Securities Training Corporation

# Series 6

*Investment Company and Variable Contracts Products Representative*

## Learning Guide / Workbook

v17

# 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 6

| 1 | 2 | 3 | 4 |
|---|---|---|---|
| 50 Multiple-Choice Questions | 50 Plus 5 Experimental Questions | One and a Half Hours (90 Minutes) Allotted | Passing Score is 70% of 50 Questions (35 correct) |

| Function | STC Chapter | # of Questions |
|---|---|---|
| 1. Seeks Business for the Broker-Dealer from Customers and Potential Customers | 1, 2, and 3 | 12 |
| 2. Opens Accounts After Obtaining and Evaluating Customers' Financial Profile and Investment Objectives | 1, 2, 5, and 9 | 8 |
| 3. Provides Customers with Information About Investments, Makes Suitable Recommendations, Transfers Assets and Maintains Appropriate Records | 4, 5, 6, 7, 8, 9, 10, and 11 | 25 |
| 4. Obtains and Verifies Customers' Purchases and Sales Instructions; Processes, Completes and Confirms Transactions | 3, 11, and 12 | 5 |
| **Total** | | **50** |

# Chapter 1 – Building an Investor Profile

## Key Topics

| 1 | 2 | 3 | 4 |
|---|---|---|---|
| **Financial Factors** | **Personal Characteristics** | **Financial Objectives and Goals** | **Know Your Customer** |
| Learn about the financial concerns when developing a client's investment profile. | Learn about how an investor's age, risk tolerance, and experience are used to develop the investment profile. | Learn about what types of investments may be used to achieve various investment goals. | Learn about the importance of suitability and FINRA's rules for an RR's obligations. |

## 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**

**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

**Personal Characteristics**
- Age
- Time horizon
- Investment experience
- Risk tolerance
- Social Values

**Fin. Objectives/ Inv. Goals**
- 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 determining how to address objectives

| | |
|---|---|
| Marginal Tax Bracket | ▪ At what rate will the individual be taxed? Will the alternative minimum tax (AMT) apply? |
| Investment Income | ▪ Is the individual receiving dividends and interest from existing investments? Are they qualifying dividends and is the interest from bonds taxable? |
| Estate and Gift Taxes | ▪ Gifts up to $19,000 can be transferred to any number of individuals without tax implication to the donor. Married couples could combine for a total of $38,000. |
| Capital Gains and 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 and then a maximum of $3,000 against ordinary income. |

# Non-Financial Concerns

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

- Age
  - Younger individuals generally can accept more risk since they have longer to earn and build capital
  - Individuals 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 percentage in equity.
      - 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 investors is not based solely on their financial situation; it's also based on their values and attitudes on investing. An RR needs to carefully develop a complete profile. Below are a few examples:

| YOUNG SINGLE PROFESSIONAL LIKES SPECULATION | YOUNG MARRIED COUPLE PLANNING FOR CHILD'S COLLEGE | 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 with 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:

| Objective | Goal |
|---|---|
| **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?

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 are 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:

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

# 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:<br>• Describe the criteria, methodology, and the tool's limitations<br>• Explain that results may vary over time and from use to use<br>• Describe the universe of investments the tool considers and:<br>– How investments are selected<br>– Whether certain investments are favored over others<br>– That other investments may provide similar or superior results<br>• Display a disclosure that the projections are provided by the firm's investment analysis tool<br>• Provide FINRA with access to the tool unless its solely used by institutional investors |

# Activity

Read each statement and determine whether it is TRUE/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 |
|---|---|---|---|
| **Customer Account Registrations** | **Account Types and Characteristics** | **Account Changes and Required Documents** | **Account Approval and Restrictions** |
| Learn about required information and different types of account registrations. | Learn about trust, prime brokerage, and fee-based accounts. | Learn about how to make changes to an account and some of the required documentation. | 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

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

Customers are NOT required to sign their new account forms

# Additional Information

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

| | | |
|---|---|---|
| Tax I.D./<br>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** | **Unincorporated 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 couple
- 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**
- 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<br>▪ All investments in the account are titled in the owner's name even if the business is not in the business owner's name<br>▪ The account is vulnerable to the owner's personal creditors |
| **Unincorporated Associations** | ▪ Similar to sole proprietorships and partnerships<br>▪ Account is opened in the name of the owner(s)<br>▪ The individual's ownership in the account are subject to a creditor's claims |
| **Partnerships** | ▪ Partnership agreement specifies persons authorized to execute trades<br>▪ 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)

**Limited Trading Authorization**

- Allows for execution of trades

**Full Trading Authorization**

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

**Power of Attorney**

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

# 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**

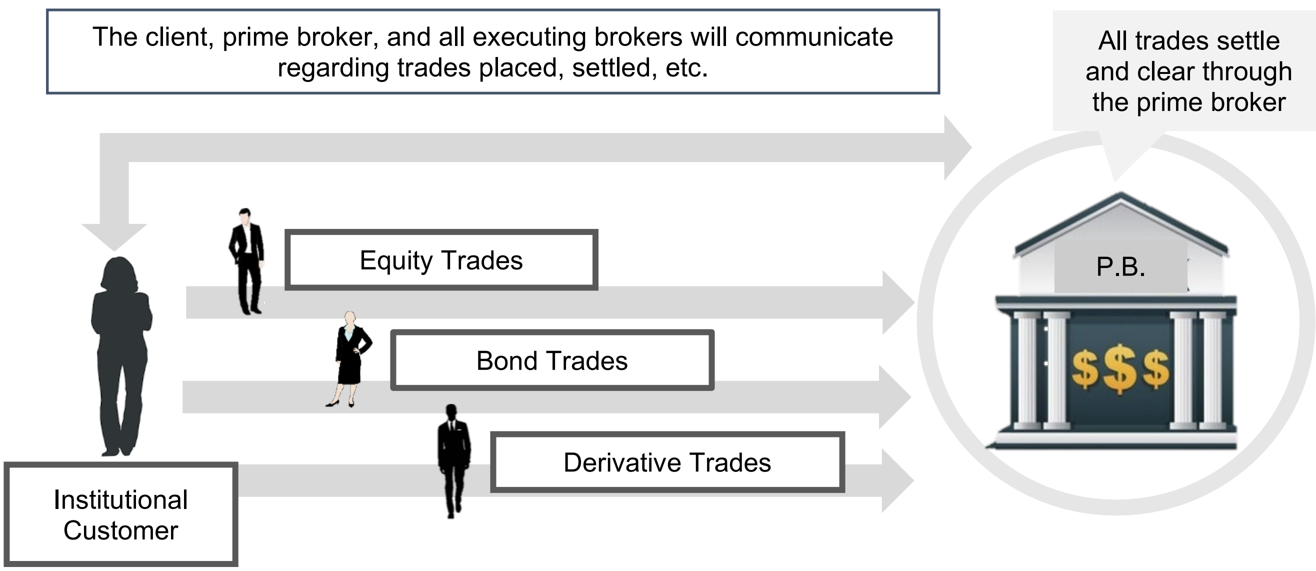
- Cannot be changed after being signed
- Will reduce estate taxes and avoid probate

# 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




# Fee-Based Accounts

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

- Traditional accounts charge on a per transaction basis assessing a commission on each trade
- Fee-based accounts roll all of the costs for services into one fee
  - Wrap accounts are a type of fee-based account

Suitability considerations:

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

# Activity

Match each description to the appropriate term.

| | |
|---|---|
| COMMUNITY PROPERTY ACCOUNT | Delivers consolidated confirmation of trades through various broker-dealers |
| FULL TRADING AUTHORIZATION | Generally not suitable for buy and hold customers |
| REVOCABLE | A person can make changes to the trust at any time |
| FEE-BASED ACCOUNT | A joint account between a married couple |
| PRIME BROKER | Allows another person to execute trades and withdraw cash and securities from an account |

