Securities Training Corporation

Series 65

NASAA Uniform Investment Adviser Law Examination

Learning Guide / Workbook

v16

About the Series 65

1	2	3	4	5
130 Multiple-Choice Questions	Three Hours Allotted to Complete Exam	10 Additional Questions are Experimental (don't count for or against the score)	Minimum Required Passing Score is 71% (92 out of 130)	30-, 30-, 180-Day Waiting Period For Failures

Function	Chapters	# of Questions
1. Economic Factors and Business Information	14 and 15	20
2. Investment Vehicle Characteristics	11, 12, and 13	32
3. Client Investment Recommendations and Strategies	10 and 15	39
4. Laws, Regulations, and Guidelines, Including Prohibitions on Unethical Business Practices	1 through 9	39

STC Study Material

15 Chapter Study Manual

8 Final Examinations

- 140-question comprehensive exams
- Complete explanations provided
    - First attempt
        - Select “Show Explanations”
        - Complete all exams with explanations shown before beginning the second attempt
    - Second attempt
        - Turn “Show Explanations” Off
        - Scores of 80% or higher indicate adequate retention
    - Create Custom Exams
        - Provides specific support by topic
        - Allows students to focus on areas of weakness

Chapter 1
– Laws, Regulations, and Guidelines Overview

Key Topics

1	2	3
UNIFORM SECURITIES ACT Learn about the model law used to regulate securities transactions at the state level.	**DEFINITIONS** A brief introduction into NASAA, administrator, NSMIA, person, and states is provided.	**FINANCIAL FIRMS** Learn where broker-dealers, agents, investment advisers, and investment adviser representatives must register.

Terms

Uniform Securities Act (USA)
- Blue-Sky laws
- A model law – not the actual law of any state
- Exam doesn't address state amendments

State Administrator (sometimes called Commissioner)
- Uses rules, orders, and laws to enforce the USA

North American Securities Administrators Association (NASAA)
- Responsible for updating the USA through various NASAA Model Rules and Statements of Policy

Terms

National Securities Markets Improvement Act (NSMIA)

- Reduced duplication of federal and state regulation
- Defined Federal Covered Securities and Federal Covered Advisers that are now exempt from state regulation

> Federal Covered Securities and Federal Covered Advisers include nationally recognized securities and advisers with a significant amount of assets under management

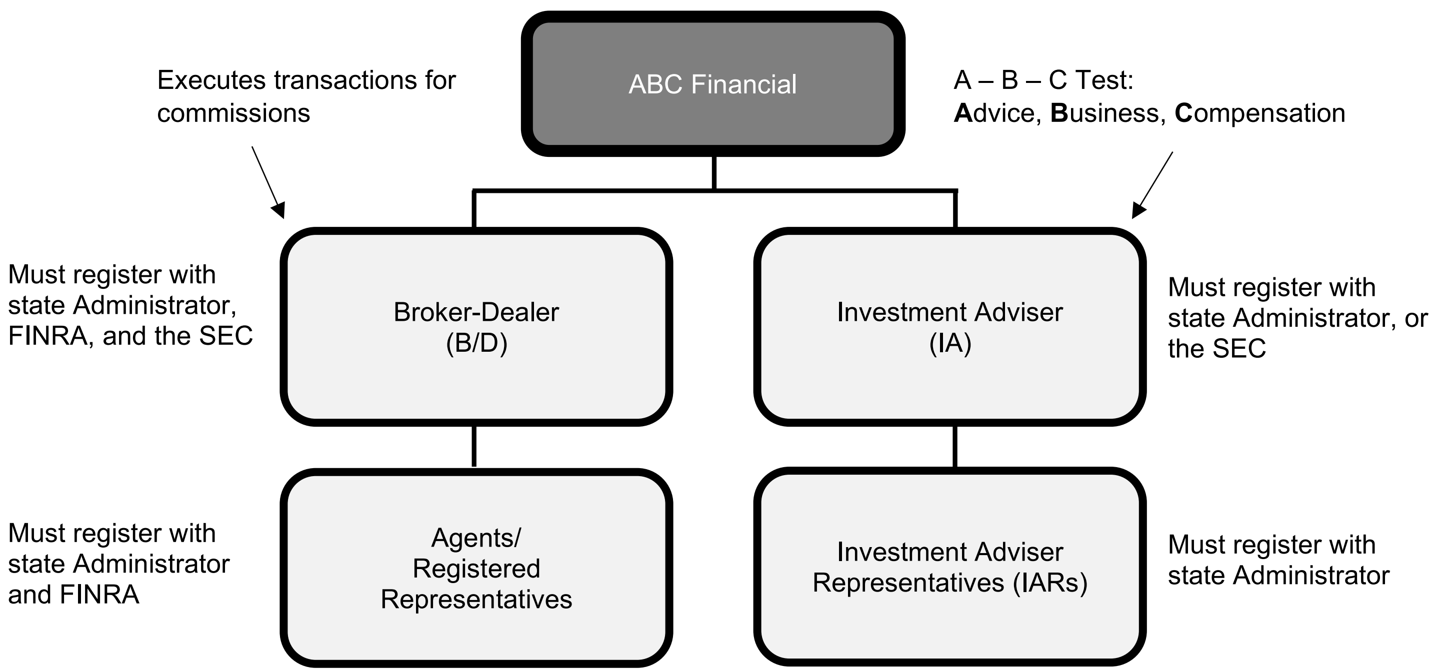
Person:

- An individual, corporation, partnership, unincorporated organization, government or political subdivision of a government, and certain trusts (any legal entity)
- The term does NOT include minors, anyone declared mentally incompetent, or a deceased person

State:

- Any state, territory or possession of the U.S., including the District of Columbia and Puerto Rico

Financial Firms



Activity

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

AN INVESTMENT ADVISER NEEDS TO REGISTER WITH FINRA	
AGENTS OF A BROKER-DEALER MUST GENERALLY REGISTER WITH THE STATE ADMINISTRATOR	
BROKER-DEALERS REGISTER WITH THE SEC AND THE STATE(S)	
INVESTMENT ADVISER REPRESENTATIVES MUST REGISTER WITH THE SEC	

Chapter 2 – State Registration of Securities

1

DEFINTION OF A SECURITY

Learn what's regulated as a security using the Howey Test.

2

METHODS OF REGISTRATION

Learn about how securities register with the states under the Uniform Securities Act.

3

ACTIONS AGAINST REGISTRATION

Learn what actions the Administrator can take to prevent fraud in the issuance of securities.

4

EXEMPT SECURITIES

Learn about which securities are not required to register under the USA.

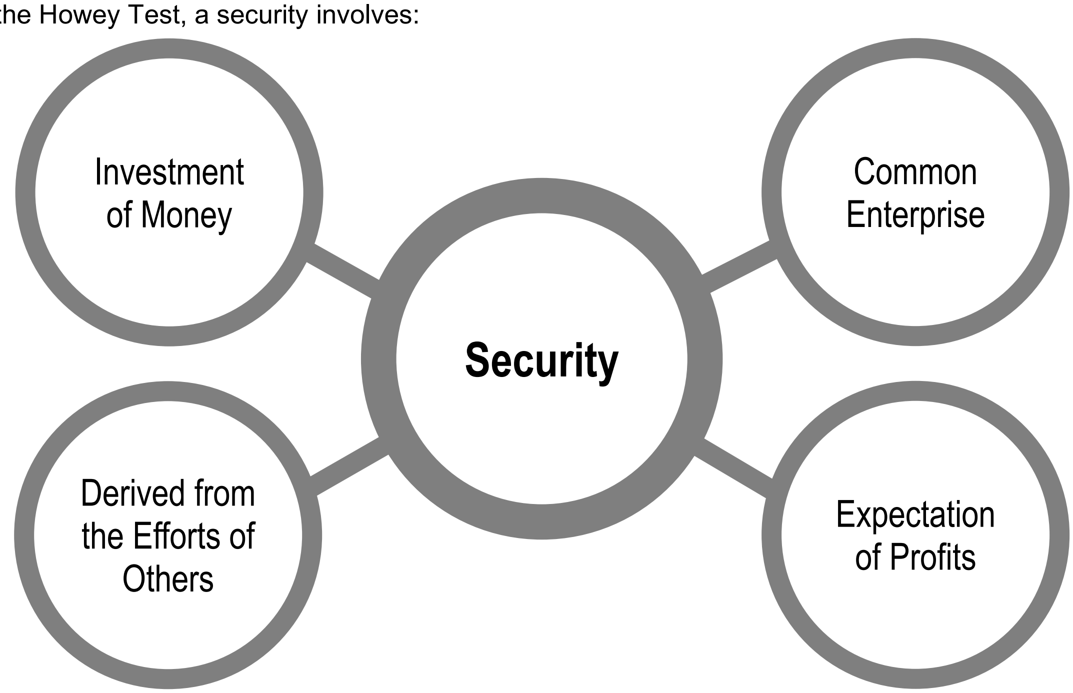
5

EXEMPT TRANSACTIONS

Learn about which transactions or issuances are not required to register under the Uniform Securities Act.

Definition of a Security

As defined by the Howey Test, a security involves:



Is the Instrument/Investment a Security?

YES

- Stocks (including treasury stock)
- Notes, bonds, and debentures
- Rights and warrants
- Investment contracts
- Preorganization certificates
- Certificates of participation in any profit-sharing agreement
- Certificates of participation in an oil, gas, or mining lease
- Investment company shares
- Limited partnerships
- Variable contracts
- Options
- Viatical investments

NO

- Life insurance
- Endowment policies
- Fixed annuities
- The four Cs:
  - Commodities
  - Collectibles
  - Currencies
  - Condominiums as a place of business or residence

Methods of Securities Registration

For larger issuers conducting follow-on interstate offerings

1. **Registration by Filing (Notification):** Issuers must meet stringent financial requirements and conditions, such as:
   - Registration statement previously filed under Securities Act of 1933
   - In business at least 36 calendar months preceding registration
   - Issuer has registered with the SEC a class of equity securities that are held by 500 or more persons
   - Issuer has at least four market makers
   - Total underwriting commissions may not exceed 10%
   - Offering price is at least $5 per share

Becomes effective at the same time as the federal registration

Methods of Securities Registration

For smaller issuers conducting interstate offerings (likely IPOs)

2. **Registration by Coordination**: State registration is coordinated with the federal registration under the '33 Act (though it doesn't need to be filed at the same time)
   - Along with a registration statement, the issuer submits a consent to service of process and a significant amount of additional information
   - Issuer must submit a copy of the latest prospectus with the SEC

Becomes effective at the same time as the federal registration

Methods of Securities Registration

For issuers conducting intrastate offerings (one state only)

3. **Registration by Qualification**: Requirements are determined by the individual state
   - No federal registration is required
   - May be used in any state, for any type of security
   - Extensive disclosures required by Administrator, with correcting amendments sent for inaccuracies

Becomes effective when determined by the Administrator

All registration statements are effective for at least one year from their effective date

General Registration Provisions

Issuers are generally required to:

- Pay a filing fee
- Disclose the amount of securities being offered in a state
- Disclose the other states in which a registration statement has been filed

A state Administrator may require a prospectus to be sent to any person to whom an offer is made

Actions Against Registration

The Administrator may deny, suspend, or revoke any registration statement if it's in the public interest and:

The registration is incomplete or contains false or misleading information	The issuer, a partner, officer, or director of the issuer, or an underwriter has willfully violated any provision of the USA
The issuer's enterprise is illegal	The underwriter's compensation is unreasonable
The offering is or may be fraudulent	The proper fee hasn't been paid

A stop order cannot be issued against an effective registration based on facts the Administrator knew when the registration became effective unless proceedings are instituted within 30 days

Securities Exemptions

Under the Uniform Securities Act, there are two types of exemptions:

1. **Exempt Securities** – Typically based on the safety of the investment
   - Examples: Treasury bonds, municipal bonds, foreign government bonds, commercial paper, stocks/bonds of banks, and Federal Covered Securities (e.g., listed securities)
2. **Exempt Transactions** – Typically based on the limited purchasers (i.e., non-public)
   - Examples: Private placements and trades between institutions (e.g., between issuer and underwriter)

Exempt Securities

Exempt securities can be issued by:

- U.S. government
- Municipal governments
- Canadian government or Canadian provinces
- Foreign governments recognized by the U.S.
- Banks, savings institutions, or trust companies; including federal savings and loan associations
- Insurance companies, but not annuity contracts
- Common carriers (e.g., railroads)

More exempt securities:

- Public utilities regulated by the Public Utility Holding Company Act of 1935
- Non-profit organizations (e.g., religious organizations)
- Short-term corporate debt (commercial paper) with the following characteristics:
    - Nine-month maximum maturity
    - Minimum denomination of $50,000
    - Rated in one of the three highest categories by a nationally recognized statistical rating organization

  (Note, under the Act of 1933, commercial paper is exempt if its maturity is 270 days or less)

Federal Covered Securities

- Securities listed on the NYSE, Nasdaq, or regional exchanges (i.e., NMS securities)
- Securities issued by an investment company (e.g., mutual funds)
- Securities issued under Regulation D Rule 506
- Securities sold to qualified purchasers (any person that owns at least $5 million of securities)

Under NSMIA, any securities that are classified as “federal covered” are given a specific state registration exemption.

Even if exempt from registration, securities remain subject to the anti-fraud provisions of both federal law and the USA.

Notice Filing

Although exempt from state registration, *issuers of investment company shares* and *private placements under Regulation D Rule 506* are subject to Notice Filing with the Administrator which involves:

- Filing copies of any offering documents (prospectuses) that have been filed with the SEC
- Filing a consent to service of process
- Payment of a fee

> Notice Filing is NOT a method of registration which can be denied by an Administrator.

Activity

Is an Administrator permitted to:

- Cancel the registration of a federal covered security?
- Prohibit the sale of a federal covered security in the state?
- Investigate fraud in the sale of a federal covered security?

Exempt Transactions

Non-Issuer Transactions	Secondary market trades ▪ *Key words*: isolated, non-recurring, or unsolicited trades ▪ Trades in securities subject to '34 Act (reporting companies) ▪ Trades in securities listed on the Toronto Stock Exchange
Private Placements	▪ Limited to no more than 10 non-institutional investors ▪ Purchases must be made for investment purposes only ▪ No commission paid for soliciting non-institutional investors
Institutional Transactions	▪ Those with banks, B/Ds, or other financial institutions; insurance, trust, or investment companies; between issuer and underwriter
Fiduciary Transactions	▪ Those involving a trustee, administrator, executor, or sheriff
Mortgage -Backed	▪ Transactions in bonds that are secured by real estate mortgages (if sold as a unit)

Application Question

Which of the following statements is/are TRUE of exempt securities?

I. If a security is registered with the SEC, it doesn't need to be registered with the state(s).
II. A security that's exempt from federal registration may need to register under the Uniform Securities Act.
III. An exempt security is subject to the antifraud provisions of the Uniform Securities Act.
IV. Federal regulations always supersede state rules.

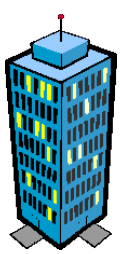
Chapter 3 – State Regulations Governing Broker-Dealers and Agents

Key Topics

1	2	3	4	5
DEFINTION OF BROKER-DEALER AND AGENT	**AGENTS OF ISSUERS**	**CANADIAN BROKER-DEALERS**	**REGISTRATION PROCEDURES**	**RECORD KEEPING**
Learn what's defined as a broker-dealer and an agent.	Learn about when an agent of an issuer must register.	Learn about provisions for Canadian broker-dealers under the Uniform Securities Act.	Learn about forms and procedures for registering broker-dealers and agents with the Administrator(s).	Learn about records that broker-dealers must keep.

Broker-Dealers and Their Agents

Broker-Dealer (B/D)



Any *person* in the business of effecting securities transactions for the accounts of others (agency) or for its own account (principal)

Agent

An *individual* who represents a B/D in effecting securities transactions is always an agent and subject to registration

- Included: all officers, partners, or directors of a B/D who are involved in the sale of securities
- Excluded: those whose jobs are clerical (file paperwork or answer phones)

Agent of Issuer

Issuer

Any *person* that issues or proposes to issue any security for the purpose of raising capital (a sale by an issuer is an *issuer transaction*)

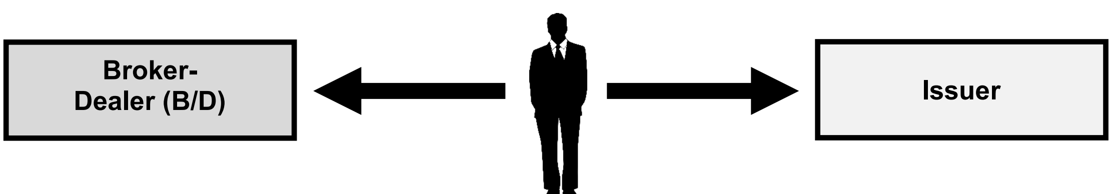
Agent

An *individual* who represents an ISSUER in the sale of certain securities is NOT required to register as an agent if the sale involves:

- An exempt security
- An exempt transaction
- A federal covered security or
- A transaction with existing employees, partners, or directors of the issuer and no commission or remuneration is paid for soliciting a person in the state

Two Types of Agents

An *individual* who represents a B/D or an issuer in effecting securities transactions



Registration is *ALWAYS* required.

Registration *MAY BE* required.
If the securities are exempt or the transaction is exempt, agents of issuers are also exempt.

“Finders” search for investors for private placements and are considered agents only if they receive compensation for completed transactions (e.g., commissions)

Is the Firm a Broker-Dealer?

