasonable efforts to obtain certain client-related information, including their age, annual income, financial situation and needs, investment experience, investment objectives, and investment time horizon (since most contracts have CDSCs), the intended use of the deferred variable annuity, existing assets (including outside investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, and tax status.

Principal Approval Once a registered representative has collected the required information on a potential deferred variable annuity customer, this complete and correct application package and the customer's check (payable to the issuing insurance company) must be promptly forwarded to the representative's Office of Supervisory Jurisdiction for approval. Typically, once received, the approving principal at the OSJ will review the application and determine whether the proposed transaction is suitable. The broker-dealer has up to *seven business days* from its receipt of the application package to make this determination.

 Copyright © Securities Training Corporation. All Rights Reserved.

Review of 1035 Exchanges Although many persons use new funds to contribute to annuities, registered representatives may also suggest moving client assets from existing contracts. Managers must be extremely vigilant when examining the validity of a proposed transfer which is typically accomplished through a 1035 Exchange. Named after IRS Section 1035, this provision permits the exchange of annuity contracts without creating a taxable event. A principal should determine if the proposed exchange will result in the client incurring a surrender charge, being subject to a new surrender period, losing existing benefits (e.g., death, living, or other contractual benefits), or being subject to increased fees or charges (e.g., mortality and expense fees or investment advisory fees). Additionally, a principal must document whether another exchange has been executed for the client within the preceding 36 months since this may be evidence of churning.

FINRA Concerns Historically, some salespersons have sold annuities to the wrong investors and/or recommended inappropriate exchanges within contracts. Additionally, annuities often have higher expenses than similar mutual funds that could instead be placed within a retirement account. Any persons saving for retirement should normally exhaust all of their opportunities to contribute to employer-sponsored retirement plans (e.g., a 401(k) or IRA) before investing in a variable annuity. The benefit to employer-sponsored plans is that they're funded with deductible (pre-tax) contributions. Although the earnings in a non-qualified variable annuity grow on a tax-deferred basis, the contributions are made with after-tax dollars.

Municipal Fund Securities

Although municipal fund securities constitute municipal securities, they may not have many of the features that are typically associated with traditional municipal securities. Instead, municipal fund securities appear to have features more similar to investment company securities or variable contract products. For instance, municipal fund securities provide investment returns and are valued based on the investment performance of an underlying pool of assets with an aggregate value that may increase or decrease from day-to-day, rather than providing interest payments (either paid currently or at maturity) at a stated rate or discount, as is the case with traditional municipal securities. In addition, unlike traditional municipal securities, municipal fund securities don't have stated par values or maturity dates and cannot be priced based on yield or dollar price.

Let's examine three different forms of municipal fund securities—*local government investment pools (LGIPs), 529 college savings plans,* and *529A plans*.

Local Government Investment Pools

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

Copyright © Securities Training Corporation. All Rights Reserved.

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

Section 529 College Savings Plans

Section 529 of the IRS Code, which was amended by Congress in 1996, enabled the establishment of state-sponsored, tax-deferred, college savings vehicles. The two types of 529 plans that can be used to meet the expenses of higher education are *prepaid college tuition plans* and *college savings plans*.

Prepaid Tuition Plans (PTP) Prepaid tuition plans are designed to cover tuition costs at public in-state colleges and universities. The donor may pay for amounts of tuition in one lump-sum or through installment payments. Some prepaid tuition plans offer contracts for a two-year or four-year undergraduate program and can cover one to five years of tuition. Other plans may even allow for the contract to be applied to graduate school.

Residency Requirements and Other Limitations Many PTP plans require that the donor or the beneficiary be a resident of the state that offers the plan. Some plans also limit enrollment to a certain period each year and they may limit the expenses that are covered. For example, some plans may cover the costs of tuition, books and laboratory fees, but may not cover the costs of room and board.

Prepaid tuition plans don't provide the donor any investment options. The price of the contract is determined prior to purchase and usually depends on the type of contract, the current grade of the beneficiary, and the current and projected cost of tuition.

Transferability If the beneficiary of a prepaid tuition plan chooses not to attend a college covered by the plan, most plans provide for a transfer to another sibling of the original beneficiary. In some cases, age restrictions may apply. Additionally, if the sibling decides not to attend college or if the donor cancels the plan, only the original contribution will be returned and any interest earned on the plan will be lost. In fact, some plans may charge a cancellation fee.

Prepaid tuition plans are not considered to be municipal fund securities. In effect, these plans lock in tuition costs at today's levels and protect the saver against future cost increases. Unlike college savings plans, tuition plans are not self-directed and typically offer guaranteed returns.

College Savings Plans College savings plans, which most simply recognize as 529 plans, are more similar to a 401(k) plan in that they offer mutual fund type investments that grow on a tax-deferred basis. Some plans offer rather limited investment choices, including aged-based portfolios that automatically adjust the asset allocation based on the beneficiary's age. These plans typically move money from stock funds to bond funds as the child grows closer to college age.

 Copyright © Securities Training Corporation. All Rights Reserved.

Under federal law, contributions are made with after-tax dollars, but any earnings grow on a tax-deferred basis. Earnings in a 529 plan account are not subject to federal income tax, and in many cases are not subject to state income tax when used for the qualified higher education expenses. Qualified education expenses include those incurred for tuition and fees, room and board, as well as books, supplies, and equipment. States that offer 529 plans are responsible for determining the specific plan rules, such as allowable contributions, investment options (e.g., mutual funds), and the deductibility of contributions for state tax purposes.

Expanded Use of 529 Plans Although originally intended to accumulate funds to only pay for college educational expenses, the funds in 529 plans may also be used for expenses related to elementary and secondary schools at public, private, or religious institutions. Today, individuals are allowed to take up to $10,000 in distributions annually from their 529 plans to pay for private school tuition and books for grades K through 12—in addition to using their account proceeds for college costs.

Additionally, an individual is now permitted to withdraw up to $10,000 on a tax-free basis (a qualified withdrawal) to repay a qualified student loan as well as expenses for certain apprenticeship programs. This is a lifetime limit that applies to the beneficiary and each of the beneficiary's siblings.

Contribution Limits Although current tax law allows a tax-free gift of up to $16,000 to any one person in any given tax year, a 529 plan may be front-loaded with an initial gift of $80,000 which is treated as if it's being made over a five-year period (five contributions of $16,000 each). Individuals may contribute these same amounts to 529 plans that are maintained for more than one beneficiary.

In other words, if an individual has five grandchildren, she's able to contribute $80,000 to each grandchild's 529 plan without incurring federal gift taxes. These amounts are doubled for a married couple who are funding multiple 529 plans. The total amount able to be contributed to a 529 plan is determined by the state. Most states use a total that's sufficient to pay for an undergraduate degree.

529 Plan Advantages These plans allow the owner to change beneficiary once per year; however, the new beneficiary must be a family member of the previous beneficiary in order to retain federal tax benefits. The ability to change beneficiaries means that funds which were contributed to a 529 plan may leave donors' estates, but not their control. Many plans have no time limit as to when the funds must be withdrawn and the donor will authorize the payment of any future educational expenses. Additionally, twice every 12 months, account owners can adjust their holdings in a 529 plan (this was previously only allowed once every 12 months).

Direct or Adviser Sold There are two method by which 529 plans may be sold to customers. One is referred to as *direct-sold*, in which there's no salesperson and the plan is sold directly through the 529 savings plan's website or through the mail. The other method is *adviser-sold*, in which the plan is sold by through a broker-dealer that has entered into a signed selling agreement with the primary distributor of the 529 plan.

Copyright © Securities Training Corporation. All Rights Reserved.

Some states may only offer plans directly (typically to their residents), while others have selling agreements with broker-dealers and offer the plans directly. The fees that are paid may be lower in direct-sold plans, but the customer will not receive the advice of an investment professional. Obviously, adviser-sold plans offer the advice of an adviser.

Section 529A Plans

Similar to 529 college savings plans, 529 ABLE (or simply referred to as 529A) accounts are savings accounts that are administered by the states. The 529A plan was authorized under the Achieving a Better Life Experience (ABLE) Act to supplement the support of persons who are disabled or who meet the government's definition of disabled and are receiving Social Security disability, Medicaid, or private insurance payments. In the past, if a disabled person earned more than $700 per month or had assets in excess of $2,000, he risked having to forfeit eligibility for government programs. Today, a 529A account will not impact Medicare or Social Security payments unless the current account value exceeds $100,000. Once the account value is again below the $100,000 level, federal and state aid resumes. The maximum contribution limit is $500,000.

A 529A account may be opened in any state that has a nationwide ABLE program. The maximum contribution into the account is $16,000 per year and it's made on an after-tax basis at the federal level (may be pre-tax at the state level). Unlike a 529 plan, there's no five-year front loading of contributions and there may only be one 529A account per beneficiary. The earnings are tax-free if they're used for qualified expenses, including basic living expenses, education, employment support, housing, financial management, legal fees, transportation, and wellness. If the funds are used for non-qualified expenses, the earnings are subject to taxes at ordinary tax rates and a 10% tax penalty.

Upon the termination of disability status or death of the beneficiary, the assets in the 529A plan are used to pay off the state Medicaid agency for any expenses that were paid out after the ABLE plan was established. The assets of the plan may also be rolled over to an eligible sibling without a taxable event. Offering documents associated with 529A plans, as well as continuing disclosure documents, are available on the MSRB's Electronic Municipal Market Access (EMMA) system. EMMA is an online repository that is maintained by the MSRB.

Conclusion

This ends the chapter on variable contracts/annuities and municipal fund securities. These products have unique features and can be very attractive to a wide variety of investors. The next chapter will continue to examine securities products, including direct participation programs (DPPs), real estate investment trusts (REITs), hedge funds, and exchange-traded products (ETPs).

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 8 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Distinguish between fixed and variable annuities
- Recognize the key differences between an insurance company's general account and a separate account
- Understand that separate accounts (and related subaccounts) of variable products are generally required to be registered with the SEC as investment companies under the Investment Company Act of 1940
- Recognize the characteristics of both the Accumulation Phase and Annuity Phase of annuities and the tax ramifications of taking withdrawals, loans, and annuity payments
- Understand the annuity payout options that are available at annuitization and where beneficiaries can be named
- Understand the difference between contract owners, annuitants, and beneficiaries
- Calculate the death benefit in the event the owner dies during the Accumulation Phase
- Understand the charges and expenses associated with annuities
- Distinguish between qualified and non-qualified annuities and the resulting tax consequences of taking withdrawals from them
- Define and understand the term *cost basis*
- Understand the difference between tax-deferred and tax-free
- Understand the different methods of funding an annuity
- Understand the suitability issues that arise when an annuity purchase or 1035 Exchange recommendation is made
- Understand how equity-indexed annuities are different from variable annuities
- Understand the requirements for contributing funds to a 529 plan and rules for using the funds
- Understand the eligibility requirements and use of a 529 ABLE plan
- Recognize recent changes made to 529 and 529 ABLE plans as a result of the SECURE Act

Create a Chapter 8 Custom Exam

Now that you've completed Chapter 8, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 9 – Alternative Investments

- *Exchange-Traded Funds and Exchange-Traded Notes*
- *Hedge Funds and REITS*
- *Limited Partnership*

Copyright © Securities Training Corporation. All Rights Reserved.

This chapter will examine some additional types of packaged products, such as exchange-traded funds (ETFs), hedge funds, and real estate investment trusts (REITs). The final section of this chapter will describe direct participation programs (DPPs), which are fairly complicated products that offer several unique tax benefits.

Other Types of Investment Companies

Mutual funds are by far the most common type of investment company; however, their shares may only be purchased or sold (issued or redeemed) at the end of the trading day. For investors who want the ability to trade packaged products (especially index fund-like products) throughout the day, exchange-traded funds (ETFs) are available.

Exchange-Traded Funds (ETFs)

ETFs issue shares that represent an interest in an underlying basket of securities which typically mirrors a specific index. Some of the indexes to which ETFs are linked represent the securities of a particular country or industry.

Some ETF examples include:

- SPDRs (Spiders), which tracks the S&P 500 Index
- QQQs (Cubes), which tracks the Nasdaq 100 Index
- DIA (DIAMONDS), which tracks the Dow Jones Industrial Average

Passive Versus Active Active management refers to the selection of securities in a portfolio by a professional manager. The ultimate goal of the manager is to outperform the market. On the other hand, passive management involves simply attempting to match the market by tracking an index.

Fee Considerations The fees associated with passive management are lower than the costs that are added for the selection of securities for a portfolio that's actively managed. Unlike purchasers of mutual fund shares who may be assessed sales charges, purchasers of ETF shares pay commissions on their transactions.

How ETF Differ from Mutual Funds Unlike mutual funds, ETFs trade on an exchange and have prices that are determined continuously by the forces of supply and demand. Additionally, ETFs often have lower expenses than mutual funds and their shares may both be sold short and purchased on margin.

Lately, specific types of ETFs—*inverse* and *leveraged ETFs*—have become popular among sophisticated investors. The value of inverse ETFs should increase when the market drops or decrease when the market rises. Leveraged ETFs seek to provide investors with a multiple of the return of a benchmark index.

Copyright © Securities Training Corporation. All Rights Reserved.

Inverse ETFs An inverse ETF is designed to perform in a manner that's the inverse of the index being tracked. This reverse tracking is accomplished by short selling the underlying investments in the index (i.e., borrowing securities and selling them with the belief that they will fall in value) or through other advanced strategies using futures and derivatives. The goal of an inverse ETF is to provide a return that's equivalent to short selling the stocks in the index. For example, if the S&P 500 Index falls by 1.5% on a given day, the inverse ETF should rise by approximately 1.5%. These products are often used by investors with long positions as a hedge against a bear market.

Leveraged ETFs Leveraged ETFs are products that use debt instruments or financial derivatives such as swaps, futures, and options to amplify the returns of a specific index. These leveraged products may be constructed to either track the specified index or an inverse of the index. For example, a leveraged long ETF may be designed to deliver 2 times or 3 times the performance of the S&P 500 (referred to as double-long or triple-long ETFs). On the other hand, a leveraged bear ETF may be designed to deliver the inverse of 2 times or 3 times the performance of the S&P 500 (referred to as double-short or triple-short ETFs).

Inverse and Leveraged ETFs are Short-Term Investment Products Most inverse and leveraged ETFs reset their portfolios *daily* to meet their objectives. In other words, all price movements are calculated on a percentage basis for that day only. On the next day, the process will restart. Due to this daily resetting process, an inverse or leveraged ETF's performance may not provide true tracking of the underlying index or benchmark over longer periods. For this reason, both leveraged ETFs and inverse ETFs are generally only appropriate for short-term trading purposes.

Exchange-Traded Notes (ETNs)

ETNs are a type of unsecured debt security that pays a return which is linked to an underlying market index or other benchmark. Like ETFs, ETNs trade on exchanges and are available in both inverse and leveraged varieties. These hybrid versions are designed as short-term trading vehicles.

Return ETNs are different than traditional bonds since they don't typically make interest payments. Instead, ETNs pay the holder an amount which is based on the performance of an underlying index or benchmark. The maturities of ETNs can range from 10 to 30 years.

Issuer Credit Risk ETNs are created by a bank or other financial intermediary and are unsecured debt obligations of the issuer. Since an ETN is a debt obligation of the issuer and backed by only the issuer's full faith and credit, the issuer's credit quality is a risk factor to consider when determining whether to invest in an ETN.

Fee Considerations There are two types of costs that are associated with ETNs. First there are reoccurring costs, such as fees included in the reference index or benchmark as well as the daily investor fees that will lower the indicative closing value of the ETN. The term *indicative value* is the reference value of the benchmark minus the daily investor fee. The other cost is the amount of brokerage commissions that investors may pay when buying and/or selling ETNs.

 Copyright © Securities Training Corporation. All Rights Reserved.

Other Types of Packaged Products

Hedge Funds

Hedge funds are private investment pools that are not required to register with the SEC under the Investment Company Act of 1940. These investments are often sold under a Regulation D (private placement) exemption and their purchasers are typically institutional and high net worth investors that can understand the unique risks associated with these products, such as their lack of liquidity and their potential use of leverage by the fund managers. These funds typically have high minimum initial investment requirements (often $1 million or greater).

Unregulated Since hedge fund offerings are generally limited to accredited investors, these products qualify for exemptions from the federal regulations that govern short selling, use of derivatives, leverage, fee structures, and the liquidity of the investment. Due to these exemptions, hedge funds may use strategies that are prohibited for more heavily regulated investment entities (e.g., mutual funds). The reason that hedge fund managers take on additional risks is to generate larger returns than the overall market. Although specific securities positions may vary from fund to fund, many hedge funds borrow money (i.e., use leverage) to increase their returns.

Illiquid Unlike mutual funds, hedge funds are not required to publish their net asset value daily and impose restrictions on withdrawals which make these assets less liquid. Since hedge funds don’t offer investors the ability to redeem at the NAV on a daily basis, these products are unsuitable for investors who are seeking liquidity. In addition, most hedge funds raise capital by offering investors limited partnership units (described later in this chapter), which will also limits their liquidity.

Compensation Mutual funds cannot assess a sales charge that exceeds 8.5% of the fund’s public offering price; however, hedge funds often impose higher and more complex fees. One typical arrangement is a *two-and-twenty fee* which involves a hedge fund manager charging a 2% management fee and then taking 20% of any of the profits.

Private Equity Funds

Hedge funds often attempt to amplify investment results while engaging in the trading of existing securities. Traditionally, the role of raising capital for start-up businesses was filled by private equity (PE) and venture capital (VC) funds. In many ways, these types of funds are similar to hedge funds, especially due to their lack of regulation and liquidity.

Unregulated and Illiquid Similar to hedge funds, PE and VC funds raise capital by offering investors limited partnership units that are sold as private placements (under the Reg. D exemption). For that reason, hedge funds are normally available to accredited investors only. These funds are not regulated under the Investment Company Act of 1940 and have no active trading venues.

Copyright © Securities Training Corporation. All Rights Reserved.

Real Estate Investment Trusts (REITs)

Regulation

Although real estate investment trusts have some features that are similar to investment companies, these products are not categorized under the Investment Company Act of 1940. However, the Securities Act of 1933 regulates REITs as securities and requires that prospectuses are sent to any investors who purchase shares that are offered to the public in the primary market.

Investment Attributes

REITs create a portfolio of real estate investments from which investors may earn profits. REITs invest in many different types of residential and commercial income-producing real estate, such as apartment buildings, shopping centers, office complexes, storage facilities, hospitals, and nursing homes. Income is received from the rental income being paid by the tenant that leases the real estate which is owned by the REIT. These investments are actually suitable for both retail and institutional investors.

The three types of REITs are listed below:

1. *Mortgage REITs* Mortgage REITs provide funding to real estate purchasers by acting in the same capacity as a bank. Mortgage REITs borrow funds from investors and then invest the funds in mortgages and typically earn income based on the difference between these two rates of interest (which is referred to as the spread).
2. *Equity REITs* Equity REITs own and operate income-producing real estate, such as apartment buildings, commercial property, shopping malls, vacation resorts, and other retail properties.
3. *Hybrid REITs* These business structures are a combination of mortgage REITs and equity REITs. By purchasing a hybrid REIT, the investor can take advantage of buying a security that invests in the actual equity ownership of real estate as well as investing in an interest-rate sensitive security (i.e., the mortgage REIT).

Liquidity There are three varieties of REITs. The first are those that are sold under Regulation D as private placements and not registered with the SEC. The other two are registered and are either listed or non-traded (unlisted). Most REITs are exchange-listed, traded each business day, and are reported on customer account statements at their current market value per share. On the other hand, private REITs and non-traded REITs are illiquid and are as difficult to price as hedge fund or limited partnership investments. These non-traded REITs are reported on customer account statements at their estimated market value per share.

Copyright © Securities Training Corporation. All Rights Reserved.

Tax Treatment of REITs The benefit of qualifying as a real estate investment trust is the favorable tax treatment that's provided under the Internal Revenue Code. Unlike other corporations, there's no double taxation on the dividends that a REIT pays to its shareholders. If 90% of the ordinary income generated from the portfolio is distributed to investors, the income will only be taxed once (at the investors' levels). Both listed and non-traded REITs avoid paying taxes on distributed income in substantially the same manner as a regulated investment company. However, unlike DPPs, neither listed nor non-traded REITs pass-through operating losses.

To qualify for the special tax treatment, all types of REITs must satisfy the following three income tests:

1. At least 95% of its gross income must be derived from dividends, interest, and rents from real property.
2. At least 75% of its gross income must be derived from real property income (e.g., rents or interest).
3. No more than 30% of its gross income may be derived from the sale or disposition of stock or securities that have been held for less than 12 months.

Tax Treatment for the Investor Real estate investment trusts offer investors a stable dividend based on the income they receive and most investors purchase these securities for this reason. The dividends that both listed and non-traded REITs pay to their shareholders don't qualify for the reduced 20% tax rate that's given to the dividend distributions paid on common and preferred stock. Instead, the dividends received by REIT investors are taxed as ordinary income. However, based on the 2018 tax reforms, the following additional benefits are provided:

- 20% of the income that's distributed by REITs is deductible (excluded from tax).
- The maximum tax rate on ordinary income has been lowered to 37% (from 39.6%).

Direct Participation Programs (DPPs)

A direct participation program is a type of investment in which the results of the business venture (cash flow, profits, and losses) directly flow through to the investors. Although DPPs come in different forms, such as general partnerships, joint ventures, limited liability companies (LLCs) and Subchapter S Corporations, this program will focus on limited partnerships.

To establish a limited partnership, the partnership files a Certificate of Limited Partnership with the state. A limited partnership requires a minimum of two partners—one general partner and at least one limited partner. The *general partner (GP)* is responsible for managing the program and must contribute at least 1% of the program's capital. The *limited partner (LP)* is a passive investor who has no control over managerial decisions. Instead, limited partners are typically the investors who contribute a large amount of the program's capital.

Copyright © Securities Training Corporation. All Rights Reserved.

Advantages of Limited Partnerships

Some of the benefits of this ownership structure include the following.

Favorable Tax Treatment Subchapter C Corporations—often simply referred to as *corporations*—are taxed twice. Corporations are required to pay taxes on their income and then their shareholders pay taxes on any dividends that the corporations distribute. Unlike corporations, partnerships are not taxable entities. Instead, the partnership's income (or loss) is allocated directly to the partners for tax treatment on their personal income tax returns (i.e., it has pass-through treatment and is reported as passive). Any passive income that's distributed is taxed as ordinary income. Since the business doesn't pay tax, limited partners may receive more income from a profitable DPP than from a profitable corporation since a corporation's dividends are paid as after-tax distributions.

As is the case with REITs, beginning in 2018, DPP investors receive the following tax benefits:

- 20% of the income that's passed through by partnerships is deductible (excluded from tax).
- The maximum tax rate on ordinary income has been lowered to 37% (from 39.6%).

Limited Liability In return for a share in a project's income and deductions, limited partners assume financial risk only to the extent of their investment. In other words, limited partners cannot lose more than the amount that they have at risk.

Diversification Many limited partnerships invest in assets that have little or no correlation to the stock and bond markets. These programs may provide an investor with a level of diversification that may not be available from traditional mutual fund offerings.

Disadvantages of Limited Partnerships

Some of the drawbacks to this form of investment include the following.

Lack of Control Limited partners may have no managerial authority regarding the daily business of the partnership. Unlike a traditional corporation, there may be very little (if any) oversight of the management by an independent board of directors.

Illiquidity Since a limited partner's investment is normally unable to be sold quickly, it's an illiquid investment. In most cases, there's no actively traded public market for these investments and limited partners are often required to obtain the permission of the general partner to sell their interest in the partnership.

Tax Issues Owning a limited partnership will likely complicate a client's year-end tax filing. Since many partnerships are constructed in such a way to take advantage of certain benefits that exist in the U.S. tax code, any change in tax laws or adverse IRS rulings could negatively impact a limited partner's future returns.

Copyright © Securities Training Corporation. All Rights Reserved.

Possible Capital Call Unlike the previously described investments, investors in limited partnerships may be asked to contribute additional funds after their initial investment. Failure to make the additional contribution could result in the investors forfeiting their interest in a project.

General Partners

General partners have unlimited liability and are responsible for all management affairs of the partnership. GPs also assemble investors' capital, collect fees for overseeing the partnership's operations, keep the partnership books, and direct the investment of the partnership's funds. General partners have a fiduciary relationship to the limited partners in these programs.

Limited Partners

In the simplest terms, limited partners are passive investors that make no day-to-day management decisions. In fact, if limited partners take on an active role in the management of the programs, they may be considered general partners and will have unlimited liability.

The following table provides a summary of each partner's rights and obligations:

Limited Partnership Summary	
General Partner	***Limited Partner***
Day-to-day manager with unlimited personal liability	Passive investor with limited liability
Must have at least a 1% interest	Contributor of capital
Fiduciary toward limited partner	Has the right to: ▪ Lend to the partnership ▪ Inspect books ▪ Compete
Last in priority at liquidation: ▪ Secured Creditor ▪ General Creditor ▪ Limited Partner ▪ General Partner	Ways to endanger "limited" status: ▪ Negotiate contracts ▪ Hire/fire employees ▪ Lend her name

DPP Offering Practices

To raise money, the general partner (also referred to as the program's sponsor) may conduct either a public or private securities offering. In a public offering, the general partner will hire an underwriter (also referred to as a syndicator) to market the program to the public and will register the DPP's interests with the SEC. Disclosure is made to investors through an offering prospectus. Although these securities may be registered with the SEC, DPP interests are generally illiquid since they're not traded on an exchange (i.e., they're unlisted).

Copyright © Securities Training Corporation. All Rights Reserved.

If sales are executed by an underwriter (syndicator), the purchasers must be accepted by the general partner to be valid. At times, GPs may themselves act as syndicators or they may hire an independent investment banker to assist in the distribution. In either case, the maximum underwriting compensation for a public offering is 10% of the gross dollar amount of the securities being sold.

In a private placement, the sponsor will attempt to locate investors without the assistance of an underwriter. These types of offerings are conducted under Regulation D of the Securities Act of 1933 and are exempt from registration. In a Reg. D offering, disclosure is provided to investors through an offering memorandum.

Tax Treatment of Individual Partners

Passive Activities Passive activities are investments in which an owner of a business doesn't materially participate in its operations throughout the year. Investments in direct participation programs and rental activities are considered passive activities.

Losses that are generated by passive activities may only be deducted against income from passive activities. If passive losses exceed passive income, the excess passive losses may be carried forward indefinitely to offset passive income in future years.

As an added benefit, when the ownership interest in a passive activity is sold, the investor can deduct all passive losses that are carried forward against any form of income—passive or non-passive.

Types of Limited Partnerships

Historically, limited partnerships have been established to allow for investment in a wide variety of assets, including timber, minerals, farming, ranching, real estate, and energy. The SIE Examination will primarily focus on two types of programs—real estate as well as oil and gas. Let's examine the details of each type.

Types of Real Estate Limited Partnerships The primary advantage for investing in real estate is the fact that land is a commodity for which supply is fixed, but demand is constantly increasing. Real estate programs focus on raw land, new construction, existing properties, and government-assisted housing.

Raw Land For the purpose of land speculation, limited partnerships may purchase large tracts of raw (undeveloped) land. Investments in raw land offer no depreciation deductions and little or no periodic income. The motivation behind speculation in raw land is the potential capital appreciation to be achieved after selling property that has significantly increased in value.

New Construction Generally, the objective of investments in new construction is capital appreciation; however, there may be some cash flow if the properties are leased to tenants after construction. A real estate construction program involves a large financial commitment which is usually accomplished through leverage (borrowing).

 Copyright © Securities Training Corporation. All Rights Reserved.

Existing Properties Certain programs are formed primarily to purchase existing commercial properties and apartments. Returns in these programs are predictable and offer a high degree of certainty. For investors in existing property partnerships, two benefits are the immediate cash flow from rentals and the availability of depreciation allowances.

Government-Assisted Housing Government-assisted housing projects are created to provide low-cost housing for low-income families. Most federally subsidized housing programs are part of the Section 8 Program which is administered by the Department of Housing and Urban Development (HUD)—a government agency. The costs associated with construction, rehabilitation, or acquisition of low-income housing qualify for tax credits, which is the major benefit of these programs.

Types of Oil and Gas Limited Partnerships Oil and gas programs are formed for the exploration, drilling, or development of oil and natural gas. Management typically provides the technology and organization; however, it may not specifically identify the areas to be drilled until after the program is created.

Exploratory Program Exploratory drilling, also referred to as wildcatting, involves searching for oil and gas in unproven areas. Due to the uncertainty of success, these programs are considered high-risk ventures.

Developmental Program In a developmental program, leases are acquired for the right to drill in proven areas. Although this type of program has high deductibility, its lower risk equates to a lower potential return than what's offered by a wildcatting program. The lower risk is based on the belief that a productive exploratory well could be surrounded by equally productive drilling locations.

Balanced Program A balanced drilling program involves a combination of both exploratory and developmental drilling. The exploratory drilling provides the potential for high yields, while the development drilling offsets the high risks associated with the exploratory drilling.

Income Program An income program acquires interests in already producing wells. These well sites are acquired from oil and gas operators that have completed the drilling and have chosen to sell the reserves, rather than holding and operating the sites. Since income programs are the most conservative oil and gas offerings, they may be suitable for clients who are somewhat risk-averse and are seeking to diversify a stock or bond portfolio with an income objective.

Risk Summary

Before investing in a limited partnership, investors should be aware of the various risk components that are inherent in the program and should evaluate the relative degree of risk that each component contributes to the overall risk of the investment. Some of the risk considerations include:

- Management ability of the general partners
- Illiquid nature of limited partnership units
- Possible loss of capital and unpredictability of income

Copyright © Securities Training Corporation. All Rights Reserved.

- Ability of the investor to pay any potential future assessments
- Rising operating costs
- Availability of good properties or leases
- Changes in the tax laws and government regulations
- Economic and environmental occurrences (e.g., an energy crisis)

Investor Certification Prior to executing sales, registered representatives are required to certify that they have informed their customers of all relevant facts relating to both the lack of marketability and liquidity of limited partnerships. In addition, RRs must have reasonable grounds to believe that their customers have sufficient net worth and income to withstand the potential loss of their entire investment.

Discretionary Accounts Due to the complexity of these products and the requirement to certify the eligibility of investors prior to purchase, RRs are not permitted to exercise discretion when recommending a DPP. In other words, a customer's written approval is required to be obtained prior to purchase.

Comparison of Alternative Investments			
Product	**Secondary Market Trading**	**Subject to Act of 1940**	**Marginable**
ETFs	Yes	Yes	Yes
ETNs	Yes	No	Yes
Hedge Funds	No	No	No
PE Funds	No	No	No
REITs	Generally	No	Generally
DPPs	Limited	No	No

Conclusion

This concludes the chapter on alternative investments. The next chapter will examine options contracts, which are a form of derivative investment that can be used to speculate on the direction in which an underlying instrument will move, as a hedge against adverse movement in an underlying instrument, or to generate income in a portfolio.

 Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 9 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Recognize that an exchange-traded fund (ETF) is a type of investment company, but is NOT an open-end investment company
- Understand why ETFs are considered *passively managed*
- Recognize that an ETF can be structured as an inverse ETF or a leveraged ETF
- Define and recognize the characteristics of a leveraged inverse ETF
- Understand the characteristics of exchange-traded notes (ETNs)
- Understand whose credit rating is critical when evaluating an ETN
- Recognize that an ETN can be structured as an inverse ETN or leveraged ETN
- Understand the characteristics of a hedge fund
- Understand the characteristics of a real estate investment trust (REIT) and recognize the three different types (mortgage, equity and hybrid)
- Understand the different tax implications for both the REIT and the REIT investors
- Recognize the different forms of direct participation programs (DPPs)
- Understand how DPPs act as a flow through investment vehicle for tax purposes
- Recognize the structure of a limited partnership (LP) and understand its characteristics
- Understand the obligations and rights of the general and limited partners
- Understand the priority of liquidation of a limited partnership

Create a Chapter 9 Custom Exam

Now that you've completed Chapter 9, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 10 – Options

- *Buyers versus Sellers*
- *Calls and Puts*
- *Options Terminology*
- *The OCC*
- *Speculation and Hedging*

Copyright © Securities Training Corporation. All Rights Reserved.

The goal of this chapter is to increase a person's knowledge of the following option-related concepts—hedging or speculation, expiration date, strike price, premium, underlying security or cash settlement, in-the-money versus out-of-the money, covered versus uncovered positions, American versus European exercise, exercise and assignment procedures, varying strategies (e.g., long, short), special disclosures (e.g., Options Disclosure Document (ODD), and the Options Clearing Corporation (OCC) for listed options.

Options

Let's start with answering the question, what's an option? An option is a derivative security and, in the simplest terms, is a contract whose value is derived from the movement of an underlying stock, index, currency, or other asset. These derivatives trade in markets that are very similar to those in which stocks and bonds trade. The foundation for understanding options is to examine the terms that are essential to any option discussion.

Equity Options – Terminology

Buyers and Sellers

An option is a contract that's entered into by two parties. On one side of the contract is the *buyer, owner*, or *holder* of the option, who is also considered *long* the option. The buyer pays the option's premium (i.e., the contract's market price) and receives the right to exercise the contract. Depending on the type of contract that's purchased, the holder has the right to either buy or sell the underlying security.

On the other side of the contract is the *writer* or *seller* of the option, who is also considered *short* the option. The seller receives the option's premium and assumes an obligation if the contract is exercised in the future. Depending on the type of contract that's sold, the writer may be obligated to either buy or sell the underlying security.

Remember, a buyer *pays* the premium and receives the *right* to exercise. However, if the option expires worthless, the premium paid represents the buyer's maximum loss.

A seller *receives* the premium and assumes an *obligation* if exercised against. However, if the option expires worthless, the premium received represents the seller's maximum gain.

Synonymous Terms	
Buyer	Seller
Owner	Writer
Holder	Short
Long	

Copyright © Securities Training Corporation. All Rights Reserved.

Types of Options

The two types of options that may be purchased and/or sold are calls and puts.

- A *call option* gives the owner the right to buy the underlying security. In other words, a call buyer is able to *call* the security away from the writer at a fixed price. The writer of the call has the corresponding obligation to sell the security at the fixed price if the owner exercises the contract.
  - Buyers of calls are bullish (want the underlying asset to rise)
  - Sellers of calls are bearish (want the underlying asset to fall)

- A *put option* gives the owner the right to sell the underlying security. In other words, a put buyer is able to *put* the security to the writer at a fixed price. The writer of the put has the corresponding obligation to buy the security at the fixed price if the owner exercises the contract.
  - Buyers of puts are bearish (want the underlying asset to fall)
  - Sellers of puts are bullish (want the underlying asset to rise)

The following table summarizes the rights or obligations and strategies of the two sides of an option:

	Long	Short
Call	Right to Buy (Bullish ↑)	Obligation to Sell (Bearish ↓)
Put	Right to Sell (Bearish ↓)	Obligation to Buy (Bullish ↑)

Components of an Option

An equity option is a contract to buy or sell a specific number of shares of a particular stock at a fixed price over a certain period. An option contract is described by the name of the underlying security, the expiration month of the contract, the exercise (strike) price, and the type of option. For example, let's assume that an investor purchased one call option on XYZ stock, with a May expiration, an exercise price of $30, and a premium of 3. The contract will appear as follows:

Investor is:	Number of Contracts	Underlying Security	Expiration Month	Exercise Price	Option Type	Premium
Long	1	XYZ	May	30	Call	3

The individual components of the option contract shown above represent the following:

Underlying Security — *XYZ* Each equity option typically represents the right to buy or sell 100 shares (one round lot) of the underlying stock.

 Copyright © Securities Training Corporation. All Rights Reserved.

Expiration Month — *May* All listed options (those that trade on an exchange) have fixed expiration dates. If an option has not been exercised or liquidated prior to its expiration, it expires (ceases to exist). In this example, the buyer of the call has the right to purchase 100 shares of XYZ stock from the writer until the option expires in May.

Exercise (Strike) Price — *30* The exercise price, also referred to as the strike price, is the price at which the call owner may buy stock from the writer. For put options, it's the price at which the put owner may sell stock to the writer.

Type of Option — *Call* Remember, a call option gives the owner of the contract the right to buy the stock, while the seller accepts the obligation to sell the stock if exercised against. In our example, the call buyer has the guaranteed ability to purchase 100 shares of XYZ at a price of $30, regardless of how high the price of XYZ increases between the time the option is purchased and its expiration in May.

Premium — *3* The current market price of this option contract is 3 points, or $3 per share. Since the contract is for 100 shares, the purchase price is $300 ($3 x 100 shares). This is the amount that a buyer pays to the seller for the rights conveyed by the contract.

The market price (premium) is not a fixed component of an option contract. Instead, it's constantly changing and is determined in the secondary market between buyers and sellers. The premiums of call and put options are determined by changes in the prices of the underlying securities. In other words, as the market values of the underlying assets rise and fall, so too do the option premiums.

The premium is influenced by a number of factors including the:

- Relationship between the current market price of the underlying stock and the strike price of the option contract
- Time remaining until the expiration of the option
- Volatility of the underlying stock

Intrinsic Value and Time Value

The premium of an option is potentially made up of two components—*intrinsic value and time value*. Intrinsic value is the amount by which an option is in-the-money, while time value is the portion of an option's premium that exceeds its intrinsic value.

Copyright © Securities Training Corporation. All Rights Reserved.

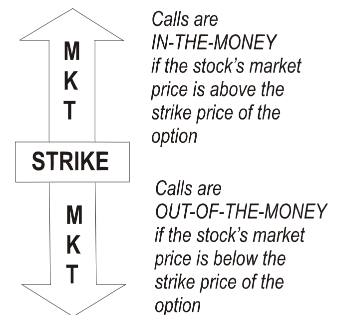
For calculation purposes, remember than an option will only have **IN**trinsic value if it's **IN**-the-money.

Option Premium = Intrinsic Value + Time Value

In-, At-, and Out-of-the-Money The relationship between the strike price of an option and the current market price of the underlying security determines whether an option is in-, at-, or out-of-the-money.

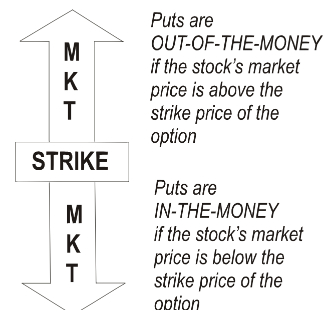
For call options, the relationships may be summarized as follows:

- Calls are IN-THE-MONEY if the stock's market price is above the strike price of the option.
- Calls are AT-THE-MONEY if the stock's market price is the same as the strike price of the option.
- Calls are OUT-OF-THE-MONEY if the stock's market price is below the strike price of the option.



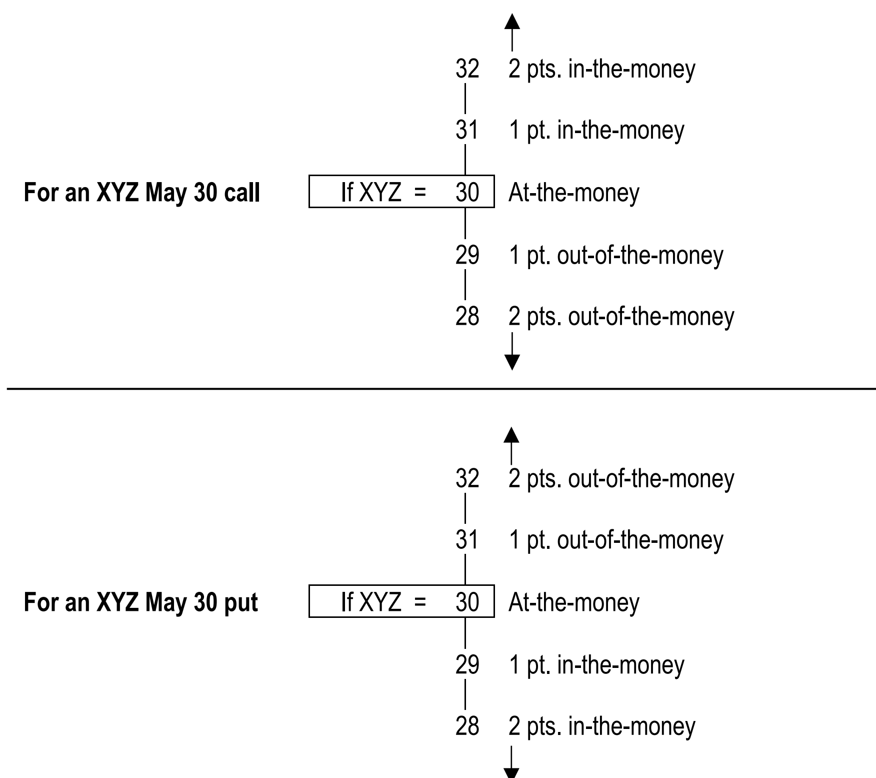
For put options, the relationships are the opposite:

- Puts are IN-THE-MONEY if the stock's market price is below the strike price of the option.
- Puts are AT-THE-MONEY if the stock's market price is the same as the strike price of the option.
- Puts are OUT-OF-THE-MONEY if the stock's market price is above the strike price of the option.



Copyright © Securities Training Corporation. All Rights Reserved.

The following illustrations summarize when options are in-, at-, and out-of-the-money:



Keep in mind, the intrinsic value of an option will either be a positive amount or zero; there will be no negative intrinsic value. If an option is in-the-money, it has positive intrinsic value; however, if an option is at-the-money or out-of-the-money, it has zero intrinsic value.

An important note is that intrinsic value is a concept that applies to an option contract; it's NOT based on whether the investor is a buyer or seller of the contract. Option buyers prefer that their options gain intrinsic value since they own the assets and want them to increase in value. On the other hand, writers dislike intrinsic value since this *in-the-money* amount represents a potential obligation if the contract is exercised (assigned to the writer).

Determining Time Value Since only in-the-money options have intrinsic value, any premium associated with at- or out-of-the-money options will consist only of time value. However, for in-the-money options, the time value may be determined by simply subtracting the intrinsic value from the premium. Using the earlier example, let's assume the XYZ May 30 call has a premium of 3 at a time when XYZ stock is trading at $32 per share. The premium of 3 consists of the 2 points of intrinsic value (from 30 to 32), with the remainder being 1 point of time value.

If the XYZ May 30 call has a premium of 3, but the stock is trading at $30 per share, how is the premium determined? With the stock at $30, a 30 call option is at-the-money. This would mean that the option has zero intrinsic value, and therefore, the entire 3-point premium is time value.

Copyright © Securities Training Corporation. All Rights Reserved.

Generally, the longer the time until an option expires, the greater its time value. If it's currently January, an XYZ August 30 call will trade at a higher premium than an XYZ May 30 call since the August option has more life remaining than the May option. However, an option's time value will diminish with the passage of time and, at expiration, it will have no remaining time value.

Breakeven

The premium of an option is a vital component in calculating an investor's breakeven point. The breakeven point represents the price at which a stock must be trading so that an investor will neither make nor lose money.

To find the breakeven point, remember the phrase "*Call UP and Put DOWN*." For calls, it's the strike price *plus* (or UP) by the premium, but for puts, it's the strike price *minus* (or down) by the premium.