# Registration Changes and Internal Transfers

**Account Registration Changes:**

- For persons who get 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<br>▪ Legal address (residence or business)<br>▪ Date of birth<br>▪ 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<br>▪ Social Security number |
| Identification Number for Non-U.S. Persons | ▪ One or more of the following:<br>– Taxpayer ID<br>– Passport number<br>– Alien ID Card number<br>– 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<br>▪ 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 doesn't 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<br>▪ File **Form 4** to report purchases and sales within two business days; however, there's no required filing for certain transactions within a 401(k) plan |
| INSIDERS ARE PROHIBITED FROM: | ▪ Engaging in short sales of their company's shares<br>▪ 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:<br>▪ Obtain employer's prior written consent<br>▪ Provide written notification of his association to the executing firm<br>▪ 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.<br>▪ 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. A privacy notice must be provided to client when __________________________ and ________________________.
2. In order to change an account registration after marriage or divorce requires a ________________________ or a _____________________.
3. An individual holding more than a 10% voting interest in a corporate is defined as an ____________.
4. The _______________ is maintained to identify the names of terrorists and/or criminals.
5. 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 |
|---|---|---|
| **Communication Standards** | **Types of Communications** | **Product Specific Advertisements** |
| Learn about the general standards that apply to customer communications. | Learn about the different types of communications, approvals, and filing requirements. | Learn about the disclosures required on mutual fund and variable products. |

## 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

# Definition of Communications

| Correspondence | Retail Communication | Institutional Communication |
| --- | --- | --- |
| ▪ Written or electronic communication that a member firm distributes or makes available to 25 or fewer *retail investors* (prospective or existing) within any 30-calendar-day period<br>• Subject to review and supervision | ▪ Written or electronic communication that a member firm distributes or makes available to more than 25 *retail investors* within any 30-calendar-day period<br>• 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)<br>• 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 |
| --- |
| Communications regarding:<br>• Investment companies that contain self-created rankings<br>• Security futures |

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

# Additional Communication Information

| For the following communications, NO principal approval is required |
|---|
| 1. Retail communications<br>– Material that makes NO financial or investment recommendation and does NOT promote a product or service of the member firm<br>– Market letters that make NO financial or investment recommendation<br>2. Correspondence<br>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)<br>– 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)<br>– 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)<br>▪ Social media cannot be used if it automatically deletes and erases content<br>▪ Records must be maintained for any business communication, including those made through personal devices<br>▪ 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?

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

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

- That the data being quoted represents past performance and that past performance doesn't 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 doesn't reflect the deduction of the sales load or fee, but does reflect ongoing fees (expense ratio)

***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

# 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's been hired to provide a ranking symbol to the fund<br>▪ Nationally recognized ranking entities include Morningstar and Lipper |
| SEC Required Standardized Yields | ▪ For money-market funds: 7-day yield<br>▪ For other funds: 30-day yield |
| Disclosures | ▪ The objective of the fund<br>▪ Name of the ranking entity<br>▪ Criteria used for ranking<br>▪ That past performance is not a guarantee of future results<br>▪ 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 exist that relate to sales 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<br>▪ Must disclose all charges and expenses associated with variable annuities<br>▪ 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<br>▪ Rates must be consistent with current market conditions<br>▪ Must reflect the maximum expenses and sales charges<br>▪ Statement must be made that the rate is hypothetical and not a prediction of return |

# Activity

Match the communication with its correct description.

| | |
|---|---|
| Omitting Prospectus | Fund advertising that can be used at any time |
| 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 |
| Generic Advertising | Provides guarantees in a variable product |
| Insurance Company | An organization hired to compare different mutual funds |

# Chapter 4 – Offerings

## Key Topics

| 1 | 2 | 3 | 4 |
|---|---|---|---|
| **Primary Market and Underwriting Commitments** | **The Securities Act of 1933** | **Exempt Transactions** | **Municipal Offerings** |
| Learn about the primary market and issues regarding underwritings. | Learn about the process of registration and various disclosure documents. | Learn about private placements and intrastate offerings. | Learn about the available information sources for municipal offerings. |

## 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; share liability
- 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 not bought through a rights offering | | |

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

# 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 member of the underwriting distribution group that only assists in sales with no liability | |
| The regulation that requires a prospectus to be provided with the solicitation of a new issue | |
| Securities that are not subject to the registration requirements of the SEC | |
| Registration with individual states | |
| The day on which new issues are permitted to be sold to the public | |

# Accredited Investors and QIBs

**Accredited Investors**

There are other terms used for certain investors, but they are based on regulatory definitions

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

**QIBs**

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

# Exempt Transactions

**Regulation D – Private Placements**

- 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 **35** 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 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

# 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:<br>▪ Issuer's legal, valid, and enforceable obligation<br>▪ Tax exempt status of the issue |
| New Issue Confirmations | Provided to purchasers, along with a copy of the official statement, by no later than settlement date |
| Committee on Uniform Securities Identification Procedures | Underwriters are expected to apply for CUSIP numbers that are used to identify unique securities (e.g., by maturity) |

# Electronic Municipal Market Access (EMMA)

MSRB website used by issuers and underwriters to submit documents

- Provides electronic public access to information about the municipal market
  - Trade activity
  - Market statistics
- Various documents:
  - Pre-sale documents
  - Official statements
  - Continuing disclosures
- 529 plan information

EMMA®
Electronic Municipal Market Access
A service of the MSRB

# Activity

Read each statement and fill in the blanks.

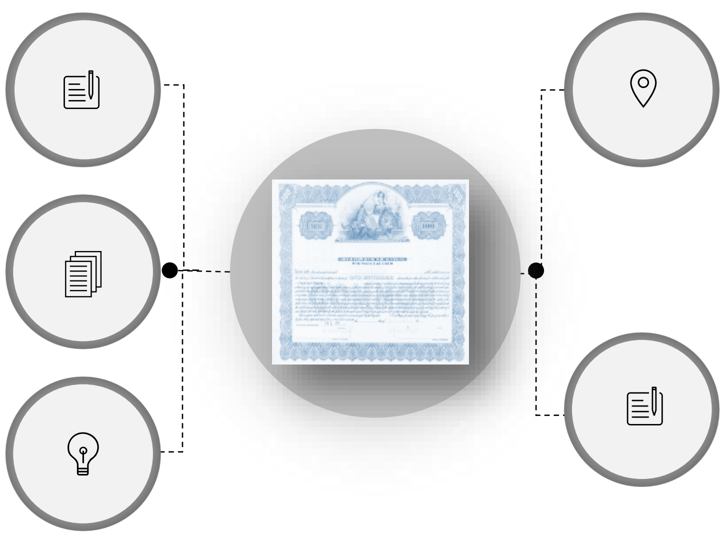
1. A ________________________ invests a minimum of ___________ in securities.
2. The disclosure document used for a private placement is referred to as an ___________________.
3. Intrastate public offerings of securities are exempted under _______________.
4. No less than _______ of the assets, revenues or proceeds from an intrastate offering must come from the state where the offering is to take place.
5. ______________ are used to identify unique securities.
6. The MSRB website used by issuers and underwriters to submit documents is known as _______.
7. A municipal bonds tax-exempt status is evidenced through the ____________.

# Chapter 5 – Overview of Securities and Tax Considerations

## Key Topics

| 1 | 2 |
|---|---|
| **Types of Securities**<br>Learn about the basic characteristics of common stock, preferred stock, corporate bonds, etc. | **Tax Considerations**<br>Learn about the tax considerations when investing in stocks and bonds. |

## Common Stock Ownership Rights



Inspection of Books

Evidence of Ownership

Transfer of Ownership

Participation in Corporate Earnings
- Entitled to dividends if declared (not guaranteed)

Voting power, including:
- Election of board members
- Authorization of additional shares and stock splits (but NOT dividends)

# 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

# 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 doesn't 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 are referred to as **debentures**. If the issuer defaults, the owners of these bonds have the same claim on the company's assets as any other general creditor.

