Securities Training Corporation

Series 66

Uniform Combined State Law Examination

Learning Guide / Workbook

v13

About the Series 66

1	2	3	4	5
100 Multiple-Choice Questions	Two Hours and 30 Minutes Allotted to Complete Exam	10 Additional Questions are Experimental (don't count for or against the score)	Minimum Required Passing Score is 73%	30-, 30-, 180-Day Waiting Period For Failures

Function	Chapter	Number of Questions
1. Economic Factors and Business Information	12	8
2. Investment Vehicle Characteristics	11 and 12	17
3. Client Investment Recommendations and Strategies	10 and 12	30
4. Laws, Regulations, and Guidelines, Including Prohibitions on Unethical Business Practices	1 through 9	45

STC®

STC Study Material

12 Chapter Study Manual

10 Final Examinations

- 110-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

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

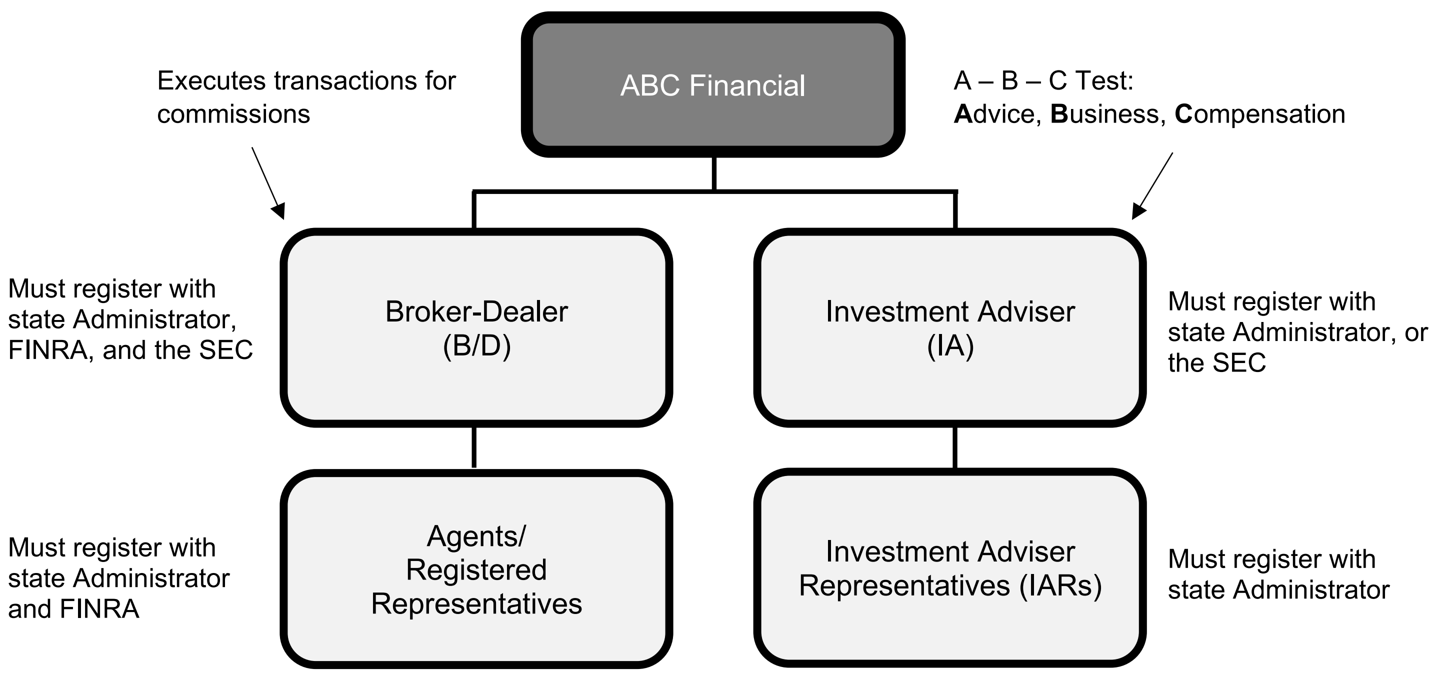
Person:

- 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.

