Securities Training Corporation

Series 7

General Securities Registered Representative

Learning Guide / Workbook

v28

How to Use This Learning Guide

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

About the Series 7 Exam

1	2	3	4	5
125 Multiple-Choice Questions	3 Hours and 45 Minutes Allotted to Complete Exam	10 Additional Questions are Included as Experimental (don't count for or against the score)	Minimum Required Passing Score is 72%	30-, 30-, 180-Day Waiting Period For Failures

Function	Chapters	# of Questions
1. Seeks Business for the Broker-Dealer from Customers and Potential Customers	3 and 13	9 (7% of exam)
2. Opens Accounts After Obtaining and Evaluating Customers' Financial Profile and Investment Objectives	1 and 2	11 (9% of exam)
3. Provides Customers with Information About Investments, Makes Suitable Recommendations, Transfers Assets and Maintains Appropriate Records	4, 5, 6, 7, 8, 9, 10, 11, 12 , 14, 15, 16 and 20	91 (73% of exam)
4. Obtains and Verifies Customers' Purchases and Sales Instructions and Agreements; Processes, Completes and Confirms Transactions	17, 18, 19 and 20	14 (11% of exam)

Chapter 1 – Building an Investor Profile

Key Topics

1	2	3	4
FINANCIAL FACTORS Learn about the financial concerns when developing a client's investment profile.	PERSONAL CHARACTERISTICS Learn about how an investor's age, risk tolerance, and experience are used to develop the investment profile.	FINANCIAL OBJECTIVES AND GOALS Learn about what types of investments may be used to achieve various investment goals.	KNOW YOUR CUSTOMER Learn about importance of suitability and FINRA's rules for an RR's obligations.

Regulation Best Interest (BI)

Client Relationship Summary (Form CRS)	Its purpose is to provide retail investors with information about the nature of their relationship with their financial professional in a simple, easy-to-understand format ▪ Form CRS must be NO LONGER than two pages ▪ New customers must receive 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 CRD; investment advisers must file Form CRS with IARD
Titles in Form CRS	In order to use the term *adviser or advisor*, a firm must be a registered investment adviser ▪ Registered representatives can only use these terms in their title if they're registered with either a Series 65 or Series 66 designation
Sales Contests	Reg BI effectively bans all sales contests, quotas, bonuses, and other forms of non-cash compensation that are tied to sales of specific securities or specific types of securities within a limited period ▪ Compensation based on total sales, asset growth or accumulation, or customer satisfaction is still permitted

Know Your Customer

Since every customer is unique, it's imperative to gather the necessary information and develop a complete profile of the customer in order to recommend a suitable portfolio.

Financial Factors	Personal Characteristics	Financial Objectives and Investment Goals
Income ▪ Earned ▪ Investment ▪ Retirement **Tax Considerations** ▪ Marginal tax bracket ▪ Capital gains and losses ▪ Estate and Gift taxes **Financial Situation** ▪ Balance sheet and Income statement ▪ Liquid net worth	▪ Age ▪ Time horizon ▪ Investment experience ▪ Risk tolerance ▪ Social Values	▪ Cash reserve ▪ Preservation of capital ▪ Liquidity ▪ Current income ▪ Growth ▪ College funding ▪ Retirement funding ▪ Speculation ▪ Tax relief

Financial Factors

Create a personal income statement for the client:
- Identify all sources and amounts of income
- Document all expenditures
- Determine the amount of discretionary income available for investments

AN INVESTOR'S PERSONAL INCOME STATEMENT	
MONTHLY INCOME	
Salary	$8,000
Investment Income	500
Other Income	1,000
TOTAL MONTHLY INCOME	$9,500
MONTHLY EXPENDITURES	
Taxes	$3,100
Mortgage Payments	2,000
Loan Payments	1,000
Living Expenses	2,000
Insurance Premiums	200
Entertainment and Travel	400
Other Expenses	300
TOTAL MONTHLY EXPENDITURES	$9,000
DISCRETIONARY OR NET INCOME	$500

Tax Considerations

An investor's tax situation is important when addressing investment objectives

MARGINAL TAX BRACKET	▪ At what rate is the individual taxed? Will the alternative minimum tax (AMT) apply?
INVESTMENT INCOME	▪ Is the individual receiving dividends and interest from existing investments? For dividends, are they qualifying dividends? For interest, is if from taxable bonds?
ESTATE AND GIFT TAXES	▪ Gifts up to $19,000 can be transferred to any number of individuals without tax implication to the donor. ▪ Gift amount doubles to $38,000 for married couples.
CAPITAL GAINS AND CAPITAL LOSSES	▪ Short-term gains are taxed at ordinary income rates, while long-term gains are taxed at a maximum rate of 20%. ▪ Capital losses are first used to offset capital gains; a maximum of $3,000 of remaining losses must be used against ordinary income.

Non-Financial Concerns

There are personal characteristics that help define the client's profile.

- **Age**
  - Younger individuals can generally accept more risk as they have longer to earn and build capital
  - Individuals who are nearing retirement usually need to be more conservative with their investments
- **Time Horizon**
  - 100 – Age = Equity
    - A formula often used to determine the percent of the portfolio that should be devoted to equities.
      - The younger the investor, the greater the percentage in equities
      - The older the investor, the greater the percentage in more conservative investments (e.g., debt)

Additional Personal Concerns

- **Investment Experience**
  - A history of investing tends to lead to a better understanding of the different products and the reason behind certain recommendations
- **Social Values**
  - Certain companies' policies and practices on social issues are contrary to an individual's beliefs
  - Investors may want to avoid including securities of these companies in their portfolio

Risk Factors

Risk tolerance for individuals is not based solely on their financial situation; it is also based on their values and attitudes on investing. An RR needs to carefully develop a complete investor profile. Below are a few examples:

YOUNG SINGLE PROFESSIONAL LIKES SPECULATION	YOUNG MARRIED COUPLE PLANNING FOR CHILD'S EDUCATION	OLDER COUPLE WITH SUFFICIENT RETIREMENT SAVINGS
▪ Can likely be more aggressive with investments, but should be aware of potential risks	▪ Will be investing for the long-term growth potential or college savings plans	▪ More concerned with income and capital appreciation to offset inflation

Financial Objectives and Goals

Some of the common objectives and corresponding goals are listed below:

Safety
Low credit risk

Short-Term, Capital Preservation
Safety of principal

Income
Reliable stream of cash

Growth and Income
Less volatility; reduced earnings

Long-Term Growth
Longer time horizon; greater volatility

Aggressive Growth
High risk, high reward

Speculation
Active, short-term speculation

Reduce/Defer Taxes
Tax advantaged investments

Activity

Which statements are TRUE regarding an investor's profile and the investment objective?
Circle all that apply in your workbook.

I. A 40-year-old investor should consider her portfolio to consist of approximately 50-60% equity.
II. An older couple with sufficient retirement income will likely be aggressive in their investment strategy.
III. An individual who is concerned with labor policies in foreign countries may avoid investments in emerging markets.
IV. A couple saving for a child's college education will tend to be very conservative and safe with the investments.

Suitability

The Basics of Suitability
Suitability is based on the client's profile when an account is opened ▪ Applies to recommended transactions and investment strategy ▪ Suitability is not determined by gains and losses ▪ RRs may not place their own interests ahead of the client's, such as: • Recommending one product over another to generate a larger commission

Institutional Suitability
Institutional suitability – The extent of the obligations is based on: ▪ Those servicing the account having a reasonable belief that the client is capable of evaluating investment risks ▪ The institutional client affirmatively stating that it is exercising independent judgement

FINRA's Suitability Rules

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

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

Verifying Net Worth and Sophistication

Certain investments may require individuals to satisfy net worth, earnings, or sophistication standards before investing. The SEC has *suggested* these methods to verify a customer's standing:

- Review previously filed IRS tax forms
- Review bank and brokerage account statements
- Obtain written verification as to the customer's accredited status from broker-dealers, investment advisers, etc.

The SEC does not require that any of the methods be used, but requires a reasonable attempt should be made to determine whether the investor's status has been verified before recommending any similar investments.

Using an Investment Analysis Tool

THE TOOL	▪ An Investment Analysis Tool is a technological tool that provides simulations and statistical analyses of the likelihood of different investment outcomes when specific investments are made or strategies are implemented
FIRM REQUIREMENTS	▪ In order to provide such a tool to investors, the firm must: • Describe the criteria, methodology, and the tool's limitations • Explain that results may vary over time and from use to use • Describe the universe of investments the tool considers and: – How investments are selected – Whether certain investments are favored over others – That other investments may provide similar or superior results – Display a disclosure that the projections are provided by the firm's investment analysis tool – Provide FINRA with access to the tool unless its solely used by institutional investors

Activity

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

AN INVESTMENT ANALYSIS TOOL USED ONLY BY INSTITUTIONAL CLIENTS IS NOT REQUIRED TO BE PROVIDED TO FINRA	
THE SEC REQUIRES A CLIENT'S NET WORTH TO BE VERIFIED BEFORE RECOMMENDING CERTAIN INVESTMENTS	
SUITABILITY IS NOT BASED ON GAINS AND LOSSES	
SUITABLE RECOMMENDATIONS MAY BE CONSIDERED EXCESSIVE	

Chapter 2 – Customer Accounts

Key Topics

1	2	3	4	5
CUSTOMER ACCOUNT REGISTRATIONS Learn about required information and different types of account registrations.	ACCOUNT TYPES AND CHARACTERISTICS Learn about day trading, prime brokerage, DVP/RVP, and fee-based accounts.	RETIREMENT ACCOUNTS Learn about ERISA rules, different qualified and non-qualified plans, and basic educational savings plans.	ACCOUNT CHANGES AND REQUIRED DOCUMENTS Learn about how to make changes to an account and some of the required documentation.	ACCOUNT APPROVAL AND RESTRICTIONS Learn about a principal's responsibilities and account restrictions.

FINRA Rules for Customer Account Information

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

Customers are NOT required to sign their new account forms

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

Additional Information

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

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

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

Customer Account Registrations

SOLE PROPRIETORSHIPS	**PARTNERSHIPS**
JOINT ACCOUNTS	**UNICORPORATED ASSOCIATIONS**

Joint Accounts

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

COMMUNITY PROPERTY ACCOUNT
▪ Can only be used by legally married couples ▪ Must also complete Community Property Document ▪ Essentially the same as JTWROS ▪ Based on laws of the state in which the couple resides ▪ Each owns half of the account

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

Other Forms of Registration

SOLE PROPRIETORSHIP	▪ A sole proprietorship is a business operated under the name of an individual owner ▪ All investments in the account are titled in the owner’s name even if the business is not in the business owner’s name ▪ The account is vulnerable to the owner’s personal creditors
UNICORPORATED ASSOCIATIONS	▪ Similar to sole proprietorships and partnerships ▪ Account is opened in the name of the owner(s) ▪ The individual’s ownership in the account are subject to a creditor’s claims
PARTNERSHIP	▪ Partnership agreement specifies persons authorized to execute trades ▪ Information must be collected on each managing partner

Discretionary Accounts

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

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

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

Limited Trading Authorization

- Allows for execution of trades

Full Trading Authorization

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

Trust Accounts

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

Revocable – also referred to as living or inter vivos trusts

- A person has the ability to revoke or change any terms in the trust
- Does not reduce estate taxes, but avoids probate if funded prior to donor's death

Irrevocable

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

Pattern Day Trading

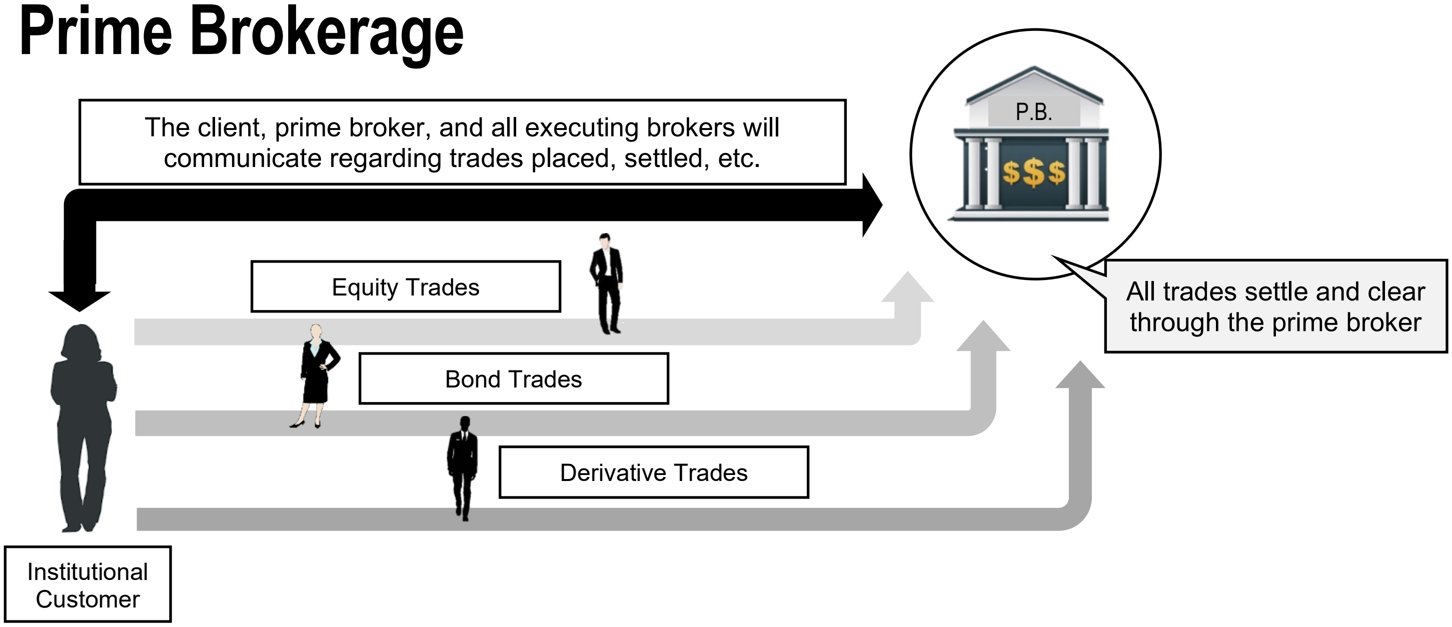
Definitions	▪ Day Trading • The purchase and sale (or short sale and purchase) of the same security, on the same day, in a margin account ▪ Pattern Day Trader • A client who executes four or more day trades within a five-day period
Risk Disclosure Statement	▪ Prior to opening a day trading account for a non-institutional customer, a firm must provide a Risk Disclosure Statement which indicates: • Day trading can be extremely risky • Be wary of claims of large profits from day trading • Day trading requires knowledge of the securities markets and the firm's operations • Day trading will generate substantial commissions • Day trading on margin or short selling may result in losses beyond your initial investments
Approval Procedures	▪ Firm must have reasonable grounds to believe that day trading is appropriate for the customer ▪ If the customer has provided written notice that the account will not be used for day trading, but the firm has evidence of the occurrence of day trading, the account must be approved for day trading within 10 days

Prime Brokerage Accounts

Prime Brokerage

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

Prime Brokerage



COD/DVP/RVP

These acronyms are used to describe situations in which a client (usually an institution) uses a bank to settle trades with one or more B/Ds

DVP or COD	Delivery Versus Payment (DVP) or Collect On Delivery (COD) ▪ Client is buying securities ▪ B/D delivers securities to client's bank and is paid by bank
RVP	Receipt Versus Payment (RVP) ▪ Client is selling securities ▪ Client's bank delivers securities to B/D; B/D makes payment to bank

- Before accepting a DVP/RVP account, the B/D must obtain the customer's account number and the name of its agent bank (i.e., an institutional identifier)
- Since DVP/RVP trades are settled with the customer's agent, account statements from B/Ds generally do not reflect any cash balance or security position at the quarter's end

Fee-Based Accounts

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

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

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

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

Activity

Match each description to the appropriate term.

COMMUNITY PROPERTY ACCOUNT	B/D delivers securities to a client's bank and is paid by the bank
FULL TRADING AUTHORIZATION	Executes four or more day trades in a five-day period
REVOCABLE	A person can make changes to the trust at any time
PATTERN DAY TRADER	A joint account between a married couple
DELIVERY VS. PAYMENT	Allows another person to execute trades and withdraw cash and securities from an account

ERISA

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

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

Taxation of Retirement Plans

Tax status of contributions:

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

Earnings typically grow **tax-deferred**

Retirement plans never generate capital gains or losses

Tax status of distributions:

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

Non-Retirement Distributions

Early withdrawal penalty:

- Before age 59 ½ and 10% of taxable amount

Exemptions from the penalty and taxation:

Rollover:
- Owner receives proceeds
- Once per year (rolling 12 months)
- Must be completed within 60 days

Trustee-to-Trustee Transfer:
- Owner does not have access to the funds
- May be more than one per year

457 and Profit-Sharing Plans

457 PLANS
- Employees may elect to contribute (generally pre-tax)
  - 457 plans generally have a zero cost basis since they are funded with pre-tax contributions, with earnings that grow tax-deferred
  - Contributions are subject to a maximum annual amount
- Employers may match contributions, but are not required to do so

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

ESOPs and Deferred Compensation Plans

Employee Stock Ownership Plans (ESOPs)
- Company contributes its stock or money to purchase its stock
- Stock not held directly while employed, but distributed when no longer employed

Non-Qualified Deferred Compensation Plans (NQDC)
- An agreement between an employer and an employee to pay the employee compensation in the future
- Generally unfunded; represent a "promise to pay" at retirement
- Not subject to ERISA requirements and exempt from IRS approval requirements

Education Savings Plans

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

Registration Changes and Internal Transfers

Account Registration Changes:

- For persons married or divorced:
  - Requires marriage certificate, divorce decree, or court document
- To add a person to or remove a person from an account
  - Birth date, Social Security number, and contact information for the person being added are required
  - Typically both parties must sign and submit forms
- A registered principal must approve the change
  - Change must be documented and approved before transactions are executed in the account

Internal Transfers:

- All parties on the account must provide approval of the transfer
- If transferring stock to another person, a stock transfer form must be completed
- This process is different than transfers of accounts between brokerage firms

Customer Identification Program

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

Protecting Client Information

Privacy

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

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

Corporate Insiders

The SEC defines an insider as any officer or director of the issuer, or greater than 10% owner

Insiders Must:	▪ File **Form 3** with the SEC within 10 days ▪ File **Form 4** to report purchases and sales within two business days; however, there is no required filing for certain transactions within a 401(k) plan
Insiders are Prohibited from:	▪ Engaging in short sales of their company's shares ▪ Retaining short swing profits (stock held less than six months)

Outside Brokerage Accounts

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

Firm Supervision: Principals

Principals are persons who are engaged in management of a member firm and are responsible for account approval and maintenance

- Includes officers, directors, and partners of the firm
- All RRs must be assigned to a principal

Activity	Required Registration or Title
Supervise option activities	Registered Options Principal
Supervise municipal securities activities	Municipal Securities Principal
Supervise general securities activities and written supervisory procedures (WSP)	General Securities Principal

Restricting Activity in an Account

According to the FRB, the Regulation T payment must be obtained for purchases that are made in either cash or margin accounts within two business days of settlement (S + 2 or T + 3)	Payment extension may be granted by the firm's SRO	If no payment is made and no extension is granted, the position is closed out (securities sold) on the third business day following settlement	The result of non-payment is that the account is frozen for 90 days (all payments must be made in advance)

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

Activity

Read each statement and fill in the blanks.

1. ______ determines eligibility and vesting schedules for qualified retirement plans.
2. A privacy notice must be provided to client when ______ and ________.
3. Unfunded retirement plans that generally promise to pay are considered _______.
4. In order to change an account registration after marriage or divorce requires a ______ or a ________.
5. An individual holding more than a 10% voting interest in a corporate is defined as an ______.
6. The ______ is maintained to identify the names of terrorists and/or criminals.
7. An employee of a B/D opening an account at another B/D must ________ and provide __________.

Chapter 3 – Customer Communications

Key Topics

1	2	3	4
COMMUNICATION STANDARDS Learn about the general standards that apply to customer communications.	TYPES OF COMMUNICATION Learn about the different types of communications, approvals, and filing requirements.	PRODUCT SPECIFIC ADVERTISING Learn about the disclosures required on mutual funds, variable products, options, and other securities ads.	RESEARCH REPORTS Learn about the rules on the distribution of research reports and preparation by third parties.

Communication Standards

All communications are subject to regulatory standards which include:

- Providing a basis for evaluating investments, being fair and balanced, and being based on fair dealing and good faith
- Not containing false, exaggerated, or misleading claims
- Being clear and balanced as to the risks and potential benefits
- Being considerate of the audience to which the communication is directed
- Not predicting or projecting performance, or implying that past performance will be repeated

Definitions of Communications

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

Filing Requirements

The following *retail communications* must be filed with FINRA

At least 10 business days *prior to* first use	*Within* 10 business days of first use
Communications regarding: ▪ Investment companies that contain self-created rankings ▪ Security futures ▪ Bond mutual funds that incorporate volatility ratings	Communications regarding: ▪ Investment companies that contain no self-created rankings ▪ Direct participation programs (DPPs) ▪ Collateralized mortgage obligations (CMOs) ▪ Securities derived from another security or index Any template for written reports that are produced by investment analysis tools Broker-prepared, widely disseminated free writing prospectuses (FWPs)

Additional Communication Information

For the following communications, no principal approval is required

1. Retail communications
   - Material that makes NO financial or investment recommendation and does NOT promote a product or service of the member firm
   - Market letters that make NO financial or investment recommendation
2. Correspondence
3. Institutional communications

Retail communications and correspondence must disclose the name of the broker-dealer.

Public Appearances

When engaged in an unscripted seminar, public forum, radio or other public appearance, associated persons are required to adhere to the following standards:

If making a recommendation, any conflict of interest must be disclosed	Written procedures must be established to supervise the public appearances	Any scripts, slides, handouts, etc. are considered communications

Unscripted public appearances are NOT considered retail communications, institutional communications, or correspondence.

Social Media

Interactive Content	Supervision of Interactive Content
▪ Refers to content which is posted or disseminated for direct, real-time interaction (e.g., chatting or messaging) ▪ Any posting or dissemination of content to an interactive social networking site, which may be defined as advertising, is supervised in a manner that's similar to correspondence (i.e., it must be reviewed and supervised, but not preapproved) ▪ Static content posted for an extended period is not interactive, is considered retail communication, and may be subject to pre-approval	▪ A principal must approve any social media site an RR intends to use for business communications (not sites for strictly personal use) ▪ Social media cannot be used if it automatically deletes and erases content ▪ Records must be maintained for any business communication, including those made through personal devices ▪ Suitability rules apply to recommendations made through social media, and recommendations made by a RR must be pre-approved

Social Media and Third-Party Posts

Third-party posts to a broker-dealer's social media

- Generally not considered a retail communication, but subject to recordkeeping rules
- Will be considered a retail communication if the broker-dealer:

Is involved in the preparation of the content (entanglement)

Has explicitly or implicitly endorsed or approved the content (adoption)

Links to third-party websites

- Broker-dealers are prohibited from linking to third-party sites that contains false or misleading content
- In a personal communication, an RR can link or share content from the broker-dealer that doesn't relate to the firm's products or services

Not considered retail communication

For example, sharing a link to a charity event being sponsored by the firm

Testimonial concerns

- Unsolicited third-party opinions to a site that are used by an RR for business are not considered testimonials
- If the RR shares or likes the comments, they're subject to FINRA's rules and may be considered testimonials
- The use of testimonials is prohibited by firms that are registered as investment advisers

Activity

Which statements are TRUE regarding requirements for customer communications?
Circle all that apply in your workbook.

I. An electronic communication to 35 retail investors within a 30-calendar-day period is a retail communication.

II. An advertisement regarding investment companies sent to 15 retail investors must be filed within 10 business days of use.

III. Scripts used during a public appearance are considered retail communications.

IV. An electronic communication sent to 40 institutional investors need not be filed with FINRA.

Investment Company Communications

Omitting Summary Prospectus (allowed under SEC Rule 482)
▪ Filed with the SEC and contains the highlights ▪ Client may make a purchase based on the contents of this document, but must be told a complete version is available ▪ A complete prospectus must be sent by settlement (along with a confirmation)

Required Disclosures
▪ Before investing, an investor must carefully consider the investment objectives, risks, charges, and expenses (which are included in the prospectus) ▪ The prospectus should be read carefully before investing ▪ The source from which an investor may obtain a prospectus

Additional Rule 482 Information

In an Omitting Prospectus:

Performance information and fee disclosure must be prominently displayed in a font size that's at least as large as that which is used for non-standardized performance information

If a 482 advertisement includes performance information, it must disclose:

- That the data being quoted represents past performance and that past performance does not guarantee future results
- That an investment's return and principal value will fluctuate; therefore, when shares are redeemed, they may be worth more or less than their original cost
- Performance data does not reflect the deduction of the sales load or fee, but does reflect ongoing fees (expense ratio)

Generic Fund Advertising

Although generic advertising cannot refer to a specific fund by name, it may include:

- How the fund operates and the services that it offers
- A basic description of the generic types of funds
- An invitation to inquire for additional information

	Regulation of Investment Company Advertising/Sales Literature		
	Preceded/Accompanied by a Prospectus?	May Performance Information be Included?	When it May Be Used?
Tombstone Ad	No	No	Waiting period and/or post-effective period
Omitting Prospectus	No	Yes	Waiting period and/or post-effective period
Supplemental Sales Literature	Yes	Yes	Post-effective period only
Generic Advertising	No	No	At any time

Use of Ranking Entities

Ranking Entity	An organization, independent from the investment company, that has been hired to provide a ranking symbol to the fund ▪ Nationally recognized ranking entities include Morningstar and Lipper
SEC Required Standardized Yields	▪ For money-market funds: 7-day yield ▪ For other funds: 30-day yield
Disclosures	▪ The objective of the fund ▪ Name of the ranking entity ▪ Criteria used for ranking ▪ That past performance is not a guarantee of future results ▪ An explanation of the symbols used in the ranking

Bond Fund Volatility Rating

Independent third party's measurement of how sensitive a bond fund's NAV is to changes in economic and market conditions

- Ratings based on:
  - Credit quality of fund's portfolio
  - Market volatility of the portfolio
  - Fund performance
  - Interest rate risk, prepayment risk, currency risk, etc.
- Can only be used in supplemental sales literature if a statutory prospectus is provided to the customer
- Disclosures:
  - Name of the rating entity
  - Most current rating and the date of the rating
  - Explanation of the symbols used in the ranking

Variable Product Communications

Special guidelines have been established related to the sale of variable life insurance and variable annuities

Both must be identified as insurance products	Describing them as short-term, liquid investments is prohibited	Guarantees	Hypothetical illustrations of rates of return
▪ Never state or imply that they are mutual funds ▪ Must disclose all charges and expenses associated with variable annuities ▪ Disclose the potential penalties and tax implications of liquidating a variable annuity prematurely	▪ Must disclose that loans and withdrawals will impact both cash value and death benefit	▪ Features are guaranteed by insurance company, not by the selling B/D or RR	▪ A gross rate of 12% is permitted as long as a 0% is also provided ▪ Rates must be consistent with current market conditions ▪ Must reflect the maximum expenses and sales charges ▪ Statement must be made that the rate is hypothetical and not a prediction of return

Options Communications

The current options disclosure document (*Characteristics and Risks of Standardized Options)* must be delivered to each customer either prior to or at the time the account is opened.