- For buyers of options, breakeven represents the amount they need the underlying stock to move in their favor to recapture the premium paid.
  - Breakeven for the buyer of a call: *Strike price + premium*
    - Investor buys an XYZ May 50 call at 5. The breakeven point is if the stock rises to $55.
  - Breakeven for the buyer of a put: *Strike price – premium*
    - Investor buys an XYZ May 45 put at 4. The breakeven point is if the stock falls to $41.
- For sellers of options, breakeven represents the amount they can afford the underlying stock to move against them because they received the premium.
  - Breakeven for the seller of a call: *Strike price + premium*
    - Investor sells an XYZ May 50 call at 5. The breakeven point is if the stock rises to $55.
  - Breakeven for the seller of a put: *Strike price – premium*
    - Investor sells an XYZ May 45 put at 4. The breakeven point is if the stock falls to $41.

Speculation versus Hedging

Investors purchase and sell options to either speculate on the potential movement of an underlying instrument or hedge an existing position. *Speculation* refers to generating a profit based on an anticipated price change in the value of a security on which the investor has no existing position. Buying a call in anticipation of an increase in the price/value of an underlying instrument and buying a put in anticipation of a decrease in the price/value of an underlying instrument are examples of speculation. Conversely, writers of either calls or puts are simply speculating that their options will expire worthless.

Hedging refers to purchasing options to protect against the risk of adverse movement in the value of the underlying instrument. For example, an investor who owns stock can buy a put option to hedge the risk of the stock declining in value. The put purchase locks in sales price (the strike price) if the underlying stock falls in value. Hedging will be covered in greater detail later in this chapter.

 Copyright © Securities Training Corporation. All Rights Reserved.

Option Events

Since an option is a security with a fixed life, the contract will eventually be subject to one of three possibilities. The contract may be liquidated, it may be exercised, or it may expire.

Liquidate, Trade, or Close-out Liquidating (trading) an option position is essentially an alternative to exercising the option. To liquidate an option, an investor (either the buyer or seller) executes an opposite transaction on the same option contract. Since there's an active and liquid secondary market for listed option contracts, an investor who is long an XYZ May 30 call may close out the position by selling it. On the other hand, an investor who is short an XYZ May 30 call may close out that position by buying it.

- The buyer of an option creates the position with an *opening purchase* and could subsequently liquidate the position through a *closing sale*.
- The seller of an option creates the position with an *opening sale* and could subsequently liquidate the position through a *closing purchase*.

The difference between what an investor pays and what he receives is the profit or loss.

For example, an investor bought (made an opening purchase) an XYZ May 30 call at 3. Later, XYZ stock has increased to $40 and the investor liquidates the position (makes a closing sale) for its adjusted premium of 11 (10 points of intrinsic value and 1 point of remaining time value). Since the investor originally paid $300, but later sold the call for $1,100, his resulting gain is $800.

Exercise The second event that would close an option position is an exercise. The investor who is long an option has the exclusive right to exercise that option. The two styles of exercise are:

- **American Style Exercise**: Options using *American style* may be exercised at any time up to the day on which they expire. All listed equity options use American style exercise.
- **European Style Exercise**: Options using *European style* may only be exercised at a specified point in time, usually on the day of expiration. European style exercise is prevalent with index and currency options.

If an investor is long an XYZ May 30 call and the underlying stock is trading at $38 per share, the call holder could exercise the option and buy the stock at the strike price of $30 per share. Thereafter, the investor could sell the stock in the market for $38 per share, which results in a gain of $8 per share (actual gain is less the premium paid).

Similarly, an investor who is long an XYZ May 30 put may choose to exercise that contract if the stock is trading at $22. Assuming the investor did not currently own the stock, he could buy it in the secondary market for $22 per share, and then immediately sell the stock at the strike price of 30. The purchase at $22 and subsequent sale at $30 would result in a gain of $8 per share (actual gain is less the premium paid).

Copyright © Securities Training Corporation. All Rights Reserved.

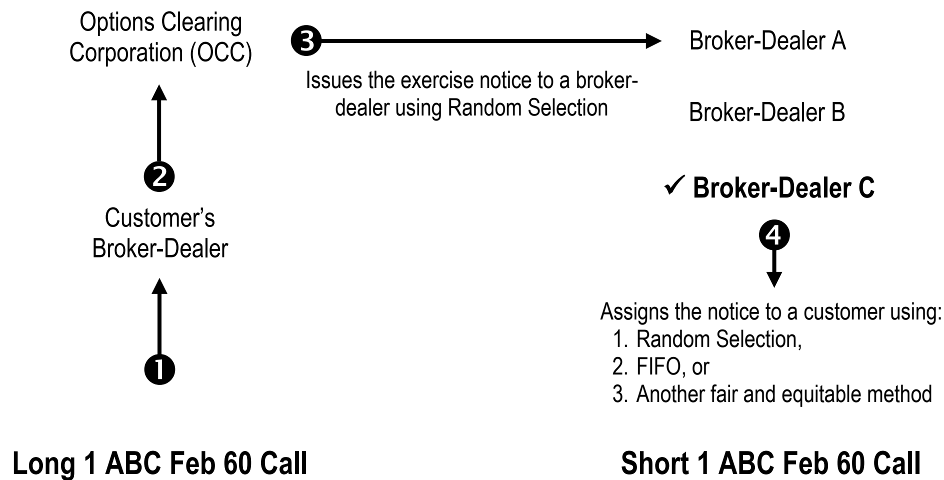
If a buyer exercises an option, the seller is required to fulfill his obligation. For this reason, the seller is considered to have been assigned an exercise notice. If the seller of a May 30 call is exercised against, he must deliver 100 shares of XYZ at a price of $30 per share, regardless of the market value of the stock at that time. The seller of a put has an opposite obligation. If the seller of an XYZ May 30 put is exercised against, he must buy 100 shares of XYZ stock for $30 per share, even if the stock is worth much less.

Buyer's Exercise / Writer's Assignment *Step 1* - The process begins when an investor decides to exercise her contract and notifies her broker-dealer. *Step 2* - The broker-dealer will then notify the Options Clearing Corporation (OCC). *Step 3* - Once the OCC (discussed later) receives exercise instructions from the purchaser's broker-dealer, it will *randomly* issue the exercise notice to a broker-dealer whose account shows a short option position that's identical to the long option position being exercised.

Step 4 - The broker-dealer that receives the exercise notice, must select a client to whom the notice will be assigned. There are three methods by which this assignment may be accomplished—(1) using random selection, (2) using *first-in, first-out (FIFO)*, or (3) using any other method that's deemed to be *fair and equitable*. Every member firm must notify its clients as to which method is used and how it will be implemented.

For equity options, since exercise involves the purchase and sale of the underlying stock, settlement of an *exercised option* occurs in two business days (T + 2).

A picture of the steps involved in the exercise of an option is shown below:



Expiration The last event that could close an option position is the expiration of the contract. If an option is at- or out-of-the-money on the expiration date, the holder of the contract has no incentive to exercise the contract.

 Copyright © Securities Training Corporation. All Rights Reserved.

Also, since there would be no time remaining on the contract, the contract expires worthless. This expiration triggers the maximum profit for the seller of a call or put (i.e., the premium initially received). Conversely, the expiration of an option triggers the maximum loss that the buyer of the call or put could experience (i.e., the premium paid).

Deadlines for Expiration In the life of an option, the third Friday of the expiration month is an important day. Although most options expire at 11:59 p.m. ET on the third Friday of the expiration month, a buyer must notify her brokerage firm of her intent to exercise the option by 5:30 p.m. ET on that Friday. Additionally, at 4:00 p.m. ET on that third Friday, options stop trading.

Options Clearing Corporation (OCC)

In an effort to eliminate the possibility of option sellers being unable to fulfill their obligation and to protect options investors from counterparty risk, the OCC guarantees all listed options. Essentially, the OCC acts as a seller for every buyer and a buyer for every seller.

Options Disclosure Document

Either at or before the time that an option account is opened for a customer, a member firm is required to provide the customer with the options disclosure document (ODD)—also referred to as the *Characteristics and Risks of Standardized Options*. This brochure offers investors with a description of the options market and discusses the relevant terminology, tax implications, transaction costs, margin requirements, and trading risks. The disclosure document is created by the OCC.

Index Options

As mentioned in the introduction of this chapter, options are also available on indexes (e.g., the S&P 500). Although there are many similarities in the analysis of equity options and index options, one significant difference involves exercise settlement.

Cash Settlement With equity options, the exercise settlement involves the receipt or delivery of the underlying stock; however, with index options, the exercise settlement involves the *receipt or delivery of cash*. The seller of an index option must deliver to the buyer cash which represents the amount by which the option is in-the-money (i.e., the difference between the contract's strike price and the index value).

Hedging with Options

Many people view options as risky, speculative investments; however, options can actually provide a significant hedge (protection) for an investor with an existing stock position. For example, when a person wants to insure or protect his life, home, or car, he purchases an insurance policy. Similarly, if a person has either a long or short stock position and wants *to hedge or protect* against potential risk, he may *purchase an option*.

Copyright © Securities Training Corporation. All Rights Reserved.

The following chart summarizes the two basic hedging strategies:

	Hedging Strategy	Reasons
If Long Stock	Buy a Put	▪ Provides the right to sell ▪ Protects downside risk
If Short Stock	Buy a Call	▪ Provides the right to buy ▪ Protects upside risk

Long and Short Hedge If an investor is long stock and fears that the stock will decline, buying a put on the stock creates a *long hedge*. This is an effective protection strategy since the put will gain value as the stock declines; therefore, any loss on the stock is offset by the gain on the put. To breakeven on the position, the stock must rise by an amount equal to the stock's purchase price *plus* the premium paid.

If an investor is short stock and fears that the stock will rise, buying a call on the stock creates a *short hedge*. This is an effective protection strategy since the call will gain value as the stock rises; therefore, any loss on the stock is offset by the gain on the call. To breakeven on the position, the stock must decline by an amount equal to the short sale proceeds *minus* the premium paid. Remember, to hedge or protect a position, an investor must *buy the option*.

Covered and Uncovered Option Positions

The concept of covered or uncovered relates to the seller of an option position. It's the responsibility of a firm's margin department to verify that a client who writes an option is in a position to deliver securities (if short a call) or cash (if short a put) if exercised against.

Covered Call The seller of a call is obligated to sell (deliver) the underlying stock if the buyer of the call exercises the contract. Therefore, for the call to be covered, the seller must own the underlying stock. If an investor is long XYZ stock and has written (is short) an XYZ call option, he has created a covered call and is interested in generating income on his portfolio. A covered call writer anticipates that the market price of the underlying security will not rise above the strike price prior to expiration and hopes that the option will expire worthless. If the contract expires, the investor will generate income from the premium received plus any potential cash dividend that's paid on the stock. To breakeven on the position, the investor can afford the stock declining by an amount equal to the premium received (stock purchase price *minus* premium received).

Uncovered Call If an investor sells an XYZ call and doesn't own XYZ stock, it's an uncovered call. An uncovered call writer has an *unlimited* maximum potential loss since there's no limit as to how high the price of the security may rise. The investor is effectively short the stock since she doesn't own the deliverable if the contract is assigned. This risky position may only be created in a margin account.

Copyright © Securities Training Corporation. All Rights Reserved.

Covered Put The seller of a put is obligated to buy the underlying stock if the buyer of the put exercised the contract. Therefore, for the put to be covered, the seller must either be short the underlying stock or deposit cash equal to the strike price. If an investor sells an XYZ put and doesn't deposit sufficient cash, the position is considered an uncovered put.

Summary of Profit and Loss Potential for Various Positions

Long Call	Unlimited profit; limited loss
Long Put	Limited profit; limited loss
Short Call (Uncovered)	Limited profit; unlimited loss
Short Put (Uncovered)	Limited profit; limited loss
Covered Call	Limited profit; limited loss

Conclusion

This concludes the chapter on options. Remember, the four basic option strategies are directional bets in which an investor is either bullish or bearish on an underlying stock. The buyers risk their money (premium) in return for significant potential profits. On the other hand, the writers receive their money (premium) up front and will retain these funds if the option expires worthless. Lastly, remember that hedgers buy options as insurance for their core stock position.

Chapter 10 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Understand the fundamental definition of an option and related options terminology
- Understand rights and responsibilities of the buyer and seller involved in an option transaction
- Describe the difference between a call option and a put option
- Recognize the components an option's premium:
  - Intrinsic Value
  - Time Value
- Distinguish between an option that's in-, at-, or out-of-the-money
- Identify and describe the components of an options contract
- Understand the strategy for each option position:
  - Long Calls and Short Puts = Bullish
  - Short Calls and Long Puts = Bearish
- Determine the breakeven, maximum gain, and maximum loss for both the buyer and the seller of a call or put option
- Distinguish between speculation and hedging positions
- Distinguish between covered and uncovered options positions

Copyright © Securities Training Corporation. All Rights Reserved.

- Determine the impact of option events on the participants:
  - Liquidation
  - Exercise
  - Expiration
- Describe the procedure for the exercise of an equity option
- Describe the role of the OCC in options transactions
- Understand the process and procedures for opening an options account
- Compare and contrast the characteristics of equity and index options

Create a Chapter 10 Custom Exam

Now that you've completed Chapter 10, log in to *my.stcusa.com* and create a 10-question custom exam.

 Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 11 – Offerings

- *Primary Market and Underwriting Commitments*
- *The Securities Act of 1933*
- *Exempt Securities and Transactions*
- *Municipal Offering*

Copyright © Securities Training Corporation. All Rights Reserved.

As described earlier, one of Wall Street's functions is to assist issuers in raising capital. For most firms, the investment banking (underwriting) division handles these money raising efforts. Let's first examine some of the language that's associated with these financing transactions and then move onto the federal regulations and SRO rules the relate to new issues.

Capital Formation

When a corporation or other type of issuer intends to raise capital, it usually does so by selling stocks and/or bonds through a formal offering. The nature of these offerings will differ depending on the type of issuer and investors involved in the transactions. Certain issuers (e.g., corporations) are often subject to various federal regulations when they issue securities, while others (e.g., the U.S. Treasury) are exempt from this level of SEC oversight.

Offering Securities to Investors

Public Offerings Securities may be offered or issued in two ways—public offerings and private placements. The primary advantage of a public offering is that an unlimited number of investors (both retail and institutional) are permitted to participate. However, the disadvantages of a public offering include the regulatory costs (legal and accounting) and time required to fulfill the disclosure requirements of the Securities Act of 1933.

Private Placements In some cases, institutional investors (e.g., pension funds, insurance companies, venture capitalists, and private equity investors) provide start-up capital to new companies. The capital is typically raised through a form of non-public offering that's referred to as a *private placement*. The primary advantages of a private placement is that it's faster and less costly than a public offering. However, there may be limits as to the type and number of investors that may participate in these types of transactions.

Initial Public Offering (IPO) Versus Follow-On Offering When an issuer offers securities to the public for the first time, the process is referred to as its initial public offering (IPO). However, if a company has already gone public and intends to raise additional capital through a sale of common stock, it's conducting a *follow-on* offering. Keep in mind; these additional (post-IPO) offerings are still considered *primary distributions.* The best way to define a primary distribution is that it's an offering in which the proceeds of the deal are paid to the issuer.

Disclosure of Participation or Interest in Primary or Secondary Distribution (FINRA Rule 2269) While involved in a follow-on offering, a FINRA member firm may be recommending or trading the existing shares of a company in the secondary market, while also soliciting potential investors for the additional shares being offered. FINRA rules generally require written disclosure to customers for trades in any security in which a firm is participating in the distribution or is otherwise financially interested.

 Copyright © Securities Training Corporation. All Rights Reserved.

Combined (Split) Offerings In a combined offering, some of the shares are offered by the issuer, while the remainder are offered by selling shareholders. The shares being sold by the company are newly created, constitute a primary offering, and increase the company's number of outstanding shares. The company issuing the securities receives the proceeds on this portion of the sale. When the company's existing shares are sold by some of its current (selling) shareholders, it's considered a secondary offering. The selling shareholders receive the proceeds on this portion of the offering, not the issuer.

If the offering is split, it's imperative for the underwriters to disclose to any purchaser that a portion of the offering's proceeds will be paid to the selling shareholders. Selling shareholders may include officers of the company or early-entrance investors (e.g., the institutional investors that were mentioned previously) that are seeking to either cash out or reduce their holdings in the company.

The Role of an Underwriter/Investment Banker

An *underwriter* is a broker-dealer that helps corporations or municipalities that are interested in raising capital. When acting as an underwriter, an investment banker may assume risk by buying the new issue from the issuing corporation and reselling it to the public. The investment banking function brings together the issuer and potential buyers. The proceeds of these offerings may represent new funds to the issuer or they may be used to refinance its capital structure.

Underwriting Commitments

The sale of a public offering is typically conducted through a group of broker-dealers that's referred to as an *underwriting syndicate*. The responsibilities of the syndicate members are dependent on the type of underwriting agreement.

Firm-Commitment (Acting as Principal) If a syndicate agrees to purchase the entire offering from the issuer and absorb any securities that remain unsold, it's engaging in a *firm-commitment* underwriting. In this case, the syndicate is firmly committing itself to the issuing corporation for the entire amount of the offering. Regardless of whether it can sell all of the securities, the syndicate acts in a principal (at risk) capacity.

For example, a corporation wants to sell $10,000,000 of stock, but the syndicate is only able to sell $8,000,000. In a firm commitment, the syndicate members will absorb the $2,000,000 of unsold stock for their own accounts.

Best-Efforts (Acting as Agent) In a *best-efforts* underwriting, the syndicate agrees to sell as much of the new offering as they're able. Best-efforts underwriters are acting in the capacity of an agent by finding purchasers for the issuer, rather than as a principal for their own accounts.

For example, a corporation wants to sell $10,000,000 of stock, but the underwriters are only able to sell $8,000,000. In a best-efforts underwriting, only the $8,000,000 of stock will be issued. The unsold portion is returned to the issuer.

Copyright © Securities Training Corporation. All Rights Reserved.

Under certain circumstances, a corporation may require a specific minimum amount of capital to be raised. The reason for this is that the issuer may determine that raising a lesser amount will be insufficient to accomplish its objectives. Ultimately, if the minimum contingency is not met, the offering will be cancelled.

All-or-None One of these contingencies is the *best-efforts-all-or-none*. As in a simple best-efforts arrangement, the underwriters act as agents for the issuer and attempt to sell as much of the offering as possible. However, if the entire offering is not sold, all sales that were made must be cancelled and the money must be returned to the subscribers.

Mini-Maxi Another variation of a best efforts underwriting is the *mini-maxi* underwriting. With this form, there's a minimum threshold of sales that must be met for the offering to avoid being cancelled. However, once that minimum is met, additional sales may be made up to a specified maximum amount.

For example, a corporation intends to sell $10,000,000 of stock. Based on the company's capital needs, it requires that at least 70% of the offering be sold. Therefore, a minimum of $7,000,000 of the stock must be sold or the entire issue will be cancelled. Once the minimum sales level has been satisfied, the underwriters will continue to sell the remaining securities ($3,000,000) without the risk that the offering will be cancelled.

Standby Agreements If a corporation intends to sell additional shares, it may conduct a preemptive rights offering (as described in Chapter 3). In this offering, the current shareholders are given rights which provide them with the opportunity to purchase additional shares at a small discount before the offering is made public.

However, out of the fear that a significant number of existing shareholders will choose to leave the rights unsubscribed, the issuer may arrange for a standby underwriting. In a standby underwriting arrangement, the syndicate (in return for a fee) agrees to purchase any unsubscribed shares remaining after the rights offering. Standby agreements are executed on a firm-commitment basis.

Type of Underwriting	Comments	Liability for Unsold Shares
Firm-Commitment	Syndicate must absorb losses on unsold shares	Syndicate
Best-Efforts	Unsold shares are returned to issuer	Issuer
Best-Efforts All-or-None	Offering is cancelled if all shares are not sold	Issuer
Best-Efforts Mini-Maxi	Offering is cancelled if set minimum is not sold	Issuer
Standby	Syndicate agrees to buy any shares not purchased by existing stockholders in a *rights offering*	Syndicate

Copyright © Securities Training Corporation. All Rights Reserved.

Market-Out Clause

If the written agreement that's entered into by the underwriting syndicate and the issuer contains a *market-out clause,* the syndicate may be permitted to cancel the agreement. The justification for cancelling the commitment is based on certain events occurring that make marketing the issue difficult or impossible. Examples include a material adverse event that affects the (proposed) issuer or a general disruption in financial markets.

Shelf Registration

Certain issuers of existing publicly traded securities can utilize a form of registration that allows them to sell additional securities on either a delayed or continuous basis. This process is referred to as shelf registration and is allowed only for an amount that may reasonably be sold within *three years* after the initial date of registration. The advantage of the shelf registration method is that the issuer can complete all the necessary paperwork in advance and be prepared to market the shares to the public when conditions are the most favorable.

Distribution of Securities

A broker-dealer that's contemplating the possibility of becoming the syndicate manager in a distribution of securities must perform due diligence on both the issuer and the issue. This due diligence process is completed by examining the issuer's history, the quality of the company's management, labor relations, financial and operational data, legal matters, and comparable companies in the same field to determine the viability of the distribution and the price at which to offer the securities.

Syndicate

If the syndicate manager is interested in working with an issuer, it will then form a syndicate by inviting other firms to participate in the distribution and share in liability. The written agreement between the manager and syndicate members (referred to as the *syndicate letter* or *agreement among underwriters)* is signed by the participants and specifies each firm's rights and obligations. The role of the syndicate is to guarantee (underwrite) the offering. A broker-dealer's syndicate desk assists in the pricing of the offering, helps to build the book of orders, markets (distributes) the issue and, if necessary, places a stabilizing bid.

Selling Group

In some cases, the syndicate will recruit other broker-dealers to assist in the distribution. These firms are *selling group* members that *do not* assume financial liability for the offering; instead, they act as sales agents. Any shares that are not sold by the selling group are retained by the syndicate since the syndicate members remain financially liable for any unsold shares. To join a selling group, a broker-dealer must sign a *selling group agreement* which provides details regarding the relationship and responsibilities between the selling group and the syndicate manager. The underwriters and selling group members are collectively referred to as *distribution participants*.

Copyright © Securities Training Corporation. All Rights Reserved.

Determining the Public Offering Price (POP)

For a primary offering, the price is fixed and will apply to all sales that are made to the public. To price an IPO, the underwriters will take various factors into account including corporate earnings, dividend payouts, the prices of similar companies currently trading in the secondary markets, indications of interest, and current market conditions. To price a subsequent offering, the underwriters normally price it at a small discount to the current market price of the existing shares.

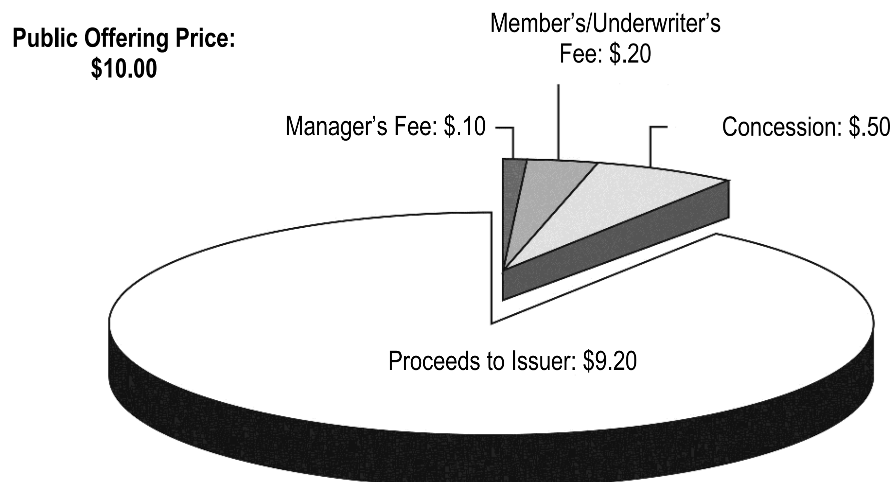
Underwriting Spread

The term *underwriting spread* refers to the difference between the amount paid by the investing public and the amount received by the issuing corporation. In fact, the spread represents the syndicate's gross profit. Depending on how the shares are sold, the spread may be shared by the manager, syndicate members, and selling group members.

The spread consists of the following components:

- Manager's Fee—the portion that's paid to the managing underwriter for each share of the offering
- Member's/Underwriter's Fee—the portion that's paid to the syndicate member that assumes the risk or liability for the shares. This portion is also referred to as the *additional takedown.*
- Concession—the portion that's paid to the firm that sells the shares. The term *total takedown* represents the combination of the underwriter's fee plus the concession, which is the amount that's paid to a syndicate member when it sells shares of the offering.

Example: The Distribution of an Underwriting Spread



Syndicate Compensation In the example above, the corporation is issuing stock to the public at $10 per share, with a total spread of $.80 per share. Of the $.80 spread per share, $.10 is allocated to the manager, $.20 is allocated to the firm that assumes liability for the shares, and $.50 is allocated to the firm that sells the shares.

 Copyright © Securities Training Corporation. All Rights Reserved.

Selling Group Compensation Remember, the selling group is comprised of broker-dealers that don't assume financial liability. Therefore, if a selling group member sells the shares, it's only entitled to the $.50 selling concession per share.

The table below provides details regarding the potential compensation of each entity:

	If the Manager Sells Shares	If a Syndicate Member Sells Shares	If a Selling Group Firm Sells Shares
Manager's Compensation	$.80	$.10	$.10
Syndicate Member's Compensation	.00	$.70	$.20
Selling Group Member's Compensation	.00	$.00	$.50

Payments for Market Making Broker-dealers that act as underwriters may also choose to act as a market maker for an issuer's securities in the secondary market. In this scenario, FINRA is concerned that issuers may compensate these firms to agree to act as market makers. Since issuers are not regulated by FINRA, the rule prohibits a FINRA member firm or any person who is employed by the member from accepting any payment or other compensation (either directly or indirectly) from an issuer of a security or any affiliate or promoter for:

- Publishing a quote (including indications of interest)
- Acting as a market maker in a security
- Submitting an application in connection with market-making activity

The rule doesn't prohibit a member firm from accepting (1) payment for bona fide services, such as investment banking (which includes underwriting fees), and (2) reimbursement for registration fees that are paid to the SEC or a state regulator, or for listing fees that are imposed by an SRO.

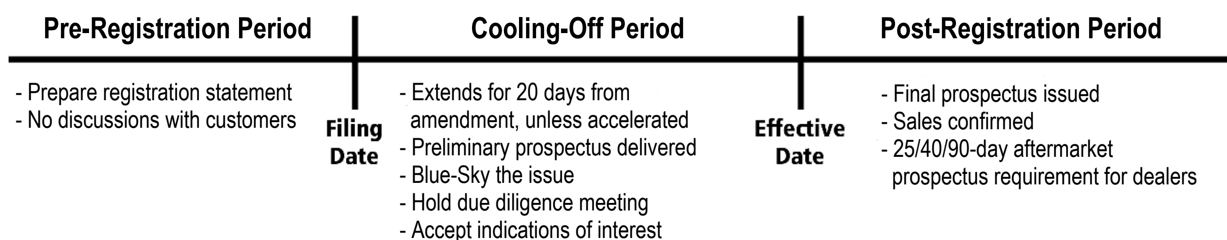
Securities Act of 1933 – Registration

Many corporate offerings are subject to SEC registration requirements. The Securities Act of 1933 attempts to prevent fraud in the sale of new issues by requiring registration and ensuring that investors are provided with adequate information about the offering to make an informed investment decision. This information is provided through the *registration statement,* which is a public document that issuers file with the SEC.

Copyright © Securities Training Corporation. All Rights Reserved.

The Registration Process

Let's take a look at the process by which securities are registered. The process includes the following three phases:



The Pre-Registration (Pre-Filing) Period

During the pre-registration phase, an issuer prepares its registration statement. An underwriter will often assist the issuer during this process; however, the underwriter may not yet discuss the new issue with its customers. This is the point at which the due diligence process begins for the managing underwriter. When the registration statement is completed, the issuer files it with the SEC. The date on which it's filed marks the end of the pre-registration period.

Registration Statement According to the Securities Act of 1933, a registration statement must contain detailed information about the issuer, its business, its owners, and its financial condition. The required information includes:

- The character of the issuer's business
- A balance sheet created within 90 days prior to the filing of the registration statement
- Financial statements that show profits and losses for the latest fiscal year and for the two preceding fiscal years
- The amount of capitalization and use of the proceeds of the sale
- Funds paid to affiliated persons or businesses of the issuer
- Shareholdings of senior officers, directors, and underwriters, and identification of individuals who hold at least 10% of the company's securities

Issuers are also required to prepare a *prospectus* for distribution to potential purchasers. The prospectus is essentially an abbreviated version of the registration statement.

No Guarantees (Section 23 of the Securities Act of 1933) The SEC doesn't guarantee the truthfulness of the information that's contained within a registration statement. Additionally, the SEC doesn't guarantee the accuracy or completeness of the filing.

Copyright © Securities Training Corporation. All Rights Reserved.

What this basically means is that underwriters are prohibited from suggesting that an offering has been "approved of" or "guaranteed by" the SEC. The cover page of a prospectus will include the following disclaimer:

> *Neither the Securities and Exchange Commission nor any other regulatory body has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.*

The Cooling-Off Period

The second phase in the registration process is the 20-day cooling-off or waiting period. During this time, the SEC reviews the issuer's registration statement to determine if it's complete and that it contains no misleading statements. However, the SEC does *not* judge the investment merits of the issue or the appropriateness of the pricing of the issue. If the SEC believes the registration statement to be incomplete or misleading, it sends a *deficiency letter* to the issuer. If this happens, the issuer is required to refile an amended registration statement for SEC review.

Preliminary Prospectus (Red Herring) During the cooling-off period, broker-dealers are able to send a condensed form of the registration statement to potential buyers. This document is referred to as the *preliminary prospectus* or *red herring*. The red herring has a statement on its cover page (in red writing) to indicate that a registration statement has been filed with the SEC, but has not yet been declared effective. Also, the final offering price is not included in the red herring; instead, it may indicate a price range (e.g., $14 to $17 per share).

During the cooling-off period, underwriters are permitted to:

- Discuss the issue
- Provide the red herring to potential purchasers
- Record the names of persons that provide an indication of interest (the indications are non-binding for either party)

During this period, underwriters are *not* permitted to:

- Accept payment for the new issue in advance
- Sell the new issue (since the deal is not effective and has not been priced)

No Prospectus Alterations For a new issue, the prospectus is the primary source of information for most retail investors. This document may not be amended or altered in any way, including highlighting, summarizing, or underlining relevant portions of the document.

State or Blue-Sky Laws As mentioned in an earlier chapter, in addition to satisfying SEC registration requirements, issuers are required to comply with applicable state registration laws for the securities that they issue. This process is conducted during the cooling-off period. State securities laws are established under the *Uniform Securities Act (USA)* and are often referred to as *Blue-Sky Laws*.

Copyright © Securities Training Corporation. All Rights Reserved.

The three methods of state securities registration are:

1. **Notification** (also referred to as Filing) – This method is not allowed in all states. Notification is used by larger issuers that are simply required to submit an application with the state Administrator requesting approval to offer securities in the state.
2. **Coordination** – This form is completed simultaneously with a federal registration that's filed under the Securities Act of 1933 and generally becomes effective at the same time.
3. **Qualification** – This method involves meeting the specific requirements of one state and becomes effective at the discretion of the state Administrator.

Due Diligence Just prior to the SEC's anticipated determination of the effective date, a *due diligence meeting* is held. The participants at this meeting include the lead underwriter(s), syndicate members, officers of the issuer, attorneys, and accountants. The purpose of the meeting is to review the different aspects of the planned underwriting, including certifying that the issuer and its underwriters have satisfied state and federal laws.

Effective Date The effective date represents the end of the cooling-off period and the beginning of the post-effective period. Generally, a registration statement's *effective date* is 20 days after the filing or after the last amendment in response to a deficiency letter. If a written request is received from the issuer or its underwriters, the SEC may accelerate this process.

The Post-Effective Period

Once the offering's registration is declared effective, the *public offering price* (POP) is set by the underwriters. Only at this point can sales of the offering begin. Purchasers must be provided with a copy of the final prospectus (which includes the offering price) by no later than the time a sale is confirmed. Under SEC rules, providing clients with electronic access to a prospectus equates to the delivery of the relevant documentation.

Actions by Salespersons After the effective date, the deal will be priced and syndicate members will be notified of their allocation of shares. The firm's registered representatives should then contact all clients who received a preliminary prospectus to determine if they have made a purchase decision. If the client acknowledges his interest and places an order, the order is binding. All broker-dealers are required to provide a final prospectus to purchasers in the primary market.

Disclosure Requirements

Aftermarket Prospectus Delivery Requirement

Although the delivery of a prospectus is typically a primary market requirement, depending on the type of company that's issuing the security, a dealer may be required to satisfy an aftermarket prospectus delivery requirement. The requirement differs based on:

1. Whether the offering is an IPO or a follow-on, and
2. Whether the company is/will be listed on an exchange (e.g., NYSE or Nasdaq) or is an unlisted over-the-counter security that is/will be trading on the or OTC Pink Market

Copyright © Securities Training Corporation. All Rights Reserved.

Essentially, if more information is known about the offering or if the company is satisfying an exchange's listing standards, it will be required to provide a prospectus for a shorter period. The following table summarizes a dealer's prospectus delivery requirement in the after-market:

After-Market Prospectus Delivery Requirements	
Security	**Time Frame**
For an unlisted IPO	90 days
For an unlisted follow-on offering	40 days
For an IPO of a security to be listed on the NYSE or Nasdaq	25 days
For an NYSE or Nasdaq-listed follow-on offering	No requirement

Types of Prospectuses

Definition According to the Securities Act of 1933, a prospectus is defined as any notice, circular, advertisement, letter, or communication (whether written or broadcast on television or radio) that offers a security for sale. Although this is a very broad definition, it includes an exemption if the information only identifies the security, the price, the name of the underwriters, and from whom a prospectus may be obtained. This type of advertisement is referred to as a *tombstone* and is used to provide information to potential investors and to suggest that they request a prospectus.

Statutory Prospectus The *statutory prospectus* is a condensed form of the registration statement that includes:

- Risk factors and use of proceeds
- Dividend policy
- Industry and other data
- Capitalization and selected consolidated financial data
- Management's discussion and analysis of financial condition and results of operations
- Business and management
- Executive and director compensation
- Principal and selling stockholders
- Shares eligible for future sale
- Underwriting conflicts of interest and legal matters

Preliminary Prospectus In a *preliminary prospectus (red herring)*, the following information can be omitted:

- The offering price of the issue
- The underwriting discounts (or commissions) and discounts to dealers
- The amount of proceeds to be received by the issuer
- Conversion rates or call prices
- Other matters that are dependent on the offering price

Copyright © Securities Training Corporation. All Rights Reserved.

Once the offering is declared effective, the final version of the statutory prospects will include the final offering price, size of the offering, discounts to dealers, etc.

Mutual Fund Summary Prospectus While a statutory prospectus is based on the information that's contained within the registration statement, a summary prospectus further summarizes the information. The summary prospectus is often used as a stand-alone sales tool for mutual fund offerings provided the investor is informed of the availability of a longer form (statutory) prospectus. Both of these documents may usually be found on the fund sponsor's website. This summary is often only three to four pages long and must include:

- Investment objective
- Costs
- Principle investment strategies, risks, and performance
- Name of investment adviser, as well as the name, title, and length of service of up to five portfolio managers
- Purchase (including minimum purchase amounts), redemption, and tax information
- Financial intermediary compensation information

Free Writing Prospectus A free writing prospectus (FWP) is any communication that doesn't meet the standards of a statutory prospectus. Examples of free writing prospectuses include:

- Press releases
- E-mails or web pages
- Preliminary or final term sheets
- Video recordings (electronic road shows)
- Various marketing materials

These communications constitute an offer to sell or a solicitation to buy the securities that are related to a registered offering. FWPs are generally filed with the SEC and used after the formal registration statement has been filed.

Offering Memorandum For private placements, no registration or prospectus is required to be filed with the SEC. However, the issuer will provide a specific detailed written disclosure document to its purchasers. This document is referred to as an offering memorandum or private placement memorandum (PPM).

Exempt Securities

Certain issuers are not required to register their securities with the SEC. For issuers that qualify for an exemption from registration, there's significant time and cost savings.
The SEC has determined that the following securities are exempt from the registration and prospectus requirements of the Act of 1933:

- U.S. government and U.S. government agency securities
- Municipal securities
- Securities issued by non-profit organizations

 Copyright © Securities Training Corporation. All Rights Reserved.

- Short-term corporate debt instruments that have a maximum maturity of 270 days (e.g., commercial paper)
- Securities issued by domestic banks and trust companies
- Securities issued by small business investment companies

Although these securities are exempt from the registration and prospectus requirements of the Securities Act of 1933, they remain subject to the Act's anti-fraud provisions.

Exempt Offerings

In some cases, rather than being based on the issuer or type of security, the exemption from registration is based on the manner in which the securities are being offered.

Regulation D

Under Regulation D, an issuer's private placement of securities qualifies for an exemption provided the following conditions are met:

- The issuer has reason to believe that the buyer is a sophisticated investor (i.e., one who is experienced enough to evaluate any risks involved)
- The buyer must have access to the same financial information that would normally be included in a prospectus. This information is provided in the *private placement memorandum*.
- The issuer must be assured that the buyer doesn't intend to make a quick sale of the securities. This is usually accomplished by means of an investment letter (also referred to as a *lock-up agreement*).
- The securities are sold to no more than 35 *non-accredited* investors.

Accredited Investor For private placements, there's no restriction on the number of accredited investors. An accredited investor includes any of the following:

- Financial institutions (e.g., banks), large tax-exempt plans, or private business development companies
- Directors, executive officers, or general partners of the issuer
- Individuals who meet either one of the following criteria:
  - Have a net worth of at least $1,000,000 (not including primary residence) or
  - Have gross income of at least $200,000 (or $300,000 combined with a spouse) for each of the past two years with the anticipation that this level of income will continue

Restrictive Legend Shares that are acquired through a private placement carry a restrictive legend that's printed across the face of the certificate. The legend indicates that the securities have not been registered with the SEC and are not eligible for resale unless the legend is removed. In many cases, the removal of the legend is accomplished under SEC Rule 144.

Copyright © Securities Training Corporation. All Rights Reserved.

Rule 144

Rule 144 regulates the sale of *restricted* stock and *control* (affiliated) stock. Restricted stock is unregistered stock and is typically acquired by an investor through a private placement. Control stock is registered stock and is acquired by a control (affiliated) person in the secondary market. Control persons may include officers, directors, or other insiders (those with more than 10% ownership) and their respective family members. Any stock that's acquired by control persons, even if purchased in the open market, must be sold according to Rule 144. Insiders may also have other regulatory requirements which restrict their ability to sell stock.

Holding Period Rule 144 imposes certain holding periods on investors. For restricted stock, the purchaser must hold the stock for a specific period before he may dispose of it. If the issuer is a reporting company, the holding period is six months; however, if the issuer is a non-reporting company, the holding period is one year. For control stock, there's no mandatory holding period.

Filing Requirement Under Rule 144, an investor who intends to sell either restricted or control stock must file Form 144 to notify the SEC at the time he places the sell order with the broker-dealer. If the securities are not sold within 90 days of the date that the notice was filed with the SEC, an amended notice must be filed. However, SEC notification is not required if the amount of the sale doesn't exceed 5,000 shares or the dollar amount doesn't exceed $50,000.

Volume Limitation Rule 144 sets a limitation on the amount of stock that an affiliate may sell over any 90-day filing period. For NYSE- and Nasdaq-listed stock, the maximum that may be sold is the greater of 1% of the total shares outstanding or the stock's average weekly trading volume of the past four weeks.

For restricted (private placement) stock, there's no volume restriction for non-affiliates of the issuer. Non-affiliates are persons who are not associated with the issuer. However, volume restrictions continue to apply to insiders and affiliates.

For example, an issuer has 7,000,000 shares outstanding and the average weekly trading volume for the past four weeks was 60,000 shares. Since 1% of the total shares outstanding is 70,000 shares and the four-week average is 60,000 shares, an affiliated holder is able to sell the greater of these two amounts, which is 70,000 shares.

Restricted Stock			
Issuer	**Holding Period**	**Affiliated Seller**	**Non-Affiliated Seller**
Reporting Company	Six Months	Volume Restrictions Apply	No Volume Restrictions
Non-Reporting Company	One Year	Volume Restrictions Apply	No Volume Restrictions

 Copyright © Securities Training Corporation. All Rights Reserved.

Private Investment in Public Equity (PIPE) Although most private placements occur prior to the issuer's IPO, a PIPE offering is a private placement that occurs afterward. A broker-dealer assists an issuer by distributing restricted (i.e., unregistered) securities to a small group of accredited investors, such as hedge funds. These restricted securities are typically purchased at a discount to the issuer's publically traded stock. Often PIPE investors hold the restricted securities for a short period and, upon registration, will then quickly resell them in the public marketplace.

Rule 144A

Rule 144A is designed to permit sales of restricted securities to sophisticated investors without being subject to the conditions that are imposed by Rule 144. Ultimately, Rule 144A creates a more liquid private placement market. The securities being offered under Rule 144A may be equity or debt securities and they may be offered by either a domestic or foreign issuer. After the issuance, the securities may be immediately resold to *qualified institutional buyers*.

Qualified Institutional Buyers (QIBs) To be considered a qualified institutional buyer, the entity must satisfy the following three-part test:

1. First, only certain types of investors are eligible, including:
   - Insurance companies
   - Registered investment companies and registered investment advisers
   - Small business development companies
   - Private and public pension plans
   - Certain bank trust funds
   - Corporations, partnerships, business trusts, and certain non-profit organizations
2. The buyer must be purchasing for its own account or for the account of another QIB.
3. The buyer must own and invest at least $100 million of securities of issuers that are not affiliated with the buyer.

Note: *Under no circumstances* is an individual considered to be a QIB.

Rule 145

Under Rule 145 of the Securities Act of 1933, certain types of securities reclassifications are considered to be sales and are subject to the registration and prospectus requirements of the Act. The reclassifications include:

- An issuer that substitutes one security for another
- A merger or consolidation in which the securities of one corporation are exchanged for the securities of another corporation
- A transfer of assets from one corporation to another

However, stock splits, reverse stock splits, or changes in par value are not considered reclassifications and are therefore not subject to the rule.

Subject to Rule 145	Not Subject to Rule 145
▪ Substitutions ▪ Mergers/Consolidations ▪ Transfers of assets	▪ Stock splits ▪ Reverse stock splits ▪ Changes in par value

Copyright © Securities Training Corporation. All Rights Reserved.

Rule 147 and 147A

A federal registration exemption is available for securities that are sold within the borders of one state, provided the instruments of interstate commerce are not used to sell the securities. If a company is conducting an offering *and only selling its securities to its state residents*, the offering is exempt from SEC or federal registration. However, the issuer is required to register the securities in the state in which it's being sold.

Under Rule 147, an issuer is required to meet one of the following four requirements:

1. At least 80% of its consolidated gross revenues are derived from the operation of a business or of real property that's located in the state or territory or from the rendering of services within the state or territory;
2. At least 80% of its consolidated assets are located within the state or territory at the end of its most recent semi-annual fiscal period prior to the first offer of securities under the exemption;
3. At least 80% of the net proceeds from the offering are intended to be used by the issuer, and are in fact used in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within the state or territory; or
4. A majority of the issuer's employees are based in the state or territory

Provisions include:

- The issuer must utilize a reasonable belief standard when determining the residency of the purchaser at the time the securities are sold. This standard is supported by the requirement that the issuer obtain a written representation from all purchasers as to their residency.
  - If the purchaser is a legal entity (e.g., a corporation, partnership, trust, or other form of business organization), residency is defined as the location where, at the time of the sale, the entity has its principal place of business.
- Resales to persons who reside outside of the state in which the offering is conducted are restricted for a period of *six months* from the date of the sale by the issuer to the purchaser (formerly nine months).
  - A legend requirement applies in order to notify offerees and purchasers about the resale restriction.