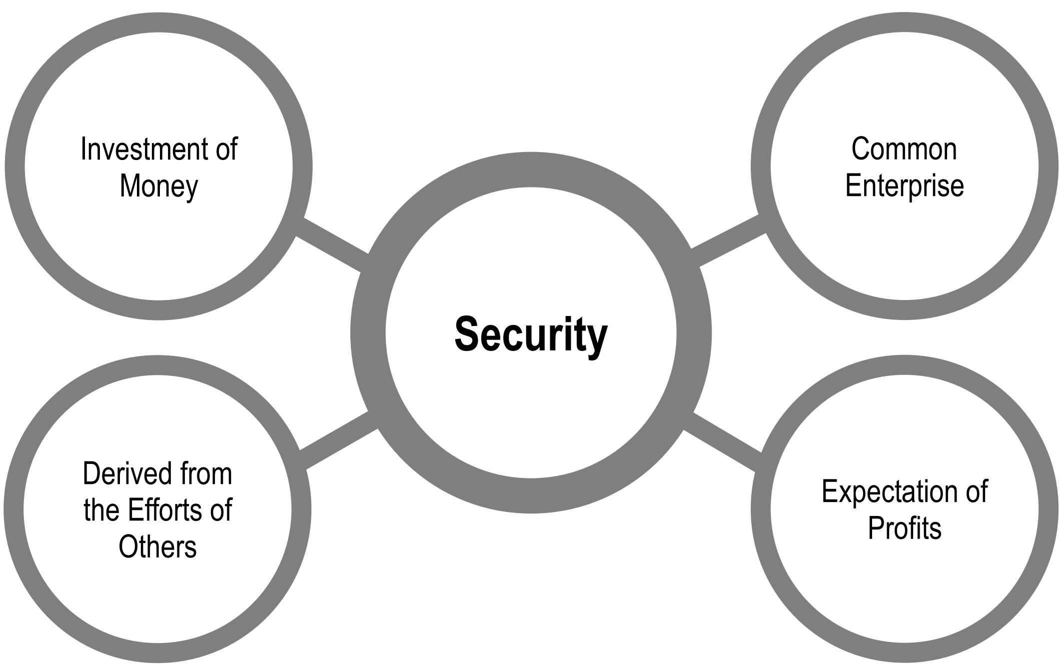
AN INVESTMENT ADVISER NEEDS TO REGISTER WITH FINRA	
AGENTS OF A BROKER-DEALER MUST GENERALLY REGISTER WITH THE STATE ADMINISTRATOR	
BROKER-DEALERS REGISTER WITH THE SEC AND THE STATE(S)	
INVESTMENT ADVISER REPRESENTATIVES MUST REGISTER WITH THE SEC	

Chapter 2 – State Registration of Securities

1	2	3	4	5
DEFINTION OF A SECURITY	**METHODS OF REGISTRATION**	**ACTIONS AGAINST REGISTRATION**	**EXEMPT SECURITIES**	**EXEMPT TRANSACTIONS**
Learn what's regulated as a security using the Howey Test.	Learn about how securities register with the states under the USA.	Learn what actions the Administrator can take to prevent fraud in the issuance of securities.	Learn about which securities are not required to register under the USA.	Learn about which transactions or issuances are not required to register under the USA.

Definition of a Security

As defined by the Howey Test, a security involves:



Is the Instrument/Investment a Security?

YES	NO
Stocks (including treasury stock)	Life insurance
Notes, bonds, and debentures	Endowment policies
Rights and warrants	Fixed annuities
Investment contracts	The four Cs: Commodities; Collectibles; Currencies; Condominiums as a place of business or residence
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	

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)

1. **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?

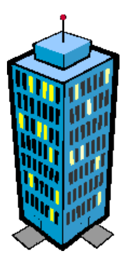
I. If a security is registered with the SEC, it doesn't need to be registered with the state(s).
II. A security that's exempt from federal registration may need to register under the Uniform Securities Act.
III. An exempt security is subject to the antifraud provisions of the Uniform Securities Act.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

Chapter 3 – State Regulations Governing B/Ds and Agents

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 USA.	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

Broker-Dealer (B/D)

Issuer

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 IAs and IARs

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 USA.	Learn about the disclosure document that investment advisers give to their clients.	Learn about records that investment advisers must keep under the USA.

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:

Exemptions:

Adviser with no place of business in a state and:

- All clients there are financial institutions, or
- Has no more than five 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 IAs

1

DEFINTION OF FEDERAL COVERED IA

Learn which investment advisers are regulated by the SEC.

2

EXEMPTIONS AND EXCLUSIONS

Learn about SEC Release 1092 and which investment advisers are not required to register.

3

FEDERAL IA RULES

Learn about several SEC rules and regulations for investment advisers.

4

SOLICITORS

Learn about requirements and disclosures for investment advisers that use solicitors.