Additional rules for options communications include:

- A warning that options are not suitable for all investors
- Must be clear and balanced as to the risks and potential benefits of investing in options
- Projected annualized rates of return are permitted, but cannot be based on less than a 60-day experience
- Historical performance must cover no less than the most recent 12-month period and must include all relevant costs

CMO Communications

Collateralized mortgage obligations (CMOs) are multi-class debt instruments backed by a pool of mortgage-related securities. Due to their nature, they are subject to specific disclosures:

General Standards	Educational Material	Suitability
▪ Must include within the name “Collateralized Mortgage Obligation” ▪ Cannot compare to any other investment vehicle ▪ Disclose that yield and average life will fluctuate ▪ Radio and TV ads must suggest contacting an RR before investing	The following must be offered prior to the sale to non-institutional customers: ▪ A description of the risks and characteristics of CMOs ▪ The structure and types of tranches ▪ Questions that should be asked ▪ A glossary of terms	▪ They provide investors with the ability to choose the yield, maturity schedule, and risk exposure to meet their needs ▪ They allow investors to customize prepayment risk ▪ They may expose investors to extension risk ▪ Retail investors should review carefully before investing

Municipal Communications

General Provisions	▪ Ads include published or used in electronic or social media any promotional material made available to the public ▪ Does not apply to preliminary official statements or official statements, but does apply to abstracts of such ▪ Form letter is any written letter or e-mail distributed to 25 or more persons within a 90 consecutive day period ▪ Ads cannot be false or misleading
New Issue Advertisements	▪ The syndicate may show the initial reoffering price or yield even if price, yield to maturity or maturity have changed as long as date of sale by the issuer is contained. ▪ Date of sale for competitive is dates bids were submitted to issuer ▪ Date of sale for negotiated is date the contract to purchase securities is executed ▪ Statement must be made that new issues may no longer be available at time of advertisement
Municipal Fund Securities	▪ In addition to basic disclosures, MFS requires: • If investing outside of one's state of residence, home state tax benefits should be considered • If past performance is presented that it does not guarantee future performance • Maximum sales loads are included in performance • Print or electronic advertisements must be presented in font sizes and styles that provide information in a balanced manner • Average annual yields must be presented for 1, 5 or 10 years
Approval by Principal	▪ Each advertisement must be approved in writing prior to first use by a general securities principal or municipal securities principal ▪ Copies of advertisements must be maintained for four years from each (last) use

Research Reports and Quiet Periods

Type of Offering	Role of Firm	Length of Quiet Period
IPO	Manager/Co-Manager	10 calendar days
IPO	Other distribution participant	10 calendar days
Follow-on offering	Manager/Co-Manager	Three calendar days
Follow-on offering	Other distribution participant	No restrictions
IPO or Follow On	Non- Distribution Participant	No Restrictions

Distribution participants may not initiate coverage (but may continue coverage) prior to the effective date

Research Reports and Disclosures

Reports must be written in a plain English format and must disclose:

- Name and certifications of the analyst who prepared the report
- Plain meanings of the ratings used
- Any material conflicts of interest
- Whether the firm:
  - Owns 1% or more of the stock
  - Is a market maker for the stock
  - Has received investment banking compensation in the past 12 months or expects to receive such compensation in the next three months
- Whether the analyst (or any member of the analyst's household):
  - Has a financial interest in the company (owns shares, warrants, or options of the company)
  - Is an officer, director, or subject company advisory board member

Third Party Research

Third-Party Research	Independent Third-Party Research
▪ Defined as material prepared by either an affiliate of a broker-dealer or at the request of a broker-dealer that maintains editorial influence over the content of the report ▪ Disclosure rules apply to: ▪ The firm that created the report and ▪ Any firm that distributes the report	Defined as material prepared by a person or firm that is unaffiliated with the distributing broker-dealer ▪ The distributing broker-dealer has no editorial control and is not required to approve the report Disclosure rules apply to: ▪ The firm that creates the report, but NOT a firm that distributes the report

Activity

Match the communication with its correct description.

Omitting Prospectus	Investment cannot be compared to other investments
Ranking Entity	May include hypothetical illustrations of rates of return
Bond Fund Volatility Rating	A document that can include mutual fund performance information; sent to a client before making a purchase
Variable Product Communication	An independent third party's measurement of the NAV's sensitivity to changes in economic and market conditions
CMO Advertising	Research reports may not be distributed by underwriting participants
Quiet Period	An organization hired to compare different mutual funds

Chapter 4 – Equity Securities

Key Topics

1	2	3	4	5
COMMON STOCK	PREFERRED STOCK	RIGHTS, WARRANTS, AND ADRs	AUCTION MARKETS	EQUITY TRANSACTION TAX TREATMENT
Learn about the characteristics of common stock and other means of acquiring stock.	Learn about the characteristics of the different types of preferred stock.	Learn about the differences of rights and warrants, and investing outside the U.S. with ADRs.	Learn about the different types of electronic exchanges and auction markets.	Learn about how different equity transactions are taxed.

Issued and Repurchased Shares

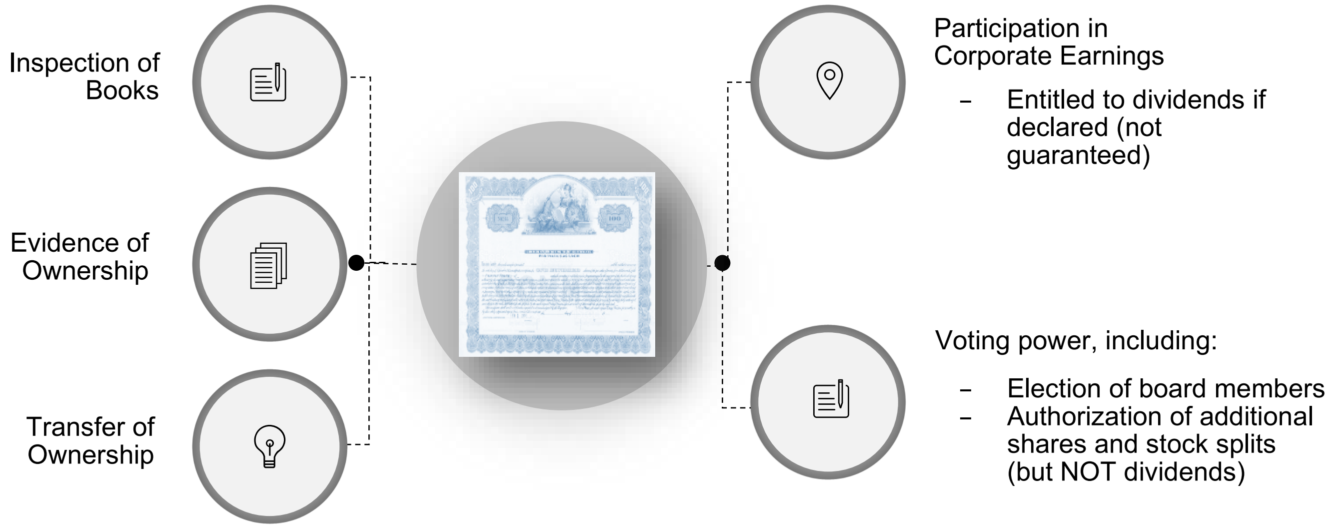
Corporate Charter determines the number of shares that are authorized and can be issued

Any outstanding shares repurchased by the issuer become Treasury stock

	Initial Public Offering	After Share Repurchase
Authorized	1,000,000,000	1,000,000,000
Issued	10,000,000	10,000,000
Treasury		
Outstanding		

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

Common Stock Ownership Rights



Voting Methods

Statutory
▪ Beneficial for **large shareholders** ▪ One vote, per share, per issue

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

If there are four candidates running for three seats on a corporation's board of directors, let's consider how statutory or cumulative voting works for an investor who owns 300 shares:

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

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

M&A and Spinoffs

Mergers and Acquisitions (M&A)

- Merger – the combination of two companies
  - Results in the distribution of new shares
- Acquisition – one company purchasing and assuming control of another
  - Acquiring company's shares continuing to trade, while the acquired company's shares cease to trade

Spinoffs

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

Penny Stocks

Defined as over-the-counter (OTC) stocks that have a bid price below $5 per share

- Clients must be approved for penny stock trading and receive risk disclosure document
- Required disclosures for **solicited sales** include:
  - Current quote of penny stock
  - Compensation received by B/D and RR
  - Does not apply to unsolicited transactions
- Special suitability rules apply for new clients, but not established clients
- Established clients are those who have:
  - Been clients of the firm for more than one year, or
  - Made three separate purchase of three different penny stocks on three different days

Preferred Stock

- Designed to provide returns that are comparable to bonds
- Pays a stated dividend
  - Stated as a percentage of par
    - Par value is typically $100
- Dividends are paid to preferred shareholders before common shareholders
- Senior to common stock in the event of corporate bankruptcy
- There are multiple types of preferred stock

Types of Preferred Stock

1. Non-Cumulative
▪ Investor is only entitled to the current dividend, NOT any unpaid dividend (dividend in arrears)

2. Cumulative
▪ Investor is entitled to unpaid dividends (those in arrears) before common stock dividends are paid

3. Callable
▪ Issuer can repurchase its stock; typically repurchased at a premium over par value

4. Convertible
▪ Investor may convert the preferred stock into a predetermined number of common shares

5. Participating
▪ Investor may receive additional dividends based on the company's profits

6. Adjustable / Variable Rate
▪ Dividends vary based on a benchmark ▪ The benchmark is typically T-bills

7. Series K Shares
▪ Begins with a fixed rate and later changes to a floating rate ▪ Depository shares with each share representing a number of preferred shares

Example of Cumulative Preferred Stock

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

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

Convertible Preferred Stock

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

- What is the conversion ratio?

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

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

Market value of common x Conversion ratio = Price of Preferred

Since the price of the common stock has risen to $12,
the convertible preferred stock should be trading at $120.

Preemptive Rights

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

Preemptive rights are given to existing stockholders when the issuer distributes additional shares

Warrants

Attached to bonds or stock; act as "sweeteners"

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

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

May be "detached" and traded separately

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

American Depositary Receipts (ADRs)

Characteristics:

- Facilitates trading of foreign equities in U.S. markets
- Priced in U.S. dollars
- Pay dividends in U.S. dollars
- Sponsored or Unsponsored

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

Activity

Read each statement and determine what it describes.

STOCK REPURCHASED BY A CORPORATION	
TYPE OF VOTING THAT BENEFITS SMALL SHAREHOLDERS	
UNLISTED STOCK WITH A BID PRICE BELOW $5 PER SHARE	
DIVIDENDS CAN EXCEED THE STATED AMOUNT	
STOCK CAN BE PURCHASED FROM THE ISSUER AT LESS THAN MARKET PRICE	
REPRESENTS FOREIGN EQUITY	

Secondary Markets

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

NYSE and other traditional centralized exchanges:

- Provide a specific location for trade execution
- Trading is normally monitored by a *specialist* or *designated market maker (DMM)*
- Exchanges include:
  - NYSE
  - Nasdaq
  - Regionals

Taxation of Dividends for Corporations

- Dividends – Qualified vs. Non-Qualified
  - Qualified cash dividends are taxed at a *maximum of 20%* after satisfying a holding period of *more than 60 days* for common stock and *90 days* for preferred stock
  - Non-qualified cash dividends are taxed at ordinary income rates
- Taxes paid on foreign investment income (ADRs) may be used as a tax credit or tax deduction
- Corporate Dividend Exclusion:
  - Based on its ownership percentage, a corporation may exclude from taxes a portion of the dividends that it receives from another corporation's common or preferred stock

Ownership Percentage:	Percentage excluded from taxes:
Less than 20%	
20% or greater	

Dividends from REITs are not considered qualified and they do not benefit from the corporate dividend exclusion.

Cost Basis and Capital Events

Cost Basis	▪ Represents the total amount paid to acquire a security ▪ Typically includes commissions and other fees paid
Capital Gains	▪ The result of the sale or redemption of an asset if the proceeds exceed the basis (Holding period is measured from trade date to trade date) • Short-term: Assets that are held for one year or less – Taxed at: ____ • Long-term: Assets that are held for greater than one year – Taxed at: _____
Capital Losses	▪ The result of the sale of an asset if the proceeds are less than the basis ▪ As it relates to holding period, short-term and long-term losses are defined the same as capital gains ▪ If losses exceed gains up to $3,000 can be used to offset ordinary income

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

Offsetting Capital Gains and Losses

Capital Losses	Capital Gains	Ordinary Income
$40,000	$25,000	$110,000
$25,000 of the capital losses are used against the capital gains	$0	$107,000
$15,000		
$3,000 of the remaining losses are used against the ordinary income		
$12,000 Carried forward		

How much could the investor realize in capital gains in the following year without being subject to tax? _______

Basis – Special Cases

Securities Converted to Stock	Inherited Securities	Gifted Securities
▪ Stock takes the basis of the converted security • Cost of convertible ÷ conversion ratio = basis per share ▪ No taxable event until stock is sold	▪ Beneficiary's basis is the market value at the time of death ▪ Estate taxes are paid based on that market value ▪ Holding period is always long-term	▪ Recipient's basis is the lower of donor's cost or market value

Basis – Stock Split and Dividends

- Additional shares are generally not taxed when received
- Investor's total basis is unchanged, but basis per share is adjusted

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

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

Investor's total position: $18,000

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

Investor's total position: $18,000

Identifying Securities Sold

An investor made the following purchases of the XYZ common stock:

Year	Shares	Price
2013	1,000	$5
2014	2,000	$10
2015	2,000	$8
2016	1,000	$22

FIFO; creates a $15,000 capital gain

Specific ID; creates a $2,000 capital loss

In the current year, the investor redeems 1,000 shares at $20 per share.

Taxpayer may use specific identification

- Must be identified at time of transaction
- If not identified, IRS assumes FIFO (first in-first out)

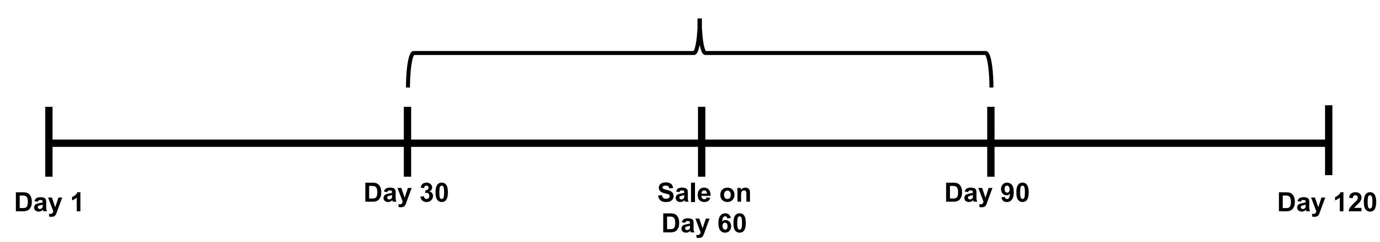
Tax Swaps and Wash Sale Rule

Assets may be sold to generate losses in order to offset taxable gains

However, the IRS will disallow the capital loss if, within 30 days of the sale, the investor purchases *substantially the same* security (or covers a short position and shorts *substantially the same* security)

- Disallowed loss is added to the basis of the newly purchased security
- What is *substantially the same*?
  - For stock – the stock itself, bonds and preferred stock that are convertible into the stock, as well as rights, warrants and call options that are exercisable into the stock
  - For bonds – bonds of the same issuer, coupon, and maturity

61-Day Wash Sale Period



Sale and Repurchase of Stock

An investor owns 1,000 shares of ABC with a basis of $43 per share. The current market value is $22, but it's expected to rise in the near future.

In order to offset significant capital gains, she sells the stock on December 3 at $22, recording a $21,000 loss. Fearing an imminent rise in the stock's value, she repurchases 1,000 shares of ABC at $24 on December 20.

- Consequences?

    - What if she bought ABC Jan 25 Calls or ABC convertible bonds on December 20?

Activity

Read each statement and determine whether it's TRUE or FALSE.

A CORPORATION CAN DEDUCT UP TO 65% OF THE DIVIDENDS IT RECEIVES FROM STOCK IF IT OWNS MORE THAN 20% OF THE ISSUER	
AN UNLIMITED AMOUNT OF ORDINARY INCOME CAN BE OFFSET WITH CAPITAL LOSSES	
THE GAIN OR LOSS ON THE SALE OF INHERITED SECURITIES IS BASED ON THE MARKET VALUE AT THE TIME OF INHERITANCE	
IF STOCK IS REPURCHASED WITHIN 30 DAYS OF A SALE FOR A LOSS, THE LOSS WILL BE DISALLOWED	

Chapter 5 – Fundamentals of Debt

Key Topics

1	2	3	4
BASIC STRUCTURE	BOND YIELDS	RETIRING DEBT	TAX IMPLICATIONS
Learn about the basic characteristics, how bonds are quoted, and risks influencing their value.	Learn about the relationship between nominal yield, current yield, yield-to-maturity, and yield-to-call.	Learn about call and put provisions, as well as methods used to refinance debt.	Learn about the tax implications when investing in taxable debt.

Terminology

10%

- Interest rate, coupon rate, nominal yield
- A fixed percentage of par; set at issuance
- Stated annually, but paid semi-annually

General Training

10% Debenture

Due 1/15/20XX

- The maturity or due date of the bond
- The date on which principal is returned and the last interest payment is made

$1,000 Par

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

Quoting Bonds

Bond prices and interest rates are generally quoted as a percentage of par ($1,000):
- A bond priced at 100 is selling at 100% of its par value, or $1,000

Bonds may be quoted in terms of points or dollars
- Each point is equal to 1% of the bond's par value, or $10.
- Corporate and municipal bonds trade in increments of 1/8 of a point, or $1.25.

Bonds may also be quoted in yield or basis terms
- Yield generally determines the bond's value.
- Allows comparison of bonds with different characteristics.

Accrued Interest

Interest originally begins to accrue on the *dated date* and then every coupon date thereafter
- Buyer pays the seller the bond's market price plus the accrued interest
  - Start counting at: **last coupon date**
  - And count up to: **but not including, the settlement date**
- Corporate, municipal and U.S. government agency bonds calculate accrued interest on a 30/360-day basis
- Treasury bonds and notes calculate accrued interest on an actual calendar/365-day basis
- The following formula is used to calculate the amount of accrued interest that's added to the purchase price:

Calculation: $$\text{Annual Interest \$} \times \frac{\text{\# of accrued days}}{\text{360 or 365-day year}}$$

Term and Serial Maturities

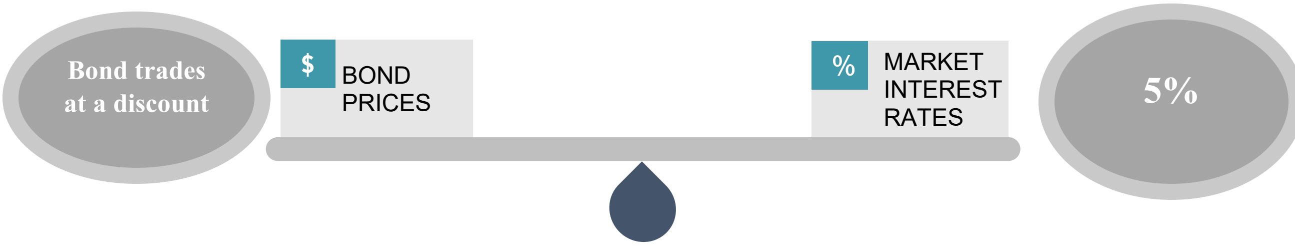
- Two of the ways that an issuer may structure its loan repayment or maturity are **term** and **serial**.
  - *Term maturity*: the entire bond offering matures on the same date
    - Generally quoted on a dollar basis
  - *Serial maturity*: the bond offering matures over several years (i.e., has a series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

Why Bond Prices Fluctuate from Par

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

A bond's par value can differ greatly from the price that investors pay

Interest-Rate Risk



INVERSE RELATIONSHIP

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

Credit Risk

Credit risk is a recognition that an issuer may default and be unable to meet its obligations to pay interest and principal to its bondholders.

- Issuers that are considered high credit risks must pay a higher rate of interest in order to induce investors to purchase their bonds.
- Securities issued by the U.S. government have the lowest possible credit risk.
- Credit risk is more difficult to evaluate when the bonds are issued by a corporation or a municipality.

If a bond has a high rating, it will have a lower yield and higher price.

Credit Ratings

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

Activity

Read each statement and determine what it describes.

PERCENTAGE OF PAR, STATED ANNUALLY, PAID SEMI-ANNUALLY	
INTEREST ACCRUES ON A 30/360 DAY BASIS	
COMBINED INTEREST AND PRINCIPAL PAYMENTS ARE THE SAME EACH YEAR	
ISSUED AT THE SAME TIME, MATURE AT THE SAME TIME	
RELATIONSHIP BETWEEN BOND PRICES AND INTEREST RATES	
CONCERN THAT BOND ISSUER MAY DEFAULT ON PAYMENTS	

Bond Yields

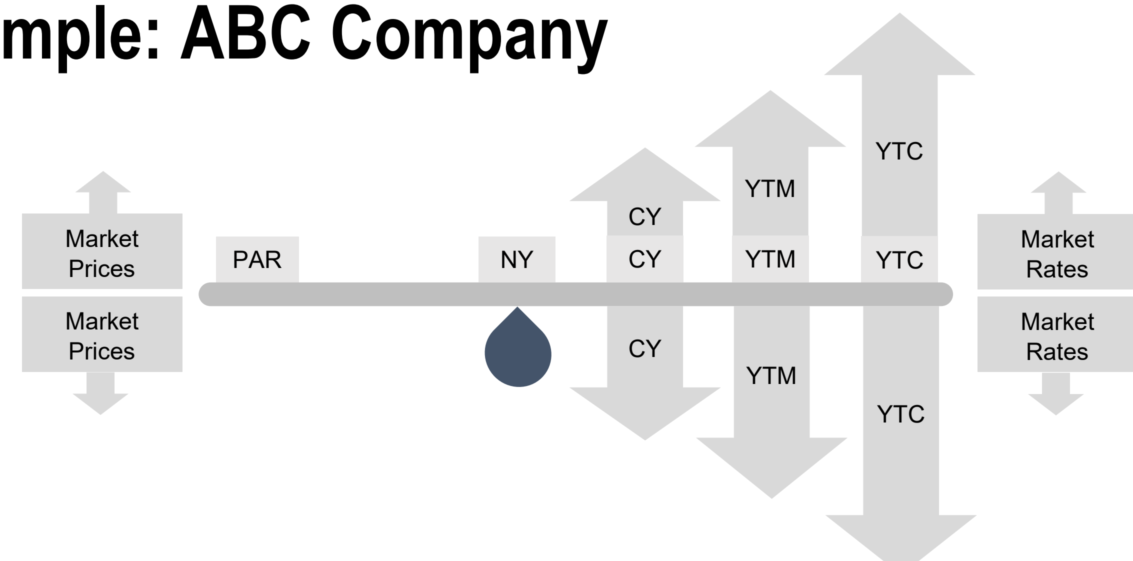
Yield is the return an investor gets on a bond

NY	CY	YTM	YTC
Nominal Yield (NY) ▪ Same as coupon ▪ Fixed percentage of par	Current Yield $\frac{\text{Annual Interest}}{\text{Current Market Price}}$	Yield-to-maturity ▪ Same as basis and yield ▪ Includes the reinvestment of annual interest and the gain or loss over the life of the bond ▪ Measured to the bond's maturity	Yield-to-call ▪ Includes the reinvestment of interest and the gain or loss if the bond is called ▪ Measured to the bond's call date(s) ▪ Disclosed if lower than YTM

1.00% = 100 basis points

.01% = 1 basis point

Example: ABC Company



Retiring Debt Prior to Maturity

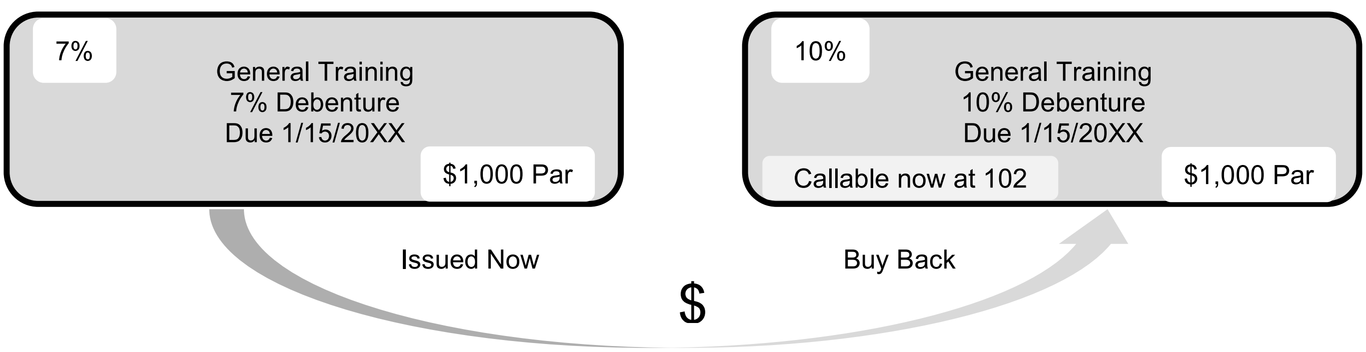
When a bond reaches its maturity date, the bondholder will redeem it to the issuer and receive the bond's par value plus the last interest payment.

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

Some bonds are redeemed *before* they mature.

Call Provision	**What is it?** ▪ Allows the issuer to redeem bonds prior to maturity – either in-whole or partial (lottery call) ▪ If called, the investor receives the full return of principal plus any accrued interest **When is it used?** ▪ When interest rates are falling **Why purchase?** ▪ Higher yield ▪ Call protection ▪ Call premium
Put Provision	**What is it?** ▪ Gives the bondholder the right to redeem (or put back) the bond on a date prior to maturity (opposite of a call provision) **When is it redeemed?** ▪ When interest rates are rising **Why purchase?** ▪ Allows bondholders to redeem their bonds at values greater than market value as interest rates rise

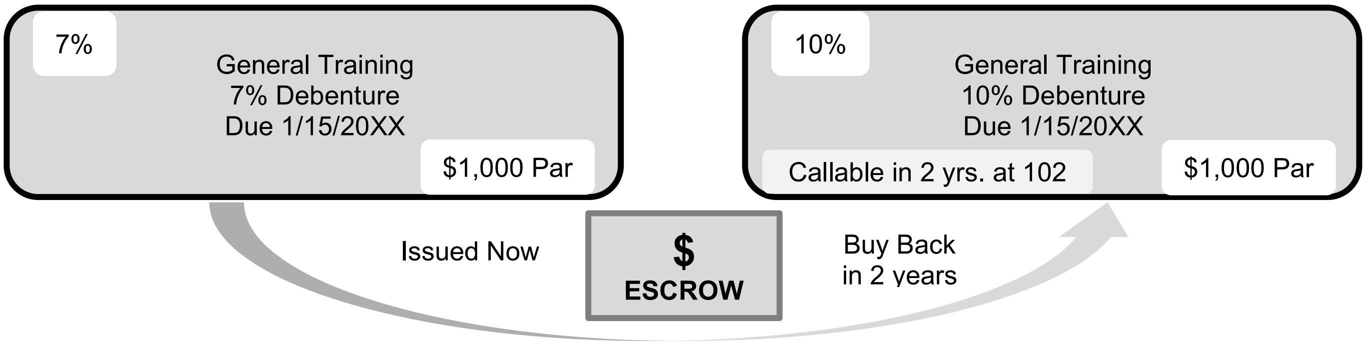
Refunding



An issuer refinances an existing bond to take advantage of lower interest rates

- New bond is issued to raise capital in order to call the outstanding bond
    - Existing bonds retired within 90 days of refunding issue
- Issuer benefits from lower interest rate
- Existing bondholders must reinvest at lower rate

Advance Refunding (Pre-Refunding)



- New bond issued; proceeds deposited into escrow account and invested in U.S. government securities; managed by trustee
- Amount deposited is sufficient to pay debt service
  - If paid off at call date: *Pre-refunded to the call*
  - If paid off at maturity: *Escrowed-to-maturity (ETM)*
- Pre-refunded bonds are no longer the issuer's liability (AAA rated)
- Defeasance – elimination of restrictive covenants

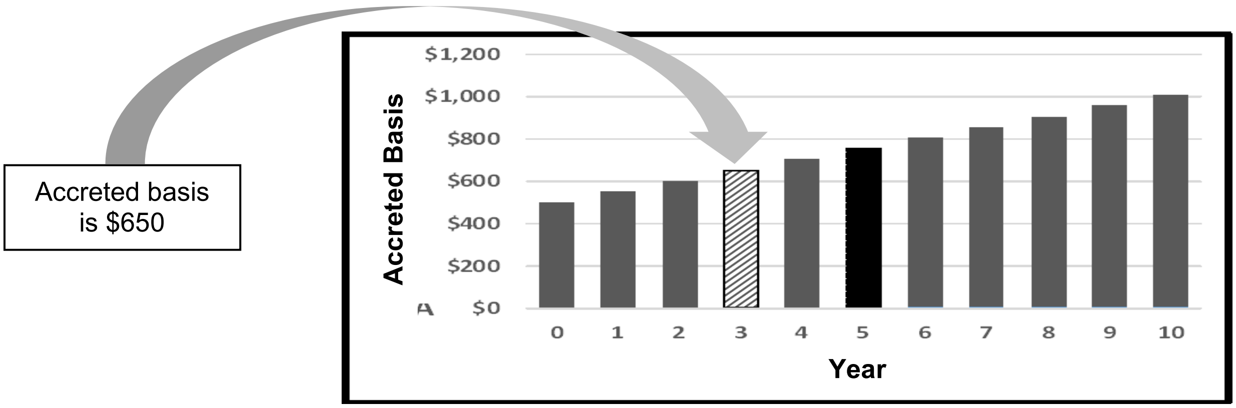
Tax Implications for Taxable Bonds

Interest	Zero-Coupon	Premium Bonds
▪ Treated as ordinary income; subject to federal, state, and local taxation ▪ Accrued Interest: • Seller reports the amount of interest received from buyer • Buyer reports interest payment minus the amount paid to seller	▪ Issued at a discount, but matures at par value ▪ Difference between purchase price and par is considered interest income ▪ Cost basis is accreted each year up to par ▪ Accreted amount is considered taxable income • IRS requires the constant yield or constant interest method of accretion ▪ Trades flat (without accrued interest); has no reinvestment risk	▪ Cost basis is amortized down to par ▪ Amortized amount reduces taxable interest

Discount Bond Taxation

Bond Sold Prior to Maturity

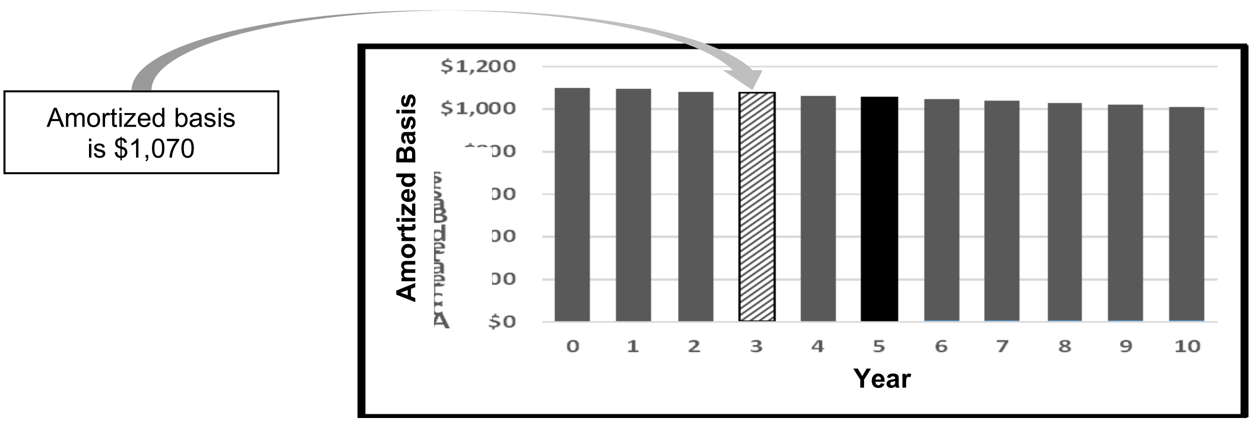
- Capital gain or loss determined by difference between the bond's cost basis and the sales proceeds
- Zero-coupon bonds:
  - If an investor purchased a 10-year zero-coupon bond three years ago for $500 and sold it today for $500, she realizes a: ______



Premium Bond Taxation

Premium bonds:

- Capital gain or loss is determined by the difference in amortized cost basis and sales proceeds
- An investor purchased a 5% bond with 10 years to maturity for $1,100. If it's sold after three years for $1,050, the result is a: ________



Activity

Match each description to the appropriate term.