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

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

# Liquidation Proceedings

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

# Money Market Instruments

Characteristics

- Short-term debt instruments (one year or less to maturity)
- Provide safety of principal and liquidity
- Suitable for investors who seek safety when intending to make a purchase in the near future or while evaluating different investment options

Principal Types

- T-Bills – short-term Treasury debt
- Banker's Acceptances (BAs) – facilitate foreign trade (import/ export)
- Commercial Paper – unsecured corporate debt
- Negotiable Certificates of Deposit (CDs) – unsecured bank debt ($100,000 minimum)
  - Federal Deposit Insurance Corporation (FDIC) insures up to $250,000
- Repurchase Agreements (Repos) – a dealer selling securities to another dealer with the agreement to repurchase

# U.S. Treasury Debt

| Characteristics |
| --- |
| ▪ Issued directly by the U.S. Government<br>▪ Highly liquid; no credit risk |

| Taxation of Interest |
| --- |
| ▪ Interest taxable at federal level<br>▪ 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<br>▪ Accrued interest: Actual/365 | |
| **How They're Initially Sold** | Weekly auction | Periodic auction | |

# 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 are often used to supplement retirement income.

# Options Overview

An option is a contract between two parties

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

SELLER
- Short the option
- Receives the premium
- Assumes an obligation

# Types of Contracts

If an option is exercised…

| | BUYER'S RIGHT | SELLER'S OBLIGATION |
|---|---|---|
| **CALL** | To Buy Stock | To Sell Stock |
| **PUT** | To Sell Stock | To Buy Stock |

# Speculation Versus Hedging

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

# Activity

Read each statement and fill in the blanks.

1. Common stockholders are entitled to receive cash dividends if _________ by the board of directors.
2. ________________ pays its dividend as a percentage of par value which is typically $100.
3. Corporate bonds that are backed by specific assets of the business are referred to as ________.
4. Unsecured corporate bonds are also referred to as ____________.
5. Money market instruments are debt that matures in _______________.
6. Interest on Treasury notes and bonds is __________ federal tax and _____________ state and local tax.
7. Calls are options to ______ and puts are options to _____.

# 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 *more than 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 don't benefit from the corporate dividend exclusion.

# Taxation of Interest on Bonds

Interest is considered income, but whether it's federally taxable, state/locally taxable, or both is determined by the issuer of the bond. The table below identifies by whom the interest is taxable:

| Security | Federally Taxable | State/Local Taxable |
|---|---|---|
| **Corporate Bonds** | Yes | Yes |
| **U.S. Government Treasuries** | Yes | No |
| **Municipal Bonds** | No | Varies* |
| **Territory/Possession Bonds** | No | No |

* In most states, taxpayers don't pay state and local taxes on bonds that are issued by municipalities that are located in their state of residency.

# 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**<br>**Carried forward** | | |

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

# 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

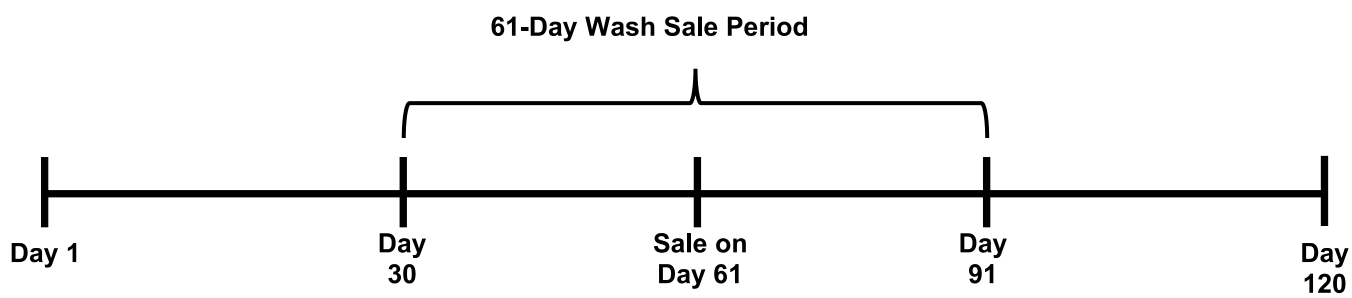
- Must be identified at time of transaction
- If not identified, IRS assumes FIFO (first in-first out)

# 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




# 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/FALSE.

| | |
|---|---|
| A CORPORATION CAN DEDUCT UP TO 65% OF THE DIVIDENDS IT RECEIVES FROM STOCK WHEN OWNING MORE THAN 20% OF THE ISSUER FINRA | |
| AN UNLIMITED AMOUNT OF ORDINARY INCOME CAN BE OFFSET WITH CAPITAL LOSSES | |
| UNLESS IDENTIFIED, THE IRS WILL USE A FIRST IN-FIRST OUT METHOD TO DETERMINE GAINS AND LOSSES | |
| A REPURCHASE OF STOCK WITHIN 30 DAYS OF A SALE FOR A LOSS WOULD DISALLOW THE LOSS | |

# Chapter 6 – Investment Companies

## Key Topics

1

**Types of Investment Companies**

Learn about the different types of investment companies, with focus on mutual funds.

2

**The Organization of a Mutual Fund**

Learn about the responsibilities of the different service organizations connected to mutual funds.

3

**Categories of Mutual Funds**

Learn about the different types of funds and the contents of their portfolios.

4

**Buying and Selling Mutual Fund Shares**

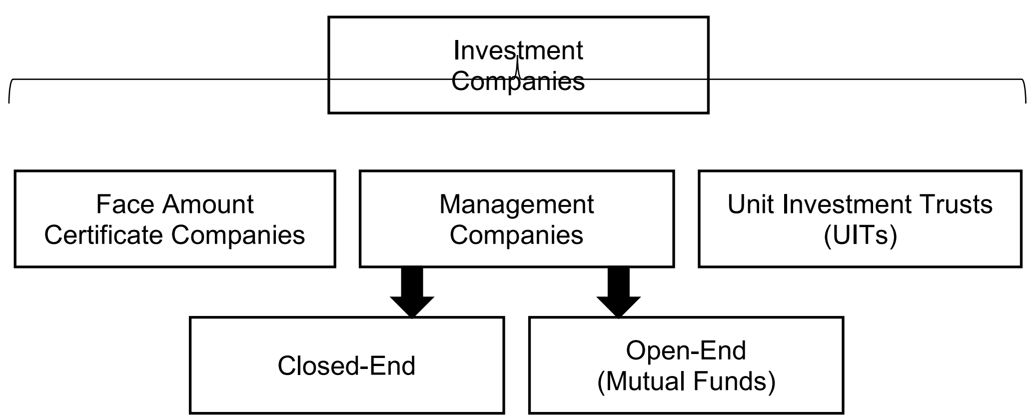
Learn about the costs associated with purchases and sales of mutual fund shares.

5

**Other Types of Investment Companies**

Learn about unit investment trusts, Exchange Traded Funds, and closed-end funds.