5

ADVERTISING

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

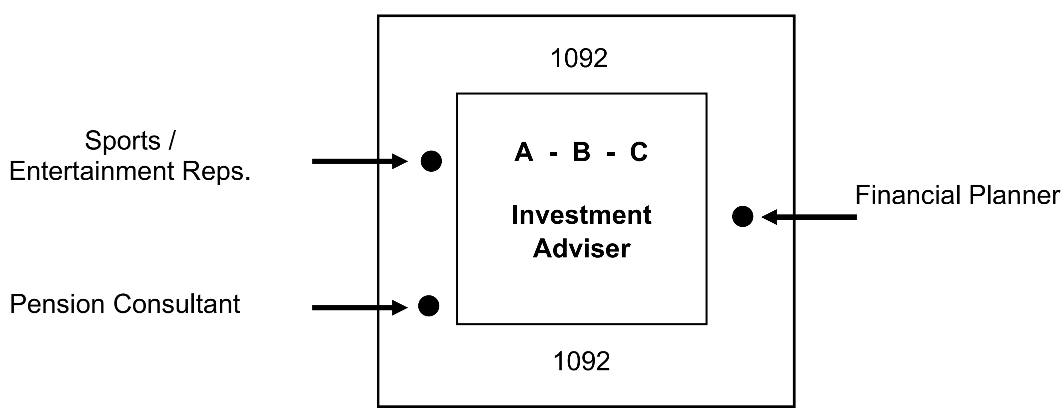
An IA advises several mutual funds and those funds have total combined assets under management of $55 million. With whom must the IA register?

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 <u>10 or fewer persons</u>*

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

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

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 USA.	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

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

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 <u>neither</u> 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

Powers of the Administrator

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

Justifications for the above actions include:
- 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, **and** 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

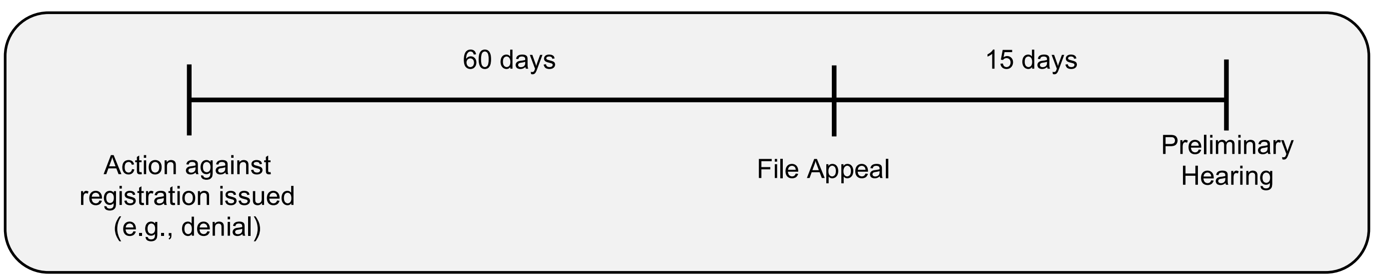
An Administrator can do which of the following if an agent violates the USA?

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

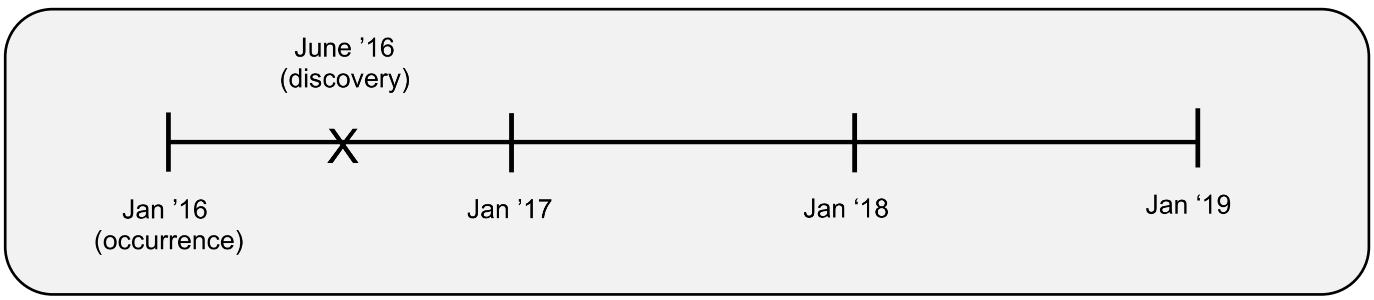
A person who suffers damage or injury from the bad acts and even accidents of others can seek financial remedies in a civil court.