CALL PROVISION
PREMIUM BOND
PRE-REFUNDING
ZERO-COUPON BOND
YIELD-TO-MATURITY

Also referred to as a bond's basis
Not subject to reinvestment risk
Issuing new debt to retire debt at some point in the future
Issuer's ability to retire debt prior to maturity
Basis is amortized to determine gain or loss on sale

Chapter 6 – Corporate Debt

Key Topics

1	2	3
TYPES OF CORPORATE BONDS	CONVERTIBLE BONDS	EQUITY-LINKED SECURITIES
Learn about the different types of corporate bonds and the quality of secured vs. unsecured debt.	Learn about the characteristics of convertible debt and the ability to obtain an equity position in the issuer.	Learn about exchanged-traded notes and reverse convertibles.

Corporate Bonds

Corporations that issue bonds use the proceeds from the offering for many purposes – from building facilities and purchasing equipment to expanding their businesses.

- The advantage is that the corporation does not give up any control or portion of its profits.
- The disadvantage is that the corporation is required to repay the money that was borrowed plus interest.
- Although buying corporate bonds puts an investor's capital at less risk than purchasing stock of the same company, bonds typically don't offer the same potential for capital appreciation as common stocks.

Types of Corporate Bonds

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

Although all debt 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

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

Unsecured Bonds

When corporate bonds are backed by only the corporation's full faith and credit, they'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.

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

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

Liquidation Proceedings

Secured creditors, including secured bonds ► Administrative expense claims (taxes, current wages, lawyer and accountant fees) ► General creditors ► Subordinated creditors ► Preferred stockholders ► Common stockholders

Other Types of Corporate Bonds

Income Bonds	High-Yield Bonds	Stepped Coupon Bonds
▪ Normally issued by companies in reorganization ▪ Issuer promises to repay the principal amount at maturity, but NOT interest unless it has sufficient earnings	▪ Bonds with a low rating that must offer a higher yield due to the greater risk of default ▪ Bonds rated lower than Moody's Baa3 or S&P and Fitch's BBB are considered high-yield ▪ Also referred to as low-grade or junk bonds	▪ Issued with low coupon rates that increase at regular intervals ▪ Issuers generally have the right to call the bond on the dates the coupon will be adjusted ▪ Also referred to as dual coupon or step-up coupons

Zero-Coupon Bond

Issued	Issued at deep discount
Maturity	Matures at face value (par)
Interest	Considered the difference between the purchase price and par value
Carrying Value	The investor's carrying value (cost basis) must be accreted yearly
How it Trades	Trades flat (without accrued interest)
Reinvestment Risk	Not subject to reinvestment risk
Suitability	Suitable for an investor who is planning for a specific futures investment goal

Debt with Foreign Characteristics

Sovereign Debt	Eurodollar Bonds	Yankee Bonds	Eurobonds
▪ Debt issued by a foreign national government ▪ Credit rating is based on the issuing government ▪ The country's repayment ability is reflected in the debt's yield	▪ Principal and interest are paid in USD, but are issued outside of the U.S. (primarily in Europe) ▪ Issuers include foreign corporations, foreign governments, and international agencies (e.g., the World Bank)	▪ Allow foreign entities to borrow money in the U.S. marketplace ▪ Registered with the SEC and sold primarily in the U.S.	▪ Sold in one country, but denominated in the currency of another ▪ Issuer, currency, and primary market may all be different

Brokered CDs and Commercial Paper

- Brokered CDs – generally offered by broker-dealers and have different characteristics than typical bank offered CDs
  - If not a bank product, FDIC insurance will not apply
  - Fees and/or commissions may apply
  - Maturities are generally longer than one year
  - Call features may apply
  - A limited secondary market will influence liquidity
- Corporate commercial paper – unsecured debt that's typically used for satisfying short-term liabilities
  - Maturities are typically 270 days or less

Activity

Read each statement and fill in the blanks.

1. Bonds backed by investments of other issuers are referred to as ________.
2. A _______ is another name for an unsecured bond.
3. Bonds issued with low coupons that increase over time are referred to as ________.
4. High-yield bonds are a type of ______.
5. _________ is a type of bond that is issued by foreign government.
6. Bonds issued outside of the U.S. which pay their debt service in U.S. dollars are referred to as _______.
7. Unsecured corporate debt typically used to pay short-term liabilities is known as ______.

Convertible Debenture

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

The number of shares the investor will receive at conversion

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

The price at which the bond can be converted

Conversion Parity

XYZ Corporation
6% Debenture
Market Price $1,100 and Convertible at $20

$$\text{Conversion Ratio} = \frac{\text{Par Value of Bond}}{\text{Conversion Price}} = \frac{\$1{,}000}{\$20} = 50 \text{ shares}$$

Conversion parity means equivalent market values

Price of Convertible Bond = Aggregate Market Value of the Common Stock

If XYZ's common stock was currently trading at $25, the bond's parity price would be $1,250 (50 shares x $25)

Exchange-Traded Notes (ETNs)

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

ETN Details:

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

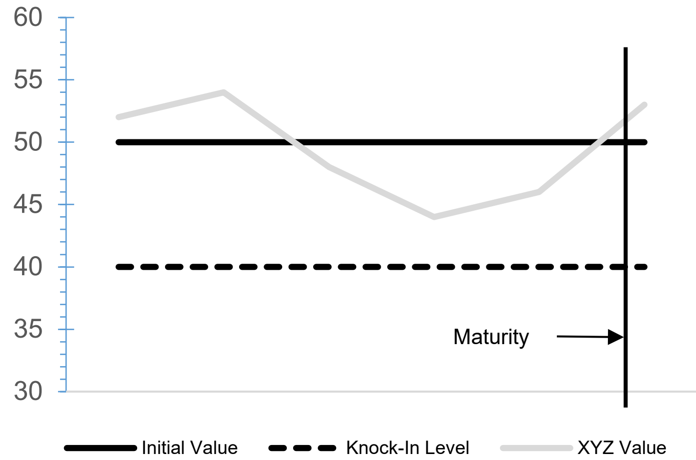
Reverse Convertible

A structured product that's issued as a short-term, high yield note

Often linked to a single underlying stock (reference security) of another issuer

Fundamental Characteristic	A high yield (coupon) ▪ Typically much higher than other fixed income securities with similar maturities
Knock-In Level	This a level that's normally 70 to 80% of the initial value of the reference security ▪ If the reference security never falls below the knock-in level, the investor continues to receive interest and the principal at maturity
Value of Reference Security Falls	If the reference security falls below the knock-in level and, at maturity, closes below the initial value, the issuing broker-dealer will deliver the reference security at the depreciated value ▪ At this point, the investor no longer receives the principal at maturity

Performance of Reverse Convertibles

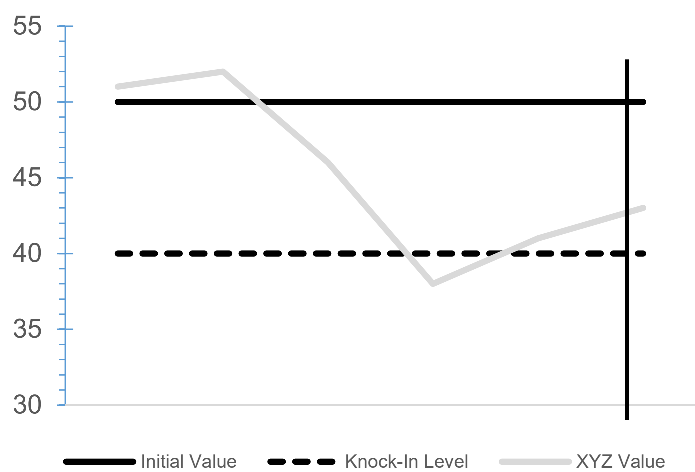


Scenario #1:
- Principal value: $1,000
- Maturity: 1 year
- Annual coupon: 12%
- Initial value of XYZ: $50
- Knock-in level: $40
- Convertible into 20 shares of XYZ

Results:
- XYZ never falls below knock-in level
- At maturity, XYZ closes at $53
- Customer receives $1,000 of principal and $120 of interest

Since XYZ never fell below knock-in level, the principal amount is paid regardless of where XYZ closes at maturity.

Performance of Reverse Convertibles



Scenario #2:
- Principal value: $1,000
- Maturity: 1 year
- Annual coupon: 12%
- Initial value of XYZ: $50
- Knock-in level: $40
- Convertible into 20 shares of XYZ

Results:
- XYZ falls below knock-in level
- At maturity, XYZ closes at $43
- Customer receives 20 shares of XYZ (MV = $860) and may receive $120 of interest

Since XYZ fell below knock-in level and ended below initial value, the issuer delivers 20 shares of XYZ and $120 of interest at maturity.

Activity

Read each statement and determine whether it's TRUE or FALSE.

A CONVERTIBLE BOND IS AT PARITY WHEN ITS MARKET VALUE IS EQUAL TO THE VALUE OF THE SECURITY INTO WHICH IT'S CONVERTIBLE	
AN EXCHANGE-TRADED NOTE IS SECURED BY THE SECURITIES TO WHICH IT'S LINKED	
AN INVESTOR DECIDES WHETHER TO EXERCISE A REVERSE CONVERTIBLE	
WHEN STOCK FALLS BELOW THE KNOCK-IN LEVEL, THE REVERSE CONVERTIBLE MAY BE EXERCISED	

Chapter 7 – Municipal Debt

Key Topics

1	2	3
TYPES OF MUNICIPAL DEBT	MUNICIPAL NOTES AND MUNICIPAL FUND SECURITIES	TAX CONSIDERATIONS
Learn about different types of municipal debt and how they would be evaluated.	Learn about how municipal notes are used and the benefits of municipal fund securities.	Learn about the tax benefits of investing in municipal securities and the special rules that apply.

Municipal Bonds and Their Issuers

States and Political Subdivisions	Public Agencies and Authorities	Territories
▪ Cities ▪ Counties ▪ School Districts	▪ Transit Systems ▪ Housing Authorities ▪ Water, Sewer, and Electric Systems	▪ Puerto Rico ▪ Guam ▪ U.S. Virgin Islands

Types of Municipal Bonds

General Obligation (GO) Bonds	Purpose: ▪ Issued for general purposes to meet any need of the issuer Sources for payment of debt service: ▪ Taxes and the Issuer's full faith and credit State level: ▪ Sales taxes, income taxes Local level: ▪ Ad Valorem (property taxes) • Assessed value x millage rate = tax bill (1 mill = .001) ▪ Parking/licensing fees
Revenue Bonds	Purpose: ▪ Issued to fund a specific project Sources for payment of debt service: ▪ Revenue (user fees) from a specific project Typical Projects: ▪ Toll roads, bridges, stadiums, airports Considered: ▪ Self-supporting debt

Analyzing General Obligation Debt

There are four fundamental factors in determining the ability of the issuer to generate sufficient taxes to pay debt service

Demographics	Evaluate the tax base, geographic location, businesses and property values
Nature of the Issuer's Debt	Consider the debt trend, past and present attitude toward debt, and the schedule of debt repayment
Aspects Affecting the Issuer's Ability to Pay	Existing unfunded pension liabilities, tax limitations, tax rates and collections, current financial condition, and outstanding litigation
Municipal Debt Ratios	Issuer's net overall debt (direct and overlapping), debt-to-assessed valuation, and per capita net debt

Sample Property Tax Bill

TOWN OF HARWICH, MA – PROPERTY TAX BILL		
Fair Market Values (FMV):		
Land	$120,000	
Structure	$300,000	
Total FMV	**$420,000**	
Total Assessed Value:	$336,000	80% of FMV
Tax Rate:	.007	Based on $7.00 per $1,000 of Assessed Value
Property Taxes:	**$2,352**	$336,000 x .007

Types of Revenue Bonds

Type	Source for Paying Debt Service
TRANSPORTATION REVENUE	Use tolls and user fees
SPECIAL TAX	Excise taxes on purchases, such as gasoline, tobacco, and liquor
SPECIAL ASSESSMENT	Assessments on the benefitting properties; used for sidewalks, sewers, etc.
DOUBLE BARRELED	Two sources – project revenue and tax dollars (from GO bonds)
MORAL OBLIGATION	If project revenue is insufficient, the state legislature is morally (but not legally) obligated for the shortfall
PRIVATE ACTIVITY	A bond in which more than 10% of the proceeds will benefit a private entity (e.g., a sports team)
INDUSTRIAL DEVELOPMENT BOND (IDB)	Issued by a municipality and secured by a lease agreement with a corporate user of the facility

Analyzing Revenue Bonds

Feasibility Study	▪ A detailed report focusing on the economic viability and the need for the program or service ▪ Factors evaluated include: • The anticipated demand for the program • Revenues and costs for similar programs • Engineering aspects of the proposed project
Credit Enhancements	▪ Credit of an entity other than the issuer provides security of the debt financing ▪ Examples include: • Bond insurance • Letters of credit • State or other government guarantees

Legal Opinion

- Prepared by bond counsel for the issuer and provides opinions on:
  - Issuer's legal, valid, and enforceable obligation
  - Tax exempt status of the issue
- Qualified versus Unqualified legal opinion
  - A qualified legal opinion is conditional and subject to qualifications
  - An unqualified legal opinion is rendered if there is nothing to adversely affect the issue

Covenants

RATE	Pledge to maintain the user fees at a level sufficient to meet debt service and other obligations
MAINTENANCE AND OPERATION	Pledge to maintain the project in good working order and to contribute to a fund for that purpose
INSURANCE	Pledge to carry insurance on the property
CATASTROPHE CALL	Provides the issuer with the ability to retire a bond due to destruction of the revenue source backing the bond
ADDITIONAL BONDS	Pledge not to issue more debt unless certain tests are met
NON-DISCRIMINATION	Pledge to not grant special rates to any one person or group
FLOW OF FUNDS	Establishes the priority for payment of debt service ▪ Net vs. Gross

Net vs. Gross Revenue Pledge

Net Revenue Pledge Bond	
Start:	Gross Revenue
Deduct:	Maintenance and Operation
Leaving:	Net Revenue
From which is paid:	Debt Service

Gross Revenue Pledge Bond	
Start:	Gross Revenue
Deduct:	Debt Service
From what's left is paid:	Maintenance and Operation

<u>Debt Service Coverage Ratio</u> is calculated by taking the amount *available for debt service* and dividing by the amount *needed for debt service.*

Activity

Read each statement and determine what it describes.

THE RATE CHARGED TO GENERATE PROPERTY TAXES	
BOND SUPPORTED FROM BOTH TAXES AND REVENUES	
DOCUMENT THAT PROVIDES INSIGHT INTO THE TAX-EXEMPT STATUS OF THE ISSUER	
THE COVENANTS STATING THAT THE FEES CHARGED WILL BE SUFFICIENT TO COVER EXPENSES	
A CALL THAT MAY BE USED TO RETIRE DEBT DUE TO THE DESTRUCTION OF A FACILITY	
THE PRIORITY USED FOR THE PAYMENT OF DEBT SERVICE	

Municipal Notes

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

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

Ratings for Municipal Notes

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

Variable Rate Municipal Securities

Variable Rate Demand Obligations (VRDO)	▪ Long-term securities marketed as short-term investments ▪ Debt securities that offer a variable rate of interest adjusted at specified intervals (e.g., daily, weekly, or monthly) ▪ Holders can redeem for par plus accrued interest at any time that rates are reset ▪ Includes a Put provision
Auction Rate Securities (ARS)	▪ Long-term investments with a variable interest rate that is reset at periodic intervals through a “Dutch Auction” ▪ Auction sets the lowest interest rate at which all the securities being offered for sale will clear the market (“net clearing rate”) ▪ Interest rate reset periods range from 7, 28, or 35 days ▪ Does NOT include a Put provision

Municipal Fund Securities

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

529 Plans

- Funded with after-tax dollars; investment grows tax-deferred
- Money invested in one state's plan may be used in another state
- To avoid gift tax, the maximum contribution is $19,000 per person, per year (doubled for married couples)
  - The plan allows for front-loading five years of contributions ($95,000 per person or $190,000 for married couples)
- A federal tax exemption is provided to the beneficiary for qualified withdrawals:
  - College tuition, books and supplies, room and board, a maximum withdrawal of $10,000 for tuition and books for grades K-12 per year, and up to $10,000 (lifetime limit) to repay a qualified student loan or expenses related to certain apprenticeship programs

529 Plans and 529 ABLE Plans

529 plans may be direct-sold or adviser-sold

DIRECT-SOLD
▪ Involves no salespersons; instead, the plan is sold directly through the 529 savings plan's website or through the mail

ADVISER-SOLD
▪ The plan is sold through a broker-dealer that has entered into a selling agreement with the primary distributor of the 529 plan

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

- Available to individuals who are disabled and are receiving Social Security disability, Medicaid, or private insurance payments
  - Maximum contribution is $19,000 per year (no front-loading)
  - Disability payments continue if account value does not exceed $100,000
  - Distributions are tax-free if used to pay qualified expenses

Tax Considerations

Municipal bond interest:

- Interest received is *exempt from federal tax*; however, it **may be** subject to state and local tax if purchased from a state that's not the bondholder's resident state
- Interest paid on bonds issued by U.S. territories and possessions is *triple tax exempt*
- Bank-Qualified (BQ) bonds are issued by "qualified small issuers" that issue no more than $10 million per year. BQ bonds allow banks to deduct 80% of the interest cost paid to the depositors on the funds that are used to purchase these bonds.

> Investors in higher tax brackets benefit more from the tax-exempt nature of municipal debt; however, municipals are generally unsuitable for investors who are in lower tax brackets or as an investment in retirement accounts.

Additional Tax Considerations

Zero-Coupon Municipals	Capital Appreciation Bonds (CABs)	Private Activity Bonds
▪ Annual accreted amounts are considered tax-free interest ▪ Accretes to par value at maturity	▪ Issued at deep discount ▪ Investment return on initial value is reinvested at a compounded rate ▪ At maturity, investors receive a single payment representing initial amount and investment return (discount is not accreted)	▪ Typically taxable for investors who are subject to alternative minimum tax (AMT) ▪ Yields are higher than non-AMT bonds

Yield Calculations

An investor is earning 4.55% on a tax-free municipal and is in the 35% tax bracket. What must a taxable bond yield to be equivalent?

Taxable Equivalent Yield Formula: $\dfrac{\text{Tax-Free Yield}}{(100\% - \text{Tax Bracket }\%)}$

An investor purchased a 7.0% corporate bond and is in the 35% tax bracket. What tax exempt yield would be required to equal the taxable yield?

Net Yield Formula: Taxable Yield x (100% – Tax Bracket %)

Considering the State Tax

An Ohio resident purchases a State of Ohio G.O. bond yielding 4.25%. He is subject to a 30% federal tax and a 3% state tax. What must a taxable bond yield to be equivalent?

Taxable Equivalent Yield Formula:

$$\frac{\text{Tax-Free Yield}}{(100\% - \text{Federal} + \text{State Tax }\%)}$$

Neither federal nor state tax apply since he is an Ohio resident

An Iowa resident purchases the same State of Ohio G.O. bond and is also subject to a 30% federal tax. What is the taxable equivalent yield?

Taxable Equivalent Yield Formula:

$$\frac{\text{Tax-Free Yield}}{(100\% - \text{Federal Tax }\%)}$$

Since she is not an Ohio resident, she is only exempt from federal tax

OID Bond Taxation

- Original Issue Discount (OID) Bond
  - Basis must be **accreted** at a rate that will bring basis to par at maturity
  - If sold prior to maturity, capital gain or loss determined by difference between the bond's cost basis and the sales proceeds
  - If held to maturity, accreted adjustment is considered tax exempt interest, which results in no taxable gain

The following examples for OID and Premium bond taxation use the straight line method to adjust the cost basis, which is what's used for any exam questions. However, the actual method is referred to as the *constant yield or constant interest method.*

OID Sold Prior to Maturity

An OID is purchased at $700 with 10 years to maturity. Five years later, the bond is sold for $880. What is the result for tax purposes?

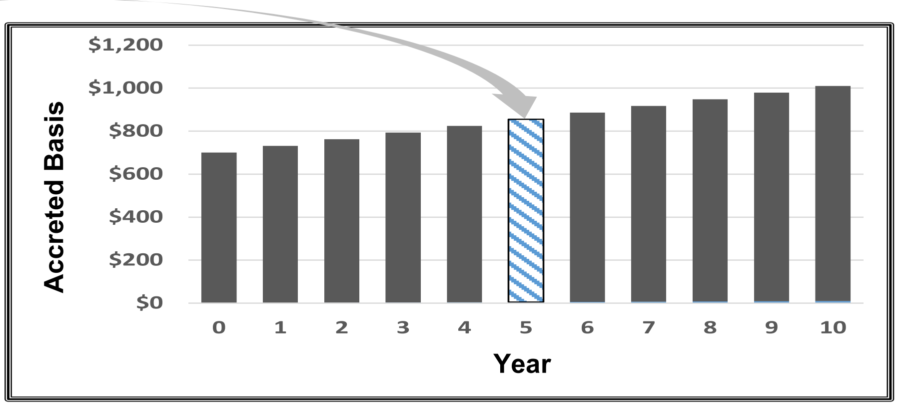
$1,000 par
- $700 cost

$300 discount

$\frac{\$300 \text{ discount}}{10 \text{ years}}$ = $30 is accreted each year, but not taxable

After five years, the basis is $850 ($30 x five years = $150). The $150 is treated as tax exempt interest income.

If sold at $880, the $30 difference ($880 – $850) is treated as a capital gain.



Premium Bond Taxation

- Premium Bond:
  - Basis must be **amortized** at a rate that will bring basis to par at maturity
  - If sold prior to maturity, capital gain or loss determined by difference between the bond's adjusted cost basis and the sales proceeds
  - If held to maturity, amortized adjustment is not deductible, which results in no taxable loss

Premium Bond Sold Prior to Maturity

A bond is purchased for $1,050 with 10 years left to maturity. Five years later, the bond is sold at $1,030. What is the result for tax purposes?

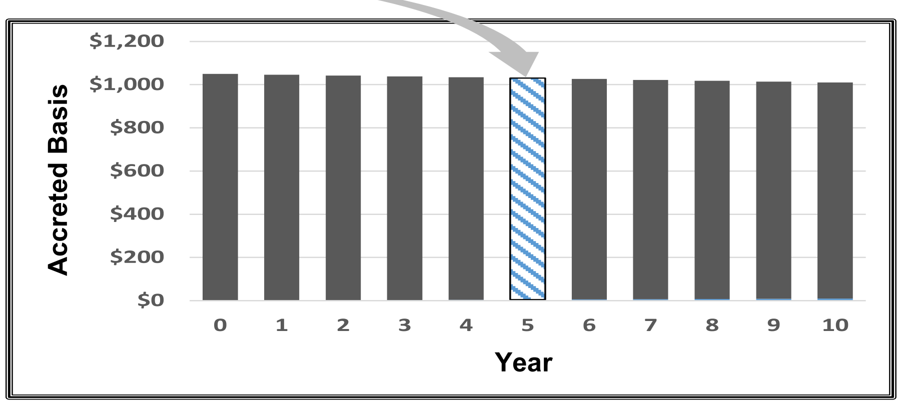
$1,050 cost
-$1,000 par

$50 premium

$\frac{\$50 \text{ premium}}{10 \text{ years}}$ = $5 is amortized each year

After five years, the basis is $1,025 ($5 x five years = $25). The $25 is an adjustment to the cost basis, but is not deductible.

When sold at $1,030, the $5 difference ($1,030 – $1,025) is treated as a capital gain.



Secondary Market Discount Bond Taxation

- Secondary Market Discount Bond
  - Bond that was issued at par, but is later purchased at a discount in the secondary market
  - The basis is not adjusted
  - When the bond is sold or matures, the accreted market discount is taxed as ordinary income

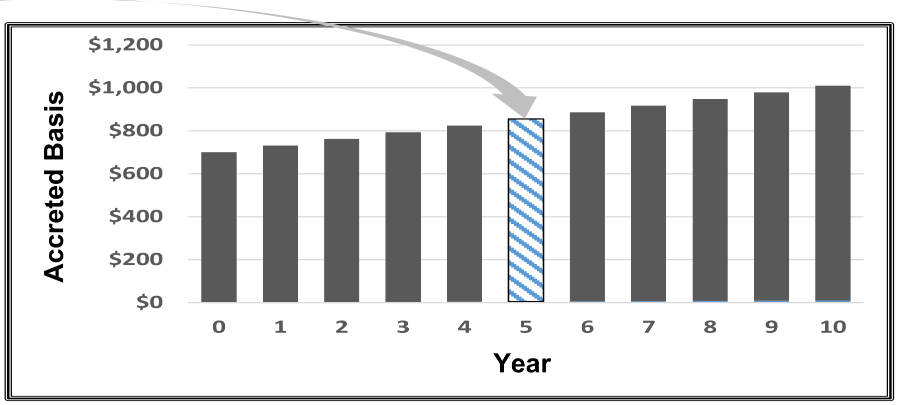
Market Discount Sold Prior to Maturity

A bond was issued at par, later purchased for $900 with 10 years left to maturity. Five years later, the bond is sold at $980. What is the result for tax purposes?