The Primary Market for Municipal Bonds

Although municipal securities are exempt from the registration and prospectus requirements of the Securities Act of 1933, their underwriting process follows many of the same guidelines that are used for corporate underwritings.

The Municipal Securities Rulemaking Board (MSRB), which is the self-regulatory organization (SRO) for firms that deal in municipal securities, formulates the rules and regulations that relate to municipal underwritings. Remember, even if a specific security is exempt from registration, the antifraud provisions of the Securities Act of 1933 apply to all securities.

Copyright © Securities Training Corporation. All Rights Reserved.

Issuing General Obligation (GO) Bonds

Since GO bond issues are backed by taxes, the following two requirements must be satisfied:

Voter Approval The issuance of general obligation bonds usually requires voter approval since its funds that are generated by taxing citizens which are used to repay the debt. The indenture (bond resolution) for a general obligation bond will usually include the statutes which permit the issuer to levy taxes.

Debt Ceiling Limitations A GO issue is generally subject to debt limitations that are placed on the municipality by a voter referendum or by statutes. Prior to the issuance of the bonds, these legal obligations must be upheld. A municipality is not permitted to issue bonds in excess of its debt limitation since doing so will exceed its *debt ceiling*.

Issuing Revenue Bonds

Since revenue bonds are backed by the user fees that are generated by a project or facility and not by taxes, they don't require voter approval. However, there are special procedures to be followed and requirements to be met prior to issuing revenue bonds. One of these procedures is conducting a *feasibility study*.

Feasibility Study To identify whether a revenue project will be able to bring in the necessary revenues the municipality must hire a consulting engineer to study the project and present a report. This report examines the general need for the proposed project and whether the project is a sound economic investment. An accounting firm is usually retained to help determine if the revenues will be sufficient to cover expenses and debt service.

New Issue Underwritings

Once a municipal issuer has determined that there's a need for a bond issue and has followed the preliminary steps required to offer a bond (e.g., obtaining voter approval for a GO issue or completing a feasibility study for a revenue issue), it may continue the process of issuance. To do so, a municipality will normally seek the assistance of an underwriter (investment banker).

Selecting an Underwriter In some cases, the issuer will simply appoint its underwriter using a process that's referred to as a *negotiated sale*. Another method involves requesting that interested underwriters submit proposals through a bidding process and is referred to as a *competitive sale*.

Municipal Advisors The issuer may also employ the services of a *municipal advisor* to assist with the offering. Municipal advisors are persons who advise municipal issuers on the structure, timing, and/or terms of their municipal offerings in return for a fee. The firms that employee these individuals are required to be registered with the MSRB.

Copyright © Securities Training Corporation. All Rights Reserved.

Forming a Syndicate

As is often the case for corporate offerings, broker-dealers will combine to form a syndicate with one firm acting as the syndicate manager (lead underwriter). Since municipal issues are typically sold on a firm-commitment basis, firms that are asked to join the syndicate must be financially strong enough to absorb unsold bonds if there are problems distributing the issue.

Responsibilities of Syndicate Manager (Rule G-11) The manager generally makes the largest underwriting commitment. Some of the responsibilities of the manager include keeping track of all sales and the number of bonds that remain unsold, presiding over the preliminary pricing meeting in which the members are asked to submit their pricing scale, and maintaining/preserving books and records related to syndicate operations. These records include:

- Settlement date with issuer
- Allotment of securities and sale prices
- Names of syndicate members and their percentage of liability

Syndicate Letter For a competitive sale, as the manager forms the syndicate, it will invite other firms to participate by sending a *syndicate letter* which binds all of the members together. For a negotiated sale, the document is referred to as the *agreement among underwriters*.

Underwriting Documentation

The following list identifies some of the documents that may be utilized during a primary distribution of municipal bonds.

Notice of Sale

When an issuer intends to sell bonds through a competitive sale, it will advertise through a *Notice of Sale*. The Notice of Sale typically contains essential information that an underwriter needs in order to submit a bid, including the size of the offering, its maturity date, the coupon rate, and the details related to the bidding process.

Legal Opinion

Every municipal issue must be issued with a *legal opinion*. The legal opinion is written by a recognized bond counsel that's hired by the issuer to attest to the validity and tax-exempt status of the bond issue. Essentially, the legal opinion assures investors that the issuer has the legal right to issue the bonds.

Official Statement

The primary client disclosure document that's used in municipal offerings (both negotiated and competitive) is referred to as the *official statement*. This document essentially takes the place of a prospectus; however, it's not required to be filed with the SEC since municipal issuers are exempt from the Securities Act of 1933.

 Copyright © Securities Training Corporation. All Rights Reserved.

The official statement contains detailed information about both the issuer and the offering and, if produced, it must be distributed to investors. As is the case with a prospectus, there's both a preliminary and final version of the official statement. Final official statements must be provided to customers at the time that the trade is confirmed.

Contents of a Typical Official Statement

1. Offering terms
2. Summary statement
3. Purpose of the issue
4. Authorization of the bonds
5. Security of the bonds
6. Description of the bonds
7. Description of the issuer
8. Construction program
9. Project feasibility
10. Regulatory matters
11. Specific provisions of the Indenture and/or the Resolution
12. Legal proceedings
13. Tax status
14. Continuing disclosure certification
15. Appendix
    a. Various consultant reports
    b. Legal opinion
    c. Financial statements and audit

Official Statement Summary

Preliminary and final official statements are not considered advertising since they're either prepared by or for the issuer. However, if an official statement is altered by a municipal securities firm to create a summary or abstract of the official statement, it's considered advertising. Due to the alteration, the summary of an official statement must be approved by a Municipal Securities Principal.

Electronic Municipal Market Access (EMMA) – Rule G-32 This rule requires that disclosure documents be filed with the MSRB and provided to customers. EMMA is the MSRB's data port through which municipal bond underwriters and issuers submit specific documents (e.g., official statements).

EMMA provides free public access to official statements, trade data, credit ratings, educational materials, and other information about the municipal securities market. EMMA presents the information in a manner that's specifically tailored for retail, non-professional investors who may not be experts in financial or investing matters.

Copyright © Securities Training Corporation. All Rights Reserved.

If an official statement has been submitted to EMMA, a broker-dealer may send a notice to any customers who purchase a new issue of municipal securities which advises them as to how an official statement may be obtained from EMMA. This process may be used instead of sending a physical copy of the official statement to a customer. However, the notice must include a statement that a copy of the official statement will be provided by the broker-dealer upon request. Therefore, if a customer contacts the broker-dealer and requests a printed copy of an official statement, it must be sent.

Assignment of Underwriter and Obtaining CUSIP Numbers In addition to their EMMA submission requirements, underwriters are also expected to apply for a CUSIP number. CUSIP is an acronym for the Committee on Uniform Security Identification Procedures. This nine-digit, alpha-numeric number is used to identify securities and is assigned to each maturity of a municipal security offering. The application window for a CUSIP is as follows:

1. For a negotiated sale, the underwriter must apply by no later than the time that pricing information for the issue is finalized.
2. For a competitive sale, the underwriter must apply immediately after receiving notification of the award from the issuer.
3. A financial advisor must apply by no later than one business day after dissemination of a notice of sale.

New Issue Confirmations

Each customer who purchases a new issuance of municipal bonds must be provided with a final confirmation and a copy of the official statement by no later than the settlement date. For a negotiated sale, the following information must be disclosed to the customer either separately or included in the official statement:

- The amount of the underwriting spread
- The amount of any fee received by the broker-dealer for acting as agent for the issuer
- The initial reoffering price for each maturity in the offering

Conclusion

This ends the discussion of offerings. Once issued, most securities may be freely resold to other investors at the prevailing market price. The following chapters will examine the secondary market in which these securities trade between retail and institutional investors. Trading markets are governed by the Securities Exchange Act of 1934(‘34 Act.) and various SRO rules.

 Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 11 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Define the terms *public offering, private placement, IPO, and split (combined) offering*
- Understand the role of the underwriter/investment banker, syndicate member, and selling group
- Define the terms *firm commitment, best efforts, all-or-none, mini maxi, and stand-by*
- Define the terms *market out clause* and *shelf registration*
- Understand the term *public offering price (POP)* and how it's established
- Recognize the components of the underwriting spread
- Understand the steps involved in the registration process
- Define the terms *preliminary prospectus (Red Herring), statutory prospectus, mutual fund summary prospectus, free writing prospectus, and offering memorandum*
- Identify the exempt securities and exempt offerings
- Define the term *accredited investor* and understand the specific qualifications
- Define and understand the application of Rules 144, 144A, 145, 147, and 147A
- Define the terms *qualified institutional buyer (QIB)* and *private investment in public equity (PIPE)*
- Define the terms *official statement* and *legal opinion*
- Understand the purpose of the MSRB's Electronic Municipal Market Access (EMMA) system

Create a Chapter 11 Custom Exam

Now that you've completed Chapter 11, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 12 – Orders and Trading Strategies

- *Trade Capacity*
- *5% Policy*
- *Types of Transactions*
- *Types of Orders*

Copyright © Securities Training Corporation. All Rights Reserved.

The goal of this chapter is to increase a person's knowledge of different types of orders, including market orders, limit orders, and stop orders. The chapter will also address how broker-dealers can execute securities trades; specifically, as either an agent or a principal. Trading strategies, such as going long or going short will be covered, as well as details regarding whether those positions are bullish or bearish. Finally, the chapter will examine the process of selling options on both a covered and uncovered basis.

Trade Capacity – How Broker-Dealers Act

When executing trades, broker-dealers can act in two capacities—as a broker and as a dealer. However, to execute a customer transaction, a firm may act in only one of the two capacities.

Brokers (Agents) Regardless of whether a client wants to buy or sell a security, a firm that acts as a *broker (agent)* is attempting to find the other side of the trade on behalf of its client. If a client wants to buy, a broker will try to find a seller. On the other hand, if a client wants to sell, a broker will attempt to find a buyer. The firm is not buying or selling shares for its own account; instead, the broker tries to find a buyer or seller for its customer. This activity is also referred to as brokering a trade.

Commissions When a firm acts in a broker (agent) capacity, it earns a commission for its efforts. The commission is a separate dollar amount that must be noted on the client's trade confirmation. However, if a trade is not executed, no commission is earned.

Dealers (Principals) When a firm buys securities for, or sells securities from, its own account (inventory), it's acting as a dealer (principal). A dealer that always stands ready to buy or sell a specific stock is also referred to as a *market maker* in that stock. As both a buyer and a seller, a market maker provides a two-sided quote—its *bid* is the price at which it's willing to buy stock and its *ask (offer)* price is the price at which it will sell the stock. For example, if a dealer (market maker) is quoting a stock at $19.90 – $20.25, it's willing buy stock at $19.90 per share and sell it for $20.25 per share *to other dealers*. The $.35 difference between the bid of $19.90 and the ask of $20.25 is the spread—a source of profit for the market maker.

Bids and offers are typically posted in round lots (i.e., 100-share multiples). Investors who want to trade less than 100 shares are trading in odd lots. For example, if an investor buys 567 shares of XYZ stock, she's purchasing five round lots of 100 shares plus an odd lot of 67 shares. This order may be placed on one ticket.

Markups/Markdowns When acting in a dealer capacity, a firm will adjust its prices for retail customers, in other words, the dealer will include either a markup or markdown. All markups and markdowns are calculated from a security's inside market. The inside market represents the highest bid and the lowest ask (offer) of any market maker in a given security.

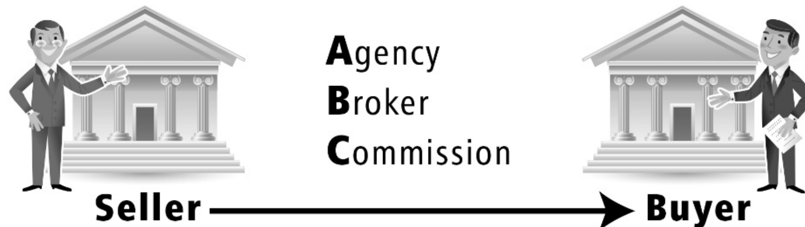
Copyright © Securities Training Corporation. All Rights Reserved.

Let's assume that a security's inside market is of $20.00 – $20.20. In this case, if a client wants to sell stock to a dealer, the firm may pay her $19.95 net per share—a $.05 markdown from the prevailing market price. On the other hand, if the client wants to buy stock, a dealer may offer to sell her the shares at $20.26—a $.06 markup. The dealer profits by purchasing securities from customers at one price and selling those securities to other customers at a higher price. These price adjustments are built into the net price of the trade, but are generally required to be noted on the client's trade confirmation.

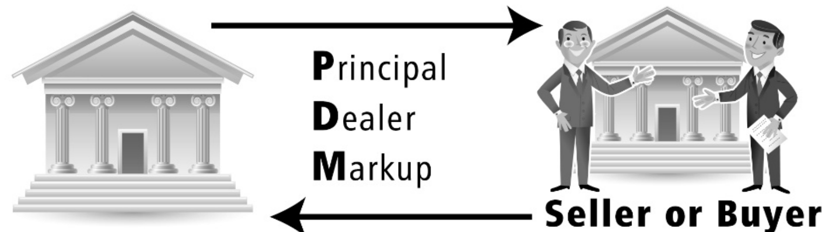
To summarize:

- When acting as a broker:
  - The firm is an agent.
  - It doesn't assume risk.
  - It earns a commission.
- When acting as a dealer:
  - The firm is a principal.
  - It does assume risk.
  - It earns a markup or markdown.

A Broker Firm that executes a customer order by locating another party willing to take the other side of the transaction



A Dealer Firm that executes a customer order by taking the other side of the transaction itself



Fair Prices and Commissions – The 5% Markup Policy

FINRA members are prohibited from charging prices or commissions that are unfair or excessive. To assist members in determining the appropriate level of charges, FINRA has developed the 5% Markup Policy. Although stated in terms of a markup, the policy applies to markups, markdowns, *and* commissions. The guideline applies when a broker-dealer is acting in an agency or principal capacity for transactions involving both exchange-listed and non-exchange-listed securities.

 Copyright © Securities Training Corporation. All Rights Reserved.

In some ways, the 5% Policy seems like a fairly simple principle. For example, at a time when a stock's market price is $20, a broker-dealer sells stock to a customer at $21 per share. The firm charged a $1 per share markup which is exactly 5%. The percentage is calculated by dividing the markup of $1 by the prevailing market price of $20. However, part of the determination regarding an acceptable markup involves the consideration of all relevant factors. Over the years, FINRA has taken many enforcement actions against firms that it believes have charged excessive markups. By reviewing those decisions, it has developed some guidelines for determining the fairness of transaction compensation.

Factors That Influence the Level of Markups Since FINRA emphasizes that 5% is merely a guideline, it's possible that certain circumstances will justify higher markups; while conversely, there are other times when even 5% is too much.

The following factors are considered when determining whether a markup is excessive:

- *The type of security involved* – Some securities carry higher markups than others as a matter of industry practice. For example, the markups on common stocks or limited partnership units typically are higher than the markups on bonds.
- *The availability of the security in the market* – If more effort is required to locate a particular security and execute a transaction, then a higher markup is justified.
- *The price of the security* – The percentage of markup generally increases as the price of the security decreases. This is due to the fact that lower-priced securities may require more handling and expense.
- *The amount of money involved in a transaction* – A transaction for a small total dollar amount may require greater handling expenses on a proportionate basis than a larger transaction.
- *Disclosure* – Disclosing to the customer that the circumstances may warrant a higher-than-normal markup helps to make the dealer's case. However, the circumstances also must justify the charges.
- *The pattern of markups* – FINRA's punishment tends to be most severe on firms that show a persistent pattern of excessive markups. However, the markup in each transaction must be justified on its own merits.
- *The nature of the broker-dealer's business* – Firms that offer certain additional services to customers (e.g., research) may justify charging higher markups than firms that don't offer these services. However, if a firm has high expenses for services that provide no benefit to customers, then these expenses don't justify higher charges.

Proceeds Transactions A proceeds transaction occurs when a customer directs a member firm to sell a security and use the proceeds of the sale to buy another security. For these types of transactions, the member firm must follow the 5% policy and compute the markup as if the customer had purchased the securities for cash. Therefore, the compensation received on the customer's sale is added to the compensation that the firm received on the customer's purchase. In other words, the charge assessed on the liquidation is added to the charge for the subsequent purchase. For example, a customer instructs her brokerage firm to sell $5,000 of ABC stock and use the proceeds to purchase $5,000 of XYZ stock. When computing the markup percentage, the member firm must use its total compensation (from both the customer's sale and purchase) as a percentage of $5,000.

Copyright © Securities Training Corporation. All Rights Reserved.

Exemptions Securities that require the delivery of a prospectus or offering circular are exempt from the provisions of the 5% policy because these primary issuances are sold at a specific public offering price. Examples of the securities that are exempt include initial public offerings, municipal bonds, and mutual fund shares.

Discretionary Order/Discretion Not Exercised

If a client has granted discretionary authority to his registered representative, this should be indicated for each discretionary order. When completing an order ticket, if a client consents to a specific trade recommendation before execution, it's important for the RR to check off *discretion not exercised*.

The importance lies in the fact that discretionary trades have more heightened supervisory requirements. Keep in mind, indicating *discretion not exercised* is not the same as indicating that the trade was unsolicited. If placing a trade was the client's idea, the order ticket is marked *unsolicited*. On the other hand, if the trade was recommended by the registered representative, the ticket should be marked *solicited*.

Types of Transactions

When an order is placed, the first determination to verify for the order ticket is the client's desired action or intent. These may include:

- A purchase
- A long sale
- A short sale

When purchasing securities, the client must designate whether the trade is to be paid in full or being paid for with borrowed funds (on margin). When selling securities, the process can be a bit more complicated. With sales, the issue becomes whether the customer is selling securities that she owns or selling securities that she doesn't currently own (i.e., securities that have been borrowed). If the customer sells stock that she currently owns, it's referred to as a long sale and she must either have the securities in her account with the broker-dealer or be able to deliver them promptly. Conversely, what if the customer doesn't currently own the stock being sold?

Short Positions A short sale is one in which the investor sells shares that she doesn't own; therefore, the shares must be borrowed. As long as the shares are able to be borrowed, the short seller's broker-dealer will execute the short sale. Since the borrowed shares will ultimately need to be returned to the lender, the short seller will need to buy back the stock at some point in the future. A profit for the short seller is realized if she's able to buy the shares back at a price that's less than the price at which they were originally sold. The strategy for a short seller is bearish (i.e., she will profit if the price of the stock falls). On the other hand, if the price rises, the investor's loss could be significant since the stock would need to be purchased at a price that's higher than the price at which the shares were originally sold.

 Copyright © Securities Training Corporation. All Rights Reserved.

For example, an investor sells shares short 100 shares at $50. The investor receives proceeds of $5,000 into her account, but will need to spend money to buy the shares back at some point in the future. Later, if the stock is trading for $40, the investor can buy the stock back to cover the short position and realize a profit of $1,000 ($5,000 sales proceeds – $4,000 total purchase). However, if the share price had risen to $60 and the investor bought the shares back, she would realize a loss of $1,000 ($5,000 sales proceeds – $6,000 total purchase).

Margin Requirement Short sales must be executed in a margin account. Brokerage firms provide short sellers with stock that has been borrowed from other margin customers. However, the other margin customers must provide permission for the firm to lend their securities to short sellers. The permission is obtained through the signing of a loan consent agreement at the time that the account is opened.

As long as the short seller's margin account maintains the minimum required equity, there's no set time by which the short seller must repurchase the borrowed shares. While maintaining a short position, if a cash dividend is paid on the borrowed stock, the short seller is responsible for paying the dividend to the lender.

Covered and Uncovered Options Writers As described in Chapter10, if the seller of a call option owns the underlying stock, she's considered to be the seller of a covered call. The position is covered because the client is able to deliver the shares if the contract is exercised and she's assigned. On the other hand, if the seller of a call doesn't own the shares, she's considered to be uncovered or *naked*. These terms indicate that, if assigned, the writer is at risk of being required to buy shares at an unknown market price in order to complete the delivery of the shares to the call buyer. Uncovered call writing is riskier than covered writing and may only be executed in a margin account.

Types of Orders

Market Orders

The most basic type of order is a *market order*. When placing this order, the client doesn't specify a price. Instead, the order will be executed at the best available price when the order is entered (i.e., the highest bid for market orders to sell and the lowest offer for market orders to buy). Although market orders will be immediately executed, the client is not assured of a specific execution price. Market orders are often used for stocks that have active (liquid) markets in which the spread (difference between the bid and ask price) is narrow.

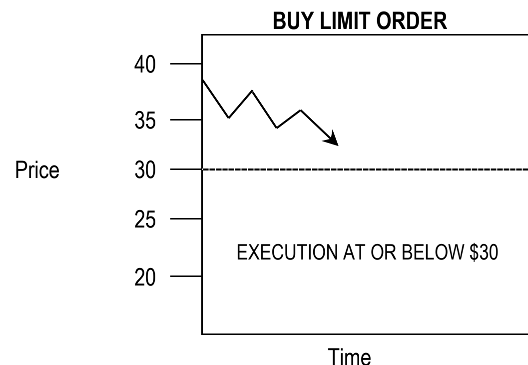
Limit Orders

When customers want to buy or sell securities at a specific price, they enter limit orders. A limit order may be executed only at the specified price or better. A buy limit order may only be executed at the limit price or lower, while a sell limit order may only be executed at the limit price or higher.

Copyright © Securities Training Corporation. All Rights Reserved.

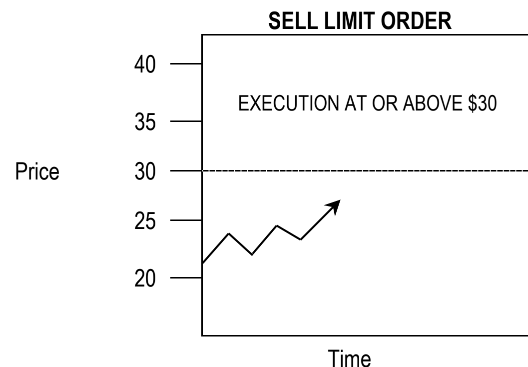
For example, let's assume XYZ stock is currently trading at $31. A customer wants to buy the stock if it drops slightly and, therefore, enters a limit order to buy 100 shares of XYZ at $30. The order may not be executed unless the stock is able to be purchased at $30 or below.

A buy limit order is placed below the current market price of a security.



Now, let's assume a client originally bought stock at $22 and it's now trading at $29. If the client wants to sell the stock, but only if it rises slightly, he may place a sell limit order at $30. The order will not be filled unless the stock is able to be sold at $30 or above.

A sell limit order is placed above the current market price of a security.



Since limit orders are entered away from the market price, a person who places a limit order must be patient. Depending on which way the market moves, he may not receive an execution. If the market price doesn't trade at or better than the customer's limit price, the client will not receive a trade execution. If the customer's order was entered as a day order (only good for one day) and it didn't receive execution, it would need to be reentered on the following day.

Limit orders are often used for large orders in thinly or infrequently traded securities in which the spread is wide (i.e., a larger distance between the bid and ask prices). Although an investor is able to specify the price of a limit order, the risk is that the order may never be executed.

Stop (Loss) Orders

Again, investors who enter either market or limit orders *want* to receive execution. However, stop orders are often entered by customers who are trying to prevent a large loss or protect a profit on an existing stock position. In most cases, these investors would rather not receive execution on their stop orders.

 Copyright © Securities Training Corporation. All Rights Reserved.

A stop order is a contingent order, which means that it won't receive execution unless the market rises or falls to a certain price. This certain price that's specified by the investor is referred to as the *stop price*. If the market reaches the stop price, the stop order is activated (triggered) and becomes a market order to buy or sell. Since an activated stop order becomes a market order, the investor is guaranteed that the order will be executed; however, there's no guarantee as to the price of execution.

Sell Stop Order A sell stop order is placed below the current market price of the security and is used to limit a loss or protect a profit on a long stock position.

For example, a customer purchases 100 shares of XYZ stock at $25 and determines that she would like to limit any losses to approximately 5 points; therefore, she enters a sell stop order at $20. If the stock falls to $20 (the stop price) or below, the sell stop order is triggered and becomes a market order to sell 100 shares of XYZ. With this order, the customer is attempting to limit the loss on her position immediately.

Rather than XYZ stock declining in price, let's assume that it appreciates to $35. The customer may decide that she wants to protect this profit by entering a sell stop order at $33. If the stock subsequently falls and trades at or below $33, the order will be activated and when the customer sells the stock, she will have protected a portion of her profits.

Buy Stop Order A buy stop order is placed above the current market price of the security and is used to limit a loss or protect a profit on a short sale. Remember, short sellers anticipate that the security will fall in value (i.e. bearish), but they will lose money if the position rises.

For example, a customer sells short 100 shares of ABC at $40 and is bearish. However, he would like to protect his position against a rise in the price of ABC and places a buy stop order at $45. If ABC stock rises to the stop price of $45 or above, the customer's order will be activated and he will buy 100 shares at the market to close out (buy back) the short position. Once the order is activated, he's not guaranteed an execution price of $45, but is guaranteed that the position will be closed out (covered) immediately.

Stop-Limit Order

A stop-limit order is similar to a stop order in that if the market trades at or through the preset stop price, the order will be activated. However, once activated, a stop-limit order becomes a limit order and may be executed only at a specified price or better. These orders are a combination of both stop orders and limit orders, which means the customer may not receive execution on the order. Essentially, a stop-limit order presents a risk/reward trade-off. The risk is that since a specific limit price is set, the order may never receive execution. The reward is that, if the order receives execution, the customer will receive the preset limit price or better.

Sell Stop-Limit Order As with a sell stop order, a sell stop-limit order is placed below the current market price of the security and is used to limit the loss (or protect a profit) on a long position. However, once activated, the sell stop-limit order becomes a sell limit order and, therefore, execution will only occur if the stock can be sold at the limit price or higher.

Copyright © Securities Training Corporation. All Rights Reserved.

For example, an investor purchases 1,000 shares of DEF at $15 and, fearing a decline in its price, places a sell stop-limit order at $10. After the order is entered, market transactions occur as follows:

Trigger Execution

*$10.70…$10.45…$10.05…**$10.00…**$9.97…$9.97…**$10.00***

The order is activated by the first trade at $10.00 and becomes a limit order to sell 1,000 shares at $10.00 or higher. After being triggered, notice that the stock subsequently fell below the stop price. The order was only able to be executed because the stock increased back to $10.00. Remember, once activated, the risk is that, unless the order can be filled at the limit price or higher, the order will not be filled.

Buy Stop-Limit Order As with a buy stop order, a buy stop-limit order is placed above the current market price of the security and is used to limit the loss (or protect a profit) on a short position. However, once activated, the buy stop-limit order becomes a buy limit order and, therefore, execution will only occur if the stock can be purchased at the limit price or lower.

For example, an investor sells short 1,000 shares of GHI at $20 and, fearing a rise in its price, places a buy stop-limit order at $24. After the order is entered, market transactions occur as follows:

Trigger Execution

*$23.55…$23.80…$23.95…**$24.02**…$24.03…$24.02…**$24.00***

The order is activated by the trade at $24.02 (notice that the market traded through the stop price of $24.00) and becomes a limit order to buy 1,000 shares at $24.00 or lower. After being triggered, notice that the stock subsequently rose above the stop price. The order was only able to be executed because the stock decreased back to $24.00. Remember, once activated, the risk is that, unless the order can be filled at the limit price or lower, the order will not receive execution.

Order Qualifiers

When orders are being placed, there are several different qualifiers that may be used. However, let’s consider two of the more important order qualifiers.

Day Order Unless otherwise specified, every order is considered a day order and will be available for execution from 9:30 a.m. to 4:00 p.m. Eastern Time (ET). If the order is not executed during the normal trading day, it’s cancelled at the end of the day.

Good-‘Til-Cancelled (GTC) or Open Order A GTC order is one that remains in effect on a broker-dealer’s order book until it’s either executed or cancelled. Any firm that accepts GTC orders should periodically update them with the exchange(s). GTC orders must also be updated due to any partial fills. A customer may enter an order that’s good for a week, a month, or another specified time. If the order is not executed by the end of the specified time, the customer’s brokerage firm will simply cancel it.

 Copyright © Securities Training Corporation. All Rights Reserved.

Conclusion

This concludes the examination of the capacities in which a broker-dealer operates, the various trading strategies, and the different types of orders. The next chapter will focus on settlement of transactions and corporate actions, such as dividend payments and stock splits.

Chapter 12 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Recognize and understand the function of brokers (agents) and dealers (principals) act and how they're compensated
- Understand the 5% policy and the factors that influence a firm's commission or markup
- Define the term *proceeds transaction*
- Recognize and understand the different types of transactions (e.g., purchase, long sale, short sale)
- Understand the difference between a covered and uncovered option writer
- Recognize and understand the various types of orders, including market; limit; buy limit; sell limit; and stop orders
- Define the terms *day order* and *good 'til cancelled (GTC or open order)*
- Identify the price and size of a market maker's quote
- Understand the types of purchases and sales that can be executed in cash and/or margin accounts

Create a Chapter 12 Custom Exam

Now that you've completed Chapter 12, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 13 –
Settlement and Corporate Actions

- *Transaction Settlement*
- *Securities Delivery*
- *Corporate Actions*
- *Forwarding Official Communications*

Copyright © Securities Training Corporation. All Rights Reserved.

The previous chapter examined the mechanics of order entry and various trading strategies. This chapter will describe the actions that occur after a trade is executed. These actions include the process by which transactions are cleared and settled. Lastly, details regarding the various adjustments that may be made to a client's position after settlement will be reviewed.

Trading, Clearing, and Settlement

The trading process begins with an order being entered through the submission of either a paper or electronic order ticket. If the order is executed, the two firms involved must agree on the details of the trade. This agreement is referred to as *clearing* or affirming the trade. Finally, the buyer and seller must swap securities for funds in a process that's referred to as *settlement*. The settlement process is typically facilitated through a third party, such as Depository Trust and Clearing Corporation (DTCC) (which was described in Chapter 1).

Let's examine some of the different terms that are vital to this process:

- **Order Entry –** The placing of a trade into the system either using either a print or electronic ticket
- **Execution –** The occurrence of a trade or fill in the secondary market (i.e., on the NYSE or Nasdaq)
- **Clearing –** Agreement by executing firms as to the details of a trade
- **Settlement –** The swapping of securities for funds that completes the transaction between firms
- **Custody and Safekeeping –** The safeguarding of client and firm assets after settlement

Settlement Dates

If all of the parties involved in a trade agree to the details (clearance of the transaction), settlement is the next step. The date on which the transaction *must be* completed (settled) between the broker-dealers representing the buyer and the seller is referred to as the *settlement date*.

Regular-Way Most securities settle on a *regular-way* basis, which refers to the normal number of days to complete the transaction. However, the required number of days is primarily determined by the securities involved. For corporate securities (stocks and bonds) and municipal securities (covered under MSRB Rule G-15), the settlement for regular-way transactions is two business days after the trade date (i.e., T + 2). For Treasury securities and options transactions, settlement occurs one business day after the trade date (i.e., T + 1).

Copyright © Securities Training Corporation. All Rights Reserved.

Special Settlement If either party seeks to alter the timing of settlement on a trade, the adjusted period must be agreed to prior to the transaction. For example, if a stock seller is in urgent need of funds and needs a next-day settlement (rather than T + 2), the buyer must agree to these conditions prior to the transaction and may offer a slightly lower price for the shares.

Cash Settlement The settlement is completed on the same day as the trade. This option, which requires the agreement of both parties, can be used for any type of security.

Seller's Option If trade settlement cannot be completed on a regular-way or for-cash basis, the seller may request a *seller's option* settlement. At the time of the transaction, both parties to the trade may agree to a seller's option, which gives the selling firm additional time beyond the normal two business days to make good delivery. Often, a seller's option is used when the seller needs additional time because of legal requirements, such as the removal of a legend from a stock certificate.

When Issued On certain occasions securities are authorized, but not yet issued (e.g., new issues, spin-offs, etc.) These transactions will settle when the security becomes available for delivery.

Settlement Dates	
Corporate or Municipal Bonds	Second business day following the trade (T + 2)
U.S. Government Securities	Next business day (T + 1)
Cash Trade/Settlement	Same day (T)
Seller's Option	Negotiated settlement not earlier than two business days after the trade (i.e., additional time is required)
When Issued	As determined by the National Uniform Practice Committee

Customer Payment Versus Settlement

Don't confuse a customer's obligation with those of the firms involved in a given trade. Regulation T requires that *customer* payment for purchases in cash and margin accounts be made promptly, which typically means by no later than two business days following regular-way settlement (i.e., S + 2).

Remember, trade settlement refers to the timing of payment and delivery between member firms and is governed by FINRA's Uniform Practice Code. The date on which customer payment must be made (Reg. T payment) is set by the Federal Reserve Board (FRB) and this authority was established under the Securities Exchange Act of 1934.

Copyright © Securities Training Corporation. All Rights Reserved.

To keep these two concepts clear, the differences between them are summarized in the following table:

Settlement versus Customer Payment		
Security/Trade	**Settlement**	**Customer Payment**
Corporate Securities in a cash or margin account	Two business days (T + 2)	Four business days (T + 4 or S + 2)
Municipal Securities	Two business days (T + 2)	Exempt from Reg. T (generally settlement)
U.S. Government Securities	Next Business Day (T + 1)	Exempt from Reg. T (generally settlement)
Option Trades	Next Business Day (T + 1)	Four business days (T + 4)
***Cash transactions* for any security settle on the same day.**		

Settlement Methods

Today, for most securities, the settlement process is handled electronically by the Depository Trust Clearing Corporation (DTCC); however, some security positions are not DTCC-eligible. Essentially, the DTCC simply adjusts the security positions and cash balances of the contra-parties on its internal books. Since the settlement is guaranteed by the DTCC, there's no contra-party risk.

The client-to-broker-dealer payment and delivery (this is not settlement) is also often handled electronically since clients typically hold positions in street name. Because of this, there are very few paper securities deliveries between customers and their broker-dealers.

DTCC Settlement Rules for settlement of contracts between member firms are established under FINRA's Uniform Practice Code. Again, settlement represents the day on which the buying firm must pay for the securities and the selling firm must deliver them and receive the proceeds from the sale. For example, stock trades done regular-way will settle on the second business day after the trade (T + 2). As noted earlier, the DTCC simply journals the movement of security positions and monies between each clearing firm's account. This process is referred to as *book-entry settlement*.

Book-Entry Settlement Rather than making physical delivery of securities or cash when settling securities trades, many firms use book-entry settlement. If a firm intends to use book-entry settlement, all transactions in *depository-eligible securities* must be settled through a registered securities depository, such as the DTCC or the National Securities Clearing Corporation (NSCC). For locked in (affirmed) stock trades, each firm is actually settling the position with the NSCC—the DTCC subsidiary.

Depository-eligible securities are those that may be deposited at the clearing agency for which ownership can be transferred through book-keeping entries rather than through physical delivery of certificates. Cash transfers are also processed through book entries by the clearing agency rather than through a bank routing process.

Copyright © Securities Training Corporation. All Rights Reserved.

Delivery of Physical Securities

Paper Settlement

In some cases, physical securities may be delivered for settlement. Reasons for this include that the client is personally holding the certificates or the security itself is not DTCC-eligible. In either case, the physical securities must be in proper order and have all of the necessary endorsements before being delivered to the buyer. If all paperwork is in order, the position is referred to as a *good delivery.*

FINRA's Uniform Practice Code establishes the requirements for good deliveries of securities. One of the purposes of the rule is to ensure that the securities will be acceptable to the transfer agent. The transfer agent will make the final determination as to whether a security is a good delivery and may be transferred to the new owner. This section will detail what constitutes good delivery.

CUSIP Numbers One aspect of good delivery is the assurance that the correct security is delivered. Many issues have similar features and maturities and may be confused with one another. CUSIP numbers are similar to bar codes for items in a store and are identifying numbers assigned to each maturity of an issue. CUSIPs are essential in the identification and clearance of securities.

Endorsements and Assignments A customer who sells a security is required to sign the certificate. The usual method of endorsing a stock certificate is to sign the certificate on the back and then mail the certificate to the broker-dealer. In order to safeguard the certificate while it's in the mail, the seller could send the certificate by registered mail. An alternate method is for the customer to send the certificate, unsigned, in one envelope and to send a signed stock power in a separate envelope. In this way, if the certificate falls into unauthorized hands, it has no value since it's non-negotiable.

Units of Delivery For certificates to be acceptable for broker-to-broker delivery, they must be in certain units. If the selling broker delivers units in multiples other than what's allowed, the buying broker is not required to accept the certificates.

Stock Transactions On stock transactions, certificates must be delivered in multiples of 100 shares. For example, on a transaction involving 500 shares, one certificate for 500 shares, or five certificates for 100 shares each, or two certificates for 200 shares and one certificate for 100 shares are all good delivery since they're all in multiples of 100 shares. However, multiples that are not 100 shares, such as two certificates for 250 shares each or one certificate for 450 shares and one certificate for 50 shares, are not good delivery.

Bond Transactions Registered bonds are good delivery if they're in $1,000 units or multiples thereof. Additionally, amounts of $100 or multiples aggregating to $1,000 are acceptable, but with no denomination larger than $100,000.

Copyright © Securities Training Corporation. All Rights Reserved.

Restricted Securities As mentioned in Chapter 11, securities that carry a restrictive legend are not considered to be in good delivery form. Generally, these certificates must have the legend removed, which is the responsibility of the selling firm. Only a transfer agent has the authority to remove a restrictive legend.

However, the transfer agent will not remove the legend unless the client has obtained the consent of the issuer in the form of an *opinion letter* that's created by the issuer's counsel. The process of cleaning the certificate (removing the legend) is typically accomplished under Rule 144.

Corporate Actions

As illustrated by the table below, the corporate actions area of a broker-dealer handles a variety of post-settlement issues. These issues range from stock splits and stock buybacks (described in Chapter 3), to major events such as mergers and tender offers.

Corporate Actions	
▪ Stock Splits	▪ Proxy Notices
▪ Exchange Offers	▪ Tender Offers
▪ Stock Buybacks	▪ Spinoffs
▪ Rights Offerings	▪ Mergers and Acquisitions

Corporate Actions in Equities

Stock Splits (Forward Splits) If a company chooses to split its stock, it's usually done to decrease the price of its stock in order to make it more marketable. The company issues more shares at a certain ratio to its existing stock (e.g., 2-for-1, 3-for-2). The stock's par value and market price are adjusted accordingly. Although the markets tend to react favorably to a stock split, there's really no immediate change in the absolute value of an investor's holdings.

To determine the number of shares that an investor will own after a split, the number of shares owned is multiplied by the split ratio. For example, let's assume that Widget Inc. has 100,000 shares of stock outstanding and the shares have significantly increased in price to $100 per share. If Widget splits its stock 2-for-1, an investor who owned 1,000 shares before the split will own 2,000 after the split.

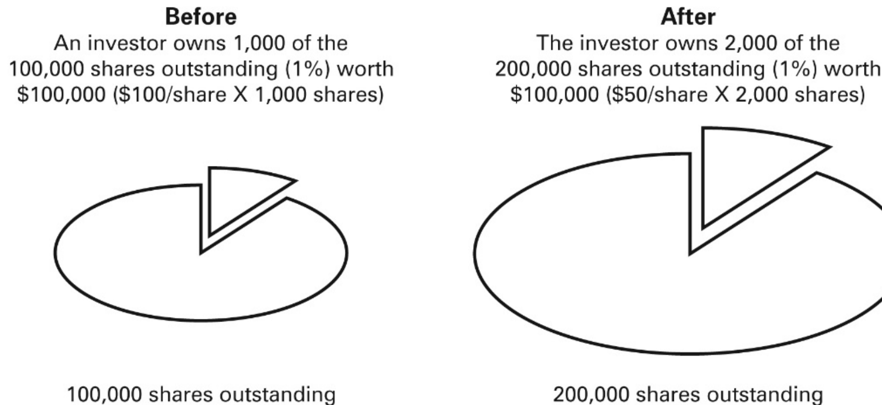
$$1{,}000 \times 2/1 = 2{,}000$$

To find the price of the stock after the split, the current price is multiplied by the inverse of the split ratio. If the stock was worth $100 per share before the split, it will be worth $50 per share after the split.

$$\$100 \times 1/2 = \$50$$

Copyright © Securities Training Corporation. All Rights Reserved.

Remember, the investor's total share value remains the same. The value was $100,000 before the split (1,000 x $100) and is still $100,000 after the split (2,000 x $50).



The Value of the Investor's Holdings Doesn't Change.

For stock splits, the ex-dividend date is the business day following the *payable* date. To ensure that the proper shareholder receives the additional shares, the stock will trade with a *due bill* attached beginning on the record date and continuing through the payable date.

Reverse Stock Split There are times in which a company's shares may be trading at a very low price. Since many investors shy away from low-priced stocks (those that sell for $5.00 per share or less), a company may want to raise the price of its stock. Executing a *reverse stock split* can help the company accomplish this objective.

In a forward stock split, the number of outstanding shares are increased and the price is decreased. However, in a reverse stock split, the company decreases its number of outstanding shares and increases the stock's price proportionally. For example, let's assume that Microcap Holdings has 10,000 shares outstanding and the shares are trading at $1.00 per share. If Microcap executes a 1-for-5 split, each stockholder will receive one share for each five shares currently owns. The result is that Microcap will now have 2,000 shares outstanding with a market value of $5 per share ($1/share x 5/1).

Tax Impact of Stock Splits and Stock Dividends Stock splits and stock dividends are not taxable to the investor. The only action that must be a taken is for the investor to adjust his per share cost basis in the security.

> *Example 1*: Jon Smith bought 100 shares of XYZ Corp for $4000. His cost basis is computed as $4000/100 shares or $40 per share. If the stock had a 2-for-1 split, Mr. Smith would end up with 200 shares (2/1 x 100). His new cost basis would be $20 per share ($4,000/200).

 Copyright © Securities Training Corporation. All Rights Reserved.

Example 2: Mike Jones bought 100 shares of XYZ Corp for $5,000. His cost basis is computed as $5,000/100 shares or $50 per share. If the company paid a 10% stock dividend, Mr. Jones would end up with 110 shares. His new cost basis would be $45.45 per share ($5,000/110).

Tender Offers A tender offer is a public offer which indicates a person's or company's (including the issuer's) intent to buy a specific stock at a fixed price (normally above the current market price) in order to take control of the company or to gain representation on its board of directors. Tender offers may be placed to purchase all of the outstanding shares or for only a limited number of shares. In a partial tender offer, the exact number of shares that will be accepted from any person who tenders her stock is unknown until all of the tenders are collected and counted. For example, if a buyer is attempting to acquire 10 million shares, but 20 million shares are tendered, each person who tenders the shares may potentially have only 50% of her shares accepted for tender.