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

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 or 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:

- <u>Three</u> years from the <u>occurrence</u> or <u>one</u> year from the <u>discovery</u>; 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

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

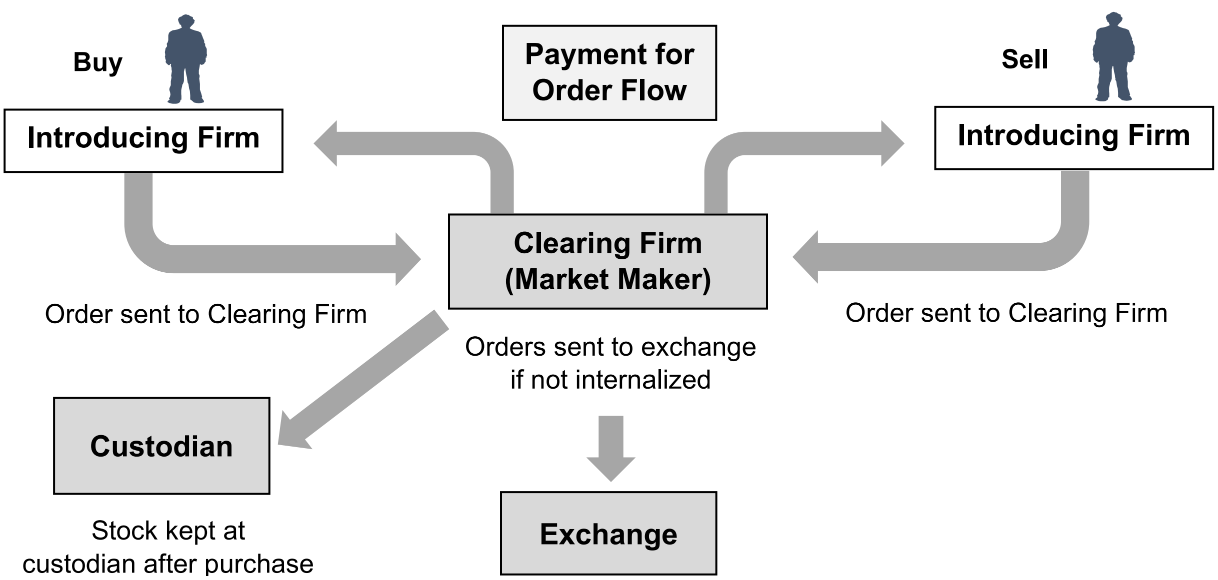
Insider Trading Act of 1988

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

When does a new issue need to deliver the prospectus?

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

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

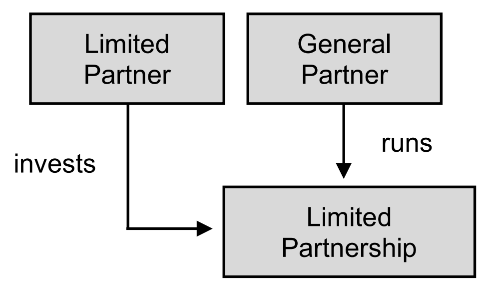
Partnership: A business structure that's created by at least two persons

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

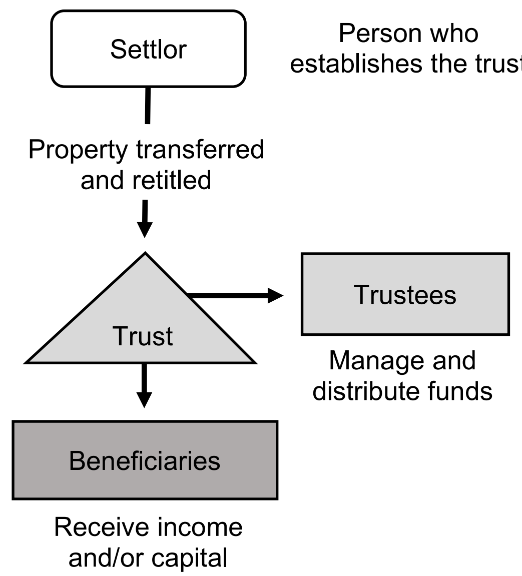
- The total assets and liabilities of a deceased person
- Decedent's will identifies the executor and the process of distribution to heirs
  - If no will exists, court appoints the intestate administrator
- Suitable investments tend to be short-term, safe, and liquid
  - Per Stirpes – divided among each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

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)

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

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

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

Tax Fundamentals

<u>Tax Rates:</u>

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

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)	**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)

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

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 a person 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 inherits an IRA 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 – Investment Vehicles

1	2	3	4	5
INSURANCE	**ANNUITIES**	**BONDS**	**HEDGE FUNDS**	**DERIVATIVES**
Learn about term, whole, universal, and variable life insurance policies.	Learn about qualified, fixed, and variable annuities.	Learn about bond basics and the different bond yields.	Learn about the characteristics and tax treatment of hedge funds.	Learn about options, futures, and how investors can use derivatives to supplement their portfolios.