$1,000 par
\- $900 cost
$100 discount

$\frac{\$100 \text{ discount}}{10 \text{ years}}$ = $10 is accrued each year

After five years, the difference between the cost ($900) and the proceeds ($980) is $80
- $50 of the difference is treated as ordinary income ($10 x five years)
- $30 is treated as a capital gain



Activity

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

A VRDO CONTAINS A PUT PROVISION	
TAX-FREE DISTRIBUTIONS CAN BE TAKEN FROM A 529 PLAN FOR PRE-COLLEGE EXPENSES	
EXEMPTION FROM A STATE TAX NEED NOT BE CONSIDERED WHEN EVALUATING EQUIVALENT YIELDS	
THE DISCOUNT ON AN OID IS CONSIDERED ORDINARY INCOME	
A CAPITAL LOSS CAN BE THE RESULT OF SELLING A PREMIUM BOND PRIOR TO MATURITY	

Chapter 8 – U.S. Treasury and Government Agency Debt

Key Topics

1	2	3	4
U.S. TREASURY SECURITIES	ISSUING TREASURY SECURITIES	U.S. GOVERNMENT AGENCY DEBT	CMOs AND CDOs
Learn about the types of Treasury securities and how they are priced.	Learn about how a Treasury auction is conducted.	Learn about the different types of agency debt and their use.	Learn about the structure of collateralized mortgage and collateralized debt obligations.

U.S. Treasury Debt Overview

Characteristics
▪ Issued directly by the U.S. Government ▪ Highly liquid; no credit risk

Taxation of Interest
▪ Interest taxable at federal level ▪ Interest exempt at state and local levels

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

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

The three most prevalent types of these marketable issues are:

- T-Bills
- T-Notes
- T-Bonds

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

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

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

	T-BILLS	T-NOTES	T-BONDS
MATURITIES	Up to 1 year	2 – 10 years	Greater than 10 years
DENOMINATIONS	All in $100 multiples		
FORMS OF ISSUANCE	Book Entry		
INTEREST	Discount securities	• Stated annually, paid semi-annually • Accrued Interest: Actual/365	
HOW THEY'RE INITIALLY SOLD	Weekly auction	Periodic auction	

Pricing of Government Securities

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

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

- In a T-bill dealer's quotation, the bid's higher yield represents a lower price, while the ask's lower yield is a higher price.

BID	ASK
2.94%	2.90%

TIPS

How can Treasury investors protect themselves from inflation?

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

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

TIPS Example

PRINCIPAL	COUPON RATE	ANNUAL PAYMENT
$1,000	4%	$40.00
CPI increases by 1% (inflation)		
$1,010	4%	$40.40

T-STRIPS

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

T-STRIPS are non-interest bearing

Bidding at the Auction

WHAT ARE AUCTIONS?
- The government sells Treasuries through auctions conducted by the U.S. Treasury.

COMPETITIVE BIDS
- Placed by large financial institutions
- Indicate both quantity and price

NON-COMPETITIVE BIDS
- Placed by the public
- Indicate quantity only
- Are filled first
- Bidder agrees to pay the lowest price (highest yield) of the accepted competitive bids

T-BILLS
- Settle on the Thursday following the auction.

EXAMPLE: $100,000,000 bond offering at 4.5% coupon

Bids across all bidders:
- $20 million (non-competitive)
- $40 million at 4.90%
- $40 million at 5.00%
- $30 million at 5.1%

THE RESULT?
The highest bid is 5%; therefore, all bidders get a 5% yield at the auction clears at 5%.

Activity

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

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

Agency Securities

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

Farming Loans	Federal Farm Credit Bank (FFCB) ▪ Provides agricultural loans to farmers ▪ Subject to federal tax, but exempt from state and local taxes
Mortgage-Backed Securities	Mortgage-backed securities represent an interest in a mortgage pool. ▪ Monthly payments consist of interest and principal ▪ Interest portion is fully taxable ▪ Subject to prepayment risk Agencies that issue mortgage-backed securities include: ▪ GNMA or Ginnie Mae ▪ FNMA or Fannie Mae ▪ FHLMC or Freddie Mac NOTE: The most common security issued by government agencies is a mortgage-backed pass-through certificate. Pass-throughs provide excellent credit quality and a slightly higher yield than Treasuries; they're often used to supplement retirement income.

Collateralized Mortgage Obligations (CMOs)

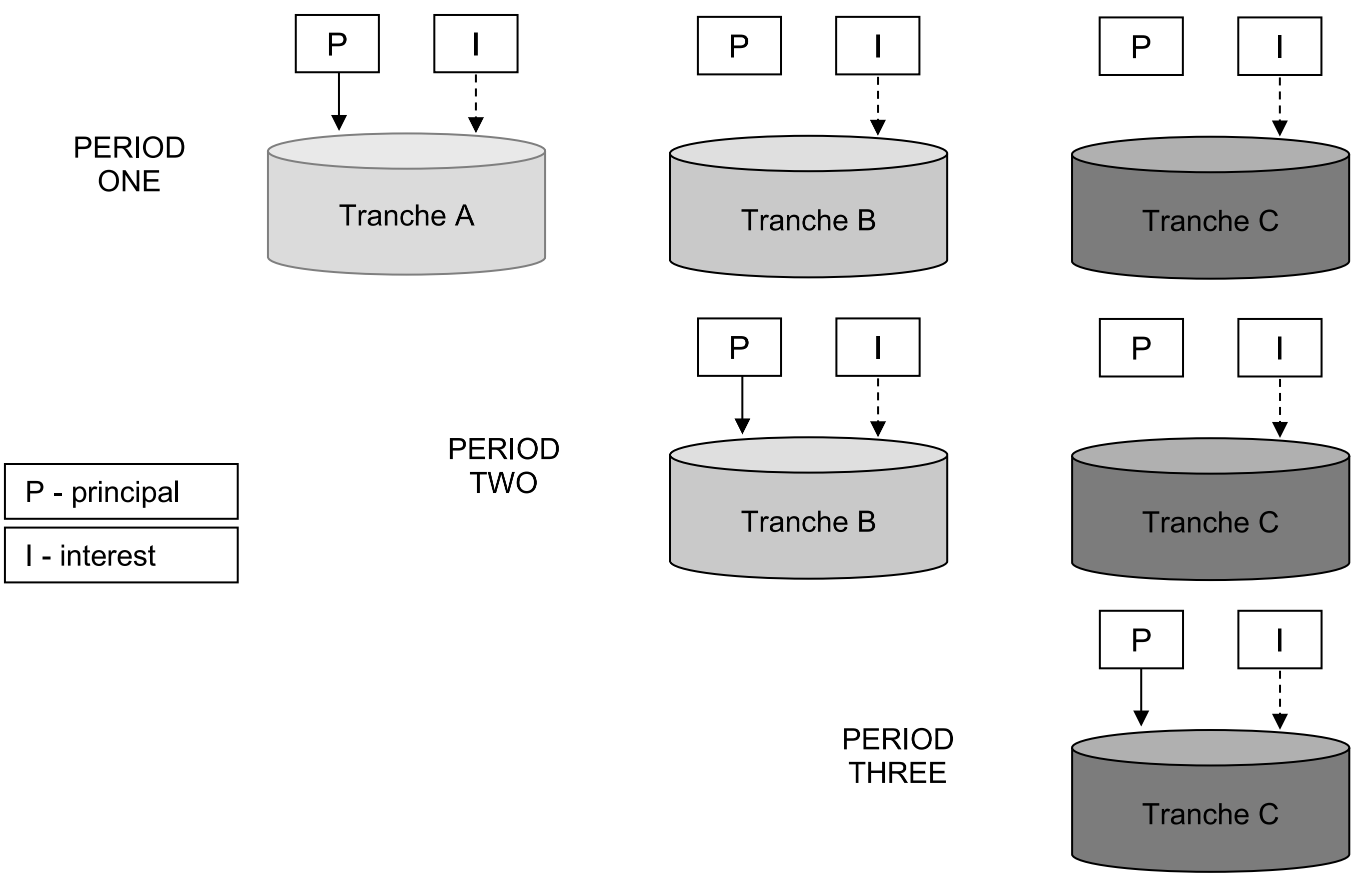
Mortgage-backed bonds created by dividing mortgage pools (GNMA, FNMA, and FHLMC) into various bond classes (tranches)

- Distribute the impact of prepayment risk to different tranches
- Interest is generally paid monthly (fully taxable), with principal paid sequentially
- Issued in $1,000 denominations
- Subject to Act of 1933 registration and the Trust Indenture Act of 1939

Private Label CMOs

- Pools include non-U.S. agency mortgage securities
- Subject to the credit risk of the issuer

CMOs – Sequential Pay/Plain Vanilla



Types of CMOS

Planned Amortization and Target Amortization Class	Planned Amortization Class ▪ Provides the most predictable cash flow and maturity ▪ Designed for more risk-averse investors Target Amortization Class ▪ Provides protection from prepayment risk ▪ Subject to extension risk
Companion Tranche	▪ Provides the least predictable cash flow and maturity ▪ Reflects excess or shortfalls in payments to PACs and TACs
Z-Tranche	▪ Last tranche to receive payments ▪ Similar in structure to a zero-coupon bond

Collateralized Debt Obligations (CDOs)

CDOs repackage individual fixed-income assets into a product that can be separated into tranches and then sold in the secondary market.

Referred to as CDOs since the assets being packaged (e.g., mortgages, corporate debt, auto loans, or credit card debt) serve as collateral for investors.

- Each of the tranches have different maturities and interest payments
- Similar to CMOs, but do not limit investments to mortgages
- Primary purpose of CDO is to distribute risk
- The quality of the underlying debt determines the risk of the CDO

CDO investors own a right to receive a portion of the pool's interest income and principal

Activity

Read each statement and fill in the blanks.

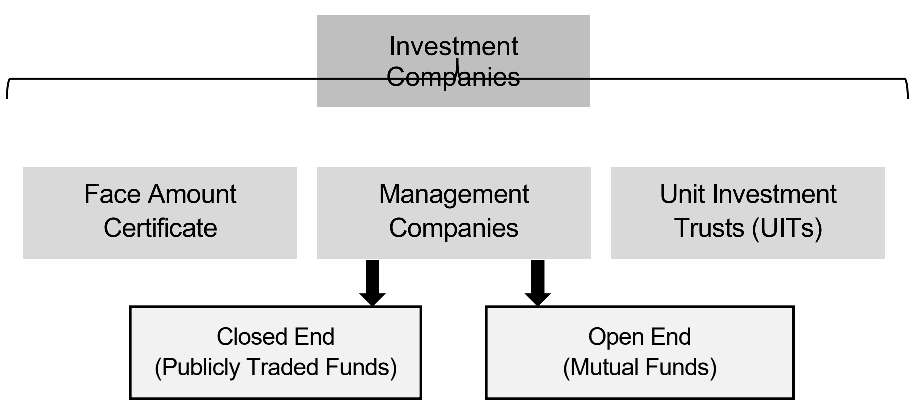
1. Although agency securities are not direct obligations of the U.S. government, their credit risk is still considered ___________.
2. Agency securities are _______________ from state and federal registration.
3. Ginnie Mae, Fannie Mae, and Freddie Mac offer _______________________________ securities.
4. Mortgage-backed securities represent an interest in a _____________ of mortgages.
5. ___________________________________ is unique to mortgage-backed securities.
6. CMOs distribute payments through various _______________________.
7. _____________ are types of securities backed by various types of debt that attempt to distribute risk.

Chapter 9 – Investment Companies

Key Topics

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

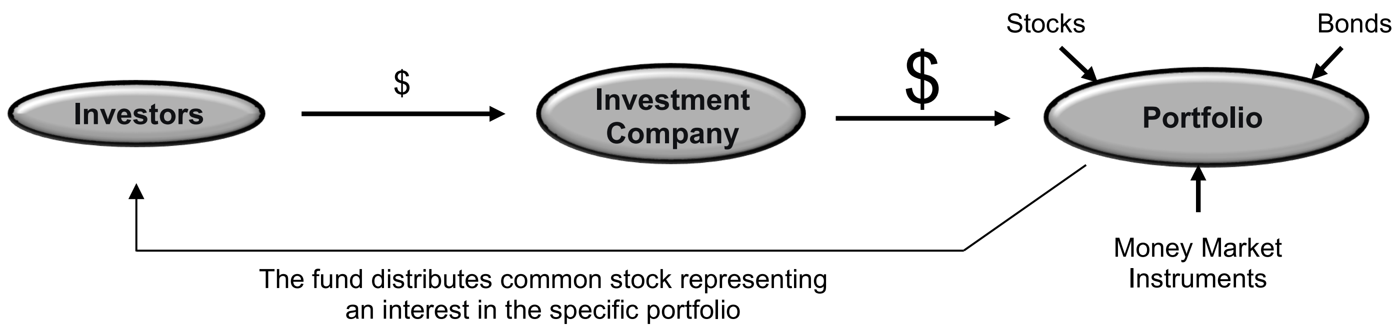
Types of Investment Companies



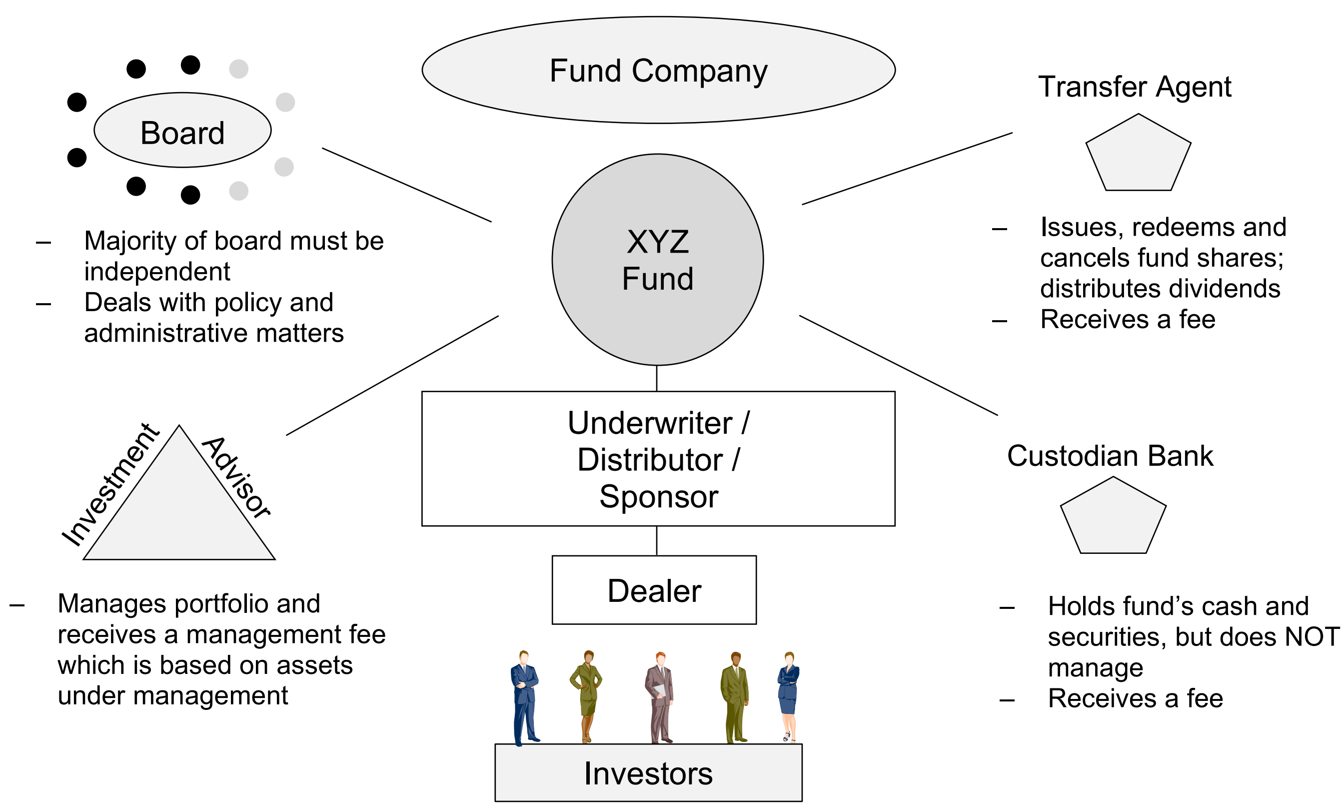
Investment Companies

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

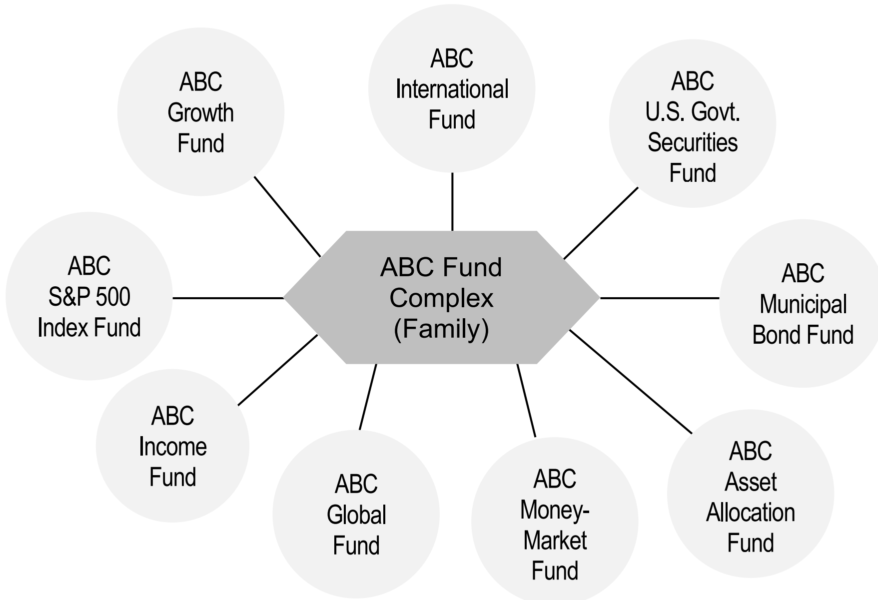
- Allows investors to acquire an interest in a large number of securities
- Mutual fund benefits include:
  - Professional management
  - Diversification
  - Liquidity
  - Convenience and cost
  - Exchanges at net asset value (NAV)



Mutual Fund Structure



Mutual Fund Complex



Net Asset Value

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

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

$$\text{Calculating NAV per share: } \frac{(\text{Total Assets} - \text{Total Liabilities})}{\text{Number of Shares Outstanding}}$$

Calculating the Sales Charge

Difference between the NAV and POP is the sales charge

NAV (Bid)	POP (Ask)
9.20	10.00

Sales charge is expressed as a percentage of the POP

$$\text{Calculating Sales Charge \%} = \frac{(\text{POP} - \text{NAV})}{\text{POP}} = \frac{(10.00 - 9.20)}{10.00} = \frac{.80}{10.00} = 8\%$$

Calculating Public Offering Price

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

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

Sales Charges

Amount deducted from an investor's purchase

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

<table>
<tr><td>Front-End Loads</td><td>

Assessed at the time an investor purchases shares
Total investment, less the sales charge, is directed to the portfolio
Typically associated with Class A shares

</td></tr>
<tr><td>Back-End Loads</td><td>

Assessed at the time an investor redeems
Percentage decreases as the holding period lengthens
Typically associated with Class B shares

<table>
<tr><th>Holding Period</th><th>CDSC</th></tr>
<tr><td>1 year</td><td>5%</td></tr>
<tr><td>2 years</td><td>4%</td></tr>
<tr><td>3 years</td><td>3%</td></tr>
<tr><td>4 years</td><td>2%</td></tr>
<tr><td>5 years</td><td>1%</td></tr>
<tr><td>6 years +</td><td>0%</td></tr>
</table>
</td></tr>
<tr><td>12b-1 Fees</td><td>

Established under Section 12b-1 of the Investment Company Act of 1940
Annual fee levied against the fund's assets
Allows distribution costs to be borne by the fund, rather than from front-end charges
Used to finance promotion, advertising, and commissions
Includes continuing commissions or "trailers"
If a written contract exists, it may be paid to RRs who are still employed with a firm or to retiring RRs based on existing assets
Typically higher for Class C shares

</td></tr>
</table>

No-Load Funds

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

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

A no-load fund may have a redemption fee (since it's not considered a sales charge)

- Rather than benefitting selling brokers, the fee represents what remains behind in the fund benefitting the remaining owners

Mutual Fund Expense Ratio

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

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

> The largest expense for a fund is typically the management fee.

Methods to Decrease Sales Charge

Breakpoints – dollar levels at which sales charge is reduced

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

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

Breakpoints – Example

A customer invests $60,000 in a mutual fund. The Fund's next calculated NAV is $19.61 and the maximum offering price is $20.80. The fund charges a 1% redemption fee. Using the previous breakpoint schedule, how many shares is the investor able to purchase?

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

Mutual funds allow the purchase of fractional shares

Letter of Intent

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

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

A letter of intent is offered as an incentive for investors to contribute as much as possible in the fund.

Rights of Accumulation (ROA)

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

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

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

Individual Purchasers	Purchaser's Immediate Family Members (spouse, dependent children)
Fiduciary for a Single Fiduciary Account	Trustee for a Single Trust Account
Pension and Profit-Sharing Plans (that meet IRC guidelines)	Other Groups (Investment Clubs) formed for reasons other than paying reduced sales charges

Dollar Cost Averaging (DCA)

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

- Results in average cost per share being less than the average price per share
- Does not guarantee attainment of any specific investment goals
- Necessary disclosures:
    - No assurance of long-term growth
    - Prices are subject to change
    - Contributions must continue even when prices decline, otherwise losses could occur

Activity

Read each statement and determine what it describes.

DETERMINES WHICH INVESTMENTS ARE PLACED IN THE FUND'S PORTFOLIO	
DEDUCTED FROM THE POP AND EXPRESSED AS A PERCENTAGE OF POP	
AMOUNT THAT DECREASES THE LONGER SHARES ARE HELD	
RETROACTIVE REDUCTION IN SALES CHARGE	
SALES CHARGE IS REDUCED WHEN A BREAKPOINT IS REACHED	
RESULTS IN COST PER SHARE BEING LESS THAN PRICE PER SHARE	

Redeeming Mutual Fund Shares

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

Withdrawal Plans

Allows investors to receive regular, periodic payments from their accounts

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

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

Sales Practice Violations

Breakpoint sales

- Soliciting sales of shares at amounts just below a breakpoint

Recommending purchases from different fund families due to the potential for higher sales charges

Switching between different fund families due to the impact of new sales charges or holding periods

- For switch recommendations, RRs may be responsible for justification of:
  - Tax ramifications (both exchanges and switches are taxable)
  - Potential sales charges on new purchases

Excessive purchases of Class B shares

- Salespersons should not recommend purchasing large quantities of B shares (since they don't qualify for breakpoints)

Mutual Fund Distributions

Earnings from a fund are distributed to shareholders and are reported on IRS Form 1099-DIV

1	2
Investment Income ▪ Cash dividends and interest from the securities in the portfolio ▪ Short-term capital gains are distributed as income ▪ May be distributed more frequently than once per year	**Capital Gains** ▪ Generated by the sales of securities in the portfolio where the proceeds exceed the original cost (basis) ▪ Distributed once per year ▪ Always considered long-term capital gain

Both distributions are taxed in the year received whether they're taken or reinvested

Subchapter M

Relieves a fund's burden of paying taxes on income as the distributions pass through to the mutual fund shareholders (conduit or pipeline theory)

- To qualify as a **Regulated Investment Company**, a fund must distribute at least ______% of net investment income to its investors

Net Investment Income	=	(Dividends + Interest) – (Expenses and Mgmt. Fees)

- If it qualifies, the fund is only taxed on the undistributed portion
- Burden for paying taxes ultimately falls on shareholders

Investor's Cost Basis

A person's cost basis equals the invested amount plus any reinvested distributions

For example:	Jun. 2015:	A person invests $10,000 in the XYZ Growth Fund
	Dec. 2015:	Income of $600 is reported on Form 1099
	Dec. 2016:	Income of $700 is reported on Form 1099
	Feb. 2017:	The person redeems her shares for $14,500

What is the taxable gain?

Proceeds:

– Basis:

Taxable Amount:

Other Types of Investment Companies

Face Amount Certificate Company (FAC)

- Issues debt certificates
- Issuer promises face value at maturity or surrender value if presented prior to maturity

Unit Investment Trust Company

- Supervised, not managed (no management fee)
- Portfolio generally remains fixed for the life of the trust
- Ownership usually referred to as *shares of beneficial interest (SBI)*

Closed-End Compared to Open-End

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

ETFs Compared to Index Funds

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

Inverse and Leveraged ETFs

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

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

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

Activity

Read each statement and fill in the blanks.

1. An investor who cashes out mutual fund shares too early may be subject to a ______________________________.
2. A _____________________________ is the result of selling mutual fund shares just below the amount that qualifies for reduced sales charges.
3. Moving assets from one fund family to another family is referred to as _____________________ and is a _________________ event.
4. Mutual funds make _______________________________ distributions only once per year.
5. A ____ serves as a pipeline for income distributions to be taxed to the shareholder.
6. An investment company that can issue preferred stock and bonds is considered a ____________________________________.
7. ____ can be inverse and leveraged.

Chapter 10 – Variable Products

Key Topics

1	2	3	4
INSURANCE VERSUS ANNUITIES	VARIABLE ANNUITIES	SUITABILITY	VARIABLE LIFE INSURANCE
Learn about the difference between pure insurance products and annuities and the role of the separate account.	Learn about what happens during the accumulation phase and the annuity phase.	Learn how to identify individuals who may benefit from variable products.	Learn about the basic characteristics of variable life insurance policies.

Types of Annuities

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

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

What is an Annuity?

