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Series 6 *Top-Off*

Investment Company and Variable Contracts Products Representative Qualification

v08

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TRENDING TOPICS

REGULATION BEST INTEREST (REG BI)

In June of 2019, the SEC adopted a package of rulemakings and interpretations that are designed to enhance the quality and transparency of **retail customers'** relationships with broker-dealers and investment advisers. These rules will bring the legal requirements and mandated disclosures in line with reasonable investor expectations, while preserving access (in terms of choice and cost) to a variety of investment services and products. Specifically, these actions include new Regulation Best Interest, the new Customer Relationship Summary (Form CRS), and separate interpretations under the Investment Advisers Act of 1940.

Regardless of whether a retail customer chooses a broker-dealer or an investment adviser (or both), the retail customer is entitled to a recommendation (from a broker-dealer) or advice (from an investment adviser) that's in the customer's best interest and that doesn't place the interests of the firm or the financial professional ahead of the customer's interests. In other words, any strategy or product that firms or individuals recommend to retail customers must be in the customers' best interest (not just suitable).

Who's a Retail Customer? Currently, Reg BI only applies to retail customers. According to the regulation, a retail customer is defined as a natural person, or this person's *non-professional legal representative*, who:

- Receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer; and
- Uses the recommendation primarily for personal, family, or household purposes

Professional legal representatives (e.g., financial industry professionals) and other fiduciaries are not considered retail customers.

Client Relationship Summary (Form CRS) Along with the passage of Reg BI, the SEC adopted a new relationship summary disclosure document that broker-dealers must provide for retail customer—the *Client Relationship Summary (Form CRS)*. Form CRS must be no longer than two pages. The purpose of Form CRS is to provide retail investors with information about the nature of their relationship with their financial professional in a simple, easy-to-understand format.

- New retail investors must receive a copy of Form CRS by no later than the time they open a brokerage account, place an order, or receive a new recommendation for an account type, securities transaction, or investment strategy.
- All existing retail customers will receive Form CRS early in the summer of 2020.

Broker-dealers must file Form CRS with the Central Registration Depository (CRD), while registered investment advisers must file Form CRS with the Investment Adviser Registration Depository (IARD) as Part 3 of Form ADV.

General Obligations Brokerage firms must fulfill the following four specific obligations in order to satisfy their overall duty under Regulation BI:

1. Disclosure – Provide certain required disclosures regarding any recommendation made to a retail customer and the relationship between the firm and the customer before or at the time of the recommendation.
2. Care – Exercise reasonable diligence, care, and skill in making recommendations.

3. Conflicts of interest – Establish, maintain, and enforce written policies and procedures that are reasonably designed to address conflicts of interest.
4. Compliance – Establish, maintain, and enforce written policies and procedures that are reasonably designed to achieve compliance with Reg BI.

Broker-dealers are subject to Reg BI, whereas investment advisers are subject to the provisions of the Investment Advisors Act of 1940. Reg BI applies to any recommendations that are made to retail customers and extend beyond securities or portfolio recommendations, including whether an investor should roll over a 401(k) into an IRA or recommendations as to the type of account that a retail customer should open.

Suitability Since Reg BI serves to supplement FINRA's existing suitability rules, firms are required to comply with both rules. However, one change implemented by Reg BI applies to the difference between a "retail customer" (as used by Reg BI) and FINRA's use of the term "institutional customer." FINRA's definition of an institutional customer includes a natural person who has total assets of at least $50 million; however, Reg BI doesn't establish a dollar limit. In other words, for a natural person who has assets exceeding $50 million, the provisions of Reg BI will apply, while for other institutional investors (e.g., banks, IAs, investment companies), FINRA's suitability rules apply.

Titles Under Reg BI, unless a broker-dealer is also a registered investment adviser (i.e., the firm is dually registered as a broker-dealer and an adviser), the SEC has stated that it's a violation of the disclosure obligation to use either the term "adviser" or "advisor" in its title. From a practical standpoint, if an registered representative is neither Series 65 or Series 66 registered and currently uses either of these terms in her title, her firm must provide her with a different title that she can use on all of her marketing materials. To use either term, the representative must take and pass either the Series 65 or Series 66 Exam.

Sales Contests Regulation BI effectively bans all sales contests, quotas, bonuses, and other non-cash compensation that are tied to sales of specific securities or specific types of securities within a limited period. However, compensation that's based on other metrics, such as total sales, asset growth or accumulation, or customer satisfaction is still permitted. Training and education meetings are also permitted as long as attendance is not based on selling certain products within a limited period. Current SRO rules on non-cash compensation were updated to reflect that the rules must be consistent with Reg BI.