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

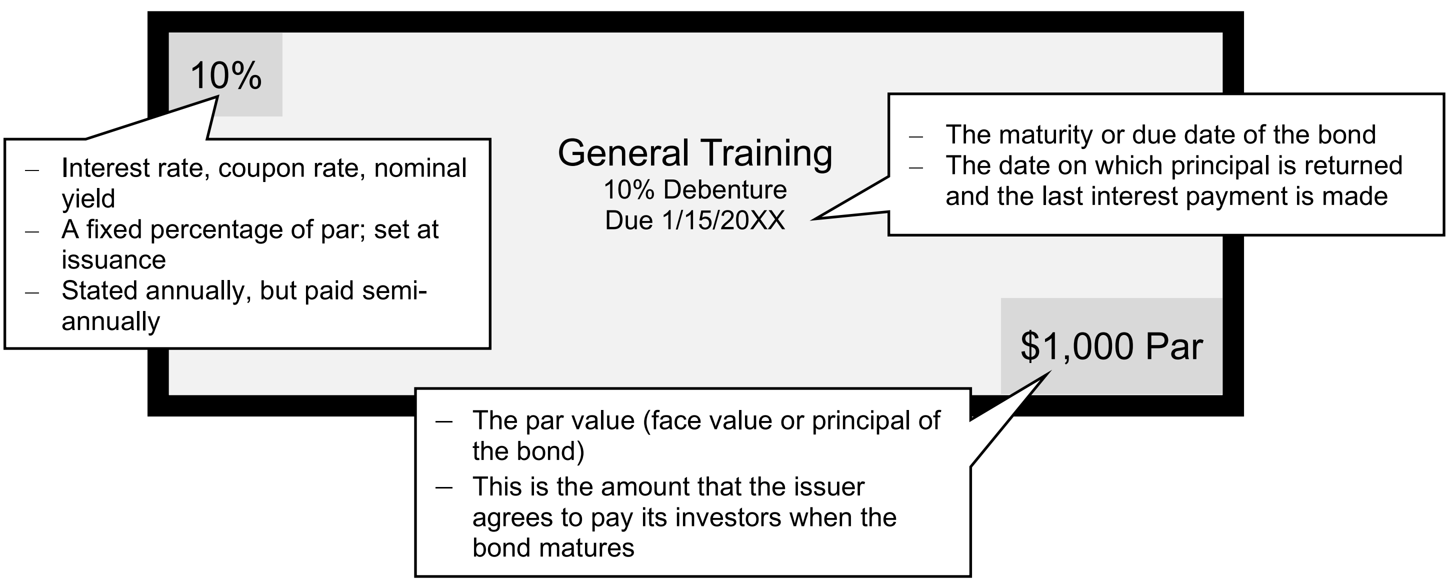
Provision in the tax code permitting direct transfer of the cash value in certain insurance products without incurring tax liability (since no check is issued to the client)

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	

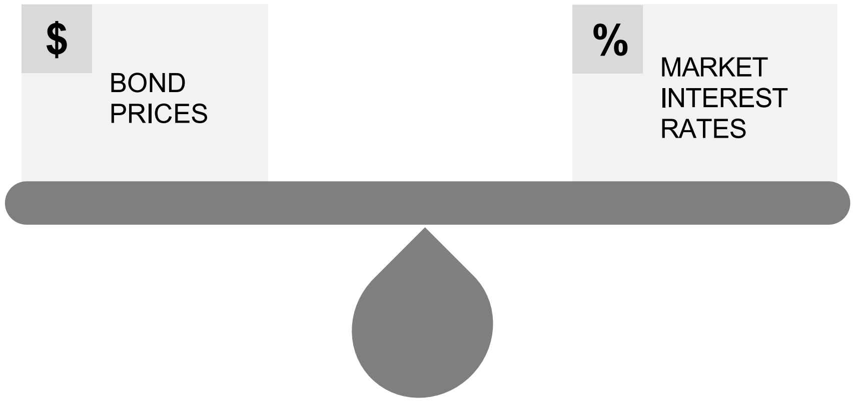
Justifications for transfer:

- Circumstances or investment goals change
- Dissatisfied with insurance company

Bond 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.