An annuity is a hybrid insurance/investment vehicle which allows for the tax-deferred growth of the contributions

- A person invests funds on either a lump-sum or periodic basis and can be either immediate or deferred

Immediate Annuities	Purchased in one lump-sum with the payout generally starting immediately
Deferred Annuities	Purchased with period payments and payout typically starts after retirement

- The contract has a death benefit if the owner dies during the contribution period
- Many contracts guarantee that the owner will not run out of money in retirement even if the funds are exhausted

The Separate Account

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

The Separate Account and its Subaccounts

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

The Accumulation Phase – Phase 1

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

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

Annuity Charges and Expenses

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

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

Receiving Benefits – Withdrawals

While still in the accumulation phase …

- Annuitants may choose to take withdrawals from their annuity
    - Annuitants control the timing and amount of their withdrawals
    - Earnings are withdrawn first and taxable
- Premature withdrawals
    - Withdrawals of earnings prior to age 59 ½ are subject to a 10% penalty
    - The gross amount is also added to taxable income

Death During Accumulation Phase

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

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

The Annuity Phase – Phase 2

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

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

Payout Options

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

Assumed Interest Rate

AIR is:

- A hypothetical return on investment
- A fixed percentage
- Not a guaranteed or minimum rate

Cause:	**Effect:**
If account performance is:	**Annuity payment will:**
Higher than AIR	
Lower than AIR	
Equal to AIR	

Equity-Indexed Annuities (EIA)

Like a fixed annuity, an EIA offers a guaranteed minimum return that protects against loss of principal; but like a variable annuity, its return varies (based on index performance)

Investor's return is determined by a participation rate and cap rate:

Participation Rate:

- Sets the percentage of the index gain that's credited to the annuity
- Example: If the index increases by 10% and the participation rate is 80% of the index, then 8% is credited to the annuity

Cap Rate:

- Sets the maximum rate of interest that the annuity will earn
- For above example: If the contract has a 7% cap rate, then 7%, and not 8%, would be credited

Annuity Suitability Issues

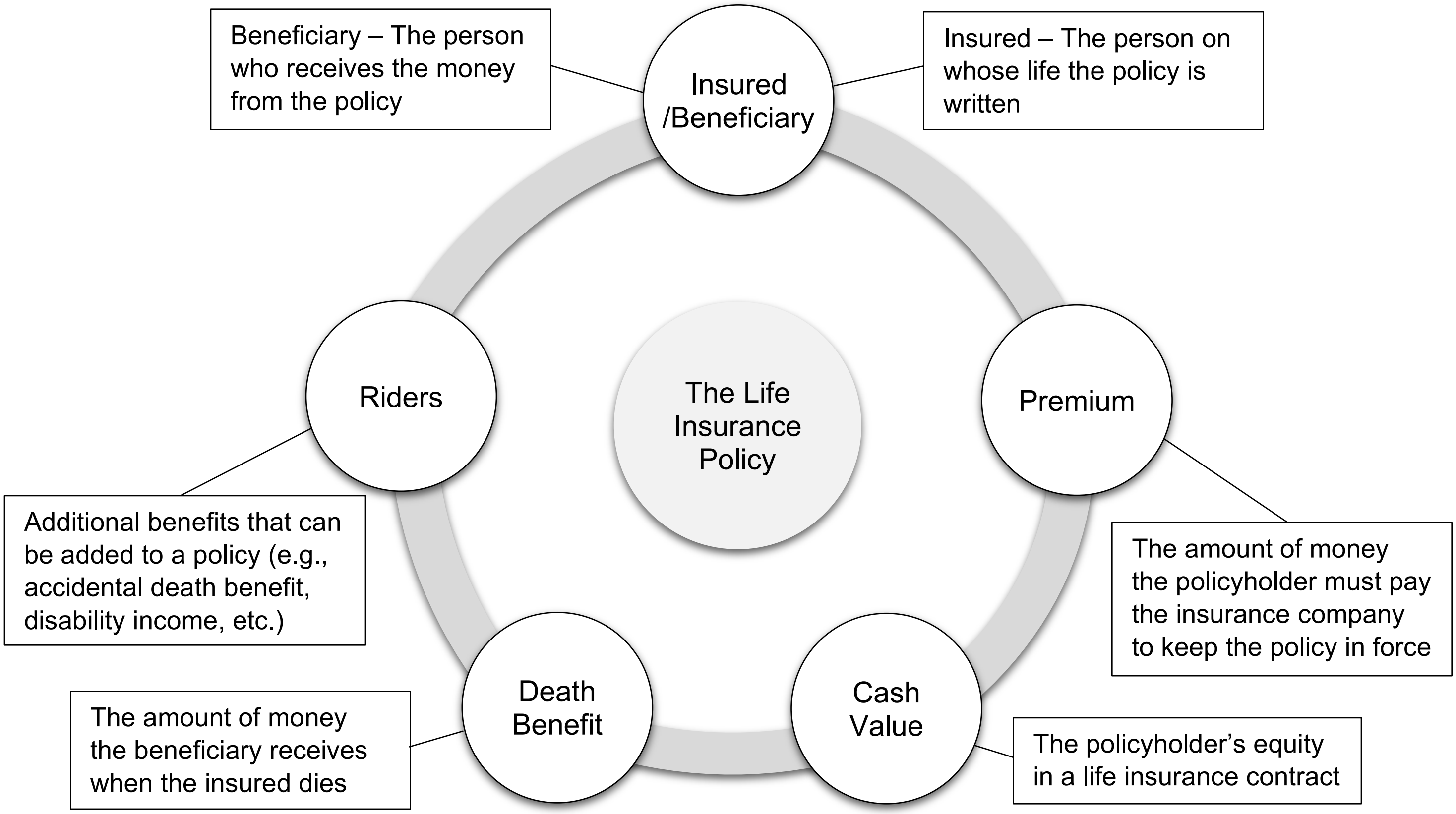
Target Market	▪ Generally for investors within the age range of 30 to 55 ▪ Persons seeking tax-deferred growth or to offset inflation ▪ Persons who have maximized qualified plan contributions
Unsuitable for:	▪ Senior citizens or persons who are seeking immediate tax benefits ▪ Investors with short investment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

Activity

Match each description to the appropriate term.

DEFERRED ANNUITY	The portfolio into which an investor directs some or all of their money in a variable annuity
SUBACCOUNT PRODUCT	The settlement option that offers the greatest potential payout
ACCUMULATION PHASE	An annuity purchased with periodic payments and distributions made at some point in the future
STRAIGHT LIFE ANNUITY	The period during which money is deposited and growth is tax-deferred
ASSUMED INTEREST RATE	The hypothetical return used to determine whether payouts are increasing or decreasing

Life Insurance Terminology



Characteristics of Variable Life Insurance

Death Benefits	Must provide a preset fixed minimum benefit, which may grow based on performance
Cash Value	No guarantee of cash value
Loans	Allows a loan against a percentage of the cash value
Premium Payments	Premiums are generally paid in fixed amounts at fixed intervals
Investment Account	Policyholders choose from various subaccounts of the separate account
Risk	Policyholder assumes risk that investment returns will be lower than anticipated

Tax Treatment of Variable Life

Policy Surrender	FIFO is the system used. Premiums paid (already taxed) are returned first, while the excess is taxable as income.
Loans	Loans against a policy's cash value are tax-free
Death Benefit	Tax-free to beneficiary
Estate Taxation	Death benefit is included in the deceased's estate

Activity

Read each statement and determine whether it's TRUE or FALSE.

AN INSURANCE PREMIUM IS REDUCED IF A POLICY'S CASH VALUE IS GREATER THAN ITS DEATH BENEFIT	
DEATH BENEFITS IN A VARIABLE POLICY MAY EXCEED ITS STATED AMOUNT	
CASH VALUES ARE GUARANTEED IN VARIABLE LIFE POLICIES	
IF A VARIABLE LIFE POLICY IS SURRENDERED, THE PREMIUM PAYMENTS ARE RETURNED TAX-FREE, FOLLOWED BY THE TAXABLE CASH VALUE	
THE DEATH BENEFIT OF A VARIABLE LIFE POLICY IS TAX-FREE TO THE BENEFICIARY	

Chapter 11 – Alternative Products

Key Topics

1	2	3
REAL ESTATE INVESTMENT TRUSTS Learn about various types of REITs and examine tax and suitability issues.	LIMITED PARTNERSHIPS Learn about the characteristics and different types of limited partnerships.	HEDGE FUNDS Learn about hedge funds and the suitability concerns regarding these aggressive investments.

Real Estate Investment Trust (REIT)

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

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

Methods of Offering REITs

1.	Registered, exchange-listed, and publicly traded ▪ Liquid, but may trade at a discount or premium to the portfolio's NAV
2.	Registered, but not exchange-listed (non-traded) ▪ Often have a lack of liquidity
3.	Unregistered; offered through a private placement ▪ Illiquid

Direct Participation Programs (DPPs)

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

Examples of direct participation programs include:

- Subchapter S Corporations
- Joint Ventures
- General Partnerships
- Limited Partnerships
  - An LP is formed by filing a Certificate of Limited Partnership with the state
    - Owned by general and limited partners
    - Limited Partnership Agreement defines the relationship between the partners

Advantages of Limited Partnerships

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

Disadvantages of Limited Partnerships

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

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

Effects of Tax Law Changes

Increased Tax Complexity

Calls to Contribute Additional Funds

General and Limited Partners

General Partner	Limited Partner

▪ Day-to-day manager with unlimited personal liability
▪ Must have at least a 1% interest
▪ Fiduciary toward limited partner
▪ Last at liquidation:
  • Secured Lender
  • General Creditor
  • Limited
  • General
	▪ Passive investor with limited liability
	▪ Contributor of capital
	▪ Have certain rights:
	  • Lend money to the partnership, inspect books, and compete
	▪ Ways to endanger "limited" status:
	  • Negotiate contracts, hire/fire employees, or lend name

General creditor

To assist in raising capital

Offering Practices

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

Real Estate Programs

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

Oil and Gas Programs

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

Equipment Leasing Programs

Used to lease equipment, such as:

- Computers
- Transportation Equipment (Airplanes and railroads)
- Construction Machinery

Equipment is purchased from manufacturers and then leased to end users

Advantages:
Investors receive consistent income as well as depreciation tax benefits

Disadvantage:
No appreciation of underlying assets

Public Equity and Debt Programs

DPPs may invest in the public equity of debt of existing issuers

Small Capitalization Debt	Small Capitalization Equity
▪ Many of these bonds are illiquid ▪ Many issuers are unrated ▪ Above average yields	▪ Publicly traded, but may be illiquid ▪ These programs are often concentrated in a specific industry in which the GP has expertise

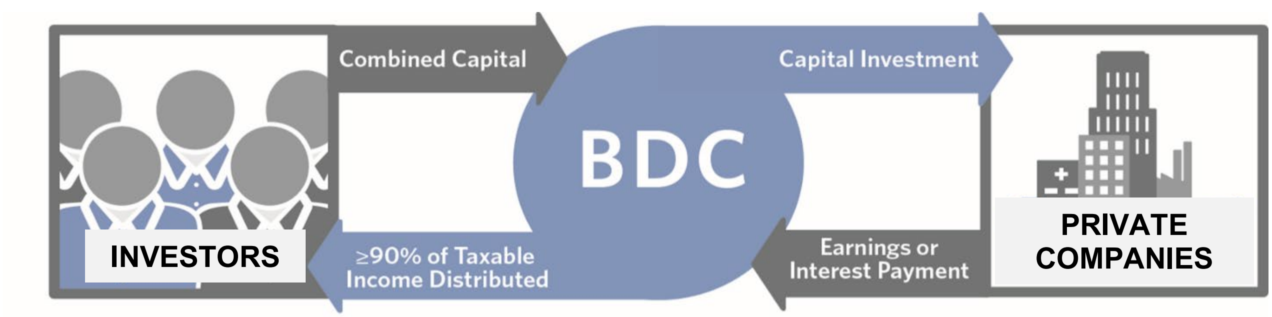
Business Development Companies (BDCs)

Most BDCs are formed as registered investment companies (closed-end) and they invest in both the equity and debt of typically non-public companies, including:

- Small and developing companies
- Financially troubled companies
- Private companies

Income and net worth requirements are avoided since BDCs are public offerings

Most trade on exchanges providing liquidity



DPPs – Risk Summary

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

- Management has extreme control
- Illiquid nature and potential loss of capital
- Unpredictable income
- Potential future mandatory assessments
- Rising operating costs
- Changes in tax laws and government regulations
- Economic and environmental occurrences

Successfully investing is about managing risk, not avoiding it.

DPPs – Evaluation

Investors and RRs should use the following factors when evaluating the potential and merits of a given program:

- Managerial track record
- Start-up costs
- Time to crossover
- Use of leverage
- Competitive landscape
- GP exit strategies (i.e., ultimate asset sale)
- Economic soundness of the program

DPPs are complicated products. The focus should be on finding the best fit for the client.

Investor Considerations

Investor Certification

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

Discretionary Accounts

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

DPP Suitability Issues

Those considering DPPs as a potential investment should:

- Have liquidity in other investments
  - There may be an extended time required to reach the *crossover point* (i.e., the beginning of positive cash flow)
- Have a need for both present and future tax benefits
- Be aware of the risks involved
- Be able to tie up funds for a long period of time

These products are often only suitable for sophisticated investors who are seeking performance that's not correlated to the stock market.

Alternative Packaged Products

Hedge Fund	Fund of Hedge Funds	Interval Funds
▪ Investment fund generally for wealthy investors ▪ Offered under Reg. D exemption to accredited investors ▪ Not considered a registered investment company under the Act of '40 ▪ Uses exotic strategies involving derivatives, leverage, and selling short ▪ Investors are seeking over-sized performance that's often uncorrelated to stock market	▪ Fund which allocates money to hedge fund managers ▪ Generally suitable for wealthy investors ▪ May place restrictions on withdrawing money	▪ A type of closed-end fund ▪ Unlike most closed-end funds, their shares are continuously offered, but don't trade in the secondary market at prices that are above or below their current NAV ▪ Instead, investors are able to sell a portion of their shares back to the fund at preset intervals ▪ Their fees and expenses tend to be higher than other closed-end funds and mutual funds ▪ Offer limited liquidity and are most suitable for long-term investors

Hedge Funds – Risk Summary

Investors should be aware of the following risks of hedge funds:

- Illiquidity
- Gating policies
- Concentration of portfolio
- Use of leverage/derivatives
- Lack of control over management
- High initial and ongoing costs
- Unregulated nature means far less regulatory disclosure

Hedge Funds are one of the most aggressive investment choices and are only appropriate for very sophisticated investors.

Activity

Match each description to the appropriate term.

HYBRID REIT	Responsible for decisions in a limited partnership
GENERAL PARTNER	Invests in mortgages and properties
RAW LAND	Invests in developing and financially troubled companies
INCOME PROGRAM	Riskiest real estate program
HEDGE FUND	Oil and gas program that generates immediate cash flow
BUSINESS DEVELOPMENT COMPANY	Uses exotic investment strategies

Chapter 12 – Options

Key Topics

1	2	3	4	5
BUYERS VERSUS SELLERS Learn about the role of options buyers and the sellers and the standard components of option contracts.	LIFE OF AN OPTION Learn about the life of an option and how the contract may be adjusted while it is open.	BASIC STRATEGY Learn about the basic strategies behind options and how to calculate breakeven.	ADVANCED STRATEGY Learn about straddles, spreads, and combining stock and option positions.	NON-EQUITY OPTIONS AND TAXATION Learn about non-equity options and how different positions are taxed.

Options Overview

An option is a contract between two parties

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

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

Types of Contracts

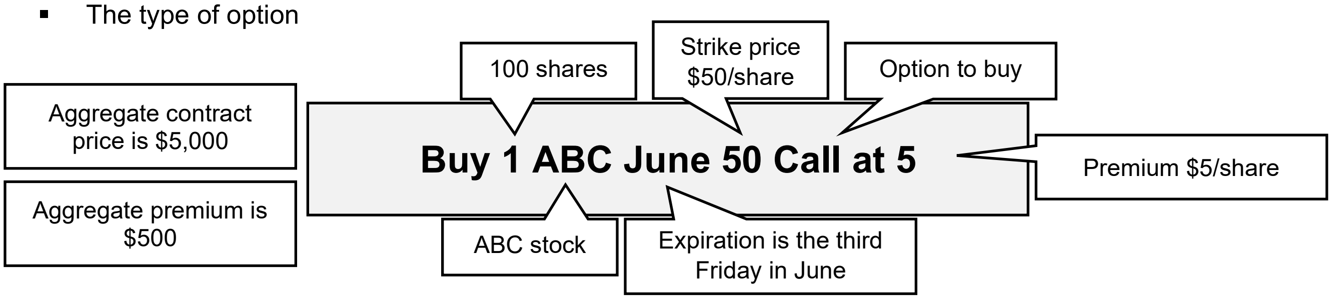
If an option is exercised…

	BUYER'S RIGHT	SELLER'S OBLIGATION
CALL		
PUT		

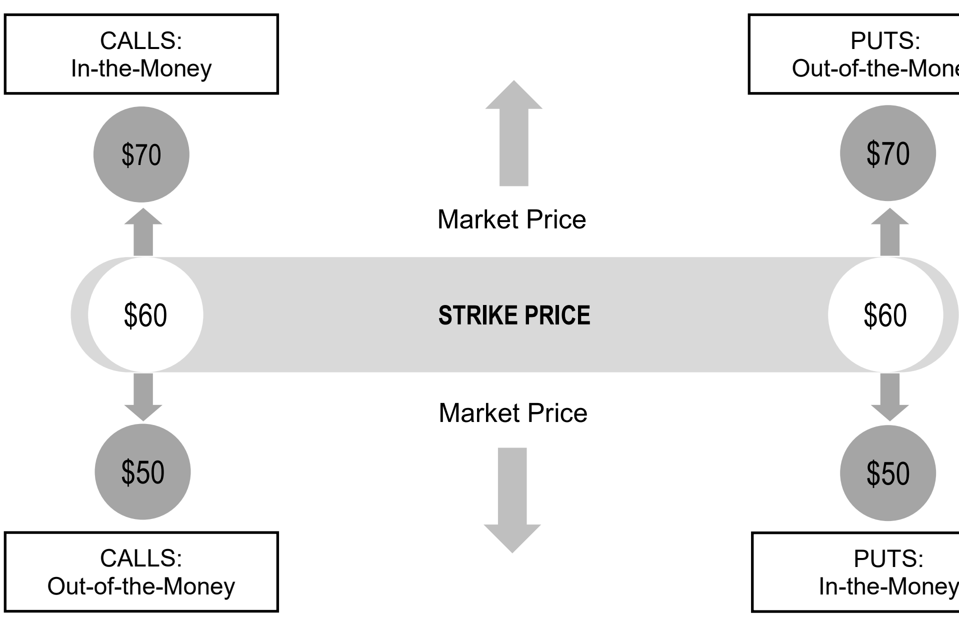
Standardized Components

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

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



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



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

An Option's Premium

PREMIUM = Intrinsic Value + Time Value

Intrinsic Value: The amount by which an option is in-the-money

Time Value: The portion of an option's premium that exceeds its intrinsic value

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

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

The concept of INtrinsic value is tied to options that are IN-the-money.

Time value is based on:

- Time left until expiration
- Market volatility

Adjustment of Terms

Start: 1 ABC Feb 60 Call			Aggregate Contract Value: $6,000	
Adjust for:	Number of Contracts	Shares per Contract	Strike Price	Aggregate Value

Even Splits	Increase	Unchanged	Decrease	Aggregate
2-for-1				

Odd Splits / Stock Dividends	Unchanged	Increase	Decrease	Aggregate
3-for-2				

Adjustment of Terms

Start: 1 BBA Mar 5.00 Call			Aggregate Contract Value: $500	
Adjust for:	Number of Contracts	Shares per Contract	Strike Price	Aggregate Value

Reverse Split	Unchanged	Decrease	Increase	Aggregate
1-for-10				

Strike price is not adjusted for a cash dividend on ex-dividend date.

The Life of an Option

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

Example: Exercise Versus Close-out

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

1 ABC May 65 Call at 3

Later, near expiration, ABC's market value has risen to 72 and the ABC May 65 Calls are trading at a premium of _____.

Scenario #1: Exercised, stock sold	
DEBIT (CASH OUT)	CREDIT (CASH IN)

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

The OCC and Options Trading

The Options Clearing Corporation:

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

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

Four Key Concepts for Basic Options

Strategy:	**Breakeven:**
For option BUYERS, remember the phrase "CALL UP and PUT DOWN" ▪ Buyers of Calls are BULLISH (want stock to rise) ▪ Buyers of Puts are BEARISH (want stock to fall) Sellers are the opposite (Sellers of Calls are BEARISH and Sellers of Puts are BULLISH)	To find the stock price (value) at which an investor will breakeven, remember the phrase "CALL UP and PUT DOWN" ▪ For Calls, strike price + premium (CALL UP) ▪ For Puts, strike price – premium (PUT DOWN)
Maximum Gain:	**Maximum Loss:**
For SELLERS of options, the PREMIUM received represents the MAXIMUM GAIN For BUYERS of Calls, the maximum gain is UNLIMITED (since a stock's rise is unlimited) For BUYERS of Puts, the maximum gain is realized if the stock falls to zero (i.e., strike price – premium x 100 shares)	For BUYERs of options, the PREMIUM paid represents the MAXIMUM LOSS For SELLERS of Calls, the maximum loss is UNLIMITED (since a stock's rise is unlimited) For SELLERS of Puts, the maximum loss is realized if the stock falls to zero (i.e., strike price – premium x 100 shares)

Long Call – Analysis

When the current market value of XYZ stock is at:

45

Buy 1 XYZ Feb 45 Call at 3

Breakeven:

Strategy:

Maximum Gain:

Maximum Loss:

Later, with XYZ at $58, the investor exercises the option and immediately sells the stock. Result?

Debit (Cash Out)	Credit (Cash In)

Short Call – Analysis

When the current market value of XYZ stock is at:

45

Sell 1 XYZ Feb 45 Call at 2.50

Breakeven:

Strategy:

Maximum Gain:

Maximum Loss:

Later, with XYZ at $52.50, the investor is exercised against. Result?

Debit (Cash Out)	Credit (Cash In)

Long Put – Analysis

When the current market value of ABC stock is at:

94

Buy 1 ABC Apr. 95 Put at 3.50

Breakeven:

Strategy:

Maximum Gain:

Maximum Loss:

Later, with ABC at $80, the investor exercises the option. Result?

Debit (Cash Out)	Credit (Cash In)

Short Put – Analysis

When the current market value of DEF stock is at:

36

Sell 1 DEF Nov. 35 Put at 4

Breakeven:

Strategy:

Maximum Gain:

Maximum Loss:

Later, with DEF at $25, the investor is exercised against and the stock is immediately sold. Result?

Debit (Cash Out)	Credit (Cash In)

Activity

Read each statement and determine what it describes.

MARKET PRICE ABOVE STRIKE PRICE	
PREMIUM – INTRINSIC VALUE	
INCREASE IN THE NUMBER OF CONTRACTS, BUT THE SHARES IN THE CONTRACT STAY THE SAME	
REQUIRED DOCUMENT WHEN OPENING AN OPTIONS ACCOUNT	
STRIKE PRICE + PREMIUM	
STRIKE PRICE – PREMIUM	

Straddles and Combinations

Created by either:
- **Buying both** a call and a put on the same underlying security OR
- **Selling both** a call and a put on the same underlying security

Strategy
- Long straddle or combination:
- Short straddle or combination:

STRADDLE:	COMBINATION:
▪ Same expiration months and strike prices	▪ Different expiration months and/or strike prices

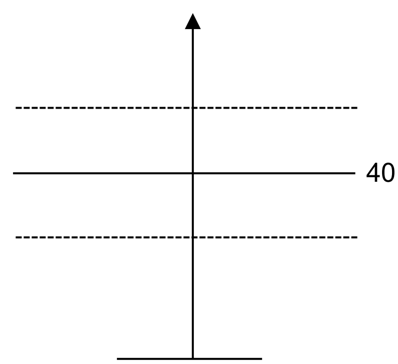
If an investor has one option component and adds another to create a multiple option position, he is considered to have *legged* into the position.

Long Straddle – Analysis

Uncertain of the exact direction in which ABC stock is going to move, an investor:

Buys 1 ABC Jun 40 Call at 3 Buys 1 ABC Jun 40 Put at 2
The total combined premium is ____

Breakeven Points:



Strategy:

Maximum Gain:

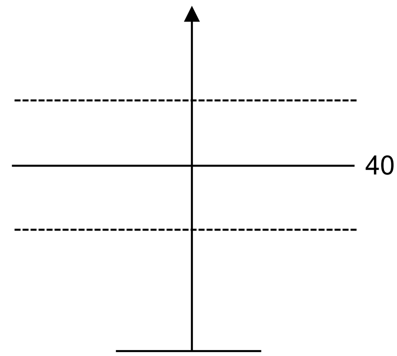
Maximum Loss:

Short Straddle – Analysis

Believing that ABC's stock price will remain flat, an investor:

Sells 1 ABC Jun 40 Call at 3 Sells 1 ABC Jun 40 Put at 2
The total combined premium is ____

Breakeven Points:



Strategy:

Maximum Gain:

Maximum Loss:

Spreads

Positions which allow an investor to limit losses in exchange for limiting gains

- Created with the sale and purchase of two options of the same *class,* but different *series*
  - Class: options of the same type on the same underlying security
  - Series: options of the same class, same expiration, and same strike prices
- Spreads may be either bullish or bearish and either debit or credit

Price/Dollar/Vertical	**Time/Calendar/Horizontal**	**Diagonal**
Buy 1 ABC Jun **40** Call Sell 1 ABC Jun **50** Call	Buy 1 XYZ **Dec** 40 Call Sell 1 XYZ **Sep** 40 Call	Buy 1 DEF **Sep 40** Put Sell 1 DEF **Mar 30** Put

Call Spread – Analysis

An investor who is moderately bullish on XYZ stock, but wants to minimize the cost of establishing the position, does the following:

Buys 1 XYZ Feb 80 Call at 3 Sells 1 XYZ Feb 90 Call at 1

Spread Rules:

- The breakeven must be between the strikes.
- The max gain PLUS the max loss will equal the difference in the strike prices.

Net Premium:

Buyer or Seller:

Debit or Credit:

Widen or Narrow:

Breakeven:

Bull or Bear:

Maximum Gain:

Maximum Loss:

90

80

Put Spread – Analysis

An investor who is moderately bullish on ELG stock, but wants to minimize the risk of a short position, does the following:

Sells 1 ELG Nov 95 Put at 8
Buys 1 ELG Nov 80 Put at 1

Spread Rules:

- The breakeven must be between the strikes.
- The max gain PLUS the max loss will equal the difference in the strike prices.

Net Premium:
Buyer or Seller:
Debit or Credit:
Widen or Narrow:
Breakeven:
Bull or Bear:
Maximum Gain:
Maximum Loss:

95

88 --------------------------------

80

Spreads – Bull/Bear, Debit/Credit, Widen/Narrow?

Buy an XYZ Nov 90 Call
Sell an XYZ Nov 80 Call

For CALL spreads, the dominant leg is always determined by the LOWER strike

Write an ABC Mar 35 Put
Buy an ABC Mar 40 Put

For PUT spreads, the dominant leg is always determined by the HIGHER strike

Short a JMK Oct 75 Call
Long a JMK Dec 75 Call

For HORIZONTAL spreads, the dominant leg is always determined by the LONGER expiration

Butterfly Spread

A combination of two spreads – one is a debit and one is a credit

- Can be created with either calls or puts

Long 1 ABC May 60 Call (out-of-the-money)

Short 2 ABC May 50 Calls (at-the-money)

Long 1 ABC May 40 Call (in-the-money)

What insect has a short body, but two long wings?

A neutral strategy (recognize the 1-2-1 strategy:

- Maximum gain is at the middle strike price ($50)
- Maximum loss is below the lower strike price ($40) and above the higher strike price ($60)

Hedging, Speculation, and Income Generation

Options may be created for different purposes:

Speculation	Hedging	Generate Income
▪ Options can be purchased or sold to generate a profit ▪ In this case, the investor has no existing position in the underlying security • Long Calls and Short Puts are bullish • Long Puts and Short Calls are bearish	▪ To hedge (protect) an existing stock position, an investor could BUY an option • Long Puts may be used to protect the downside risk of a long stock position • Long Calls may be used to protect the upside risk of a short stock position	▪ To generate income on an existing stock position, an investor could SELL an option • Short Calls may generate income on long stock positions • Short Puts may generate income on short stock positions

Covered and Uncovered Positions

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

Stock and Option Positions

Options may be purchased to hedge either long or short stock positions.

Options may be sold to generate income.

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

- Long Stock + Long Put
  - If the stock decreases, the value gained on the put can offset the loss on the stock
- Short Stock + Long Call
  - If the stock increases, the value gained on the call can offset the loss on the stock

To **generate income** in a stable market:

- Long Stock + Short Call (Covered Call) OR
- Short Stock + Short Put (Covered Put)
  - For both positions, if the stock remains stable, the options will expire and the premiums will be retained
  - However, for the Covered Put, the upside risk is **unlimited**

Long Hedge or Protective Put

An investor who is bullish on ABC stock, but fears the stock's downside risk, does the following:

Buys 100 shares of ABC at 96 and
Buys 1 ABC Jun 90 Put at 3

Strategy:

Maximum Gain:

Breakeven:

At what price must ABC be trading for the investor to breakeven?

Debit (Cash Out)	Credit (Cash In)

Later, ABC falls to $80 and the investor exercises the put. What's the result?

Debit (Cash Out)	Credit (Cash In)

Covered Call Writing

An investor owns DEF stock, but believes it will trade flat for the next short period. To generate income, she could create the following position:

Long 100 shares of DEF at 42 and
Sells 1 DEF Jun 45 Call at 2

What's sacrificed?

Loss is realized if DEF stock:

Breakeven:

At what price can DEF be trading for the investor to breakeven?

Debit (Cash Out)	Credit (Cash In)

Later, DEF rises to $67 and the investor is exercised against. What's the result?

Debit (Cash Out)	Credit (Cash In)

Ratio Call Writing

A position that consists of a long stock position, but more calls written than the number of shares owned

Buy 100 shares of XYZ at 50
Write 2 XYZ Jun 50 Calls

Since ratio writing includes an uncovered call, the potential risk is unlimited.

