1.1 Regulation of Investment Advisors - Introduction

Within this section we'll examine the legal and regulatory requirements relating to the investment adviser profession. The material presented over the following three chapters will comprise approximately 15% of the questions on your upcoming Series 65 exam.

1.2 - Who Must Register As An Investment Adviser?

The Investment Advisers Act of 1940 was enacted to protect the public by requiring those who provide investment advice for compensation to register as advisers with the Securities and Exchange Commission (SEC). The Investment Advisers Act of 1940 is distinct from the Investment Company Act of 1940, which regulates mutual funds and other pooled funds invested on behalf of smaller investors.The provisions of the act set out both required and prohibited behaviors for advisers who meet the following definition:

An investment adviser (IA) is an individual or entity who:for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analysis or reports concerning securities.

To translate that definition into plain English, we can break it down to three main components:

1. ***Giving advice about securities***
   - this includes references to securities in general, not just specific investment recommendations; for example, even advising a client to invest a set percentage in "stocks" is considered advice about securities
2. ***Being in the business of giving that advice***
   - this refers to presenting yourself as an investment adviser
3. ***Being compensated for that advice***
   - this includes receiving compensation of any kind, including fees, commissions, or a combination of the two - and the compensation does not have to be received directly from the client

Exam Tips and Tricks Many questions on the exam hinge on the components of the definition of an IA. Remember that **all three** of these criteria must be present to require registration as an investment adviser. For example, you might find a question where a professional, such as an accountant or an attorney, provides advice about asset allocation but does not charge a separate fee for this service. In that case, he/she is not being compensated for the advice and so is not required to register.

1.3 - Exclusions from IA Registration

At first glance, it seems that virtually all financial planners, stockbrokers, money managers, pension consultants, etc. would be covered under this definition. However, there are a number of exclusions that may apply:

- Banks, or bank holding companies
- Professionals, such as lawyers, accountants, teachers, etc., whose advice is incidental to their profession and who receive no special compensation for making recommendations
- Publishers of bona fide newspapers, magazines or financial publications of a general and regular circulation
- Government securities advisers
- Broker-dealers and their registered representatives whose advisory services are incidental to the securities business and who receive no special compensation for making recommendations

This last exception may seem illogical, since stockbrokers seem to be the major dispensers of investment advice. However, their job function is investment sales and they receive transaction based compensation and not a fee for advice; therefore, the investment advice they give is considered incidental to that role. Also, broker-dealers and their representatives are regulated by the Securities Exchange Act of 1934. **Others who are exempt from registration include:**

- IAs whose only clients are insurance companies
- IAs who qualify for the private-adviser exemption (i.e., less than 15 clients, do not hold themselves out to the public as investment advisers and do not advise registered investment companies)

Exclusions versus exemptions It is important to understand the difference between exclusions and exemptions as applied to investment adviser registration requirements. A person excluded from IA regulations means that person does not fall within the definition of an IA under federal or state standards. An exemption means the person does meet the definition of an IA, but under the applicable federal or state standard is exempt from registration requirements.For instance, under the federal Investment Advisers Act of 1940, bank holding companies are excluded from the definition of investment adviser.An example of an exemption from registration requirements under the federal law - despite meeting the definition of investment adviser - would be an adviser to a church employee pension plan.

*Look Out!***You can expect at least one question on the "out of state" clients. One of the options may be "IAs whose only clients are banks"; but remember it is IAs whose only clients are insurance companies that are exempt - not those with other institutional clients.**

1.4 - SEC Investment Adviser Releases IA 770 & 1092

IA 770 was issued in 1981 to clarify the definition of investment advisers. It provided guidance on the following matters:

- **What is a "security"** - life insurance and fixed securities are not securities, so those who give advice solely on these financial instruments are not required to register as IAs

- **What is "advice"** - the guideline here is very broad - simply recommending that a client buy "stocks" instead of insurance is considered advice

- **Who is "in the business" of giving advice about securities** - the standard requires only that you "hold yourself out" as a financial planner or investment adviser (e.g., by advertising, making business cards, etc.) even if you have no clients yet

- **What is "compensation" for giving advice about securities** - compensation includes fees, commissions, assigning a liability of the adviser to the client or requiring the purchase of another product

IA 1092 was issued in 1987 as a result of the increased activity in financial planning and investment advice. It essentially reaffirmed the definition of an IA as stated in IA 770, with some refinements:

- Pension consultants and advisers to athletes and entertainers are considered to be providers of investment advice
- Firms that recommend investment advisers may have to register themselves
- An IA does not have to give advice as his/her principal business activity - simply doing so with some regularity is enough to require registration
- If a registered representative of a broker-dealer sets up a separate business entity to provide financial planning or investment advice for a fee, he/she may not rely on the broker-dealer exemption from registration (this is known as a statutory investment adviser)
- "Compensation" does not have to be monetary to fall under the definition - receipt of products, services or discounts is also considered compensation

In regard to sports or entertainment agents, those who negotiate contracts but do not render investment advice would be excluded from the definition of an IA.

The complete IA 1092 release can be viewed here.