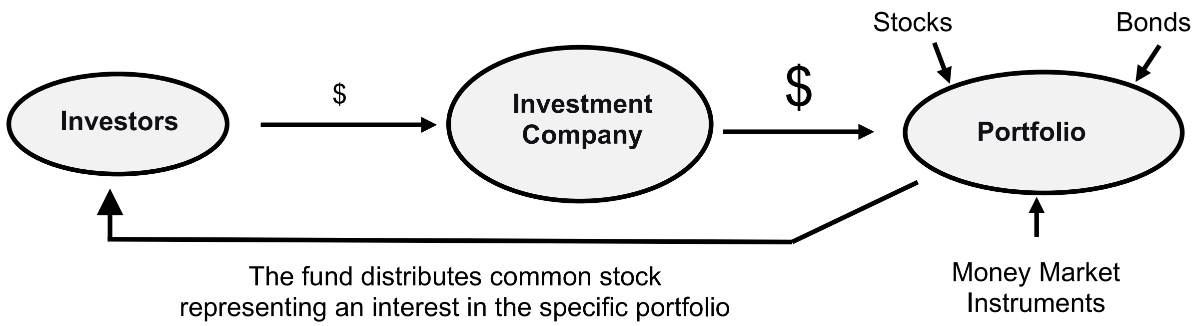
## Types of Investment Companies



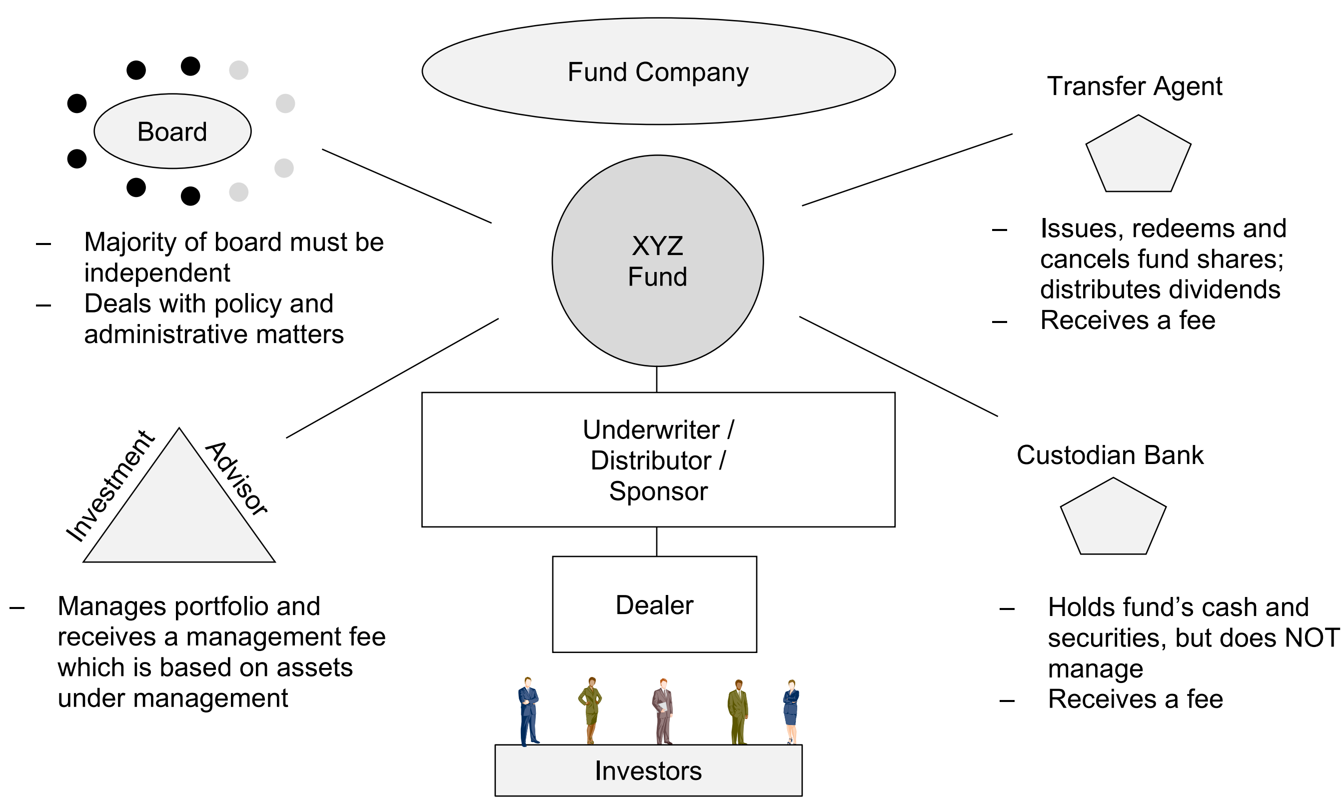
# Investment Companies

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

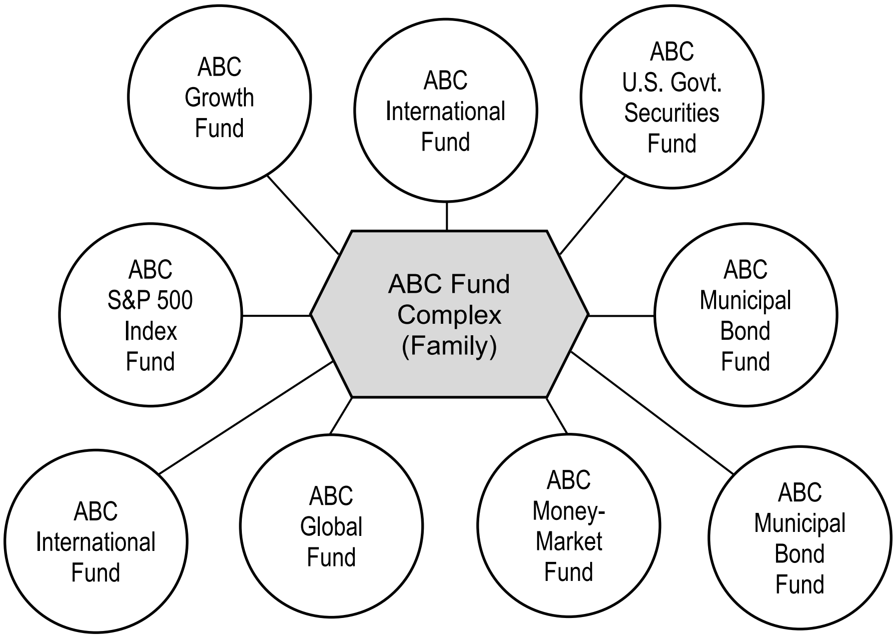
- Allows investors to acquire an interest in a large number of securities
- Mutual fund benefits include:
  - Professional management
  - Diversification
  - Liquidity
  - Convenience and cost
  - Exchanges at net asset value (NAV)




# 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

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 | $\frac{\mathbf{69.80}}{\mathbf{(100 - 5\%)}}$ | $\frac{\mathbf{69.80}}{\mathbf{95\%}}$ | **$73.47** |
| 8.5% | $45.95 | $\frac{\mathbf{45.95}}{\mathbf{(100 - 8.5\%)}}$ | $\frac{\mathbf{45.95}}{\mathbf{91.5\%}}$ | **$50.22** |

# 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 **8.5%** of the POP

**Front-End Loads**

- 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

**Back-End Loads**

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

| Holding Period | CDSC |
|---|---|
| 1 year | 5% |
| 2 years | 4% |
| 3 years | 3% |
| 4 years | 2% |
| 5 years | 1% |
| 6 years + | 0% |

**12b-1 Fees**

- 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

# No-Load Funds

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

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

A no-load fund may have a redemption fee (since 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 $21.32. The fund charges a 1% redemption fee. Using the previous breakpoint schedule, how many shares is the investor able to purchase?

| Sales Charge | NAV | $\dfrac{\text{NAV}}{(100 - \text{Sales Charge \%})}$ | 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

- **13**-month time period
- May be back dated **90** 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

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

# Activity

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 THE POP | |
| AMOUNT THAT DECREASES THE LONGER THE 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 shares' 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's returned to the fund's portfolio

# Withdrawal Plans

Allows investors to receive regular, periodic payments from their accounts

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

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

Payments are not guaranteed for the life of the investor

# 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

**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 gains

Both distributions are taxed in the year they're 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 **<u>Regulated Investment Company</u>**, a fund must distribute at least **90**% of net investment income to its investors

| | | |
|---|---|---|
| **Net Investment Income** | = | (Dividends + Interest) – (Expenses and Mgmt. Fees) |
| | | **(Capital gains are NOT included)** |

- 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: | June 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:

<u>- Basis:</u>

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, <u>not managed</u> (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<br>• Could issue preferred stock or bonds | Continually issue new shares<br>• Common shares<br>• 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 doesn't 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; can 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 | Don't allow leverage |

# Inverse and Leveraged ETFs

**Inverse ETFs**

- Designed to perform in a manner that is 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 ETFs**

- 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 to early may be subject to a ___________________.
2. A _________________________ is the result of selling mutual funds 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 7 – Variable Products and Municipal Fund Securities

## Key Topics

1

**Insurance versus Annuities**

Learn about the differences between pure insurance products and annuities and the role of the separate account.

2

**Variable Annuities**

Learn about what happens during the accumulation phase and the annuity phase.

3

**Suitability**

Learn how to identify individuals who may benefit from variable products.

4

**Variable Life Insurance**

Learn about the basic characteristics of variable life insurance policies.

5

**Municipal Fund Securities**

Learn about the local government investments pools, prepaid tuition plans and 529 plans.