YES

Then state registration is required

NO

These are NOT broker-dealers (excluded)

- Agents
- Issuers
- Banks, savings institutions, trust companies
- A person with no place of business in a state and only transacts business there with:
  - Issuers involved in the transaction
  - Other broker-dealers
  - Financial institutions, or
  - Existing clients who are not residents of the state (e.g., students, vacationers)

Agent Exemptions

Agents may engage in securities transactions in a state in which they are not registered if:

1. Existing customer is temporarily visiting another state (e.g., students, vacationers)
2. Existing customer moves to a new state and:
   - Agent's registration is pending in new state
   - Agent is registered in at least one other state
   - Agent is registered with a national securities association, such as FINRA
   - Agent's B/D is registered in the new state

Canadian Broker-Dealers

The USA allows for the limited registration of broker-dealers and agents that are residents of Canada and that have no place of business in a state provided:

They only transact business with a Canadian person who is temporarily in the state	They don't solicit new clients in the state
They file an application with the Administrator along with a consent to service of process	The broker-dealer is a member of an SRO or Canadian stock exchange

Renewal applications are filed prior to December 1 each year

Registration Requirements

	Registration Form:	Where Filed:
Broker-Dealers	Form BD	Central Registration Depository (CRD)
Agents	Form U4	CRD
Investment Advisers	Form ADV Parts 1 and 2	Investment Adviser Registration Depository (IARD)
Investment Adviser Representatives (IAR)	Form U4	IARD

Registration Procedures

Applies to Broker/Dealers, Agents, IAs, and IARs

Application	Consent to Service of Process	Filing Fee
▪ Becomes effective 30 days after filing ▪ Expires annually on December 31 ▪ Updated annually at time of renewal ▪ Amendments for material changes are filed promptly (usually within 30 days)	▪ Filed once, not renewed; irreversible ▪ Grants the Administrator power of attorney to receive and process non-criminal legal complaints	▪ Paid annually ▪ For successor firms (firm ownership changes): • New application must be filed • No additional filing fee for remainder of year

Registration Procedures

Bonding Requirement
Posted to cover cost of lawsuits ▪ Required for B/Ds, agents, and IAs that have custody of, or discretionary control over, client funds and securities ▪ Not required if B/D's net capital or IA's net worth exceeds the minimum set by Administrator ▪ Must be maintained for as long as B/D or IA is in business, plus three years thereafter ▪ In lieu of bond, cash or securities may be deposited (amount and type of securities determined by Administrator); no other personal property

Minimum Financial Requirements

	Who determines requirement?	Minimum Net Capital Requirement	When to report a deficiency
B/Ds	SEC (no state may impose a higher requirement)	Depends on activity	Within one business day

If deficient, firms must also:

- Submit a statement of financial condition by the next business day
- Obtain a surety bond to make up the deficiency

Broker-Dealer Recordkeeping Requirements

Maintain books, records, and correspondence as required by Administrator for:

- **Three** years; easily accessible for first two years

File with Administrator any advertising, sales literature, or other communication that's disseminated to existing or prospective clients (unless it deals with *exempt securities*)

File with Administrator any required financial reports, with amendments for material changes filed promptly (within 30 days)

Application Question

Which statement(s) is/are TRUE regarding broker-dealers and agents?

I. An agent of an issuer who sells exempt securities needs to register with the Administrator.

II. If a broker-dealer's net capital falls under the minimum, it must notify the Administrator within one business day.

III. If a broker-dealer's client moves to a new state, the firm must register in the new state before the client moves.

IV. An agent of a broker-dealer who sells exempt securities needs to register with the Administrator.

Chapter 4 – State Regulations Governing Investment Advisers and IARs

Key Topics

1	2	3	4	5
DEFINTION OF IA AND IAR	**EXEMPTIONS AND EXCLUSIONS**	**FORM ADV**	**BROCHURE RULES**	**RECORD KEEPING**
Learn what's defined as an investment adviser and investment adviser representative.	Learn about the persons that are not required to register as an investment adviser.	Learn about how to register an investment adviser under the Uniform Securities Act.	Learn about the disclosure document that investment advisers give to their clients.	Learn about records that investment advisers must keep under the Uniform Securities Act.

Investment Advisers and Their Representatives

Investment Adviser (IA)

Any *person* that meets the ABC test:

- **A**dvice — Provides advice about securities, including asset allocation
- **B**usiness — As a regular business
- **C**ompensation — Receiving compensation for the advice

Investment Adviser Representative (IAR)

Any *individual* who:

- Provides or determines investment advice
- Manages accounts
- Solicits advisory services *
- Manages those who perform these functions (but *not* managers of accounting, human resources, etc.)

* Under the USA, third-party solicitors may be considered IARs and may be subject to registration in most states

Is the Firm an Investment Adviser?

YES

Is registration required?

Yes, unless exempt:

<u>Exemptions</u>:
Adviser with <u>no place of business</u> in a state and:

- All clients there are financial institutions, or
- Has no more than <u>five</u> non-institutional clients in the state within the last 12 months (de minimis)

NO

These are NOT Investment Advisers (excluded)

- Investment Adviser Representatives (IARs)
- Banks, savings institutions, trust companies
- **L**awyers, **A**ccountants, **T**eachers, **E**ngineers
- Broker-dealers and their agents
- Publishers (e.g., newspapers and magazines)
- Federal Covered Advisers (under NSMIA)

Application Question

Engaging in which of the following activities will require a person to register as an *adviser* under the USA?

a. Selling fixed annuities
b. Selling mutual funds
c. Selling municipal bonds
d. Selling investment management services

Form ADV Part 1

To register with the SEC or state(s), an IA must file Form ADV Parts 1 and 2 through the IARD

This information is available to the public through the Investment Adviser Public Disclosure website

- ADV Part 1 provides specific disclosure information for SEC and state use, including:
  - IA name, number of employees, nature of business
  - Name, address, education, and 10-year business history of each partner, officer or director
  - How firm maintains custody of client assets
  - If principal business consists of investment supervisory service
  - Number and size of discretionary and non-discretionary accounts

Form ADV Part 2

ADV Part 2 provides information for client purposes and may be used as the firm's brochure. It discloses/includes:

- All actual and potential conflicts of interest and affiliations
- Services provided and related fees
- Soft dollar arrangements
- Types of securities on which advice is given
- Types of analyses used
- Education and business background of those rendering investment advice (The IA Act of 1940 sets no standards)
- The IA's balance sheet if it has custody of client funds or securities or collects prepaid fees of more than $1,200, six months or more in advance
  - At the state level, the prepaid fee trigger is $500

Form ADV

Required annual renewal

- Within 90 days of year end, an IA must file an Annual Updating Amendment to determine whether it's eligible for state or SEC registration
  - Calendar year is used by an IA that's state covered
  - Fiscal year is used by an IA that's a federal covered adviser

Amendments to Form ADV

- Material changes are filed promptly (within 30 days)
  - Change in status of a general partner
  - Change in the manner of custody
  - Change in the structure of fees
- Routine changes updated at annual renewal
  - Change in the number of employees
  - Change in the number of discretionary accounts

Additional Forms

Form ADV-W	For advisers filing for a full or partial withdrawal of registration ▪ Full withdrawal – when no longer operating as an IA ▪ Partial withdrawal – when no longer eligible to be a federal covered advisor (FCA) or withdrawing from a state (effective within 180 days of the end of adviser's fiscal year)
Form ADV-E	Filed by independent public accountant to report the result of an audit of adviser that has custody of client funds or securities ▪ Must be filed within 120 days of the audit
Form ADV-NR	Filed by advisers with general partners or managing agents who are non-U.S. residents ▪ Appoints the Secretary of the SEC (or state official) as the adviser's agent for receipt of legal papers

Advisory Contracts

Under the Uniform Securities Act, IA contracts:

- Must be in writing
- May not contain exculpatory provisions (hedge clauses) or mandatory arbitration clauses
- Generally prohibit performance fees (percentage of profit)
  - Compensation is typically expressed as a percentage of the total value of the account averaged over a given period of time (i.e., assets under management, or AUM)
  - Performance fees may be charged to *qualified clients* (those with at least $1.1 million under management with adviser or more than $2.2 million net worth)
- May only be assigned to another adviser with client consent
- Must state that, if the IA is a partnership, all clients will be notified of any change in partners

The Brochure Rule

An IA's written disclosure document (brochure) must be delivered to clients by no later than the signing of the contract

- Thereafter, it must be delivered to clients at least annually

Exclusions:

- Contracts with registered investment companies
- Contracts for impersonal advisory services costing less than $500 per year

According to the USA, delivery of the brochure is required:

- 48 hours prior to signing a contract OR
- At the time the contract is signed, provided the client is allowed to cancel within five business days without penalty

The Brochure Rule

An IA's brochure must contain the following information:

- Adviser's name, address, and website
- Details of the firm's background, business practices, financial information, and assets under management
- Fees, compensation, and types of clients
- Soft dollar arrangements
- Adviser's code of ethics
- Statement that registration is not an indication of skills or expertise
- Disciplinary information, such as civil and criminal actions that resulted in conviction
- Whether the firm has filed for bankruptcy in the last 10 years

Custody of Funds and Securities by Adviser

Custody by investment advisers means holding client funds or securities, directly or indirectly, or having the authority to obtain possession of them

- Examples include an adviser having:
  - Full discretion over an account that's held with a separate broker-dealer
  - Check-writing privileges in a client's account

An adviser is not considered to have custody if it:

- Inadvertently held or obtained a client's securities or funds and returned them to the client *within three business days* OR
- Forwards third party checks *within three business days*

Custody of Funds and Securities by Adviser

According to NASAA's Custody of Client Funds or Securities by Investment Advisers Model Rule, if an investment adviser has custody of client funds or securities, it must:

1. Notify the Administrator in writing
2. Appoint a qualified custodian (e.g., bank or broker-dealer) to hold client funds and securities in a separate account
3. Notify clients of the name of the custodian and the manner in which assets are held
4. Ensure that clients receive quarterly statements (sent by the IA itself or the custodian)
   - If sent by the IA, it must arrange for an unannounced (surprise) annual audit by an independent CPA
   - CPA must report audit results to Administrator and provide Form ADV-E within 120 days of the completion of the audit

Minimum Financial Requirements

	Who determines requirement?	Minimum Requirement	When to report a deficiency
IAs	State Administrator where the IA's home office is located (no other state can impose a higher requirement)	▪ \$35,000 for custody ▪ \$10,000 for discretion only	Within one business day

If deficient, firms must also:

- Submit a statement of financial condition by the next business day
- Obtain a surety bond to make up the deficiency

IA Recordkeeping Requirements (USA)

Investment Advisers must:

- Maintain books, records, and correspondence as required by Administrator for:
  - **Five** years for IAs – appropriate office for first two years
- File with Administrator any advertising, sales literature, or other communication disseminated to existing or prospective clients (unless it deals with *exempt securities*)
- File with Administrator any required financial reports along with the *prompt filing* (within 30 days) of amendments for material changes
- Provide full and fair disclosure to clients (for IAs – the *Brochure Rule/Form ADV Part 2*)

Federal Covered Adviser records are also subject to inspection by the Administrator

Books and Records

The following must be maintained by an IA:

- All checkbooks and bank statements
- All written agreements with clients
- All ledgers and trial balances
- All written communications received as well as sent regarding recommendations, advice given, receipt or delivery of funds or securities, or execution of orders
- Copies of powers of attorney and the adviser's Code of Ethics
- Copies of any circular/advertisement sent to *two or more persons*
- Records regarding political contributions and advisory services provided to any government entity
- Written complaints

Application Question

What information is required to be included when an investment advisory contract is being renewed?

I. The investment advisory fee

II. A statement that no assignment of the contract will be made by the investment adviser without the consent of the client

III. A statement regarding the amount of prepaid fees that gets returned if contract is terminated

IV. The educational background of each IAR

Chapter 5 – Federal Regulations Governing Investment Advisers

1	2	3	4	5
DEFINTION OF FEDERAL COVERED IA	**EXEMPTIONS AND EXCLUSIONS**	**FEDERAL IA RULES**	**SOLICITORS**	**ADVERTISING**
Learn which investment advisers are regulated by the SEC.	Learn about SEC Release 1092 and which investment advisers are not required to register.	Learn about several SEC rules and regulations for investment advisers.	Learn about requirements and disclosures for investment advisers that use solicitors.	Learn about advertising rules for investment advisers.

Investment Adviser Registration

AUM of more than $110 million	• Federal Covered Adviser (FCA) – must register with the SEC
AUM between $100 and $110 million	• IA may choose to register with the SEC or state Administrator(s)
AUM between $25 and $100 million	• Mid-Sized Adviser – must register with state Administrator(s)
AUM of less than $25 million	• Small Adviser – must register with state Administrator(s)

If IA registers with SEC and its AUM falls below $90 million, it's required to withdraw its federal registration and register at the state level

FCA may be subject to Notice Filing in the state(s) in which it has an office

Federal Covered Advisers

Regardless of AUM, the following advisers are required to be registered with the SEC:

- Advisers to investment companies
- Advisers to business development companies
- Advisers that are not regulated by the state in which they have their principal office
- Pension consultants that provide advice to employee benefit plans that have assets of at least $200 million
- Internet advisers that provide advice through an interactive website based on client-provided information
- Advisers to private funds with assets of $150 million or more
- New advisers that believe they will be eligible for SEC registration within 120 days of registering
- Multi-state advisers that would otherwise be required to register in 15 or more states

Application Question

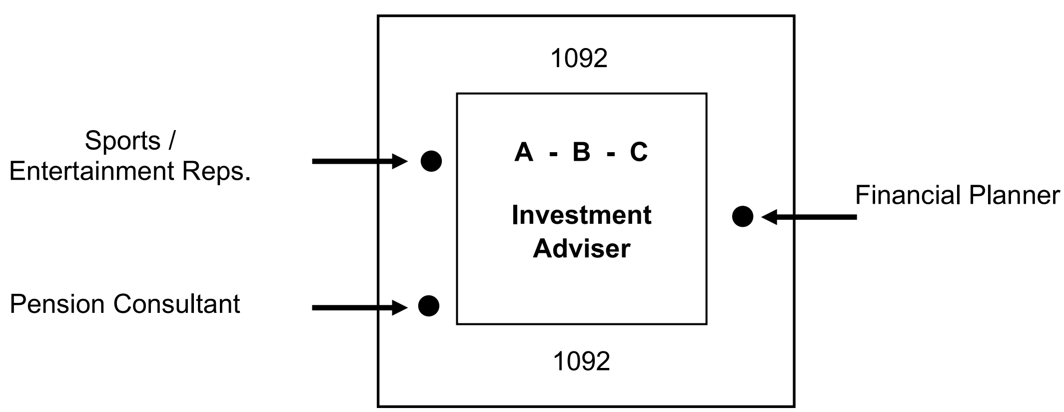
An IA advises several mutual funds and those funds have total combined assets under management of $55 million. With whom must the IA register?

a. Both SEC and State Administrator
b. SEC only
c. State Administrator only
d. Neither

SEC Release 1092

Developed by the SEC in conjunction with NASAA to determine the applicability of the definition of an IA

Expanded the definition of an IA to determine if it includes other professionals



Release 1092 – Expansion of the IA Definition

Advice, reports, or analyses regarding securities, includes:

- General information about advantages/ disadvantages of investing in securities
- Recommending asset allocation services
- Evaluating investment managers

Business Standard

- IA holds itself out as an investment adviser through advertising, written form, word of mouth, etc.
- Provides advice on other than rare occasions
- Provides recommendations regularly, which may include *investment supervisory service* (continuous advice tailored to specific client needs)

Compensation

- Any economic benefit for providing investment advice
- Fees, or fee / commission combination (wrap fees), rebates, soft dollars

Exclusions from the IA Definition

State (USA)	Federal (IA Act of 1940)
1. Banks, savings institutions, trust companies • **Not bank holding companies**	1. Banks or **bank holding companies** • **Not IA subsidiaries of banks or bank holding companies**
2. Professionals giving incidental advice (L,A,T,E)	2. Professionals giving incidental advice (L,A,T,E)
3. B/Ds and their agents	3. B/Ds and their RRs
4. Publishers of newspapers or periodicals (no timed or tailored advice)	4. Publishers of regular and general circulation publications (impersonal)
5. **Investment Adviser Representatives**	5. **U.S. Government Securities Advisers**
6. **Federal Covered Advisers**	6. **Credit rating agencies – NRSROs (e.g., S&P, Moody's)**
7. Any other person designated by Administrator	7. **Family offices that manage the wealth or affairs of a single family**
	8. Any other person designed by SEC

Exemptions from IA Registration

State (USA)	Federal (IA Act of 1940)
Adviser has no place of business in the state AND ▪ **Institutional Exemption:** Its only clients are specific institutional investors OR ▪ **De Minimis Exemption:** No more than 5 non-institutional clients in a 12-month period who are residents of the state	**Intrastate Advisers:** All clients are residents of the state in which the adviser's office is located and it doesn't provide advice on exchange-listed securities **Advisers to Insurance Companies:** All clients are insurance companies **Private Fund Advisers:** Provide advice to private funds (e.g., hedge funds) that have less than $150 million in AUM in the U.S. **Venture Capital Advisers:** Solely provide advice to one or more venture capital funds **Foreign Private Advisers:** Have no place of business in the U.S., have fewer than 15 U.S. clients in its private funds, and have less than $25 million in AUM attributable to the U.S. clients

Registration of IAs and IARs

For a state-registered IA and its IARs		For a federal covered IA and its IARs	
State registration is required:		State registration is required:	
Investment Adviser (IA)	If it has an office in the state OR more than 5 non-institutional clients in the state	**Investment Adviser (IA)**	NEVER
	If they have an office in the state OR more than 5 non-institutional clients		Only if they have an office in the state (not based on number of clients)