1.5 - State Registered Investment Advisers

Some IAs must register with the state rather than with the SEC. We will explain how to determine which registration is required below. If you register through your state, you are regulated by the Uniform Securities Act instead of the Investment Advisers Act of 1940. Under the Uniform Securities Act, you must register as an investment adviser if you provide any of the following services for compensation:

- Engaging in the business of advising others, either directly or indirectly (such as via a newsletter), as to the value of securities or the advisability of investing in securities; OR
- Issuing analyses or reports on a regular basis as part of a business; OR
- Providing investment advisery services to others in a financial planning practice.

An IA must register in every state where he or she does business with clients, whether or not he/she actually maintains a place of business in the state. The only exemption is for advisers with no place of business in a state who:

- Only deal with institutional investors OR
- Have five or less clients in that state

If an existing client is temporarily visiting another state, the IA is not subject to registration requirements in the second state.

Look Out!
Note that the definitions and exclusions for *state* covered advisers and *federal* covered advisers are similar but not identical.

Exclusions from this definition include:

- Banks, savings and loans, trusts
- Professionals, such as lawyers and accountants, whose advice is incidental to their professional practice
- Broker-dealers whose advice is incidental to the conduct of their business and who receive no special compensation for these services
- Publishers, employees, or columnists of bona fide newspapers, news magazines, business or financial periodicals, and owners and employees of cable, radio, or TV networks where the content is NOT based on the specific investment situation of each client
- Federal covered advisers

Look Out!
Notice that this Uniform Securities Act definition for IAs who must register if they have out of state clients is very different from the one under the Investment Advisers Act of 1940 mentioned in the earlier section. On the exam, make sure you determine whether a question is about a state-registered or a federally-registered IA.

1.6 - Federal (SEC) vs. State Registration

The National Securities Markets Improvement Act of 1996 (NSMIA) was signed into law October 7, 1996. Title III, the Investment Adviser Supervisory Coordination Act ("Coordination Act"), went into effect on July 8, 1997. NSMIA divided registration and oversight responsibilities between state and federal securities regulators. However, with the implementation of the Dodd-Frank Act, the amount thresholds at which investment advisers (IAs) were required to registered federally increased.

- ***The value of client assets*** under management is one key indicator of whether you must register with the SEC instead of with your individual state.
    - "Assets under management" means securities portfolios for which an investment adviser provides continuous and regular supervisory or management services.
    - Under Dodd-Frank, the SEC generally registers investment adviser firms with over $100 million in assets under management, while the states register investment adviser firms within the $25 million to $100 million range in assets under management.
    - If assets under management are at $110 million, an IA must register with the SEC. Those with client assets at about $100 million may register with the SEC **or** their individual state(s). Those with a lesser amount of client funds must register with their state instead, unless their state does not regulate advisers.

The following table summarizes the above requirements:

	Investment Advisers
Less than $25M	State Registration
Between $25M and $100M	SEC or State registration*
Between $90M and $110M	May register once $100M acquired; *must* register at $110M.
More than $110M	SEC registration

*There are certain situations that require IAs with more than $25 million but less than $100 million AUM to register with the SEC instead of their state(s):

- IAs whose state does not regulate investment advisers
- If the principal office and place of business is in New York or Wyoming (unless exempt, like an IA to a private fund.)
- Newly formed IAs who reasonably believe they will become eligible for federal registration within 0 days

Look Out!
Note that all IAs, even those not required to register, are subject to the anti-fraud provisions of the Uniform Securities Act.

Exam Tips and Tricks
Exam questions will often refer to definitions or regulations for either the Uniform Securities Act or the Investment Advisers Act of 1940. Most of the requirements are similar, but make sure you read the question carefully, since there may be differences. Here are examples of each type of question:

1. **Which of the following are defined as "investment advisors" under the Uniform Securities Act?**
    I. **General circulation newspaper with an investing column**
    II. **Publisher of an investment newsletter that offers specific advice for clients in certain circumstances**
    III. **Individual who charges a fee for giving clients advice about securities**
    IV. **Lawyer who advises a pension client about investments at no charge**
    e. I & IV
    f. III & IV
    g. I & III
    h. II & III

2. **Which of the following are defined as federal covered investment advisers?**
    . **An engineer who provides investment advice for a fee to 20 of his colleagues**
    I. **A stockbroker who gives a free financial plan to his clients**

II. **An investment adviser whose only clients are insurance companies**
III. **An investment adviser whose only clients are lawyers**

d. I & IV
e. III & IV
f. I, II & III
g. All of the above

Answers:
While there are some common exclusions between the two definitions (such as publishers of general investing information and professionals who give incidental advice), there are several important differences in the definitions:

Question 1 *is very straightforward, the correct answer is* ***"d"****.*

Question 2*is more difficult. Your first instinct may be to exclude III & IV, due to the exclusion of professionals. However, there is no exclusion for providing advice* ***to*** *attorneys, only insurance companies, so the correct answer is* ***"a"*** *- the engineer who has more than 15 clients does not qualify for the private adviser exemption and the investment adviser to attorneys also doesn't qualify for exemption.*

1.7 - State Registration Process

While the Investment Advisers Act of 1940 governs federal registration of IAs, state registration of IAs is regulated under the Uniform Securities Act (Weblink 1.3). Registration of investment advisers and investment adviser representatives is now available using the Investment Adviser Registration Depository (IARD) system referenced below. Under the Uniform Securities Act, state-registered IAs must also file what's known as a "consent to service of process," which appoints the state administrator as your agent to receive and process any legal complaints.