A neutral strategy:

- In the above example, the maximum gain is realized at $50
- One call is covered by the 100-share position, but the second call is uncovered

Index Options

Provide the opportunity to speculate on, or hedge against, the movement of the market, rather than the movement of a specific stock

Broad-based Index: reflects performance of the entire market

- SPX – S&P 500
- OEX – S&P 100
- VIX – Volatility Index
- DJX – Dow Jones Industrial
- RUT – Russell 2000
- WLX – Wilshire 5000 (broadest)

Narrow-based Index: reflects performance of a particular sector

- Biotechnology
- Computer Technology
- Oil

Index Option Specifications

	Equity	Index
Underlying Interest	Stock	Value or average of an index
Multiplier	100 shares	$100
Exercise	Receive or deliver stock	Receive or deliver cash
Settlement on Exercise	One business days	One business day
Exercise Style	American	European

Volatility Index (VIX) Options

The VIX is a barometer of investor sentiment and expected market volatility based on the premiums for S&P 500 Index options over the next 30 days

- VIX options are cash settled, with each point equal to $100 (value of 11.27 x $100 = $1,127)
- Use European style exercise

When does volatility tend to increase?

If an investor believes the S&P 500 Index will fall in value, an investor may:

World Currency Options

Provide the opportunity to speculate on, or hedge against, the movement of exchange rates on foreign currencies compared to the U.S. dollar

- Currency spot prices are established in the **Interbank Market** which:
  - Has unlimited trading hours (spot trades)
  - Is unregulated and decentralized
- Currency options trade on NASDAQ PHLX and currencies are selected by the exchange

World Currency Option Specifications

Expiration:	The third Friday of the expiration month
Exercise:	U.S. dollar-settled, European style exercise
Contract Size:	10,000 units, except Yen which is 1 million
Quoted:	Most are quoted in cents per unit ($.01) ▪ Yen quoted in units of 1/100th of one U.S. cent per unit ($.0001)
Multiplier:	$100 (e.g., 2.25 x $100 = $225)

There are no options on the U.S. dollar issued on U.S. exchanges.

Currency Option Strategy

A speculator believes the U.S. dollar will weaken, resulting in a British Pound rally. The speculator decides to:

Buy 1 Euro Jun 160 Call at 3.35

Breakeven:

Strategy:

Maximum Gain:

Maximum Loss:

If the Euro increases to 166 and the option is closed out at its in-the-money amount, the result is:

Debit (Cash Out)	Credit (Cash In)

Yield-Based Option Strategies

Preferred stock and bond prices and yields are inversely related:

- When anticipating a fall in bond prices, an investor expects a rise in bond yields
- When anticipating a rise in bond prices, an investor expects a fall in bond yields

If Investors Believe:	They Should:
Yields will decrease	▪ Buy yield-based puts or ▪ Sell yield-based calls
Yields will increase	▪ Buy yield-based calls or ▪ Sell yield-based puts

Option Taxation

Tax result is determined by the method of option disposal

1. Expire Worthless	2. Liquidated, Offset, Closed-out	3. Exercised
▪ Short-term capital gain or loss if option purchased with maturities of one year or less ▪ Long-term if a LEAPS® is purchased and held for more than one year ▪ Short-term if option position is established with a sale (short)	▪ Short-term capital gain or loss if option was held for one year or less ▪ Long-term if a LEAPS® is purchased and held for more than one year ▪ Short-term if option position is established with a sale (short)	▪ The option premium will not generate a gain or loss ▪ To calculate the cost basis or sales proceeds: ▪ Of an exercised call, the premium is added to the strike price (i.e., CALL UP) ▪ Of an exercised put, the premium is subtracted from the strike price (i.e., PUT DOWN)

Taxation of Exercised Call Options

An investor is long one ABC Jun 90 Call at 4. If the option is later exercised, the investor will have:

1. A basis of $9,200
2. A basis of $8,800
3. A basis of $8,600
4. A basis of $9,400

Debit (Cash Out)	Credit (Cash In)

The cost of the stock has NO impact on sales proceeds

An investor owns 100 shares of XYZ at $42 per share and sells an XYZ Dec 40 Call for 3. If the call is exercised, what are the investor's sales proceeds for tax purposes?

1. $3,700
2. $3,900
3. $4,300
4. $4,500

Debit (Cash Out)	Credit (Cash In)

Taxation of Exercised Put Options

An investor is long a DEF Feb 45 Put at 3. If the option is later exercised when DEF is at 40, the investor will have:

1. Proceeds of $200
2. Proceeds of $4,200
3. Proceeds of $4,500
4. Proceeds of $4,800

Debit (Cash Out)	Credit (Cash In)

The stock's value has NO impact on cost basis

An investor sells one GHI Aug 60 Put for 4. If GHI falls to 50 and the put is exercised, what's the investor's cost basis?

1. $4,600
2. $5,400
3. $5,600
4. $6,000

Debit (Cash Out)	Credit (Cash In)

Puts and Holding Period

Stock Holding Periods	▪ If a stock's long-term holding period is not yet established: • The purchase of a put terminates the holding period for the stock • The holding period begins anew only after the put expires or is closed out ▪ If a stock's long-term holding period is already established, a put purchase doesn't change it (it remains long-term)
Married Put	▪ A put purchased on the same day that stock is purchased • The holding period for the stock starts on the purchase date • The premium paid becomes part of the stock's basis, even after expiration

Activity

Read each statement and fill in the blanks.

1. A straddle involves ____ ____.
2. The breakeven on a straddle is found by ______________________________________ and ____ from the strike price.
3. Vertical spreads have ___________________________, but ___________________________.
4. For vertical spreads, the difference in the strike prices equals the ____.
5. A debit put spread is ______________ and the investor wants the *spread* to ______________.
6. Long calls are used to hedge ________________________ and short calls generate income on ____________________________.
7. A VIX call will likely become valuable after the market __________________.
8. In an investor believes bond prices may be falling, she may want to purchase ______________________.
9. The holding period on stock and a put on the stock will run concurrently if the two are _________________.

Chapter 13 - Offerings

Key Topics

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

The Primary Market

Issuer
- Needs capital
- Hires underwriter

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

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

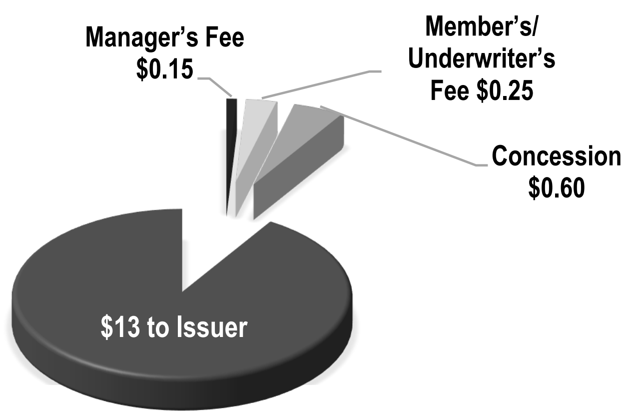
Selling Group
- B/Ds accepting no liability, assist in sales only
- Signs Selling Agreement with manager

Underwriting Commitments

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

The Underwriting Spread

Public Offering Price
$14



Distribution of the Spread

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

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

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

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

Securities Act of 1933

Scope of the law

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

Requires SEC registration of new issues

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

Liability

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

The Registration Process

1. Pre-Registration Period	2. Cooling-Off Period	3. Post Registration Period
▪ Document preparation and due diligence begins ▪ Registration statement is completed ▪ B/Ds and RRs may have no communication with the public	▪ File the registration statement with the SEC ▪ Issuer distributes preliminary prospectus (Red Herring) ▪ "Blue Sky" the issue ▪ Final due diligence meeting held	▪ Effective date ▪ Sales confirmed and Final Prospectus delivered ▪ Must contain the SEC no-approval clause

Additional Underwriting Issues

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

Crowdfunding

The Jumpstart Our Business Startups (JOBS) Act established *crowdfunding* procedures

- Allows small businesses to raise capital using the internet
- Capital can only be raised through an online platform of a broker-dealer or an approved funding portal
- Amount that a person may invest is limited based on her income and/or net worth

Types of Prospectuses

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

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

After-Market Prospectus Requirements

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

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

The more public information available about the company, the shorter the period.

The New Issue Rule

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

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

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

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

Activity

Read each statement and determine what it describes.

UNDERWRITING COMMITMENT THAT REQUIRES THE ENTIRE OFFERING TO BE SOLD OR RETURNED TO THE ISSUER	
THE AMOUNT OF THE UNDERWRITING SPREAD THAT'S USED TO COMPENSATE THE SELLING GROUP	
AN OFFERING THAT CAN BE SOLD ON A DELAYED OR CONTINUOUS BASIS	
CAPITAL ONLY PERMITTED THROUGH ONLINE OFFERING	
OFFERING TERM SHEET IS AN EXAMPLE	
PROSPECTUS FOR AN IPO TO BE LISTED ON NASDAQ MUST BE DELIVERED FOR NO LESS THAN ____________	

Accredited Investors and QIBs

The following terms are used for certain investors; however, they are based on regulatory definitions

Accredited

- *Accredited investors* are institutional investors as well as individuals who have met a financial test:
  - Net Worth of: $1,000,000 excluding their primary residence
    OR
  - Annual Income of: $200,000 in each of the last two years ($300,000 for married couples)

QIBs

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

Registration Exemptions

	Regulation A+ Tier 1	Regulation A+ Tier 2
Maximum offering size	$20 Million	$75 Million
Time period	12 Months	12 Months
Maximum amount that may be sold by existing shareholders	$6 Million	$22.5 Million

These are <u>public offerings</u> of securities and Offering Circulars must be provided.

Exempt Transactions

Regulation D – Private Placement

- A sale of securities directly to "accredited" investors (and/or to a limited number of non-accredited investors)
- Unlimited number of accredited investors
  - Officers/directors of the issuer
  - Institutions
  - Individuals who have met a financial test:
    - Net Worth of: ______________________________________

      OR
    - Annual Income of: ___________________________________

      ____
- No more than ______ non-accredited investors

Regulation D – Private Placement

Purchaser Representative (no specific qualifications)

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

Private placement (offering) memorandum (disclosure document)

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

Rule 144

Permits the sale of restricted and control stock

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

When intending to sell, the SEC must be notified

- Form 144 filed at the time the sell order is placed
- Securities may be sold over ____________ through unsolicited broker's trades or to dealers acting as principal
- To sell any shares remaining unsold from this filing, an investor must file an updated Form 144

Maximum sale allowed for control persons is the greater of:

- ______ of the outstanding shares or the average weekly trading volume over the ________________________

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

Rule 144 – Maximum Sale

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

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

Multiple Choices:

1. 57,000
2. 58,000
3. 58,800
4. 59,000

Rule 144A

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

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

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

Rule 147 and 147A

Rule 147 (Intrastate Offering) – Provides an exemption for the sale of securities to residents of one state if:

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

Rule 145

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

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

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

Regulation S

Provides an exemption from registration to U.S. and foreign issuers that offer securities outside of the U.S. if the offer or sale is an offshore transaction

- No offer may be directed to a U.S. person and the transaction must be effected through an overseas securities market
    - U.S. person is any natural person who is a U.S. resident

Regulation S securities may be resold:

- Immediately through a designated offshore securities market, or
- In the U.S.:
    - After 40 days if they are non-convertible debt
    - After one year if they are equities of non-reporting issuers / six months if they are equities of reporting issuers

Issuing G.O. and Revenue Bonds

Municipal debt issues are exempt from the registration and prospectus requirements

Issuing General Obligation (GO) Bonds
▪ Usually requires voter approval ▪ Subject to debt limitations placed on the municipality which limits its ability to add debt above its *debt ceiling*

Issuing Revenue Bonds
▪ Don't required voter approval since they're backed by fees that are paid for use of the system or services ▪ A consultant is hired to produce a *feasibility study*

Selecting an Underwriter

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

Competitive Sale	Negotiated Sale

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

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

Syndicate Practice

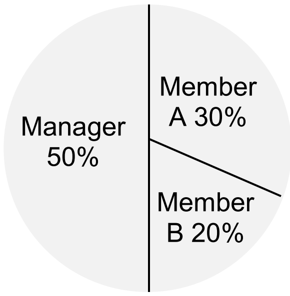
Formation of a Syndicate

- Manager invites other B/Ds to participate and share in liability by sending *Syndicate Letter (Agreement Among Underwriters)*
- Syndicate Letter addresses the following:

Syndicate Letter

Size and type of offering (most offerings are firm commitments)	Percentage required to participate (manager usually assumes the greatest responsibility)
Type of Syndicate ▪ Undivided (Eastern) – each member is responsible for a specific percentage of the unsold bonds ▪ Divided (Western) – members are not responsible for bonds that are left unsold by other members	Priority of orders ▪ The manner in which credit for orders are allocated among members of the distribution group

Syndicate Liability for Unsold Bonds



A three-member syndicate is involved in a firm commitment underwriting of a $100 million bond offering

Reallocation of:

Member	Sales	Divided Acct.	Undivided Acct.
Manager	$50 million		
Member A	$30 million		
Member B	$5 million		

Priority of Orders

The hierarchy by which underwriters allocate orders among the distribution group

1) Pre-Sale	In a competitive underwriting, orders received before bonds are awarded and priced
2) Group Net	Benefits all syndicate members according to their percentage interest
3) Designated	Buyer determines which member or members will receive credit for the sale
4) Member	Syndicate member placing the order is the only member to receive credit for the sale

Municipal Documents / Information

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

Electronic Municipal Market Access (EMMA)

MSRB website used by issuers and underwriters to submit documents

Electronic Access	▪ Provides electronic public access to information about the municipal market, including: • Trade activity and market statistics
Documents	▪ Various documents: • Pre-sale documents, official statements, and continuing disclosures
Plan Info	▪ Includes 529 plan information

Activity

Read each statement and fill in the blanks.

1. A ____ invests a minimum of _____________________ in securities.
2. Reg A+ Tier 1 allows a maximum offering size of ________________________.
3. The disclosure document used for a private placement is referred to as an ________________________________.
4. ___________________applies to the sale of restricted and control stock.
5. Intrastate public offerings of securities are exempted under _________________________.
6. A U.S. issuer conducting a public offering outside the U.S. to non-residents is exempted under ____________________________.
7. A ______________________________________ uses a bidding process to choose an underwriter.
8. Unsold portions of an underwriting are reallocated in an _____________________________________.
9. A municipal bonds tax-exempt status is evidenced through the ______________________________.

Chapter 14 – Account Disclosures, Risks, and Returns

Key Topics

1	2	3	4
ACCOUNT DISCLOSURES Learn about the disclosures that are required on transactions and different accounts.	ACCOUNT TRANSFERS Learn about the process of transferring an account from one B/D to another.	SYSTEMATIC VS. UNSYSTEMATIC RISKS Learn about the different risks that can influence an investor's decisions.	INVESTMENT RETURNS Learn about the different investment returns and the tax results of receiving gifts of securities.

Disclosures

Disclosures Made Prior to Execution

- Risks associated with specific investments, including:
  - Speculative nature of options
  - Limited marketability of penny stocks
  - Default risk of high-yield bonds
- Potential conflicts of interest
  - Investment positions held by the firm
  - Control relationships with issuers
- Investment limitations of the firm, including whether:
  - Certain securities are unavailable
  - The B/D is limited in transactions

Disclosure of Costs and Fees

Those assessed on different transactions

- Mutual funds
  - Different share classes (A, B, C, etc.)
  - Redemption fees
- Annuities
  - Surrender charges
  - Mortality and expense charges
- Non-discretionary, fee-based accounts
  - Fee assessed based on AUM
  - Unsuitable for buy-and-hold investors
- Soft-dollar arrangements

Executing an Equity Trade

Capacity	Form of Compensation and Disclosure
Agent	▪ Commission is disclosed on the confirmation
Principal	▪ Markups on NMS securities are disclosed on client purchases ▪ Markdowns on NMS securities are disclosed on client sales ▪ Compensation calculation is based on NBBO
Dual Agency Cross	▪ Internal trades that are executed between the bid and offer ▪ Commission charged to both the buyer and seller ▪ Commissions must be disclosed on the confirmation

Executing an Equity Trade

Capacity	Form of Compensation and Disclosure
Riskless Principal	▪ Firm's purchase and resale to its client is reported as one trade ▪ Markup must be disclosed on confirmation
Net Basis	▪ Firm's purchase and resale to its client is reported as two trades ▪ Markup is NOT disclosed ▪ Retail client must provide prior written consent ▪ Institutional clients may provide both oral and written consent or use a negative consent letter

Soft-Dollar Arrangement

This practice involves an investment adviser (IA) receiving research or other services from a B/D in exchange for order flow

- The services received from the B/D must benefit its clients.

Acceptable	Unacceptable
▪ Research reports (in-house and third-party) ▪ Access to analysts ▪ Portfolio analysis software ▪ Subscription to industry trade publications ▪ Attendance cost for a securities conference or seminar ▪ IA Software	▪ Office space ▪ Accounting fees ▪ Advertising/marketing expenses ▪ Travel reimbursement ▪ Professional licensing fees ▪ Subscription to mass-marketed publications (e.g., WSJ) ▪ Bloomberg hardware

Trade Confirmations

Confirmations are sent on, or before, settlement and include the following:

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

WE HAVE BOUGHT THE FOLLOWING SECURITIES FOR YOU

COMPANY:

SECURITY: ORDINARY FULLY PAID

ABC

DATE:	6/06/20XX
AS AT DATE:	6/06/20XX
CONFIRMATION NO:	
ORDER NO:	
ACCOUNT NO:	
TOTAL UNITS:	588
CONSIDERATION	$2,610.72
BROKERAGE & COSTS INCL GST:	$19.95
(may include printed confirmation postal fee)	
APPLICATION MONEY:	$0.00
TOTAL COST:	$2,630.67
TOTAL GST:	$1.81
SETTLEMENT DATE:	6/08/20XX

PAYMENT METHOD - DIRECT DEBIT OF CLEARED FUNDS FROM NOMINATED BANK A/C ON SETTLEMENT DATE.

UNITS AT PRICE	
588	4.440000

AVERAGE PRICE: 4.440000

ORDER COMPLETED

CONTRACT COMMENTS:

Bought on Agency Basis
Unsolicited

Customer Account Statements

Broker-dealers must send customer statements *at least quarterly*

- For active accounts, they are sent *monthly*

Information includes:

- Summary of the total value of investments and cash
  - Unrealized and realized gains and/or losses
- Detailed information on the specific investments in the portfolio
- Income generated from investment for the statement period and year-to-date
- Daily activity for the statement period
- Required disclosures

Updating Client Information

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

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

SEC requires the updating of customer information at least every three years.

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

Financial Exploitation Rules

DEFINITION

Financial exploitation rules apply to specified adults who are most likely to be exploited, including:

- Persons age 65 or older
- Any persons age 18 or older who are believed to have a mental or physical impairment that jeopardizes their ability to protect their own interests

PROCEDURE

If signs of diminished capacity or dementia are identified, the firm should place a temporary hold on the disbursement of funds, execution of securities transactions, and transfer of securities.

- The customer's designated trusted contact person should be notified
  - Information regarding the trusted contact person should be obtained when an account is opened (although not required, a reasonable effort should be made)

Account Transfer Process

Customer initiates transfer by completing and delivering Automated Customer Account Transfer Service (ACATS) Form to receiving B/D

→ Receiving B/D inputs ACAT Form and a Transfer Initiation Form (TIF) is sent to the carrying B/D

→ Carrying B/D has one business day to validate or protest the transfer

→ After validation, transfer is completed within three business days

Once validated:

- Account is frozen
- Open orders cancelled
- No new orders accepted

Account Transfer

Reasons to protest transfer request:

- Additional documentation is required (e.g., death certificate)
- Account is flat; reflects no assets
- Invalid account number
- Social Security number or account title does not match
- Existing court order or tax liens
- *Written* instructions to rescind the transfer are received from the client

But NOT due a dispute over securities positions or money balances

If discrepancy claim occurs after transfer, carrying B/D must resolve it within five business days

Systematic Risks

Systematic risks are those that affect the value of all securities and cannot be avoided through diversification, including:

Market Risk	Risk inherent in all securities due to market fluctuation
Interest-Rate Risk	Risk that the value of a fixed income investment (bond) will decline due to a rise in interest rates
Inflation Risk	Risk that an asset or the purchasing power of income may decline over time, due to the shrinking value of the country's currency ▪ To find a bond's real interest rate, the formula is: Nominal Yield – Inflation Rate
Event Risk	Risk that a significant event will cause a substantial decline in the market

Unsystematic Risks

These risks are unique to a specific security and can managed through diversification

BUSINESS RISK	▪ Risk that a company may perform poorly causing a decline in the value of the stock
REGULATORY RISK	▪ Risk that new regulations may have a negative impact on an investment's value
POLITICAL RISK	▪ Risk that political event outside of the U.S. could adversely affect the domestic markets
LIQUIDITY RISK	▪ Due to a lack of marketability, this is risk that an investment cannot be bought or sold quickly enough to prevent or minimize a loss

Additional Risks

CAPTIAL RISK	CREDIT RISK	CURRENCY RISK	LEGISLATIVE RISK
▪ Risk of investors losing their invested capital (lower for bonds)	▪ Risk that a bond may not repay its obligation	▪ Risk of loss when converting an investment that's made in a foreign currency into U.S. dollars	▪ Risk that new laws may have a negative impact on an investment's value (e.g., tax code changes)

Additional Risks

OPPORTUNITY RISK	REINVESTMENT RISK	PREPAYMENT RISK
▪ Risk of passing on the opportunity of making a higher return on another investment	▪ Risk that interest rates will fall and semiannual coupons will be reinvested at a lower rate	▪ Risk that mortgages will be paid off early due to lower interest rates, resulting in reinvestment in lower yielding investments

Investment Returns

The following return measures are based on the different types of investments

EQUITY	▪ Current Yield $\dfrac{\text{Annual Dividend}}{\text{Current Market Price}}$
DEBT	▪ Nominal Yield ▪ Current Yield (based on annual interest) ▪ Yield-to-Maturity ▪ Yield-to-Call
MUNICIPAL BONDS	▪ Tax-Equivalent Yield $\dfrac{\text{Tax-Free Yield}}{\text{(100\% - Tax Bracket \%)}}$
CAPITAL GAINS AND CAPITAL LOSSES	▪ Gain – realized when sales proceeds exceed cost basis ▪ Loss – realized when sales proceeds are below cost basis ▪ Return of Capital – return of investor's original investment

Tax Considerations

When giving or receiving securities the tax implications must be taken into account

Unified Gift and Estate Taxes	Securities Received as a Gift	Inherited Securities
▪ The amount of assets that can be left in an estate without incurring estate taxes **Annual Gift Limit** ▪ $19,000 can be gifted each year to as many as desired without tax to the donor ▪ Amounts in excess reduce the lifetime exclusion ▪ Unlimited amounts can be gifted between spouse	▪ If fair market value (FMV) exceeds donor's (original) cost basis • Use original basis (OB) • Use donor's holding period ▪ FMV less than donor's cost basis and sold for: • More than OB, use OB • Less than OB, use FMV	▪ Cost basis is the value at time of death • Stepped up if deceased's cost basis is lower • Stepped down if deceased's cost basis is higher

Activity

Match each portfolio to the appropriate term.

MARKUP/MARKDOWN	Paying for office space and professional licensing fees
UNACCEPTABLE USE OF SOFT DOLLARS	Used in account transfers
DESIGNATED TRUSTED CONTACT	Charged on principal transactions
ACATS AND TIF	Business, political, and prepayment risk
UNSYSTEMATIC RISK	Required under Financial Exploitation Rules

Chapter 15 – Portfolio and Market Analysis

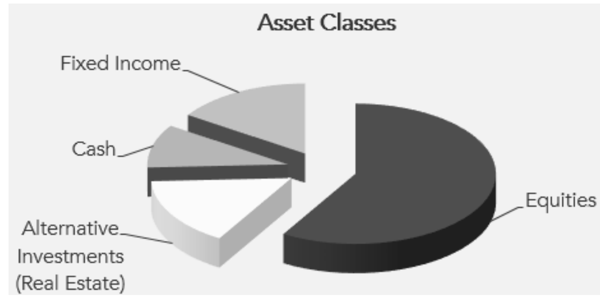
Key Topics

1	2	3
INVESTMENT SELECTION	ASSET ALLOCATION	TECHNICAL ANALYSIS
Learn about the factors which influence the selection of investments for a customer.	Learn about how different asset classes can be used to construct an optimal portfolio.	Learn about the different tools that can be used to indicate the direction of prices and the market.