What May be Tendered? An investor may participate in a tender offer if she:

- Has title to the stock (or her agent has title to the stock). This includes owning the stock or an equivalent security, such as a convertible security, warrant, or right.
- Has entered into an unconditional contract to buy the stock, but has not yet received delivery
- Owns a call option and has exercised the option

If convertible securities, rights or warrants are tendered and accepted, only then will the investors be obligated to convert/tender the securities into the underlying stock and make delivery. However, an important note is that an investor must exercise her call options to participate in a tender offer. Since call options are not issued by the company, these securities must first be exercised.

Exercising Rights and Warrants A broker-dealer's corporate actions area handles all client instructions regarding the disposition of rights and warrants. These instructions could include purchasing the underlying shares or selling the derivatives in the open market. Rights may be freely transferred and usually trade in the same market as the underlying stock. For example, if Widget stock trades on the NYSE, then so too will the Widget rights. If an investor chooses not to exercise her rights, she can sell them in the open market. However, if the investor wants to exercise her rights, she will typically tender them to the issuer's transfer agent.

Other Corporate Actions

Mergers and Acquisitions The difference between these two terms is somewhat difficult to define. Generally if two companies combine, it's referred to as a merger. Merger examples include the creation of The Bank of New York Mellon or TimeWarner. An acquisition implies that one company is purchasing the other. An acquisition example is Amazon's purchase of Whole Foods.

Spinoffs In some situations, a company may want to spin off a business unit to existing shareholders. Examples include Metlife's spin off of Brighthouse Financial and Ebay's spin off of PayPal.

Copyright © Securities Training Corporation. All Rights Reserved.

Forwarding Official Communications

Official Communications One of the many services that a broker-dealer may provide to its customers is safekeeping. The securities may be held in bearer form, book-entry form, or registered in the name of the customer with the firm holding them to provide protection against loss or theft. In many cases, customer securities are held in *street-name* (in the name of the broker-dealer) to facilitate transfers. When securities are held in street-name, the customer is considered the beneficial owner of the securities. Many times, the issuer knows the identity of the beneficial owners of its securities; however, in other cases, the owners may prefer that the issuer not know their identity.

If the broker-dealer receives official communications that are directed to the beneficial owners, it must make a reasonable effort to retransmit the information to the owners. Official communication is considered any relevant information that's distributed by the issuer, a trustee, or a state or federal taxing authority.

Beneficial Owners As just described, beneficial owners are persons who have security positions that are being held by a financial intermediary (e.g., a broker-dealer or trustee) with which they do business. These positions are typically registered in street name and each individual customer's ownership is internally recorded on the firm's stock record.

For example, if ABC Brokerage holds 15,000,000 shares of Big-Time Industries, the issuer (Big-Time Industries) may not have access to the individual client names which make up the broker-dealer's street name position—it depends on the client's status.

Non-Objecting Beneficial Owner (NOBO) If a beneficial owner gives permission to her broker-dealer to release her name and address to the issuer, she's considered a *non-objecting beneficial owner*. With this information, the issuer is directly able to provide NOBOs with shareholder communications, including proxies and financial filings (e.g., Forms 10-K and 10-Q).

Objecting Beneficial Owner (OBO) If a client instructs her broker-dealer to keep her personal information confidential, it may not be provided to issuers. In this case, the issuer will distribute the communications in bulk to the broker-dealer. In turn, the broker-dealer will redistribute the material to the *objecting beneficial owners*.

Proxies As described in Chapter 3, a corporation's common stockholders have the right to vote on issues that impact the corporation. Although these stockholders may choose to vote in person, most vote by proxy (voting power of attorney). By signing a proxy, shareholders give another person the authority to vote on their behalf. Broker-dealers that hold customer securities in street-name are responsible for promptly forwarding these proxies to the beneficial owners.

Copyright © Securities Training Corporation. All Rights Reserved.

An example of a proxy is shown below:

Management Proxy
MaxCo Corporation
Proxy for Annual Shareholders Meeting
To Be Held July 1, 20XX

The Undersigned hereby constitutes and appoints HAROLD THOMAS and JOHN PUBLIC and each of them, with power of substitution, as attorneys and proxies to appear and vote all of the shares of stock standing in the name of the undersigned, at the Annual Meeting of the Stockholders of **MaxCo** Corporation, to be held at 5691 Oak Street, Chip City, California, on July 1, 20XX at 2pm and any adjournments thereof:

1. Authority to vote for the election of directors
   ☐ WITH ☐ WITHOUT
2. The appointment of Beans & Franks LLP as auditors for the Corporation
   ☐ FOR ☐ AGAINST
3. Upon such other business as may properly come before the meeting or any adjournment thereof.

The share represented by this proxy will be voted as specified.

The undersigned hereby acknowledge the receipt of the Notice of Meeting and Proxy Statement.

Dated_________________ 20_______

____
(Please sign name exactly as registered on stock certificate)

Forms 10-K and 10-Q A broker-dealer is required to promptly forward all issuer-related financial information to its customers who own the stock. The information includes 10-K filings (annual reports) and 10-Q filings (quarterly reports).

Charging Issuers for Services A member firm may charge *issuers* for forwarding materials to the beneficial owners. The reimbursement rates are standardized under FINRA rules.

Charging Customers for Services A member firm may also charge its *customers* for services, including safekeeping of securities, collection of dividends and interest, and exchange or transfer of securities. However, the charges must be reasonable and cannot unfairly discriminate between customers.

A member firm is not permitted to charge a customer for forwarding proxies or other financial reports from a corporation since reimbursement is typically collected from the issuer directly. The member firm is required to forward these materials to its customers if the corporation reimburses the member firm for the expenses involved.

Copyright © Securities Training Corporation. All Rights Reserved.

Conclusion

That concludes the chapter on Settlement and Corporate Actions. The next chapter will examine the paperwork requirements and associated regulations regarding customer accounts.

Chapter 13 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Recognize and understand the dealer-to-dealer regular-way settlement dates for the following securities:
  - Corporate and municipal securities
  - U.S. government securities and options
    - *Review the Settlement Date chart*
- Recognize and understand the difference between settlement date and Reg T payment date for both a cash account and margin account
  - *Review the Settlement versus Customer Payment Date chart*
- Understand the impact if payment is not made by the Reg T payment date
- Define the term *cash settlement* and understand how it differs from regular-way settlement
- Define the term *freeriding* and identify its occurrence
- Define the term *good delivery* and understand why a stock power is relevant
- For *tender offers*:
  - Understand the term and the reason the company or a third-party may use this process
  - Identify the number of shares a customer will receive if a tender offer is either undersubscribed or oversubscribed
- For both a forward and reverse stock split:
  - Calculate both the number of shares and the price per share after the split
    - *Review the 2-for-1 Stock Split Adjustment to Shares Outstanding graphic*
  - Understand the tax treatment of a stock split and calculate the revised cost basis

Create a Chapter 13 Custom Exam

Now that you've completed Chapter 13, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 14 – Customer Accounts

- *Account Types and Characteristics*
- *Customer Account Registrations*
- *Retirement Accounts*

Copyright © Securities Training Corporation. All Rights Reserved.

This chapter will focus on the different types of customer accounts and their characteristics. Some of the accounts to be examined are defined by whether credit has been extended by the broker-dealer, while others are recognized by the purpose of the account. Additionally, this chapter will cover the different account registrations, including individual, joint, corporate, custodial, as well as retirement.

Account Types and Characteristics

Cash Accounts

A cash account is a type of brokerage account in which the investor is required to pay the full amount for the securities being purchased. In a cash account, an investor is not allowed to borrow funds from his broker-dealer in order to pay for transactions in the account. Most firms require that customers pay for their trades by the settlement date or risk incurring potential interest charges. However, Regulation T requires customers to pay for their purchases within two business days of regular-way settlement (i.e., S + 2).

Margin Accounts

A margin account is a type of brokerage account in which a broker-dealer lends money to the customer so that he's able to purchases securities. The broker-dealer will hold the purchased securities as collateral for the loan. Margin increases the customer's purchasing power, but also exposes investors to the potential for large losses if the securities decline in value. Transactions that are executed in a margin account are also subject to Regulation T requirements. Reg. T impacts margin accounts in the following two ways: 1) customers are typically required to deposit 50% of the trade amount and the firm will lend the other 50%, and 2) customers may pay their portion within two business days of regular-way settlement.

> *For example, if a customer buys 100 shares of ABC common stock with a $5,000 total purchase price, he needs to deposit $2,5000 ($5,000 purchase price x 50%) within two business days of the settlement date (i.e., T+4).*

There are two types of positions that may be established in a margin account:

- Long—the client borrows funds from the broker-dealer to purchase shares and
- Short—the client borrows shares from the broker-dealer in order to execute a short sale
  - For both long and short positions, no loan (money or stock) is provided unless the customer's equity is at least $2,000.

Since not all margin customers start with substantial purchases, industry rules establish minimum equity requirements for initial transactions in their margin accounts. For a long position, the customer's minimum required deposit is the lesser of $2,000 or 100% of the purchase price; however, for a short position, the customer's minimum required deposit is $2,000.

 Copyright © Securities Training Corporation. All Rights Reserved.

Marginable Securities Under Regulation T, only certain securities may be purchased using margin. These *marginable securities* are listed on either the NYSE or Nasdaq (e.g., ETFs).

On the other hand, non-marginable securities cannot be purchased on margin and these include mutual fund shares, initial public offerings (IPOs), and over-the-counter (OTC) stocks. The fact that these securities are not marginable doesn't mean that they cannot be purchased in a margin account; it simply means that any trades involving these securities must be paid for in full at the time of purchase.

Margin Agreements To open a margin account, a *margin agreement* must be signed by the client which contains the following key provisions:

- The *credit agreement* discloses the terms under which the broker-dealer will finance the customer's purchase, including both how interest is calculated and how it's charged to the account.
- The *hypothecation (pledge) agreement* indicates that the securities purchased by the customer will collateralize the debt to the broker-dealer. In addition, the broker-dealer may rehypothecate the securities (i.e., use the customer's securities to obtain a loan from a bank).
- The *loan consent agreement* gives the broker-dealer the right to lend the customer's securities to other clients or broker-dealers (for short-sale purposes). Since a customer loses the right to vote the loaned stock, the signing of this part of the margin agreement is optional.

Although selling stock short in a margin account doesn't involve the same type of financing arrangement as a long purchase, a margin agreement is still required. This is required since the broker-dealer will be selling borrowed stock on behalf of the customer.

Margin Disclosure Statement For any customer who opens a margin account with a member firm, a *Margin Disclosure Statement* must be provided to indicate that:

- The customer can lose more money than the amount deposited in the margin account.
- The firm can force the sale of securities or other assets in the account.
- The firm can sell the customer's securities or other assets without contacting him.
- The customer is not entitled to choose which securities or other assets in his account are liquidated or sold to meet a margin call.
- The firm can increase its in-house maintenance margin requirements at any time and is not required to provide the customer with prior written notice.
- The customer is not entitled to an extension of time for a margin call.

Options Accounts

Options trading involves the high degree of risk that purchasers may lose their entire investment if the option expires. Therefore, options trading may not be suitable for all customers. Firms must have a procedure in place that requires a customer's account to be approved for options trading before the firm may accept an order from a customer to buy or write (sell) options.

Copyright © Securities Training Corporation. All Rights Reserved.

Options Agreement To open an options account, a registered representative must gather a customer's financial and background information to determine both his ability to understand the nature of the investment and willingness to assume risk. This information is obtained through an Options Account Agreement which is completed by an RR on behalf of the customer. The broker-dealer attempts to verify this information by sending the agreement to the customer.

This verification is done by having the customer complete the form or correct any of the entered information. If there's no response from the customer concerning his personal data, the information may be considered verified. However, if the customer refuses to provide certain requested information, a note to this effect must be made on the agreement.

Within 15 calendar days after a customer's account has been approved for options trading, the firm must obtain from the customer a written agreement that she's aware of and agrees to be bound by the rules that are applicable to the trading of option contracts.

Discretionary Accounts

A *non-discretionary* brokerage account is one in which the customer decides which securities to buy and sell. If an RR makes a transaction recommendation to the customer who has this type of account, it requires the customer's specific approval before execution.

On the other hand, if a customer has given trading authorization (written power of attorney) to a registered representative, the account is generally referred to as a *discretionary account*.

If a member firm permits discretionary accounts, a principal must accept the discretionary authorization in writing before it becomes effective. Thereafter, each discretionary order must be approved by the principal promptly (i.e., on the day of the trade, but not in advance) and the account's activity must be reviewed frequently. The customer may decide to offer this person either full or limited authorization.

Limited versus Full POA A *limited trading authorization* permits the authorized person to place orders for the account, but not to make withdrawals. With *full trading authorization*, in addition to placing buy and sell orders, the authorized person can withdraw money and securities from the account.

In either case, the broker-dealer must receive written trading authorization that's signed by the account owner prior to permitting the authorized person to trade the account. The firm should also obtain the signature of each authorized person and the date that the trading authority was granted.

One area of concern in discretionary accounts is excessive trading—also referred to as *churning*. When investigating allegations of excessive trading, the most important elements are the number and size of the transactions in relation to the investment objectives of the customer.

 Copyright © Securities Training Corporation. All Rights Reserved.

A customer's investment objectives are instrumental in guiding a registered representative's decisions and should always be considered prior to making recommendations. Frequent trading may be acceptable in the account of a day trader, but inappropriate for many other investors. Remember, to determine if there's evidence of churning, it's the frequency of trading that matters, not whether the client lost money.

Disclosing Conflicts With discretionary accounts, the authorized third party generally is not required to obtain the account holder's permission prior to executing any transactions. However, if a member firm is selling its own stock to the public and it wants to place some of the issue in a customer's discretionary account, the firm must obtain the customer's written consent prior to executing the trade.

Time/Price Exception In some cases, a registered representative may accept a customer's verbal authorization to make certain decisions without it being considered discretionary. If a customer indicates (1) the specific security (asset), (2) whether it's to be bought or sold (action), and (3) the number of shares or other units to be bought or sold (amount), but leaves discretion only as to the time and/or price of execution, this is ***not*** considered a discretionary order and written authorization is ***not*** required. Remember, if a customer specifies the three order details that start with the letter "A" (asset, action, and amount), the order is not considered discretionary.

The orders that provide time and/or price discretion are referred to as *not-held orders and* are limited to the trading day on which the order was placed. A client must give her RR written instructions if the not-held order is to remain in effect for more than one day.

Authorized Activities	Document Required
Trades Only	Limited POA
Trading, deposits, and/or withdrawals of funds	Full POA
Not-Held Orders (for one day)	None

Fee-Based versus Commission Based Accounts

Customers who purchase and sell securities are either charged a percentage-based fee that's based on assets under management (AUM) or they incur a charge for each transaction. In a fee-based account, a customer is charged an annual fee for investment advice, regardless of whether any transactions occur. On the other hand, in a commission-based account, a customer pays a commission or other type of payment on each investment transaction.

Although being charged a single fee for all account services may seem like an attractive feature, it may not be the best approach for all customers. For customers who favor a low turnover strategy, being charged commissions for each executed transaction may be less expensive than a fee-based account. On the other hand, for customers who favor strategies that involve higher turnover, the fee-based account may be more economical than a commission-based account.

Copyright © Securities Training Corporation. All Rights Reserved.

Another type of payment option is referred to as a *wrap fee account.* In this type of investment account, customers are charged a single, bundled, or "wrap" fee that covers investment advice, brokerage services, administrative expenses, and other fees and expenses. The fee is generally based on a percentage of the assets under management.

Educational Accounts

In addition to saving for their own retirement, many parents and grandparents attempt to partially or fully fund education savings plans for members of their families. Although the owner typically establishes a plan for a family member, the beneficiary is not required to be a relative. Contributions to these plans are made on an after-tax basis. The U.S. government's tax code offers incentives to funding these plans by allowing the generated earnings to be distributed on a tax-free basis if they're used for qualifying educational expenses.

Coverdell Education Savings Account (ESA) A Coverdell ESA is not a retirement account; instead, it's a tax-advantaged method of saving money for a designated beneficiary's elementary or higher education. A parent, grandparent, or even a non-relative who has adjusted gross income within certain limits may make a maximum after-tax contribution of $2,000 per year to an account established for a beneficiary who is under the age of 18.

Although the contribution is non-deductible, the money accumulates on a tax-deferred basis and withdrawals are tax-free if they're used to pay for the beneficiary's expenses at an eligible educational institution. However, if the withdrawals are not used to pay for the beneficiary's educational expenses, then the earnings portion of the withdrawal is subject to ordinary income taxes *plus* a 10% tax penalty. If the money is not used by the beneficiary's 30th birthday and is withdrawn, it's subject to ordinary income taxes as well as a 10% penalty. To avoid the penalty, the money may also be transferred to a family member who is under the age of 30.

Unlike state sponsored 529 plans, investment options in Coverdell accounts are self-directed. Investors may buy and sell virtually any type of securities. Coverdell ESAs may be set up at brokerage firms, mutual fund companies, and other financial institutions.

Section 529 College Savings Plans As covered in detail in Chapter 8, Section 529 plans are not retirement accounts; instead, they're versatile savings vehicles that offer federal, and possibly state, tax benefits. The plans are generally operated by a state and are designed to help families set aside funds for future college and K-12 education costs. Funds in these programs are not taxed at the federal level if they're used for *qualified education expenses*, the definition of which has been expanded to include computers, up to $10,000 per year in K-12 tuition, and a lifetime limit of $10,000 to repay a qualified student loan as well as expenses for certain apprenticeship programs.

Section 529 plans can be used to meet costs of qualified colleges nationwide. With most plans, a person's choice of school is not impacted by the state in which a 529 plan is formed. For example, a person can be a resident of State A, invest in a plan that's offered by State B, and ultimately attend a college in State C.

 Copyright © Securities Training Corporation. All Rights Reserved.

Customer Account Registrations

During the process of a broker-dealer collecting all necessary information, a client must specify the type of account to be opened. Some of the different forms of account ownership require documentation that goes beyond the new account form.

Individual Account

An individual account is opened by and for one person. That person is the only one who may direct activity in the account unless a third party has been authorized. For example, if a married person opens an individual account, his spouse is not authorized to execute trades in the account unless he has granted third-party trading authorization to the spouse.

Numbered and Nominee Accounts In order to protect privacy, clients are permitted to trade under nominee names or use an account number in lieu of their name. However, under Customer Identification Program (CIP) rules, firms are still required to maintain records regarding the beneficial owners of all such accounts.

Joint Account

Joint accounts have more than one owner of record; however, the owners don't need to have an equal share of the assets in the account. In most cases, any joint owner may initiate activity in the account.

However, when signatures are required (e.g., to transfer securities), all owners are normally required to sign and any check that's made payable to the account may only be drawn in joint names (as the account is titled). New account information should be obtained for each account owner, not solely for the person filling out the application.

State law generally dictates the forms of joint ownership available, such as:

- Joint Tenancy with Right of Survivorship (JTWROS)
- Joint Tenancy in Common (JTIC or TenCom)

Joint Tenancy with Right of Survivorship and Joint Tenancy in Common are the most common forms of joint ownership. JTWROS accounts are often created by spouses and each person fully owns the account. Therefore, if one tenant dies, the ownership of the account will pass to the remaining tenant without being subject to probate. In a TEN COM account, each owner has a percentage of ownership and, at the time of death, the deceased person's interest passes to his estate.

Be aware that although background information is collected on each owner, all tax reporting data is listed under one designated tax ID number that belongs to one of the account owners.

Copyright © Securities Training Corporation. All Rights Reserved.

Corporate/Institutional Accounts

For a corporate account to be opened, a registered representative must be assured that the person opening the account is authorized to do so. This is evidenced by means of a *corporate resolution.* The resolution is a document created by the board of directors which appoints one or more persons to operate the account. (Note: the customer is the corporation, not the person opening or responsible for the account.)

If a corporation intends to open a margin or options account, a copy of the *corporate charter* must also be obtained. The charter is the document that certifies whether the corporation is authorized to have such an account. The following table identifies when the corporate resolution and/or charter are required:

Activity	Corporate Resolution	Corporate Charter
Cash Account Trading	Yes	No
Margin Trading	Yes	Yes
Options Trading	Yes	Yes

Partnership Accounts

To open an account for a partnership, a member firm must collect certain information from each general (managing) partner. This information includes their name, address, citizenship, and tax identification number. A *partnership agreement* must be created which will specify the partners who are authorized to execute transactions on behalf of the partnership. For recordkeeping purposes, member firms are required to maintain a copy of the partnership agreement in the account file.

Trust Accounts

In a *trust*, one person (the trustee) is put in charge of managing the assets for the benefit of another (the beneficiary). The trustee has legal control of the trust assets, but must manage it in the interest of the beneficiary. To open a trust account, an RR must obtain the following:

- Evidence of the trustee's authority to transact business in the account
- A copy of the trust agreement—the legal document that establishes the trust account

Revocable and Irrevocable Trusts When it comes to understanding trusts, knowing the difference between revocable and irrevocable trusts is crucial. The importance lies in the significant differences in the legal and tax consequences.

Revocable Trusts Revocable trusts, also referred to as living trusts or inter vivos trusts, can be changed at any time. In other words, if a person has second thoughts about a provision in the trust or changes her mind about who should be a beneficiary or trustee of the trust, then she can modify (amend) the terms of the trust agreement. Additionally, if a person decides that she doesn't like any of the features of the trust, then she can either revoke the entire agreement or change/amend its contents. The downside of a revocable trust is that assets funded into the trust are considered the person's personal assets for creditor and estate tax purposes.

 Copyright © Securities Training Corporation. All Rights Reserved.

Irrevocable Trusts An irrevocable trust is simply a trust that cannot be changed after the agreement has been signed. The typical revocable trust will become irrevocable when the person who created the trust dies. At this point, the trust can be designed to break into a separate irrevocable trusts for the benefit of a surviving spouse or into multiple irrevocable lifetime trusts for the benefit of children or other beneficiaries. Irrevocable trusts are commonly used to remove the value of property from a person's estate so that the property cannot be taxed when the person dies. In other words, the person who transfers assets into an irrevocable trust is giving over those assets to the trustee and beneficiaries of the trust so that the person no longer owns the assets.

Custodial Accounts

Since minors are not permitted to open accounts in their own names, any accounts opened for their benefit must be established as custodial accounts. Although most states use age 18 as the age of majority, each state sets its own standard. There are two approaches to opening accounts for minors—UGMA and UTMA accounts.

Uniform Gifts to Minors Act (UGMA) and Uniform Transfers to Minors Act (UTMA)

Accounts for minors are generally opened under either the Uniform Gifts to Minors Act (UGMA) or the more updated Uniform Transfers to Minors Act [UTMA]. The provisions of both Acts are very similar.

Under the UGMA/UTMA, an irrevocable gift of cash or securities is given to a minor by an adult donor. An adult custodian is appointed to act as a fiduciary for the minor. There may be only one custodian and only one minor per account and the custodian may also be a donor. Although there's no limitation on the amount of gifts that may be given, taxes may be due from the donor if certain dollar thresholds are exceeded (currently $16,000 per year).

Most custodial accounts are registered in the name of the custodian for the benefit of the minor. For ease of trading, an account opened under UTMA may allow for street name holding. The account is opened under the *minor's Social Security number* and the minor is responsible for paying taxes on any income generated in the account. Provided the custodian is not the donor of the assets in the account, a custodian may receive a fee for managing the account.

Due to an amendment to the Uniform Prudent Investor Act (UPIA), a custodian is permitted to authorize investment discretion to a competent third party (e.g., an RR or investment adviser representative). This is especially important for situations in which the custodian lacks investment experience and wants to take advantage of another person's expertise.

There are certain restrictions that apply to custodial accounts. As with most fiduciary accounts, UGMA accounts may not be margin accounts. This prohibition limits some of the investments/activities that can be executed in the accounts. For example, since commodity futures may only be purchased on margin and engaging in short sales may only be done in a margin account, neither of these activities is allowed in a custodial account.

Copyright © Securities Training Corporation. All Rights Reserved.

Retirement Accounts

Traditional Individual Retirement Accounts (IRAs)

One of the more popular retirement accounts are IRAs which are funded directly by the individual owners. Prior to recommending investments to be made in these individual plans, RRs should be assured that their customers are making full use of any work-sponsored plans since most employer plans allow for pre-tax contributions and may have lower overall expenses than self-directed accounts.

Any person, regardless of age, who has earned income from employment during the year may contribute to a traditional IRA. Earned income may be derived from wages, salaries, commissions, professional fees, and taxable alimony. However, earned income doesn't include interest, dividends, capital gains from investments, income from annuities, or rental income from real estate.

Under certain circumstances, IRA contributions are tax-deductible; however, in all cases, the income earned by the money invested in an IRA accumulates on a tax-deferred basis until it's withdrawn. An IRA account may not trade on margin and must specify a beneficiary who will receive the account's assets in the event of the account owner's death.

A person may maintain an IRA at either a bank or brokerage firm. Although the institution acts as a custodian for the account, the account owner is responsible for deciding how the funds are to be invested. They may be placed in a wide variety of investment vehicles including stocks, bonds, mutual funds, annuities, or U.S. gold coins. However, money contributed to an IRA may not be used to purchase life insurance or collectibles such as art, antiques, stamps, etc. The income earned from investments in IRAs accumulates tax-deferred until it's withdrawn.

Contribution Limits The maximum amount that an individual may contribute to an IRA on an annual basis is $6,000 or 100% of earned income—whichever is less. Contributions in excess of this amount are subject to a 6% tax penalty for over-funding. Individuals who are age 50 and older are allowed to make an additional $1,000 catch-up contribution, which increases their annual contribution to $7,000. Please note, contributions must be made in cash; a person may not contribute property.

Spousal Accounts If both spouses of a married couple are employed, each may separately open an IRA and contribute a maximum of $6,000 annually. Married couples with only one employed spouse may also contribute a maximum of $12,000 per year into two separate IRAs, assuming the working spouse has earned income of at least $12,000 per year. However, no more than $6,000 may be contributed to either account. The account for the non-working spouse is referred to as a *spousal account*.

Copyright © Securities Training Corporation. All Rights Reserved.

Deductibility of IRA Contributions A single person *who is not covered by an employer-sponsored retirement plan* may always deduct an IRA contribution of up to $6,000 annually from his taxable income. The same is true of a married person and his spouse provided neither person participates in such a plan. However, if a person or his spouse is covered by an employer-sponsored plan, the person's taxable income determines the level of deductibility of the contribution (full, reduced, or zero).

Transfers and Rollovers An investor may *transfer* funds from one IRA to another without incurring taxes. A transfer is a situation in which plan assets move directly from one trustee to another. There's no limit to the number of these transactions that may be executed annually.

An investor may also *roll over* distributions from qualified retirement plans, such as 401(k)s, into IRAs without incurring taxes. In a rollover, the investor takes receipt of the money. To avoid a tax penalty, the rollover must be completed *within 60 days* and may only be done *once every rolling 12 months*.

Early Withdrawals from IRAs An investor who withdraws money from an IRA before reaching the age of 59 1/2 will be required to pay a 10% tax penalty on the amount withdrawn, in addition to being liable for ordinary income taxes on the withdrawal. The amount of the early withdrawal will be added to the investor's taxable income for that year.

> *For example, a 40-year-old investor who earns $45,000 per year takes a $5,000 withdrawal from her IRA in order to move overseas. She will need to pay a $500 tax penalty (10% of $5,000) for the early withdrawal and her taxable income for that year will be $50,000.*

Investors who are under the age of 59 1/2 will not be subject to a tax penalty for early withdrawals from an IRA if any of the following *exceptions* apply:

- The account owner becomes *disabled*
- The account owner *dies* and the money is withdrawn by the beneficiary
- The money is used to pay certain *medical expenses* that are not covered by insurance or *medical insurance premiums* when the owner is unemployed
- The money is used for expenses related to *being a qualified first-time home buyer* ($10,000 limit)
- The money is used for expenses related to the *birth or adoption* of a child ($5,000 limit)
- The money is used to pay *qualified higher education expenses* (including tuition, fees, books, and room and board) for the account holder or a member of her immediate family
- The withdrawals are set up as a series of *substantially equal periodic payments* that are taken over the owner's life expectancy

Although investors who fall under these exceptions and those who are 59 1/2 or older will avoid a tax penalty, they will still be required to pay ordinary income taxes on the amounts withdrawn. If an investor is under the age of 59 1/2 and withdraws money from an IRA because of a financial hardship, she will still be subject to the 10% tax penalty.

Copyright © Securities Training Corporation. All Rights Reserved.

Required Minimum Distributions (RMDs) Investors who wait too long to begin taking withdrawals from their traditional IRAs may also incur a 50% tax penalty (the penalty is based on the amount that should have been taken). The IRS will levy this penalty if the investor doesn't start taking withdrawals by April 1 following the year in which the person reaches the age of 72. (The age was increased from 70 1/2 to 72 as a result of the passage of the SECURE Act in 2019.) Please note that this RMD provision doesn't apply to Roth IRAs (since Roth IRAs are funded after-tax).

Roth IRAs

The Taxpayer Relief Act of 1997 introduced another type of IRA, commonly referred to as the *Roth IRA*. Unlike a traditional IRA, contributions to a Roth IRA are not tax-deductible. Since investors contribute to Roth IRAs with after-tax dollars, they may withdraw *contributions* at any time without being required to pay taxes.

The accumulated earnings in a Roth IRA may also be withdrawn tax-free, provided the account has been in existence for *at least five years* and one of the following conditions is satisfied:

- The account owner is age 59 1/2 or older
- The account owner has died or become disabled
- The money is used for qualified first-time home buyer expenses ($10,000 lifetime limit)
- The money is used for expenses related to the birth or adoption of a child ($5,000 limit)
- The money is used to cover certain medical expenses or medical insurance premiums
- The money is used to pay for qualified higher education expenses

If these conditions are not met, then the account owner will be subject to ordinary income taxes plus a 10% tax penalty on the earnings generated by the contributions made to the account. Investors are not subject to required minimum distributions in a Roth IRA.

Contribution Limits The contribution limits for Roth IRAs are the same as those set for traditional IRAs—the lesser of $6,000 or 100% of earned income. A married person may also contribute $6,000 per year to a spouse's Roth IRA even if the spouse is not employed outside the home or earns very little. However, the total contributions to any one person's IRA (traditional and Roth) cannot exceed $6,000 per year.

Eligibility Any person, regardless of age, is eligible to open a Roth IRA provided her income doesn't exceed certain levels. Participation in an employer-sponsored retirement plan is not relevant for determining the eligibility for contributing to a Roth IRA.

Ultimately, a person may lose the ability to contribute to a Roth IRA if his adjusted gross income exceeds a specific amount which is determined by the IRS. However, there's no income limit that precludes a person from converting her traditional IRA into a Roth IRA.

 Copyright © Securities Training Corporation. All Rights Reserved.

	Traditional IRA	Roth IRA
Similarities	100% of earned income, up to a maximum of $6,000	100% of earned income, up to a maximum of $6,000
	Spousal option: An extra $6,000	Spousal option: An extra $6,000
	Age 50 or older: An extra $1,000	Age 50 or older: An extra $1,000
Differences	May be a deductible contribution	Contribution is NEVER deductible
	Contribution is always allowed	Higher-income individuals may not contribute
	Required minimum distribution (RMD) by April 1 following year the owner reaches 72 (50% penalty for failing to begin distributions)	No withdrawal requirement
	Withdrawals are subject to tax	Withdrawals are tax-free

Qualified Retirement Plans

Employee Retirement Income Security Act (ERISA)

The purpose of ERISA is to prevent the misuse and mismanagement of pension plan funds, especially by the managers of these plans. To accomplish this goal, ERISA sets standards of conduct for all persons who deal with pension plans. Qualified retirement plans meet both ERISA and IRS requirements and receive favorable tax treatment. To be qualified, a plan must be established in writing and must adhere to the following guidelines:

1. *Eligibility Requirements* The plan must cover all employees who are age 21 or older and have worked for the employer for at least one year. For purposes of determining full-time employment, working 1,000 hours or more during the year equates to full-time.
2. *Vesting* This is the schedule under which employees' rights to receive the benefits contributed to a plan by their employers gradually become guaranteed based on their years of service. At a minimum, all participants must be either fully vested after five years or 20% vested after three years with full vesting after seven years of service. However, employees are always 100% vested in the contribution they have made to a plan on their own behalf.
3. *The Investment of Contribution and Determination of Benefits* The investment of plan assets, as well as other plan activities, is governed by strict fiduciary guidelines.

If established correctly, a qualified plan will have the following characteristics:

- *Pre-tax contributions:* Employer and employee contributions to a qualified plan are generally able to be made on a pre-tax basis. In other words, no income tax is paid on the amounts contributed by employers until the money is withdrawn from the plan
- *Tax-deferred growth:* Investment earnings (e.g., dividends and interest) on all contributions are tax deferred; therefore, income tax is not paid on the earnings until the money is withdrawn from the plan.
- *Non-discrimination:* Qualified plans cannot discriminate in favor of only highly compensated employees.

Copyright © Securities Training Corporation. All Rights Reserved.

These plans provide employers a tax break for the contributions that they make on behalf of their employees. Additionally, qualified plans allow employees to defer a portion of their salaries into the plan which reduces their immediate income-tax liability by reducing the employee's reportable taxable income. Ultimately, qualified retirement plans help employers attract and retain good employees.

There are two types of qualified plans—defined benefit and defined contribution. A defined benefit plan gives employees a guaranteed payout and puts the risk on the employer to save and invest properly to meet the plan's liabilities. However, with a defined contribution plan, the contribution is fixed, but there's no guaranteed benefit at retirement. The amount employees receive in retirement is dependent on how well they save and invest on their own behalf during their working years.

Taxation of Retirement Plans

For tax purposes, there are three distinct phases in these plans—contributions, growth of investment, and distribution. Retirement and education savings plans are not subject to preferential, long-term tax rates and any portion of the distribution that's taxable will be taxed at the same rate as ordinary income.

Since a person's contribution is made pre-tax, the funds are removed directly from the client's gross income and will not count as part of her taxable income. For example, if a client earned gross income of $100,000 per year, but made pre-tax contributions of $10,000, the IRS will tax her only on the $90,000 of net income. In effect, the client is avoiding income taxes on the $10,000 in the year in which it's earned. If a plan is funded solely with pre-tax contributions, it's said to have a *zero-cost basis* (i.e., the funds have not yet been subject to tax).

Taxation of Income and Trading Events During the Plan's Life The plan investments may generate income in the form of dividends and/or interest. Also, securities may be bought and sold within the plan. From a tax standpoint, none of these events matter since all activity within these plans is tax-sheltered (tax-deferred).

Taxation of Distributions As described earlier, distributions of pre-tax monies are typically taxable at ordinary income rates, as will all of the income and trading profits that occurred over the life of the plan. All distributions of post-tax monies will be free from taxation since these funds have already been taxed.

> * Note: The government may even allow the owners of certain plans, such as Roth IRAs and 529 college savings plans, to avoid taxation on the plan growth if the assets are used for the purpose for which they were intended and held within the plan for a minimum prescribed period.

Types of Plans

Profit-Sharing Plans Profit-sharing plans are funded by employers and allow for discretionary annual contributions from company profits. If the company is not doing well, the employer may skip that year's contribution entirely.

 Copyright © Securities Training Corporation. All Rights Reserved.

The decision as to whether contributions will be directed to the plan is made by the board of directors of the employer. Ultimately, providing this employee benefit may have a positive impact on an employer's ability to recruit and retain quality employees. If a company decides to contribute funds to the plan, it must allocate these funds to the employees in accordance with a predetermined formula. Generally, each participant receives a certain percentage of his salary.

For example, if a company decides to contribute 10% of each employee's salary for one year, then an employee earning $30,000 would receive a $3,000 contribution. Companies with unpredictable cash flows may find profit-sharing plans work well with their business.

Limitations on Contributions The employer contributions are tax-deductible and the earnings grow on a tax-deferred basis; however, the maximum annual contribution amount is determined by the IRS (inflation adjusted).

401(k) Plans 401(k) plans provide employees with retirement plan benefits that are based on the value in the employee's account at retirement. Both employers and employees can contribute to the plan. These plans are suitable for any small to large employers (including both for-profit and non-profit businesses) that want to offer a salary reduction plan with design options to their employees.

In most plans, the employees decide how to allocate their contributions from a list of investment options that are selected by their employer. This list typically includes stock funds, bond funds, a money-market fund, a guaranteed investment contract and, occasionally, employer stock. Registered representatives should caution clients, particularly if they're older, about investing too much of their 401(k) contributions in their employer's stock. The fear is the potential devastating impact on a client's retirement portfolio if the stock declines in value shortly before the client is planning to retire.

Eligibility With the passage of the Setting Every Community Up for Retirement Enhancement (SECURE) Act, access to retirement savings plans has been enhanced. One of the enhancements specifically impacts employers that offer 401(k) plans. Employers that maintain 401(k) plans are required to implement a dual eligibility requirement under which employees are eligible to participate if they complete either:

1. A one-year of service requirement (with the existing 1,000-hour requirement) or
2. Three consecutive years of service during which the employees complete at least 500 hours of service

Contribution Limits The contributions are made pre-tax (deductible) and the earnings grow on a tax-deferred basis; however, the maximum annual contribution amount is determined by the IRS (inflation adjusted). For employees who are age 50 or older, an additional amount may be contributed annually.

Copyright © Securities Training Corporation. All Rights Reserved.

Roth 401(k) Plans In many ways, Roth 401(k) plans are similar to 401(k) plans, with the exception of how employees are taxed. In 401(k) plans, employees are allowed to make contributions on a pre-tax basis. Roth 401(k) plans, just like Roth IRAs, only permit non-deductible (after-tax) contributions. However, qualified withdrawals from Roth 401(k) plans are excluded from federal tax. This means that employees are not required to pay taxes on capital gains, bond interest, or dividends.

403(b) Plans Section 403(b) plans are tax-deferred retirement plans that are available to employees of public school systems as well as employees of tax-exempt, non-profit organizations that are established under *Section 501(c)(3),* such as charitable or religious organizations. These plans are also referred to as *tax-deferred annuities (TDAs)* or *tax-sheltered annuities (TSAs)*.

While a 403(b) plan is technically not a qualified plan, it resembles a 401(k) plan by allowing the participants to exclude the contributions that they make from their taxable incomes (i.e., contributions are made pre-tax) and the earnings grow on a tax-deferred basis. As with a 401(k) plan, the maximum annual contribution amount to a 403(b) plan is determined by the IRS (inflation adjusted). Employers may also make matching contributions for their employees. Investments in a 403(b) plan are typically limited to mutual funds, fixed annuities, and variable annuities. An important note is that investors are not permitted to buy limited partnerships in a 403(b) plan.

Conclusion

This concludes the review of both the different types of customer accounts and the different forms of account registration. The next chapter will focus on a broker-dealer’s compliance considerations. Attention will be paid to anti-money laundering (AML) provisions, recordkeeping requirements, and communication with the public.

Chapter 14 Summary

Now that you’ve completed this chapter, for the following commonly tested concepts, you should be able to:

- Recognize the characteristics of cash accounts and margin accounts
- Understand and apply the minimum equity requirements for a new margin account
- Understand the procedures and required disclosures for opening margin accounts and options accounts
- Understand the requirements for opening and maintaining a discretionary account
  - Recognize the difference between full and limited power of attorney
- Understand the characteristics of a not-held order (time and/or price discretion)
- Compare and contrast the characteristics of:
  - Fee-based versus commission-based accounts
  - Coverdell ESAs versus 529 plans

 Copyright © Securities Training Corporation. All Rights Reserved.

- Understand the general process for opening a standard brokerage account, including:
  - Information required and any additional documentation
  - Rights, privileges, responsibilities, and limitations of the parties involved in a joint and/or minor's account
- Compare and contrast the different types of retirement accounts and determine the suitability for each type of account
  - Annual contribution limits
  - Whether RMD rules apply
  - Tax treatment of both contributions and withdrawals
- Understand the characteristics of employer sponsored (ERISA) plans and individual retirement plans

Create a Chapter 14 Custom Exam

Now that you've completed Chapter 14, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 15 – Compliance Considerations

- *Opening and Updating Client Accounts*
- *USA Patriot Act and Anti-Money Laundering Rules*
- *Regulation SP and Customer Statements*
- *Communication Rules and Protecting the Customer*

Copyright © Securities Training Corporation. All Rights Reserved.

The goal of this chapter is to increase a person's knowledge of the rules and regulations regarding anti-money laundering (AML), AML compliance programs, monetary reports, the U.S. Treasury's Office of Foreign Asset Control (OFAC), recordkeeping requirements, customer mail, business continuity plans, privacy requirements, Regulation S-P, communications with the public, telemarketing, suitability requirements, and know-your-customer (KYC) rules.

New Account Documentation

This chapter will address the process of opening customer accounts. For broker-dealers and their RRs, proper compliance with many securities industry requirements begins with how they collect and document customer information for opening and maintaining accounts. Effective recordkeeping protects the interests of the customers, the firms, and the registered representatives. When opening a new account, certain information regarding the customer must be obtained to comply with industry rules.

FINRA's Know Your Customer (KYC) Rule requires firms to use reasonable diligence to know the *essential facts* regarding every customer as well as any person who has been given the authority to act on the customer's behalf. The USA PATRIOT Act (described later in the chapter) imposes additional requirements on firms regarding both the verification of potential clients' identities and subsequent monitoring to ensure that they're in compliance with anti-money laundering regulations.

Customer information is collected on a new account form not only to satisfy regulatory requirements, but also to help the registered representative and the firm understand the customer's investment objectives and ensure that her suitability concerns are addressed. Of course, every firm's new account form is slightly different, but all firms must collect certain minimum information in order to meet industry standards.

Required Information

A registered representative who intends to open an account for a customer must obtain all required information prior to entering the initial order in the account. According to FINRA, the following customer information is *required* to be obtained:

- The customer's name and residence (although a P.O. box may not be used to open an account, correspondence may be sent to a P.O. box)
- Whether the customer is of legal age
- The name of the registered representative (RR) who is responsible for the account. If there's more than one RR responsible for the account, a record of the scope of responsibility for each representative is required. This provision doesn't apply to an institutional account *.
- The signature of the partner, officer, or manager (principal) who approves the account

** An institutional account is one that's established for a bank, savings and loan association, insurance company, registered investment company, registered investment adviser, or any person with total assets of at least $50 million.*

Copyright © Securities Training Corporation. All Rights Reserved.

If the customer is a business or organization rather than a person, an RR is required to obtain the names of the individuals who are authorized to transact business for the account.

Prior to the settlement date of the initial transaction, a registered representative must also make a *reasonable effort* to obtain the following customer information:

- Taxpayer ID number (TIN), such as a Social Security number
- Occupation and name and address of the customer's employer
- Whether the customer is associated with another member firm

This requirement doesn't apply to either institutional accounts or accounts in which transactions are only effected in non-recommended investment company shares (mutual funds).

Required Signatures Once the customer's information is obtained, a principal of the firm must sign the new account form to indicate his approval. Although many broker-dealers have in-house rules requiring customers to sign the new account form, industry rules don't require their signatures when opening a cash account. However, for customers who are seeking to open margin and/or option accounts, their signatures are required.

SEC Recordkeeping Requirements

In addition to FINRA's recordkeeping requirements for customer accounts, SEC Rule 17a-3 requires broker-dealers to maintain the following records for each customer or owner of an account:

- Name
- Tax ID number
- Address
- Telephone number
- Date of birth
- Employment status, occupation, and whether the customer is associated with a broker-dealer
- Annual income and net worth (excluding principal residence)
- Investment objectives

Any information that provides insight into a client's investment experience is critical when determining suitability; however, information regarding a client's educational background is *not* required to be collected. There may be circumstances in which customers are unwilling to provide their broker-dealers with certain personal information (e.g., their financial background). If an effort is made to collect the information, but the prospective customer refuses, an RR should (as a matter of good practice) document the fact that the effort was made to obtain the data. The documentation could be as simple as writing *refused* in the appropriate space on an account form, with no explanation required. Principals may refuse to approve an account if they feel that the prospective customer has provided the firm with insufficient information to appropriately assess investment objectives and/or suitability issues.