Finally, while a state may not require IAs to file if they are registered with the SEC, they may require IAs to file with the state any documents filed with the SEC, to file a consent to service of process, and/or to pay state fees.

States may also require any or all of the following:

- A passing score on a competency exam for each person acting as an investment adviser or investment adviser representative
- Payment of a fee for processing investment adviser application
- Certain disclosures to the securities agency and/or the public
- Registration of branch offices of the adviser
- A bond or minimum net capital

Exam Tips and Tricks
The Series 65 exam is likely to have a number of questions on the state registration process, but most are pretty straightforward. Here is a typical example:

1.

A state administrator can require all of the following of an investment adviser applicant EXCEPT:

a. Minimum surety bond coverage
b. Minimum competency evidenced by passing an examination
c. Minimum net capital
d. Minimum number of years of investment advisory experience

Answer
In this question the correct answer is "d", since the Uniform Securities Act does not require a specific number of years of experience.

1.8 - Federally Registered Investment Advisers

To register as an IA with the SEC, you are required to file Form ADV, parts I and II.

- Part I discloses basic information to regulators, such as contact and background information on the adviser and employees, number of accounts, compensation arrangements, etc.
- Part II serves as a disclosure document to clients and potential clients. It can be used to satisfy the "Brochure Rule" in a later section.
- The IA must amend Form ADV any time the information within it has changed.
- The form must be resubmitted within 90 days of the end of each fiscal year.
- If an adviser is no longer eligible for federal registration, it must withdraw its registration by filing a Form ADV-W Notice of Withdrawal from Registration within 180 days after the end of the fiscal year.
- An IA also must file a Form ADV-W if it ceases to conduct business as an investment adviser.

For more information on filling out Form ADV, refer to the PDF *Form ADV: General Instructions.*

The Investment Adviser Registration Depository (IARD)
All federal covered advisers are now required to register with the SEC and file notice with the states via the Investment Adviser Registration Depository (IARD). The IARD is an electronic filing system for IAs, sponsored by the SEC and the North American Securities Administrators Association (NASAA). This system collects and maintains data

for both federal- and state-registered IAs.

If you would like to learn more about the IARD, the following weblinks contain further information. Note that this is more detail than what is required for you to know for the exam: *The Investment Adviser Registration Depository*, *IARD Announcements*.

1.9 - Investment Adviser Representatives (IARs)

An investment adviser (IA) can be either an individual or a company. If you are providing investment advisery services as an employee of an IA, you are actually an investment adviser representative (IAR).
If you are listed as a partner, officer, or director of an IA at the time of initial registration, you do not need to register separately as an IAR. If not, you must register as an IAR through your state. Your employing firm will supply the necessary information for registration.

IA employees who perform any of these functions must register as an IAR:

- Making investment recommendations or giving securities advice
- Managing client accounts or portfolios
- Soliciting or offering investment advisery services
- Supervising employees who perform any of the above

IA employees who have only clerical duties do not have to register as IARs.

Look Out!
Watch for questions that ask if an office manager who supervises account managers or solicitors has to register as an IAR. While those who have only clerical duties do not needto register, those who supervise IAR employees must do so.

Exam Tips and Tricks
Watch out for the distinction between an IA and an IAR when you are reading exam questions, since there may be differences in registration requirements. You will likely find a number of questions that refer to both IAs and IARs, such as these two examples:

1.

All of the following statements regarding individuals who transact business in the state are true EXCEPT:

a. Investment adviser representatives must register in the state
b. Investment advisers must register in the state
c. Representatives of federal covered advisers must register in the state
d. Federal covered advisers must register in the state

The correct answer is "d", since federal covered advisers are not required to also register with the state.

2. **The "consent to service of process" must accompany which of the following?**
   I. **Investment adviser's initial registration application**
   II. **Investment adviser representative's initial registration application**
   III. **Investment adviser representative's renewal registration application**
   IV. **Non-criminal complaint filed against an investment adviser**
   e. II & III
   f. I & IV
   g. I & II
   h. I, II & III

The correct answer is "c" - the consent to service of process is only necessary at the time of initial registration for both investment advisers and investment adviser representatives.

2.1 Regulation of Broker-Dealers and Securities - Introduction

In this section, we'll discuss the registration and any applicable exemptions relating to broker-dealers and securities. Ensure you know the terms behind any of the concepts, as questions on your upcoming exam will be comprehensive rather than straight forward.

2.2 - Broker-Dealer Regulation

Registration
To sell securities, you must be associated with a broker-dealer. In addition to FINRA registration under the Securities Exchange Act, both the broker-dealer firm and its employees (also referred to as agents or registered representatives) must be registered with each state where they transact business under the Uniform Securities Act.

This act is basically a model for state securities rules, often referred to as Blue Sky Laws. It was created in the 1950s so that broker-dealers and investment advisers could operate in multiple states without having to fulfill different requirements in each state.