Clients' Financial Objectives

	OBJECTIVES				
	Preservation of Capital/Income	**Current Income**	**Growth/Capital Appreciation**	**Speculation**	**Tax Relief**
Time Horizon	Short to Medium	Medium	Long	Long	Varies
Securities	Money Market Funds and T-Bills	Bonds, Income Funds, Annuities, Preferred Stocks, Utility Stocks	Common Stocks, Growth Funds	Sector Funds, Aggressive Growth Funds, Emerging Markets Funds, Overseas/ Country Funds, Hedge Funds	1) Tax-Exempt: Municipal Bonds, Municipal Money-Market Funds 2) Tax-Deferred: Annuities and Retirement Plans
Risk	Low	Medium	High	Higher	Varies
Phrases associated with the objective	Parking funds, safety, liquidity, and income	Steady, reliable stream of income, in retirement and in need of fixed income	Capital appreciation	Speculation, able to withstand potential losses	High tax bracket, professional role

Asset Allocation

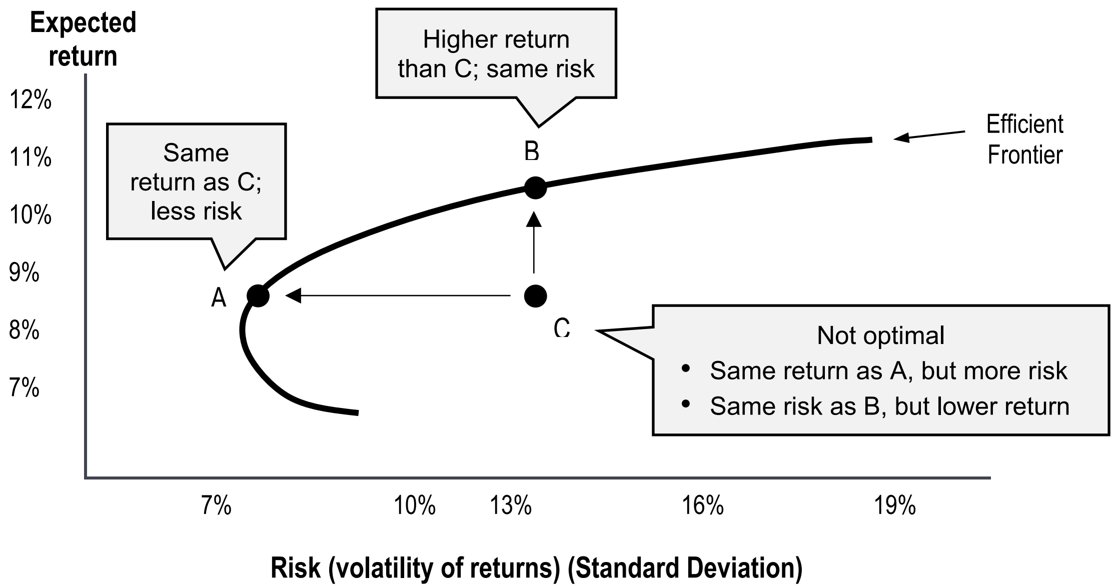


Asset allocation focuses on a portfolio constructed of various asset classes

An optimal portfolio (one producing the greatest return for a given amount of risk) is based on a client's goals, expected return, and risk tolerance

Constructing Optimal Portfolios

Using the basics of Modern Portfolio Theory, investors can describe the relationship between expected risk and expected return for a portfolio



Averages and Indexes

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

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

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

Other Averages and Indexes

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

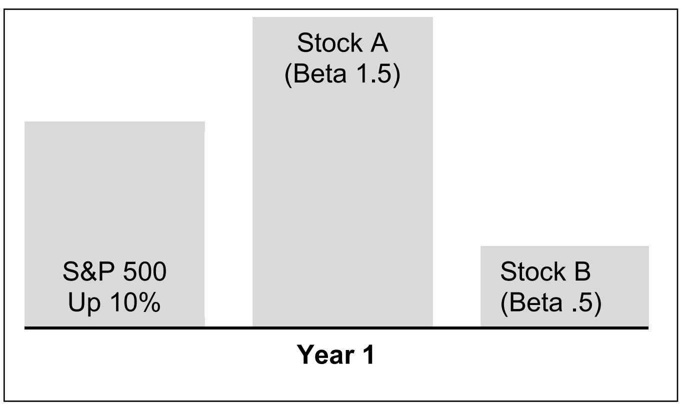
> The largest index is the Wilshire Associates Equity Index, while one of the smallest is the Dow Jones Industrial Average

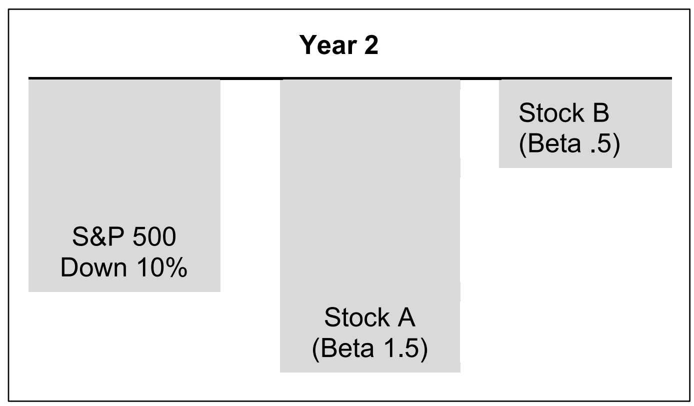
Bond Indexes
- Barclay's Capital and other B/Ds have created indexes based on existing bonds in the market

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

Measuring Systematic Risk

Beta measures the volatility of an asset (typically an equity) relative to the entire market
- A stock's beta is compared to the beta of the S&P 500, which is fixed at 1.00
- If a stock's beta is more than 1, it's expected to outperform when the market is up and underperform when the market is down
- If a stock's beta is less than 1, it's expected to underperform when the market is up and outperform when the market is down

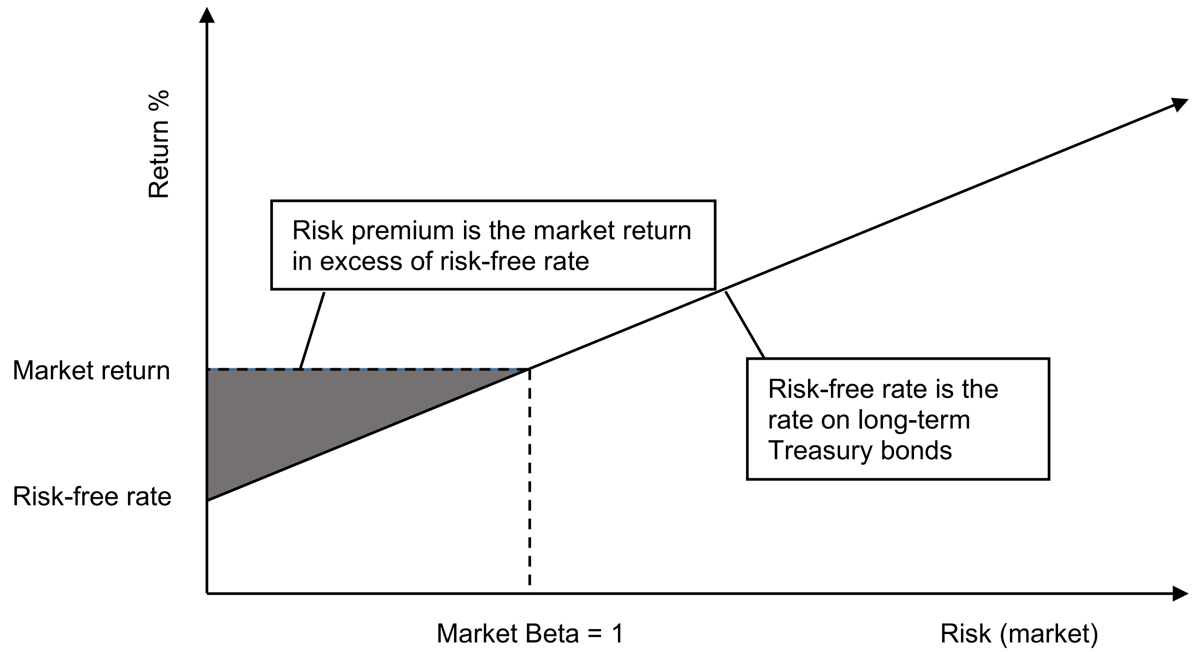




Alpha measures an investment's risk-adjusted performance against a benchmark index.
Outperforming the benchmark results in a positive alpha; underperforming results in a negative alpha.

Capital Asset Pricing Model (CAPM)

Used to determine if the return on an investment equals the risk premium in excess of the risk-free rate of return.



Market Analysis Factors

MARKET SENTIMENT
▪ Overall attitude of investors as it relates to the market or specific security.

MARKET MOMENTUM
▪ The trading volume that sustains an increase or decrease in prices. High volume increases momentum.

TRADING VOLUME
▪ An indicator of the support behind a move in the direction of stock prices.

OPTIONS VOLATILTY
▪ Used to evaluate a stock's volatility in the future.

PUT/CALL RATIO
▪ Gauges investors' sentiment in the market. ▪ A rising ratio indicates a bearish mood.

INDEX FUTURES
▪ Reflects investors' attitude towards the direction the underlying market may be headed

SHORT INTEREST
▪ The number of shares that have been sold short, but not yet covered. ▪ The ratio or days to cover is used to determine the bearish or bullish sentiment.

Municipal Market Analysis

Bond Buyer Indexes	
20 Bond	20 G.O. bonds with 20-year maturities ▪ Average rating of AA or Aa2
11 Bond	11 of the above 20 ▪ Average rating of AA+ or Aa1
25 Revenue (or Revdex)	25 revenue bonds with 30-year maturities ▪ Average rating of A+ or A1
40 Bond	40 recently issued and actively traded bonds ▪ Based on average prices as quoted by brokers' brokers
Treasury Bond	Used as a benchmark ▪ Highest yield since interest is taxable

These indexes show the average yields and are compiled on a weekly basis.

Technical Analysis

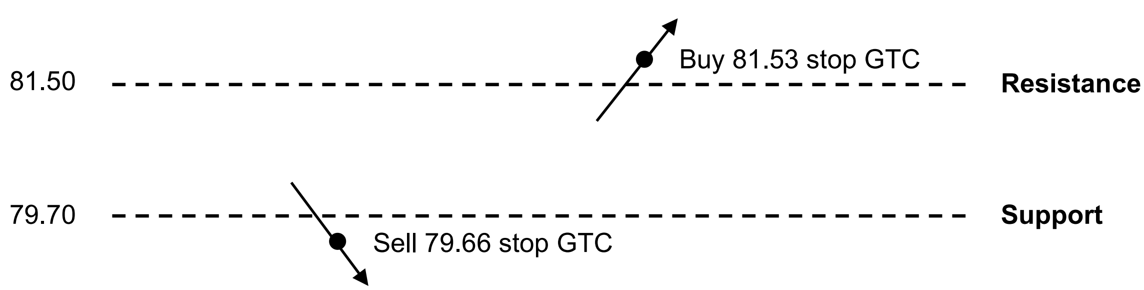
These are basic chart patterns and terms used to indicate the direction of prices

TREND LINES	▪ Straight lines that show direction and speed of price movements
SAUCER/INVERTED SAUCER	▪ Chart formations showing that an upward trend has come to an end (inverted saucer), or a downward trend has come to an end (saucer)
MOVING AVERAGES	▪ Provide a current direction of prices, removing random price fluctuations (e.g., 50-day, 200-day, etc.)
OVERBOUGHT/OVERSOLD	▪ Overbought – buying has pushed the price to high and a pullback is expected ▪ Oversold – selling has pushed the price to low and a bounce is expected

Resistance / Support Levels

Breakout

- In order to profit on a breakout, one could:
  - Enter sell stop orders below a support level (or buy puts), or
  - Enter buy stop orders above a resistance level (or buy calls)



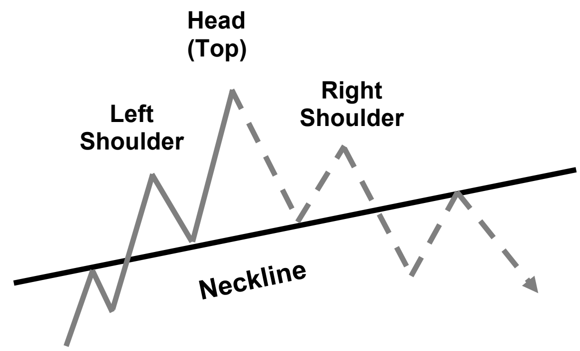
Head and Shoulder Patterns

Head and Shoulders Top

- Reversal of an ______________________ trend
- Bearish indicator

Head and Shoulders Bottom

- Reversal of a _______________________ trend
- Bullish indicator



Activity

Read each statement and determine whether it's TRUE or FALSE.

ASSET ALLOCATION MODELS ARE USED TO CREATE OPTIMAL PORTFOLIOS	
THE RUSSELL 2000 IS THE LARGEST INDEX	
A STOCK WITH A BETA OF 1.25 WILL OUTPERFORM IN A RISING MARKET AND UNDERPERFORM IN A FALLING MARKET	
CAPM STATES THAT THE RETURN ON AN INVESTMENT SHOULD EQUAL A RISK-FREE RATE OF RETURN PLUS A RISK PREMIUM	
A RISING PUT/CALL RATIO INDICATES A BULLISH SENTIMENT	
A BUY STOP ORDER MAY BE USED TO TAKE ADVANTAGE OF A BREAK IN THE SUPPORT LEVEL	

Chapter 16 – Fundamental Analysis

Key Topics

1	2	3	4
BALANCE SHEET Learn about the contents of a balance sheet.	FUNDAMENTAL TOOLS Learn about measuring financial stability and what influences the balance sheet.	INCOME STATEMENT Learn about the contents of a profit and loss statement.	EARNINGS PER SHARE Learn how to calculate EPS and other investment returns.

Balance Sheet

CURRENT ASSETS		CURRENT LIABILITIES	
Cash	$500,000	Accounts Payable	$500,000
Marketable Securities	80,000	Accrued Expenses	400,000
Accounts Receivable	90,000	Income Tax Payable	100,000
Inventories	800,000	Short-Term Debt	50,000
Other Current Assets	150,000		
Total Current Assets	$1,620,000	Total Current Liabilities	$1,050,000
FIXED ASSETS		**LONG-TERM LIABILITIES**	
Property, plant and equipment (PPE)	2,000,000	Long-Term Debt (Notes and Bonds)	480,000
		Other Long-Term Liabilities	20,000
		Total Liabilities	$1,550,000
INTANGIBLES		**STOCKHOLDERS' EQUITY**	
Goodwill	400,000	Common Stock	10,000
Other intangibles	15,000	Additional Paid-in Capital	400,000
		Retained Earnings	2,500,000
		Treasury Stock at Cost	(425,000)
		Total Shareholders' Equity	$2,485,000
Total Assets	$4,035,000	Total Liab. And Sh. Equity	$4,035,000

Inventory Valuation

First-In, First-Out (FIFO)	▪ Oldest costs are matched with first units sold ▪ Inventories reflect the cost of the latest purchases ▪ If used during inflationary times, it results in greater profits
Last-In, First-Out (LIFO)	▪ Most recent costs are matched with first units sold ▪ Inventories reflect the cost of the earliest purchases ▪ If used during inflationary times, it results in lower profits

Fundamental Tools

Measuring Financial Stability

1. Liquidity

Working Capital:

Current Assets – Current Liabilities

Current Ratio:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Quick Asset Ratio:
(Acid Test)

$$\frac{\text{Current Assets – Inventory}}{\text{Current Liabilities}}$$

2. Capitalization Ratios:

Bond Ratio:

$$\frac{\text{Total Debt}}{\text{Total Capitalization}}$$

Debt-to-Equity:

$$\frac{\text{Total Debt}}{\text{Total Shareholders' Equity}}$$

Adjustments to Balance Sheet

Transaction	Effect on Working Capital
1. Issue Stock	
2. Issue Bonds	
3. Buy Equipment for Cash	
4. Declare Cash Dividend	
5. Pay Cash Dividend	

C.A.	C.L.
F.A.	L.T.L.
INTANG.	SH. EQ.

Income Statement

REVENUE (SALES)
– Cost of Goods Sold
Gross Profit
– Operating Expenses (SG&A, D&A)
Operating Income
± Other Income or Expenses
EBIT
– Interest
Taxable Income
– Taxes
Net Income
– Preferred Stock Dividends
Earnings Available to Common Stockholders
– Common Stock Dividends
Changes to Retained Earnings

EPS, Current Yield, and Dividend Payout Ratio

$$\text{Basic EPS} = \frac{\text{Earnings Available to Common Shareholders}}{\text{Average Number of Shares of Common Stock Outstanding}}$$

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

$$\text{Dividend Payout Ratio} = \frac{\text{Annual Dividend}}{\text{EPS}}$$

Calculating EPS

A company has the following:

- EBIT = $250 million
- 21% tax rate
- 80 million outstanding shares
- $600 million of 5% debentures
- $100 million of 6% preferred stock

Basic EPS	
EBIT	$250MM
Less: Interest	$30MM ($60MM x 5%)
Taxable Income	$220MM
Less: Taxes	$46.22MM ($220MM x 21%)
Net Income	$173.8MM ($220 – $46.2)
Less: Preferred Dividends	$6MM ($100MM x 6%)
Basic EPS is $167.8/80MM shares outstanding = $2.10	

Using P/E Ratio	
Price-to-EPS	20:1
Market Value of Stock	$42
Basic EPS is MV/PE = $42 / 20 = $2.10	

If debt and/or preferred stock is convertible, fully diluted EPS is recalculated after converting to common stock.

Activity

Read each statement and fill in the blanks.

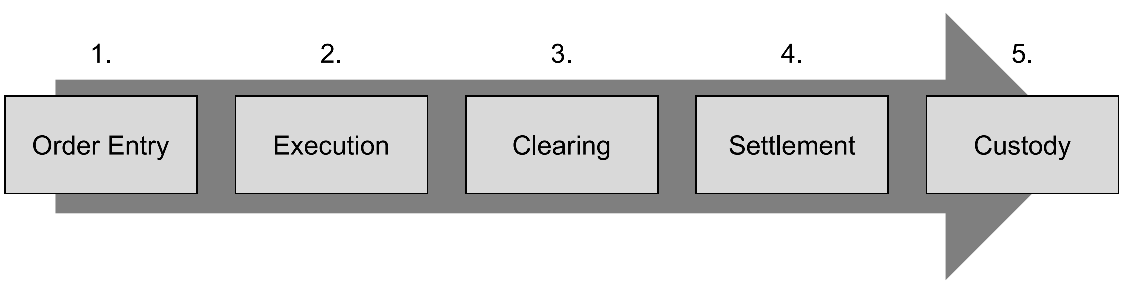
1. During periods of inflation, profits will be greater if inventory is valued using ______________ and lower using ________________.
2. The quick asset ratio removes ________________________ from current assets.
3. The percentage of total capitalization represented by debt is found in the _________________________.
4. Working capital will ______________________________________ when a cash dividend is paid.
5. To determine net income, taxes are deducted ___________________ bond interest.
6. In order to find the current yield of stock, the _________________________________ is divided by the ____.
7. Calculating EPS after accounting for convertible securities results in _________________________________.

Chapter 17 – Orders and Trade Execution

Key Topics

1	2	3	4	5
OVERVIEW	TRADE CAPACITY	MARKET MAKING	ORDER ENTRY	REGULATION
Learn about the life cycle of a trade and obtain an overview of trading markets.	Learn about the difference between a firm acting as a broker or a dealer on a transaction.	Learn about the process of market making and rules concerning the various types of quote in different venues.	Learn about the different types of orders and the required information on an order ticket.	Learn about the various SEC and FINRA rules and regulations which govern trading markets.

Processing a Trade



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

Secondary Markets

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

NYSE and other traditional centralized exchanges:

- Provide a specific location for trade execution
- Trading is normally monitored by a *specialist* or *designated market maker (DMM)*
- The DMM:
  - Creates a fair and orderly market
  - Keeps "the book" for a given security

How Broker-Dealers Function

B R O K E R	▪ Firm acts as a conduit or agent by finding another party willing to take the other side of the trade ▪ Sells to a bid or buys from an offer ▪ Collects commission for the service ▪ No risk to the firm

A

B

C

How Broker-Dealers Function

D E A L E R	▪ Firm acts as a principal ▪ Firm takes the other side of the trade ▪ Entitled to markup/markdown (discussed shortly) ▪ Inventory/risk

P

D

M

Dealer-to-Dealer Markets

Nasdaq	▪ Non-physical; phone and computer network ▪ Negotiated market ▪ Unlimited number of "market makers" ▪ Classified as a securities exchange
Non-Exchange Issues (OTC)	▪ Often low priced and thinly traded ▪ Two systems which offer real-time quotations: • OTCQX – Issuers must be reporting companies • OTC Pink Market – Issuers are not required to be reporting companies ▪ During normal business hours, priced quotes are firm for a size that varies inversely with the security's price
Market Makers	▪ Stand ready to buy or sell at least 100 shares at their quoted prices (quotes are firm) Bid: 22.90 / Ask: 23.05 ▪ The MM's bid price is the price at which it will buy ▪ The MM's ask price is the price at which it will sell ▪ The difference between the bid and ask is the spread ▪ Quotes are subject to SRO rules
Traders	▪ Execute trades for their firm or their firms' clients ▪ Do not maintain an inventory

Other Secondary Market Terms

Third Market	▪ Listed securities traded OTC ▪ Trades included in NYSE volume totals
Fourth Market	▪ Transactions between institutions ▪ Most true fourth market trades are internal crosses set up by money managers
Dark Pools	▪ Provides liquidity for large institutional investors and high-frequency traders ▪ Quotes are not disseminated to the public ▪ Limits impact on the market

Quotes

The *Inside Market* represents:

- The highest bid and lowest offer of all market makers for a given stock

	Bid	Ask
MM 1	10.00	10.10
MM 2	9.98	10.08
MM 3	9.95	10.05

The client sells to the high bid and buys from the low offer

If an MM fails to honor its quote, it is considered a **backing away** violation.

Types of Quotes

Firm	Quote is guaranteed for the size indicated. ▪ Typically priced in $.01 increments ▪ Quote size is expressed in round lots ▪ For example, 16.50 – 16.57, 20 x 30 represents 2,000 shares bid and 3,000 shares offered)
Subject	Quote is tentative and subject to reconfirmation
Bid Wanted	A seller indicates the desire for a bid
Offer Wanted	A buyer indicated the desire for an offer

Calculating Markups and Markdowns

Market maker quotes are inter-dealer, but are adjusted when trading with retail customers

- Allows dealers to profit on trades with customers
- Price adjustments are built into the trade, but are generally disclosed on the confirmation
- Mark-up/Mark-down is always calculated based on the <u>inside market</u>

This quote shows the inside market:

Bid	Ask
22.95	23.00

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

Price for Selling Client	Price for Buying Client
22.90	23.05

The Nasdaq Stock Market

ABCO	Bid	Ask	Size
	22.95	23.00	10 x 30
MM 1	22.90	23.05	50 x 50
MM 2	22.95	23.15	10 x 40
MM 3	22.85	23.00	20 x 30

<u>Level 1</u>:

- Inside market only (highest bid and lowest asked/ offer) without identifying any market makers

<u>Level II</u>:

- Quotes of all market makers that deal in the security
- TotalView provides additional depth and aggregate size at the five best price levels

<u>Level III</u>: (same information as Level II)

- Allows market makers to enter or change their quotes

Alternative Trading System (ATS)

Defined as an SEC-approved electronic trading system that's designed to match the buy and sell orders of its subscribers

- Under Regulation ATS, systems are required to register as either an exchange or broker-dealer

Examples include:

- Electronic Communication Networks (ECNs)
- Firm internal execution systems
- Trade Crossing Networks

The importance of an ATS is that it provides an alternative means to access liquidity.

Activity

Read each statement and determine what it describes.

A COMMISSION IS CHARGED ON THE TRANSACTION	
TRANSACTIONS DIRECTLY BETWEEN INSTITUTIONS	
HIGH BID AND LOW OFFER	
QUOTE IS GUARANTEED FOR A SPECIFIC PRICE AND SIZE	
COST OF EXECUTING A PRINCIPAL TRANSACTION	
ECNs AND TRADE CROSSING NETWORKS	

Components of an Order Ticket

Created at the time an order is received and includes:

- Branch identifier
- RR responsible for account and person accepting the order
- Whether a purchase or sale
- Sales must be marked long or short (covered shortly)
- Symbol or description of security and quantity
- Account number/name and type (e.g., cash or margin)
- Time stamps - time of entry and execution (if filled)
- Whether discretionary, solicited, or unsolicited (covered shortly)

Orders must be approved by a principal on the day of entry

Missing Information: firm capacity, accrued interest, compensation, and CUSIP number are items found on a confirmation

Types of Transactions

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

Purchase	Trade may be paid in full or purchased on margin
Long Sale	Sale of securities that are owned by the customer
Short Position Created By:	Sale of securities that are not owned by the customer ▪ Customer borrows securities from the B/D and sells them with the agreement to repurchase and deliver on a future date ▪ The appropriate amount of margin must be deposited to borrow securities ▪ Risk is on the upside and unlimited

Regulation SHO

Regulates the practice of selling short

1. Marking Requirement

Sell order tickets must be marked *long* or *short*

- Tickets may be marked long if:
  - Client or client's agent has title (e.g., DTCC or prime broker)
  - Customer has unconditional contract, but the trade has not yet settled
  - Convertibles have been tendered
  - Options, warrants, or rights have been exercised

  And the B/D believes the security will be delivered promptly

2. Locate Requirement

Applies if sell order ticket is marked *short*

- B/Ds must use an *Easy-to-Borrow* list that is less than 24-hours old
- Difficult to borrow stocks may need to be manually located prior to short sale

Types of Orders

Market Order	• Customer wants to buy or sell • Customer specifies the security and size of the order only • Order is immediately executed at the best price available
Limit Order	• Customer wants to buy or sell at a set price or better • Customer specifies the security, size, and price • Order is only executed if the limit price is able to be met – Buy limit: at pre-set price or lower – Sell limit: at pre-set price or higher
Stop Order	• Customer wants to protect an existing position. • Customer specifies the security, size, and price • Order is only executed if trading occurs at or through the stop price – Sell Stop: Exit long position if price hits stop price or lower – Buy Stop: Exit short position if price hits stop price or higher

Order Duration – Qualifiers

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

Two of the more popular are:

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

Orders may specify exposure to only normal trading session
(9:30 AM to 4:00 PM) or request pre-market and/or post-market as well.

Additional Order Qualifiers

The following qualifiers may be added to an order:

All-or-None (AON)	Fill the entire order by end of day or cancel (no partial fills)
Immediate-or-Cancel (IOC)	Fill as much of the order as possible immediately and then cancel the remainder
Fill-or-Kill (FOK)	Execute the entire order immediately or cancel
Market-on-Open (MOO) **Market-on-Close (MOC)**	Buy or sell as close to the market open or market close

Discretionary Orders

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

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

If a customer specifies the action (buy or sell), amount, and asset, but allows her RR
to determine time and/or price of execution, it's a Not Held order (only good for that day).

Regulation NMS (National Market System)

Quote Increment	Limit Order Display Rule	Limit Order Protection Rule
Minimum Price / Sub-Penny Rule ▪ Prohibits market participants from accepting or displaying orders in pricing increments of less than one penny ▪ Exception: If stock is valued at less than $1.00, it may be quoted in increments of no less than one hundredth of a cent ($0.0001)	Customer *limit orders* are subject to **display**, allowing customer orders to compete with market makers (MMs) ▪ If a customer's limit price *improves* the MM's quote, it must immediately (within 30 seconds) display the order ▪ If a customer's limit price *matches* the MM's quote that's **currently the inside market:** • Customer's size is added to the MM's display	The Manning Rule ▪ Firms may not *trade ahead* of customer limit orders • While holding a customer limit (or market) order, if the MM trades for its own account at the same or better price, it must immediately (within 60 seconds) fill the customer's order at the same price or better

Prohibited Trading Practices

Interpositioning	Trading Ahead of Research	Quoting a Security in Multiple Mediums
Refers to the insertion of a third party between a customer and the best market. ▪ Prohibited if detrimental to customer ▪ Acceptable if advantageous to customer	If a firm has knowledge of material, non-public information regarding the contents of a research report, it may NOT establish, increase, decrease, or liquidate an inventory position in a security or its derivative. ▪ Information barriers must exist between trading and research departments	Refers to displaying quotes on the same security in multiple markets ▪ Permitted if quotes are at the same price

Prohibited Trading Practices

Market Rumors	Front-Running	Marking-the-Close/Opening	Anti-Intimidation/ Coordination Interpretation
▪ Spreading false or misleading information to influence the price of stocks and/or bonds	▪ RRs executing trades for proprietary accounts (or those for which they have discretion) ahead of a customer's block order (a market moving order)	▪ Effecting trades near the opening or close of trading in an attempt to influence a stock's closing price up or down	Prohibited Actions: ▪ MMs coordinating price quotes, transactions, or trade reports ▪ Threatening, harassing, or intimidating other MMs ▪ Retaliating against or discouraging the competitive activities of another MM

Fair Prices and Commissions

The 5% Policy	▪ This is FINRA's policy; it's NOT a rule ▪ Instead, it's a guideline for commissions, markups, and markdowns • Certain transactions may justify a higher markup/markdown • Other transactions may justify a lower markup/markdown
The Factors That Influence the Charge	▪ Influential Factors • Type of security involved (equity or debt) • Availability of the security • Price • Amount of money involved • Pattern of markups • However, the type of client or whether the firm will profit is NOT relevant
Application and Exclusions	Application ▪ The policy also applies to proceeds transactions • Involves a client directing a B/D to liquidate securities and use the proceeds to buy other securities • Markup is calculated based on one trade (as if done for cash) Exclusions ▪ Trades involving securities sold by prospectus or offering circular (e.g., new issues, mutual funds, variable annuities) ▪ Exempt securities (e.g., U.S. government and municipal securities)

Trading Halts

The SEC may issue a halt or trading suspension:

- For any individual security – for up to 10 business days
- On any exchange – for up to 90 days

During a halt, member firms are prohibited from <u>all quoting and trading</u>, even in foreign markets or internal crossing systems

Trading halts may be imposed due to declines in the S&P 500 (percentage triggers are reset each day)

7% decline	13% decline	20% decline
Halt for 15 minutes	Halt for 15 minutes	Halt for remainder of day

Activity

Read each statement and fill in the blanks.

1. If executed, order tickets must be __________________________ and approved __________________________________.
2. In order to execute a short sale an ________________________________ must checked by the broker-dealer.
3. An order that may be activated but not executed is referred to as a _________________________________.
4. __________________________________ order must be completely executed immediately cancelled.
5. When a trading decision was made by an RR without the client's consent the order ticket is marked _______________________________.
6. If a customer's limit order improves the market maker's quote it must be displayed within _______________________________.
7. Placing a third party between a customer and the best market is referred to as _________________________.
8. The __________________________ is a FINRA guideline that dictates fair prices.
9. A __________________________ in the S&P 500 from the previous day's close results in a market halt for the remainder of the day.

Chapter 18 – Margin

Key Topics

1	2	3
OPENING MARGIN ACCOUNTS Learn about what is needed when opening margin accounts and margin terminology.	MARGIN ACCOUNT VALUATION Learn about how changes in market value influence a customer's equity.	OTHER MARGIN ISSUES Learn about some unique margin considerations.

Opening a Margin Account

Margin Basics	▪ Use of margin increases customer purchasing power ▪ However, potential losses are also increased due to adverse market changes ▪ Subject to the FRB's Regulation T 50% deposit requirement, which can be met by depositing: • Cash equaling 100% of Reg T call • Fully-paid marginable securities equaling 2 x the Reg T call
Credit Agreement	▪ This document discloses the terms of the loan • Interest amount, how computed, and when charged
Hypothecation (Pledge) Agreement	▪ Customer hypothecates securities to B/D as collateral ▪ B/D borrows money from a bank to replace the loan that was made to the customer • What amount of cash can the B/D borrow from a bank? • What amount of the customer's securities can be rehypothecated to the bank as collateral?