 Copyright © Securities Training Corporation. All Rights Reserved.

Trusted Contact Person When a customer account is opened, a firm must make a reasonable effort to obtain the name of, and contact information for, a trust contact person of the customer's choosing. If obtained, the firm is required to disclose to the customer in writing, which may be electronic, that an associated person of the firm is authorized to contact the trusted contact person and disclose information about the customer's account.

The purpose of any disclosure is to address possible financial exploitation or to confirm the specifics of the customer's current contact information, health status, or the identity of any legal guardian, executor, trustee, or holder of a power of attorney.

Verification and Ongoing Updating of Client Information To ensure that an RR has properly characterized a client's profile and investment objective, copies of the account record or the documentation of the information collected must be sent to the customer either within 30 days of opening the account *or* with the client's next statement. Periodic updates and verification of account information must be sent to the customer at least every 36 months.

Change of Information If a customer provides a broker-dealer with updated account record information, the broker-dealer must send a copy of the revised account record to the customer. Member firms are required to send the updated documentation within 30 days after it received notification of the change or at the time the next statement is mailed to the customer. Examples of the changes that may be made to an account record include a name, address, and/or investment objective change. If a request is made to change a client's address, notification must be sent to both the previous address on file and to the registered personnel who are responsible for the account within 30 days of the change.

Know Your Customer and Suitability

A broker-dealer must use reasonable diligence to learn the important facts regarding every customer. In other words, according to the regulators, it's vital to *know your customer* to provide them with appropriate services. This obligation extends to any person who is authorized to act on behalf of a customer, including an investment adviser that has been given the authority to enter orders in a customer's account. Only after a registered representative understands the financial needs of his customers are the proper investment recommendations able to be made.

Suitability

Broker-dealers have a suitability obligation to each of their customers. For non-institutional (retail) customers, broker-dealers and their registered persons must have a reasonable basis for recommending a specific transaction or investment strategy (e.g., day trading or margin trading). These recommendations must be based on information that's obtained from the customers and then used to identify their investment profile.

Copyright © Securities Training Corporation. All Rights Reserved.

A customer's investment profile includes the following items:

- Age
- Other investments
- Financial situation and needs
- Tax status
- Investment objectives and experience
- Investment time horizon
- Liquidity needs
- Risk tolerance
- Any other information obtained from the customer

Although customers are not obligated to provide all of the information listed above, an RR should make an effort to obtain as much information as possible to provide the most suitable recommendations.

An investment recommendation should be in the customer's (not RR's) best interest. The simple fact that a customer may agree to a recommendation doesn't relieve a firm of its suitability obligation. Some examples of potential violations of the suitability rule include:

- RRs making recommendations of one product over another in an effort to generate large commissions
- RRs making mutual fund recommendations that are designed to maximize their commissions rather than to establish a portfolio for their customers
- RRs attempting to increase their commissions by recommending the use of margin
- RRs recommending a new issue that's heavily promoted by their firm in an effort to keep their jobs

FINRA has established the following three main suitability obligations:

1. The *reasonable basis obligation* – Requires a member firm and its RRs to have a reasonable basis to believe that a recommendation is suitable for at least some investors. If the firm or its RRs don't understand a product, it should not be recommended to customers.
2. The *customer-specific obligation* – Requires a member firm and its RRs to have a reasonable basis to believe that a recommendation is suitable for a particular individual based on the customer's investment profile
3. The *quantitative obligation* – Requires a member firm and its RRs to have a reasonable basis to believe that a series of recommended transactions, even if they're suitable for a customer, are not excessive when considering the customer's investment profile

Age-Based Suitability Concerns A customer's age is typically one of the factors used to determine if a specific transaction is suitable. For clients who are younger and willing to assume greater risks, listing their investment objective as growth and/or speculation may be suitable. However, age-based suitability determinations are more difficult for income producing investments since they range from high risk (non-investment grade securities) to very safe instruments (U.S. Treasury securities).

 Copyright © Securities Training Corporation. All Rights Reserved.

In fact, there are certain situations in which a firm may determine that age is irrelevant in determining suitability. For example, if a customer is seeking liquidity to meet a short term obligation, age is not a factor when making the investment decision since liquidity is the overriding concern. If a client is seeking capital preservation, age is again not a factor since safety of principal is the overriding concern.

Institutional Suitability Institutional suitability obligations may vary based on the nature of the institution. Some of these customers are sophisticated and manage billions of dollars, while others may be relatively new to the investment process. For a broker-dealer to determine the extent of its suitability obligations regarding an institutional customer, there are two important guidelines:

1. The firm and the RRs servicing the account must have a reasonable basis to believe that the institutional customer can evaluate investment risks independently, both in regard to the specific securities and the different investment strategies.
2. The institutional customer must affirmatively state that it's exercising independent judgment in evaluating the recommendations.

When dealing with institutional customers, firms are exempt from the *customer-specific obligation* that was listed previously. However, the *reasonable basis* and *quantitative obligations* standards still apply.

Regulation Best Interest (Reg BI)

In June of 2019, the SEC adopted a package of rulemakings and interpretations that are designed to enhance the quality and transparency of *retail customers'* relationships with broker-dealers and investment advisers. These rules will bring the legal requirements and mandated disclosures in line with reasonable investor expectations, while preserving access (in terms of choice and cost) to a variety of investment services and products. Specifically, these actions include new Regulation Best Interest, the new Customer Relationship Summary (Form CRS), and separate interpretations under the Investment Advisers Act of 1940.

Regardless of whether a retail customer chooses a broker-dealer or an investment adviser (or both), the retail customer is entitled to a recommendation (from a broker-dealer) or advice (from an investment adviser) that's in the customer's best interest and that doesn't place the interests of the firm or the financial professional ahead of the customer's interests. In other words, any strategy or product that firms or individuals recommend to retail customers must be in the customers' best interest (not just suitable).

Who's a Retail Customer? Currently, Reg BI only applies to retail customers. According to the regulation, a retail customer is defined as a natural person, or this person's *non-professional legal representative*, who:

- Receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer; and
- Uses the recommendation primarily for personal, family, or household purposes

Professional legal representatives (e.g., financial industry professionals) and other fiduciaries are not considered retail customers.

Copyright © Securities Training Corporation. All Rights Reserved.

Client Relationship Summary (Form CRS) Along with the passage of Reg BI, the SEC adopted a new relationship summary disclosure document that broker-dealers must provide for retail customer—the *Client Relationship Summary (Form CRS)*. Form CRS must be no longer than two pages. The purpose of Form CRS is to provide retail investors with information about the nature of their relationship with their financial professional in a simple, easy-to-understand format.

- New retail investors must receive a copy of Form CRS by no later than the time they open a brokerage account, place an order, or receive a new recommendation for an account type, securities transaction, or investment strategy.

Broker-dealers must file Form CRS with the Central Registration Depository (CRD), while registered investment advisers must file Form CRS with the Investment Adviser Registration Depository (IARD) as Part 3 of Form ADV.

Anti-Money Laundering and the USA PATRIOT Act

The Bank Secrecy Act (BSA) is the primary U.S. anti-money laundering (AML) law. However, the BSA has been amended to include certain provisions of the USA PATRIOT Act to detect, deter, and disrupt terrorist financing networks that use laundered money to fund their operations. In response to the September 11, 2001 attack, President Bush signed the USA PATRIOT Act into law. The Act imposed a number of new regulatory obligations on broker-dealers and focused renewed attention on previously established AML laws.

Money laundering generally takes place in the following three stages:

1. *Placement*—The money launderers place illegal cash into the flow of a broker-dealer's business, most often through the purchase of securities.
2. *Layering*—The launderers execute transactions in several layers to avoid detection or the triggering of a reporting requirement. One form of layering (also referred to as structuring) involves the purchase of several blocks of securities each with cashier's checks that are drawn on different institutions and in amounts of less than $10,000. Taking opposite positions on the same security (e.g., both long and short positions) or using different customer accounts for each purchase are other sophisticated forms of layering.
3. *Integration*—The launderers put the proceeds from the transactions back into the stream of commerce, making them appear to be from a legitimate source. For example, securities are purchased with illegally obtained cash, then after their sale, the proceeds are deposited in a bank account. Once the funds are used to purchase goods and services, the money has now been successfully integrated into the legitimate economy.

FinCEN's Required Reports

The Financial Crimes Enforcement Network (FINCEN) is a part of the U.S. Department of the Treasury whose main purpose is to create and implement policies and procedures that are designed to detect and prevent money laundering.

 Copyright © Securities Training Corporation. All Rights Reserved.

The two primary means by which FinCEN accomplishes its objectives are:

1. Requiring financial institutions (e.g., broker-dealers) to file certain transactions reports under the provisions of the Bank Secrecy Act (BSA), and
2. Providing law enforcement agencies with the information from the reports to assist in combating money laundering

Broker-dealers are required to file *Bank Secrecy Act Currency Transaction Reports (BCTRs).* The BCTR is filed for all cash transactions that exceed $10,000 and are executed by a single customer during one business day. The definition of currency includes both cash and coins. The reporting requirement is also triggered if a customer places multiple, smaller transactions in a single day that, in the aggregate, exceed $10,000.

> *For example, one morning, a customer deposits $6,000 of cash at one of her brokerage firm's branch offices. Later, on the same day, she deposits an additional $7,000 in traveler's checks at one of the firm's other branch offices. The broker-dealer must file a BCTR to report these transactions since they total more than $10,000 when combined and they occurred on the same day.*

The customer's actions are an example of *structuring*. Structuring occurs when a customer executes several small transactions in dollar amounts that are below the reporting thresholds to evade the reporting requirements. Registered representatives should be on the alert for clients who execute several transactions in amounts that are just below the $10,000 reporting level or clients who deposit instruments that are sequentially numbered.

Broker-dealers may also be required to file *Suspicious Activity Reports (SARs)*. Until the USA PATRIOT Act was passed, only broker-dealers that were subsidiaries of bank holding companies were required to file SARs.

Today, a firm must file an SAR whenever a transaction (or group of transactions) equals or exceeds $5,000 and the firm suspects one of the following activities:

- The client is violating federal criminal laws.
- The transaction involves funds related to illegal activity.
- The transaction is designed to evade the reporting requirements (structured transactions).
- The transaction has no apparent business or other legitimate purpose and the broker-dealer cannot determine a reasonable explanation after examining all the available facts and circumstances surrounding the transaction (i.e., something just doesn't seem right).

The filing of an SAR is confidential, as is the information contained in the report. Under no circumstances may a registered representative inform the subject of an SAR that the report has been filed. Instead, disclosure may only be made to federal law enforcement or securities regulators.

Copyright © Securities Training Corporation. All Rights Reserved.

Mandatory AML Compliance Programs

All broker-dealers are now required to establish AML Compliance Programs which, at a minimum, must include:

- Policies and procedures that are reasonably expected to detect and report suspicious transactions and deter money laundering
- The designation of a compliance officer who is responsible for the firm's AML program (There's no requirement for this person to be FINRA-registered.)
- An ongoing employee training program
- An independent audit function to test the effectiveness of the firm's AML program

Industry rules also require AML programs to be in written form and approved by a member of senior management. The independent audit function, sometimes referred to as a *stress test*, must be conducted annually unless the member firm doesn't execute transactions for customers or otherwise hold customer accounts (i.e., it's a proprietary trading firm). In these cases, the stress test is only required to be conducted every two years (on a calendar-year basis).

Customer Identification Program (CIP) As a part of their AML compliance program, broker-dealers must create a customer identification program in order to verify the identity of any person who seeks to open an account. Firms are also required to maintain records of the information used to verify a person's identity and determine whether the person is listed as a known or suspected terrorist or an affiliated organization.

Specially Designated Nationals and Blocked Persons List Firms and their representatives must make certain that they're not doing business with any person whose name is on a list that's maintained by the Treasury Department's Office of Foreign Assets Control (OFAC). This list is referred to as the Specially Designated Nationals and Blocked Persons List, or simply the *SDN List*.

The SDN List identifies known and suspected terrorists, other criminals, as well as pariah nations (e.g., Syria and Iran). Doing business with any of these individuals or entities is prohibited. If a firm discovers that one of its clients is on the SDN List, it must block all transactions immediately and inform the federal law enforcement authorities.

Broker-dealers are required to exercise special due diligence when opening private banking accounts for foreign nationals. They're also prohibited from maintaining correspondent accounts for foreign shell banks (i.e., banks with no physical presence in any country).

Customer Verification A broker-dealer must verify a customer's identity within a reasonable period either before or after the customer's account is opened. Under the new regulations, the following minimum information is *required* to be obtained from a customer:

- Name
- Date of birth (for an individual, not a business)
- Address (For an individual this must be a residential or street address. For corporate accounts, it must be a principal place of business or local office.)

 Copyright © Securities Training Corporation. All Rights Reserved.

- An identification number:
  - For U.S. citizens: taxpayer ID number (e.g., Social Security number or employer identification number)
  - For non-U.S. citizens: taxpayer ID number, passport number and country of issuance, alien identification card number, or government-issued identification showing nationality, residence, and photograph

A broker-dealer may use documentary (e.g., driver's license or passport) or non-documentary (e.g., references from other financial institutions or consumer reporting agencies) methods in order to verify the identity of a customer.

Taxpayer ID Exception A broker-dealer that receives an application to open an account may waive the obligation of obtaining a taxpayer ID number if the person has applied for, but not yet received, the number. However, in lieu of the number, the broker-dealer must retain a copy of the person's taxpayer identification application.

Record Retention Under the CIP rules, a broker-dealer must maintain records of the methods it used to verify a customer's identity for five years following the closing of the account. In addition, broker-dealers are required to retain records related to transmittals or transfers of funds (e.g., wire transfers) that exceed $3,000. This includes the order details, names of the transmitter and recipient, as well as the identity of the recipient's financial institution.

Penalties In an effort to discourage money laundering activities, the penalties for violating existing AML laws are severe and include both potential incarceration and fines. Under criminal law, a registered representative who is found guilty of facilitating money laundering may be sentenced to 20 years in prison and may receive a fine of up to $500,000 per transaction or twice the amount of the funds involved—*whichever is greater*.

Registered representatives don't need to have knowledge of a money laundering scheme or even participate in it to be prosecuted. Instead, RRs and their firms may be held liable for being willfully blind to the activity.

SEC Regulation SP

Privacy of Consumer Financial Information

In November 1999, the Gramm-Leach-Bliley Act was enacted to require institutions that are engaged in certain financial-related activities to (1) establish privacy policies with regard to information they collect from and about their customers, (2) notify customers of those privacy policies, and (3) give customers the right to *opt-out* of any disclosures of their *non-public personal information* to certain third parties (i.e., customers may instruct the financial institution that their information may not be disclosed to unaffiliated third parties).

Copyright © Securities Training Corporation. All Rights Reserved.

The SEC adopted rules to implement these privacy requirements under Regulation SP which applies to all broker-dealers, investment companies, and SEC-registered investment advisers.

Confidentiality Requirements and Safeguard Requirements In order to safeguard customer records and information, every broker-dealer is required to adopt policies and procedures to physically safeguard customer records and information. These polices must ensure the security and confidentiality of customer records and information, protect against anticipated threats or hazards to the security or integrity of customer account records, and protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

Scope of Information That Must Be Protected Remember, Regulation SP is protecting a customer's *non-public, personal information* which includes information that a financial institution obtains from the customer. Non-public information can also be created from customer lists based on personally identifiable information (e.g.., personal financial and account information).

However, disclosure of a customer's *publicly available information* is not restricted under the regulation. Publicly available information includes that which is lawfully available to the general public from official public records, information from widely distributed news media (e.g., information found on the internet), and information that's required to be disclosed to the general public by federal, state, or local law.

Privacy Notice Under Regulation SP, firms must provide their customers with a description of their privacy policies (a privacy notice) at the time of the account opening and annually thereafter. Among other things, these privacy notices must state the types of personal information that the firm collects and the categories of both affiliated and unaffiliated third parties to whom the information may potentially be disclosed.

The timing of the notice depends on the client's relationship with the firm. Regulation SP divides clients into two categories—consumers and customers. A *consumer* is a person who is in the process of providing information to the firm in connection with a potential transaction. A *customer* is a person who has an ongoing relationship with the firm.

> *For example, if John has a meeting with a financial adviser from ABC Securities about establishing a financial plan, he's a consumer (a potential customer). However, if John opens an account with ABC Securities, he's a customer.*

For *consumers*, a firm must provide a privacy notice before it discloses non-public, personal information to any unaffiliated third party. However, if the firm doesn't intend to disclose any consumer information to an unaffiliated third party, then a notice is not required to be provided. For customers, a firm must initially provide a privacy notice at the time the relationship is first established. Thereafter, it must follow up with an updated version of this notice annually.

 Copyright © Securities Training Corporation. All Rights Reserved.

The notice must disclose to consumers/customers that they have the right to opt-out of having their information shared with unaffiliated third parties and the process for opting out. The opt-out method being used by a broker-dealer must be reasonable. Acceptable methods include electronic responses or a toll-free telephone number for customers to call; however, requiring a customer to write a letter is unreasonable.

Identity Theft Prevention—FTC Red Flags Rule

The Federal Trade Commission's (FTC) Red Flags Rule requires many financial institutions, such as banks and broker-dealers, to create and implement a written Identity Theft Prevention Program. Each firm must have policies and procedures that address the appropriate actions to take if identity theft is suspected and/or detected.

The intent of the rule is to assist firms in quickly spotting suspicious activities (red flags) with the goal of preventing the theft of their clients' assets. The policies and procedures that are found under these programs must be referenced in a firm's Written Supervisory Procedures documentation.

Use of Stockholder Information for Solicitation As indicated by Regulation SP and the FTC Rule, firms and their RRs are responsible for protecting their client's information. This requirement raises an important question—can a firm that's acting as a trustee for a corporation use a shareholder list to cold-call or prospect in other matters? Generally, this practice is a violation of industry rules. SRO rules don't allow a trustee to use stockholder information for solicitation purposes unless the member firm is specifically directed to do so by, and for the benefit of, the corporation.

Client Notifications

Once an account is opened, broker-dealers are required to provide the client with information, including trade confirmations, statements, and other miscellaneous mailings. The SEC mandates the frequency and timing of the delivery of this information.

Account Statements and Other Notifications At least quarterly, broker-dealers are required to provide customers with account statements. Most firms provide monthly statements for any account in which activity has occurred.

At a minimum, the account statement must contain:

- A description of all security positions
- All money balances
- All account activity since the last statement

Account activity includes purchases, sales, interest credits or debits, charges or credits, dividend payments, transfer activity, securities receipts or deliveries, and/or journal entries relating to securities or funds in the possession or control of the broker-dealer.

Copyright © Securities Training Corporation. All Rights Reserved.

Confirmations Statements The SEC requires broker-dealers to provide customers with a detailed confirmation of each purchase or sale. The confirmation must be given or sent at or before the completion of any transaction—which is generally the settlement date. The confirmation must include the following information:

- The identity and price of the security bought or sold
- The number of shares, units, or principal amount
- The date of the transaction, as well as the time of execution (or a statement that the time will be furnished on written request)
- The capacity in which the broker-dealer acted, such as:
  - Agent for the customer
  - Agent for another person
  - Agent for both the customer and another person (referred to as a cross)
  - Principal for its own account
- The commission, mark-up, or mark-down for the transaction, calculated in compliance with applicable rules and expressed as a total dollar amount and as a percentage of the prevailing market price.
- The dollar price and yield information on debt securities
- Whether a security is callable and a statement that further information will be provided on request
- The settlement date

Even if an RR has discretion over a customer's account, confirmations for all transactions must be sent to the customer. Statements and trade confirms may also be sent to an investment adviser or other third party, but only if the written consent of the customer is obtained.

Holding of Client Mail A firm may hold mail for a customer who will not be receiving it at his usual address provided the firm:

- Receives written instructions from the customer which include the time period during which the mail will be held. If the period requested *exceeds three consecutive months,* the customer's instructions must include the valid reason for this request. However, convenience is not considered a valid reason.
- Gives written disclosure to the customer regarding alternative methods through which he may monitor the account (e.g., through e-mail or the firm's website).
- At reasonable intervals, verifies that the customer's instructions still apply.

During the time that the customer's mail is being held, the firm is also required to ensure that the mail is not being tampered with, held without the customer's consent, or used by any of the firm's associated persons in a manner that violate securities laws.

 Copyright © Securities Training Corporation. All Rights Reserved.

Electronic Delivery of Client Records All account records, such as confirmations, statements, and tax reporting information may be delivered to the client electronically. Under SEC rules, providing client access to the records equates to delivery. Essentially, if a client chooses to receive electronic documents, there's no need to follow up with paper copies. Some firms may charge customers a nominal processing fee if they choose to have confirmations processed in a paper format.

Regulation of Communications

FINRA divides communications with the public into three categories—*correspondence, institutional communications,* and *retail communications*. For exam purposes, part of the challenge is being able to distinguish between the different forms in situational questions.

Correspondence

Traditionally, correspondence has been viewed as any communication that's sent to one person. However, FINRA's current definition is more precise. Correspondence is defined as written or electronic messages that a member firm sends to *25 or fewer* retail investors within any 30-calendar-day period. The 25 or fewer investors may be any type of retail client (i.e., existing and/or prospective). The typical delivery methods include physical (paper) written letters, text messages, and e-mail.

Institutional Communications

Institutional communication includes any type of written or electronic communication that's distributed or made available *only* to institutional investors, but doesn't include a member firm's internal communications. FINRA defines institutional investors as:

- Banks, savings and loans, insurance companies, registered investment companies, and registered investment advisers
- Government entities and their subdivisions
- Employee benefit plans, such as 403(b) and 457 plans, and other qualified plans with at least 100 participants
- Broker-dealers and their registered representatives
- Individuals or entities with total assets of at least $50 million
- Persons acting solely on behalf of these institutional investors

Under FINRA rules, a member firm must establish policies and procedures that are designed to prevent institutional communications from being forwarded to retail investors. One acceptable method is placing a legend on the communication stating, "*For Use by Institutional Investors Only*."

If a member firm becomes aware that an institutional investor (e.g., another broker-dealer) is making institutional communications available to retail investors, the firm is required to treat future communications to that institutional investor as retail communications.

Copyright © Securities Training Corporation. All Rights Reserved.

Retail Communications

Retail communication is defined as written or electronic communications that are distributed or made available to *more than 25* retail investors within a 30-calendar-day period. A retail investor is considered any person who doesn't meet the definition of an institutional investor.

Retail communications are the broadest category and include both advertising and sales literature. All materials that are prepared for the public media in which the ultimate audience is unknown are considered retail communications, including:

- Television, radio, and billboards
- Magazines and newspapers
- Certain websites and online interactive electronic forums, such as chat rooms, static blogs, or social networking sites (assuming retail investors have access to these sites)
- Telemarketing and sales scripts
- Independently prepared reprints (e.g., newspaper or magazine articles) that are sent to more than 25 retail investors

E-Mail and Instant Messaging A challenging aspect to e-mail and instant messages is that they may ultimately be considered correspondence, retail communications, or institutional communications. For example, e-mail that's sent only to registered investment advisers (i.e., institutional investors) is considered institutional communication. E-mail that's sent to 25 or fewer retail investors is considered correspondence. And finally, e-mail that's sent to more than 25 retail investors is considered retail communication.

Social Media Sites Social media sites fall under the requirements of a public appearance and certain disclosures may be required. Since firms may be unable to monitor their RRs' activities on these sites, most firms don't permit their representatives to use them for communicating with customers or conducting business.

Approvals Correspondence and institutional communication must be supervised and reviewed by the brokerage firm; however, they don't require approval. Unless an exception applies, retail communication must be approved by a qualified principal (supervisor) of the firm. In addition, certain types of retail communication (e.g., those related to options and mutual funds) must also be filed with FINRA.

Telemarketing — An Alternative Communication Method

The process of attracting new customers is often accomplished through telephone solicitations or cold calling. In an effort to combat abuses, Congress passed the federal Telephone Consumer Protection Act of 1991 which applies to both wired and wireless telephone numbers.

 Copyright © Securities Training Corporation. All Rights Reserved.

The industry has incorporated the main provisions of this law into their SRO rules, including the following:

- Telephone solicitations may be placed only between 8:00 a.m. and 9:00 p.m. local time of the party being called, unless that person has given prior consent or the person being called is another broker-dealer.
- When calling prospective customers, callers must provide their name, the entity or person on whose behalf the call is made (e.g., the name of the member firm), a telephone number or address where that entity or person may be reached, and that the purpose of the call is to solicit the purchase of securities or other related services. This information must be provided promptly and in a clear and conspicuous manner.
- Each broker-dealer is responsible for creating a Do Not Call List. If an individual is solicited by telephone and asks not to be called again, the broker-dealer must place that number on the list. Under FINRA rules, broker-dealers are required to honor a person's do not call request within a reasonable period, which may not exceed 30 days from the date the request was made. In addition, the firm must train its registered personnel to use the list properly and must create a written policy to describe how the list will be maintained.
- Registered representatives may not make calls that harass or abuse the person called. Examples of prohibited behavior include using language that may be interpreted as threatening or intimidating, using profane or obscene language, or causing a phone to ring repeatedly or continuously with the intent to annoy, abuse, or harass.
- When a broker-dealer engages in telemarketing, it's required to ensure that its outbound telephone number is not being blocked by the recipient's caller identification service.
- The rule prohibits the use of pre-recorded messages unless the broker-dealer has received the caller's prior written permission.

FINRA recognizes that when a representative has an existing relationship with a customer, it may be important to contact the client outside the 8:00 a.m. to 9:00 p.m. window. Therefore, the time-of-day and disclosure requirements don't apply to calls made to clients with whom the firm has an established business relationship. However, the purpose of these calls must be to maintain or service the existing accounts of the firm.

An *established business relationship* between a broker-dealer and a person exists when one of the following conditions is met:

- Within 18 months prior to the telemarketing call, the person has made a securities transaction, or has a security position, a money balance, or account activity with the broker-dealer or its clearing firm.
- Within 18 months prior to the telemarketing call, the firm making the call is considered the broker-dealer of record for the account.
- Within three months prior to the telemarketing call, the person has contacted the broker-dealer to inquire about a product or service that's offered by the firm.

Copyright © Securities Training Corporation. All Rights Reserved.

National Do Not Call List

When a person registers her telephone number on the Federal Trade Commission's (FTC) National Do Not Call registry, an RR is prohibited from contacting her. Firms are required to update their Do Not Call list by contacting the FTC and adding any telephone number that appears on the national list.

However, one exception to the prohibition is when the person to be called has *given prior written consent to being contacted* by the member firm. Another exception is based on a *personal relationship that exists* between the RR and the person to be called, such as a family member, friend, or an acquaintance.

Safekeeping of Customer Funds and Securities

Several SEC rules are designed to protect customer funds and securities that are in the possession of broker-dealers.

The Customer Protection Rule

SEC Rule 15c3-3 (the Customer Protection Rule) contains provisions to ensure the safekeeping of both customer securities and customer funds. The rule defines a customer as any person for whom the broker-dealer holds funds or securities, but doesn't include another broker-dealer, a partner, officer, or director of the broker-dealer, or a subordinated lender.

Customer Securities A broker-dealer is required to promptly obtain and thereafter maintain physical possession or control of all fully paid and excess margin securities that belong to its customers. The term *control of securities* means that the securities are under the direct control of the broker-dealer. The rule defines several sites as good control locations, including the office of the broker-dealer, in transit between its offices, or in an SEC-approved depository (e.g., the DTC).

Excess margin securities are defined as those securities whose value exceeds 140% of the debit (loan) balance of a customer. For example, a customer who owns stock worth $10,000 and has a debit balance of $5,000 would have excess margin securities worth $3,000 ($10,000 – [140% x $5,000]).

On a daily basis as of the close of the preceding business day, a broker-dealer is required to compute the quantity of fully paid and excess margin securities that are in its possession or control and those that are not in its possession or control. The broker-dealer is required to take affirmative action to promptly obtain possession and control of the required amount of securities. If a customer sells securities and fails to deliver the securities within 10 business days of the settlement date, the broker-dealer must buy in the customer. Under exceptional circumstances, the broker-dealer may apply to FINRA for an extension.

Copyright © Securities Training Corporation. All Rights Reserved.

Customer Free Credit Balances

SEC rules require broker-dealers to advise their customers regarding their free credit balances on at least a quarterly basis. Free credit balances represent the funds that are available to customers, but that are currently on deposit in their accounts (e.g., sales proceeds that haven't been reinvested or withdrawn). Customers must receive written notice of the amount that's due to them along with a statement that the funds are payable on demand.

The notice is also required to state that the funds are not segregated and may be used in the conduct of the broker-dealer's business. If the broker-dealer sends statements to its customers more frequently than quarterly, notification of the free credit balances must be sent with each statement.

A broker-dealer is not required to comply with these provisions if it segregates customer free credit balances in such a way that prohibits their use by the broker-dealer.

FINRA Rules

While most financial responsibility rules have been created by the SEC, FINRA has additional rules that are designed to enhance the fiscal security of members and their customers.

Disclosure of Financial Condition Member firms are required to send balance sheets to customers every six months and (upon request) make available to customers a copy of the firm's most recent balance sheet. A customer is defined as any person having funds or securities in the possession of the member firm.

Fidelity Bonds

FINRA members that are required to join the Securities Investors Protection Corporation (SIPC) must maintain a blanket fidelity bond (essentially an insurance policy) which covers officers and employees and provides protection against loss for fidelity (on premises or in transit), forgery and alteration (including check forgery), securities loss (including securities forgery), and counterfeit currency. The bond must include a provision that the carrier will promptly notify FINRA if the bond is canceled, terminated, or substantially modified.

Business Continuity Plan (BCP)

What steps must a member firm make if it's faced with a catastrophe, such as flooding or a terrorist attack? Although a member firm's WSP manual is designed to establish its day-to-day policies and procedures, FINRA also requires that its members have plans in place to address the unexpected. Broker-dealers must establish a written business continuity plan that will identify the procedures to be followed in the event of an emergency or significant business disruption.

Copyright © Securities Training Corporation. All Rights Reserved.

These procedures must provide for all customer obligations being met and must address the firm's existing relationship with other broker-dealers and counterparties. The plan is required to be reviewed annually in light of any changes to the firm's business structure, general operations, or location. The BCP is not required to be filed with FINRA, but it must be made available to an SRO upon request. Although there are many elements that make up a business continuity plan, at a minimum, the plan must address the following concepts:

- Data backup and recovery
- Financial and operational assessments
- Alternative communications between the firm and customers and between the firm and employees
- Alternative physical location for employees
- Regulatory reporting and communications with regulators

Each member firm must provide its SRO with emergency contact information, including the designation of two emergency contact persons. At least one of these individuals must be a member of senior management and a registered principal of the member firm. If the second contact person is not a registered principal, she must be a member of senior management who has knowledge of the firm's business operations.

FINRA Rule 4370 also specifies that both emergency contact persons must be associated persons of the member firm. In the case of a small firm with only one associated person (e.g., a sole proprietorship without any other associated persons), the second emergency contact person may be either a registered or non-registered person with another firm who has knowledge of the member firm's business operations. Possible candidates for this role include the firm's attorney, accountant, or a clearing firm contact.

Client Disclosure Each member firm must disclose to its customers how its business continuity plan addresses the possibility of a future significant business disruption and how the member plans to respond to these events. This disclosure must be provided in written format at the time an account is opened and must be posted on the member's website.

Books and Records

The SEC and SROs rely on broker-dealer records and reports to monitor compliance with industry rules. Therefore, it's critical for a broker-dealer to maintain accurate records and file timely reports. SEC Rule 17a-3 requires broker-dealers to create specific records, while Rule 17a-4 requires those records to be kept for a number of years after their creation. Records may be divided into those that must be retained for the life of the firm, those that must be retained for six years, and those that must be retained for three years. Note that all records must be kept in an easily accessible place for the *first two years* of their existence.

 Copyright © Securities Training Corporation. All Rights Reserved.

Lifetime Records	Six-Year Records	Three-Year Records
Corporate or partnership documents	Blotters (records of original entry), municipal complaints*, new account forms, PoAs	Trade tickets, confirms, statements, Forms U4/U5 and employee records, all communications, trial balances, etc.
* FINRA requires that complaint records be maintained for *four years* at the OSJ.		

Conclusion

The goal of this significant chapter was to provide details regarding many of the requirements that apply to the smooth operation of a brokerage firm. Firms are required to adhere to KYC rules, AML rules, privacy and recordkeeping requirements, as well as the process for handling the different forms of communication. The next chapter will examine activities which are prohibited for member firms.

Chapter 15 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Recognize the customer information that's required to be obtained to open a new account
- Recognize the customer information that should be requested (NOT required)
- Understand the purpose for requesting the name of a customer's trusted contact person
- Understand FINRA's three suitability obligations:
  - 1) Reasonable Basis Obligation, 2) Customer-Specific Obligation, 3) Quantitative Obligation
- Recognize the Bank Secrecy Act and the USA PATRIOT Act and how they regulate money laundering
  - Recognize the three stages of money laundering (placement, layering, and integration)
- Understand the role of the Financial Crimes Enforcement Network (FinCEN) and its required reports
  - Bank Secrecy Act Currency Transaction Report (BCTR) and Suspicious Activity Report (SAR)
- Understand the importance of Regulation SP in protecting customers' private information
- Understand the delivery requirements of customer communications, including account statements and trade confirmations
- Define the three categories of customer communications:
  - *1) Correspondence, 2) Retail Communication,* and *Institutional Communication*
- Understand the purpose of the Telephone Consumer Protection Act of 1991
- Understand the importance and requirements of a firm creating a Business Continuity Plan (BCP)
- Recognize records that are kept for three years, six years, or for the life of the firm (*review the chart*)

Create a Chapter 15 Custom Exam

Now that you've completed Chapter 15, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 16 – Prohibited Activities

- *Manipulative and Deceptive Practices*
- *Regulation M*
- *Insider Trading*
- *New Issue Rule*
- *Books and Records*

Copyright © Securities Training Corporation. All Rights Reserved.

The goal of this chapter is to increase a person's knowledge of securities-related prohibited and illegal activities. The chapter will cover market manipulation, insider trading rules, FINRA's IPO regulations, sharing in customer accounts, borrowing or lending to clients, exploitation of seniors, activities of unregistered people, and prohibited activities related to recordkeeping.

Manipulation

The Securities Exchange Act of 1934 prohibits manipulative and deceptive practices in the sale of securities. The section of the Act that contains specific anti-manipulation provisions is Rule 10b-5, which states:

> *It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,*
>
> *a) To employ any device, scheme, or artifice to defraud,*
> *b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or*
> *c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,*
>
> *In connection with the purchase or sale of any security.*

Although the law is somewhat open-ended, over the years the SEC has identified some specific trading activities which are illegal. In addition, two additional rules support the prohibition listed above:

- SEC Rule 10b-1 states that the prohibition also applies to securities that are exempt from SEC registration.
- SEC Rule 10b-3 states that the prohibition also applies to broker-dealers.

In summary, these three provisions prohibit manipulation of any security, whether registered or not, by persons and broker-dealers. This section will focus on some specific types of market manipulation.

Misrepresentations

Under SEC Rule 15c1-3, it's a manipulative act for any brokerage firm to represent that a firm's registration with the SEC implies that the SEC has *approved* the firm. Instead, the SEC only requires registration; it doesn't approve the firm or its activities.

Regulation M

Most aspects of new securities offerings are governed by the Securities Act of 1933, which was described in Chapter 11. However, the Securities Exchange Act of 1934 also contains some provisions that affect the sale of new issues, particularly the activities of the underwriters that participate in follow-on offerings.

Copyright © Securities Training Corporation. All Rights Reserved.

Before major federal securities laws were passed in the 1930s, syndicate members often *conditioned the market* for the new issues that they were about to distribute. After these underwriters sold their allotments and stopped their behind-the-scenes activities, the stocks involved would experience a significant decline and cause unassuming investors to suffer large losses.

In order to regulate trading practices involving new issues and the firms that initially profit from the sale of new issues, the SEC enacted Regulation M. The rule covers issuers distributing IPOs as well as those distributing additional securities to the public. Under Regulation M, the SEC restricts distribution participants (such as underwriters and issuers) from aggressively bidding for or making purchases in the secondary market of a stock that's currently being offered in a distribution. However, many of these participants are allowed to make *passive markets* (i.e., not driving up the price). This restriction is in effect for a limited period that revolves around the effective date.

The SEC specifies that broker-dealers and underwriters are prohibited from promising to repurchase shares of an IPO at no less than the original sales price. This manipulative practice of allocating IPO shares based securing prearranged purchase orders from customers in the aftermarket at a specified price is referred to as a tie-in arrangement (or laddering). The intent of laddering is to inflate the aftermarket price of an IPO and cause other market participants to buy or bid for the security at higher prices. This prohibition applies regardless of whether the transactions are actually executed. In addition, it's a violation to encourage clients, prior to the trading of an IPO, to provide information on the price and number of shares they're willing to purchase in the aftermarket.

Regulation M attempts to prevent upward price manipulation before the pricing of the offering since this practice generally results in the issuer receiving greater proceeds for the offering and the underwriters receiving more in fees. However, certain exceptions are permitted when the SEC believes the chances of manipulation are low. Under certain conditions, the SEC also makes exceptions for market makers and syndicate members that are seeking to support (stabilize) the price of the new issue. Stabilization is permitted at or below the public offering price (POP) since this activity is designed to protect the new issue's price from dropping substantially.

Market Rumors

Some investors have spread false or misleading information about companies to influence the price of stocks and bonds. The development of the internet and the overwhelming popularity of social media have increased the ability to fraudulently impact the price of securities using unsubstantiated rumors. The spreading of rumors can impact the price of a security in either a positive or negative manner. For example, in an effort to drive down the price of a company's stock, a person may use social media to falsely state that the company is being investigated by the government.

When the purpose of the rumor is to drive the price of a stock up, the SEC refers to this practice as *pump-and-dump*. This type of manipulation occurs when a larger investor, or group of investors, owns stock and spreads false positive news about the company to create a buying frenzy (pump). Before the news can be confirmed, the investor(s) sells the shares at a profit (dump).

 Copyright © Securities Training Corporation. All Rights Reserved.

Front-Running

If a broker-dealer or any persons are aware of a large impending order (block trade) that has not yet been executed, it's prohibited for them to execute an order for a proprietary account or an account in which they have discretion. Since block trades have the potential to move the market price of a security, the broker-dealer and/or associated persons have an opportunity to profit before other market participants can act. This prohibited activity is referred to as *front-running*.

Similarly, if a broker-dealer or any of its associated persons have material, non-public information regarding block trades on a company's stock, they're prohibited from placing orders for any related security of the company (e.g., convertible preferred stock or bonds, or options) in the previously mentioned accounts. This prohibition applies until the information about the block trades has been made publicly available, through reporting on the tape or through a third-party news wire service. When a partial execution of a block occurs, the trading prohibition remains in effect until information about execution of the entire block has been made public.

For purposes of this rule, a *block trade* is generally defined as a transaction that involves 10,000 shares or more, or options representing that number of shares. However, in certain circumstances, FINRA may consider a smaller number of shares as a block.

Trading Ahead of a Research Report

Due to the potential for abuses, industry regulators have long been concerned about the interaction between research departments and trading desks. Of specific concern is a firm's trading department buying or selling a company's securities just before the release of a research report by the firm's research department. This practice is often referred to as *trading ahead of research*.

For favorable reports, firms have argued that their purchases were based on their desire to meet anticipated customer demand for that security. Without the accumulation, customers who are interested in buying the security based on the contents of the report would be required to pay higher prices due to the increase in demand. However, the regulators have not accepted this argument. In fact, FINRA created a rule that prohibits a member from establishing, increasing, decreasing, or liquidating an inventory position in a security or derivative of that security based on material, non-public, advanced knowledge of the content and timing of a research report in that security.

FINRA's rule covers all securities of the issuer, including debt and derivatives. In addition, the rule covers both exchange and non-exchange-listed securities. The member firm is required to establish, maintain, and enforce policies and procedures that are designed to restrict or limit the flow of information between the research and trading departments of the member firm. Therefore, the rule requires the creation of *information barriers* to isolate the research department from the trading department. These information barriers prevent a trading department from learning of a pending research report regarding a security in which it has a position. Information barriers will also be required for broker-dealers to prevent insider trading violations.

Copyright © Securities Training Corporation. All Rights Reserved.

Excessive Trading Activity (Churning)

Churning is defined as excessive trading in customer accounts and is generally done to generate additional fees and commissions. But, how much trading is too much? Although there is no number of trades or percentage of portfolio turnover that constitutes a violation, the trading activity is viewed in light of the customer's objective. There is no need for a client to lose money for a churning violation to occur. If an RR has been granted discretionary authority over a client's account, it doesn't mean that he's permitted to trade excessively. Instead, all trading must be suitable as to type, size, and frequency.

Marking-the-Close/Marking-the-Opening

In an SEC administrative proceeding against a broker-dealer, the *marking-the-close* practice was described as:

> *…a series of transactions, at or near the close of trading, at or within minutes of 4:00 p.m., which either uptick or downtick a security. . . Marking-the-close represents a possible departure from the normal forces of supply and demand that result in the fair auction price for a security, and is of concern to those who regulate the markets.*

Similar activity at the start of the day is referred to as *marking-the-opening*.

There are two primary motivations for marking-the-close. First, brokerage firms use a security's closing price in determining the margin requirements for their customers. Some firms use $5.00 per share as a level at which they raise margin requirements, while other firms use a lower price.

When the stock drops to the predetermined price level, firms raise their requirements to 100% equity, which means that they require full cash payment for the security. Second, a security's closing price is the price that's shown in the newspapers as the final price for that security for that trading session.

In addition to affecting the value of the manipulator's position, marking-the-close can have a wider impact on the market. For instance, if the stock being manipulated is part of an index, the value of the index can be affected by marking-the-close activity. Indexes are used for a wide variety of purposes in the industry and are closely watched by investors making purchase or sale decisions.

In fact, simply changing a quote can be an example of marking-the-close. In one case, a trader engaged in a pattern of upticking his firm's quote on a regular basis within five minutes of the close. This would often cause the firm's bid to be the highest in the market at the end of the day. When the market opened the next day, the trader would then downtick the bid.

Backing Away

Broker-dealers that trade on exchanges or OTC markets for their proprietary accounts are referred to as market makers. When acting as market makers, broker-dealers have an obligation to stand behind their quotes for the size and price being displayed (i.e., quotes are firm).

Copyright © Securities Training Corporation. All Rights Reserved.

If a market maker is contacted by another dealer or customer and fails to honor its quote, it's considered a *backing away* violation. In doing so, the market maker violates FINRA and SEC rules and is subject to disciplinary action. Failing to honor a quote can result in a monetary fine and/or suspension of the firm's ability to engage in market-making activities.

Free Riding

When a customer purchases securities in either a cash or margin account, Regulation T requires that he promptly make payment. In this case, prompt typically means by no later than four business days after the trade date (i.e., T + 4), which is the same as by no later than two business after regular-way settlement (i.e., S + 2). In a cash account, the full purchase price must be paid; however, in a margin account, a specified percentage of the purchase price is due (typically 50%).