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The Crunch Time Facts are a collection of statements that we believe are valuable as you engage in the final preparation to sit for your examination. These facts are not designed to raise questions, but instead to be part of your final review and used with any notes that you created during your studies.

Chapter 1 Building an Investor Profile

- A long-term holding period is established by having held an asset for longer than one year.
- Long-term capital gains are taxed at a maximum rate of 20%.
- A short-term holding period is established by having held an asset for one year or less.
- Short-term capital gains are taxed at the same rate as the investor's ordinary income.
- Corporate bond interest is taxable at federal, state, and local levels.
- Treasury interest is taxable at federal level, but exempt from state and local tax.
- Municipal bond interest is generally exempt from federal tax, but may also be state and local tax-free for in-state buyers.
- The beneficiary of inherited securities is given a long-term holding period and the beneficiary's cost basis is stepped up to the market value at the time of the owner's death.
- The recipient of gifted securities has a cost basis that's the lesser of the market value or the donor's original cost.
- The maximum annual tax-free gift is $15,000 from one person to another person.
- Cash dividends on common stock are taxable.
- Stock dividends are not taxable, but the client's cost basis is adjusted.

Chapter 2 Customer Accounts

- The Bank Secrecy Act (BSA) was established to assist government agencies in detecting money laundering.
- The Financial Crimes Enforcement Network (FinCEN) is the lead agency under the BSA that seeks to prevent money laundering.
- When funds are dispersed from a joint account, the check must be made payable to all of the owners.
- RRs are not obligated to disclose an outside brokerage account to their employers if they only purchase unit investment trusts, variable contracts, or redeemable securities of registered investment companies.
- With written instructions from a customer, a broker-dealer can hold the customer's mail for up to three months.
- A limited POA permits an authorized third party to execute trades in a person's account.
- A full POA permits an authorized third party to execute trades and deposit/remove funds in a person's account.
- Prime brokerage accounts are often used by hedge funds.
- Regulation SP requires that privacy notices are sent to customers at time of account opening with annual supplements.
- Insiders initially report their status to the SEC by filing Form 3.
- Insiders update the SEC on their trading activity by filing Form 4.

Chapter 3 Customer Communications

- Retail communications are sent to more than 25 retail investors over a 30-day period.
- Intuitional communications may be sent to customers with assets of $50 million or greater.
- Records of all approved communications must be kept by broker-dealers for three years.

- Mutual funds typically advertise one, five, and 10-year performance.
- The maximum growth rate that may be used in a variable product illustration is 12%; however, a 0% growth rate must also be provided.

CHAPTER 4 OFFERINGS

- Securities may be required to be registered with the SEC; however, they are never approved of by the SEC.
- A prospectus may not be written on or highlighted in any way during a sales presentation.
- In a firm commitment offering, the underwriter acts in a principal (dealer) capacity.
- In a best-efforts offering, the underwriter acts in an agency (broker) capacity.
- The preliminary prospectus is also referred to as a red herring.
- Under Rule 147A, securities are offered on an intra-state basis.
- Under Regulation D, securities are offered on a private placement basis.
- For individuals to be considered accredited investors, they must have either a net worth of $1 million or annual income of at least $200,000 ($300,000 for married couples).
- State securities law is referred to as the Blue-Sky law.

CHAPTER 5 OVERVIEW OF SECURITIES AND TAX CONSIDERATIONS

- Issued Shares – Treasury Shares = Outstanding Shares
- Market Capitalization = Outstanding Shares x Current Market Price
- Statutory voting favors investors who own more shares (larger stockholders).
- Cumulative voting favors investors who own fewer shares (smaller stockholders).
- Preferred stock doesn’t provide voting rights to the owners.
- Liquidation order: (1) Secured bonds, (2) Payroll, (3) Taxes, (4) Debentures (unsecured bonds) and General Creditors, (5) Preferred Stockholders, (6) Common Stockholders
- Interest that’s derived from municipal bonds is exempt from federal income taxes.
- Zero coupon bonds pay interest at maturity; they don’t provide a stream of income.
- For investors, the attraction to corporate bonds is that they offer higher yields; the attraction to municipal bonds is that their interest is federally tax-free, and the attraction to U.S. Government bonds is that they have low credit (default) risk.
- Call buyers and put sellers are bullish.
- Put buyers and call sellers are bearish.
- The wash sale window is 61 days (it’s within 30 days of the sale; both before and after).