Additional Margin Documents

Loan Consent Agreement (generally used for short sales)

- *Not mandatory for opening account*
- If signed, B/D is able to lend the customer's securities to others

Margin Disclosure Document – must be provided to all customers opening a margin account and indicates:

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

Margin Terminology

Marginable Securities	**Non-Marginable Securities**
• Determined by the FRB; includes all listed securities	• OTC equities, standard options, and new issues
Long Market Value (LMV)	**Credit Balance**
• The current value in the long margin account	• The amount of money generated by the initial short sale plus the Reg. T deposit
Debit Balance	**Short Market Value**
• The amount of money borrowed from the firm to create a long position	• The current value in the short margin account
Equity	**Equity**
• An investor's ownership interest in an account - For long account: LMV – Debit = Equity	• An investor's ownership interest in an account - For short account: Credit – SMV = Equity
Special Memorandum Account	**Restricted Account**
• A line of credit that's created when equity exceeds 50% of market value. Not reduced due to market declines.	• Occurs when equity is less than 50% of market value, but is not required to be remedied.
Maintenance Call	
• Required deposit if equity falls below 25% of LMV in a long account, or below 30% of SMV in a short account	

LMV Increases

An investor purchases $100,000 of securities in a margin account

LMV increases by $10,000 to $110,000

Initial Purchase	
Long Market Value	$100,000
– Debit Balance	– $50,000
Equity	$50,000

- Equity must be LMV x Reg. T
  $100,000 x 50% = $50,000

SMA = $5,000

After Increase	
Long Market Value	$110,000
– Debit Balance	– $50,000
Equity	$60,000

- Equity must be LMV x Reg. T
  $110,000 x 50% = $55,000
- Any equity above 50% = SMA
  $60,000 – $55,000 = $5,000
- Buying Power = $10,000 (SMA x 2)

LMV Decreases

Later, the LMV decreases by $20,000 to fall to $90,000

Later, the LMV decreased by another $30,000 to fall to $60,000

SMA = $5,000

After Decrease	
Long Market Value	$90,000
– Debit Balance	– $50,000
Equity	$40,000

- Equity should be LMV x Reg. T
  $90,000 x 50% = $45,000
- Since equity is below 50%, the account is restricted; however, it's not required to be fixed

SMA = $5,000

After Another Decrease	
Long Market Value	$60,000
– Debit Balance	– $50,000
Equity	$10,000

- Equity must be LMV x Minimum Maintenance (25%)
  $60,000 x 25% = $15,000
- Since equity is below 25% = Maintenance Call
- The $5,000 call must be fixed promptly or securities sold out

Remember, SMA is not reduced by market declines (you only lose it if you use it)

SMV Decreases

An investor executes a $100,000 short sale in a margin account → The SMV decreases by $10,000 to fall to $90,000

Initial Short Sale	
Credit Balance	$150,000
– Short Market Value	– $100,000
Equity	$50,000

- Equity must be SMV x Reg. T
  $100,000 x 50% = $50,000
- CB = Initial short sale + Reg. T deposit
  $100,000 + $50,000 = $150,000

After Decrease	SMA = $15,000
Credit Balance	$150,000
– Short Market Value	– $90,000
Equity	$60,000

- Equity should be SMV x Reg. T
  $90,000 x 50% = $45,000
- Any equity above 50% is SMA
  $60,000 – $45,000 = $15,000
- Shorting Power = $30,000 (SMA x 2)

SMV Increases

Later, the SMV increases by $20,000 to rise to $110,000 → Later, the SMV increased by another $10,000 to rise to $120,000

After Increase	SMA = $15,000
Credit Balance	$150,000
– Short Market Value	– $110,000
Equity	$40,000

- Equity should be SMV x Reg. T
  $110,000 x 50% = $55,000
- Since equity is below 50%, the account is restricted; however, it's not required to be fixed

After Another Increase	SMA = $15,000
Credit Balance	$150,000
– Short Market Value	– $120,000
Equity	$30,000

- Equity must be SMV x Minimum Maintenance (30%)
  $120,000 x 30% = $36,000
- Since equity is below 30% = Maintenance Call
- The $6,000 call must be fixed promptly by purchasing securities

Remember, SMA is not reduced by market increases (you only lose it if you use it)

Initial Margin Requirement

For Long Positions: The lesser of $2,000 or 100% of the market value	
Purchase:	**Deposit:**
Below $2,000	100% of purchase
Between $2,000 and $4,000	$2,000
Above $4,000	50% (Reg. T)

For Short Positions: $2,000	
Short Sale:	**Deposit:**
Below $4,000	$2,000
Above $4,000	50% (Reg. T)

Buy $1,500 of ABC

Buy $3,000 of ABC

Buy $5,000 of ABC

Short $1,500 of XYZ

Short $3,000 of XYZ

Short $5,000 of XYZ

Additional Margin Considerations

Portfolio Margin	Also referred to as risk-based margin ▪ Margin requirement is based on net risk in the portfolio • E.g., risk of a long stock position being offset by a put on that stock ▪ Eligibility limited to customers approved for uncovered options writing and certain firms
Leveraged ETFs	Minimum maintenance for these products equals the leverage factor times 25% (long) or 30% (short)
Pattern Day Trading	Defined as executing four or more day trades over a five-day period ▪ Minimum equity requirement of $25,000

Activity

Read each statement and fill in the blanks.

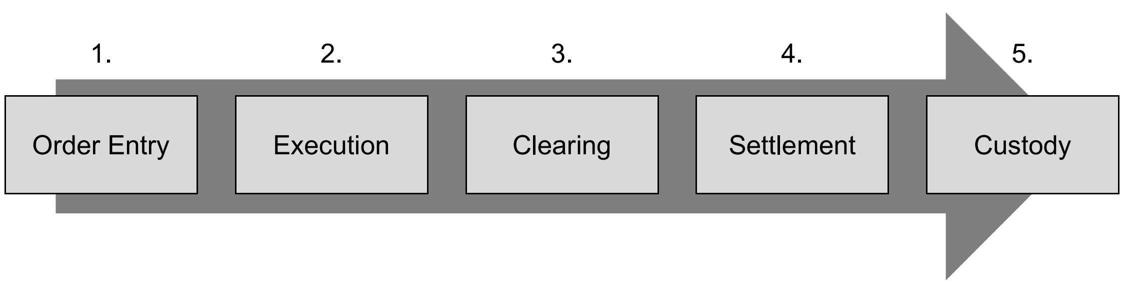
1. The document that allows a broker-dealer to lend a customer's securities to another customer, but is not mandatory when opening a margin account, is the ____.
2. The ____ determines the list of marginable securities.
3. In order to determine the equity in a long margin account, the ____________________________ is subtracted from the ______________________________________.
4. A margin account is restricted when equity is ______________________________ of the market value.
5. When equity is greater than 50% of market value, ____________________________________ is created.
6. Excess equity is created in a short margin account when the ________________________________ declines.
7. If the first transaction in an investor's margin account is a purchase of $1,800 worth of stock, the investor must deposit _________________.
8. A 3x Long ETF requires minimum maintenance of ____.

Chapter 19 – Settlement and Regulatory Reporting

Key Topics

1	2	3	4
OVERVIEW	REPORTING REQUIREMENTS	CLEARING TRADES	SETTLING TRADES
Review the components of the life cycle of a trade.	Learn about the different trade reporting systems used in the industry.	Learn about the process of agreeing to the terms of a trade.	Learn about the process of moving funds and securities and the role of the DTCC.

The Life of a Trade



1. Order entry – Order ticket details regarding how a trade is to be executed
2. Execution – Occurrence of a trade in a market center
3. Clearing – Executing firms agree to the details of a trade
4. Settlement – The process of the buyer and seller transferring money and securities
5. Custody – Safeguarding of client and firm assets

Trade Reporting Overview

The following systems are used to report trade executions:

Trade Reporting Facility (TRF)	For Nasdaq and third-market securities
OTC Reporting Facility (ORF)	For OTC equities (Pink Market)
Trade Reporting and Compliance Engine (TRACE)	Facilitates mandatory reporting for secondary market transactions in eligible fixed-income securities (not corporate money market, foreign government or municipal securities)
Real-Time Transaction Reporting System (RTRS)	For trades in municipal securities (not municipal fund securities)

Electronic Municipal Market Access System (EMMA)

EMMA is the official source for municipal securities data and documents, including:

- Documents from issuers and underwriters related to the primary market (e.g., official statements)
- Continuing disclosure information
- Daily statistics on trading activity
- Investor education materials
  - Note: EMMA is NOT a trade reporting system; it's an information portal

Clearing a Trade

Don't Know (DK) ▪ Terms of the trade don't match ▪ Wrong security? Price? Quantity? CUSIP? ▪ Contra-broker has 20 minutes to DK or Affirm
Affirmation ▪ Buyer and seller agree to the terms ▪ The trade is "locked in" and DTCC is notified ▪ The trade is now ready to *settle*

Physical or Electronic Ownership

The following are different methods that a client may hold a bond position:

Bearer	In certificate form, with no owner name noted on the physical security (interest coupons physically attached)
Registered to Principal Only	In certificate form, with name of owner evidenced (interest coupons physically attached)
Fully Registered	In certificate form, with name of owner evidenced (interest payments automatically mailed or paid electronically)
Book Entry	Position is held electronically at a depositary

Other Methods of Holding Securities

Some clients choose to hold positions away from their broker-dealers

DVP/COD/RVP

Client uses a bank to consolidate multiple brokerage accounts.

- **Delivery versus Payment (DVP) or Collect on Delivery (COD)**
  - Client is buying securities
  - Broker-dealer delivers securities to client's bank and is paid by the bank
- **Receipt versus Payment (RVP)**
  - Client is selling securities
  - Client's bank delivers securities to broker-dealer and B/D makes payment to the bank

Direct Registration System (DRS)

The Direct Registration System (DRS) enables investors to hold their assets in book entry form directly with the issuer or its transfer agent.

Depository Trust & Clearing Corporation

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

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

Transactions among members are completed through computerized bookkeeping entries

- Referred to as *book-entry settlement* with no physical delivery of securities
- Client positions are held in "street name" (in the name of their broker dealer)

Settlement Dates

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

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

Settlement versus Customer Payment

Payment date is set by the FRB under the provisions of Regulation T

- Reg. T applies to transactions involving corporate securities

Transaction	Settlement	Payment Date
Corporate securities in either a cash or margin account	One business day (T + 1)	Three business days (T + 3 or S + 2)
Municipal securities	One business day (T + 1)	Exempt from Reg. T (generally settlement)
U.S. Government securities	One business day (T + 1)	Exempt from Reg. T (generally settlement)
Option Trades	One business day (T + 1)	Three business days (T + 3)

Settlement for Equity Option Exercise

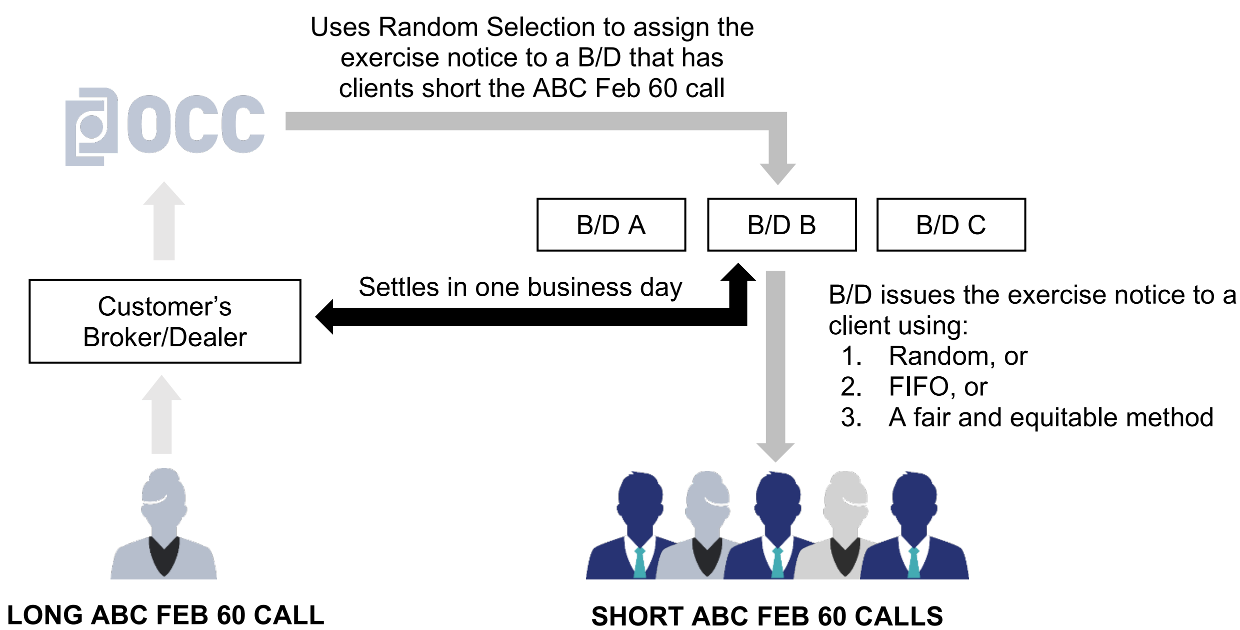
OCTOBER						
SUN	**MON**	**TUES**	**WED**	**THURS**	**FRI**	**SAT**
		1	2	3	4	
6	7	8	9		11	
13	14	15	16	17	18	19
20	21	22			25	26
27	28	29				

Trading ceases at 4:00 pm ET

Options expire at 11:59 pm ET

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

Exercising an Equity Option



Good Delivery

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

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

Delivery Issues with Physical Securities

- Stock is restricted (bears a legend)
- Security is not endorsed
- Endorsement does not match registration (if a joint account, both must sign)
- Security is mutilated/illegible
- Bond is missing coupons
- Missing documentation due to death of owner
- Stock has been reported lost, missing, or stolen

Other Settlement Concerns

The following are potential factors that could affect settlement:

Ex-Dividend	Buyers must have a settled their trades on or before record date to be entitled to a cash or stock dividend (*record and ex-date are the same day*)
Ex-Rights	Buyers must have a settled their trades on or before record date to be entitled to a participate in a rights offering
Due Bill	If a security is sold before it trades "ex-dividend" (or "ex-rights") and is delivered too late to be transferred on or before the record date, it will be accompanied by a due-bill. The due bill is evidence of a seller's obligation to deliver the dividend (or right) to the buyer.
Due Bill Check	A due bill in the form of a check payable on the date of payment of a cash dividend, interest on registered bonds, or interest on unit investment trust securities.

Activity

Read each statement and determine what it describes.

TRACKS THE LIFE OF A NASDAQ TRANSACTION FROM BEGINNING TO END	
A SOURCE FOR MUNICIPAL DISCLOSURES	
REPORT OF A TRADE THAT'S NOT AGREED UPON BY BOTH PARTIES	
ELECTRONIC OWNERSHIP OF SECURITIES AT A DEPOSITORY	
EXERCISE NOTICE FOR AN OPTION MUST BE REPORTED BY NO LATER THAN THIS TIME	
THE DATE ON WHICH A STOCK BEGINS TO TRADE WITHOUT ITS DIVIDEND	

Chapter 20 – Resolving Disputes and Suitability

Key Topics

1	2	3	4
ERRONEOUS TRADES Learn about trade errors and the process of trade corrections.	CUSTOMER COMPLAINTS Learn about the SRO requirements for handling customer complaints.	DISPUTE RESOLUTION Learn about the various procedures used to resolve complaints.	REQUIRED DISCLOSURES Learn about the various disclosures required of associated persons.

Handling Errors

Error Account	Failing to Follow Instructions	Client Errors
▪ Maintained by all B/Ds; used <u>if the firm or an RR executes a trade in error</u> (wrong security/quantity or wrong side of market) ▪ To place trades in the account, principal authorization is required ▪ If execution was for the wrong customer, the *cancel and rebill* process must go through error account	▪ Clients may refuse trades if their instructions were not followed (e.g., failing to execute at the client's limit price or better; buying more shares than ordered) • To correct the error, a principal must be consulted	▪ B/Ds are not responsible for errors that are caused by the client (e.g., client placed order for wrong stock or failed to cancel an order)

Note: If client receives an erroneous trade report, the actual price is binding.

Clearly Erroneous Trades

- Trades done at prices not related to the current market value
- Erroneous transactions due to system malfunctions
- News events, trading halts, stock splits and reorganizations are all factors in making the determination
- The process is designed to ensure fair and orderly markets
- FINRA decisions are appealable by affected parties

> Clearly Erroneous Trades may be declared null and void and cancelled by a regulator

Customer Complaint

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

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

Code of Procedure

Process used to discipline members who violate FINRA rules

Complaint Filed	Forwarded to Department of Enforcement
↓ Copy of complaint and Letter of Acceptance, Waiver, and Consent (AWC) is sent	Respondent is given opportunity to respond ▪ First: 25 days ▪ Second: 14 days • If rejected (not signed), a hearing is held
↓ Hearing Panel	Potential results: fine, suspend / revoke registration, bar from association
↓ Appeal Decision	First to National Adjudicatory Council, then to the SEC, and finally to Federal Court

Code of Arbitration

Participants	Arbitration Panel	Simplified Arbitration	Statute of Limitations
Members and/or customers, provided customer has signed pre-dispute clause of new account form	Typically three persons. If a public customer is involved, a majority of the panel must be independent (not associated with the securities industry)	For disputes not exceeding $50,000, one arbitrator, generally no hearing held, and document submission only	There is a six-year statute of limitations

Arbitration Disclosures

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

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

Mediation

Viewed as an alternative to arbitration

- Neutral facilitator assists parties with a disagreement to reach a mutually acceptable resolution
- If a dispute is eligible for arbitration, mediation may be used instead
- If mediation is not successful, the parties proceed to arbitration
- If a settlement is reached, the decision is private and confidential

> Mediation is generally a short-term, structured, task-oriented, and "hands-on" process.

Reporting Requirements

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

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

Disclosures/Updates on Forms U5 and Form U6

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

Reporting on BrokerCheck

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

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

Activity

Read each statement and fill in the blanks.

1. ________________________________ is used if an execution was for the incorrect customer.
2. In order for a trade to be placed in an error account, ____________________________________ is required.
3. A trade resulting from a system malfunction that can be voided by a regulator is referred to as a ____.
4. FINRA receives ______________________ complaint reports from broker-dealers and the broker-dealers must maintain records of complaints for ________________________.
5. The ______________________________ is the first to review and determine what if any action will be taken regarding a violation of industry rules.
6. Monetary disputes between member firms and customers are settled through the ________________________.
7. A fine in excess of $2,500 that's assessed to an RR must be reported within ____________________________.

Suitability Review

The Basics of Suitability

Suitability is based on a client's profile at the time that a transaction or investment strategy is recommended

- Suitability is not determined by gains and losses
- A client's profile will change due to various life events
(e.g., marriage, children, job changes, college, retirement, etc.)
- Know your customer
    - Objectives and goals
    - Time horizon/age
    - Risk tolerance
    - Tax bracket
- Know your products

Steps to Determine Suitable Investments

There are basic factors to consider when evaluating a customer's portfolio

Investment Objective	▪ What does the customer want to accomplish with the investments?
Time Frame	▪ Is the customer seeking a short-term, intermediate-term, or long-term investment goal?
Risk Tolerance	▪ How much risk is the customer willing to assume? ▪ Risk is influenced by time frame: • Investors with long-term goals can typically assume more risk • Investors with short-term goals will typically assume less risk
Age (Impacted by time frame and risk tolerance)	▪ Younger investors typically take long-term approaches ▪ Older investors generally have shorter time horizons and seek more stable investments • 100% - Age = % of equity often used for asset allocation questions • Tax implications for retirement plan distributions

Suitability Question 1

A customer is in his late 20s, has an above-average income, has his own home and other valuable assets, and has little debt other than his mortgage. He tells his RR that his goal is to retire before age 55. He indicates that the stock market makes him nervous and he's never been comfortable putting his money in anything but money-market funds. Which of the following is TRUE regarding this situation?

I. The investor's low risk tolerance is unsuitable for a person in his situation and the RR should ignore it.
II. Since the investor is capable of assuming risk, the RR cannot recommend conservative strategies.
III. Regardless of whether the investor can assume some risk, the RR must take his low risk tolerance into account when making recommendations.
IV. Once the investor reveals his low risk tolerance, the RR cannot attempt to convince him that assuming a moderate level of risk may be suitable.

Clients' Financial Objectives

	OBJECTIVES					
	Preservation of Capital/Income	**Current Income**	**Growth/Capital Appreciation**	**Speculation**	**Speculation**	**Tax Relief**
Time Horizon	Short to Medium	Medium	Long	Long	Short	Varies
Securities	▪ Money Market Funds ▪ T-Bills ▪ CDs	▪ Bonds ▪ Bond Funds ▪ Income Funds ▪ Preferred Stock ▪ Utility Stock ▪ Investment Grade Bonds ▪ T-Bonds and Notes ▪ U.S. Agency Debt	▪ Common Stock ▪ Growth Stock ▪ ADRs ▪ Stock Funds ▪ Index Funds ▪ Stock ETFs	▪ Micro-Cap Stocks ▪ Sector Funds ▪ Aggressive Growth Funds ▪ High-Yield Bonds ▪ BDCs ▪ Hedge Funds ▪ Drilling and Raw Land Partnerships	▪ Option Strategies ▪ Leveraged ETFs ▪ Short Positions ▪ Margin Trading ▪ Day Trading	▪ Tax-Exempt Muni Bonds and Funds ▪ Annuities, IRA and Retirement Plans ▪ DPPs ▪ CESA and 529 Plans
Risk	Low	Medium	High	Higher	Highest	Varies
Phrases associated with the objective	Parking funds, safety, liquidity, and income	Steady, reliable stream of income, in retirement and in need of fixed income	Capital appreciation	Speculation, able to withstand potential losses	Aggressive, short-term speculation	High tax bracket, professional role

Suitability/Risk Spectrum

Conservative	Moderately Conservative	Moderate	Moderately Aggressive	Aggressive/ Speculation
Little Risk / Capital Preservation ▪ Cash ▪ Money Market Instruments ▪ Money Market Mutual Funds	**Low Risk / Low Return** ▪ Investment-Grade Corporate Bonds ▪ Income Mutual Funds ▪ Preferred Stocks ▪ Fixed Annuities ▪ U.S. Government and Municipal Bonds	**Some Risk / Higher Return** ▪ Blue Chips and Utility Stocks ▪ Growth and Income (Balanced) Mutual Funds ▪ Index Mutual Funds ▪ ETFs ▪ Variable Annuities ▪ Convertible Bonds ▪ REITs	**High Risk / Even Higher Return** ▪ Growth Stocks ▪ Growth Mutual Funds ▪ Sector Funds ▪ Small/Micro-Cap Stocks	**Extremely Risky / Highest Return** ▪ High-Yield Bonds ▪ Precious Metals ▪ Hedge Funds ▪ Oil and Gas Limited Partnerships ▪ Certain Option Positions ▪ Leveraged ETFs ▪ Short Stock Positions

Suitability Question 2

A 32-year-old customer wants capital appreciation and is willing to accept a moderate level of risk. The customer is concerned about the impact of inflationary risk on his portfolio. Which of the following investments is the MOST suitable?

I. Equities
II. Treasury bond
III. High-yield corporate bond
IV. Variable annuity

Suitability Question 3

An investor who just turned 35-years-old wants capital appreciation and tax-deferred growth. She's willing to accept a moderate level of risk in her initial investment; however, she's concerned about the impact of inflationary risk on her portfolio. Which of the following investments is the MOST appropriate?

I. Equities
II. Treasury bond
III. High-yield corporate bond
IV. Variable annuity

Suitability Question 4

An investor has been heavily invested in gold. Now that he's retired, he wants to diversify and move some of his investments into assets that will help to pay his expenses. Which of the following investments/strategies should an RR recommend to the investor?

I. Buy a CMO Z-tranche
II. Sell equity options
III. Buy preferred stock
IV. Buy common stock

Age Considerations

- Younger individuals generally can accept more risk since they have longer to earn and build capital
- Individuals nearing retirement typically need to be more conservative with their investments

Time Horizon
- 100 – Age = Equity
  - A formula often used to determine the percentage of the portfolio that should be devoted to equities
    - The younger the investor, the greater the percentage in growth investments (e.g., equity)
    - The older the investor, the greater the percentage in more conservative investments (e.g., debt)

Asset Allocation

Asset allocation focuses on a portfolio constructed of various asset classes

An optimal portfolio (one producing the greatest return for a given amount of risk) is based on a client's goals, expected return, and risk tolerance

Suitability Question 5

A couple are both in their late 40s and are seeking to grow their investment portfolio. Which of the following portfolio recommendations would be the LEAST suitable?

I. 10% Money Market, 70% Municipal Bond Fund, 20% Convertible Bond
II. 5% Cash, 40% S&P Index ETF, 10% Foreign Stock Mutual Fund, 45% Corporate Bond Fund
III. 20% Money Market Mutual Fund, 20% Growth Fund, 20% High Yield Bond, 40% in a Balanced Fund
IV. 10% Cash, 30% GNMAs, 20% Foreign Bond Fund, 10% in each of four different Blue Chip stocks

Suitability Question 6

A 42-year-old New Jersey resident recently inherited $750,000. She's married, has two children (ages 15 and 11), and is a partner in a dental practice. She earns $325,000 with benefits, while her husband is a radiologist and earns $175,000. They can comfortably handle their mortgage, car payments, two annual vacations, and life insurance premiums. When re-assessing their portfolio, given their windfall, what should an RR recommend?

I. 45% Money-Market Funds, 35% State of New Jersey Bond Fund, 20% Index Fund
II. 65% Options, 20% REITs, 15% CMO tranche
III. 40% AA-Rated Corporate Bonds, 40% New Jersey Turnpike Bonds, 20% Sector Fund
IV. 40% Zero-Coupon Bonds, 55% Large-Cap Equity Fund, 5% Options

Suitability Question 7

A 56-year-old single mother has one child who started college two years ago. After receiving several unusually large bonuses, she's interested in finding the best investment strategy for maximizing tax-free income. Which of the following represents the BEST allocation for the funds?

I. Contribute the maximum annual amount to a 529 plan
II. 50% ETF, 20% Treasury Inflation-Protected Securities (TIPS), 15% Dormitory Bonds, and 15% GO Bonds
III. 20% High-Yield Corporate Bonds, 20% Utility Revenue Bonds, 20% General Obligation Bonds, 20% Treasury Bonds, and 20% Grant Anticipation Notes
IV. 40% General Obligation Bonds, 20% High-Yield Municipal Bonds, 20% Airport Revenue Bonds, 10% Special Tax Bonds, and 10% Housing Revenue Bonds

Suitability Question 8

An individual is a fairly aggressive investor and is willing to take significant risk in his portfolio. He has made an investment in a very volatile stock and is seeking a recommendation of how to best protect that position. Which of the following recommendations is the MOST suitable?

I. Sell call options against the stock
II. Enter a sell stop order on the stock
III. Buy puts on the stock
IV. Sell put options against the stock position

Suitability Question 9

A customer is in her late 40s and is currently in the 15% tax bracket. She recently inherited $6,000,000 and informs you that she considers herself a somewhat conservative investor and wants your advice concerning investing the inheritance. Which of the following choices is the BEST method of investing the funds?

I. 20% in equities, 30% in Treasury bonds, and 50% in tax anticipation notes
II. 40% in equities, a 30% mixture of in-state and out-of-state municipal bonds, 15% in Treasury bonds, 15% in revenue anticipation notes
III. 30% in-state municipal bonds, 30% in out-of-state municipal bonds, 30% in Treasury bonds, 10% in revenue anticipation notes
IV. 25% in-state municipal bonds, 25% in out-of-state municipal bonds, 25% in corporate bonds, and 25% in Treasury bonds

Suitability Question 10

A couple, both in their late 50s, have a portfolio that's structured to offset inflation and build value to prepare for retirement. The portfolio consists of 60% growth fund, 10% international stock fund, 10% money market fund, and 20% investment grade bond fund. The husband has lost his job and wants to adjust their portfolio. What's the best recommendation?

I. Sell the growth and international stock funds, invest some in an index fund, increase the investment in both the money market fund and the investment grade bond fund.
II. Sell the investment grade bond fund and increase the investment in the growth fund.
III. Sell the international stock fund and invest the money in a high-yield bond fund.
IV. Sell the growth and international stock funds, invest the proceeds in a high-yield bond fund and retain the amount in the money market and investment grade bond fund.