If the required amount is not paid by the Regulation T payment date (T + 4 or S + 2), the broker-dealer is required to close out the transaction by selling out the securities and will then freeze the account for 90 days. During the period in which the account is frozen, the customer must pay for all purchases in advance. If payment is made in advance for the 90-day period, the customer is considered to have reestablished credit and may once again be extended normal credit terms (i.e., pay for trades in four days).

A potential violation involving purchased securities is referred to as *freeriding*. This prohibited practice can be explained in the following steps:

1. A customer purchases securities in hopes of the value rising.
2. Before making payment, the securities rise in value.
3. The customer directs his firm to liquidate a portion of the securities and to use the sales proceeds to cover the payment requirement.
4. Since the customer's payment requirement is satisfied without having deposited funds, it's considered freeriding.

Prohibited Trading Practices and Other Trading Rules

The SIE exam may contain questions that relate to various types of violations which may occur when broker-dealers trade securities. The following section will summarize some of FINRA's rules and interpretations.

Anti-Intimidation/Coordination Interpretation

Under this interpretation, the following actions are considered inconsistent with the just and equitable principles of trade for any member or person associated with a member:

- To coordinate prices (including quotes), trades, or trade reports with any other member or person associated with a member
- To direct or request another member to alter a price (including a quote)
- To engage, directly or indirectly, in any conduct that threatens, harasses, coerces, intimidates, or otherwise attempts to improperly influence another member or person associated with a member

Copyright © Securities Training Corporation. All Rights Reserved.

    - This includes, but is not limited to, any attempt to influence another member or person associated with a member to adjust or maintain a price or quote, regardless of whether it's displayed on an automated system that's operated by Nasdaq.
- To engage in conduct that retaliates against or discourages the competitive activities of another market maker or market participant

Payments to Influence the Market Price

Broker-dealers are prohibited from paying any party to influence the market price of a security. Although firms are allowed to advertise and issue research report, they cannot pay any electronic or public media outlet that has the ability to influence the price of a security.

Best Execution

If a broker-dealer fails to use reasonable diligence to assist customers in obtaining the best price on purchases and sales, it's a violation of FINRA and MSRB (for municipal securities) rules.

To determine whether a member firm has used reasonable diligence, the following factors are considered:

- The general character of the market for the security (e.g., the price, volatility, relative liquidity, and available communications)
- The size and type of transaction
- The number of markets checked
- Accessibility of the quotation
- The terms and conditions of the order which resulted in the transaction

The market for municipal securities is not as centralized as corporate equity securities. For that reason, the standards for best execution should be considered broadly, with the realization that municipal securities currently trade over-the-counter without a central exchange or platform.

Time of Trade Disclosures (MSRB Rule G-47)

In addition to the best execution rule for municipal securities, a municipal securities dealer is required to disclose to a client all material information that's either known or reasonably accessible to the market. These time of trade disclosures are required to be made *at or prior to* the time of the trade and can be made either verbally or in writing. The main purpose of this rule is to require dealers to disclose to clients all of the relevant information concerning the securities that they're considering purchasing or selling. Many municipal securities have unique features and characteristics that should be disclosed to a client.

Additionally, the disclosure rules apply regardless of whether the transaction is recommended or unsolicited, occurs in the primary market or secondary market, or is a principal or agency transaction. The rule states that information is considered material if there is a substantial likelihood that a reasonable investor would consider the information to be important or significant when making an investment decision. A municipal securities dealer may NOT satisfy its disclosure obligation by simply directing a customer to an established industry source or through a disclosure that's made in general advertising materials.

Copyright © Securities Training Corporation. All Rights Reserved.

Interpositioning

Interpositioning is defined as the insertion of a third party between a customer and the best market and is generally prohibited. In fact, the practice is specifically prohibited when it's to the detriment of the customer.

> *For example, a broker-dealer receives an order from a customer to buy 100 shares of XYZ at the market. The best offer of any market maker is $40. Rather than buying directly from the market maker, the broker-dealer interposes another firm that buys the stock at $40, and then sells it to the member firm at $41. The member firm ultimately sells the stock to the customer at $42 and the two firms share the one-point extra markup that was charged to the customer.*

Please note, interpositioning isn't prohibited if a member firm can demonstrate that an execution was advantageous to its customer as a result of the intervention of a third party (e.g., the use of a broker's broker). This may occur when an order is crossed with a retail order from another firm or when the member firm determines that the market may be adversely affected (to the detriment of the customer) due to the disclosure of the member firm's identity. An order may also be routed through a third party if (1) that party is an established correspondent, (2) the name of the customer's member firm is provided, and (3) the customer is not charged for the correspondent's services. However, the lack of sufficient personnel to effectively execute an order is NOT a suitable reason for failing to obtain the best price for a customer.

Trading Ahead of Customer Orders (Limit Order Protection Rule)

A broker-dealer is in violation of FINRA rules if the firm accepts and holds a customer order (either market or limit) for an equity security and executes a trade involving that security for its own account at the same price and on the same side of the market (buy or sell). For example, if a customer places an order with her broker to buy 1,000 shares of XAM at $35 per share and, while holding this order, the firm buys 1,000 shares of XAM at $35 for its own account, it has an obligation (within 60 seconds) to fill the customer's buy order at $35 or better.

An exception is granted if the firm had different departments that traded the same security under certain conditions. In the previous example, if the department that purchased the shares of XAM at $35 is different than the department that's holding the customer's order, the customer's order is not required to be executed. However, the two departments must have proper information barriers in place for this exception to apply.

Quoting a Security in Multiple Mediums

In some circumstances, a broker-dealer may want to display a quote for the same security in more than one market. FINRA permits a firm to engage in this practice, but requires the same price to be displayed. For example, if a firm has placed an offer to sell stock at $20 per share in one market, and wants to enter another offer for that same stock in another market, the offer to sell must also be $20 per share.

Copyright © Securities Training Corporation. All Rights Reserved.

Mutual Fund Trading Rules

Under certain conditions, a mutual fund is permitted to buy securities from and/or sell securities to another mutual fund without being subject to trading restrictions. Rules 17a-6 and 17a-7 of the Investment Company Act of 1940 provide an exemption if the transactions are considered minor and are strictly between portfolio affiliates or between an investment company and certain affiliate persons. For example, a mutual fund can purchase securities from another mutual fund if both funds are controlled by the same investment company.

Insider Trading

Sections 10b5-1 and 10b5-2 of the Securities Exchange Act of 1934 are the most important rules that relate to insider trading. Insider trading involves the purchase or sale of securities using material, non-public information about those securities in a fraudulent manner. Material, non-public information is considered information that, if released publicly, would most likely affect stock or bond prices.

The fraud usually involves either the misuse of confidential information by a person who has a fiduciary duty to shareholders (e.g., an officer or director), or the misappropriation of confidential information obtained from an employer (e.g., a broker-dealer employee who misappropriates and uses sensitive information). Keep in mind, trading by a firm or individual that's based on information regarding a large client's potential buying or selling doesn't constitute insider trading. Instead, this prohibited practice is referred to as *front-running*.

If a corporation has material information, it must release it to the public before any person may use the information to complete a transaction. Releasing the information only to broker-dealers, financial analysts, shareholders, or any other limited group is prohibited. One way by which information is considered to have been released publicly if it's provided to the financial news media. Once provide, the media will have the opportunity to disseminate it.

Tippers and Tippees In some situations, material, non-public information (MNPI) is passed from one person (the tipper) to another person (the tippee). The tippee then trades on the information. If the tippee knew, or should have known, that the information was confidential, both the tippee *and* the tipper may have violated insider trading rules. For instance, assume a member of a corporation's board of directors tips a relative about a pending takeover involving the corporation. If the relative trades on the information, this is likely a violation of the Exchange Act. Another example is when an investment banker is working on a deal with a company and then tips off a trader. Ultimately, a broker-dealer is responsible for the actions of its representatives even if the broker-dealer doesn't use the information to trade for its own account.

Insider Trading Legislation Over the years, several high-profile cases brought significant congressional interest in insider trading. Since some of these cases involved broker-dealer employees, the Insider Trading Sanctions Act of 1984 (ITSA) and the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) were the response.

 Copyright © Securities Training Corporation. All Rights Reserved.

Establishment of Procedures The ITSFEA required broker-dealers to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the misuse of material, non-public information by both the firms and their associated persons.

The ITSFEA stipulates that any individual who purchases or sells a security while in possession of material, non-public information, or has communicated such information to another party in connection with a transaction, may be liable for trading violations under the Act. Broker-dealers must not only create such written policies, they must also ensure that they're implemented. A broker-dealer with a written, well-thought-out system of procedures to prevent insider trading may still be subject to SEC penalties if it fails to follow through on the procedures.

These procedures should contain several key elements, including:

- A system for monitoring employees' personal trading and trading in firm proprietary accounts
- Restricting or monitoring the trading of securities in which the firm has access to insider information (watch lists and restricted lists)
- Procedures to restrict access to files containing confidential information, including the establishment of information barriers (discussed next)
- Education of employees regarding insider trading issues

Information Barrier Procedures An *information barrier* consists of a set of procedures for preventing the transmission of confidential information from one department to another within a broker-dealer. (Information barriers were formerly referred to as Chinese Walls.) These barriers may be physical, but also procedural. For firms that have access to confidential information, the importance of implementing adequate information barrier procedures cannot be overstated. The SEC has not mandated any particular system in order to account for the differences in the way various broker-dealers operate. However, this also means there is no safe harbor for a firm's information barrier procedures. The burden is on the firm to be able to show that its procedures are adequate.

Restricted and Watch Lists Only firms that engage in investment banking, research, or arbitrage activities are required to maintain restricted and watch lists. However, these firms must have written procedures to address the use of material, non-public information by their employees. The restricted and watch lists include securities that employees are either restricted or prohibited from trading, or issues that are subject to closer scrutiny by the member firm. The restrictions or limitations associated with the lists apply to employee transactions and to solicited transactions with customers.

The restricted list must be distributed to employees; however, the content of the watch list is generally known only to selected members of the legal and compliance departments. The firm's written supervisory procedures should include a description regarding when and why securities have been added to, or removed from, the lists. The restricted and watch lists should include the name of the contact person who added the security to, or deleted it from, the list; however, the rationale for the decision is not required.

Copyright © Securities Training Corporation. All Rights Reserved.

Notifying Compliance If a securities professional comes into possession of material, non-public information about a company, the best course of action is for her to immediately notify her Compliance Department. At that point, the Compliance Department can put the issue on the firm's watch list.

Consequences of Insider Trading Violations Violations of insider trading rules by broker-dealer employees can have serious consequences for both the individual and the firm.

Civil Penalties Insider trading violations may result in civil penalties of up to three times the amount gained, or loss avoided, in the transactions (i.e., the SEC can sue for treble damages). The SEC may also demand disgorgement of profits. In other words, the inside trader could be required to return any profits earned. Any person who controls the violator (e.g., manager or supervisor) is subject to civil penalties not exceeding the greater of $1 million or three times the profit gained or loss avoided as a result of the violation.

Criminal Penalties The ITSFEA substantially increased the criminal penalties for violations of the Exchange Act, including insider trading. An individual may be subject to fines of up to $5 million and/or imprisonment for up to 20 years per violation. Corporations and other non-natural persons may be fined up to $25 million per violation. The Department of Justice (DOJ) is responsible for criminal actions.

Bounties The Act also allows the granting of bounties for information that leads to the payment of penalties in connection with insider trading violations. The SEC has the power to determine the amount of the bounty; however, it may range between 10% and 30% of the money collected.

Other Prohibited Activities

The New Issue Rule

New issues (e.g. IPOs) may dramatically increase in price immediately in the aftermarket (after the shares are sold to initial investors). Under the FINRA rule titled *Restrictions Preventing Associated Persons from Buying IPOs (the New Issue Rule), a* brokerage firm is required to make a bona fide offering of new issues to the public and not withhold any shares for its own account, or employee accounts, or accounts of other industry insiders. The rule also prohibits a FINRA member broker-dealer from selling a new issue to an account in which a restricted person has a beneficial interest.

However, an exemption exists that allows personnel of a limited broker-dealer to purchase shares of a new issue. A limited broker-dealer is one that restricts its business to investment company/variable contract securities or direct participation programs. For example, a registered representative who is employed by a firm that sells only mutual fund shares is exempt from this rule.

 Copyright © Securities Training Corporation. All Rights Reserved.

The rule contains definitions of key terms, a number of exemptions, and an obligation that the broker-dealer should obtain a representation from the account holder stating that he's eligible to purchase new issues. The following text details specifics of the rule.

New Issues New issues include all initial public offerings of equity securities that are sold under a registration statement or offering circular. However, the following securities are NOT considered new issues and may be sold to restricted persons:

- Secondary offerings
- Private offerings, including securities sold pursuant to Regulations D and 144A
- All debt offerings, including convertible and non-investment-grade debt
- Preferred stock and rights offerings
- Investment company offerings
- Exempt securities as defined under the Securities Act of 1933
- Direct participation programs and REITs
- Rights offerings, exchange offers, and offerings made pursuant to an M&A transaction
- ADR offerings that have a pre-existing market outside of the U.S.

Preconditions for Sale Prior to selling a new issue to any account, a firm must meet certain *preconditions for sale*. Before distributing shares of a new issue to an account, a firm must obtain a written representation from the account holder, or any authorized party of the account, which states that the account is eligible to purchase new issues. The representation from the account holder may be in the form of an *affirmative statement* that positively declares that the account is eligible. This information must be verified every 12 months.

Prohibited Sales A firm or any person associated with a member firm is prohibited from offering or selling a new issue to any account in which a *restricted person* has a beneficial interest. Additionally, a member firm or any person associated with a member firm may not purchase a new issue unless an exemption applies.

Restricted Persons The following are considered restricted persons:

- FINRA member firms and any associated person (i.e., employee) of the member firm
- An immediate family member of an employee of a member firm. Immediate family members include a spouse, children, parents, siblings, in-laws, and any other person who is materially supported by an employee of a member firm. (Under the rule, aunts, uncles, and cousins are not defined as immediate family members and are therefore not considered restricted persons.)
- The previously listed immediate family members are only considered restricted persons if *any one* of the following three conditions apply:

    1. The employee gives/receives material support to/from the immediate family member. Material support is defined as providing more than 25% of the person's income or living in the same household as the person associated with the member firm.
    2. The employee is employed by the member firm that's selling the new issue.
    3. The employee has the ability to control the allocation of the new issue.

Copyright © Securities Training Corporation. All Rights Reserved.

For example, John is employed by ARW Investment Bank and he supports his brother. His brother is considered a restricted person.

Another example: Keith is employed by NJF Investment Bank and his firm is the managing underwriter of Mattco IPO. Keith's immediate family members are restricted from purchasing any of the shares in the Mattco IPO from NJF.

Other restricted persons include the following:

- Finders and fiduciaries, such as attorneys and accountants involved in the offering of the new issue and any person to whom they provide material support
- Portfolio managers purchasing for their own account, which include persons who can buy or sell securities on behalf of institutional investors (e.g., banks, investment companies, investment advisers, insurance companies, savings and loan institutions) as well as any person to whom they provide material support. These are people who are in a position to direct future business to the firm, which is the reason for their restricted status. (It's important to remember that a portfolio manager is only a restricted person if she's purchasing an equity IPO for her personal account. There is no restriction if she's purchasing shares for the fund that she manages.)
- Persons who own a broker-dealer (including any person who owns 10% or more of the firm).

General Exemptions The New Issue rule also provides a number of general exemptions. The exemptions allow a new issue (as defined under the rule) to be sold to the following accounts:

- Investment companies that are registered under the Investment Company Act of 1940
- The general or separate account of an insurance company
- A common trust fund
- An account in which the beneficial interest of all restricted persons doesn't exceed 10% of the account. (This is a de minimis exemption that allows an account owned in part by restricted persons to purchase a new issue if all restricted persons combined own 10% or less of the account.)
- Publicly traded entities, other than a broker-dealer or its affiliates, that engage in the public offering of new issues
- Foreign investment companies
- ERISA accounts, state and local benefit plans, and other tax-exempt plans under IRS Code 501(c)(3)

Another exemption under the rule allows a broker-dealer to purchase shares of a new issue if the offering is undersubscribed. This exception means that an underwriter can place shares in its own investment account as long as all public demand for the shares has been met. However, an underwriter cannot sell shares of an undersubscribed issue to other restricted persons.

 Copyright © Securities Training Corporation. All Rights Reserved.

Issuer-Directed Securities SRO rules permit certain persons that are related to the issuer to purchase shares of a new issue as long as the issuer specifically directs securities to them. The purchasers that fall under this exemption include the following:

- The parent company of an issuer
- The subsidiary of an issuer
- Employees and directors of an issuer

This exemption allows a registered representative to purchase her employing broker-dealer's equity IPO shares or the shares of the parent or subsidiary of the broker-dealer. In addition to a registered representative, other restricted persons (e.g., immediate family members of employees of a broker-dealer and finders and fiduciaries that are involved with the offering) may purchase shares of a new issue, provided they're employees or directors of the issuer.

Sharing in Accounts and Guarantees

Employees of FINRA and MSRB member firms are generally prohibited from sharing in profits or losses in their customers' accounts. However, an exception is made if the following conditions are met:

- The employee has made a financial contribution to her customer's account and shares in the profits or losses in direct proportion to her financial contribution
  - This condition doesn't apply to situations in which the employee has an account with an immediate family member (e.g., a joint account with a spouse or a parent)
- The customer's prior consent is given
- The employing broker-dealer's prior written consent is given

Investment Advisory Accounts An exception to the prohibition on sharing in customer profits and losses is made for investment advisory accounts in which a fee is charged. To qualify for the exception, the employing firm's and the customer's prior written consent are required and the firm must be in compliance with SEC regulations that relate to investment advisory services.

Guarantees Employees of member firms may neither guarantee against losses in customer accounts or transactions within customer accounts, nor may they reimburse a customer for any losses that at are incurred.

Borrowing and Lending Practices with Customers

Registered representatives are generally prohibited from borrowing money from, or lending money to, a customer. However, the practices are permitted if a member firm implements written procedures and satisfies any one of the following five provisions:

1. The customer and the registered person are immediate family members.
2. The customer is a financial institution that's regularly involved in the business of extending credit or providing loans.
3. Both persons are registered with the same firm.
4. The loan is based on a personal relationship between the customer and registered person.
5. The loan is based on a business relationship that's independent of the customer-broker relationship.

Copyright © Securities Training Corporation. All Rights Reserved.

If any one of the conditions indicated in provisions 3, 4, or 5 is satisfied, the registered person is required to notify the firm prior to the entering of these arrangements. The firm is also required to provide written preapproval of these arrangements and maintain the approvals for a period of at least three years after the arrangements are terminated. If the registered person involved in these practices is terminated, the approvals must be maintained for at least three years after termination.

Financial Exploitation of Specified Adults – FINRA Rule 2165

FINRA created a hotline for seniors who had questions or concerns about their brokerage accounts. One of the major issues that was highlighted by these investors was suspected financial exploitation. In order to address this issue, FINRA created Rule 2165 which is titled *Financial Exploitation of Specified Adults*.

Specified Adults According to FINRA's rule, the term *specified adult* is defined as:

- Any person who is age 65 or older
- Any person who is age 18 or older and who the firm reasonably believes has a mental or physical impairment that renders the person unable to protect his own interests. This determination should be based on the facts and circumstances that are observed in the firm's business relationship with the person.

To assist these specified adults, FINRA also established a process by which a firm could respond to situations in which it has a reasonable basis to believe that financial exploitation has occurred, is occurring, has been attempted or will be attempted. The process includes the appointment of a trusted contact person.

Trusted Contact Person Firms may now contact a customer's designated *trusted contact person* and, when appropriate, place a temporary hold on a disbursement of funds or securities from a customer's account. A trusted contact person must be age 18 or older and would be essential in assisting the firm in protecting the customer's account and its assets and also responding to possible financial exploitation.

The trusted contact person's name and contact information (mailing address, phone number and email address) would be a part of the customer account information that should be obtained when a member firm opens or updates an account. Although the trusted person's contact information is *not required* to open the account, a firm should make a reasonable effort to obtain it.

Financial Exploitation According to FINRA's rule, *financial exploitation* includes:

- Wrongful or unauthorized taking, withholding, appropriation, or use of a specified adult's funds or securities; or
- Any act or omission taken by a person, including through the use of a power of attorney, guardianship, or any other authority, regarding a specified adult, to:
  - Obtain control, through deception, intimidation, or undue influence, over the specified adult's money, assets or property; or
  - Convert the specified adult's money, assets or property

 Copyright © Securities Training Corporation. All Rights Reserved.

Temporary Hold The rule permits a firm to place a *temporary hold* on the disbursement of a specified adult's funds or securities, as well as on the execution of transactions in the account. A hold may be placed on any request for the proceeds of a sale to be sent to another person if there's a reasonable belief of the existence of financial exploitation. The temporary hold will apply to both a single disbursement and a transfer of an entire account (ACATS transfer). However, if the firm places a hold on an account, it must allow disbursements if there's no reasonable belief of financial exploitation (e.g., normal bill paying).

Account Movement Between Accounts at the Same Firm The temporary hold also applies to the transfer of assets from one account to another account at the same brokerage firm. For example, the temporary hold applies when a relative or friend of an account owner is attempting financial exploitation and initiates the transfer of assets to her account which is held at the same brokerage firm.

Reasons for the Hold If a member firm places a temporary hold, the rule requires the firm to immediately initiate an internal review of the facts and circumstances that caused it to reasonably believe that financial exploitation of the specified adult has occurred, is occurring, has been attempted or will be attempted.

Notification of the Hold By no later than *two business days* after the date that the member first placed the temporary hold on the disbursement of funds or securities, the member firm must provide notification, either orally or in writing (which may be electronic), of the temporary hold and the reason for the hold. The notification must be provided to:

- All parties who are authorized to transact business in the account, unless a party is unavailable or the firm reasonably believes that one party has engaged, is engaged, or will engage in the financial exploitation of the specified adult; and
- The trusted contact person(s), unless this person is unavailable or the firm reasonably believes that the trusted contact person(s) has engaged, is engaged, or will engage in the financial exploitation of the specified adult

The intent of the rule is to prohibit a firm from dealing with the person(s) who might be exploiting the specified adult. For example, if the adult child of a senior investor is the trusted contact person who may be misappropriating funds, it's *not* prudent for this person to be contacted.

Before placing a temporary hold, it's recommended for the firm to first attempt to resolve the situation with the customer. However, if the temporary hold is placed, the firm is required to notify the trusted contact person. Once a temporary hold is initiated, the firm is permitted to terminate it only after contacting either the customer or the trusted contract person and discussing the situation. The customer's objection to the temporary hold or information obtained during the discussion with the customer or trusted contact person may be used by the firm when determining whether the hold should be placed or lifted.

Copyright © Securities Training Corporation. All Rights Reserved.

Period for the Temporary Hold A temporary hold will expire by *no later than 15 business days* after the date that it was first placed on the account, unless it was otherwise terminated or extended by another authorized regulatory entity. If a member firm's internal review of the facts and circumstances supports its reasonable belief that the financial exploitation of the specified adult has occurred, is occurring, has been attempted or will be attempted, the firm may extend the temporary hold for an *additional 10 business days*, unless otherwise terminated or extended by another authorized regulatory entity. Lastly, to provide greater protection, if the firm's internal review still supports its reasonable belief of the potential for financial exploitation, the temporary hold may be extended by the member firm for *no longer than 30 business days* following the date above unless it was terminated or extended by another authorized regulatory entity.

- Essentially, member firms are able to maintain a temporary hold on disbursements or transactions for a maximum of 55 business days.

Accounts at Other Broker-Dealers and Financial Institutions

For supervisory reasons, member firms are required to monitor the personal accounts that their employees (both clerical and registered persons) open or establish with a firm other than the one at which they're employed. For example, if a registered person of ABC Brokerage approaches another financial institution to open an outside (away) account to trade securities, both the employee and the firm must observe special rules prior to the account being opened. For purposes of this rule, the term *financial institution* refers to a broker-dealer, investment advisor, bank, insurance company, trust company, or investment company.

Employee Requirements Employees who intend to open outside accounts in which securities transactions may be executed are required to obtain the prior written consent of their firm. In addition, before an outside account is opened, the employees are required to provide written notification to the executing firm of their association with another member firm.

Related and Other Persons This rule also applies to accounts in which securities transactions can be executed and in which the employee has beneficial interest, including any account that's held by:

- The employee's spouse
- The employee's children (provided they reside in the same household as, or are financially dependent on, the employee)
- Any related person over whose account the employee has control, and
- Any other individual over whose account the employee has control and to whose financial support the employee materially contributes

Previously Opened Account If an employee had opened an account prior to the time that he became associated with a broker-dealer, the employee is required to obtain the written consent of his employer within 30 days of the beginning of his employment to maintain the account. Also, the employee is required to provide written notification to the executing firm of his employment with another broker-dealer.

 Copyright © Securities Training Corporation. All Rights Reserved.

Once an account has been opened for a member firm employee, the executing firm is not required to obtain the employing firm's approval prior to the entry of each order. However, the employee's activities are subject to any rules or restrictions that have been established by his employing firm.

Executing Broker-Dealer Requirements Upon written request, the executing firm is required to send duplicate copies of confirmations, statements, or any other transactional information to the employee's broker-dealer.

Exemptions The requirements of this rule don't apply to accounts that are limited to transactions involving redeemable investment company securities (mutual fund shares), unit investment trusts, variable contracts, or 529 plans.

Payments to Unregistered Person

A broker-dealer is not permitted to pay any form of compensation to either another broker-dealer or a person associated with another broker-dealer unless they're properly registered. The term compensation is broad and includes commissions, discounts, concessions on new issues, and fees.

Retiring Representatives If a bona fide contract is created, a member firm is permitted to continue to pay commissions to retiring representatives after they leave the firm, but only based on their existing accounts. The language of the contract between the retiring RR and the firm must stipulate that the RR is prohibited from soliciting new business or opening new accounts.

Forgery

The act of forgery involves one person signing another person's name to a document without authorization, or causing another person to do so. Obviously, forgery is a serious offense that may result in criminal prosecution as well as regulatory sanctions. RRs must also be careful not to inadvertently commit a technical forgery. This occurs when a well-meaning representative signs a client's name to a document because she believes that she has the client's authorization.

Books and Records

Recordkeeping Formats

As described in Chapter 15, broker-dealers must maintain records for a certain number of years after creation. The SEC allows for the maintenance of records in forms other than paper. For example, firms may maintain their files on micrographic media or electronic storage media. Micrographic media includes microfilm, microfiche, or similar methods, while electronic storage media includes methods of digital storage (e.g., CD-ROM).

Copyright © Securities Training Corporation. All Rights Reserved.

If a firm decides to use electronic storage media, it must notify its primary regulator prior to the beginning of its use. Also, if a firm changes the form of electronic storage media that it's currently using, it must notify its regulator at least 90 days prior to using the other method.

When maintaining records using electronic storage media, the firm must:

- Maintain records in non-rewriteable and non-erasable formats
- Automatically confirm the quality and accuracy of the media recording process
- Maintain records in serial form with time and date information that documents the required retention period for the information stored
- Be able to download the indexes and records maintained to any medium that's accepted by the SEC or other SRO of which the firm is a member

In addition to the aforementioned requirements, a firm that uses micrographic or electronic storage media must establish a location from which the SEC and the firm's SRO can immediately review stored files and have duplicates of the files available. All duplicates of the files being maintained must be kept separate from original records. The records (original and duplicates) must be accurately organized and indexed. The indexes are required to be duplicated, kept separate from originals, and made available for examination by regulators if a review is requested.

FINRA and the MSRB also have recordkeeping requirements for any books and records that were not specifically referenced under SEC Rules. For FINRA, the requirements are found in Rule 4511; however, for the MSRB, the requirements are found in Rule G-8 (the records that must be kept) and Rule G-9 (how long the records must be kept).

Conclusion

This concludes the chapter devoted to providing information regarding the securities-related activities that are considered prohibited and illegal. Much of the attention is focused on market manipulation, insider trading rules, FINRA's IPO regulations, sharing in customer accounts, borrowing or lending to clients, exploitation of seniors, and recordkeeping. The next chapter will examine the regulations that apply to the associated persons of member firms.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 16 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Recognize how the Securities Exchange Act of 1934 prohibits manipulative and deceptive practices in the sale of securities
- Understand the basic purpose of Regulation M of the Securities Exchange Act of 1934
- Recognize various prohibited activities, including spreading market rumors, front-running, trading ahead of a research report, churning and reverse churning, marking-the-close/marking-the-open, etc.
- Recognize various prohibited trading practices, including making payments to influence market price, interpositioning, trading ahead of customer orders, quoting a security in multiple mediums at different prices, insider trading, etc.
- Understand the purpose of FINRA's New Issue (Equity IPO) Rule and identify the eligible purchasers
- Understand the regulations regarding sharing in accounts, guarantees, and borrowing from or lending money to clients
- Understand the rule regarding the financial exploitation of specified adults, as well as the importance of a trusted contract person, and the implementation of a temporary hold
- Understand the rules regarding a member firm employee opening an account with another firm
- Understand the rules regarding the role and limitations of unregistered persons

Create a Chapter 16 Custom Exam

Now that you've completed Chapter 16, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 17 – SRO Requirements for Associated Persons

- *SIE and Employees of Member Firms*
- *Registered Representatives and Principals*
- *Registration and Continuing Education*

Copyright © Securities Training Corporation. All Rights Reserved.

This chapter will focus on the registration requirements that apply to associated persons. The focus will be on details regarding the SIE Examination, the different SRO registration categories, fingerprinting, statutory disqualification, and the activities of non-registered persons. Additionally, the industry-mandated continuing education program will be examined, including both the firm element and regulatory elements. This chapter and the next chapter will include information regarding registration documentation (both Forms U4 and U5).

SIE Exam – The First Step to Registration

Beginning on October 1, 2018, FINRA has restructured its qualification program by implementing the *Securities Industry Essentials (SIE) Exam* to ensure that potential industry professionals have a broad knowledge of the fundamental concepts and rules of the securities industry. The SIE Exam brings together much of the information that's static and unlikely to be impacted by regulatory changes, such as basic product knowledge, the structure and function of securities industry markets, regulatory agencies and their functions, and regulated and prohibited practices. The goal of the SIE Exam is to reduce the redundancy of subject matter content that's addressed on multiple exams.

Some of the key features of the SIE Exam include the following:

- The exam is open to any person who is age 18 or older, including students and prospective candidates who are interested in demonstrating their basic industry knowledge to potential employers.
- Current association with a member firm is not required; instead, individuals are permitted to take the exam either before or after associating with a firm.
- Exam results are valid for four years.

However, passing the SIE exam alone will not qualify a person for FINRA registration. To become an associated person of a member firm, an individual will also be required to pass an appropriate representative-level qualification exam which relates to the registration category pertaining to his intended job function. For example, on October 10, 2018, if a person is applying for registration as a General Securities Representative, he's required to pass both the SIE Exam and the new, revised General Securities Representative (Series 7) examination. These requirements also apply to applicants who are seeking a representative-level registration as a prerequisite to a principal-level registration. Additionally, current registered representatives will be considered to have passed the SIE Exam.

Associated Persons

According to FINRA, associated persons are defined as any:

- Officers, directors, partners, or branch managers of a member firm
- Employees of the member firm, unless the employee's function solely and exclusively clerical or ministerial
- Persons engaged in investment banking or securities business that's controlled by the member firm

Copyright © Securities Training Corporation. All Rights Reserved.

Activities of Non-Registered Persons

Although some broker-dealer employees are not required to obtain securities registrations, their ability to have direct contact with customers is somewhat limited. These non-registered persons may:

- Extend invitations to firm-sponsored events
- Inquire as to whether a prospective customer wishes to discuss investments with a registered representative
- Inquire as to whether a prospective customer wishes to receive investment literature from the firm

Non-registered persons who engage in the activities listed above need to be supervised closely by their employing firms. These employees may not discuss either general or specific investment products that are offered by their firms, prequalify prospective customers regarding their financial status, investment history, and objectives, or solicit new accounts or orders.

A registered person may not offer to pay commissions or finder's fees to a non-registered person who generates referrals for the RR's firm, such as an attorney or accountant. However, the RR may recommend the services of the accountant or attorney to his clients.

Accepting Customer Orders The function of accepting customer orders is not considered a clerical or ministerial function. In all circumstances, any person who is associated with a member firm and accepts customer orders must be registered in an appropriate registration category. When an appropriately registered person is unavailable, an unregistered associated person is not considered to be accepting a customer order by occasionally transcribing order details that are submitted by a customer as long as the registered person contacts the customer to confirm the order details before the order is entered.

Most associated persons of a registered broker-dealer must register with FINRA based on the type of business in which the firm is engaged, the securities products handled by the person, and the capacity in which the person functions.

FINRA identifies two levels of qualification and registration:

- Registered representatives—generally sales personnel engaged in securities business activities.
- Principals—generally officers and other management or supervisory personnel who are involved in day-to-day management or operations of the member firm's securities business.

Of course, registered representatives and principals must pass qualifying examinations. For example, the Series 7 – General Securities Registered Representative Exam for registered representatives and the Series 24 – General Securities Principal for principals.

Let's review the different types of registered representatives and supervising principals.

 Copyright © Securities Training Corporation. All Rights Reserved.

Registered Representative Designations

For any new registrants to become registered representatives, they must pass the SIE Exam as well as one of the following qualification exams:

FINRA Representative Designations		
Series 6	Investment Companies and Variable Contracts Products Representative	This limited representative exam qualifies a person to solicit, purchase and/or sell the following securities products: ▪ Mutual funds, closed-end funds on the initial offering only, and unit investment trusts (UITs); variable annuities and variable life insurance; and municipal fund securities (e.g., 529 savings plans, local government investment pools)
Series 7	General Securities Representative	This comprehensive exam qualifies a person to solicit, purchase and/or sell all securities products in both the primary and secondary market, including: ▪ Corporate securities, municipal fund securities, options, direct participation programs, and investment company products and variable contracts
Series 22	Direct Participation Programs Representative	This limited representative exam qualifies a person to be involved in offerings of ▪ Direct participation programs (real estate, oil and gas, and equipment leasing), limited partnerships, limited liability companies, and S corporations
Series 57	Securities Trader	This representative exam allows a person to be involved in: ▪ NASDAQ equity trading, OTC equity trading, and proprietary trading
Series 79	Investment Banking Representative	This representative exam allows a person to advise on and/or facilitate the following: ▪ Debt and equity offerings (private or public offerings); mergers and acquisitions; tender offers; financial restructurings and asset sales; divestitures or other corporate reorganizations; and business combination transactions
Series 82	Private Securities Offerings Representative	This representative exam allows a person to solicit and sell private placement securities products as part of a primary offering.
Series 99	Operations Professional	This representative exam is for any person responsible for: ▪ Client on-boarding, including account and document maintenance; receipt and delivery of securities and funds; depository and firm account management and reconciliation; settlement, contributing to the process of preparing and filing financial regulatory reports; and defining and approving business security requirements and policies for information technology.

Copyright © Securities Training Corporation. All Rights Reserved.

MSRB Representative Designations		
Series 50	Municipal Advisor Representative	This representative exam allows a person who is associated with a municipal advisor to engage in municipal advisory activities on behalf of the municipal advisor.
Series 52	Municipal Securities Representative	This representative exam allows a person to be involved in: ▪ Underwriting, trading or sales of municipal securities – including municipal fund securities; financial advisory or consultant services for issuers in connection with the issuance of municipal securities; research or investment advice with respect to municipal securities; or any other activities which involve communication, directly or indirectly, with public investors in municipal securities.

Principal Designations

Any person seeking to become a principal of a member firm will need to take one of the following exams; however, the specific exam taken will be determined by that person's responsibilities.

FINRA Principal Designations		
Series 9/10	General Securities Sales Supervisor	This limited principal exam allows a person to supervise sales of: ▪ Corporate securities (equity and debt); investment company products and variable contracts; municipal securities; options; government securities; and direct participation programs. ▪ However, this person doesn't supervise underwriting, trading, or overall firm compliance with financial responsibilities.
Series 24	General Securities Principal	This principal exam allows a person to supervise: ▪ All areas of the member firm's investment banking and securities business, such as underwriting, trading and market making, advertising, and/or overall compliance with financial responsibilities. ▪ However, this person doesn't supervise activities related to municipal securities or options.
Series 26	Investment Companies and Variable Contracts Products Principal	This principal exam allows a person to have regulatory compliance over sales of the following: ▪ Mutual funds; closed-end funds (initial offering only); variable annuities; and variable life insurance
Series 27	Financial and Operations Principal	This principal exam allows a person to supervise: ▪ Back office operations; preparation and maintenance of a member firm's books and records; compliance with financial responsibility rules that apply to self-clearing broker-dealers and market makers

Copyright © Securities Training Corporation. All Rights Reserved.

MSRB Principal Designations		
Series 51	Municipal Fund Securities Limited Principal	This limited principal exam allows a person to manage, direct, or supervise one or more of the following activities: ▪ Underwriting of municipal fund securities; trading of municipal fund securities; selling municipal fund securities to customers; communicating with customers or maintaining records relating to any of the above activities; processing, clearing, and (in the case of securities firms) safekeeping of municipal fund securities; and training of principals or representatives.
Series 53	Municipal Securities Principal	This principal exam allows a person to manage, direct, or supervise one or more of the following activities: ▪ Underwriting of municipal securities; trading of municipal securities; buying or selling municipal securities from or to customers; rendering of financial advisory or consultant services to issuers of municipal securities; communicating with customers or maintaining records relating to any of the above activities; processing, clearing, and (in the case of securities firms) safekeeping of municipal securities; and training of principals or representatives.

Failing an Exam If a person fails a qualification examination, a 30-day waiting period applies between the first and second attempt, and again between the second and third attempt. However, if a person fails the qualifying examination on his third attempt, he must wait 180 days between all subsequent attempts.

Exam Confidentiality FINRA considers the content of its qualification exams confidential and prohibits a person from sharing details with another person. According to FINRA, it’s a violation to:

- Remove all or part of a regulatory exam from an examination center
- Reproduce parts of an exam
- Disclose parts of an exam to another person
- Receive parts of an exam from another person
- Compromise the contents of a past or present exam in any way

Any person who violates the confidentiality rules of a regulatory examination may be subject to sanctions as determined by FINRA’s Code of Procedure. Possible sanctions include the suspension or revocation of the person’s registration.

Supervision of Registered Representatives

Each member firm must establish, maintain, and enforce written procedures for the supervision of registered representatives and associated persons in order to ensure compliance with securities laws, rules, and regulations.

Copyright © Securities Training Corporation. All Rights Reserved.

To adequately supervise their personnel and activities, member firms must comply with the following requirements:

- Keep and preserve records for carrying out supervisory procedures
- Review and endorse, in writing, all transactions that are executed by registered representatives and all correspondence that's created in connection with those transactions
- Approve customer accounts and review them periodically in an effort to detect and prevent abuses
- Inspect certain locations at least annually (e.g., an office of supervisory jurisdiction or OSJ)
- Ascertain the good character, business repute, qualifications, and experience of all persons being certified for registration and monitor their good standing on a continuing basis

Each registered representative must be assigned to a specific supervisor or principal who has passed the appropriate regulatory examination. A supervisor is required to review the activities of the firm's registered representatives and reasonably determine that the applicable rules and regulations are being followed.

If the regulators find that a representative has violated an industry rule, one of their first questions is likely to be, "Who was assigned to supervise that person?" The requirement that a representative be assigned to a particular supervisor exists to ensure that a specific individual is responsible for the activities of that person. On the actual examination, if a scenario-based question is asked regarding the potential clarification of a rule, the correct answer may be to contact the designated supervisor.

Registration of Representatives and Principals

The registration process typically begins with the filing of an application with the regulators. The application for registration is Form U4—the Uniform Application for Securities Industry Registration or Transfer (which will be described in detail in Chapter 18).

Form U4 and the Central Registration Depository

Each individual who is to be registered under SRO rules must complete Form U4. This form, along with a fingerprint card that's used for identification purposes, is filed with and reviewed by FINRA's Central Registration Depository (CRD). Essentially, the CRD is an automated, computerized database containing information regarding a registered person's permanent record within the securities business, including both employment and disciplinary history. The CRD provides registration information regarding broker-dealers and registered representatives to state regulators, other SROs, and the SEC.

On Form U4, an applicant must answer questions about his personal background, including both residential and business history. The form also contains a series of questions about the applicant's history with respect to any violations of laws or SRO rules. For example, applicants are asked whether the SEC has ever entered an order against them in connection with an investment-related activity.

Copyright © Securities Training Corporation. All Rights Reserved.

Statutory Disqualification

A broker-dealer may be prohibited from employing an individual who is subject to statutory disqualification (often referred to as an SD person) in any capacity unless FINRA provides specific permission. The denial of registration may be based on a person's past transgressions, including:

- Being expelled or suspended from a self-regulatory organization
- Having a registration denied, suspended, or revoked by the SEC or another regulatory agency (including the Commodity Futures Trading Commission [CFTC] or other foreign regulators)
- Violating or assisting in the violation of any securities law, commodities law, or rule of the Municipal Securities Rulemaking Board (MSRB)
- When acting as a principal or supervisor, failing to reasonably supervise a subordinate who violates rules. Disqualification doesn't apply if (1) there's a supervisory system in place that's reasonably expected to detect the violation, and (2) the supervisor reasonably discharged supervisory duties under the system.
- Being convicted within the last 10 years of any felony or a misdemeanor involving investments and related to fraud, extortion, bribery, or other unethical activities

It's also important to understand that the intentional submission of false information or the omission of pertinent facts will result in the immediate statutory disqualification of an applicant. If a person is convicted of a felony and is later pardoned, he must still report the conviction on Form U4. The pardon releases an individual from the punishment for the felony, but doesn't remove the conviction.

To hire or continue to employ an SD person, a firm must file an application with FINRA requesting special permission through a process referred to as an *Eligibility Proceeding*. FINRA's Department of Member Regulation evaluates the application and makes a recommendation to the National Adjudicatory Council (NAC) to either approve or deny the request.

When analyzing a firm's application, FINRA takes into consideration:

- The nature and gravity of the disqualifying event
- The length of time that has elapsed since the disqualifying event
- Whether any intervening misconduct has occurred
- Any other mitigating or aggravating circumstances
- The nature of the securities-related activity in which the applicant wishes to participate
- The disciplinary history and industry experience of both the member firm and the person being appointed by the firm to serve as the responsible supervisor of the disqualified person

When considering whether a firm may employ a statutorily disqualified person, FINRA requires the firm to engage in *heightened* supervision of the person and to include its supervisory plan for the person in its application.

The supervisory plan must be tailored to the specific SD person being supervised and often includes the following cautionary measures:

- For suitability purposes, reviewing and approving all of the SD person's order tickets, incoming and outgoing correspondence, and new account forms

Copyright © Securities Training Corporation. All Rights Reserved.

- Keeping written records of all supervisory reviews and approvals
- Meeting periodically with the SD person to review his transactions with clients
- Immediately reviewing customer complaints—whether written or oral—and forwarding the complaints to the firm's Director of Compliance

Background Check

Under FINRA's background check rule, firms are responsible for investigating the good character, business reputation, qualifications, and experience of any applicants applying for registration. Additionally, it's necessary for firm's to perform a search of "reasonably available public records" to verify the completeness and accuracy of the details that are included on a person's Form U4. For a person who switches firms, the new firm is also required to make a reasonable effort to review the person's most recent Form U5. Form U5 provides information regarding the reason for the termination of a registration with a member firm, as well as any potential claims regarding investment misconduct or other derogatory activities.