CHAPTER 6 INVESTMENT COMPANIES

- For mutual fund shares, the bid and NAV are synonymous with the redemption price.
- The ask, offer, or public offering price (POP) is the price at which customers purchase mutual fund shares.
- According to the Investment Company Act of 1940, an investment company is considered diversified if 75% of the portfolio’s assets are invested in such a way so that no more than 5% is concentrated in one issuer’s securities and no more than 10% of the outstanding common shares of any one company is owned.
- For an investment company, a majority of its board must be independent.

- The share price of an open-end investment company is based on its NAV and all purchases and/or redemptions are subject to forward pricing (the next calculated NAV).
- Closed-end fund shares are traded on an exchange and their share prices fluctuate during the trading session. On the other hand, open-end fund shares are purchased and/or redeemed based on the closing NAV.
- Closed-end fund shares may trade at prices that are higher or lower than their NAV.
- A no-load fund may not assess a front-end load, a back-end load, or a 12b-1 fee that exceeds 25 basis points (.25%) of the fund's annual net assets.
- The mutual fund share class that assesses a front-end load is referred to as an A share.
- Back-end loads are sales charges that are deducted from the sales proceeds at redemption. The longer the individual stays invested, the lower the deferred sales charge.
- Back-end loads are referred to as contingent deferred sales charges (CDSC).
- A mutual fund share class that assesses a back-end load is referred to as a B share.
- Under the rights of accumulation provision, investors are able to qualify for sales charge reductions based on the total amount invested in a fund family.
- Within a mutual fund family, the total dollar value invested or the current market value of a person's investments is used to determine the discounted sales charge on Class A shares (front-end load fund shares).
- By signing a letter of intent (LOI), an investor may qualify for a sales charge reduction on an initial investment if, within 13 months, she invests the additional funds necessary to reach a breakpoint.
- A letter of intent may be backdated for up to 90 days and is non-binding on the investor.
- Breakpoint tables are located in a fund's prospectus and establish the amount of money that a person must invest in order to receive a lower sales charge on Class A share purchases.
- A mutual fund's NAV is typically calculated on a daily basis at market close (i.e., 4:00 p.m. ET); however, it may be calculated more frequently than daily.
- Technically, the NAV of a mutual fund is calculated "as specifically stated in the prospectus."
- The formula for calculating the Net Asset Value (NAV) per share is:
- (Total Assets – Liabilities) ÷ Shares Outstanding
- POP = NAV ÷ (100% – Sales Charge %)
- NAV = Offer x (100% – Sales Charge %)
- Sales Charge % = (Offer – NAV) ÷ Offer
- According to FINRA rules, the maximum sales charge on investment company shares is 8.5% of the POP.
- Expense ratio = Total Expenses ÷ Average Net Assets
- The lower the expense ratio of a mutual fund, the more efficient it is to operate the fund.
- An international fund invests in securities of companies that are domiciled outside of the U.S.; however, a world or global fund may invest in the securities of both foreign and domestic companies.
- Regardless of whether the distributions from a mutual fund are reinvested, they are taxable.

CHAPTER 7 VARIABLE PRODUCTS AND MUNICIPAL FUND SECURITIES

- Non-qualified annuities are funded with after-tax money, while qualified annuities are funded with pre-tax money.
- Fixed annuities have a fixed and guaranteed cash value.
- If the monthly performance of the separate account of a variable annuity exceeds the assumed interest rate (AIR), that month's payment will exceed the previous month's payment.

- If the monthly performance of the separate account of a variable annuity falls below the assumed interest rate (AIR), that month's payment will be less than the previous month's payment.
- If the monthly performance of the separate account of a variable annuity is equal to the assumed interest rate (AIR), that month's payment will be equal to the previous month's payment.
- Variable life insurance offers a guaranteed minimum death benefit and the death benefit may grow along with the value of the separate account.
- A life insurance policy owner may take withdrawals up to his cost basis without paying taxes on the distributions.
- For a life insurance policy, any distributions are made on a First-In, First-Out (FIFO) basis.
- During the accumulation stage of an annuity, any premature withdrawals are taxed at the same rate as the person's ordinary income.
- For an annuity, any withdrawals are taken on a Last-In, First-Out (LIFO) basis.
- Annuity assets may be transferred to another contact on a tax-free basis through a 1035 exchange.
- The annual contribution limit to a 529 plan is $15,000 (a plan can also be front-loaded with five years of contributions for a total of $75,000).
- A 529 plan can be transferred to a relative of the beneficiary without penalty.