Continuing Education (CE) for IARs

IARs must:	▪ Complete 12 credits* of CE by the end of each calendar year • **6 credits of IAR Regulatory and Ethics** – 3 credits (50%) must specifically cover ethics • **6 credits of Products and Practices** – IARs that are dually registered as IARs and agents of a FINRA member firm who have completed their FINRA CE requirements are considered to be in compliance with the Products and Practices requirement ▪ The CE requirement is due at the end of the first reporting period after an IAR becomes registered

**One credit equates to 50 minutes of educational content from an approved provider*

Application Question

A federal covered adviser has offices in every state. One of its IARs splits his time between the NYC and NJ offices and has 10 non-institutional clients in CT and 8 in PA. Where must the IAR register?

a. With the SEC

b. In NY and NJ only

c. In NY, NJ, CT and PA

d. In all 50 states

Advisory Contracts

Under the Act of ‘40, investment advisory contracts:

- May be, but are not required to be, in writing
- May not contain exculpatory provisions (hedge clauses) or mandatory arbitration clauses
- May only be assigned to another adviser with client consent
  - For an IA established as a corporation, another entity acquiring a majority of the firm’s shares results in assignment
  - For an IA established as a partnership, a majority change in partners results in assignment (however, a minority change only requires client notification)
  - Change in IAR does NOT constitute assignment
- Performance-based fees are generally prohibited (however, certain exceptions apply)

Performance Fees

The IA Act of 1940 generally prohibits performance-based fees; however, several exceptions are available including:

Fulcrum Fees—a contract with a registered investment company or a client with more than $1.1 million in assets

- Involves averaging the adviser's fee over a specified period and increasing or decreasing the fee proportionately with the investment performance of the company or fund in relation to the investment record of an appropriate index

Arrangements with:

- Non-U.S. clients
- Qualified clients—those with at least $1.1 million in AUM after entering into the contract or net worth of more than $2.2 million
- Qualified purchasers—those with not less than $5 million invested
- Registered investment companies
- Business development companies
- 3(c)(1) private investment companies with no more than 100 shareholders (e.g., hedge funds)

Wrap Fee Programs

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

- Rather than the regular brochure, SEC requires delivery of a special wrap account disclosure brochure which details:
    - The amount of the wrap fee and services provided
    - How portfolio managers are chosen
    - That the adviser may have an incentive to recommend the program over other services
    - That costs may be higher than paying for services separately
- Suitability considerations:
    - Are the services appropriate given client's needs?
    - Are the fees reasonable given the client's trading history?
        - Generally, wrap accounts are not suitable for clients who trade infrequently (Buy and Hold)

> If a wrap account is sponsored by a B/D, the firm is required to register as an investment adviser

Trade Allocations

Advisers often bunch orders (aggregate client orders) to obtain volume discounts on execution costs with a broker-dealer

- Shares received must be allocated non-preferentially

Advisers must treat all clients fairly and equitably

- Adviser is responsible for adopting a program or formula for allocating securities among different clients (e.g., randomly or average price)
- Favoring one client or group of clients is prohibited

The SEC's concern is that retail money managers will "cherry-pick" — give preferential treatment on trades to clients who pay higher fees to use pooled investments, which leads to unfair distribution of trade proceeds.

Solicitors

A person who directly or indirectly solicits any client for, or refers any client to, an IA

- If solicitor is affiliated, such as a partner, officer, director, or employee of the adviser, the relationship must be disclosed
- For third-party (non-affiliated) solicitors (e.g., CPAs, attorneys) to receive a cash referral fee from an adviser:
  - The adviser must be registered
  - A written contract must exist between solicitor and adviser describing the solicitor's activities and compensation
- The IA Act of 1940 doesn't require solicitors to register; however, state registration may be required

Solicitors

Non-affiliated solicitors must provide the following to clients:

- Adviser's brochure
- Separate solicitor's written disclosure statement, which discloses:
  - Whether the solicitor will be compensated by adviser
  - Any amount added to the advisory fee which is attributable to the solicitor arrangement

The adviser must receive signed acknowledgement from clients that both documents have been received

IA Advertising and Recordkeeping Rules

Definition:

- Both the USA and IA Act of 1940 define advertising as any notice, circular, letter, or other written communication that's addressed to *more than one person*

Recordkeeping:

- Both the USA and IA Act of 1940 require an adviser to maintain a record of any advertisement that's sent to *more than one person*

Recipient Names and Addresses:

- Under both the USA and IA Act of 1940, an adviser is NOT required to maintain the names and addresses of the recipients if it's sent to *more than 10 persons*
  - *In other words, the names and addresses of recipients must be maintained if it's sent to 10 or fewer persons*

Standards for Adviser Advertising

An adviser's advertising may not:

- Refer to past recommendations unless the advertisement lists all of the recommendations made by the adviser in the last year
- Refer to any service as free unless it's free of cost and obligation
- Use the abbreviation RIA or IAR

An adviser's advertising may refer to a testimonial if it's not misleading

> Performance advertising is prohibited if it fails to disclose market/economic conditions or the possibility of loss

IA Recordkeeping Requirements (SEC)

IAs are required to maintain books and records for:

- Five years
  - In the principal office for the first two years and an easily accessible place for the balance of the five years

If registration withdrawn, records are kept an additional three years

Records may be maintained:

- In physical form, microfilm, microfiche, or electronically
- For electronic storage, disks must be WORM (write once-read many) and tamper-evident

Access must be limited to authorized personnel, SEC, and examiners

Activity

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

FOR AN IA, THE TERM "ADVERTISEMENT" IS DEFINED AS COMMUNICATION THAT'S DIRECTED TO MORE THAN ONE PERSON	
ADVISERS REGISTERED WITH THE STATE MUST KEEP A RECORD OF ADVERTISEMENTS SENT TO TWO OR MORE PERSONS	
ADVISERS REGISTERED WITH THE SEC MUST KEEP A RECORD OF ADVERTISEMENTS SENT TO TWO OR MORE PERSONS	
ADVISERS MUST KEEP RECORDS OF THE NAMES AND ADDRESSES OF CUSTOMERS WHO RECEIVE ADVERTISEMENTS IF IT'S SENT TO MORE THAN 10 PERSONS	

Chapter 6 – Investment Advisory Practices

Key Topics

1	2	3
FIDUCIARIES Learn about the definition of fiduciary and analyze a fiduciary's responsibilities.	**UPIA** Learn about the Uniform Prudent Investor Act (UPIA).	**SOFT DOLLAR ARRANGEMENTS** Learn about soft dollars and required disclosures to advisory clients.

Investment Adviser's Fiduciary Duty

Broker-dealers have a duty to provide suitable recommendations to their clients

Investment advisers have a fiduciary duty to act in the best interest of their clients, which includes:

- Having a reasonable and objective basis for the investment advice being provided
- Ensuring that investment advice is suitable based on the client's objectives, needs, and circumstances
- Obtaining the best execution for its clients' securities transactions when in a position to direct brokerage
- Disclosing potential conflicts of interest and material facts
- Consulting with other professionals when appropriate

Uniform Prudent Investor Act

Used by advisors as a guide when implementing financial plans; it's based on the Modern Portfolio Theory

Uniform Prudent Investor Act (UPIA)

Examines the trade off between risk and reward (management of risk, not complete avoidance)	Analyzes the portfolio as a whole, rather than focusing on individual securities
Recognizes the need for diversification within a portfolio	Places no categorical restrictions on investments (e.g., options and futures are not specifically prohibited)

Soft Dollar Arrangements

An IA may pay higher commissions for trade execution in return for "soft dollars" if used to acquire services that will benefit its advisory clients

Acceptable Use:	Unacceptable Use:
▪ Research Reports ▪ Analysis ▪ Market Data ▪ Seminars ▪ Software used to provide analysis	▪ Computer hardware ▪ Telephone lines ▪ Hiring personnel (salaries) ▪ Rent ▪ Travel, entertainment, or meals

Soft dollar arrangements must be disclosed in an adviser's Form ADV Part 2 or Brochure

Application Question

Which of the following actions/investments made by a fiduciary will MOST likely violate prudent investor standards?

a. Diversifying a portfolio

b. Investing 5% of a customer's assets into foreign stock

c. Investing 100% of a customer's portfolio into T-Bonds

d. Selling covered options in a customer's portfolio

Chapter 7 – Prohibited and Unethical Business Practices Under the USA

Key Topics

1	2	3	4	5
FRAUD VERSUS UNETHICAL	**PROHIBITED PRACTICES**	**ADVISORY CONFLICTS**	**PAY-TO-PLAY**	**ADVISORY TRADES**
Learn the legal definition of fraud and how it differs from unethical practices.	Learn about which actions and transactions are prohibited under the Uniform Securities Act.	Learn about investment adviser disclosures regarding conflicts of interest.	Learn about rules regarding investment advisers and their employees contributing to political elections.	Learn about agency crosses and adviser principal trades and required disclosures.

Fraudulent Versus Unethical Activity

Fraud typically has three parts:

1. Misrepresentation of a material fact
2. Reliance on the misrepresentation
3. Injury or harm occurring as a result of the misrepresentation

Note: Fraud is intentional

Unethical activities are prohibited by law or regulation

Fraud is almost always unethical (i.e., against the law), but not all unethical activities are fraudulent (e.g., accidentally breaking the law).

Fraudulent Versus Unethical

Intentionally misstating a company's net income to a potential investor is:
a. Fraudulent
b. Unethical
c. Both
d. Neither

Failing to annually update an IAR's Form U4 is:
a. Fraudulent
b. Unethical
c. Both
d. Neither

Prohibited and Unethical Practices

Prohibited activities include making false or misleading statements, as well as failing to provide adequate disclosure

- Claiming that securities are **approved** by a regulator
- Stating that a security is to be listed without justification
- Inducing the purchase of a security (stock or mutual fund shares) based on an impending dividend ("*selling dividends*")
- Referring to a mutual fund as "no load" if it has a 12b-1 fee *that exceeds .25% of average net fund assets* (can't have a front-end or back-end load)
- Failing to disclose sales charges when soliciting investment company shares
- Failing to disclose mutual fund breakpoints and letter of intent features

Prohibited and Unethical Practices

Soliciting orders for unregistered, non-exempt securities (acceptable if unsolicited and client acknowledges through a signed statement)

Churning or reverse churning

Exercising discretion without written authorization
- Without written authorization, B/Ds may only accept *not held* orders
- IAs may exercise oral discretion for 10 days

Borrowing from, or lending to, a client
- Allowed if the client or firm is in the business of lending cash or securities

Prohibited and Unethical Practices

- Omitting material facts
- Failing to deliver a final prospectus when selling a new issue
- Failing to disclose conflicts of interest
- Failing to maintain client confidentiality
- Syndicate members withholding sales of IPO shares
- Unnecessarily delaying payment or delivery of securities
- Splitting commissions with another agent
  - Permitted if both agents are registered with the same B/D (or related B/Ds) and registered in the B/D's state

Prohibited and Unethical Practices

- Commingling clients' and firm's securities (must be segregated)
  - B/Ds are not required to segregate client cash
  - IAs must segregate both client cash and securities
- Conversion (misappropriation) of client funds or securities
- Agents sharing in profits or losses in a client's account, unless:
  - Agent has written permission from both his B/D and client, and
  - Agent shares in direct proportion to his contribution
- Selling away
  - Executing trades that are not recorded on the B/D's books
- Painting the tape
- Frontrunning

Handling IA Conflicts – Disclose or Abstain

Advisers must <u>disclose</u> all potential conflicts of interest to clients, such as:

Adviser also acts as a B/D ▪ May include effecting ***agency cross transactions*** where it acts as a broker for its advisory client and the person on the other side of the trade	Adviser receives any compensation that's related to the securities it recommends to its clients	Adviser is paid to solicit for, or refer clients to, another adviser or B/D	Adviser receives rebates (cash or non-cash), fees, or soft dollar arrangements from B/Ds (e.g., access to B/D's research)

IA Pay-To-Play Rule

Practice in which an IA makes campaign contributions to elected officials of a state or municipal government in order to influence the awarding of contracts to manage public pension plan assets and other government investment accounts

Two-year time out:

- An IA is prohibited from receiving compensation for providing advice to a government entity **within two years** after the adviser makes a contribution to an official who is able to influence the awarding of advisory business for the entity

Agency Cross Transactions

To execute these types of transactions, the adviser:

- Is prohibited from recommending both sides of the trade – *one side must be unsolicited*
- Must obtain the client's written consent prior to effecting the first agency cross transaction (blanket consent)
- Must disclose the trade date and compensation earned for each trade
- Must disclose potential conflict of interest
- Must annually send a statement which identifies:
  - Total number of agency cross transactions executed in client's account
  - Total commissions received for these transactions

All client statements must include a disclosure that clients may revoke their permission at any time

Adviser Principal Transaction

Occurs when an adviser buys from or sells to a client a security into, or out of, its own inventory

- Written disclosure of potential conflicts must be provided
- Written, revocable consent must be obtained from the client authorizing potential principal trades
- Before each principal trade, written or oral disclosure must be made and client's consent obtained
- Confirmations must disclose the capacity in which the adviser acted
- A statement must be sent annually identifying:
  - Total number of principal transactions executed in client's account
  - Dates and prices of the transactions

Application Question

When can an agent of a broker-dealer and a client share in an account?

a. If the agent is related to the client
b. If the client has a net worth of $1 million
c. If the agent is also registered as an IAR
d. If the agent has proportionate risk in the account

Chapter 8 – Administration of the USA

Key Topics

1	2	3	4	5
OFFER AND SALE	**JURISDICTION**	**ADMINISTRATOR POWER**	**CIVIL LIABILITIES**	**CRIMINAL LIABILITIES**
Learn the legal definition of offer and sale.	Learn about the transactions that can be regulated by a specific state Administrator.	Learn about what an Administrator can do in order to enforce the Uniform Securities Act.	Learn about the civil liabilities and statute of limitations under the Uniform Securities Act.	Learn about the criminal liabilities and statute of limitations under the Uniform Securities Act.

Offer and Sale

The Administrator has jurisdiction over every offer or sale that's made or accepted in the Administrator's state

Offer	Sale
Any attempt to dispose of a security for value	Any agreement or contract to sell a security

The following include both an offer and sale:

- Any security given or delivered with, or as a bonus for, the purchase of a security or any other item (e.g., warrants attached to a bond purchase)
- A gift of assessable stock* (the USA requires disclosure of material facts about the stock)

  ** Stock which gives the issuer the right to demand additional capital from the holder*

A gift of non-assessable stock is neither an offer nor sale and is therefore not subject to the Act

Jurisdiction Over Offers

An offer is considered to be made in an Administrator's state if it:
- Originated in the state, or was
- Directed into and received in the state to which it was directed, or was
- Accepted or transacted in the state

Medium	Which state has jurisdiction?
U.S. Mail or Telephone	**Two states at most** ▪ The state from which an offer originates and the state to which it was directed and received (For mail, not the state to which it may be forwarded)
Television or Radio	**One state only** ▪ The state in which the camera or microphone is located
Newspaper or Magazine	**One state or no state** ▪ The state in which it's published, unless more than two-thirds of the circulation is outside the state

Actions Associated with Registration

<u>Powers of the Administrator</u>

The Administrator may, in the public interest:
- Deny, suspend, or revoke registration of a firm or employee
- Bar an employee from association with any registered firm
- Limit the activities of a registrant

But MAY NOT levy fines or impose prison sentences directly

<u>Justifications for the above actions include:</u>
- Providing false or misleading information on applications
- Conviction of any felony or a misdemeanor involving the securities industry
- Prohibition by any court from engaging in securities activities
- Willfully violating securities laws of any foreign jurisdiction within the past five years
- Insolvency
- Failure to pay the proper filing fee
- Lack of qualification on the basis of training, experience, **<u>and</u>** knowledge of the securities business

Enforcement of the USA

Inspectorial Power

When investigating violations, the Administrator has broad *inspectorial powers* and may:

- Require statements under oath from witnesses inside and outside of the state
- Subpoena records in any state
- Initiate criminal liability action

Cease and Desist Order

If violations have occurred (or may occur), the Administrator may issue a *cease and desist order*

- Orders may be appealed in state court within 60 days
- Appeals don't act as a stay of the order

If necessary, the Administrator may *ask a court* to issue an *injunction*

Application Question

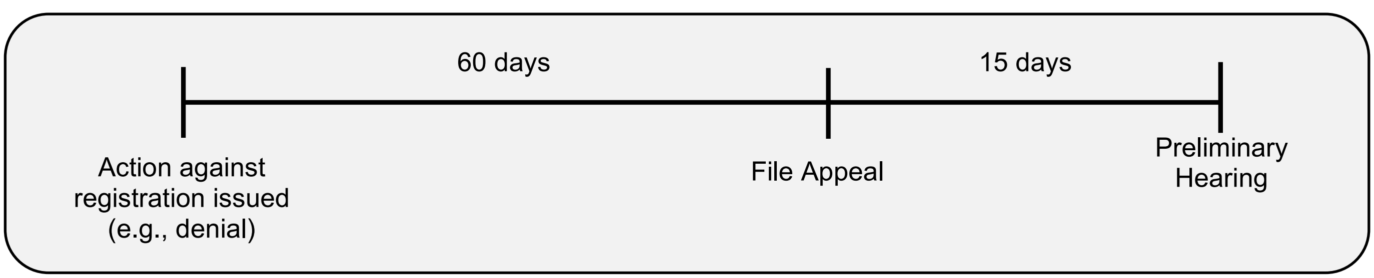
An Administrator can do which of the following if an agent violates the USA?

a. Enjoin the agent
b. Impose a prison sentence not exceeding three years
c. Assess a fine that doesn't exceed $5,000
d. Revoke the agent's registration

Actions Associated with Registration

If registration is *denied, suspended, or revoked* by the Administrator, the registrant must be notified in writing, provided written findings of fact, and given an opportunity for a hearing

- If requested, a hearing must be held within **15 days**



An Administrator may *cancel a registration* if an individual has died, been deemed mentally incompetent, or cannot be located after reasonable search

- A firm's registration will be canceled if it's gone out of business

Civil Liabilities

If securities are sold in violation of the USA, or if advice was fraudulent or unethical and the client suffered a loss as a result, the client has a "right of action" and may sue in civil court to recover:

The original consideration (i.e., purchase price) or any loss due to the advice

plus interest

plus court costs and reasonable attorney's fees

minus any income received from the security/advice

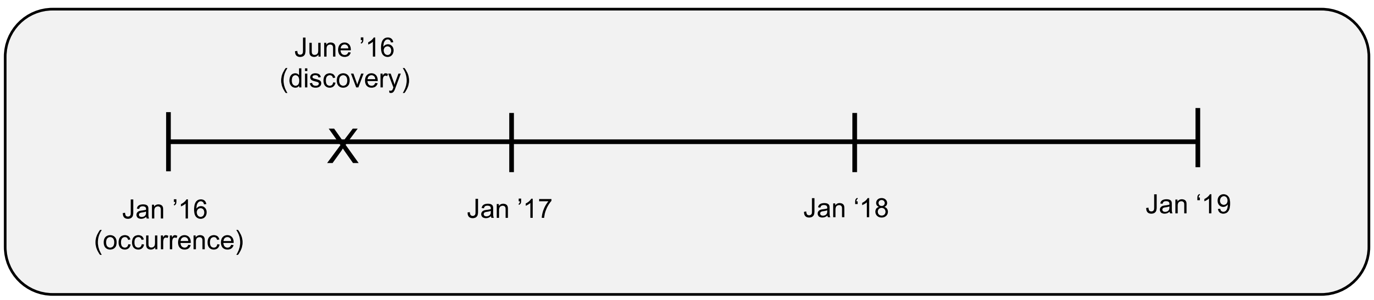
> A person who suffers damage or injury from the bad acts and even accidents of others can seek financial remedies in a civil court.