The Registration Process
The registration process is essentially the same for broker-dealers, agents, investment advisers, and investment adviser representatives. However, instead of the Investment Advisor Registration Depository (IARD) system, broker-dealers and agents use the Central Registration Depository (CRD) system. While IAs use the IARD, their investment adviser representatives also use the CRD.

You can visit the Central Registration Depository by clicking here.

To register, the applicant must file an application along with the consent to service of process and a filing fee. In addition, there may be a minimum net capital requirement and/or a bond to cover potential legal costs.

States may not establish requirements which exceed the federal requirements in these areas:

- Record keeping
- Bonding
- Margin
- Net capital
- Financial responsibility
- Custody of securities

Exam Tips and Tricks
Most likely, questions about broker-dealer regulation under the Uniform Securities Act will include investment advisers as well. For example:

1. **The state administrator can require the filing of an application, the consent to service of process and a filing fee from all of the following EXCEPT:**
    a. An investment adviser
    b. An investment adviser representative
    c. A federal covered adviser
    d. A broker-dealer registered representative

The correct answer is "c", since the administrator cannot require an application from a federal covered adviser but does have jurisdiction over broker-dealers and their representatives who do business in the state.

2.3 - Securities Regulation

Under the Uniform Securities Act, all securities sold in a particular state must be registered in that state, unless they meet one of the following exemptions:

1. **Certain Issuers -** The securities associated with the following issuers are exempt from state registration:
   - government and municipal issuers
   - issuers regulated under other laws (such as banks, credit unions, insurance companies, railroads and public utilities)
   - nonprofit organizations such as cooperatives and employer benefit plans

2. **Federal Covered Security -** See the section below for more details

3. **Exempt Transactions** - These are transactions that do not involve the public, including the following:
   - Fiduciary transactions
   - Unsolicited transactions
   - Real estate transactions secured by a mortgage
   - Isolated non-issuer transactions
   - Transactions between issuers and underwriters
   - Transactions with financial or institutional investors
   - Private placements
   - Sales where no commissions or fees are involved
   - Non-issuer transactions in outstanding securities registered under either the Securities Act of 1934 or the Investment Company Act of 1940

Exam Tips and Tricks
A common trick question on the exam involves the "certain issuers" exemption from securities registration. Some of the incorrect options may include securities issued by bank holding companies (only banks themselves are exempt) and airlines (only railroads are exempt).

Registering a Security

- government and municipal issuers
- issuers regulated under other laws (such as banks, credit unions, insurance companies, railroads and public utilities)
- nonprofit organizations such as cooperatives and employer benefit plans

There are three methods that can be used to register a security:

1. **Registration by Filing** - used by established companies who are permitted to use the prospectus filed with the SEC under the Securities Act of 1933 as the filing document for the state

2. **Registration by Coordination** - similar to registration by filing, but can be used by any company. The state registration is filed at the same time as the SEC filing, along with copies of the issuer's articles of incorporation, bylaws and other documents.

3. **Registration by Qualification** - this is the most difficult method to use and requires the most detailed disclosures. Issuers must provide detailed information on the identity, background and earnings of each officer, director, and 10% of shareholders; as well as all contracts within the last two years; legal and accounting opinions; and how the sale proceeds will be used.

2.4 - State Authority over Federal Covered Securities

A state administrator cannot require the registration of federal covered securities in the state. Federal covered securities include any of the securities listed below:

- **Exchange-listed Securities -** This refers to any security listed on the New York Stock Exchange, American Stock Exchange or Nasdaq, as well as senior securities (such as preferred stocks and bonds of a company whose stock is so listed).

- **Investment Company Shares -** This refers to mutual fund shares issued by a registered investment company and sold to qualified purchasers (an individual with at least $5 million in investments or investment managers with at least $25 million in assets under management).

- **Initial Public Offerings -** A state administrator cannot require registration of IPOs, but they can require a notice filing in the state and a payment of a filing fee.

Exam Tips and Tricks
Questions about securities registration tend to be very straightforward. Remember that only two questions involving securities registration are scheduled to be on the exam. Here are two likely questions involving exempt securities or transactions:

1.

Which of the following securities is NOT exempt under the Uniform Securities Act?

a. Limited partnerships
b. Convertible bonds of a NYSE-listed company
c. U.S. Treasury bonds
d. Stock issued by a nonprofit organization

The answer is A, since all the other options listed are specifically exempted.

2. **ABC Corporation has never previously issued securities registered by the SEC. It can register in the state by which method(s)?**
   I. **Registration by filing**
   II. **Registration by coordination**
   III. **Registration by qualification**
   IV. **Registration by administration**
   e. I only
   f. II only
   g. II and III
   h. I, III & IV

The correct answer is C, since registration by filing is only available to companies that have previously registered securities with the SEC, and registration by administration is not a valid registration method.

3.1 Remedies and Administrative Provisions - Introduction

Within this section we will study the extent of a State Administrator's authority, as well as what specific IA and IAR behavior will result in the Administrator exercising their authority. This chapter concludes our three-part discussion of investment adviser legal and regulatory guidelines.