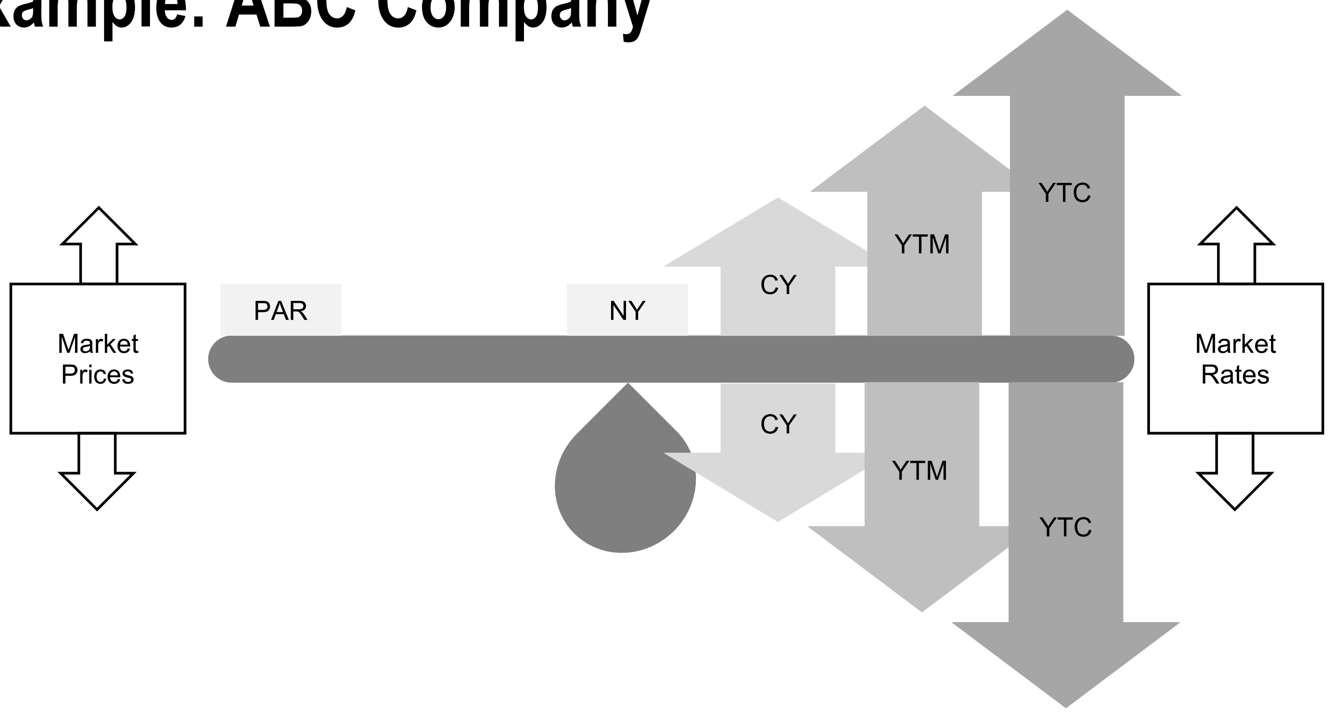
Bond Yields

NY	CY	YTM	YTC
Nominal yield ▪ Same as coupon ▪ Fixed percentage of par	Current yield $\frac{\text{Annual Interest}}{\text{Current Market Price}}$	Yield-to-maturity ▪ Same as basis and yield ▪ Includes the reinvestment of 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

Hedge Funds

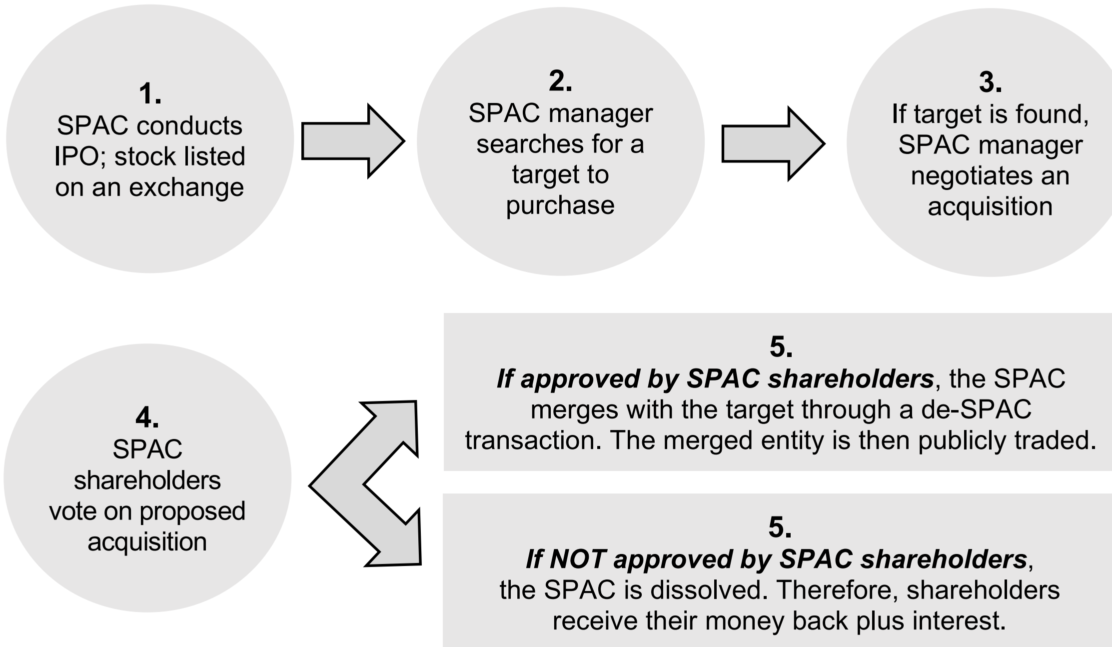
Private, unregistered investment pools, usually set up as limited partnerships or LLCs (*sold under the Regulation D private placement exemption*)