## Traditional Versus Variable Products

Insurance companies offer products with varying levels of risk and potential reward

| | Traditional Products | Variable Products |
|---|---|---|
| Investment risk: | **Insurance Company** | **Contract Owner** |
| Is it a security? | **No** | **Yes** |
| Investment Account: | **General** | **Separate** |
| Portfolio: | **Safe, secure, and predictable with guarantees** | **Subaccounts that meet investor objectives** |
| Inflation hedge: | **Poor** | **Superior** |

# 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 periodic 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 won't 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 life of the contract with no tax implications

# 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's 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 Benefit (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 the beneficiary

# The Annuity Phase – Phase 2

**Also referred to as the Pay-out 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
- Payments are broken down proportionately:
  - Percentage is a return of capital (tax-free)
  - Percentage is a receipt of investment income (taxable)

# Payout Options

| | |
|---|---|
| **Straight Life Annuity** | Annuitant receives payments for life<br>▪ 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<br>▪ The longer the period certain, the higher the cost |
| **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<br>▪ At death, any remaining amount is paid to a beneficiary |

# Assumed Interest Rate (AIR)

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 | **Increase** |
| Lower than AIR | **Decrease** |
| Equal to AIR | **Stay the same** |

# Annuity Suitability Issues

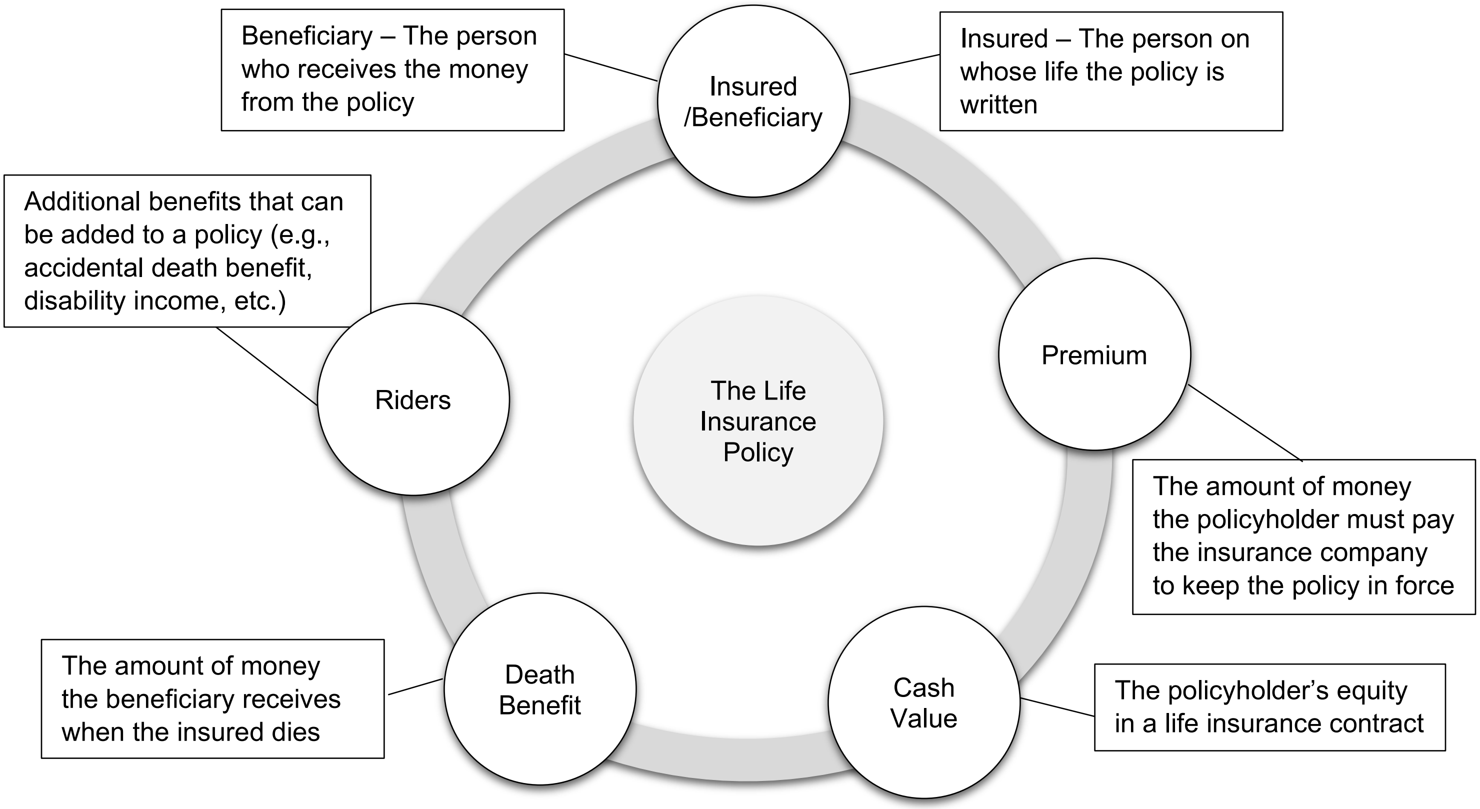
| | |
|---|---|
| Unsuitable for: | • Senior citizens or persons who are seeking immediate tax benefits<br>• Investors with short investment time horizons |
| Target Audience: | • Generally for investors within the age range of 30 to 55<br>• Persons seeking tax-deferred growth or to offset inflation<br>• Persons who have maximized qualified plan contributions |
| Concerns with 1035 Exchanges: | • Customer must benefit from the new annuity<br>• Any benefits potentially lost in the exchange<br>• Whether the RR recommending the exchange has signed off and the application was approved by a 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 |
| SUB-ACCOUNT 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 (usually about 75%) |
| **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 |

# Municipal Fund Securities

**Local Government Investment Pools (LGIPs)**

- 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

**Prepaid Tuition Plans**

- 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

**529 Plans**

- 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, and up to $10,000 (lifetime limit) to repay a qualified student loan or expenses related to certain apprenticeship programs

# 529 Plans and 529 ABLE Plans

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

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

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

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

# 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 LIFE POLICY MAY EXCEED ITS STATED AMOUNT | |
| CASH VALUES ARE GUARANTEED IN VARIABLE LIFE POLICIES | |
| LOCAL GOVERNMENT INVESTMENT POOLS ARE NOT AVAILABLE TO THE PUBLIC | |
| 529 PLANS ALLOW TAX-FREE WITHDRAWALS FOR UP TO $10,000 TO PAY FOR QUALIFIED K-12 EXPENSES | |

# Chapter 8 – Retirement Plans

## Key Topics

| 1 | 2 |
|---|---|
| **ERISA**<br>Learn about ERISA rules, vesting and eligibility requirements. | **Taxation and Types of Retirement Plans**<br>Learn about how contributions and distributions are taxed and the different types of plans. |

## ERISA

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

- Rules apply to private sector defined benefit and defined contribution plans
- Determines qualified status
  - Employer and employee contributions are tax-deductible
  - Earnings are typically tax-deferred
- Plans cannot be discriminatory and must be 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 doesn't have access to the funds
- May be more than one per year

# 457 and Profit-Sharing Plans

**457 PLANS**

- Used by state and local government employees
- 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; decided by the board of directors
- Contributions are subject to maximum annual amounts
- Allocation of contributions to employees is based on a predetermined formula

# 401(k) and 403(b) Plans

**401(k) PLANS**

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

**403(b) PLANS**

- Contributions are subject to maximum annual amounts
- Available to employees of public school systems and of tax-exempt, non-profit organizations
- Often referred to as tax-deferred annuities (TDAs) or tax-sheltered annuities (TSAs)

# 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; represents a "promise to pay" at retirement
- Not subject to ERISA requirements and exempt from IRS approval requirements

# Activity

Match each description to the appropriate term.

| | |
|---|---|
| ERISA | An unfunded promise to pay |
| TAX-DEFERRED | Eligible employees include those of local governments |
| 10% | Penalty for premature distributions |
| 457 PLANS | Determines eligibility status for employees |
| NQDC PLANS | Growth of earnings in a retirement plan |

# Chapter 9 – Investment Risks, Returns and Disclosures

## Key Topics

| 1 | 2 | 3 | 4 |
|---|---|---|---|
| **Account Disclosures** | **Account Transfers** | **Systematic vs. Unsystematic Risks** | **Investment Returns** |
| Learn about the disclosures that are required on transactions and different accounts. | Learn about the process of transferring an account from one B/D to another. | Learn about the different risks that can influence an investor's decisions. | Learn about the different investment returns and the tax results of receiving gifts or inheritance 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<br>▪ Markdowns on NMS securities are disclosed on client sales<br>▪ Compensation calculation is based on NBBO |