Civil Liabilities

Statute of Limitations

- **Three years** from the **occurrence** or **two years** from the **discovery**, whichever comes **first**

What's the latest date for this investor to file a civil suit?



Civil Liabilities

Letter of Rescission

- If an agent discovers a violation of the USA, a letter of rescission may be tendered, in which the agent offers to:

  Buy back the security

  plus interest

  minus any income received

> Rescission is defined as the unwinding of a transaction to bring the parties (as much as possible) to the position at which they were before entering into the contract.

- A customer has 30 days to respond; if she fails to respond, she waives her right to sue
- A customer who receives a letter of rescission after selling the security may still initiate civil action

Criminal Penalties

Any person who *willfully* violates any provision of the USA may be subject to criminal penalties

- Three years in prison, or $5,000 fine, or both
    - However, if an agent had no knowledge of the rule violated, he may avoid a prison sentence
- Five-year statute of limitations

For criminal issues, the key word is "fraudulent," which suggests that the violation was deliberate.

Activity

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

CIVIL LAWSUITS MUST BE FILED WITHIN FIVE YEARS	
CRIMINAL CHARGES MUST BE BROUGHT WITHIN THREE YEARS OF OCCURRENCE OR TWO YEARS OF DISCOVERY	
AN INDIVIDUAL HAS 60 DAYS TO APPEAL AN ACTION THAT'S TAKEN AGAINST HER REGISTRATION	
THE STATE HAS 15 DAYS AFTER AN APPEAL TO HOLD A PRELIMINARY HEARING	

Chapter 9 – Federal Securities Acts

Key Topics

1

SECURITIES ACT OF 1933

Learn about federal securities laws, including registration requirements and exemptions.

2

SECURITIES EXCHANGE ACT OF 1934

Learn about several investor and issuer filings under the Act of 1934.

3

INSIDER TRADING

Learn about trading practices and penalties under the federal insider trading rules.

4

INVESTMENT COMPANY ACT OF 1940

Learn about registration and reporting requirements for investment companies.

The Primary Market

- Needs capital
- Hires underwriter
- Public versus Private Issuance

IPO: Private company selling SEC-registered stock for the first time

Secondary: Public company selling more SEC-registered shares

Securities Act of 1933

Regulates the primary market and requires securities to be registered unless:

- Exempt from registration or
- Sold under an exemption

Exempt securities include:

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

All remain subject to the antifraud provisions of the Act

Securities Act of 1933 – Prospectus Rules

Broker-dealers that sell securities in the primary market must provide purchasers with a copy of the prospectus. In addition, investors who buy shares on the exchange (i.e., the after-market) must be provided with a copy of the prospectus for a specific period from the effective date.

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

Exempt Transactions

Rule 147 – Intrastate Exemption

- Most of the issuer's activities must be confined to one state and all investors must be state residents
- Securities are registered with state Administrator(s) using Qualification

Regulation D – Private Placement

- An offering to no more than 35 non-accredited investors, but an unlimited number of accredited investors, such as:
  - Institutions, officers or directors of the issuer, or
  - Individuals who have a net worth of $1 million <u>or</u> annual income of $200,000 in each of the last two years ($300,000 for spouses)
- Disclosure made through an Offering Memorandum

Penalties and Liabilities

1

Criminal penalties for violations of the '33 Act:

- A fine of up to $10,000 and/or
- Imprisonment for up to five years

2

Civil Liabilities under the '33 Act:

- The cost of the security

  plus interest

  minus any income received on the sale

3

Civil Statute of Limitations under the'33 Act:

- Three years from the occurrence or one year from the discovery; whichever comes first

Securities Exchange Act of 1934

Regulates trading in the secondary market

- Created the SEC
- Gives Self-Regulatory Organizations (SROs) rulemaking authority
- Establishes statutory disqualification for convictions within 10 years
- Requires issuers (reporting companies), exchanges, and B/Ds to register with the SEC
- Requires owners of more than 5% of a company's equity to file Schedule 13D
- Requires investment managers that exercise discretion over $100 million in securities to file Schedule 13F quarterly

SEC Reporting

Additional information about reporting corporations may be found in:

- Form 10K – Annual financial report filed with the SEC
- Form 10Q – Quarterly report filed with the SEC (three filings per year)
- Form 8K – filed to report events which may affect the corporation or its shareholders (e.g., bankruptcy or merger)
  - Filed within four business days of event

> Auditor's will issue an opinion when auditing financial statements
> 1. Unqualified – The most common
> 2. Qualified – All details are fair, with the exception of a specified issue
> 3. Adverse – The financials don't fairly represent the issuer's performance

Securities Exchange Act of 1934

Insider Defined and Requirements/Limitations

A company's officers and directors, and any owners of more than 10% of the company's equity securities

- Must register within 10 days (Form 3)
- Trades are reported within two business days (Form 4)
- May not keep *short-swing profits* (profits earned on stock held less than six months)
- No short selling

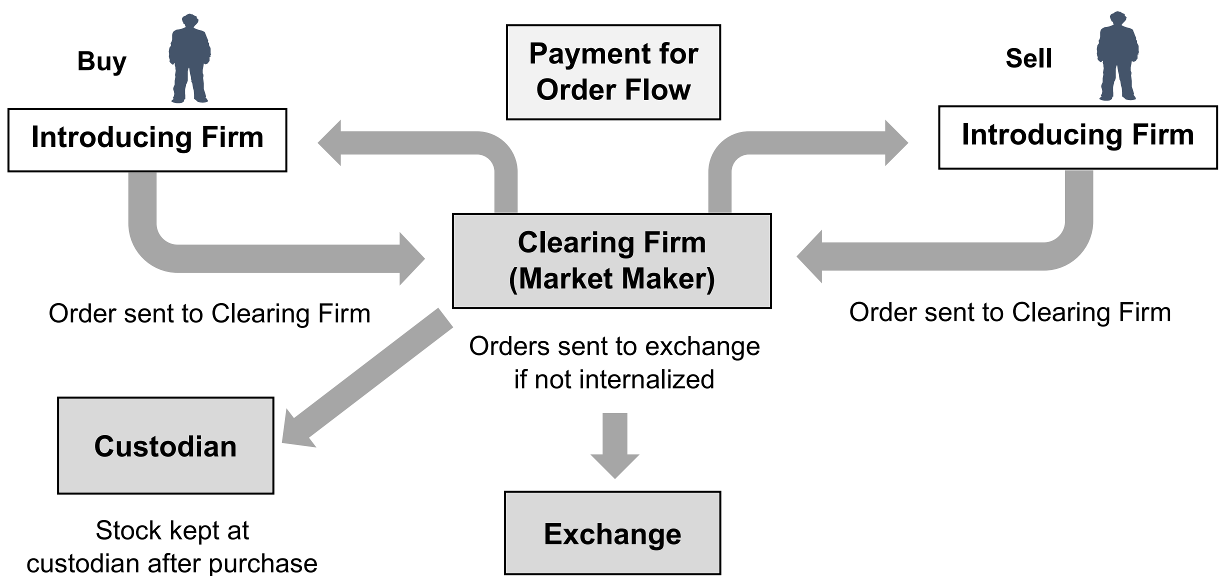
Insider Trading Act of 1988

Prohibits any person with material, non-public information from using it to make a profit or avoid a loss

Insider Trading Penalties

- Criminal: $5 million fine and/or 20 years imprisonment
- Civil: SEC may sue for three times the damage (treble damage)

Clearing and Settlement



Investment Company Act of 1940

Purpose

Created to reduce abuses in the sales of investment company securities

Types of Investment Companies

1. Face amount certificates
2. Unit investment trusts (UITs)
3. Management companies (open- and closed-end)

Rules and Regulations

- Company with more than 100 shareholders must register with the SEC
- Company must have a minimum net worth of $100,000 before offering shares publicly
- To change fund objectives, a majority vote of shares is required
- Certain communications related to investment company securities may be distributed prior to prospectus delivery, provided the full prospectus is offered (Omitting Prospectus Rule)

Application Question

For a new issue, when is a prospectus required to be delivered?

a. For primary market transactions
b. For secondary market transactions
c. For primary and potentially secondary market transactions
d. Never. Only the summary prospectus is required.

Chapter 10 – Investment Advisory Clients

Key Topics

1	2	3	4	5
TYPES OF CLIENTS	**ESTATES AND TRUSTS**	**KYC RULES AND CLIENT PROFILES**	**TAXATION**	**RETIREMENT AND OTHER ACCOUNTS**
Learn about the different types of business structures and tax treatments.	Learn about estates and trusts, as well as the taxation of both types of accounts.	Learn “Know Your Customer” rules and the process for developing financial profiles of clients.	Learn about tax issues including, income, gains and losses, Social Security, and gift taxes.	Learn about IRAs, qualified plans, and education savings accounts.

Types of Clients

Individual

Sole Proprietorship

- Has one owner who is entirely responsible for the business
- Offers flow-through tax treatment (single taxation), but unlimited personal liability

S Corporation

- A maximum of 100 shareholders
- Flow-through tax treatment (single taxation)
- Shareholders have limited liability

C Corporation

- Has an unlimited number of shareholders who have limited liability
- Earnings are subject to regular corporate taxation – Corporate FEIN
- Shareholders are subject to taxation on cash dividends (double taxation)
- Has continuity of life and may raise an unlimited amount of capital

Partnerships

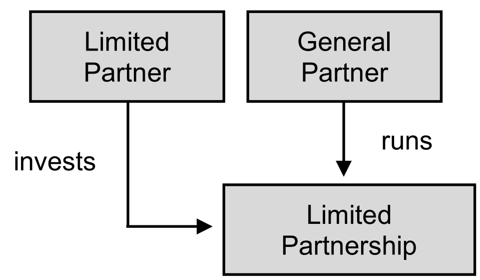
Partnership
A business structure that's created by at least two persons

General Partnership
Each partner may participate in the management of the business and has unlimited personal liability

Limited Partnership
Consists of at least one general partner and one limited partner
- General partner manages the business and has unlimited liability, while the limited partner is a passive investor with limited liability
- General partner must file a Certificate of Limited Partnership

Limited Partnerships

- Qualifies for flow through tax treatment (single taxation)
- An annual K-1 statement is sent to each partner in order to determine his share of passive income and passive losses
- Risk of partnerships:
  - Illiquidity
  - Capital, business, and regulatory risk
  - Potential of future capital calls and IRS audits
  - Potential of triggering the alternative minimum tax (AMT)



Types of Clients

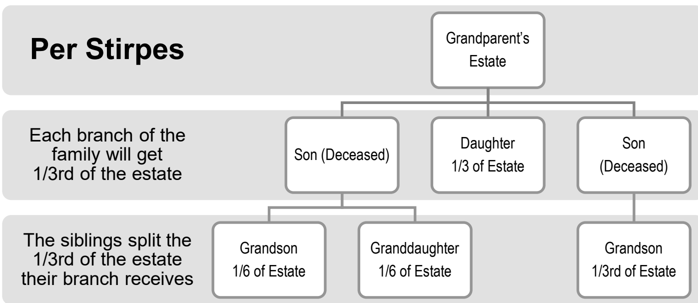
Limited Liability Company (LLC)

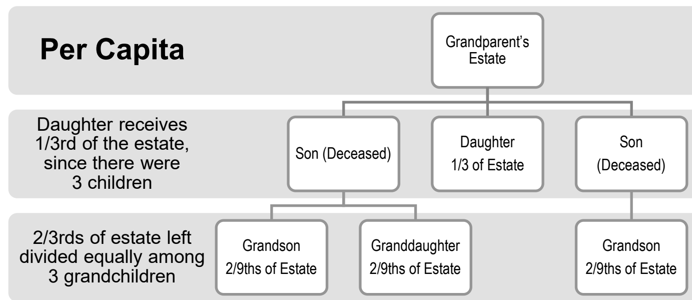
- Combines the flow-through treatment of a partnership with the limited liability of corporate shareholders
- Easier to set up and more flexibly structured than an S Corporation

LLC Advantages:
- Limited personal liability
- Pass-through taxation
- Flexible ownership structure
- Less formalities and paperwork

Estates

- The total assets and liabilities of a deceased person
- Decedent's will identifies the executor and the process of distribution to heirs
  - If no will exists, court appoints the intestate administrator
- Suitable investments tend to be short-term, safe, and liquid
  - Per Stirpes – divided among each branch of a family
  - Per Capita – divided equally among each family member of a generation



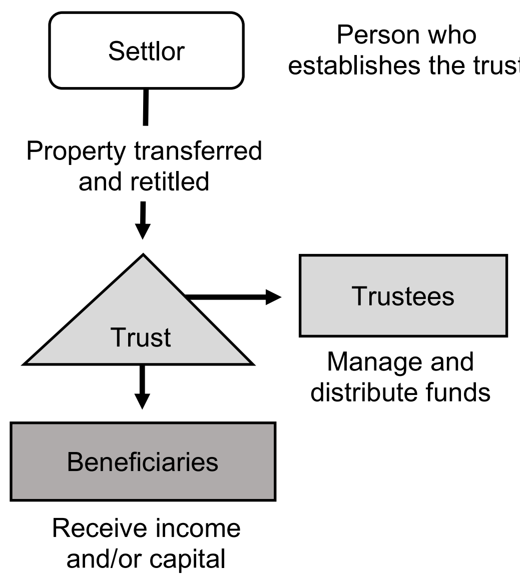


Trust Accounts

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

Creator = Grantor, Donor, Trustor, Settlor, or Maker

- All actions of the trustee must be to the benefit of the beneficiary
- Unless stated in the trust agreement, all beneficiaries are equal
- If conflicts arise, trustee must review the trust agreement for resolution
- Along with a management fee, trustees may charge for other services



Features for Trust Accounts

Distributions

1. Simple: All earnings must be distributed annually; no principal (corpus) distribution
2. Complex: May retain some earnings and distribute principal

Creation

1. Testamentary: Generally created at or after the grantor's death
2. Inter vivos: Created while the grantor is living

Estate Taxes

1. Revocable: Doesn't reduce estate taxes, but does avoid probate if funded prior to donor's death
2. Irrevocable: Reduces estate taxes and avoids probate; effective when established and usually cannot be changed

Know Your Customer

For broker-dealers and investment advisers, it's important to develop a *client profile* which includes the client's:

- Assets, liabilities, income, and tax rate
- Net worth, liquid net worth, and occupation
- Age and time horizon
- Investment experience and risk tolerance
- Social values and attitudes
- Goals and objectives such as:
  - Cash reserves
  - College funding or retirement
  - Preservation of capital or current income
  - Growth of capital or speculation
  - Liquidity or tax reduction
  - Protection in the event of death or disability

Personal Balance Sheet

Assets:	House		$500,000
	Automobiles		40,000
	Furniture / Jewelry		20,000
	Stocks and Bonds		200,000
	401(k) Plan		50,000
	Pension Plan		100,000
	Checking Account		2,000
	Savings Account		3,000
		Total Assets:	$915,000
Liabilities:	Home Mortgage		$350,000
	Car Loans		20,000
	Credit Cards		5,000
		Total Liabilities:	$375,000
Net Worth:			$540,000

Total Assets – Liabilities = Net Worth

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

Non-Financial Considerations

Fiduciaries must also consider non-financial factors when managing their clients' funds. Clients who show an aversion to certain industries (e.g., alcohol or tobacco) may want their advisers to avoid purchasing securities from those industries.