To maintain compliance, member firms are responsible for adopting written procedures for verifying the information on Form U4. These procedures should specify the process for completing the necessary public record research and stipulate the review will include, at minimum, a national search of available filings.

Fingerprinting Requirement

Under federal securities laws, every partner, officer, director, and most employees of a broker-dealer must be fingerprinted for purposes of completing a criminal background check. The associated person must thereafter submit her fingerprints to the U.S. Attorney General.

However, this requirement doesn't apply to:

- Broker-dealers that sell only certain securities that are not ordinarily evidenced by certificates (e.g., mutual funds and variable annuities) and
- Associated persons who don't:
  - Sell securities
  - Have access to securities, money, or original books and records
  - Supervise persons who sell securities or have access to the above

Essentially, if a person comes into contact with funds, securities, or the firm's books and records, the fingerprinting requirement applies.

Copyright © Securities Training Corporation. All Rights Reserved.

State Registration (Blue-Sky Rules)

In addition to ensuring that RRs are properly registered under FINRA rules, RRs will need to be properly registered as agents in each state in which they conduct business. Most states require that representatives pass the Series 63, Series 65, or Series 66 Examination, each of which cover the state securities regulations found in the Uniform Securities Act (USA). Firms must also submit an application and pay fees to the appropriate state Administrator(s).

Similar issues arise regarding the registration of securities. Each security that's sold to a customer must either be registered (blue-skyed) under state law or be exempt from registration. If more than one state is involved, such as when the representative is in one state and the client is in another, the security must generally be registered or exempt in each jurisdiction.

Continuing Education

A member firm's registered and associated persons are also required to participate in an industry-mandated Continuing Education (CE) program. The program is divided into two parts:

1. The Regulatory Element—which is created and administered by regulators
2. The Firm Element—which is the responsibility of each broker-dealer

Regulatory Element

RRs are required to participate in Regulatory Element training at the two-year anniversary of their initial securities registration and every three years thereafter. This requirement continues for as long as a person is associated with a member firm in a registered capacity. The content of the Regulatory Element CE requirement is written by the Securities Industry/Regulatory Council on Continuing Education. In the computer-based training session, RRs are provided with information about compliance, regulatory, ethical, and sales-practice standards. As they progress through the program, RRs must answer questions based on the scenarios presented using the information they have just seen.

FINRA will notify a broker-dealer at least 30 days in advance of an RR's appropriate anniversary date. This is the anniversary of a registered representative's initial registration or any significant disciplinary action (disciplinary action restarts the clock). The RR will then have 120 days from that anniversary date to complete the Regulatory Element training. If the person doesn't complete the training within the prescribed time frame, that person's registration will become inactive. An RR with an inactive registration is prohibited from performing any activity or receiving any compensation that requires securities registration.

Rather than requiring a person to make a reservation at a testing center, FINRA has transitioned the delivery of the Regulatory Element to an online format which is referred to as the CE Online Program. This program provides participants with the flexibility to satisfy their CE Regulatory Element requirement from either a home or office computer.

Copyright © Securities Training Corporation. All Rights Reserved.

Firm Element

With regard to the Firm Element of Continuing Education, any registered person (and her immediate supervisor) who has direct contact with customers in the conduct of a member firm's securities sales, trading, or investment banking activities is considered a *covered person*. At least once per year, firms must demonstrate to the regulators that they have analyzed and prioritized the training needs of their covered personnel and have developed a written training plan based on that needs analysis.

A broker-dealer is required to maintain records documenting the content of its program and the completion of the program by its covered registered persons. Unless a specific request is made, a broker-dealer's Firm Element plan is not required to be submitted for regulatory review. Minimum standards for Firm Element plans require that they enhance the securities knowledge, skill sets, and professionalism of registered representatives.

Such training must cover the securities products, services, and strategies offered by the firm, with particular emphasis on:

- General investment features and associated risks
- Suitability and sales practice considerations
- Applicable regulatory requirements

Inactive Status—Military Duty After proper notification to FINRA, a registered person of a member firm who volunteers for or is called into active duty in the Armed Forces of the United States shall be placed on *special inactive status*. During the period of active service, individuals are not permitted to function as RRs or contact customers; however, they may continue to receive compensation based on securities transactions that are executed by existing clients.

While performing military service, these registered representatives are not subject to the two-year inactive status limitation and are also exempt from continuing education requirements. At the time of military discharge, the regulators provide registration relief regardless of whether these RRs return to their previous employer or seek registration with another firm.

Conclusion

This closes the chapter on the regulation and registration requirements that apply to broker-dealer employees. The next chapter will examine employee conduct and reportable events.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 17 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Understand the purpose and key features of the SIE Exam, including limitations and subsequent qualification exam requirement
- Define the term *associated person*
- Describe the permitted activities of non-registered persons as they relate to interaction with the public
  - Restrictions
  - Compensation
  - Supervision
- Understand the general role/responsibilities of the different registered representatives and supervising principals
  - *Review the summary tables*
- Recognize the exam confidentiality requirements
- Describe the characteristics of Form U4 and the purpose of the Central Registration Depository (CRD)
- Describe the terms and conditions under which a member is subject to *statutory disqualification*
- Understand a firm's request to FINRA of an eligibility proceeding with a pledge to conduct heightened supervision
- Recognized the personnel who are required to be fingerprinted
- Distinguish between FINRA and Blue-Sky (state) registration requirements
- Understand the two elements of FINRA's Continuing Education requirements
  - Regulatory Element and Firm Element
- Understand how *Special Inactive Status* classification is given to a registered person who actively serves in the military

Create a Chapter 17 Custom Exam

Now that you've completed Chapter 17, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 18 – Employee Conduct and Reportable Events

- *Forms U4, U5, and U6*
- *FINRA and MSRB Investor Education*
- *Customer Complaints and Reporting Requirements*
- *Required Disclosures*

Copyright © Securities Training Corporation. All Rights Reserved.

This chapter will examine the process by which individuals register with FINRA as associated persons, as well as the requirements for updating FINRA for any relevant changes in an individual's application. Parts of this chapter will expand on the registration documentation that was introduced in the previous chapter. Additionally, an analysis is included of how member firms are required to handle customer complaints and the various issues which result in reporting requirements for individuals and firms.

Employee Conduct

Registration of Representatives and Form U4

Any person who engages in the securities business of a member firm must be registered, except for employees whose activities are solely clerical or ministerial. Member firms must investigate the good character, business repute, qualifications, and experience of personnel whom they intend to register with FINRA. To initiate registration, a person must complete Form U4—*the Uniform Application for Securities Industry Registration or Transfer*.

Form U4 On Form U4, an applicant must answer questions about personal data, including residential and business history. In addition, the form contains a series of questions about the applicant's history with respect to violations of laws or SRO rules. For example, applicants are asked whether the SEC has ever entered an order against them in connection with an investment-related activity.

Disclosures by Applicant Page three of Form U4 contains a series of questions about the applicant's involvement in the following:

- Criminal legal proceedings (felonies and securities related misdemeanors)
- Regulatory disciplinary actions
- Civil judicial actions
- Customer complaints
- Terminations
- Financial events (bankruptcies, liens, bonding denials)

Applicants who file false, incomplete, or misleading information will have their registration suspended or revoked. By signing the U4, registered representatives agree to file timely amendments (within 30 days) if any information on the form changes. The failure to provide complete disclosure of facts and circumstances could potentially result in a person being barred from the securities industry.

A *Yes* answer to any of the questions related to violations of laws or SRO rules generally requires an explanation on the appropriate disclosure reporting page (DRP) of the U4 and could lead to a *statutory disqualification*.

Arbitration Disclosures Form U4 contains a predispute arbitration clause. By signing this form, a person agrees to use arbitration as the process for resolving disputes that involve his employer, other member firms and associated persons, and customers.

Copyright © Securities Training Corporation. All Rights Reserved.

The member firm is required to make the following disclosures regarding arbitration:

1. You are agreeing to arbitrate any dispute, claim, or controversy that may arise between you and your firm, or a customer, or any other person that's required to be arbitrated. This means you are giving up the right to sue a member, customer, or another associated person in court, including the right to a trial by jury, except as provided by the rules of the arbitration forum in which a claim is filed.
2. A claim alleging employment discrimination, including a sexual harassment claim, in violation of a statute is not required to be arbitrated under FINRA rules. Such a claim may be arbitrated at FINRA only if the parties have agreed to arbitrate it, either before or after the dispute arose. The rules of other arbitration forums may be different.
3. A dispute arising under a whistleblower statute that prohibits the use of predispute arbitration agreements is not required to be arbitrated under FINRA rules. Such a dispute may be arbitrated only if the parties have agreed to arbitrate it after the dispute arose.
4. Arbitration awards are generally final and binding; a party's ability to have a court reverse or modify an arbitration award is very limited.
5. The ability of the parties to obtain documents, witness statements, and other discovery is generally more limited in arbitration than in court proceedings.
6. The arbitrators are not required to explain the reason(s) for their award unless, in an eligible case, a joint request for an explained decision has been submitted by all parties to the panel at least 20 days prior to the first scheduled hearing date.
7. The panel of arbitrators may include arbitrators who were or are affiliated with the securities industry or public arbitrators, as provided by the rules of the arbitration forum in which a claim is filed.
8. The rules of some arbitration forums may impose time limits for bringing a claim in arbitration. In some cases, a claim that's ineligible for arbitration may be brought in court.

Waivers A disqualified person may apply for a waiver from an SRO to enter or reenter the securities industry; however, the waiver can only be granted following an Eligibility Proceeding. If the SRO grants the waiver, it must notify the SEC. Ultimately, the SEC has the authority to overturn the waiver. If the SEC has no objections, the person is often placed under heightened supervision procedures at the employing broker-dealer and these procedures are detailed in the firm's Written Supervisory Procedures (WSP).

Generally, a prospective employee who is subject to disqualification may not associate with a FINRA member in any capacity unless/until the waiver is granted. If a person is currently employed by the member when the disqualifying event occurs, she may be permitted to continue to work in a limited capacity pending the outcome of the Eligibility Proceeding.

Review of New Hires Each member needs to establish and implement written procedures that are reasonably designed to verify the accuracy and completeness of the information contained in an applicant's initial or transfer Form U4. This review must take place no later than 30 calendar days after the form is filed with FINRA.

 Copyright © Securities Training Corporation. All Rights Reserved.

If a person was previously registered with FINRA, a broker-dealer must obtain and review the latest Form U5—*the Uniform Termination Notice for Securities Industry Registration*, which will be examined in greater detail shortly. Review of Form U5 must be completed within 60 days of the date that the person files an application for registration. If an applicant seeking registration receives a request for a copy of their Form U5, he must provide the form within two business days of the request.

The Central Registration Depository

The Central Registration Depository (CRD) is an automated database that contains information concerning the employment and disciplinary histories of registered persons. The CRD system is used to process applications for agent registrations for the states, as well as for processing applications for withdrawal, for agents and broker-dealers. If any information on an individual's Form U4 changes, an amendment to the CRD must be filed promptly.

Updating Form U4

Providing disclosure or updating a Form U4 is required if a person has been convicted or charged, or pled guilty or no contest to any felony or misdemeanor involving investments or an investment-related business or any fraud, false statements or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or a conspiracy to commit any of these offenses. A person who has been arrested, but has not yet been charged with a crime, is not required to report the event on Form U4 or to FINRA. However, most firms have an in-house rule that requires notification if a registered person is arrested for any offense.

Form U5

After a registered person resigns or is terminated from a member firm, the firm is required to notify FINRA within 30 days on Form U5, with the applicable details. The firm must also provide the former employee with a copy of the form. Form U5 includes the reason for the RR's departure (voluntary or involuntary) and must be updated (within 30 days) if answers to certain questions change following termination. If a broker-dealer receives a written customer complaint after the RR has left the firm, it's still required to notify FINRA regardless of how long ago the RR had left the firm. There's no requirement to send a copy of the complaint to the RR.

Even after termination, FINRA maintains jurisdiction over any associated persons previously employed by the broker-dealer for two years. For this reason, a person who terminates her registration, but wants to return to a brokerage firm as a registered representative without having to requalify by examination, must do so within a two-year period.

Form U6 Regulators, states, and/or jurisdictions use Form U6 to report disciplinary actions against registered representatives and/or firms. FINRA also uses Form U6 to report final arbitration awards against RRs and firms. As is the case with Form U4 and U5, any information that's processed on Form U6 is fed into the CRD system and some of the content may be available to the public through FINRA's BrokerCheck website.

Copyright © Securities Training Corporation. All Rights Reserved.

Release of Disciplinary Information BrokerCheck is FINRA's public disclosure program and provides information about the disciplinary history of member firms or registered representatives.

The BrokerCheck system provides information on individuals who are currently registered or have been registered within the last 10 years. This information is on file with CRD and can be obtained by the public through a toll-free telephone number or the website of FINRA Regulation. The information provided about individuals includes the following:

- The current employing firm, 10 years of employment history, and all approved registrations
- Certain legal and regulatory charges and actions brought against the RR, such as felonies, certain misdemeanors and civil proceedings, and investment-related violations
- Pending customer-initiated arbitrations and civil proceedings involving investment-related activities, any arbitrations or civil proceedings that resulted in an award to a customer, and settlements of $10,000 or more in an arbitration, civil proceeding, or complaint involving investment-related activities
- Written customer complaints alleging sales practice violations and compensatory damages of $5,000 or more that were filed within the last 24 months
- Formal investigations involving criminal or regulatory matters
- Terminations of employment after allegations involving violations of investment-related statutes or rules, fraud, theft, or failure to supervise investment-related activities

If a currently registered person disagrees with the information found on BrokerCheck, he's required to file an amended Form U4 with FINRA. However, if a person is not currently registered with FINRA (but was registered within the last 10 years), he must submit a Broker Comment Request Form with FINRA to provide an update or add context to the information that's made available on BrokerCheck.

Investor Education FINRA's Investor Education and Protection Rule requires member firms, at least once every calendar year, to provide to each customer, in writing (which may be electronic), the following:

- FINRA's BrokerCheck hotline number
- FINRA website address
- A statement regarding the availability of an investor brochure that includes information describing FINRA's BrokerCheck

However, any member that doesn't carry customer accounts and doesn't hold customer funds or securities is exempt from these provisions.

MSRB rules also contain an Investor Education Rule, which requires that the following disclosures are made at least once every calendar year:

- That the regulated entity is registered with the MSRB and the SEC
- The MSRB's website address

 Copyright © Securities Training Corporation. All Rights Reserved.

- That there's a brochure (*Investor Brochure*) available on the MSRB's website which describes the protections available under MSRB rules as well as the process by which a complaint may be filed with the appropriate regulatory authority

A previous MSRB rule stated that investors would only receive information about filing a complaint with the appropriate regulatory authority when they made a complaint to or about a firm. Firms are now required to annually notify a customer about the availability of educational material.

Expungement If information in the CRD system is incorrect, FINRA has established procedures for the removal (expungement) of disputed information that relates to arbitration cases from an RR's CRD record. This removal of information from the CRD is permitted only if:

- The claim, allegation or information is factually impossible or clearly erroneous.
- The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds.
- The claim, allegation or information is false.

Once information is removed from the CRD system, it's permanently deleted and is no longer available to the investing public (through BrokerCheck), regulators, or prospective employers.

Complaints

FINRA defines a *complaint* as any written statement of a customer, or any person acting on behalf of a customer, which alleges a grievance involving the activities of any persons under the control of a member firm in connection with the solicitation or execution of any transaction or the disposition of securities or funds of that customer. If received, the original customer complaint must be forwarded to a supervising principal. The principal's responsibility is to review and initial the complaint.

Member firms are required to maintain a separate file of all written complaints, including e-mail and text messages, in each office of supervisory jurisdiction for four years. The file must also contain a description of actions taken by the member, if any, regarding the complaint and must contain, or refer to another file containing, any correspondence related to the complaint. Response to a customer's written complaint may be in written or oral form. Note that even if a member has not received any complaints, a complaint file (even if empty) must be maintained.

CRD Updates Member firms may be required to file a report with FINRA regarding certain customer complaints and other incidents that may arise. If the reporting requirement is triggered, a member firm must report these events promptly, but by no later than 30 calendar days after learning of them. Events that may require reporting include the discovery by the firm that it or one of its associated persons:

- Is the subject of any written customer complaint involving allegations of theft, misappropriation of funds or securities, or forgery
- Has been found to have violated any securities law or regulation or any standards of conduct of any government agency, self-regulatory organization, financial business, or professional organization

Copyright © Securities Training Corporation. All Rights Reserved.

- Has been denied registration or has been expelled, enjoined, directed to cease and desist, suspended, or otherwise disciplined by any securities, insurance, or commodities regulator, foreign regulatory body, or self-regulatory organization
- Has been named as a defendant in any proceeding brought by a domestic or foreign regulatory body or self-regulatory organization alleging the violation of any securities, insurance, or commodities regulation
- Has been indicted or convicted of, or pleaded guilty to or no contest to, any felony or misdemeanor involving securities, bribery, burglary, larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds
- Is a director, controlling stockholder, partner, officer, or sole proprietor of, or an associated person with, a broker-dealer, investment company, investment advisor, underwriter, or insurance company that was suspended, expelled, or had its registration denied or revoked by any domestic or foreign regulatory body, or pleaded no contest to any felony or misdemeanor in a domestic or foreign court
- Is a defendant or respondent in any securities or commodities-related civil litigation or arbitration- that resulted in an award or a settlement of more than $15,000 (for any associated persons) or more than $25,000 (for member firms)
- Is the subject of any action taken by the member firm against an associated person of that firm that results in a suspension, termination, withholding of commissions, or the imposition of fines in excess of $2,500

Quarterly Reports FINRA members are required to provide FINRA with statistical and summary information about customer complaints on a quarterly basis, even if the complaint doesn't trigger the preceding reporting requirement. The report is due on the 15th of the month following the end of the calendar quarter in which the complaints were received. However, if no complaints were received during the quarter, no report is required to be filed.

Confidential Settlement of Complaints The terms of a customer's settlement against a broker-dealer may be confidential. Although this means that the customer may not disclose the terms, the registered person is still required to report the terms to CRD.

Red Flags

SEC has emphasized that "reasonable supervision" requires strict adherence to internal company procedure (i.e., WSP), but principals are also expected to identify problematic situations despite having limited information. Supervising principals are required to look for any indication of real or potential violations of securities regulations. These indications of potential wrongdoing are often referred to as *red flags*. Since the shortest path to failure is to ignore potential problems, principals must respond to red flags.

Copyright © Securities Training Corporation. All Rights Reserved.

When a red flag is discovered, a supervisor must do the following:

1. *Investigate the situation* This means that the supervisor must make a reasonable effort to ascertain all of the relevant facts and circumstances that led to the red flag. This investigation should include an evaluation of all documentation that's available, and often involves direct contact with the client. Regulators often want to see that supervisors have ongoing communication with the clients of the RRs who are under their supervision.
2. *Document the investigation* This means that all of the records reviewed, interviews conducted, and clients contacted need to be documented in writing. It's important to show the steps that were taken and the specific nature of conversations and interviews conducted. In a formal action by the regulators, the notes and records of the supervisor are often key elements of the investigation. From a regulator's viewpoint, if documentation is not in writing, it didn't happen.
3. *Pursue the investigation to a conclusion* Often an investigation will involve more than one supervisor or department. It's important that the supervisor who initiates the investigation take responsibility to ensure that the matter is brought to some resolution. In fact, the resolution may be that no violation occurred. Customer complaints and other allegations often arise from poor communication between RRs and clients and/or between RRs and firms.

A red flag doesn't necessarily mean that a violation has occurred. Regardless of the findings, the supervisor must bring the investigation to a conclusion and must document this conclusion and how it was determined.

Any investigation should be as objective as possible, and should always include evidence other than an employee's word. This could include consulting other supervisors or members from other departments, such as compliance or legal. The employee's prior conduct should always be taken into account. Violations are often not isolated incidents, but rather part of a pattern of ongoing misconduct. An RR who has a history of previous misconduct may be a red flag for a supervisor to investigate. Also, hiring an RR who has demonstrated a pattern of unauthorized transactions without being monitored has been viewed as a failure to supervise by some regulatory authorities.

Personal Activities of Employees

Outside Business Activities

Registered representatives who are employed by FINRA member firms must provide written notice to their employers before participating in any business activities outside of the scope of their normal relationship with their firms (e.g., a second job on weekends). The purpose of notification is to guard against potential conflicts of interest. For example, if a registered representative is a member of a publicly traded company's board of directors and the RR's firm recommends that company's securities, a conflict of interest exists. Even part-time employment by a registered representative must be reported to the broker-dealer. However, charitable activities or volunteer work conducted by registered employees are not required to be documented.

Copyright © Securities Training Corporation. All Rights Reserved.

Private Securities Transactions

Private securities transactions are those that are executed outside of the regular scope of an associated person's employment with a member firm. An associated person who engages in these types of transactions must provide written notice to his employing member. If a registered person executes securities transactions without providing notice to his employer, it's a prohibited practice which is referred to as *selling away*. Selling away may include participating in private placements, traditional public offerings, and arranging loans. FINRA has established the following rules regarding private securities transactions:

- If the associated person *will receive compensation for the transaction*, the member must specifically approve the transaction in writing for the person to be permitted to participate. In this case, the transaction must be recorded on the member firm's books.
  - Compensation for this activity can come in many forms, including commissions, finders' fees, securities (or the right to receive securities), and tax benefits.
- If the associated person *will not receive compensation for the transaction*, the employee is still required to provide written notification to her employer. Thereafter, the member must provide written acknowledgement of its receipt and may require the associated person to adhere to specific conditions in order to participate in the transaction.

Personal transactions involving investment company and variable annuity securities are not covered by this rule.

Influencing or Rewarding Employees of Others (The Gift Limit)

Under the gift limit rule, FINRA member firms and their associated persons may not provide gifts that exceed $100 per year to any person, principal, proprietor, employee, agent, or representative of another firm if the payment or gratuity is in relation to the business of the employer of the recipient of the payment or gratuity. The underlying concern is that the gifts could cause the recipient to act in a manner that's contrary to the interests of the employer and/or its clients because of the gift. However, the rule doesn't apply to gifts that a firm makes to its own employees or gifts that are made by an employee to a coworker.

Valuing a Gift Generally, a gift should be valued at *the greater* of its cost or its market value at the time it was given. If a gift is given to a group, a pro rata amount is deemed to have been given to each of the individuals. For example, if a $200 gift basket is sent to a branch office of four individuals, each individual is considered to have received a gift valued at $50 ($200 ÷ 4 = $50). Gifts of tickets to sporting or entertainment events are valued at the greater of cost or face value, not market value. For example, let's assume that a ticket to a concert with a face value of $50, was purchased for $90, but can now be sold for $200. In this case, the gift will be valued at $90.

Personal, De Minimis, Promotional, or Commemorative Gifts Some gifts, because of their nature and the circumstances surrounding them, are more clearly personal gifts rather than gifts connected to the firm's business. For example, wedding gifts and congratulatory gifts on the birth of a child are personal gifts that are excluded from the $100 aggregate limit.

Copyright © Securities Training Corporation. All Rights Reserved.

De minimis gifts are those that have a trivial or minimal value. Typically, these gifts include pens, notepads, or modest desk ornaments. Promotional gifts are those that display a firm's logo and have nominal value, including umbrellas, tote bags, and shirts. For de minimis and promotional gifts to be excluded, their value must be well below the $100 limit. Commemorative items are generally decorative (e.g., Lucite plaques) and serve to recognize a business transaction or relationship. These commemorative gifts are also excluded from the limit.

Business Entertainment Ordinary and usual business entertainment is excluded from the limit if two conditions are met:

- The business entertainment is not so frequent as to raise a question of impropriety.
- The member or its associated persons host the clients and guests.

Business entertainment may include a social, hospitality, charitable, or sporting event, a meal, or other leisure activity. In addition to the event itself, the term business entertainment includes transportation and lodging expenses that are incidental to the event. Generally, although no business is being conducted, a person associated with the member firm *must accompany* and participate with the employee. Providing tickets, but not accompanying the employee, is considered a gift rather than business entertainment.

Member Compensation Related to the Sale of Securities Products Broker-dealers that create investment companies (e.g., mutual funds) may not pay other broker-dealers a commission in the form of securities (e.g., stocks and/or options). With certain exceptions, registered representatives are prohibited from receiving compensation for the sales of direct participation programs (DPPs), real estate investment trusts (REITs), investment company securities, or variable contracts products (e.g., variable annuity or variable life insurance), either in cash or otherwise from any person other than the member firm with which they're associated.

For example, an RR cannot accept compensation directly from a mutual fund distributor for selling its funds. Instead, the distributor should make payments to the RR's broker-dealer, which then determines the RR's compensation.

Cash compensation includes any discount, concession, commission, service or other fee, asset-based sales charge, loan, override, or cash employee benefit received in connection with the sale and distribution of DPPs, REITs, investment company or variable contract securities. *Non-cash compensatio*n is any compensation in the form of merchandise, gifts and prizes, travel expenses, meals, and lodging.

De Minimis Exceptions There are several exceptions that permit RRs to receive cash or non-cash items from outside parties. For example, representatives may accept gifts of up to $100 per person, per year from a person who is affiliated with an investment company or variable contract issuer or distributor. Gifts of occasional meals, as well as tickets to sporting events, the theater, or comparable entertainment, are also acceptable as long as they're not excessive. Although the exceptions are based on the assumption that the gift is not preconditioned on the achievement of a sales target, the gifts may be used to recognize past performance or to encourage future sales.

Copyright © Securities Training Corporation. All Rights Reserved.

The Training and Education Exception FINRA recognizes that investment company and variable contract issuers and distributors (which are referred to as offerors) perform a valuable service when they provide training to member firms and their RRs regarding the products and services they offer. For that reason, industry rules permit offerors to pay or reimburse for meetings that serve an educational function. However, the following conditions apply:

- RRs must have their broker-dealer's permission to attend the meeting.
- Attendance may not be tied to the achievement of a sales target.
- The location of the meeting must be appropriate.
- Payments or reimbursements for guests of RRs, such as spouses, are not permitted.

In-House Incentive Programs A broker-dealer is free to create its own internal sales programs with non-cash incentives, such as merchandise and vacation trips. A firm may even accept contributions by offerors to its non-cash programs. However, FINRA has placed some conditions on these arrangements. One of the restrictions requires that a non-cash incentive program for investment company securities or variable contracts be based on the RR's total production for all of the investment company securities or variable contract products that are distributed by the broker-dealer. In addition, the credit earned by an RR toward the incentives being offered must be equally weighted among the products in the program.

MSRB Political Contribution Rule (G-37)

If no regulations existed, municipal securities dealers could make extensive political contributions in order to gain favor with politicians who might, in return, direct municipal securities underwriting business their way. To limit this pay-to-play practice, the MSRB has created specific rules against it. For purposes of Rule G-37, a political contribution includes any item of value such as a gift, subscription, loan, advance, or deposit of money.

Also included is any reimbursement of debt that's incurred in a political campaign or payment for transition or inaugural expenses of a successful candidate. The MSRB believes that the potential of making excessive contributions undermines not just the integrity of the municipal securities market, but also investor confidence in the market.

Rule G-37 applies to contributions that are made by municipal finance professionals (MFPs). MFPs are considered associated persons of a broker-dealer who *primarily* engage in underwriting, trading, sales, financial advisory or consulting services, and research or investment advice related to municipal securities. However, registered representatives who simply recommend municipal securities to retail investors are generally excluded from the definition. On the other hand, any representative who solicits municipal securities business from issuers is considered an MFP.

If a municipal securities broker-dealer makes certain political contributions to officials of issuers, it's prohibited from engaging in negotiated municipal securities business with that issuer for *two years*. However, MFPs of the broker-dealer may make certain contributions without triggering the two-year ban.

 Copyright © Securities Training Corporation. All Rights Reserved.

No violation is considered to have occurred if:

1. The MFP is entitled to vote for the official, and
2. The contribution doesn't exceed $250 per election

Interpretations Since there have been many questions raised by municipal securities dealers concerning the application of this rule, the MSRB has provided firms with guidance by issuing an interpretative notice, which includes the following examples:

Example 1 *An MFP contributes more than $250 and the ban is triggered. If the MFP leaves the firm, the ban is still in place. If that MFP is hired at a new firm and is still defined as an MFP, the new firm will also be prohibited from engaging in negotiated municipal securities business based on the date of the contribution. However, if the MFP is hired at a new firm and is not defined as an MFP, the two-year ban doesn't apply to the new firm.*

Example 2 *While employed at Dealer A, an MFP contributes $200 to a candidate. Three months later, while now employed as an MFP with Dealer B, the same MFP contributes another $200 to the same candidate. The two-year ban will only apply to Dealer B.*

Example 3 *A two-year look-back period applies to MFP contributions. If an individual is not an MFP, but she made contributions to a political candidate that would have resulted in a violation, the firm that employs the individual would be subject to the underwriting ban if she's employed in the role of an MFP within two years of the contribution.*

Example 4 *If a contribution to a political candidate is made from a joint checking account, the contribution will be split evenly by the contributors and the contribution limit applies. Therefore, if the check from the joint account exceeds $500, a violation occurs. On the other hand, if the check is signed only by the MFP, the entire amount is attributable to the MFP.*

If the spouse of an MFP made a contribution by writing a check from a personal (rather than joint) account, the contribution is NOT considered to have originated from the MFP. In which case, there's no limit on the amount that the spouse may contribute under Rule G-37.

Conclusion

This concludes the chapter on the FINRA registration process for associated persons and the requirements for informing FINRA for any relevant changes in an individual's application. The next chapter will examine economic factors and how they influence the decisions made by issuers and investors.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 18 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Recognize the contents of Form U4
  - Required personal information and disclosures
  - Arbitration provisions and required disclosures
- Understand the uses of Forms U4, U5, and U6
- Understand the purpose of FINRA's BrokerCheck
  - The information it provides
  - The length of time the information is available
- Understand the investor education requirements of both FINRA and the MSRB
- Understand the procedures for customer complaints
  - Recordkeeping requirement and quarterly reports
- The events which require FINRA notification
- Recognize and understand the rules, permissions, and notification requirements for registered persons as it pertains to:
  - Outside business activities
  - Private securities transactions (Selling Away)
  - Gifts and entertainment expenses
  - Training and education seminars
  - Political contributions

Create a Chapter 18 Custom Exam

Now that you've completed Chapter 18, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 19 – Economic Factors

- *Measuring the Economic Climate*
- *Key Interest Rates and Stock Classification*
- *Monetary and Fiscal Policy*
- *International Activities and Fundamental Tools*

Copyright © Securities Training Corporation. All Rights Reserved.

This chapter will examine several widely accepted measurements of economic conditions and how the economy impacts the decision making process of both issuers and investors. Consideration will be given to how economic factors influence market participants, including the level of interest rates, the outlook for inflation, relative currency valuations, and the perceived direction of the economy. The chapter will also briefly examine some basic financial statements that are used by investors to judge the underlying health of a corporate issuer. The format and contents of these statement s are established by the provisions of the Securities Act of 1934.

Economics

The performance of an investment is influenced by the performance of the economy. An impending recession may reduce demand for equity securities, while the effects of inflation or deflation may interfere with anticipated returns across many asset classes. The fear of rising interest rates (and falling bond prices) may cause fixed-income investors to shorten their maturities. Currency instability may cause investors to rebalance the global exposure of their portfolios. Essentially, when formulating an overall investment strategy, numerous economic factors must be considered.

Measuring National Output

Economists typically attempt to measure the relative economic health of a given country. Two of the most significant measures of U.S. economic activity are the *Gross National Product* and *Gross Domestic Product*.

Gross National Product (GNP) GNP measures the total value of all of the goods and services that are produced by a national economy. For the U.S., GNP includes the goods and services being produced overseas by a U.S. company.

Gross Domestic Product (GDP) GDP has replaced GNP as the most important measure of output and spending within the U.S. The reason for its importance is that GDP includes the final value of all of the goods and services that are produced within the U.S., without regard to the origin of the producer. For example, in the U.S., GDP includes the net profits (i.e., sales price – production costs) made by a Toyota plant in Columbus, Ohio. Components of GDP include consumer spending, investments, government spending, and net exports. The most useful variation of GDP is *real* GDP. Real GDP is adjusted for inflation using constant dollars and is considered the key measure of aggregate economic activity. Rising GDP signifies economic growth and potential inflation.

Inflation

Inflation is defined by a persistent and appreciable rise in the general level of prices. Inflation occurs when the demand for goods and services in the market increases at a faster rate than the supply of these items. In other words, inflation is when there's *too much money chasing too few goods*.

Copyright © Securities Training Corporation. All Rights Reserved.

Consumer Price Index (CPI) The *Consumer Price Index* is widely considered to be the most important measure of inflation. CPI measures the prices of a fixed basket of goods that are bought by typical consumers. If the prices of these goods are rising, then the economy is experiencing inflation.

Inflationary periods are typically characterized by rising interest rates. Along with bonds, interest-rate-sensitive stocks, such as those issued by utilities and financial service companies, also have significant reactions to changes in interest rates. Since utility companies are highly leveraged, it becomes more expensive for these companies to raise money when interest rates increase. Increasing interest charges cause a drain on earnings, which results in a decline in the prices of these securities.

Equities as an Inflation Hedge historically, equity securities or other related products, such as equity mutual funds, equity ETFs, and variable annuities, have provided the best protection against inflation. Securities which provide payments that are set at the time of issuance and remain unchanged regardless of the inflation rate are most susceptible to inflation risk (also referred to as purchasing-power risk).

Commodities as an Inflation Hedge Commodities, such as gold and silver, tend to perform well during inflationary periods. Customers are able to gain exposure to these asset classes through direct investments in the commodities or through futures or derivative products, such as mutual funds and ETFs.

Fixed-Income Investors Fear Inflation In comparison to equities, fixed-income securities are more vulnerable to inflation. Inflation actually represents a dual risk for bondholders—(1) rising interest rates will cause the market prices of their holdings to fall, and (2) the purchasing power of their interest payments will decrease. If higher rates are anticipated, bond investors will make adjustments to shorten their maturities (i.e., decrease portfolio duration) in order to minimize the effect of downward pricing pressure. Some bondholders may also attempt to protect their portfolios by purchasing inflation-indexed bonds, such as Treasury Inflation Protected Securities (TIPS).

Real Interest Rate The *real interest rate* is the rate of interest that a bond investor expects to receive after allowing for the decline in his purchasing power due to inflation. The formula for computing the real rate is the bond's yield minus the inflation rate. For example, if an investor buys a 5% bond while the rate of inflation is 2%, he expects to earn a real interest rate of 3%. This is one of the reasons why bond investors demand higher returns during an inflationary period. Essentially, they 'e factoring in the decline of the purchasing power of their future payments.

Yield – Inflation Rate = Real Interest Rate

Copyright © Securities Training Corporation. All Rights Reserved.

Deflation

Deflation is characterized by a persistent and appreciable decline in the general level of prices. Deflation may be caused by the supply of goods and services exceeding the demand for those items, resulting in producers lowering their prices to compete for the limited demand.

Deflation should not be confused with *disinflation*. Again, deflation is a drop in prices, while disinflation is a reduction in the rate of inflation.

Measurements of Economic Activity

The following table summarizes some of the more common measurements of economic activity that students may encounter on the SIE Exam:

Economic Terms	
Gross Domestic Product (GDP)	Measurement of the output of goods and services that are produced within the U.S. (disregards the origin of the producer) ▪ A key measure of aggregate economic activity
Consumer Price Index (CPI)	Measures the change in the prices of goods purchased by typical consumers ▪ A key measure of inflation
Inflation	Too much money chasing too few goods ▪ Leads to a rise in the prices of goods and services ▪ High inflation usually accompanies high interest rates
Deflation	A general decline in prices, often caused by a reduction in the supply of money or credit ▪ Interest rates trend downward

Note: In many cases throughout the regulatory examination, an acronym (e.g., GDP, CPI) may be used in place of the full name.

The Business Cycle

Over time, a pattern has emerged of the economic ebb and flow and it's the business cycle that represents this repetitive succession of changes in economic activity. The business cycle has four phases—*expansion (recovery), peak, contraction (recession),* and *trough*.

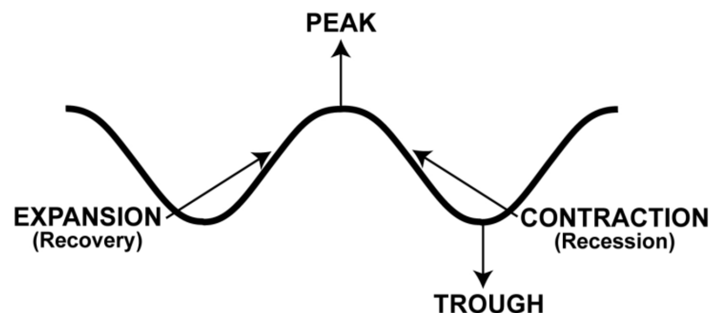
Expansion In the expansion phase, business activity is growing, production and demand are increasing, and employment is expanding. At this point, businesses and consumers normally borrow money to expand, which causes interest rates to rise.

 Copyright © Securities Training Corporation. All Rights Reserved.

Peak As the cycle moves into the peak, demand for goods begins to overtake supply. Since consumers have a large amount of available funds to use for pursuing a limited amount of goods, prices begin to rise, thereby creating inflation. With the increasing cost of products, the consumer's purchasing power is reduced.

Contraction As prices rise, demand diminishes and economic activity begins to decrease. At this point, the cycle then enters the contraction (recession) phase. As business activity contracts, employers lay off workers and unemployment increases. This usually causes the rate at which prices are rising (inflation) to decline (*disinflation*). In real terms, the situation in which prices are falling is referred to as *deflation*.

Trough The cycle finally enters the trough at the bottom of the economy's decline. Lower prices will eventually stimulate demand and cause the economy to move into a renewed period of expansion that's referred to as a recovery.



At times, the economic decline may be pronounced. By definition, a *recession* occurs when Real GDP declines for two successive quarters (six months). On the other hand, a depression occurs when Real GDP declines for a more prolonged period.

Business Cycle Indicators

Although the economy tends to follow a general pattern, it's often difficult to determine the actual direction at any given time. Economists use three types of indicators that provide monthly data on the movement of the economy as the business cycle enters its different phases. The three economic indicators are *leading, coincident*, and *lagging*. Although there are different definitions of these terms, this manual uses the most well-recognized version from The Conference Board—a global, independent research association.

Leading Economic Indicators Leading economic indicators precede the upward and downward movements of the business cycle and may also be used to predict the near-term activity of the economy. The government index of 10 leading economic indicators is released monthly. The components of the index include:

- Average weekly hours, manufacturing
- Average weekly initial claims for unemployment insurance

Copyright © Securities Training Corporation. All Rights Reserved.

- Manufacturing new orders, consumer goods and materials
- ISM Index of New Orders (this reflects the level of new orders from customers)
- Manufacturers' new orders, non-defense capital goods excluding aircraft orders
- Building permits, private housing units
- The prices for the S&P 500 Index common stocks
- Leading Credit Index (This index consists of six financial indicators based on various yields)
- Interest-rate spreads, 10-year Treasury bonds less federal funds
- Average consumer expectations for business conditions

Coincident Economic Indicators Coincident indicators usually mirror the movements of the business cycle. The composition of the coincident economic indicators includes the following four components:

- Employees on non-agricultural payrolls
- Personal income less transfer payments (Transfer payments represent aid for individuals in the form of Medicare, Social Security, and veterans' benefits, etc.)
- The Index of Industrial Production
- Manufacturing and trade sales

Lagging Economic Indicators The index of lagging indicators represents items that change after the economy has moved through a given stage of the business cycle. The index of lagging indicators should confirm the economic condition portrayed by previous leading and coincident indexes. Lagging indicators include the following components:

- Average duration of unemployment
- Ratio of manufacturing and trade inventories to sales
- Change in labor cost per unit of output for manufactured goods
- The average prime rate charged by banks
- Commercial and industrial loans outstanding
- Ratio of consumer installment credit to personal income
- Change in the Consumer Price Index for services

The Effect of the Business Cycle on Securities Markets

As the economy moves through the different phases of the business cycle, the bond and equity markets react to these changes. Naturally, investors view these changes and take corresponding actions in an attempt to take advantage of changes in the economy.

Interest-Rate Changes The level and direction of interest rates will influence numerous investments and may indicate inflationary trends. Therefore, interest rates and the effects of inflation will be important factors for investors to consider when choosing their investments.

Since bond investors are concerned with the possibility of inflation eroding the purchasing power of their interest and principal payments, it's important that they earn a rate of return that out-performs the rate of inflation. For this reason, an investor may choose to calculate the real interest rate on his investment.

Copyright © Securities Training Corporation. All Rights Reserved.

Numerous interest rates are published each day in *The Wall Street Journal*. Some of the most important rates include:

- *Prime Rate* The prime rate is what commercial banks charge their best corporate clients.
- *Discount Rate* The discount rate is what the depository institutions are charged when they borrow from the Federal Reserve.
- *Federal Funds Rate* The fed funds rate is what's charged on an overnight loan of reserves between member banks.
- *Call Rate* The call rate is what commercial banks charge on collateralized loans to broker-dealers (for margin purposes).

From lowest to highest, the usual order of these rates is—the fed funds rate, the discount rate, the call rate, and the prime rate.

Classifications of Common Stocks

Market professionals classify common stocks into various categories that are based on how they perform during various economic conditions, their market capitalization, as well as their potential for short-term or long-term capital gains. Although basic descriptions for many of these classifications were given in Chapter 3, this section will provide more detailed information on them.

Cyclical Stocks The performance of cyclical stocks is often parallel to the changes in the economy. If the economy is in a period of prosperity, these companies prosper; however, as the economy falters, cyclical stocks decline. The common stock of a machine tool company is an example of a cyclical stock. As the economy expands, new orders for machinery increase and the stocks of machine tool companies perform well. Other examples of cyclical stocks include basic industries (e.g., rubber, steel, and cement), construction firms, transportation, automotive, and energy companies, as well as homebuilders and manufacturers of durable goods.

Defensive Stocks The stocks of defensive companies have a smaller reaction to changes in the business cycle than cyclical stocks. Examples of defensive companies include utility, tobacco, alcohol, cosmetic, pharmaceutical, and food companies. Since people need basic services to exist, these companies are the last to be negatively affected as the economy moves through difficult periods. Generally, the demand for the products/services that are provided by defensive companies is not diminished by a downturn in the economy.

Growth Stocks Growth stocks are related to companies whose sales and earnings are growing at a faster rate than the overall economy. These companies often reinvest most of their earnings in order to keep expanding and therefore pay little or no dividends to their shareholders. On average, these stocks are riskier than other stocks, but also offer greater potential for capital appreciation. For investors with an objective of capital appreciation, rather than current income, these stocks are an appropriate long-term investment.

Copyright © Securities Training Corporation. All Rights Reserved.

From an analytical point of view, growth stocks have high price-to-earnings (P/E) ratios and low dividend payout ratios. To calculate the P/E ratio, the stock's current market price is divided by its earnings per share.

For example, if ABC is trading at $180 per share and its earnings are $10 per share, then its P/E ratio is 18. To calculate the dividend payout ratio, the dividends per share being paid to shareholders is divided by the earnings per share. Therefore, if ABC paid a $2.00 dividend, its dividend payout ratio is 20% ($2 ÷ $10).