# Soft-Dollar Arrangements

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 advisory clients

| Acceptable |
|---|
| ▪ Research reports (in-house and third-party)<br>▪ Access to analysts<br>▪ Portfolio analysis software<br>▪ Subscription to industry trade publications<br>▪ Attendance cost for a securities conference or seminar<br>▪ IA Software |

| Unacceptable |
|---|
| ▪ Office space<br>▪ Accounting fees<br>▪ Advertising/marketing expenses<br>▪ Travel reimbursement<br>▪ Professional licensing fees<br>▪ Subscription to mass-marketed publications (e.g., WSJ)<br>▪ 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

# 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

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 | Procedures |
|---|---|
| Financial exploitation rules apply to specified adults who are most likely to be exploited, including:<br>▪ Persons age 65 or older<br>▪ 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 | If signs of diminished capacity or dementia are identified, the firm should place a temporary hold on the disbursement of funds/securities, the execution of securities transactions, and the transfer of securities.<br>▪ The customer's designated trusted contact person should be notified<br>• 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 <u>five</u> 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<br>▪ To find a bond's real interest rate, the formula is:<br>*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 its 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

**Capital Risk**
- Risk of investors losing their invested capital (lower for bonds)

**Credit Risk**
- Risk that a bond may not repay its obligation

**Currency Risk**
- Risk of loss when converting an investment that's made in a foreign currency into U.S. dollars

**Legislative Risk**
- Risk that new laws may have a negative impact on an investment's value (e.g., tax code changes)

# Additional Risks

**Opportunity Risk**
- Risk of passing on the opportunity of making a higher return on another investment

**Reinvestment Risk**
- Risk that interest rates will fall and semiannual coupons will be reinvested at a lower rate

**Prepayment Risk**
- 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<br>▪ Current Yield (based on annual interest)<br>▪ Yield-to-Maturity<br>▪ Yield-to-Call |
| Municipal Bonds | ▪ Taxable Equivalent Yield $\dfrac{\text{Tax-Free Yield}}{\text{(100\% - Tax Bracket \%)}}$ |
| Capital Gains and Capital Losses | ▪ Gain – realized when sales proceeds exceed cost basis<br>▪ Loss – realized when sales proceeds are below cost basis<br>▪ 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**

*Unified Gift and Estate Tax Exemption*

- 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

**Securities Received as a Gift**

- 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

**Inherited Securities**

- 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 description to the appropriate term.

| | |
|---|---|
| **MARKUP/MARKDOWN** | Paying for office space and professional licensing fees |
| **UNACCEPTABLE 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 10 – Investment Strategies and Portfolio Analysis

## Key Topics

| 1 | 2 | 3 | 4 |
|---|---|---|---|
| **Investment Selection** | **Asset Allocation** | **Technical Analysis** | **Fundamental 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. | Learn about the balance sheet and valuing inventory. |

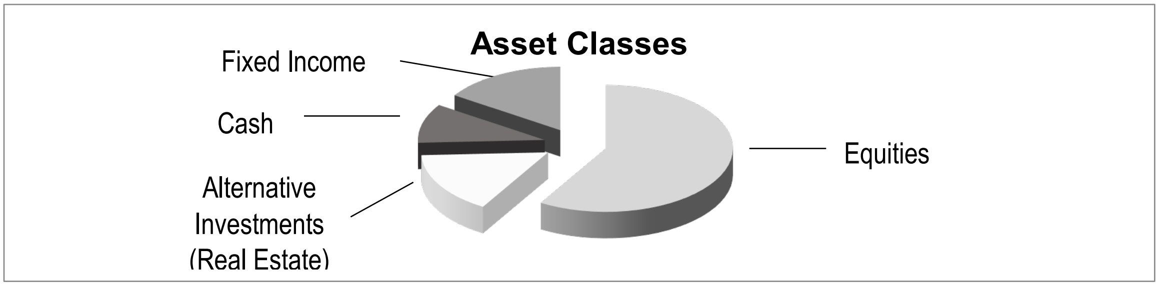
## Client's Financial Objectives

| | OBJECTIVES | | | | |
|---|---|---|---|---|---|
| | **Preservation of Capital** | **Current Income** | **Growth/Capital Appreciation** | **Speculation** | **Tax-Relief** |
| **Time Horizon** | Short | 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 | Highest | Varies |
| **Phrases associated with the objective** | Parking funds, safety, liquidity | 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




# 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

**Market Indices/Indexing**

- Basing the portfolio on a market index
- Index funds and ETFs are the popular vehicles

**Growth Analysis**

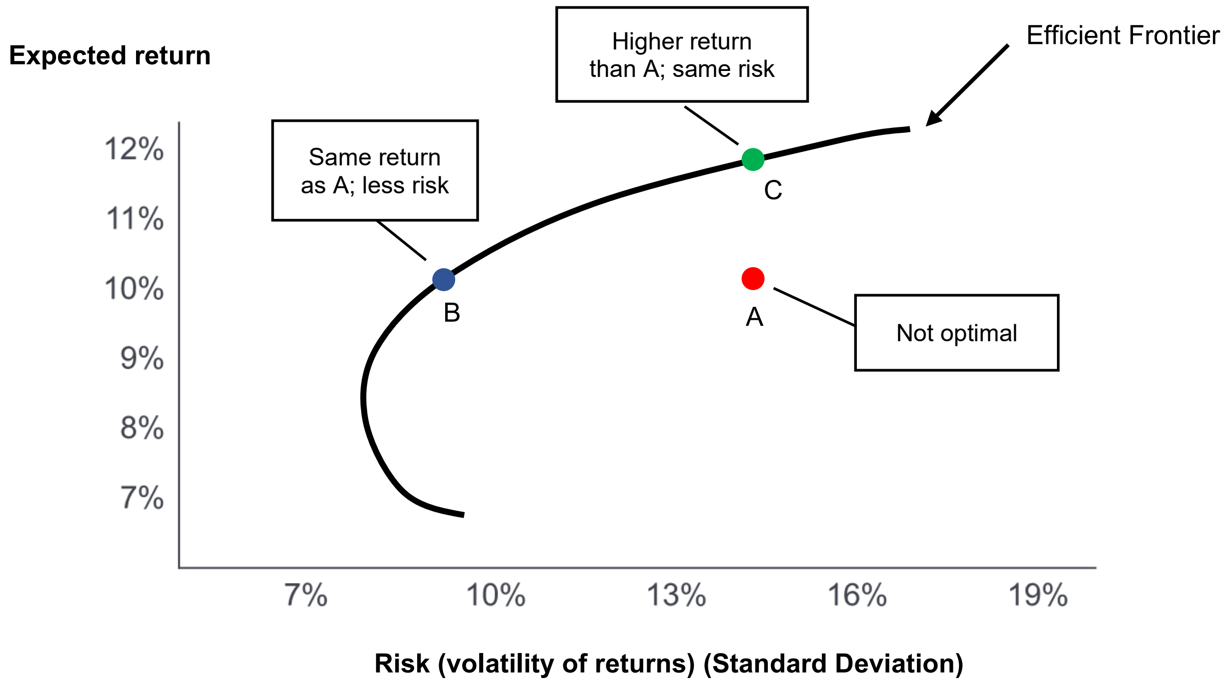
- Investors believe the company's earnings are outperforming the market
- Typically seek companies with high P/E ratios

**Value Analysis**

- Investors believe the stocks of a company are undervalued
- Companies often have low P/E ratios

# Constructing Optimal Portfolios

A Modern Portfolio Theory (MPT) model that describes 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