3.2 - Administrator Authority and Actions

The Uniform Securities Act gives the state Administrator jurisdiction in all of the following instances:

- Either the representative or his/her client resides in the state
- An offer is directed from the state
- An offer is directed into the state
- An offer is accepted in the state
- The transaction occurred in the state

Extent of State Administrator Authority: Offers
The Act gives the Administrator very broad powers that apply to offers made either verbally or in writing. The powers apply to broker-dealers, agents, investment advisers, and investment adviser representatives. The Administrator may require different qualifications for IAs than for IARs.

The following scenarios are **not** considered offers made in the state:

- If an offer is made in a newspaper with a general paid circulation that is published outside of the state (or if it is published in the state but more than two/thirds of its circulation is outside the state); or
- If an offer is made through radio, TV, or internet in another state

Extent of State Administrator Authority: IA and IAR Registration
The Administrator **can** deny, suspend, or revoke IA or IAR registration if it is in the public interest AND the registrant:

- Files a materially false, incomplete or misleading application
- Willfully violates any provision of the Uniform Securities Act
- Is prohibited by court order from engaging in the securities industry
- Becomes insolvent
- Fails to pay required fees
- Is convicted of any felony or misdemeanor involving the securities industry
- Engages in unethical or dishonest business practices
- Is unqualified due to lack of experience, training or knowledge
- Fails to properly supervise employees

However, the Administrator **cannot** deny, suspend or revoke a registration solely based on lack of experience if the applicant is otherwise qualified by training or knowledge. In addition, the Administrator may condition registration as an IA or IAR only if the person does not also Act as a broker-dealer or an agent.

Exam Tips and Tricks
While the above list of potential reasons to deny a registration application includes "lack of experience, training, or knowledge," note that the paragraph that follows states that the Administrator cannot deny or revoke a registration based on "lack of experience if otherwise qualified by training or knowledge." You are likely to be tested on that distinction, so watch for answers that state that the Administrator can deny registration if it is in the public interest and the IA has a degree in finance

but no investment adviser experience. That answer would be incorrect, since the IA does have training or knowledge.

3.3 - Civil Liabilities, Felony Punishments and Other Powers

Civil Liabilities
If the Administrator finds that the IA or IAR has unknowingly violated the Act without willful intent, civil liabilities apply. These can include the following:

- Financial restitution - refunding any money lost from the investments, as well as any fees paid to the adviser
- Payment of client's attorney's fees
- Payment of interest on the money invested, net of any income received from the investment

Felony Punishments
Willful violations of the Act can be considered fraudulent, which would make them a felony that can be punished by:

- Financial restitution - same as above
- A fine of $5,000 (the amount can vary from state to state)
- A prison term of up to three years (this can also vary from state to state)

Other Powers
In addition to those already listed, the Administrator has the following powers:

- To conduct investigations (within and outside the state) to determine if any of the above violations has occurred or is about to occur
- To cooperate in SEC investigations
- To publish information concerning such a violation
- To compel testimony regarding such a violation, even if such testimony might incriminate the individual
- To subpoena testimony and records from others
- To issue a cease and desist order without providing a hearing

When it comes to exempt securities transactions, the administrator is permitted to deny or revoke any specific transaction or security exemption but cannot enter the order to do so unless:

a. prior notice is given to all parties,
b. an opportunity is given for a hearing and
c. written findings are provided.

If the administrator issues a summary order to deny or revoke pending final determination, they must notify all interested parties of the reasons for entering the order and inform them that a hearing will be granted within 15 days of a written request.

Exam Tips and Tricks
You should be very familiar with the specific powers of the Administrator and civil versus criminal penalties. Here are two questions that could come up on the exam:

1. **Of the following statements regarding the state Administrator's powers, which are true?**
   I. **The Administrator may revoke an IA registration for the sole reason that it is "for the public good."**
   II. **If an IA's registration is suspended, any IARs who work for the IA will have their licenses suspended as well.**
   III. **If an IAR's registration is suspended, the license of the IA he/she works for is suspended as well.**
   IV. **IAs, but not IARs, may have their registration revoked for failing to properly supervise employees.**
   e. I and II only
   f. I and IV only
   g. I, II and III only
   h. II and IV only

The correct answer is "d". If the IA license is suspended, there can be no active IAR registrations, and IAs are responsible for supervising employees (IARs have no such responsibilities).

2. **A state Administrator can take all of the following steps EXCEPT:**
   a. Require a witness to testify at a hearing
   b. Inspect an IA who does business in the state, even if the IA is located in another state
   c. Suspend the constitutional privilege against self-incrimination
   d. Coordinate inspections with the SEC

The correct answer is "c". While the Administrator can compel incriminating testimony, the privilege against self-incrimination is a constitutional one, and federal law must supersede state laws.

3.4 - Administrative Requirements

Registration
The initial registration fee varies from state to state, and there is no proration if an adviser registers at mid-year.

- Registration is typically effective 30 days after the completed application is received.
- Registrations must be renewed by December 31, and a renewal fee is required.
- Most states require annual renewal, although some do call for bi-annual renewal.