More recently, Environmental, Social, and Corporate Governance (ESG) Investing has increased the focus on corporations' long-term sustainability in addition to their profitability.

ENVIRONMENTAL	SOCIAL	GOVERNANCE
▪ Pollution ▪ Net Carbon Emissions ▪ Industrial Waste	▪ Diversity, Equity, and Inclusion (DEI) ▪ Human Rights ▪ Community Outreach	▪ Executive Compensation ▪ Board Diversity ▪ Shareholder Activism

Application Question

The balance sheet of an individual will contain:

a. Savings Account
b. Salary
c. Expenses
d. Monthly mortgage payment

Tax Fundamentals

Tax Rates:

- Marginal tax rate – the rate of tax paid on the last dollar earned
- Effective tax rate – the average rate of tax paid
  (total amount of taxes paid ÷ amount of taxable income)

Types of taxable income:

- Earned – income from employment (e.g., wages, salary, fees, tips, commissions, and self-employment)
- Unearned – income from sources other than employment
  (e.g., interest, dividends, withdrawals from retirement plans or annuities, and Social Security payments)
  - Neither alimony nor child support payments are taxable income

Federal Tax Rates		
	37%	$$$$$$$
	35%	$$$$$$
	32%	$$$$$
	24%	$$$$
	22%	$$$
	12%	$$
	10%	$

An IA should never assume a client has more income than what she discloses

Tax Fundamentals

Tax Rates:

Dividends are taxed at a maximum rate of **20%**

Short-Term Capital Gains – realized if an asset is held for one year or less prior to its sale and the proceeds exceed the basis

- Taxed at the same rates as the client's **ordinary income**

Long-Term Capital Gains – realized if an asset is held for more than one year prior to its sale and the proceeds exceed the basis

- Taxed at a maximum rate of **20%**

Capital Losses – realized if an asset is sold and its proceeds are less than its basis

- Capital losses are first used to offset capital gains without limit
- If losses remain, a maximum of $3,000 can be used to offset ordinary income

Tax Fundamentals

Alternative Minimum Tax (AMT)

A method of calculating tax liability to ensure wealthy taxpayers pay a specified minimum amount of taxes

- AMT may apply to certain municipal revenue bonds and activities related to limited partnerships

Gift Tax and Basis

Gift tax avoided on gifts of up to $10,000 per person, per year, but adjusted for inflation (currently $18,000)

Recipient's basis is the lesser of donor's basis or current market value

- If securities have appreciated, original cost is used and holding period begins when purchased by the donor
- If securities had depreciated, market value is used and holding period begins on the day after the date of the gift

Unified Estate and Gift Tax Credit

<table>
<tr>
<td>The current lifetime estate tax exclusion is $13.61 for an individual, or $27.22million for a married couple. The amount is adjusted for inflation every year.

An estate that's worth less than $13.61 million can use the lifetime credit and is exempt from paying estate tax
An estate that's worth more than $13.61 million can use the lifetime credit, but will pay taxes on the amount of the estate exceeding the credit
For example, an estate worth $14 million would be required to pay the estate tax rate on $80,000 (i.e., only the amount exceeding $13.61 million)
</td>
<td>Gifts throughout a taxpayer's life are also include in the Unified Estate and Gift Tax Credit

Gifts not exceeding the annual limit of $18,000 are reported to the IRS
Gifts exceeding the annual limit are only taxed if the donor's lifetime gifts exceed the lifetime credit of $13.61 million
For example, a gift of $19,000 in one year is reported on the taxpayer's return but is not likely taxable. However, a gift of $14 million in one year is both reported on the taxpayer's return and subject to the gift tax. In addition, when the taxpayer dies, any amount remaining in his estate is also taxable since he's exceeded the lifetime credit.
Gifts to spouses are exempt from the gift tax if a person dies without reaching his lifetime credit (i.e., the person's credit is portable to the spouse)
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Types of Brokerage Accounts

Client Accounts:

- Individual account
- Individual account with third-party authorization
- Joint account (JTWROS or JTIC)
- Custodial account (UGMA or UTMA)
- Transfer on Death (TOD) or Pay on Death (POD)

Trading Accounts:

- Cash account
- Margin account
- Discretionary account:
  - Firm must obtain written Power of Attorney (PoA)
    - For IAs, oral discretion is permitted for 10 days
    - For BDs, time and price discretion is permitted (Not Held orders)

Account Documents

Account Documents

Durable Power of Attorney

- Allows an individual to designate another person to act on her behalf even if she becomes disabled or incapacitated

Stock Power

- Power of attorney enabling a person other than the owner to transfer stock ownership to another party

Third Party Trading Authorization

- Required to permit a person (e.g., spouse, child, IA), other than an RR, to execute trades on behalf of the account owner

Certificate of Incumbency

- Issued by a court to appoint a guardian to act on behalf of an incompetent/minor

Social Security

U.S. government program for the disabled and elderly

U.S. taxpayers pay in to Social Security while they work and take benefits during retirement

- Withdrawals can start at age 62, with smaller payout.
- Benefits will be maximized once an individual reaches full retirement age, which is either 66 or 67

Spouses, and occasionally children, will receive benefits after a person dies

If a person is divorced and her marriage lasted 10 years, she's entitled to receive benefits when her ex-spouse dies, if:

- She (the beneficiary) is unmarried and 62 or older
- The death benefit is larger than the benefit the survivor is entitled to receive based on her work history

Employee Retirement Income Security Act

ERISA imposes high ethical standards on the following two categories of persons:

Parties In Interest	Fiduciary
Any persons that provide services to the plan ▪ Prohibited from selling or leasing property to the plan, loaning money to the plan, or using plan assets for their own benefit	Any persons that provide investment advice, exercise discretionary authority, or are responsible for the administration of the plan ▪ Must adhere to ERISA rules, including 404(b) and 404(c)

Employee Retirement Income Security Act

ERISA 404(b) – Indicia (Evidence) of Ownership

- Except as authorized by the Secretary (of Labor) by regulations, no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the U.S.
- Fiduciaries must:
  - Act solely in the best interests of plan participants
  - Act in a manner consistent with the Prudent Investor standard
  - Diversify the plan's investments (no specific prohibitions)
  - Follow the plan's Investment Policy Statement

ERISA 404(c) – Voluntary guidelines for plan sponsors

- Prudently select and monitor plan investment options
- Provide appropriate investment choices and information enabling participants to make educated decisions

Qualified versus Non-Qualified Plans

	Qualified	Non-Qualified
Does the plan meet ERISA standards?	Yes	No
Are contributions tax deductible?	Yes	No
How do earnings grow?	Tax-deferred	Tax-deferred
How are distributions taxed?	Entirely taxed as ordinary income	Only the earnings portion is taxed as ordinary income
Main types:	Pension plans, profit-sharing plans, and 401(k) plans	Payroll deduction plans and deferred compensation plans

Summary of Plans

Plan Type	Who's Eligible?	Tax Status of Contributions	Tax Status of Distributions
401(k)	For-profit employees	Pre-tax (deductible)	Entirely taxable ($0 cost basis)
403(b)	Non-profit employees	Pre-tax (deductible)	Entirely taxable ($0 cost basis)
457	State or local government employees	Pre-tax (deductible)	Entirely taxable ($0 cost basis)
Individual (Solo) 401(k)	Self-employed persons	Pre-tax (deductible)	Entirely taxable ($0 cost basis)

Roth 401(k) and Roth Solo 401(k) plans allow for non-deductible contributions as well as qualified withdrawals that are tax-free

Summary of IRA Accounts

Plan Type	Who May Contribute?	Tax Status of Contributions	Tax Status of Distributions
Traditional IRA	Any person with earned income	Pre- or post-tax depending on income level and status in a qualifying plan	▪ Earnings are taxable ▪ Pre-tax contributions are taxable ▪ Post-tax contributions are tax-free
Roth IRA	Any person with earned income up to certain limit	Post-tax (no deduction)	▪ Contributions are tax-free ▪ Earnings are tax-free if distribution is qualified

Traditional and Roth IRAs

For both Traditional and Roth IRAs:

- Early withdrawal penalty:
  - Before age 59 ½ and 10% of taxable amount
  - Exceptions: death, disability, qualified higher education expenses, up to $5,000 for expenses associated with the birth or adoption of a child, or qualified first-time homebuyer distributions ($10,000 lifetime limit)
- Rollovers and Transfers (no penalty – no withholding)
  - Rollover (e.g., when selling and buying a home, a person uses proceeds as down payment and then replaces them with proceeds from the sale)
    - 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

The SECURE Act and IRAs

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

Increase of Age for Required Minimum Distribution (RMD) ▪ A person's initial RMD must be taken by April 1 of the year following the year in which he turns the age of 73.	**Penalty-Free Withdrawals for Birth or Adoption** ▪ An individual may take a penalty-free withdrawal of up to $5,000 from an IRA or employer-sponsored retirement plan for expenses associated with the birth or adoption of a child.
Contributions to a Traditional IRA After the Age of 73 ▪ Provided an individual has earned income, he's able to contribute to a Traditional IRA regardless of his age.	**Section 529 College Savings Plans** ▪ An individual is now permitted to withdraw up to $10,000 on a tax-free basis (a qualified withdrawal) to repay a qualified student loan as well as expenses for certain apprenticeship programs. This is a lifetime limit.
Inherited IRAs (also referred to as Stretch IRAs) ▪ An individual who inherited an IRA on or after Jan. 1, 2020, must take distributions / withdraw all funds within 10 years. • Along with decedent's spouse, an exception is made for an eligible designated beneficiary, including a minor child (until age of majority is reached), a disabled or chronically ill person, or any beneficiary who's less than 10 years younger than the decedent	**401(k) Plans for Part-Time Employees** ▪ Employers that maintain 401(k) plans must have a dual eligibility requirement under which employees are eligible if they complete either: 1. A one-year of service requirement (with the existing 1,000-hour requirement) or 2. Three consecutive years during which the employees complete at least 500 hours of service

Education Savings Plans

Plan Type	Who May Contribute?	Tax Status of Contributions	Tax Status of Distributions
Coverdell ESA	Any person with income up to a certain limit	After-tax (no deduction)	Tax-free if used for education (*any level)*
Section 529 (state-sponsored)	Any person	After-tax (no deduction)	Tax-free if used for education (originally *post-secondary only)* *

* $10,000 may be withdrawn to pay for K-12 education costs and up $10,000 (lifetime) to repay a qualified student loan and/or expenses for certain apprenticeship programs.

Application Question

Which of the following is TRUE if a 62-year-old married woman is about to start taking Social Security payments?

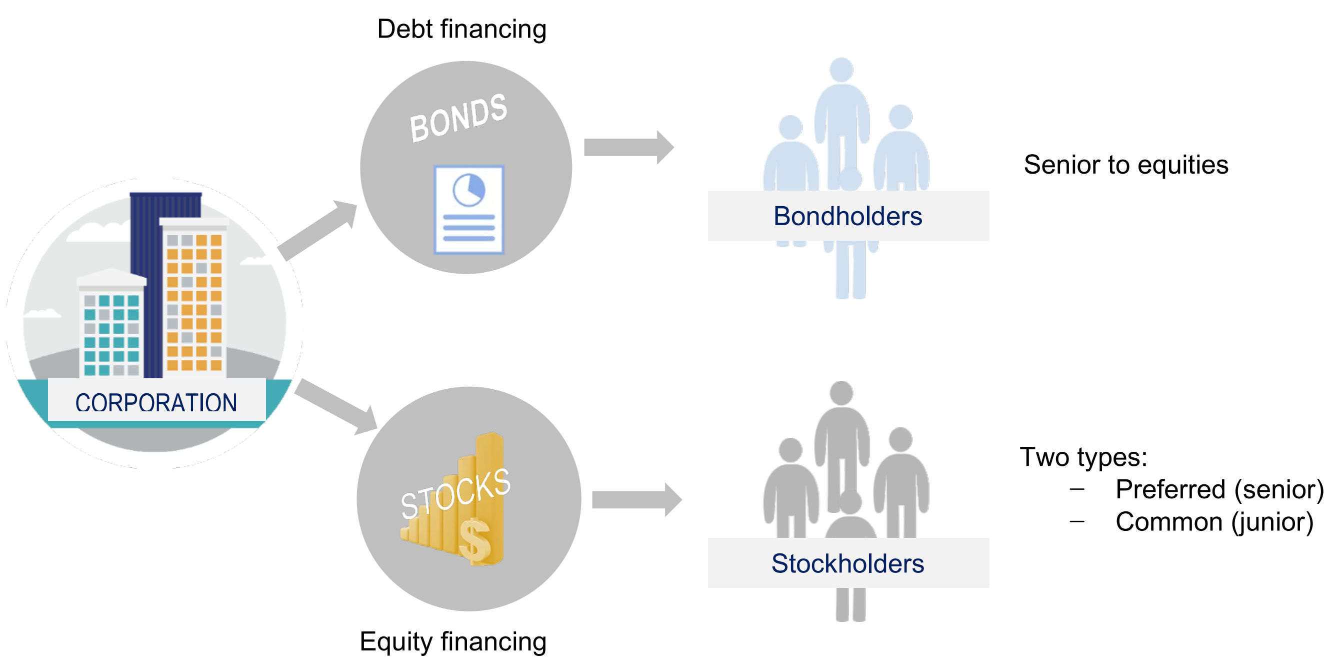
a. She locks in the payment that she will receive
b. She can take a spousal benefit which will grow until age 70
c. Her payment will decrease if she delays taking benefits
d. Since she starts taking benefits at age 62, she will not receive cost of living adjustments

Chapter 11 – Equities and Derivatives

Key Topics

1	2	3	4	5
EQUITIES	**ADRs**	**MARKETS**	**ORDERS**	**DERIVATIVES**
Learn about the characteristics of common and preferred stock.	Learn about how foreign companies issue stock in the U.S. with American Depositary Receipts.	Learn about the NYSE, Nasdaq and Over-the-Counter markets.	Learn about the characteristics of market, limit, and stop orders.	Learn about options, futures, and how investors can use derivatives to supplement their portfolios.

How Corporations Raise Money



Shares Repurchased by Corporation

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

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

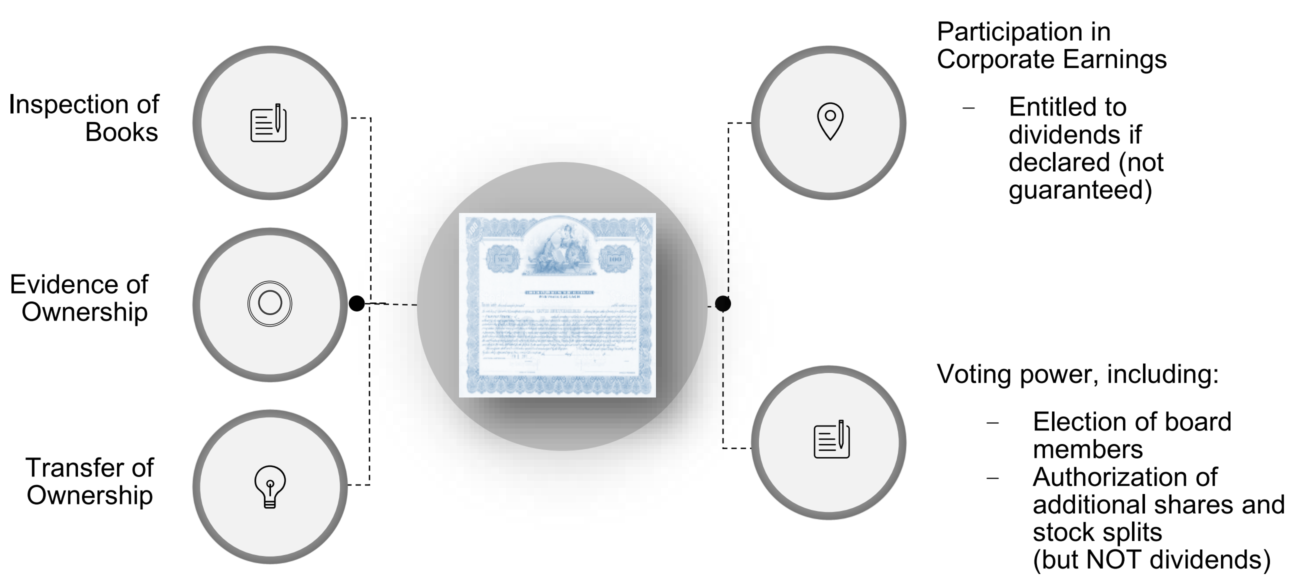
Treasury stock doesn't receive dividends and has no voting rights

Application Question

As it relates to corporate capitalization, which of the following statements is/are TRUE?