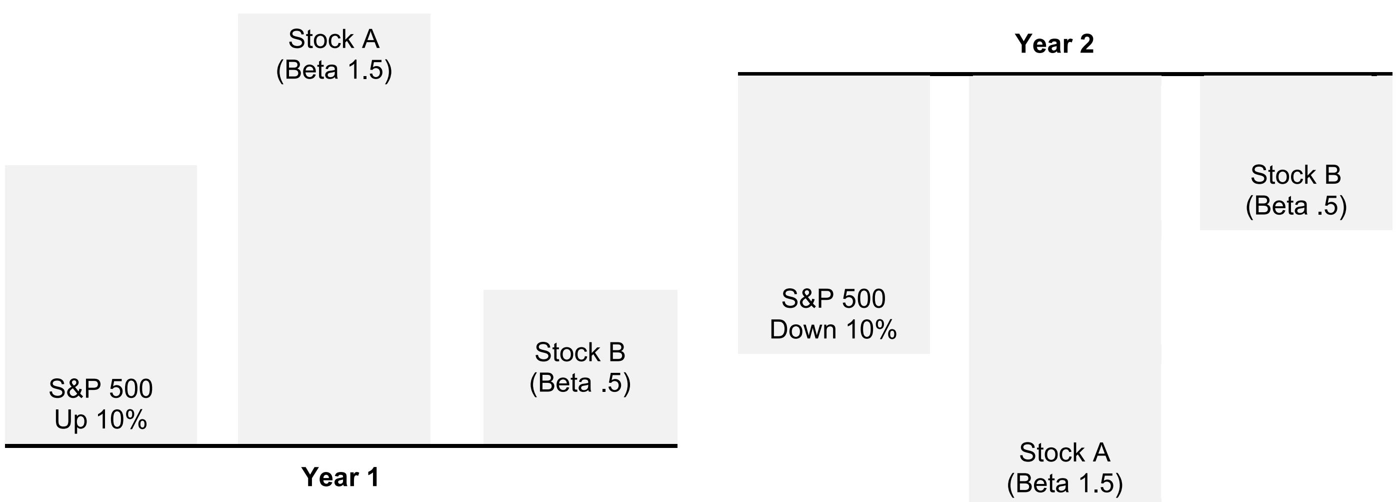
Equity Indexes:
- Wilshire Associates Equity Index – Largest index; 5,000 stocks
- Russell 2000 – Focuses on small capitalized stocks
- Nasdaq Composite Index – Based on all Nasdaq listed securities
- Nasdaq 100 – The 100 largest companies listed on Nasdaq

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

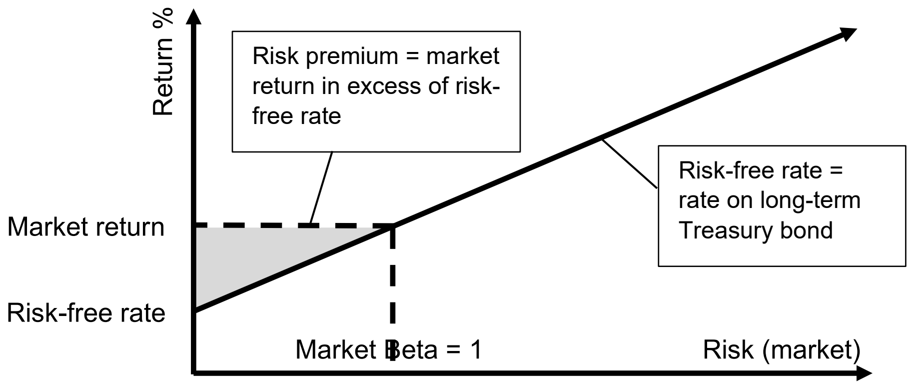



**Alpha** measures an investment's risk-adjusted performance against a benchmark index.

If it outperforms the benchmark, it's given a positive alpha; if it underperforms, it's given 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.




# Balance Sheet

| CURRENT ASSETS | |
|---|---|
| ▪ Cash | $500,000 |
| ▪ Marketable Securities | 80,000 |
| ▪ Accounts Receivable | 90,000 |
| ▪ Inventories | 800,000 |
| ▪ Other Current Assets | 150,000 |
| *Total Current Assets* | $1,620,000 |
| **FIXED ASSETS** | |
| ▪ Property, plant and equipment | 2,000,000 |
| **INTANGIBLES** | |
| ▪ Goodwill | 400,000 |
| ▪ Other intangibles | 15,000 |
| TOTAL ASSETS | $4,035,000 |

| CURRENT LIABILITIES | |
|---|---|
| ▪ Accounts Payable | $500,000 |
| ▪ Accrued Expenses | 400,000 |
| ▪ Income Tax Payable | 100,000 |
| ▪ Short-Term Debt | 50,000 |
| *Total Current Liabilities* | $1,050,000 |
| **LONG-TERM LIABILITIES** | |
| ▪ Long-Term Debt | 480,000 |
| ▪ Other Long-Term Liabilities | 20,000 |
| *Total Liabilities* | $1,550,000 |
| **STOCKHOLDERS' EQUITY** | |
| ▪ Common Stock | 10,000 |
| ▪ Additional Paid-in Capital | 400,000 |
| ▪ Retained Earnings | 2,500,000 |
| ▪ Treasury Stock at cost | (425,000) |
| *Total Shareholder Equity* | $2,485,000 |
| TOTAL LIABILITIES and STOCKHOLDERS' 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

# Activity

Read each statement and determine if it’s TRUE or FALSE.

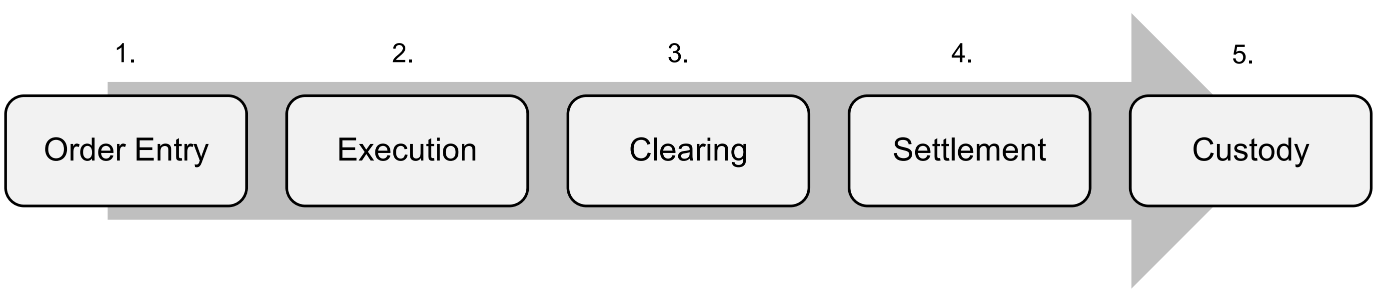
| | |
|---|---|
| ASSET ALLOCATION MODELS ARE USED TO CREATE OPTIMAL PORTFOLIOS | |
| THE RUSSELL 2000 IS THE LARGEST INDEX | |
| A STOCK WITH A BETA OF 1.25 OUTPERORMS A RISING MARKET AND UNDERPREFORMS A FALLING MARKET | |
| CAPM STATES THE RETURN ON AN INVESTMENT SHOULD EQUAL A RISK-FREE RATE OF RETURN PLUS A RISK PREMIUM | |
| THE FUNDAMENTAL FORMULA FOR A BALANCE SHEET IS TOTAL ASSETS = TOTAL LIABILITIES + STOCKHOLDERS’ EQUITY | |
| LIFO RESULTS IN GREATER PROFITS WHEN PRICES ARE RISING | |

# Chapter 11 – Orders and Trade Execution

## Key Topics

| 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|
| **Overview** | **Trade Capacity** | **Order Tickets and Transactions** | **Prohibited Trading Practices** | **Settlement and Delivery** |
| 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 what must be included on an order ticket and different types of transactions. | Learn about some of the different prohibited trading practices. | Learn the difference between settlement and payment, and what's considered good delivery. |

## 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

| BROKER | |
|---|---|
| BROKER | ▪ Firm acts as a conduit or agent by finding another party willing to take the other side of the trade<br>▪ Sells to a bid or buys from an offer<br>▪ Collects commission for the service<br>▪ No risk to the firm |

**A** gency

**B** roker

**C** ommission

# How Broker-Dealers Function

| DEALER | |
|---|---|
| DEALER | ▪ Firm acts as a principal<br>▪ Firm takes the other side of the trade<br>▪ Entitled to markup/markdown (discussed shortly)<br>▪ Inventory/risk |

**P** rincipal

**D** ealer

**M**arkup/markdown

# Dealer-to-Dealer Markets

**Nasdaq**

- Non-physical; phone and computer network
- Negotiated market
- Unlimited number of registered *market makers*
- Classified as a securities exchange

**Non-Exchange Issues (OTC)**

- Often low priced and thinly traded
- Two systems which offer real-time quotations:
  1. OTCQX
     – Issuers must be reporting companies
  2. 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

**Market Makers**

- Stand ready to buy or sell at least 100 shares at their quoted prices (quotes are firm)

| Bid | Ask |
|---|---|
| 22.90 | 23.05 |

- The MM's <u>bid price</u> is the price at which it will buy
- The MM's <u>ask price</u> 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

# 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's considered a ***<u>backing away</u>*** violation.

# 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
- Trading 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

# Prohibited Trading Practices

**Market Rumors**

- Spreading false or misleading information to influence the price of stocks and/or bonds

**Front-Running**

- RRs executing trades for proprietary accounts (or those for which they have discretion) ahead of a customer's block order (a market-moving order)

**Interpositioning**

- 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

**Trading Ahead of Research**

- 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 or its derivative
- Information barriers must exist

# Activity

Read each statement and fill in the blanks.