Value Stocks A value stock is one that tends to trade at a lower price relative to the issuing company's fundamentals (i.e., dividend yield, earnings per share, sales, price-to-earnings ratio, market price-to-book value) and is therefore considered undervalued by a value investor. These companies tend to have high dividend yields, low price-to-book ratios, and/or low price-to-earnings ratios.

The risk of purchasing a value stock is that there may be a valid reason as to why it's undervalued and why investors keep ignoring this security, which results in a price that doesn't rise. A term used to describe value investors is *contrarian*, since they purchase stocks which are not popular with other investors.

Market Capitalization Another method of categorizing a stock is according to the total value of the issuing company's outstanding common shares, which is also referred to as its market capitalization. To calculate a company's market capitalization, its total number of outstanding common shares is multiplied by its current price. For example, if XYZ Co. has 10,000,000 shares of outstanding common stock and the shares are selling for $25 per share, XYZ's market capitalization is $250,000,000 (10,000,000 x $25).

A company's outstanding shares include shares that are held by institutions, retail investors, as well as the restricted shares held by insiders, but doesn't include treasury shares (i.e., shares that have been repurchased by the company). Remember, a company's outstanding shares are found by subtracting the number of treasury shares from the number of shares that the company has issued.

The following table lists the main categories and their commonly applied capitalization values:

Category	Market Capitalization
Large-capitalization (large-cap) stocks	More than $10 billion
Middle-capitalization (mid-cap) stocks	Between $2 billion and $10 billion
Small-capitalization (small-cap) stocks	Between $300 million and $2 billion
Micro-capitalization (micro-cap) stocks	Between $50 million and $300 million
Nano-capitalization (nano-cap)	Below $50 million

The boundaries between the categories are neither officially defined, nor clear-cut. Over time, a stock's category can change as its market value rises and falls.

Copyright © Securities Training Corporation. All Rights Reserved.

Small-cap stocks are generally the equities of newer, less-established companies, while more well-established issuers typically have mid-cap or large-cap valuations. Small-caps tend to be more volatile than large- or mid-cap stocks, but also often include companies that are growing faster and have more potential for capital appreciation.

The micro-cap category includes companies with very small capitalization ($50 million to $300 million). These companies typically have a low price-per-share and are extremely volatile and risky. Lastly, the newest unofficial category is nano-cap. These stocks are of companies with capitalizations of less than $50 million. Nano-caps have a low price-per-share and are extremely volatile and risky.

Influencing the Economy – Monetary and Fiscal Policy

There are many theories as to why the economy moves in a cyclical fashion and what may be done to control that cycle. Let's review two of the more popular economic theories—*Keynesian* and *Monetary*.

Keynesian Theory

Keynesian economic theory states that government intervention in the economy is necessary for sustained economic growth and stability. As introduced by British economist John Maynard Keynes, this theory further states that the government should use fiscal policies (i.e., tax and spend programs) to combat the effects of inflation and deflation, as well as to influence economic activity.

Fiscal Policy Fiscal policy involves the government's use of taxation and expenditure programs to maintain a stable, growing economy. For example, if the economy is in a recession or trough, the government may increase its spending to stimulate demand. Alternatively, it may cut taxes to increase the disposable income of consumers. These actions would (indirectly) stimulate demand. On the other hand, if the economy is overheated (i.e., exhibiting too much demand), the government may cut its spending or increase taxes.

Fiscal policy is set by the President and Congress; therefore, some decisions may be based on political motives, rather than those that are purely economic. However, the primary focus of fiscal policy is on economic growth and high employment. The U.S. Department of Treasury is a part of the executive branch and runs the federal government's budget. The Treasury's responsibilities include the collection of taxes through the Internal Revenue Service (IRS) and the spending of government money. While the Treasury implements fiscal policy, it doesn't have direct control over it. Conversely, monetary policy is controlled by the Federal Reserve—a body that's theoretically independent of the political process.

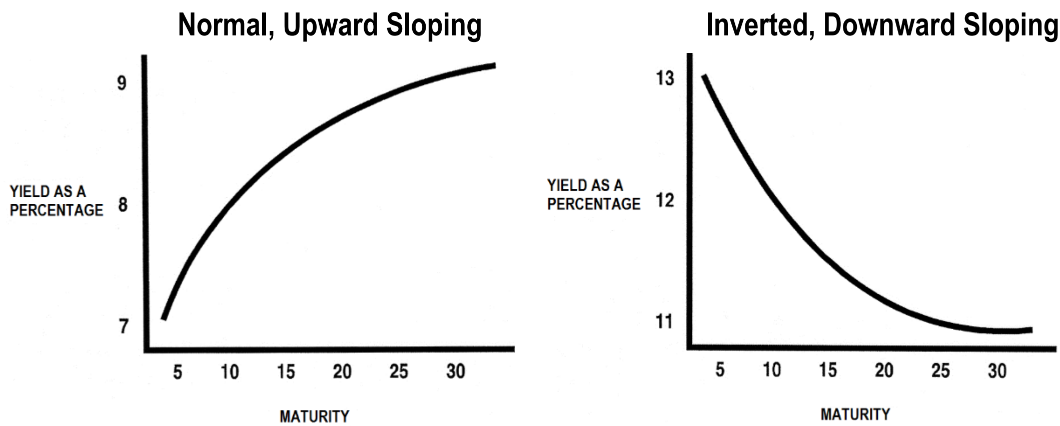
Monetary Theory

Monetary policy attempts to control the supply of money and credit in the economy. The adjustments will affect interest rates and cause an increase or decrease in economic activity. The Federal Reserve System implements monetary policy in the U.S. and primarily focuses on controlling inflation.

Copyright © Securities Training Corporation. All Rights Reserved.

Easing or Tightening of Money The method that the FRB uses to accomplish its goals is to ease or tighten money supply. When implemented by the FRB, an easy money policy involves increasing the money supply and lowering of rates, both of which should eventually stimulate the economy. On the other hand, when adopting a tight money policy, the FRB reduces the money supply and raises rates, both of which should diminish economic activity and control inflation.

Yield Curves During periods of easy money when interest rates are declining, yields on short-term debt securities will be lower than those on long-term debt securities. Yield curves will tend to slope upward from the shorter to the longer maturities, as illustrated by the normal yield curve diagram shown below. On the other hand, during periods of tight money, the yield curve may invert. This means that short-term interest rates will be higher than long-term rates. As illustrated by the inverted yield curve diagram shown below.



Money Supply Money is the unit of value by which goods and services are measured and is the medium of exchange through which business is transacted. The Federal Reserve Board attempts to control the money supply and credit to maintain a stable, growing economy with the aim of combating inflation.

However, before getting into specifics, let's define several measures of money supply:

Definitions of the Money Supply	
M1	Currency in circulation + demand deposits + other checkable deposits
M2	M1 + money market deposit accounts (MMDAs) + savings and relatively small time deposits + balances at money funds + overnight repurchase agreements at banks

Copyright © Securities Training Corporation. All Rights Reserved.

Shifts in economic conditions will influence the FRB's focus on the money supply figures. Each week the FRB compiles and publishes figures on the size of the money supply according to the M1 measure. On a monthly basis, the FRB publishes figures on M2.

Tools of the Federal Reserve Board

In an effort to implement its monetary policy, the FRB has the following tools at its disposal:

- Setting reserve requirements
- Setting the discount rate
- Implementing open market operations
- Setting margin requirements
- Using moral suasion

Reserve Requirements

Member banks are required to keep a portion of their deposits on reserve with the FRB. By adjusting the amount that banks must keep on reserve, the FRB is able to either tighten or ease the money supply. If reserve requirements are lowered, the banks are able to extend more credit, which causes the money supply to increase and interest rates to fall. The opposite effect occurs if there's an increase in reserve requirements. Changing the reserve requirement will have the greatest impact on the money supply.

After meeting its reserve requirement, a bank will seek to lend the remaining funds to borrowers. The amount of funds that a bank has above the reserve requirement is referred to as its excess reserves. The money spent by borrowers may eventually be deposited in another bank. This process continues as money is deposited from one bank to another, thereby creating a multiplier effect on deposits. In other words, the *multiplier effect* is the rate at which banks can create new money by re-lending deposits and, in turn, creating new deposits.

Discount Window

The FRB was originally established to aid the banking system by acting as a banker's banker in emergency situations. The FRB always stands ready to lend money to its members and fulfills that function through its discount window. As described earlier, the rate charged by the FRB for the loans that are made to its members is referred to as the *discount rate*.

When members of the FRB borrow funds through the use of the discount window, new money is injected into the system (which then is expanded by the multiplier effect). The FRB can encourage or discourage borrowing from the FRB's discount window by changing the rate of interest it charges for those loans.

Copyright © Securities Training Corporation. All Rights Reserved.

By decreasing the discount rate, the FRB encourages borrowing, which leads to the expansion of money supply. Conversely, the money supply will contract with an increase in the discount rate. Any change in the discount rate is usually seen as a very strong sign that monetary policy has shifted.

The discount rate is the only rate that's directly set by the FRB. Although it's largely symbolic, it acts as a benchmark off of which other key interest rates are set, such as the fed funds rate.

Federal Funds

Based on deposits, withdrawals, and loan demands, a bank may find itself with either an excess reserve position or a deficit reserve position. If a bank has excess reserves, it may lend additional funds to borrowers (e.g., commercial banks) that are in a deficit reserve position. These short-term loans of excess reserves that banks lend to one another are referred to as *federal funds* and the rate of interest charged on these loans is the federal funds rate.

The federal funds rate is determined by supply and demand. Since federal funds are used for short-term (overnight) purposes, they're considered money-market instruments. Due to the short duration of the loan, the fed funds rate is normally considered to be the *most volatile interest rate*. The effective fed funds rate is published daily and shows the average rate that was charged the previous night for federal funds.

Although the FRB doesn't directly set the fed funds rate, it does set a target or range. The FRB's open market operations are designed to maintain the fed funds rate within this prescribed target.

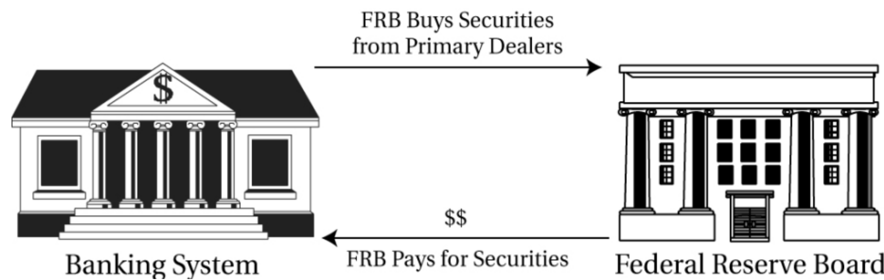
Open Market Operations

While the reserve requirements and the discount window involve very public moves on the part of the FRB, open market operations may be implemented very quietly and without significant disruption to the financial markets.

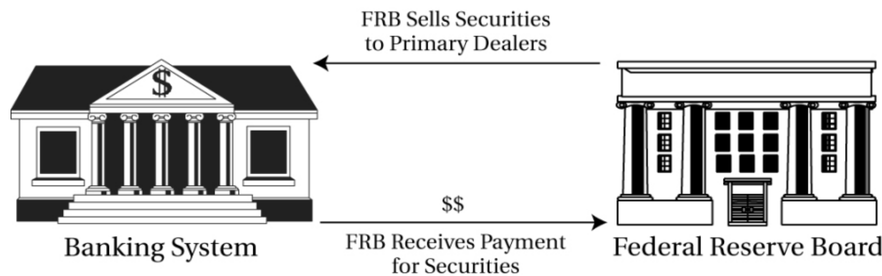
The *Federal Open Market Committee (FOMC)* oversees the FRB's buying and selling of U.S. government securities in the secondary markets. FOMC operations are the FRB's most effective and frequently used tool of monetary control. For the FRB, it's also the most flexible tool and the easiest to reverse. Open market operations typically involve the purchase and sale of U.S. government securities—primarily Treasury bills. However, the FRB also trades government notes and bonds. These trades are executed through *primary government dealers*, which are the nation's largest banks and brokerage firms that have been appointed by the FRB.

Buying Securities By purchasing securities through its open market operations, the FRB is injecting money into the banking system in order to stimulate investment and business activity. When the FRB buys securities, it pays for these securities with funds that are subsequently deposited in commercial banks. This action causes deposits at banks to increase, reserves to increase, and adds to the funds that are available for loans. At this point, money becomes more available and interest rates tend to move downward. This is referred to as an easing of the money supply. Since buying securities increases the money supply, this action may lead to inflation.

 Copyright © Securities Training Corporation. All Rights Reserved.



Selling Securities If the FRB wishes to tighten (reduce) the money supply, it will sell securities to banks and securities dealers. The banks and dealers will pay for these securities by withdrawing the money from their demand (checking) accounts. The withdrawal of money from the banks will decrease the amount of money available for loans and will have a tightening effect on the money supply, causing interest rates to rise. Since selling securities reduces the money supply, this action may curb inflation.



Repurchase Agreements A repurchase agreement (also referred to as a repo) is a contract that's entered into by the Federal Reserve to purchase U.S. government securities at a fixed price from dealers with provisions for their resale back to the dealer at the same price plus a negotiated rate of interest. When the FRB executes a repo, it's lending money and, therefore, increasing bank reserves (an easing of the money supply). A reverse repo (also referred to as a *matched sale*) occurs when the FRB sells securities to dealers with the intention of buying the securities back at a future date. This has the short-term effect of absorbing funds from the money supply (a tightening of the money supply).

Margin Requirements

The Securities Exchange Act of 1934 provided the Federal Reserve Board with the power to determine the amount of credit that may be extended to purchase securities. The provisions are established under Regulation T and apply to brokerage firms, while the provisions of Regulation U apply to banks and all other lenders.

By increasing margin requirements, the FRB reduces the amount of money that brokers and banks may lend, causing the money supply to tighten. Changing the margin requirement is the least effective method the FRB has to control credit since it affects only securities market transactions.

Copyright © Securities Training Corporation. All Rights Reserved.

Moral Suasion

There are times when the FRB attempts to influence bank lending policies through moral suasion (i.e., jawboning). The FRB exerts its influence through the public media or through the examiners who are sent to member banks. Its efforts to control the money supply by these means are limited by the extent to which they're able to elicit cooperation from these institutions.

Effects of the FRB's Activities

As with any product, when the supply increases, the price of that product will decrease. Conversely, if the supply contracts, the price will increase. The price of money is the interest rate that lenders charge borrowers; therefore, as the FRB changes the supply of money, the price of money (interest rates) must also change. As interest rates change, the FRB will adjust its monetary policy in order to influence the various sectors of the economy.

To summarize, the Federal Reserve Board's activities tend to cause the following adjustments to the money supply and interest-rate levels:

Activity	Effect on Money Supply and Credit (Loan) Availability	Impact on General Interest Rate Levels
Increase bank reserve requirements	Decrease (Tightening)	Increase
Increase the discount rate	Decrease (Tightening)	Increase
Increase margin requirements	Decrease (Tightening)	Increase
Sell government securities in the open market	Decrease (Tightening)	Increase
Decrease bank reserve requirements	Increase (Easing)	Decrease
Decrease the discount rate	Increase (Easing)	Decrease
Decrease margin requirements	Increase (Easing)	Decrease
Buy government securities in the open market	Increase (Easing)	Decrease

Any method or tool that creates additional money for the banking system is potentially inflationary. On the other hand, any tool or method that shrinks the amount of money available to the banking system is potentially deflationary. The FRB will use each of its tools to influence inflation and deflation.

 Copyright © Securities Training Corporation. All Rights Reserved.

	Comparison of Keynesian and Monetary Policy	
	Keynesian	**Monetarist**
Principally Attempts to Influence	Taxes and Expenditures	Money Supply
Responsible for Implementation	Congress	Federal Reserve Board

International Economic Factors

Exchange Rates

Changes in interest rates affect not only the domestic economy, but also international economic activity. If interest rates in the U.S. are higher than interest rates overseas, foreign investors who want to earn the higher rate may need to invest in the U.S. However, in order to invest in the U.S., foreign investors must first convert their funds into dollars. If an investor intends to immediately exchange currencies (e.g., British Pounds for U.S. dollars), the conversion is based on the *spot rate*. The spot rate is the current value of a base currency compared to a counter currency (or other asset). The name spot rate is derived from the fact that it's the price a person can get "on the spot." As demand for dollars increases, the price of dollars (the exchange rate) will increase. Therefore, when U.S. interest rates are higher than foreign rates, it may lead to a stronger dollar. Conversely, a decline in U.S. interest rates will likely cause a weakening of the dollar.

Balance of Payments

Foreign exchange rates also have an impact on foreign trade. If a county's exports (the goods sent overseas) exceed its imports (the goods received from overseas), the country is considered to have a *trade surplus*. Conversely, if imports exceed exports, a country is operating under a *trade deficit*. To correct a trade deficit, the dollar should weaken, which will cause U.S. goods to become cheaper (more competitive) abroad and foreign goods to become more expensive in the United States. This leads to more U.S. exports and fewer U.S. imports, which should help to alleviate the trade imbalance. Essentially, U.S. importers (and consumers) prefer a strong dollar, while U.S. exporters (producers) prefer a weak dollar.

Financial Statements

While there's no doubt that the level of overall economic activity is an important factor to consider when making investment decisions, fundamental analysis is much more specific. This discipline focuses on analyzing individual companies and their industry groups. Important items for a fundamental analyst include a company's financial statements (e.g., its balance sheet and income statement), details regarding the company's product line, the experience and expertise of the company's management, and the outlook for the company's industry. Obviously, the general condition of the economy will affect the prospects for a given company.

Copyright © Securities Training Corporation. All Rights Reserved.

The Balance Sheet

The balance sheet (also called a statement of financial condition) represents the financial picture of a company as of a specific date. The balance sheet is divided into three major sections—*Assets, Liabilities,* and *Stockholders' Equity*. The term balance sheet is used since the total assets must always equal the total liabilities plus the stockholders' equity. Therefore, the basic formula is:

Assets = Liabilities + Stockholders' Equity (Net Worth)

The exhibit below represents a sample balance sheet:

National Corporation Balance Sheet For period ending December 31, 20XX			
ASSETS		**LIABILITIES**	
Current Assets		**Current Liabilities**	
Cash	$ 43,000	Accounts Payable	$188,000
Marketable Securities	62,000	Interest Payable	27,000
Accounts Receivable	270,000	Dividends Payable	40,000
Inventories	330,000	Taxes Payable	72,000
Total Current Assets:	$705,000	Total Current Liabilities:	$327,000
Fixed Assets		**Long-Term Liabilities**	
Land	$ 64,000	9% Debentures due 2035	$300,000
Plant and Equipment	630,000		
Furniture and Fixtures	280,000	**TOTAL LIABILITIES**	$627,000
Less: Accumulated Depreciation	(220,000)		
Total Fixed Assets:	$754,000		
Intangible Assets		**STOCKHOLDERS' EQUITY**	
Goodwill	$ 30,000	6% Preferred Stock, $100 par value, 500 shares outstanding	$ 50,000
		Common Stock, $3.00 par value, 300,000 shares authorized, 200,000 shares outstanding	600,000
		Capital Surplus	52,000
		Retained Earnings	160,000
		Total Stockholders' Equity:	$862,000
TOTAL ASSETS	$1,489,000	**TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY**	$1,489,000

 Copyright © Securities Training Corporation. All Rights Reserved.

Assets represent all of the items that are *owned* by a corporation, while the liabilities section contains all of the items that are *owed* by the corporation. The difference between a corporation's total assets and its total liabilities is stockholders' equity (also referred to as net worth).

Components of the Balance Sheet – Assets

There are three basic subsections to the asset category—*current assets, fixed assets,* and *intangible assets*.

Current Assets Current assets represent cash and other items that can be converted into cash within a short period (usually one year). The assets that may be converted into cash include marketable securities, accounts receivable, and inventories.

Fixed Assets Fixed assets are items that are used by the company in its day-to-day operations to create its products. This section includes the company's physical property, such as land, buildings, equipment, and furniture.

Intangible Assets Although intangible assets don't have physical value, they add substantial value to a company. Some intangible assets differentiate the company from its competitors and are proprietary, such as patents, intellectual property, trademarks, franchises, and copyrights. Goodwill is another intangible asset and represents the amount that was paid above the fair market value to acquire an asset (or a company).

The Liabilities Section

The liabilities section identifies the company's debts. Some of the debts must be paid in a short period (current liabilities), while others are not required to be repaid for many years (long-term liabilities).

Current Liabilities Current liabilities are debts that become due in less than one year and are easily identified by the word *payable*. Included in this section are accounts payable (the amount a company owes for goods and services that are purchased on credit), dividends payable, interest payable, notes payable, and taxes payable.

Long-term Liabilities Long-term liabilities are debts that are incurred by a corporation which become payable in one year or more, such as bonds and long-term bank loans.

The Stockholders' Equity Section

The stockholders' equity section represents the company's net worth and also indicates the shareholders' ownership interest. The items listed in this section include the different classes of stock, retained earnings, and capital surplus. Capital surplus, or paid-in capital, is the amount of premium above the par value that's paid by investors who purchase the shares from the issuing corporation.

Copyright © Securities Training Corporation. All Rights Reserved.

The Income Statement

The other significant financial document used in fundamental analysis is the *income statement*—also referred to as the profit and loss statement. The income statement shows a company's financial performance during a specified period and provides detailed information about the company's revenues and expenses. If revenues exceed expenses, the difference represents the company's net income. However, if expenses exceed revenues, the result for the company is a net loss.

National Corporation Income Statement For period ending December 31, 20XX	
Sales	$660,000
Less:	
Operating Expenses:	
Cost of Goods Sold	240,000
Selling and Administrative Expenses	120,000
	300,000
Less:	
Depreciation Expense	80,000
Operating Income	220,000
Plus:	
Other Income	30,000
Earnings Before Interest and Taxes	250,000
Less:	
Bond Interest Expense	27,000
Earnings Before Tax	223,000
Less:	
Taxes (21% Rate)	46,830
Net Income or (Loss)	$176,170

Components of the Income Statement

Sales (revenues) represent the total money received and the amounts billed (although not yet collected) from the company's primary source of business. Sales are reduced by day-to-day operating expenses to arrive at operating income. Operating expenses reflect the daily costs of doing business and include the amount claimed for the depreciation of fixed assets.

Operating income is adjusted for other forms of income (or expenses) that are not generated by normal operations, leaving earnings before interest expense and taxes (EBIT). Other income usually represents income generated by investments (dividends and interest). However, other income may also reflect non-recurring or extraordinary items, such as earnings from the sale of assets or losses incurred by discontinuing a part of the business.

Copyright © Securities Training Corporation. All Rights Reserved.

To determine a company's net income (or net loss), EBIT is first reduced by bond interest and then by taxes. Many financial professionals use earnings before interest expense, taxes, depreciation, and amortization (EBITDA) as a measure of a company's cash flow. Although depreciation is subtracted from income, it's actually a non-cash expense because it's based on the theoretical wear and tear of assets (there's no cash outlay).

Measuring Profitability The operating profit margin is used as a measurement of a corporation's profitability. The calculation for operating profit margin is net operating income divided by sales. Another formula that requires the income statement is the bond coverage ratio, which is calculated by dividing EBIT (or EBITDA) by the interest expense.

Conclusion

This concludes the chapter on economics. The final chapter of the study manual will examine investment risks. As described in this chapter, some of these risks are due to broad economic conditions, while others are specific to a given product.

Chapter 19 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Define and understand the following common measurements of economic output:
  - *Gross National Product (GNP) and Gross Domestic Product (GDP)*
- Define the terms *inflation* and *deflation* and understand how they're measured
- Understand the importance of the Consumer Price Index (CPI)
- Calculate the *Real Interest Rate* for a fixed income security
- Recognize the four phases of the Business Cycle and the types of companies that benefit in each phase
- Recognize the different types of economic indicators
- Identify and understand key interest rates in the economy
  - Prime Rate, Discount Rate, Fed Funds Rate, Broker Call Rate
- Understand the characteristics of Keynesian and Monetary economic policies
- Understand the characteristics of the different yield curves (e.g., normal and inverted)
- Understand the definition of *money supply*
- Recognize the various tools used by the FRB and how they impact the economy
  - Review the chart on how FRB activity impacts interest rates and credit
- Define the term *balance of payments*
- Understand the various financial statements that are used by fundamental analysts
  - Balance sheets and income statements

Create a Chapter 19 Custom Exam

Now that you've completed Chapter 19, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.

Chapter 20 – Investment Risks

- *Systematic Risks*
- *Unsystematic Risks*
- *Portfolio Strategies*
- *Hedging*

Copyright © Securities Training Corporation. All Rights Reserved.

Investment risk can broadly be defined as the likelihood that an investor loses money. Some risks are specific to a particular company, while others affect an entire asset class of securities. This chapter will examine several different types of risk and explore ways that investors attempt to mitigate potential investment losses.

Investment Risks

When recommending specific securities or financial plans to clients, financial professionals are required to consider various factors. Among these factors are the client's financial holdings, risk tolerance, investment objectives, and related risk factors. This first section will outline some of the key risk factors that registered persons should discuss with clients prior to making recommendations. The concept of diversification will also be described, which in simple terms means *not putting all of your eggs (investment dollars) in one basket.*

One example of utilizing diversification is purchasing shares of a mutual fund that owns a large collection of stocks, rather than purchasing the stock of one company. To expand on the concept of diversification, let's begin a deeper discussion of risk. Investment risk is divided into two major categories—diversifiable and non-diversifiable.

Systematic (Non-Diversifiable) Risk

Systematic risk is caused by factors that affect the prices of virtually all securities. Interest rates, recession, and wars all represent sources of systematic risk since they affect all securities markets to some degree and cannot be avoided through diversification. The following are different types of systematic risk.

Market Risk Market risk represents the day-to-day potential for an investor to experience losses due to market fluctuations in securities' prices. Any security being bought and sold can decline as it's traded in the market. In a prolonged bear market, most stocks will trade down regardless of the company's individual prospects.

Beta – Measuring Non-Diversifiable Risk Avoiding diversifiable risk is as simple as constructing a portfolio of relatively uncorrelated assets (those with movements that are unrelated); however, non-diversifiable risk must be approached differently. The reason for this is that the amount of risk being assumed by a portfolio is directly related to its expected return.

The amount of non-diversifiable risk associated with a particular portfolio or asset is measured as *beta*. The value of beta describes the risk of a portfolio or asset as compared to the total market, which is measured as volatility. The total market (typically considered the S&P 500 Index) is assigned a beta value of 1.0. Stocks or portfolios with betas above 1.0 will have greater volatility than the market and those with betas below 1.0 will have lower volatility than the market. Most market professionals use the term beta when referring to the volatility of equity securities.

Copyright © Securities Training Corporation. All Rights Reserved.

Interest-Rate Risk As mentioned in Chapter 4, interest-rate risk primarily affects existing bondholders, since the market value of their investments will decline if interest rates rise. If rates do rise, new potential investors will not be interested in purchasing existing bonds at par ($1,000) due to the fact that they can obtain higher yields by purchasing newly issued bonds with higher coupon rates. For that reason, the prices of existing bonds will need to be lowered to attract purchasers.

Diversification A diversified portfolio of bonds from different issuers with different coupon rates, maturity dates, and geographic locations will provide protection against some risks, but not against interest-rate risk. In other words, since all bonds have some exposure to interest-rate risk, it's considered systematic or non-diversifiable.

Duration Bonds with longer maturities tend to be more vulnerable to interest-rate risk than bonds with shorter maturities. Also, bonds with lower interest rates are more sensitive to interest-rate risk than bonds with similar maturities and higher coupon rates. *Duration* measures the sensitivity of a bond or portfolio of bonds to a given change in interest rates. Duration is measured in years, but for practical purposes, a bond's change in price is based on its duration. For example, if a bond's duration is 10 years, a 1% increase in interest rates will cause a 10% decrease in the bond's price. Some investors will spread out (ladder) their bond maturities to minimize the impact of interest-rate risk by having a portion of their holdings in shorter term bonds.

Interest Rates and Equities Stock prices may also be influenced by interest rate changes. For example, when interest rates are rising, utilities stocks will be adversely affected because these companies are heavy borrowers (leveraged). However, stocks of cosmetic companies (defensive stocks) are not as affected by rising interest rates, which is due to the nature of their business and the low cost of their products. If interest rates rise, preferred stocks will react in a manner that's similar to debt securities. In other words, preferred stock prices have an inverse relationship to interest rate changes.

Inflation (Purchasing-Power) Risk Inflation (purchasing-power) risk is experienced by investments that provide fixed payments (e.g., bonds and fixed annuities). Inflation is the rising price levels of goods and service as measured by the Consumer Price Index (CPI). Ultimately, inflation diminishes the real value of a dollar by decreasing its purchasing power.

Historically, equity securities, variable annuities, investments in real estate, or precious metals (e.g., gold and silver) have provided the best protection against inflation. Inflation hurts bondholders in two ways, 1) inflation leads to rising interest rates which causes the market prices of their existing bonds to fall, and 2) the purchasing power of their interest payments decreases.

As stated previously, many market professionals measure an investment's *real rate of return* (for bond's, it's also referred to as the real interest rate). The formula for calculating real rate or return is an investment's return *minus* the rate of inflation (as measured by the Consumer Price Index, or CPI). For example, if an investment has an 8% return and CPI is 3%, the real rate of return is 5%.

Event Risk Event risk is the risk that a significant event will cause a substantial decline in the market value of all securities (e.g., the 9/11 terrorist attack).

 Copyright © Securities Training Corporation. All Rights Reserved.

Unsystematic (Diversifiable) Risk

In contrast to systematic risk, unsystematic risk is based on circumstances that are unique to a specific security and may be managed by diversifying the assets in a portfolio (i.e., by selecting stocks possessing different risk-return characteristics). The following are different types of unsystematic risk.

Alpha As referenced earlier, beta measures how volatile an investment is relative to the market as a whole. However, alpha measures the risk that's specific to a particular company. Using beta, investors can predict a stock's rate of return. Thereafter, alpha can be calculated by taking what the stock actually earned and subtracting its expected return. For example, based on its beta, a stock is expected to earn 5%. If the stock actually earned 8%, then alpha was 3% (8% – 5%). On the other hand, if the stock only earned 4%, the alpha is -1% (4% – 5%).

Business Risk Business risk is the risk that certain circumstances or factors may have a negative impact on the operation or profitability of a specific company. For example, a company's prospects may suffer due to either increased competition or decreased demand for its goods or services.

Regulatory Risk Regulatory risk is the risk that regulatory changes may have a negative impact on an investment's value. For example, an FDA announcement denying approval of a new drug may cause the price a pharmaceutical company's stock to decline.

Legislative Risk Legislative risk is the risk that new laws may have a negative impact on an investment's value. Changes in the law can occur at any level of government and can potentially affect all sorts of investments. For example, an increase in the legal drinking age could hurt the sales of a beer producer.

Political Risk Political risk is simply defined as the risk that foreign investors will lose money due to changes that occur in a country's government or regulatory environment. This risk is typically associated with emerging markets countries and may include acts of war, terrorism, and military coups.

Liquidity Risk Liquidity risk is the risk that investors may be unable to dispose of a securities position quickly and at a price that's reasonably related to recent transactions. This type of risk tends to increase as the amount of trading in a particular security decreases. For instance, the shares of large blue-chip companies are highly liquid, while the stocks of small companies are typically less liquid. Investments which are not traded in the market, such as hedge funds, private placements, direct participation programs (limited partnerships), and real estate have a significant lack of liquidity.

Opportunity (Cost) Risk Opportunity cost or opportunity risk represents the possibility that the return of a selected investment is lower than another investment that was not chosen. For example, an investor may be planning to hold a bond until maturity and is therefore unconcerned with the potential decline in its price if interest rates rise.

Copyright © Securities Training Corporation. All Rights Reserved.

After all, as long as there's no issuer default, he will receive the bond's par value at maturity. Of course the problem with this approach is that it fails to take into account the higher return that the investor could have possibly earned from an alternative investment.

Reinvestment Risk Reinvestment risk is the risk that an investor will not be able to reinvest her principal at the same interest rate after a bond matures or is called. This situation typically occurs when interest rates have fallen. At this point, the investor typically has two choices, 1) accept a lower rate of return, or 2) assume a higher degree of risk to keep her returns stable. Reinvestment risk is also evident if market interest rates have declined and a bond investor is forced to reinvest her bond's interest payments at a lower rate.

Currency (Exchange-Rate) Risk Currency or exchange-rate risk is the possibility that foreign investments will be worth less in the future due to changes in exchange rates. For example, an American investor owns a British stock that pays a quarterly dividend. The real value of the dividend to the investor will decline if the British pound weakens against the U.S. dollar. This is because the British pounds received will buy fewer American dollars when converted. Foreign securities, global funds, international funds, and ADRs all have a high degree of exchange-rate risk.

Currency risk may also impact the price of a company that's based in the U.S. if it earns revenue in a foreign country. For example, a U.S. company sells its products and services in Europe and earns revenue in euros. If the U.S. dollar increases or strengthens in value, the euro will decline and cause the dollar value of this revenue to fall. In addition, if the dollar strengthens, this company's products will be less competitive in Europe and result in the company exporting less.

Capital Risk Capital risk is the risk that an investor could lose all or a portion of her investment. Purchasers of options are significantly impacted by capital risk because, if the options purchased expire worthless, the investor will lose 100% of his capital. On the other hand, if an investor purchased a stock at $50 and it declined to$40, his loss of capital is 20% (10 point loss ÷ $50 purchase price).

Credit Risk Credit risk or default risk is the risk that a bond issuer will not make payments as promised. U.S Treasuries are assumed to have virtually no credit (default) risk. The ratings companies that were described in Chapter 4 provide information to market participants concerning the credit risk of an issuer's bond offering.

Call Risk Call risk is the risk that an issuer may decide to pay back its bondholders prior to maturity. Bonds are typically called when interest rates fall; therefore, bondholders receive their money back early and are unable to earn the same return when searching for a replacement investment.

Prepayment Risk In addition to the risks inherent in all fixed-income investments (e.g., interest-rate, credit, and liquidity risk), mortgage-backed securities are subject to a special type of risk that's referred to as prepayment risk. This risk is tied to homeowners paying off their mortgages early. When interest rates fall, homeowners have an incentive to refinance and pay off their existing mortgages.

Copyright © Securities Training Corporation. All Rights Reserved.

These prepayments are passed through to the pools that hold the old mortgages. At this point, the pass-through investors will need to reinvest this large amount of principal at a time when interest rates have declined and will likely have difficulty matching their existing coupon rates and returns when seeking new investments.

Attempting to Control Risk Through Diversification

Allocating assets into an optimal portfolio based on a client's risk tolerance and investment objectives is also referred to as *strategic asset allocation*. In theory, an optimal portfolio is the best mix of assets based on the client's goals and level of risk aversion. However, since various asset classes provide differing rates of return over time, the original asset allocation will eventually drift from the initial mix. For purposes of determining what's best for a client, there are numerous thoughts regarding any shift in asset allocation. This next section will examine different approaches for clients who either do or don't chose to make a portfolio correction.

Buy-and-Hold

Any investor who follows the *buy-and-hold* approach will not change her asset allocation. By not restoring the original strategic asset allocation, transaction costs and tax consequences are minimized since there's no selling or purchasing of assets. In addition, the portfolio retains any assets that may be steadily appreciating.

However, one of the problems with the buy-and-hold approach is that, as the asset mix of the portfolio drifts, its risk/reward characteristics are altered. In particular, its volatility—as measured by the portfolio's standard deviation—may become quite different from the original allocation. In fact, the difference may be so significant that it's no longer compatible with the client's risk tolerance.

Portfolio Rebalancing

Portfolio rebalancing involves a process of buying and selling assets on a periodic basis. Through rebalancing, the original strategic asset allocation—and its risk/reward characteristics—may be restored. With this approach, adjustments may be based on either time or value. If time is used as the focus, portfolio rebalancing may be done based on a prearranged schedule (e.g., monthly, quarterly, or annually). On the other hand, if adjustments are triggered by value change, the need to rebalance is based on an asset class growing or shrinking beyond a set tolerance level from the original allocation (e.g., ±10%).

More frequent rebalancing will keep a client's portfolio closer to its strategic allocation. However, more frequent rebalancing will result in higher transaction costs as some assets are sold and others are purchased.

Both the buy-and-hold and systematic rebalancing approaches assume that markets are *efficient.* Or, put another way, it's impossible to time changes in asset balances to take advantage of market movements. These passive approaches to asset allocation are in agreement with the market theory which is referred to as the *Efficient (Capital) Market Hypothesis*.

Copyright © Securities Training Corporation. All Rights Reserved.

Indexing

Investors who subscribe to the efficient market hypothesis and believe that market timing is ineffective usually favor buy-and-hold strategies and engage in market indexing. *Indexing* involves either maintaining investments in companies that are part of major stock (or bond) indexes or investing in index funds directly. Some of the indexes on which funds may be based include the DJIA, the S&P 500, the S&P 400, or the Russell 2000. An actively managed fund attempts to outperform a relevant index through superior stock-picking techniques; however, the composition of an index changes infrequently. On average, an index fund manager makes fewer trades than an active fund manager. The result of indexing is that there are lower trading expenses than actively managed investments and fewer tax liabilities to be passed on to shareholders.

Active Strategies

Investors who believe securities markets are not perfectly efficient may utilize an active strategy (e.g., market timing) to alter their portfolio's asset mix in order to take advantage of anticipated economic events. This market timing approach is often referred to as *tactical asset allocation.*

> *An investor's portfolio currently has an asset mix of 35% large-cap, 15% mid-cap and 10% small-cap equity index funds, 30% bonds, and 10% money-markets. If the investor is employing an active asset allocation approach and believes that small-cap stocks will outperform the market as a whole, what action could he take?*
>
> The investor could increase the small-cap stock allocation from 10% to 15% and reduce the mid-cap stock allocation. If the small-cap sector appreciates as predicted, the investor could then sell out of the small-cap asset class and reallocate into a different asset class. Essentially, the investor is trying to identify and buy into sectors that will outperform the market.

Sector Rotation

Sector rotation is an investment strategy that involves moving money from one industry or sector to another in an attempt to beat the market. Since not all sectors of the economy perform well at the same time, this method of asset allocation may allow investors to profit as the economy moves from one cycle to another.

The business (economic) cycle follows a certain pattern—early recession, full recession, early recovery, and full recovery. Although the length and severity of any of these stages may vary, this is the general pattern. Certain sectors of the economy tend to do better than others during different stages in the business cycle. For example, during the early part of a recession, utilities tend to perform well, while airlines tend to do badly since people have less discretionary income to spend on travel.

A portfolio manager who employs a sector rotation strategy will try to anticipate the next turn in the business cycle and shift assets to the sectors that will derive the most benefit. Therefore, if the manager believes that a recession is near its end and the economy is entering the recovery period, she would begin shifting funds to the sectors that would profit the most from the change, such as companies that make durable consumer goods (e.g., automobiles, appliances, etc.).

Copyright © Securities Training Corporation. All Rights Reserved.

Dollar Cost Averaging

Once the selection has been made regarding the best assets to purchase, investors may choose to use a systematic approach to investing. With *dollar cost averaging*, a person invests a fixed-dollar amount at regular intervals, regardless of the market price of the security. This fixed-dollar approach may be used rather than trying to predict the best time to invest. An investor using dollar cost averaging will be able to buy more shares when the price is low, but fewer shares when the price is high. As a result, the investor's average cost per share is lower than the average of the prices at which the investor purchased the shares. This method of investing makes no attempt to time the market; instead, investors buy regardless of whether the market is high, low, or somewhere in the middle. This technique is designed to take the emotion out of the investment process and accepts that markets are subject to erratic swings.

Hedging

Once assets are allocated into a client's optimal portfolio, the client may ask, "Are there ways for me to reduce risk?" For many, the answer is yes and it's referred to as hedging. Hedging (protection) essentially involves the client *buying* insurance to guard against the market moving against her.

Equity Options

If an investor has an existing stock position, an equity option can be purchased as an effective hedge. If an investor has a long position in a stock, she could purchase a put option which provides protection against a possible decline in the value of the stock. The reason that a put purchase is a hedge is that it gives the investor the right to sell the stock at the option's strike price if the stock declines in value.

On the other hand, if an investor has an existing short stock position, he may choose to purchase a call option to protect against a potential increase in the value of the stock that was sold short. The reason that a call purchase is a hedge is that it gives the investor the right to buy the stock at the option's strike price and to use the acquired stock to cover the short position.

Index Options

Equity options are effective tools for protecting single stock positions; however, there's an easier way to hedge a portfolio against risk? Let's assume that an investor is worried about a market crash. She could buy put options on a broad-based index, such as the S&P 500. If the value of the underlying index decreases below the strike price, the intrinsic value of the options increases. In this case, the investor has essentially purchased a blanket policy that covers her entire stock portfolio. What if the investor has a more concentrated position? In this case, she could buy put options on a narrow-based (specialized) index to adequately protect her position.

Copyright © Securities Training Corporation. All Rights Reserved.

Currency Options

Currency options allow investors to take a position based on the value of a foreign currency as it compares to the U.S. dollar. These contracts are U.S. dollar-settled, which means that there's no delivery or receipt of a foreign currency if the option is exercised.

In the U.S., there are no calls or puts available on the U.S. dollar; instead, investors take option positions on a foreign currency with the U.S. dollar on the other side of the contract. An investor's gain or loss is based on the inverse relationship between value of the foreign currency and the value of the U.S. dollar.

Let's consider how a U.S. importer may use currency options for hedging purposes. For example, ABC Importers is based in the U.S. and is buying goods from a company in France. ABC enters into a contract in which it will acquire goods from the French company and must pay for the goods in euros. ABC's costs will rise if the value of the euros rise and the value of the U.S. dollar falls. As a hedge, ABC Importers may buy euro calls since the options will become more valuable if the euro does rise in value, which will offset the higher costs for the French goods.

Conclusion

This concludes the reading portion of the SIE Exam preparation. Students are encouraged to review their notes and contact Securities Training Corporation with any conceptual questions prior to moving on to the final examinations.

Best of luck in the next phase of your studies!

Chapter 20 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Define and provide examples of systematic (non-diversifiable) risk
  - Identify which securities have market risk
  - Identify which securities have interest rate risk and Inflation risk
  - Identify which securities have event Risk
- Define and provide examples of non-systematic (diversifiable) risk
  - Identify which securities have business risk, regulatory risk, and legislative risk
  - Identify which securities have capital risk
  - Identify which securities have liquidity risk
  - Identify which securities have currency risk and political risk
  - Identify which securities have credit risk and prepayment risk
- Define the terms *alpha* and *beta* and understand the type of risk(s) they measure
- Understand that *duration* is a measure of interest rate risk
- Define an *efficient market* and understand the type of investors who subscribe to the *Efficient Markets Hypothesis*

 Copyright © Securities Training Corporation. All Rights Reserved.

- Understand the differences between *strategic* and *tactical* asset allocation
  - Recognize that *sector rotation* is an active investment strategy
  - Recognize that buy-and-hold, portfolio rebalancing, and indexing are all passive investment strategies
- Identify the types of risks that options can minimize through hedging

Create a Chapter 20 Custom Exam

Now that you've completed Chapter 20, log in to *my.stcusa.com* and create a 10-question custom exam.

Copyright © Securities Training Corporation. All Rights Reserved.