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

Common Stock Ownership Rights



Stock Splits

The Purpose of a Stock Split or Stock Dividend	▪ Company's attempt to improve marketability of its stock • No economic gain or loss for holders • No change to issuer's capitalization • No change to holder's percentage of equity ownership
The Two Types of Stock Splits	▪ Forward (e.g., 2:1 or 3:2) – more shares, lower price ▪ Reverse (e.g., 1:5) – fewer shares, higher price • For both types, dividends per share are adjusted proportionately
Forward Split	▪ Before: Investor owns 100 shares of XYZ at $180 per share. XYZ Company executes a 3:2 split. ▪ After: Investor owns 150 shares (100 x 3 ÷ 2 = 150) of XYZ at $120 per share ($180 x 2 ÷ 3 = $120) ▪ Investor's total investment ($18,000) is unchanged, but price per share is adjusted

Preferred Stock

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

Types of Preferred Stock

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

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

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

Participating
- Investor may receive additional dividends based on the company's profits

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

Activity

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

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

Preemptive Rights

Preemptive rights are:

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

Warrants

Attached to bonds or stocks; act as “sweeteners”

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

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

May be “detached” and traded separately

Rights	Issued to Shareholders	Short-term	Immediate discount
Warrants	Attached to a new issue	Long-term	Initial premium

Activity

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

PREEMPTIVE RIGHTS HAVE IMMEDIATE INTRINSIC VALUE	
WARRANTS MUST BE EXERCISED WITHIN A SHORT PERIOD FROM ISSUANCE	
IF AN ISSUER ATTACHES WARRANTS TO ITS BOND OFFERING, THE TWO CANNOT BE SEPARATED	
PREEMPTIVE RIGHTS PROVIDE EXISTING STOCKHOLDERS WITH THE ABILITY TO MAINTAIN THEIR PERCENTAGE OF OWNERSHIP	

American Depositary Receipts (ADRs)

Characteristics:

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

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

How Broker-Dealers Function

BROKER

Remember, A – B – C

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

DEALER

Remember, P – D – M

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

Secondary Markets

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

NYSE and other traditional centralized exchanges:

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

Dealer-to-Dealer Markets

NASDAQ	▪ Non-physical; phone and computer network ▪ Negotiated market ▪ Unlimited number of registered "market makers" ▪ Classified as a securities exchange
Non-Exchange Issues (OTC)	▪ Often low priced and thinly traded ▪ OTC Pink Markets – May be reporting companies
Market Makers	▪ Stand ready to buy or sell at least 100 shares at their quoted prices ▪ Subject to SRO rules
Dark Pools	▪ Provide liquidity for large institutional investors and high frequency traders ▪ Quotes are not disseminated to the public ▪ Limits impact on the market

Types of Orders

Market Order	• Customer wants to buy or sell • Customer specifies the security and size of the order only • Order is immediately executed at the best price available

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

Activity

Match each type of order with the appropriate description.

Market	A buy or sell order that may not be executed
Sell Limit	An order that will only be executed at a specific price or lower
Limit	A buy or sell order that will be immediately executed
Buy Limit	An order that will only be executed at a specific price or higher

Stop Orders

- May be used to limit a loss or protect a gain
- Does not guarantee a specific price when buying or selling

If Long Stock (Bullish)	▪ Hope • Stock rises in value ▪ Fear • Stock falls in value ▪ Need • Limit downside risk (enter sell stop order below the current market value)
If Short Stock (Bearish)	▪ Hope • Stock falls in value ▪ Fear • Stock rises in value ▪ Need • Limit upside risk (enter buy stop order above the current market value)

Stop and Stop Limit Orders

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

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

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

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

Sell Stop Order Example

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

The stock starts trading at lower prices

Afraid of a large loss, she enters an order: Sell 1,000 DEF at 30 stop

Today's transactions: 30.35 30.70 30.38 29.87 29.85

Trigger Price? Execution Price?

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

Buy Stop Order Example

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

The stock starts trading at higher prices

Afraid of a large loss, he enters an order: Buy 1,000 DEF at 30 stop

Today's transactions: 29.75 29.60 29.70 30.12 30.15

Trigger Price? Execution Price?

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

Activity

Read each statement and indicate to which order it applies.

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

Options

A contract between two parties

	BUYER'S RIGHT	SELLER'S OBLIGATION
CALL	To Buy (Bullish strategy)	To Sell (Bearish strategy)
PUT	To Sell (Bearish strategy)	To Buy (Bullish strategy)

The underlying interest may be:

- 100 shares of stock, an index, a debt security, a foreign currency

Risk Modification Techniques

Beyond speculation, the following represent other uses for options:

- An investor may use options as a hedging tool

If the investor is long stock and fears a decline in the market price, he should:	**BUY a put**	If the stock declines, the put option increases in value
If the investor is short stock and fears an increase in the market price, he should:	**BUY a call**	If the stock rises, the call option increases in value

- An investor may use options to generate income

If the investor is long stock and wants to generate additional income, she should:	**SELL a call**	If the stock remains reasonably stable and the option expires unexercised, the investor will realize income from the premium
If the investor is short stock and wants to generate additional income, she should:	**SELL a put**	

Option Concepts

Exercise Styles
- American – can be exercised at any time
- European – can only be exercised on the day of expiration

Covered versus Uncovered
- In a cash account, positions must be covered
- In a margin account, positions may be either covered or uncovered

Index Options
- Based on the value of an index rather than one particular stock
- When exercised cash equal to the intrinsic value is delivered, not the shares of the underlying index

Option Risks and Benefits

Risks:
- Capital, market, and liquidity risk
- Interest-rate risk (debt options)
- Currency risk (currency options)
- Business risk (equity options)
- Unlimited loss (uncovered calls)

Benefits:
- Less capital outlay and leveraging
- Limited loss (for buyers) and income generation (for sellers)
- Hedging a stock position
- Diversification
- Speculation

Straddles

Created by either:

- **Buying both** a call and a put on the same underlying security OR
- **Selling both** a call and a put on the same underlying security

Strategy

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

STRADDLE:

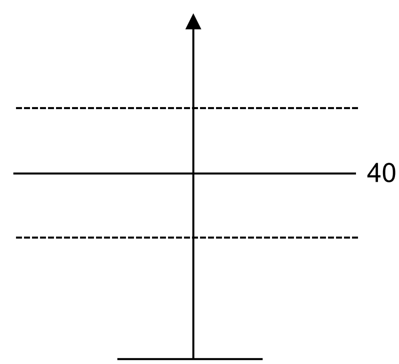
- Same expiration months and strike prices

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

Long Straddle – Analysis

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

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



Breakeven Points:

Strategy:

Maximum Gain:

Maximum Loss:

Futures and Forwards

A contract between a buyer and seller who agree to trade a specific commodity or asset at a later date (i.e., in the future)

- The underlying commodities include agricultural products, treasuries, stock indexes, currencies, crude oil, and metals

Futures	Forwards
A standardized quantity	A variable quantity (as agreed)
Exchange-traded with preset terms	OTC-traded with negotiable terms
Non-personal	Personal
May be offset	May not be offset

Application Question

An investor sold a corn futures contract at $5.16 per bushel. At the end of the contract, if the price of corn has fallen to $4.10 per bushel, which of the following statements is TRUE?

A. He makes delivery

B. He takes delivery

C. The contract expires worthless

D. He neither makes nor takes delivery

Digital Assets

Transactions in digital assets are typically recorded on a decentralized ledger using blockchains

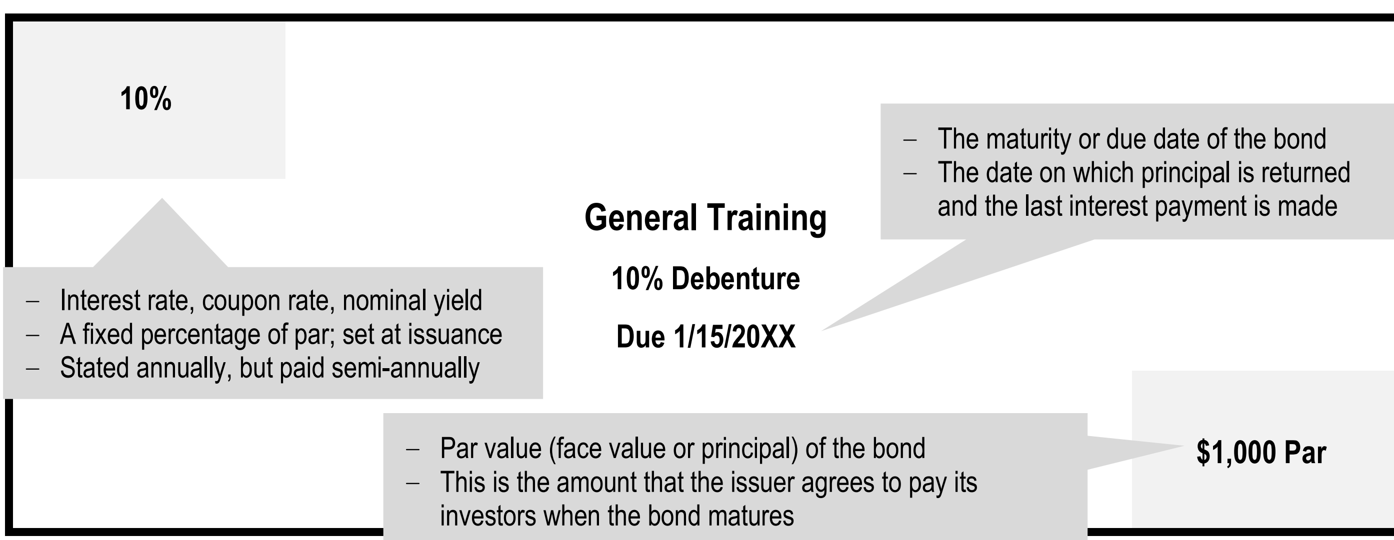
Cryptocurrencies	Non-Fungible Tokens (NFTs)	Stablecoins
▪ Currencies that exist only digitally ▪ Not regulated as securities ▪ Intended to be used as a system of payment, but largely used for speculation (e.g., Bitcoin and Ether)	▪ Unique digital tokens that represent ownership in another asset ▪ Can be used to track ownership in both real and digital assets ▪ Often trade on the same platforms as cryptocurrencies	▪ Cryptocurrencies whose values are pegged to other assets (e.g., $1 of price of gold) ▪ May be secured by physical assets (e.g., cash or gold) ▪ Used to facilitate trading other cryptocurrencies

Chapter 12 – Debt and Cash Equivalents

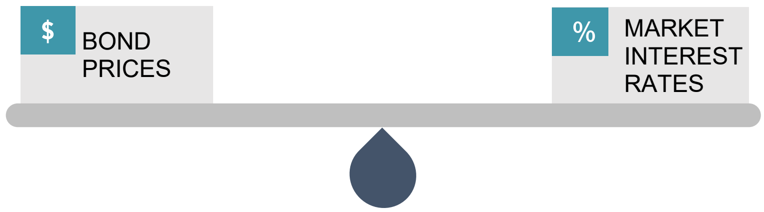
Key Topics

1	2	3	4	5
BONDS	**YIELDS**	**TYPES OF BONDS**	**MUNICIPAL BONDS**	**MONEY MARKET**
Learn about bond basics.	Learn about the different rates of return for bonds.	Learn about the different types of corporate and Treasury bonds.	Learn about the characteristics and tax treatment of municipal bonds.	Learn about short-term bonds and when they would be suitable.

Terminology



Interest-Rate Risk



INVERSE RELATIONSHIP

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

Measuring Interest-Rate Risk

Duration measures a bond's price sensitivity to *small changes* in interest rates and is stated in years (i.e., interest rate risk)

Bonds with longer durations will have more interest rate risk. A bond's duration roughly measures how much the bond will fall if interest rates rise and vice versa.

- Example: A bond with a *5-year duration* will *fall* approximately *5%*, for a *1% rise* in *interest rates*

Bonds that pay interest semi-annually will always have a duration less than their maturity

Zero-coupon bonds will always have a duration that's the same as their maturity

***Convexity* measures a bond's price sensitivity to large changes in interest rates**

Bond Yields

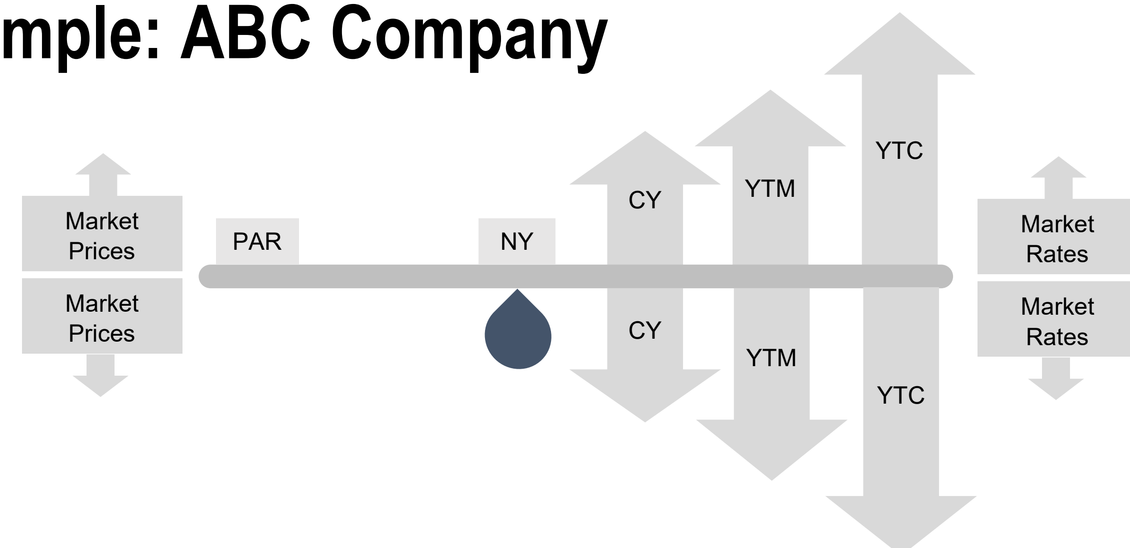
Yield is the return an investor gets on a bond

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

1.00% = 100 basis points

.01% = 1 basis point

Example: ABC Company



Application Question

A 4% coupon bond is selling at a yield-to-maturity of 4.20. If interest rates in the market decline below 4%, the bond's yield will:

A. Increase
B. Decrease
C. Increase or decrease depending on the maturity
D. Not change

Credit Risk

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

- Issuers that are considered high credit risks must pay a higher rate of interest in order to induce investors to purchase their bonds.
- Securities that are issued by the U.S. government have the lowest possible credit risk.
- Credit spreads are the difference between a corporate bond's yield and the yield on similar U.S. government bonds.

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

Credit Ratings

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

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

Convertible Bonds

Convertible bonds:

- Give investors the ability to convert the par value of their bond into a predetermined number of shares of the company's common stock
- Provide investors with safety of principal and potential stock growth
- Allow the issuer to pay a lower coupon rate

A convertible bond's conversion price is set at a premium at issuance and the bond's price is influenced by the underlying stock's price.

The number of shares the investor will receive at conversion

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

The price at which the bond can be converted

Conversion Parity

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

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

Conversion parity means equivalent market values

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

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

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

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

The three most prevalent types of these marketable issues are:

- T-Bills – short-term, zero-coupon bonds
- T-Notes – 2-10 year maturities
- T-Bonds – Greater than 10-year maturities

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

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

TIPS

How can Treasury investors protect themselves from inflation?

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

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

TIPS Example

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

Application Question

A client purchased a 4.0% TIPS with an original principal of $1,000. If the CPI increases by 2%, which TWO of the following statements are TRUE?

I. The client will receive a $40.80 annual coupon.
II. The client will receive a $20.40 annual coupon.
III. The client will receive par at maturity.
IV. The client will receive the adjusted principal at maturity.

Municipal Bonds and Their Issuers

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

Types of Municipal Bonds

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

Tax Considerations

Municipal bond interest:

- Interest received is *exempt from federal tax*; however, it **may be** subject to state and local tax if purchased from a state that's not the bondholder's resident state
- Interest paid on bonds issued by U.S. territories and possessions is *triple tax exempt*

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

Yield Calculations

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

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

$$\frac{4.55\%}{(100\% - 35\%)} = \frac{4.55\%}{65\%} = \mathbf{7.0\%}$$

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

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

7.0% x (100% – 35%) = 7.0% x 65% = **4.55%**

Money Market Instruments

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

Activity

Match each description to the appropriate item.

Banker's Acceptance	Treasury debt
Repo	Unsecured corporate debt
CD	Unsecured bank debt
Commercial Paper	Used for foreign trade
T-Bill	Involves two transactions

Chapter 13 – Mutual Funds and Insurance

Key Topics

1

MUTUAL FUNDS

Learn about mutual funds, closed-end funds, and ETFs.

2

ALTERNATIVE INVESTMENTS

Learn about hedge funds, limited partnerships, and REITs.

3

INSURANCE

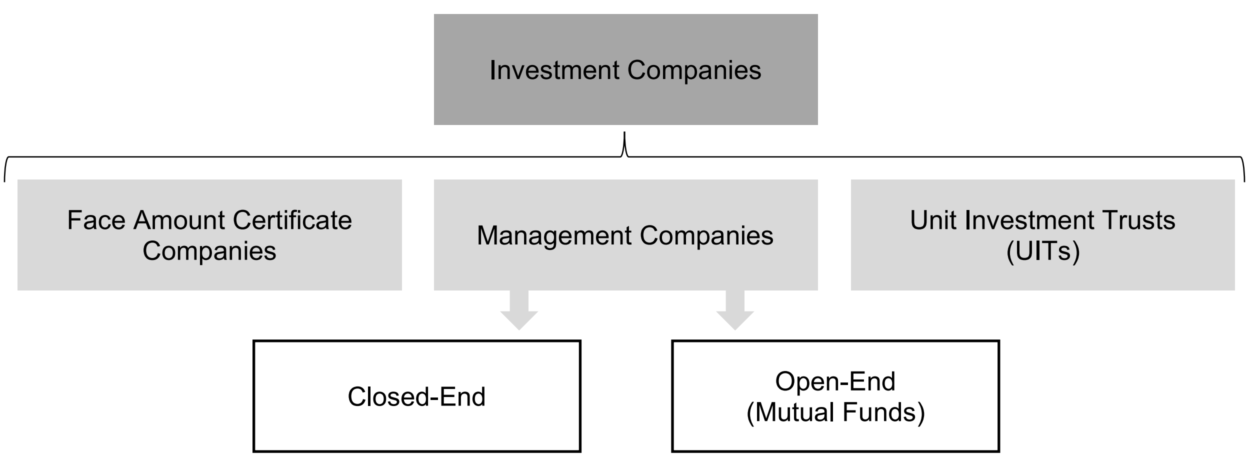
Learn about term, whole, universal, and variable life insurance policies.