Record Keeping Requirements
IAs must maintain client records and keep them current. Additional record keeping requirements may also be set by the administrator of the IA's home state. Typically, the following are required:

- Books and financial records
- Adviser contracts
- Client reports
- Inspections
- Advertising and sales literature

These records must be maintained in an easily accessible place for a period of five years from the end of the fiscal year during which the last entry was made. For the first two years, the records must be maintained in the adviser's principal office.

Exam Tips and Tricks
You are likely to be questioned about the particulars of record keeping requirements. Be sure to know how long and where records must be stored by an IA. Here is a possible question:

1. **How long are investment advisers required to maintain books and records under the Investments Advisers Act of 1940?**

a. Five years from the date the record was created
b. Five years from the date of the last entry
c. Two years from the date of the last entry
d. Five years from the end of the fiscal year during which the last entry was recorded

The correct answer is "d". The Investment Advisers Act of 1940 requires records be maintained for five years from the end of the fiscal year in which the last entry was made. During the first two years, the records must be maintained in an office of the adviser. For the final three years, the records may be stored off site, but they must be readily

accessible.

Refer the *Investment Adviser Guide* on the NASAA website for further details about record keeping requirements for IAs.

4.1 Client Communication and Compensation - Introduction

Within the securities industry there are specific rules and regulations that are in place to protect both existing and potential clients from misleading information, unethical fees or a lack of information.

Within this section we will examine several disclosure rules, as well as how to recognize the difference in contract rules specified by the Uniform Securities Act and the SEC. Finally, you will learn why advertising rules need to be stringent.

4.2 - The Brochure Rule

What is the Brochure Rule?
The most important rule regarding disclosure is the Brochure Rule, which requires an IA to provide a written disclosure document to each investment advisory client or potential client. The IA can simply provide a copy of the Form ADV Part II or create a brochure with substantially the same content. The document must include all of the following information:

- Background information of the IA and any IARs
- Services available and the fees for those services, including available discounts
- Disclosure of any compensation received from third parties (such as commissions or referral fees)
- Whether the IA exercises discretion over client funds
- Types of clients for whom advisory services are provided, including any minimum dollar amount of assets to be managed
- Disclosure of any affiliation with a broker-dealer
- Any material legal or disciplinary action that occurred within the last 10 years
- Any financial condition of the IA (such as bankruptcy) that might impair its ability to meet client commitments must also be disclosed if the IA:
    - Has discretion over client accounts
    - Has custody of client money or securities

- Requires prepayment of more than $500 in fees, more than six months in advance

When must documentation be provided?

- ***New Clients:*** The brochure must be provided at least 48 hours before entering into an advisory contract, OR at the time of entering into a contract, if the client has the right to terminate the contract without penalty within five business days.
- ***Existing Clients:*** Each year, the IA must deliver (or offer to deliver) its disclosure document to existing clients. Failure to meet disclosure requirements is considered fraudulent behavior.

> ***Exam Tips and Tricks***
> **It is crucial for you to know *when* the brochure must be given; the timing of this disclosure is frequently tested on the exam.**
> **Hints:**
>
> - **It is NOT true that a brochure must be provided prior to entering into the contract. The contract must explicitly offer the right to terminate without penalty within five business days - if this is not part of the contract, the brochure may not be provided at the time of signing the contract.**
> - **Watch for answers such as "...if the IA states they have a right to terminate within five business days...." This answer would be incorrect, since a verbal statement is not sufficient.**

4.3 - Special Disclosure Requirements

Under the Uniform Securities Act, additional disclosure is required if the IA acts as principal for its own account or as broker for both an advisory client and another person on any securities transaction. In these instances, the IA must disclose (prior to completion of the transaction) the capacity in which it is acting and must receive the client's written consent.
Special disclosure is also required for wrap accounts:

- **Wrap fee (or wrap account) programs** require a special disclosure form (Schedule H) attached to Form ADV Part II. For these purposes, the SEC definition does NOT include:
    - **Managed account programs** - traditional portfolio management services offered by money managers
    - **Mutual fund asset allocation programs** - bundled programs that charge a fee based on the percentage of the total assets being managed within a portfolio of no-load (or load-waived) mutual funds

A wrap account is an account under which investment advisory services and brokerage trades are "wrapped" into a single fee that is not based on the number of transactions in an account.

The wrap fee disclosure in Schedule H must include the following information (where applicable):

- The amount of the wrap fee, the services that are included and whether the fees are negotiable
- Any additional fees that might be required
- What methods are used to select portfolio managers
- What compensation is paid to the person who recommended the program

Form 13F Disclosure
An IA may be subject to additional disclosure requirements under other federal statutes, other than the Investment Advisers Act of 1940. Under the Securities Exchange Act of 1934, an IA exercising investment discretion over an equity portfolio of $100 million or more is required to file on a quarterly basis a Form 13F disclosing the holdings it manages on its behalf or on the behalf of others.

Exam Tips and Tricks
Be prepared to answer a number of questions on the "brochure rule". Also, familiarize yourself with what must be included on Form ADV Part II. Here are two questions you might encounter on the exam:

1.

The brochure rule applies to:

a. Only discretionary advisory contracts
b. Only written advisory contracts
c. Only oral advisory contracts
d. Both oral and written advisory contracts

The correct answer is "d". The brochure rule applies to all investment advisory contracts.