CHAPTER 8 RETIREMENT PLANS

- A 401(k) plan is for employees of a for-profit organization and is generally funded by employee contributions. However, an employer may choose to make matching contributions.
- A 403(b) plan is for employees of a non-profit organization (typically public-school systems).
- A 457 plan is for employees of state and local governments.
- Distributions that are taken prior to age 59 ½ may incur an early withdrawal penalty of 10%.
- Failure to take a required minimum distribution (RMD) results in a 50% penalty of the required amount. Current RMD rules stipulate that withdrawals must begin by April 1 of the year in which the individual turns age 72.
- Rollovers must be completed within 60 days to avoid a tax penalty.

CHAPTER 9 INVESTMENT RISKS, RETURNS, AND DISCLOSURES

- Client records must be updated within 30 days of any change.
- A firm that receives a request to transfer a customer's account must validate or protest within one business day.
- If a firm validates a request to transfer a customer's account, it must complete the transfer within three business days of the validation.
- For stock, Dividend Yield (also referred to as Current Yield) = Annual Dividends ÷ Current Market Price.
- If interest rates are increasing, bond yields are also increasing and bond prices are decreasing.
- If interest rates are going decreasing, bond yields are also decreasing and bond prices are increasing.
- For bonds, Current Yield = Annual Interest ÷ Current Market Price.
- Net Yield = Corporate Yield x (100% – Tax Bracket %)
- Tax Equivalent Yield = Municipal Yield ÷ (100% – Tax Bracket %)
- Inherited securities receive a stepped-up cost basis.
- A return of capital in NOT taxable.
- U.S. Treasuries are assumed to have no default risk; however, they still have interest-rate risk.
- Although ADRs are U.S. dollar denominated, they are subject to currency risk due to the international business operations of the issuers.

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CHAPTER 10 INVESTMENT STRATEGIES AND PORTFOLIO

- Beta measures the risk of a portfolio or asset as compared to the total market, which is measured as volatility.
- The S&P 500 Index is considered the market and is assigned a beta of 1.00.
- If a stock or portfolio has a high beta, it has more risk (volatility). On the other hand, if a stock or portfolio has a low beta, it has less risk (volatility).
- If a stock or portfolio has a beta that's greater than 1.0, it's more volatile than the market.
- If a stock or portfolio has a beta that's less than 1.0, it's less volatile than the market.
- Treasury bonds offer a risk-free rate of return.
- A corporation's assets and liabilities are listed on its balance sheet
- A corporation's profitability is listed on its income statement.

CHAPTER 11 ORDERS AND TRADE EXECUTION

- When a firm acts as a broker (agency basis), it charges a commission.
- When a firm acts as a dealer (principal basis), it includes a markup or mark down.
- A long sale involves the sale of shares that are owned.
- A short sale involves the sale of shares that are borrowed (not owned).
- Short sellers are bearish (i.e., they want the stock to decline).
- Regular-way settlement for corporate securities is two business days following the trade date (i.e., T + 2.)
- Regular-way settlement for U.S. Treasuries is one business day following the trade date (i.e., T + 1).
- Cash settlement for any security is the same day.
- Under Regulation T, customer payment is required by no later than the second business day after the settlement (i.e., S + 2, which also equates to no later than four business days after the trade date, or T + 4).

CHAPTER 12 RESOLVING DISPUTES AND SUITABILITY

- All errors must be corrected by a principal.
- Decisions that are made under the Code of Arbitration cannot be appealed.
- When using simplified arbitration, there is only one arbitrator.
- Simplified arbitration can be used if the disputes doesn't exceed $50,000.
- The statute of limitation on taking claims to arbitration is six years.
- The Code of Procedure is used to discipline members that violate either SEC or FINRA rules.
- Form U4 is used by new applicants seeking registration with a member firm.
- Form U4 must generally be updated within 30 days of any change.
- Form U5 is filed when an RR leaves her firm.
- BrokerCheck is a public information portal that provides background on RRs.
- An asset allocation tool that's used to determine investments in a person's portfolio is:
  100% – investor age = % invested in equities (the remainder is invested in debt).
- An investor who has a large sum of money to invest, but will need to liquidate the investment within the next few years, may find the Class A shares of a mutual fund to be most suitable (they don't have back-end loads).
- It's unsuitable to recommend the purchase of Class B mutual fund shares to a customer who has a significant amount of money to invest and a short investment horizon.

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- If a 60-year-old individual is about to retire and he's heavily invested in one company's stock, the most suitable adjustment to his portfolio is to reallocate the assets to 60% bonds and 40% equity.
- Variable annuity L shares are most suitable when using a 1035 exchange.
- Non-qualified variable annuities don't offer an immediate tax benefit.
- Individuals who are nearing retirement should allocate more of their portfolio to debt investments.
- Younger investors should be more focused on growth investments.