4

ANNUITIES

Learn about fixed, variable, and equity indexed annuities.

Types of Investment Companies



Classes of Shares

	A	B	C
Sales Charges	Front-end load	Contingent deferred sales charge assessed if shares are held for less than 6 to 8 years	May have a front-end load, or a contingent deferred sales charge, or both
12b-1 Fees	Low or none	Higher than Class A shares	Higher than Class A shares; generally the same as Class B shares
Other Features	Breakpoints available for large purchases	Often convert to Class A shares after 6 to 8 years; no breakpoint available	No conversion to Class A shares

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 gain

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

Closed-End Compared to Open-End

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

Activity

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

A FRONT-END LOAD IS TYPICALLY ASSOCIATED WITH B SHARES	
C SHARES WILL TYPICALLY HAVE 12B-1 FEES	
MUTUAL FUND DISTRIBUTIONS ARE NOT TAXED IF THEY'RE REINVESTED	
CLOSED-END FUND SHARES CAN TRADE AT PREMIUMS OR DISCOUNTS TO THEIR NAV	

ETFs Compared to Index Funds

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

Inverse and Leveraged ETFs

Inverse ETF

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

Leveraged ETF

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

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

Exchange-Trade Notes (ETNs)

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

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

ETN Details:

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

Activity

Read each statement and determine which security it describes.

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

Alternative Packaged Products

Hedge Fund	Fund of Hedge Funds
▪ Investment fund generally for wealthy investors ▪ Offered under Reg. D exemption to accredited investors ▪ Not considered a registered investment company under the Act of '40 ▪ Uses exotic strategies involving derivatives, leverage, and selling short ▪ Investors are seeking over-sized performance that's often uncorrelated to stock market	▪ Fund which allocates money to hedge fund managers ▪ Generally suitable for wealthy investors ▪ May place restrictions on withdrawing money

Real Estate Investment Trust (REIT)

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

Types of REITs
1. Mortgage/Debt: issue secured loans that are backed by real estate purchases 2. Equity: own and operate income-producing real estate 3. Hybrid: combination of mortgage and equity REITs

Characteristics
▪ Subject to registration requirements of the Securities Act of 1933 ▪ Shares trade in the secondary market and are marginable ▪ Distributions aren't considered qualified dividends ▪ Attractive for investors seeking current income

Special Purpose Acquisition Companies (SPACs)

1.
SPAC conducts IPO; stock listed on an exchange

2.
SPAC manager searches for a target to purchase

3.
If target is found, SPAC manager negotiates an acquisition

4.
SPAC shareholders vote on proposed acquisition

5.
If approved by SPAC shareholders, the SPAC merges with the target through a de-SPAC transaction. The merged entity is then publicly traded.

5.
If NOT approved by SPAC shareholders, the SPAC is dissolved. Therefore, shareholders receive their money back plus interest.

Life Insurance Summary

	Term Life	Traditional Whole Life	Universal Life	Variable Life
Death Benefit	Preset fixed amount	Preset fixed amount	Preset fixed amount may or may not apply	Preset minimum amount
Cash Value	None	Guaranteed	Guaranteed minimum level	No guarantee
Loans Allowed	None	Against current cash value (up to 90%)	Against current cash value	Against current cash value (approx. 75%)
Premium Payments	Fixed amounts at fixed intervals	Fixed amounts at fixed intervals	Flexible in amount and timing	Fixed amounts at fixed intervals
Investment Account	None	General Account of insurance co.	General Account of insurance co.	Separate Account (objective-based)
Risk	Insurance company	Insurance company	Insurance company	Policyholder (considered a security)

Annuities

Insurance company contracts that guarantee either fixed or variable payments to annuitants at a future date

	Pay-In is Made:	And Pay-Out is:
Immediate:	Lump sum	Immediate
Deferred:	Lump sum or Periodic	Deferred until a future date

	Contribution is Made:	Earnings Grow:
Qualified:	Deductible	Tax-Deferred
Non-Qualified:	Non-deductible	Tax-Deferred

Non-Qualified Annuities

	Fixed	Variable
Is it a security?	No	Yes
Who assumes the investment risk?	Insurance Company	Annuitant
Account into which payments are directed:	General	Separate
Advantage:	Guaranteed stream of income	Good hedge against inflation (but no guarantee)
Disadvantage:	Poor hedge against inflation	Payout varies based on separate account performance

Equity-Indexed Annuities (EIA)

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

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

Participation Rate:

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

Cap Rate:

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

1035 Exchange

Provision in the tax code permitting direct transfer of the cash value in certain insurance products without incurring tax liability (since no check is issued to the client)

Which of the following exchanges are permissible?	
A non-qualified annuity for a non-qualified annuity	
A life insurance policy for a life insurance policy	
A life insurance policy for a non-qualified annuity	
An annuity product to a life insurance product	

Justifications for transfer:

- Circumstances or investment goals change
- Dissatisfied with insurance company

Activity

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

MONEY IS DEPOSITED INTO THE GENERAL ACCOUNT	
THE INVESTOR DETERMINES WHERE THE MONEY IS DEPOSITED	
THE INVESTOR'S RETURN VARIES BASED ON PREFORMANCE OF AN INDEX	
THE INSURANCE COMPANY ASSUMES THE INVESTMENT RISK	

Chapter 14 – Accounting and Economics

Key Topics

1	2	3	4	5
FINANCIAL STATEMENTS	**FINANCIAL METRICS**	**GROWTH vs. VALUE**	**ECONOMICS**	**FOREIGN EXCHANGE**
Learn about the balance sheet and income statement.	Learn about how the income statement and balance sheet are used to analyze companies.	Learn about the differences between growth and value investors.	Learn about basic economic concepts and theories.	Learn about how currency movements will impact the economy and stock prices.

Capital Structure and Reporting

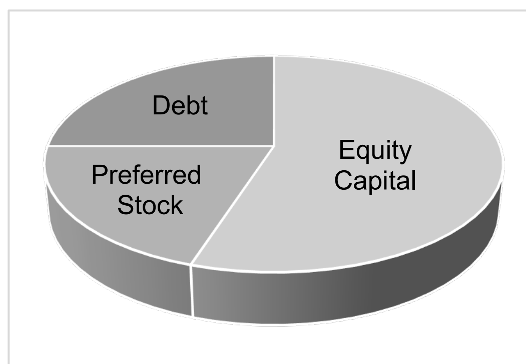
Corporations raise capital by issuing equity (stock) and/or debt (bonds)

A corporation's *market capitalization* is the value of all of its shares and is calculated by:

Market Price Per Share
x Number of Shares Outstanding

Note that shares outstanding represent:

Shares Issued – Treasury Stock



Corporate Balance Sheet

Current Assets	Current Liabilities
– Cash – Marketable Securities – Accounts Receivable – Inventory	– Accounts Payable – Dividends Payable – Interest Payable
Fixed Assets	Long-Term Liabilities
– Land – Buildings – Equipment	– Notes – Bonds
Intangibles	Shareholders' Equity
– Goodwill – Patents – Trademarks	– Preferred Stock and Common Stock – Retained Earnings – Paid-In Capital or Capital Surplus

Total Assets = Total Liabilities + Shareholders' Equity

Corporate Income Statement

Revenue (Sales)
- Cost of Goods Sold
Gross Profit
- Operating Expenses (SG&A, D&A)
Operating Income
± Other Income or Expenses
Earnings Before Interest and Taxes (EBIT)
- Interest
Taxable Income
- Taxes
Net Income or Loss

Activity

Which statements are TRUE regarding balance sheets and income statements?

I. The balance sheet equation is total assets = total liabilities + shareholders' equity.
II. Accounts receivable is considered a current liability.
III. Paid-in capital is part of shareholders' equity.
IV. In order to determine a company's earnings per share, its income statement must be examined.

Fundamental Analysis

Working Capital: Current Assets – Current Liabilities

Current Ratio: $\dfrac{\text{Current Assets}}{\text{Current Liabilities}}$

Quick Ratio: $\dfrac{\text{(Current Assets – Inventory)}}{\text{Current Liabilities}}$

Debt-Equity Ratio: $\dfrac{\text{Debt}}{\text{Equity}}$

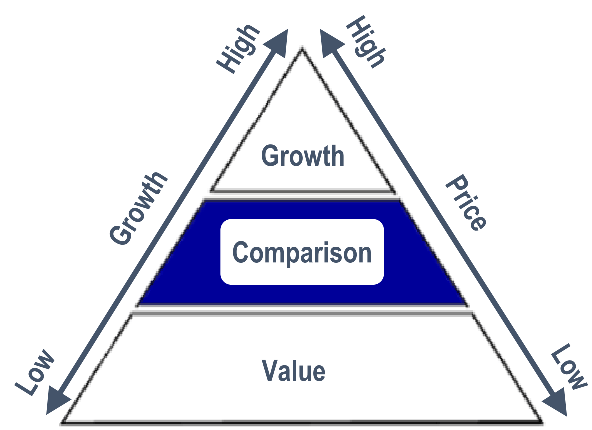
Earnings Per Share (EPS): $\dfrac{\text{Net Income – Preferred Dividend}}{\text{Common Shares Outstanding}}$

Price/Earnings (P/E) Ratio: $\dfrac{\text{Market Price}}{\text{Earnings Per Share}}$

Price / Book Ratio: $\dfrac{\text{Market Price}}{\text{Book Value Per Share}}$

Growth versus Value Stocks

	Value	Growth
General	Undervalued	Rapid growth
Price-Earnings (P/E) Ratio	Low	High (or no earnings)
Price-to-Book Value	Low	High
Typically pay dividends?	Yes	No
Possibly "out of favor" stocks?	Yes	No



Classifications of Stock

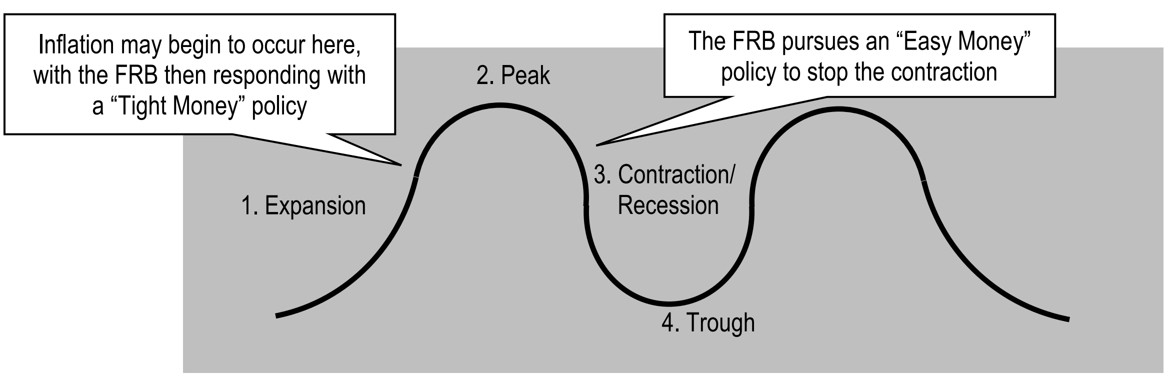
Defensive
Have smaller reactions to changes in the economy ▪ Examples include utility, tobacco, alcohol, cosmetic, pharmaceutical and food companies ▪ These tend to do better during contraction

Cyclical
Performance tends to run parallel to changes in the economy ▪ Includes machine tool companies, construction firms, transportation and automotive ▪ These tend to do well during the expansion phase of the business cycle ▪ Examples: Autos, airlines, housing, technology and luxuries

Economic Terms

Gross Domestic Product (GDP)	Measurement of the output of goods and services produced within the U.S. (disregards origin of producer) ▪ Key measure of aggregate economic activity
Consumer Price Index (CPI)	Measures the change in prices of goods purchased by a typical consumer ▪ Key measure of inflation
Inflation	"Too much money chasing too few goods" ▪ Leads to a rise in prices of goods and services ▪ High inflation usually accompanies high interest rates
Deflation	A general decline in prices, often caused by a reduction in the supply of money or credit ▪ Interest rates trend downward

The Business Cycle



Economic Indicators

Leading	Coincident	Lagging
▪ Building permits, private housing units ▪ Manufacturers' new orders, consumer goods, non-defense capital goods ▪ S & P 500 Index ▪ Initial claims for unemployment insurance ▪ Interest rate spreads, 10-year T-bonds less federal funds	▪ The Index of Industrial Production ▪ Employees on non-agricultural payrolls ▪ Personal income less transfer payments	▪ Change in the Consumer Price Index for services ▪ Average prime rate charged by banks ▪ Average duration of unemployment

Measuring Interest Rates

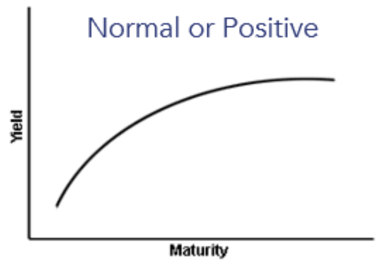
Prime Rate
- The rate charged by commercial banks to their best corporate clients

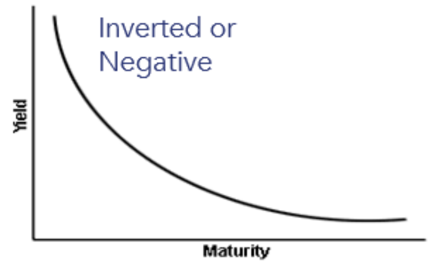
Discount Rate
- The rate charged by the FRB when a member bank borrows from it

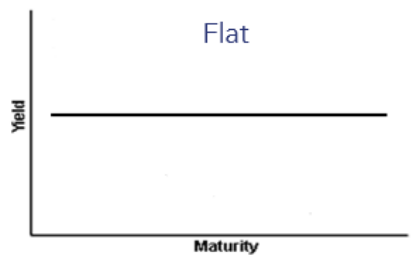
Federal Funds Rate
- The rate charged on an overnight loan of reserves between member banks

Call Money Rate
- The rate charged by commercial banks on collateralized loans to broker-dealers

Yield Curve







Monetary and Fiscal Policy

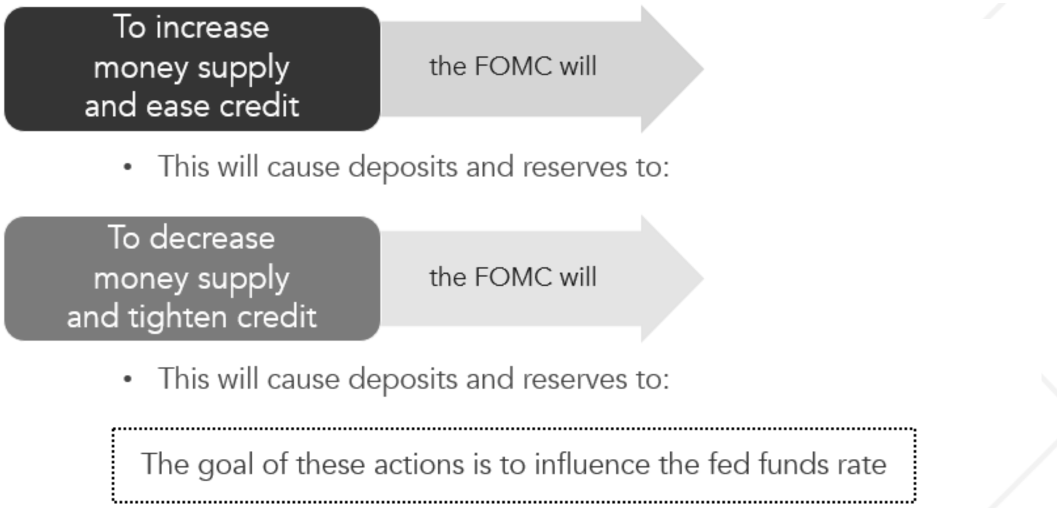
	Keynesian	Monetarist
Principally attempt to influence		
Type of policy		
Responsible for implementation		

Tools of the Fed

The following “tools” are listed from the least to the most used

Regulation T	Extension of credit by broker-dealers
Discount Rate	The only rate that’s directly controlled by the Fed
Reserve Requirement	Amount of money that a bank must maintain based on a percentage of deposits
Federal Open Market Committee (FOMC)	Trades U.S. Treasuries through “primary government dealers”

Actions of the FOMC



International Economic Factors

Interest Rates
- An inverse relationship exists between the U.S. dollar and foreign currencies
- Rising interest rates in U.S. will normally be accompanied by a strengthening of the dollar in relation to other currencies

Balance of Trade
- System of recording all of a country's economic transactions with the rest of the world over a specific period
  - Favorable balance of trade:
    - A decline in the dollar (relative to other currencies)
    - When the U.S. exports more than it imports
  - Unfavorable balance of trade
    - An increase in the dollar (relative to other currencies)
    - When the U.S. imports more than it exports

Foreign Exchange

Companies that receive revenue and incur costs in foreign currencies will have exchange-rate risk

Costs	Revenues
A U.S. company that manufactures overseas will have higher costs if the U.S. dollar falls (FC rises) and lower costs if the U.S. dollar rises (FC falls)	A U.S. company that has sales overseas will have higher revenue if the U.S. dollar falls (FC rises) and lower revenue if the U.S. dollar rises (FC falls)

Activity

Fill in the blanks with the correct answers.