- Use various investment strategies, such as short selling and leveraging, and invest in all types of securities, commodities, futures, currencies, and other vehicles
- Limited to accredited investors or financial institutions

Customers must be aware of the following risks of hedge fund investing:

- Not registered with the SEC
- Illiquid and provide limited access to invested capital
- High fees and highly leveraged
- Significant capital risk
- Less transparency

Special Purpose Acquisition Companies (SPACs)



Options

A contract between two parties

	The Buyer's Right	The Seller's Obligation
CALL		
PUT		

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

LEAPS:

- Long-term Equity AnticiPation Securities
- Maturities of up to 39 months

Option Risks and Benefits

Risks	Benefits
▪ Capital, market, and liquidity risk ▪ Interest-rate risk (debt options) ▪ Currency risk (currency options) ▪ Business risk (equity options) ▪ Unlimited loss (uncovered calls)	▪ Less capital outlay and leveraging ▪ Limited loss (for buyers) and income generation (for sellers) ▪ Hedging a stock position ▪ Diversification ▪ Speculation

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 ▪ Exchange-traded with preset terms ▪ Non-personal ▪ May be offset	▪ A variable quantity (as agreed) ▪ OTC-traded with negotiable terms ▪ Personal ▪ 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 – Portfolio Management and Investment Risk

1

FINANCIAL ANALYSIS

Learn about certain fundamental techniques used to value stocks.

2

GROWTH VS. VALUE

Learn about what indicators are used by growth and value investors to create portfolios.

3

INVESTMENT STRATEGIES

Learn about Modern Portfolio Theory, the Efficient Market Hypothesis, and passive and active investing.

4

TIME VALUE OF MONEY

Learn about the Rule of 72, Internal Rate of Return, and both Present and Future Value of Money.

5

RISKS

Learn about investment risks and how they can impact an investment's returns.

Capital Structure and Reporting

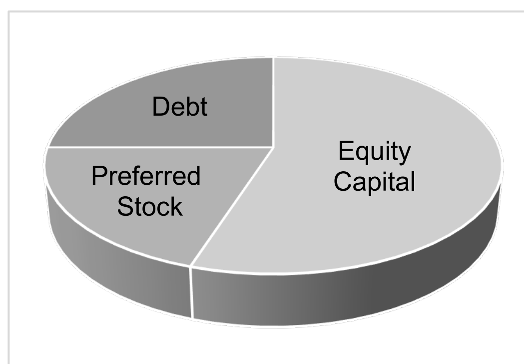
Corporations raise capital by issuing equity (stock) and/or debt (bonds)

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



Fundamental Analysis

Working Capital: Current Assets – Current Liabilities

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

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

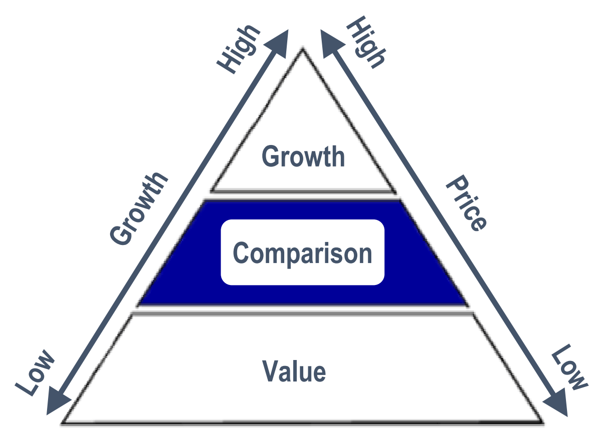
Debt-Equity Ratio: $\frac{\text{Debt}}{\text{Equity}}$

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

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

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



Contrarian Approach

- Betting against market trends or prevailing consensus
- May focus on companies out of the mainstream or those with low P/Es

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:

- Possible return of an asset weighted by the likelihood of the return (based on historical returns)

Standard deviation:

- Used as the measure of risk
- Views risk as the variability of actual returns from the expected return