2. **Under the brochure rule, the IA's clients (or potential clients) must receive a copy of the brochure:**
   a. At least 48 hours prior to entering into an advisory contract
   b. Within 24 hours of entering into an advisory contract
   c. At the time of entering into an advisory contract, as long as the client can terminate the contract without penalty within three days
   d. Within five days of entering into an advisory contract

The correct answer is "a". Option "c" is wrong because this provision only applies if the client can terminate within five days.

4.4 - Investment Advisory Contracts

Contracts between IAs and Clients
While state laws require that contracts between state-registered IAs and clients be in writing, the Investment Advisers Act of 1940 does not.
However, most IAs take the initiative to put their contracts in writing to avoid misunderstandings.

SEC Rules on WrittenIA Contracts
SEC rules impose the following conditions on a written investment advisory contract:

- Performance-based fees are generally prohibited (we'll discuss further in the next section).
- Contract language must not lead clients to believe they have waived rights to take legal action against the adviser.
- There must be no provisions that force the client to waive compliance with any of the rights or rules within the Investment Advisers Act of 1940.
- The contract must prohibit the IA from assigning the contract without the client's consent.

Exam Tips and Tricks
Although the NASAA Model Rule on Unethical Business Practices states that written contracts are required, the questions on the exam reference oral contracts.

Uniform Securities Act Rules on Contracts
Under the Uniform Securities Act, IA contracts must do the following:

- Disclose all material information regarding the services to be provided and the fees to be charged
- Disclose conditions under which the contract may be assigned to another party
- Require client consent prior to the IA assigning the contract
- Require the IA (if a partnership) to notify the client of any change in the membership of the partnership
- Prohibit the IA from being compensated on the basis of sharing in capital gains or capital appreciation of the client's accounts (however, fees based on the total value of the account, such as an assets under management fee, are allowed)

Performance Guarantees
Performance guarantees are generally considered a conflict of interest. The hallmark of an investment adviser is objectivity, so there must be no personal interest in the outcome of any specific investment recommendation. Also, guaranteeing a client's account against loss is specified as an unethical business practice under the Uniform Securities Act.

Look Out!
Remember that guaranteeing a client\'s account against loss is a type of performance guarantee. The Series 65 exam is not likely to test you on any distinction between these two concepts.

4.5 - Advertising

What Comprises the Definition of Advertising?
The Investment Advisers Act of 1940 defines advertising as any letter, notice, circular or other written communication addressed to more than one person, as well as any notice in a publication or by radio or TV that contains:

- Graphs, charts, formulas or other devices used to determine how to choose a security or when to buy or sell a security
- Information that offers analysis, reports or publications concerning securities or when to buy or sell a security
- Any other investment advisory service that relates to securities

The following media have also been identified by the SEC as forms of advertising:

- Form letters and other mass mailings
- Press releases
- Newsletters
- Marketing brochures
- Telemarketing scripts
- Slides or audio/videotapes used in marketing presentations
- Email messages sent to more than one person

Advertising Standards
IA advertising is *not* permitted to:

- **Refer (directly or indirectly) to testimonials about the adviser**
- **Refer to past specific recommendations that were profitable**. However, an IA may advertise a list of ALL recommendations made within the immediate past year (or longer), as long as all pertinent information is included (date of recommendations, market price at time of buy, sell, and current), along with a disclaimer on the first page stating: "It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list."
- **Advertise that any report, analysis or other service is free of charge if that is not completely true**. There must be no obligation or condition of any kind.
- **Represent that a graph, chart, formula or other device can (by itself) be used to determine which securities to buy or sell without disclosing the limitations in doing so**

Performance Advertising
The SEC has clarified in a guidance statement (the Clover Capital letter) that advertising of actual performance data will be prohibited if the advertising:

- Includes results that don't reflect the impact of brokerage commissions, advisory fees and other client-paid expenses.
- Fails to disclose the effect that market or economic conditions had on the results.
- Fails to disclose whether or not the results shown reflect reinvestment of dividends and capital gains.
- Makes claims about the future potential for profit without also mentioning the possibility of loss.
- Fails to disclose (if applicable) that performance results related only to a select group of the IA's clients.
- Compares results to an index without disclosing all material facts relevant to the comparison.
- Fails to disclose any material conditions, objectives or investment strategies used to obtain the results.

Exam Tips and Tricks
Expect more than one question involving performance advertising. In particular, one type of answer that appears to be correct is "IAs cannot use performance advertising that promotes results received by only a small group

of the portfolios under management." But the requirements listed above only state that it is prohibited when the fact that a small group was used is NOT disclosed. So, the answer above is actually incorrect.

4.6 - Solicitation

The Investment Advisers Act of 1940 permits an IA to pay a fee to a person who solicits advisory clients only if these two conditions are met:

- The IA is registered with the SEC
- The solicitor has never been suspended, expelled, limited or barred from associating with an investment adviser by the SEC

If solicitation is permitted, the following rules apply:

- There must be a written agreement between the IA and the solicitor, which must require compliance with the Investment Advisers Act of 1940.

- The solicitor must provide a copy of the IA's disclosure document to the potential client at the time of solicitation.