1. The Federal Reserve Board changes and provides lending through the ___________________.
2. __________________ is the rate used by the Federal Reserve Board to control the extension of credit by broker-dealers.
3. The Federal Open Market Committee will increase the money supply when it _________________, which should ______________ deposits and reserves.
4. The _____________________ dictates the amount that member banks must keep on deposit.
5. _____________________ in the U.S. generally leads to a strong dollar.
6. The balance of trade tends to become more favorable with a _________ dollar relative to foreign currencies.

Chapter 15 – Portfolio Management and Investment Risk

Key Topics

1	2	3	4	5
MODERN PORTFOLIO THEORY Learn about expected return, standard deviation and correlation.	**ASSET ALLOCATION** Learn about the different approaches to creating investor portfolios.	**INVESTMENT STRATEGIES** Learn about the Efficient Market Hypothesis and passive and active investing.	**TIME VALUE OF MONEY** Learn about the Rule of 72, Internal Rate of Return, and both Present and Future Value of money.	**RISKS** Learn about investment risks and how they can impact an investment's returns.

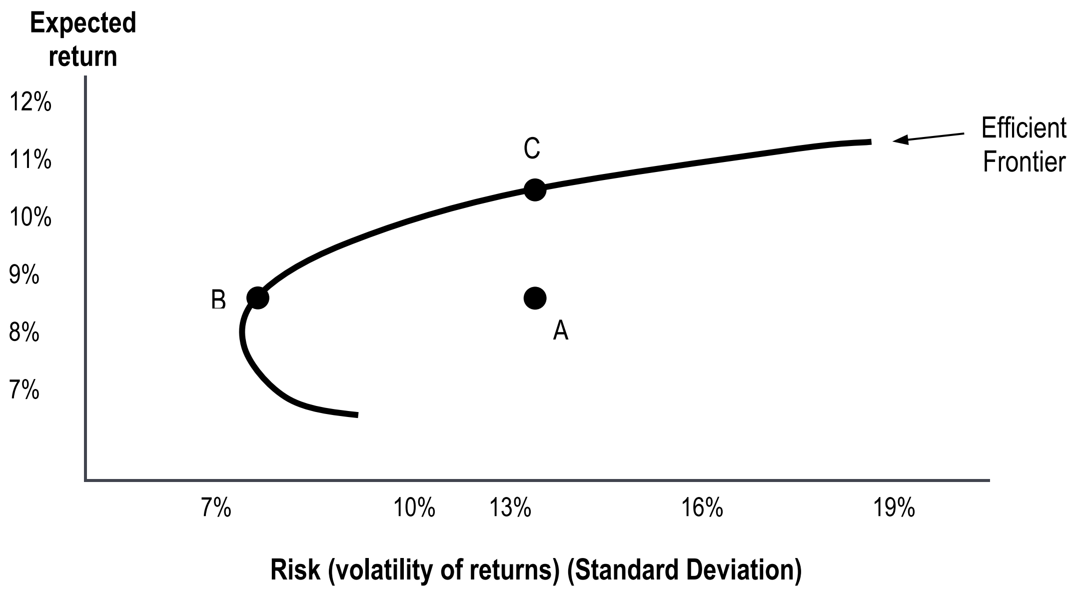
Modern Portfolio Theory

Assumes that investors are risk averse and want to take on the lowest possible risk to obtain a specific return

Expected return:	Standard deviation:	Correlation:
▪ Possible return of an asset weighted by the likelihood of the return (based on historical returns)	▪ Used as the measure of risk ▪ Views risk as the variability of actual returns from the expected return	▪ Measures the degree to which the movements of two investments are related and used to diversify investments • Positive correlation (+1): Investment returns move in the same direction • Uncorrelated (0): No pattern of correlation between two investments • Negative correlation (-1): Investment returns move in opposite directions

Constructing Optimal Portfolios

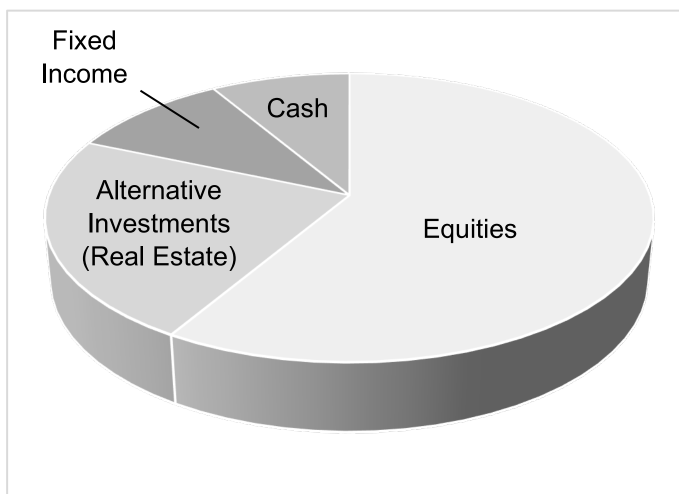
Using the basics of Modern Portfolio Theory, investors can describe the relationship between expected risk and expected return for a portfolio



Asset Classes

MPT was one of the first approaches to recommend diversifying a portfolio among different investments and asset classes

An optimal portfolio is one that produces the highest return (i.e., expected return) for the risk assumed (i.e., lowest standard deviation)



Capital Asset Pricing Model

CAPM is used to estimate the rate of an investment and is based on MPT

Rather than using standard deviation to measure risk, CAPM separates risk into two categories:

Systematic (Non-Diversifiable) Risk:

- Caused by factors that affect the prices of virtually all securities and cannot be avoided
- Examples: market risk, interest-rate risk, event risk, and inflation risk

Unsystematic (Diversifiable) Risk:

- The risk of owning securities in specific companies which may be reduced by owning uncorrelated securities
- Examples: business risk, regulatory risk, political risk, opportunity risk, and liquidity risk

Beta and Alpha

Beta	Alpha
▪ CAPM's measure of systematic (non-diversifiable) risk ▪ Compares the movement of a stock (or portfolio) to the S&P 500, which always has a beta of 1 • Stocks with a beta higher than 1 tend to gain more than the market when the market is up, but lose more than the market when it's down (e.g., industrials, home builders, airlines) • Stocks with a beta lower than 1 tend to gain less than the market when the market is up, but lose less than the market when it's down (e.g., utility companies, cosmetics, pharmaceuticals)	▪ The process by which CAPM measures unsystematic risk (diversifiable risk) ▪ Alpha is the excess return or, put another way, the difference between an asset's expected return (using CAPM) and its actual return ▪ Alpha is a return that's adjusted for the systematic risk of a stock (risk-adjusted return)

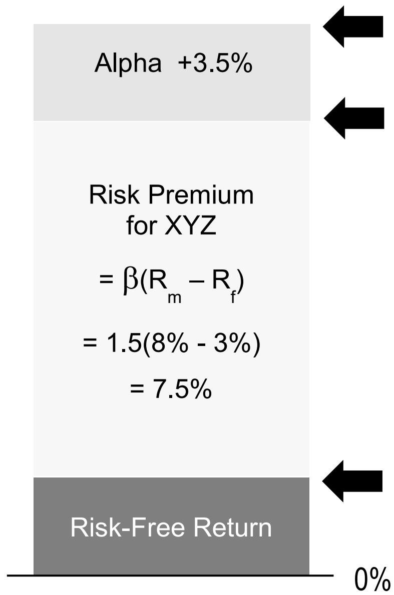
CAPM Example

XYZ Corporation has a β of 1.5 and the stock has an actual return of 14% this year. If the T-Bill yield is currently 3% and the S&P 500 earned 8%, what's XYZ's alpha?

Risk Premium for S&P 500

$= (R_m - R_f)$

$= (8\% - 3\%) = 5\%$



14% Actual rate of return

10.5% Expected rate of return

$R_i = R_f + \beta\,(R_m - R_f)$

$10.5\% = 3\% + 1.5(8\% - 3\%)$

3% T-Bill Rate of Return

CAPM Formula

$$R_i = R_f + \beta\,(R_m - R_f)$$

R_i is the expected rate of return on the stock or portfolio

R_f is the risk-free rate of return (e.g., yield on T-bill)

β (beta) is the measure of the stock or portfolio's systematic risk

R_m is the rate of return on the market (e.g. the S&P 500)

$(R_m - R_f)$ is considered the *risk premium* or the *excess market return*

Efficient Market Hypothesis

If markets are efficient, current prices will reflect all known information, making it impossible for a single investor to consistently and predictably beat the market

Weak-Form Efficiency	Semi-Strong Efficiency	Strong-Form Efficiency
Future stock prices cannot be predicted based on past trends. Fundamental analysis, but not technical analysis, could produce returns in excess of the market.	All publicly available information is reflected in a stock's price, making any form of analysis useless. The only advantage would be to have access to non-public information.	All public and non-public information is reflected in a stock's price; therefore, even insiders cannot achieve returns exceeding the market. Proper asset allocation is the only long-term approach.

Passive (Strategic) Asset Allocation

Assumes that markets are efficient; therefore, creating an optimal portfolio requires allocating assets based on a client's risk tolerance and investment objectives

Buy and Hold (do nothing)

- Minimizes transaction costs and tax consequences
- However, the asset mix of the portfolio may drift over time

Indexing

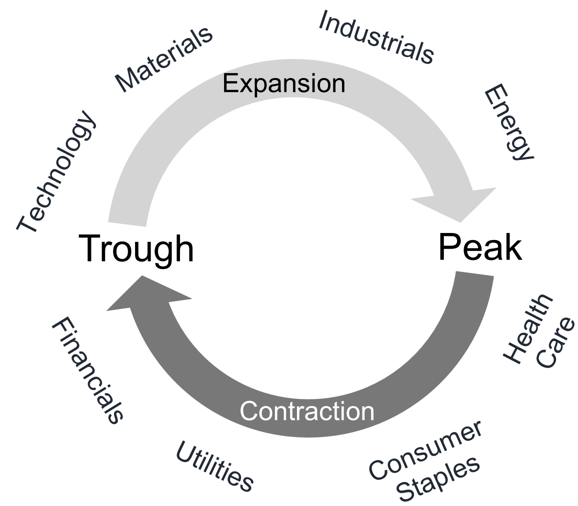
- Maintaining investments in companies that are part of major stock (or bond) indexes
- Infrequent rebalancing

Systematic Rebalancing

- Involves buying and selling assets on a periodic basis
- More frequent rebalancing keeps the portfolio closer to its strategic allocation
- May result in higher transaction costs and tax consequences

Active (Tactical) Asset Allocation

Assumes markets are inefficient; involves altering the asset mix in anticipation of changing economic conditions/events (*market timing*)



Sector Rotation

- Involves the moving money from one industry or sector to another in an attempt to beat the market
- A portfolio manager utilizing a sector rotation strategy will try to anticipate the next turn in the business cycle and shift assets into the sectors that will benefit

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

Financial Objectives and Investment Goals

- Cash reserve
- Preservation of capital
- Liquidity
- Current income
- Growth
- College funding
- Retirement funding
- Speculation
- Tax relief

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).

Systematic Risks

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

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

Activity

Match each term to the appropriate description.

Rising Interest Rates	Investment underperforms a rising market and outperforms a falling market
Falling Interest Rates	Investment outperforms a rising market and underperforms a falling market
Real Interest Rate	Bond prices are increasing
High Beta	Purchasing power is diminished
Low Beta	Factors in the rate of inflation when determining return

Unsystematic Risks

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

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

Additional Risks

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

Additional Risks

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

Activity

Read each statement and determine which type of risk it describes.

THE COST OF IMPORTING GOODS IS INCREASING	
MORTGAGE-BACKED SECURITIES ARE MATURING EARLY	
NEW LEADERSHIP ASSUMES CONTROL IN A FOREIGN COUNTRY	
CONGRESS HAS MADE CHANGES TO THE TAX CODE	

Dollar Cost Averaging

Involves making the same periodic investment regardless of share price over a fixed period of time

- Investors will purchase more shares when price is low and fewer shares when price is high
- Advantage:
  - Results in the average cost of shares being less than their average price

With **dollar cost averaging**, the good news is that:

- When share prices are up, the previously purchased shares are worth more
- When shares prices are down, the investor will be able to purchase more shares at a lower price

Present Value versus Future Value

Term	Present Value	Future Value
Example of the Concept	How much would need to be invested today to have a future value of $4,000 in three years assuming a 7% return?	How much will $10,000 invested today be worth in two years, assuming an 8% return compounded semi-annually?
Process to Calculate	Discounting is used to determine present value	Compounding increases an investment to future value
Formula (not calculated on test)	$P_0 = \dfrac{P_n}{(1 + r)^n}$	$P_n = P_0 (1 + r)^n$
Answer	$3,265	$11,700

The Present Value of a Perpetuity:
Payment in Perpetuity ÷ Discount Rate

Application Question

A grandmother wants to ensure that her three grandchildren will each receive $1,000 per month forever. Assuming an annual rate of return of 3%, how much must the grandmother invest today?

a. $33,333
b. $400,000
c. $1,200,000
d. $1,500,000

Rule of 72

The Rule of 72 can be used to find:

The number of years needed for an investment to double, if given a specific rate of return

- E.g., Jim wants to invest $20,000 in an annuity providing an 8% return for his daughter's education. How long before the investment grows to $40,000?

The average annual rate of return an investment must achieve in order to double, if given a specified number of years

- E.g., Morgan needs $30,000 in 16 years to pay for a trip she's planning. She currently has $15,000 to invest. What rate of return must she earn in order to meet her goal?

Time Value of Money Question

A client invested $1,000 10 years ago. Today, if the client's investment is worth $4,000, what's her rate of return?

Internal rate of return = ________

$1,000
Present value

10 years (compounding periods)

$4,000
Future value

In , the amount doubled times (or once every years)

Using the Rule of 72:

Discounted Cash Flow (DCF)

A method of valuing an asset (e.g., a bond) to determine its NPV by using the concepts of time value of money

The sum of all discounted cash flows are compared to the amount of the investment to determine its net present value (NPV)

- The present value (PV) of an investment minus its required purchase price is referred to as its net present value (NPV)

If NPV is greater than 0:	The investment's net return will be greater than the expected return
If NPV is equal to 0:	The investment's net return will be equal to the expected return
If NPV is less than 0:	The investment's net return will be less than the expected return

Discounted Cash Flow – Example

An investor is considering buying a three-year bond with a 4% nominal yield which will provide the following cash flow:

Year 1	Year 2	Year 3
$40	$40	$1,040

If the client insists on a 5% return, DCF analysis can be used to determine the purchase price that's required to achieve the desired return (as shown below):

Year 1	Year 2	Year 3	Sum of Cash Flows
$38.10	$36.28	$898.39	$972.77

- If bond is purchased for $1,000, return is 4% (NPV is less than 0).
- If bond is purchased for $972.77, return is 5% (NPV is equal to 0).
- If bond is purchased for less than $972.77, return is higher than 5% (NPV is greater than 0).

Application Question

An IA is evaluating an investment for a client. Current projections show that the net present value (NPV) is equal to zero and the client requires an internal rate of return of 6%. Based on this given information, what's the investment's internal rate of return (IRR)?

a. The IRR is greater than 6%
b. The IRR is less than 6%
c. The IRR is equal to 6%
d. The IRR is 0%

Measuring Performance

Range: The difference between the highest and lowest numbers in a group. For the returns listed below, the range is 11 (since 7% – (-4%) = 11)

Mode: The number that occurs the most frequently in a group. For the returns listed below, the mode is 5% because it appears twice and all of the other numbers appear only once.

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9
4%	5%	7%	-2%	-4%	2%	-1%	5%	6%

Median: The number that's in the middle of a group of numbers. It will have as many numbers above it as below it. For the returns listed above, the median is 4%.

-4%, -2%, -1%, 2%, 4%, 5%, 5%, 6%, 7%

Measuring Performance

Arithmetic Mean: Add up all of the rates of return and divide by the number of entries.

Using the following table:

Year 1	Year 2	Year 3
4%	5%	7%

Arithmetic Mean = (4+5+7) ÷ 3 = 5.33

Geometric Mean: Multiply all of the rates of return then, divide by the nth root of entries (e.g., for the returns listed above, take the cube root $\sqrt[3]{}$ of (4 x 5 x 7 = 140)

Although the geometric mean is not calculated on the exam, it's a better measure of an investor's return.

Time and Dollar Weighted Returns

Dollar Weighted Return

- Calculated in the same way as the Internal Rate of Return and the Yield-to-Maturity
- Takes into account additional deposits (i.e., investments) and withdrawals
- Useful for measuring a single investor's rate of return

Time Weighted Return

- The geometric mean of an investor's annual returns
- Takes into account the compounding effect
- Useful for comparing money managers (e.g., investment advisers that manage mutual funds)

Measuring Investment Return

Current Yield (for stock):

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

Current Yield (for bonds):

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

Dividend Payout Ratio:

$$\frac{\text{Dividend}}{\text{Earnings Per Share}}$$

Total Return or
Holding Period Return:

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

Measuring Investment Return

Real Return
(Inflation-adjusted):

Rate of Return – Inflation

Risk Adjusted Return:

Rate of Return – Risk-Free Return

Taxable Equivalent Yield:

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

After-Tax Yield:

Taxable Yield x (100% - Tax Bracket %)

Application Question:
Total Return and Annualized Return

An investor purchased a stock for $50 per share and one year later it has a market value of $55. A year after that, the stock's market value was $52 and the investor sold the shares. Each year, the stock paid a dividend of $2. What was the investor's total return? What was the investor's annualized return?

a. 6%

b. 12%

c. 8%

d. 14%