1. If executed, order tickets must be ____________________ and approved _________________________________.
2. Compensation for an agency trade is in the form of a ___________________.
3. Compensation for a principal trade is in the form of a _______________________________.
4. An _________________________________________ is designed to match buy and sell orders of subscribers.
5. When a customer borrow securities from the broker-dealer and subsequently sell them, the customer is considered to be ____________.
6. Placing a third party between a customer and the best market is referred to as __________________________.

# Firm-to-Firm 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) |

# 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 |
|---|
| • Properly registered<br>• Properly endorsed certificate<br>• Signed stock power if the stock certificate is sent unsigned<br>• CUSIP numbers may be used to identify and clear |

| Units of Delivery |
|---|
| • Stock transactions must be delivered in multiples of 100 shares<br>• Bond transactions must be in $1,000 units or multiples thereof<br>– 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

# Activity

Read each statement and determine what it describes.

| | |
|---|---|
| SETTLEMENT FOR CORPORATE SECURITIES TRANSACTIONS | |
| PAYMENT FOR CORPORATE SECURITIES TRANSACTIONS | |
| NUMBERS USED TO IDENTIFY AND CLEAR SECURITIES | |
| USED IF STOCK CERTIFICATE IS DELIVERED UNSIGNED | |
| MULTIPLES IN WHICH BONDS ARE DELIVERED | |

# Chapter 12 – Resolving Disputes

## Key Topics

| 1 | 2 | 3 | 4 |
|---|---|---|---|
| **Erroneous Trades**<br><br>Learn about trade errors and the process of trade corrections. | **Customer Complaints**<br><br>Learn about the SRO requirements for handling customer complaints. | **Dispute Resolution**<br><br>Learn about the various procedures used to resolve complaints. | **Required Disclosures**<br><br>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)<br>▪ To place trades in the account, principal authorization is required<br>▪ 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)<br>• 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

# 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<br>- First: 25 days - Second: 14 days<br>▪ If rejected (not signed), a hearing is held |
| ↓ | |
| Hearing Panel | Potential results: fine, suspend / revoke registration, bar from association **NOT prison** |
| ↓ | |
| Appeal Decision | First to National Adjudicatory Council, then to the SEC, and finally to Federal Court |

# Code of Arbitration (COA)

System in which monetary disputes are resolved

**Participants**

- Members and/or customers provided customer has signed pre-dispute clause of new account form

**Arbitration Panel**

- Typically three persons. If a public customer is involved, a majority of the panel must be independent (not associated with the securities industry)

**Simplified Arbitration**

- For disputes not exceeding $50,000, one arbitrator, generally no hearing held, and document submission only

**Statute of Limitations**

- There's 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

# 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 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 by a regulator 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 wrong for a 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 customer complaint.
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?<br>▪ Risk is influenced by time frame:<br>• Investors with long-term goals can typically assume more risk<br>• 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<br>▪ Older investors generally have shorter time horizons and seek more stable investments<br>• 100% - Age = % of equity often used for asset allocation questions<br>• 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<br>▪ T-Bills<br>▪ CDs | ▪ Bonds<br>▪ Bond Funds<br>▪ Income Funds<br>▪ Preferred Stock<br>▪ Utility Stock<br>▪ Investment Grade Bonds<br>▪ T-Bonds and Notes<br>▪ U.S. Agency Debt | ▪ Common Stock<br>▪ Growth Stock<br>▪ ADRs<br>▪ Stock Funds<br>▪ Index Funds<br>▪ Stock ETFs | ▪ Micro-Cap Stocks<br>▪ Sector Funds<br>▪ Aggressive Growth Funds<br>▪ High-Yield Bonds<br>▪ BDCs<br>▪ Hedge Funds<br>▪ Drilling and Raw Land Partnerships | ▪ Option Strategies<br>▪ Leveraged ETFs<br>▪ Short Positions<br>▪ Margin Trading<br>▪ Day Trading | ▪ Tax-Exempt Muni Bonds and Funds<br>▪ Annuities, IRA and Retirement Plans<br>▪ DPPs<br>▪ 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**<br><br>▪ Cash<br>▪ Money Market Instruments<br>▪ Money Market Mutual Funds | **Low Risk / Low Return**<br><br>▪ Investment-Grade Corporate Bonds<br>▪ Income Mutual Funds<br>▪ Preferred Stocks<br>▪ Fixed Annuities<br>▪ U.S. Government and Municipal Bonds | **Some Risk / Higher Return**<br><br>▪ Blue Chips and Utility Stocks<br>▪ Growth and Income (Balanced) Mutual Funds<br>▪ Index Mutual Funds<br>▪ ETFs<br>▪ Variable Annuities<br>▪ Convertible Bonds<br>▪ REITs | **High Risk / Even Higher Return**<br><br>▪ Growth Stocks<br>▪ Growth Mutual Funds<br>▪ Sector Funds<br>▪ Small/Micro-Cap Stocks | **Extremely Risky / Highest Return**<br><br>▪ High-Yield Bonds<br>▪ Precious Metals<br>▪ Hedge Funds<br>▪ Oil and Gas Limited Partnerships<br>▪ Certain Option Positions<br>▪ Leveraged ETFs<br>▪ 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. Growth Fund

II. Treasury Bond Fund

III. High-Yield Corporate Bond Fund

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. Growth Fund

II. Treasury Bond Fund

III. High-Yield Corporate Bond Fund

IV. Variable Annuity

# Age Considerations

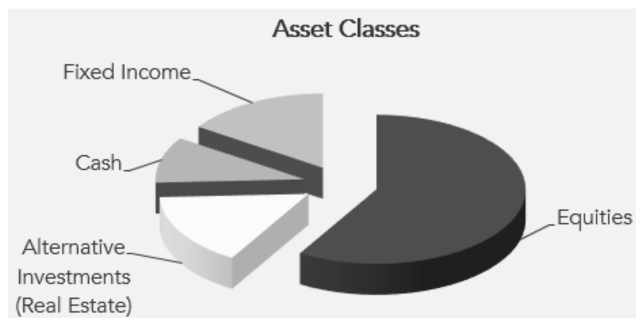
- Younger individuals generally can accept more risk since they have longer to earn and build capital
- Individuals nearing retirement typically need to be more conservative with their investments

**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 4

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% GNMA Fund, 20% Foreign Bond Fund, 40% in Growth Fund

# Suitability Question 5

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% Value Fund, 20% Treasury Bond Fund, 15% Fixed Annuity, and 15% Tax-Exempt Fund

III. 40% High-Yield Corporate Bonds, 20% In-State General Obligation Bond Fund, 20% Out-of-State Muni-Bond Fund, 20% Treasury Bond Fund

IV. 40% In-State General Obligation Bond Fund, 40% In-State Revenue Bond Fund, 20% Tax-Exempt Money Market Fund

# Suitability Question 6

A customer is in her late 40s and is currently in the 22% 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 Growth Fund, 30% in Treasury Bond Fund, and 50% in Tax-Exempt Money Market Fund

II. 40% in Growth Fund, 30% in Municipal Bond Fund, 15% in Treasury Bond Fund, 15% in Tax-Exempt Money Market Fund

III. 30% In-State Municipal Bond Fund, 30% in Out-of-State Municipal Bond Fund, 30% in Treasury Bond Fund, 10% in Tax-Exempt Money Market Fund

IV. 25% in In-State Municipal Bond Fund, 25% in Out-of-State Municipal Bond Fund, 25% in Corporate Bond Fund, and 25% in Treasury Bond Fund

# Suitability Question 7

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.