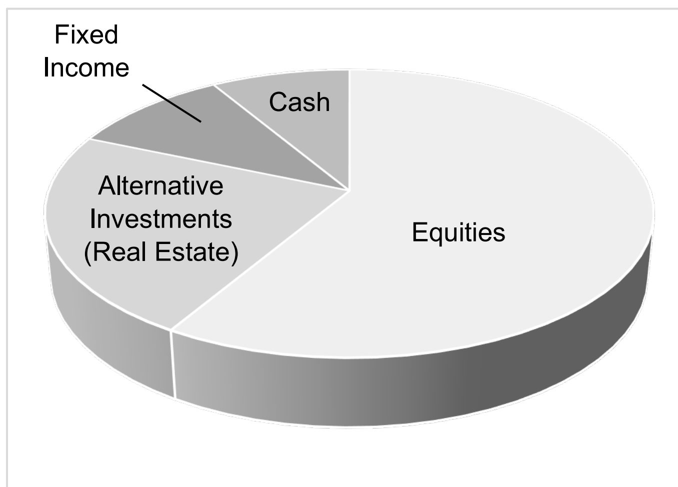
Correlation:

- 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

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 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)

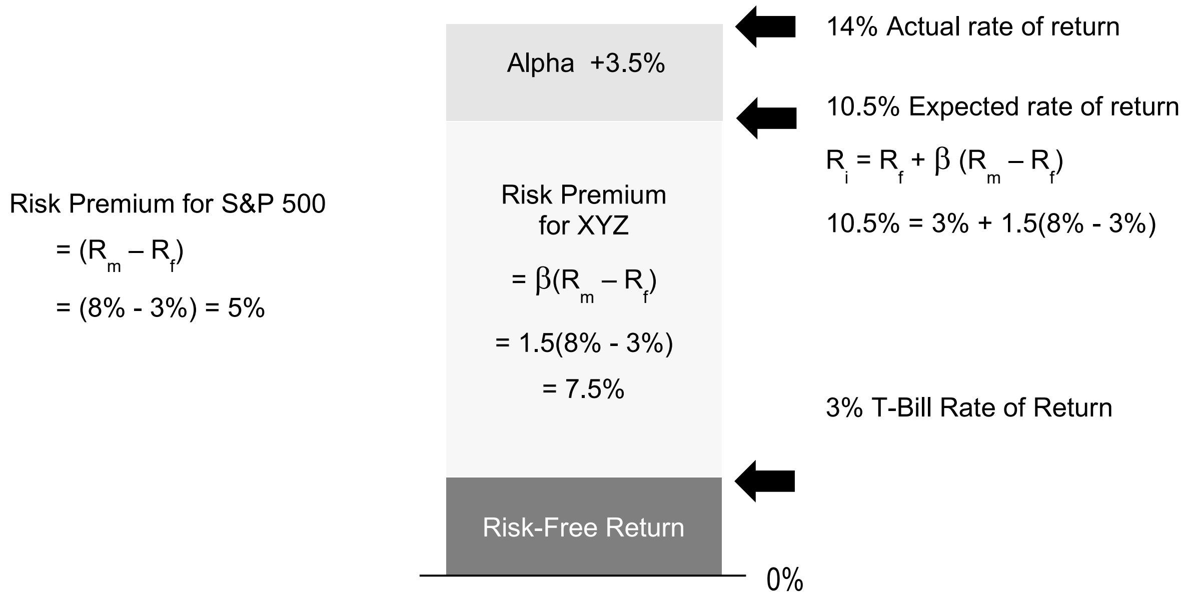
β (beta) is the measure of the stock or portfolio's systematic risk

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*

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?



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

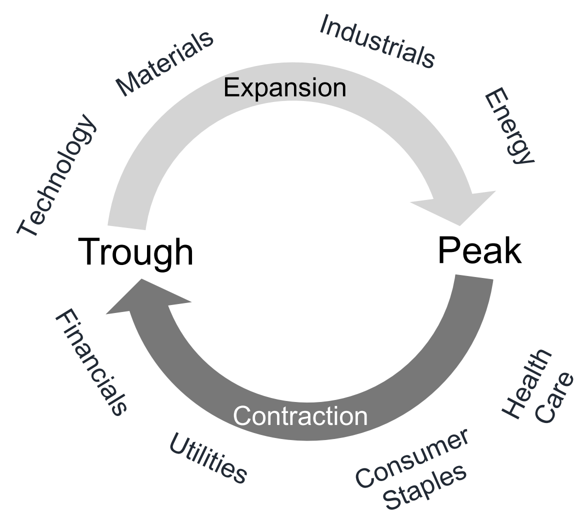
Active (Tactical) Asset Allocation

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



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?

$1,000
Present value

Internal rate of return = ________

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

Measuring Investment Return

Real Return (Inflation-adjusted):	Rate of Return – Inflation
Risk Adjusted Return:	Rate of Return – Risk-Free Return
Taxable Equivalent Yield:	$\frac{\text{Tax-Free Yield}}{\text{(100\% - Tax Bracket \%)}}$
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%