- The solicitor must provide a separate disclosure document to the potential client that spells out: a) the name of the solicitor and the IA, b) the nature of the relationship between the two, c) a statement that the IA will pay the solicitor and d) the amount above the regular advisory fee the client will be charged due to the use of the solicitor.

- The IA must obtain a signed and dated acknowledgment from the client stating that he/she has received both the IA's and solicitor's disclosure documents by the time the advisory contract is entered into.

Exam Tips and Tricks

It\'s important to know the rules for both general advertising and performance advertising. You can expect fewer questions on advisory contracts and solicitations. Here is a question you might encounter on the exam:

1.

Which of the following statements about IA advertising is FALSE under the Investment Advisers Act of 1940?

a. A performance record may only be used if it contains a disclaimer on the first page that states there is no assurance that future results will be as good as the reported results.
b. The IA may not advertise a formula without a disclaimer that refers to the limitations and difficulties of relying on any one formula or system.
c. Testimonials may be used only if written consent has been obtained from the client and the testimonial is not misleading in any way.
d. A performance record may be used only if the results are for at least one year.

The correct answer is "c". Testimonials may not be used in IA advertising.

4.7 - Compensation

Restrictions on Fees
There are few specific restrictions on fees within either the Investment Advisers Act of 1940 or the Uniform Securities Act. The advisory fee must not be "unreasonable," which means that it generally should be in line with what other advisers charge. Under the Uniform Securities Act, the following types of fee arrangements are permitted:

- Fees based on a percentage of assets under management
- Flat annual dollar amount for services agreed upon
- Brokerage fees on trades made for clients
- Wrap fees that combine all services (asset management and transaction fees) into a single annual fee

As mentioned above, performance-based fees are generally prohibited. Only two types of clients may be charged such a fee:

- Registered investment companies (mutual funds)
- An individual with an account value in excess of $1 million (Uniform Securities Act), or
- An individual with an account value in excess of $750,000 AND a net worth of at least $1.5 million (Investment Advisers Act)

In these cases, a performance-based fee (known as a "fulcrum fee") is permitted. A fulcrum fee provides for a base fee to be paid to the adviser, with additional fees permitted for performance above a specific benchmark. However, this is allowed only if the base fee would be reduced equally for inferior performance beneath the benchmark.

Look Out!
Don\'t confuse performance-based fees with

performance guarantees - read the exam questions carefully. Remember that performance guarantees are always prohibited, while performance-based fees are generally prohibited, with the exceptions discussed above.

Exam Tips and Tricks
Here is a question you might encounter on the exam:

1.

IAs may enter into advisory contracts that allow compensation:

a. Based on the level of trading activity
b. Based on a percentage of the value of all assets under management
c. Based on a percentage of capital gains or losses in the account
d. Any of the above

The correct answer is "b". The other two options are specifically prohibited.

5.1 Handling Client Funds - Introduction

Within this section we will examine how IAs with custody or discretionary authority over client accounts must uphold strict standards. In addition, we'll learn why it is important for an IA to provide suitable recommendations to clients.

5.2 - Custody

Investment Adviser Custody Requirements
Investment advisers that have the ability to withdraw money from a client's account are considered to have custody of these funds. In that case, the Investment Advisers Act of 1940 requires the IA to:

- Keep each client's securities segregated and held in safekeeping
- Not commingle client funds with the IA's funds
- Maintain client funds in accounts that name the IA as trustee or agent
- Keep records for each client account showing deposits and withdrawals
- Notify clients in writing of how the funds are maintained and when accounts are changed
- Send quarterly (or more frequent) itemized statements to each client
- Arrange an annual unannounced visit from an independent public accountant, who must then file a report with the SEC verifying the amount of client funds and securities

Exception:
These rules do not apply if the IA is also a broker-dealer, since broker-dealers are subject to similar rules at the federal level.

Under the Uniform Securities Act, IAs must notify the state administrator if they currently have custody of client funds and securities (or plan to in the future). Otherwise, the custody requirements are the same (except that the state administrator receives the annual accountant report, rather than the SEC).

5.3 - Discretion

Discretionary Powers
As with registered representatives of broker-dealers, an IA must not exercise discretionary power over securities transactions without obtaining the proper discretionary authority from the client.

- Only oral discretionary orders are permitted in the 10 days following the first transaction in a client account.
- Thereafter, specific written discretionary authority is required.
- As with registered representatives of broker-dealers, an IA may use their discretion as to the time and price of an execution - discretionary authority is not required for these details.

Look Out!
A question on time and price is sure to be tested and is easy to recognize.
However, you can expect additional questions on discretionary powers, particularly regarding scenarios in which a client is unavailable and the client\'s spouse is placing orders or giving approval to an IA\'s suggestion of a buy or sell order.

- **Remember: If the spouse has not been given written power of attorney on the account, it is always incorrect to choose an answer involving the spouse.**
- **In particular, watch out for a multiple-choice option stating the spouse can give approval as long as the client signs a power of attorney within 10 days after the trade: the 10-day rule above only applies following the first transaction to occur in a new account.**

Exam Tips and Tricks
Custody questions tend to focus on the standards of the Investment Advisers Act. Consider this sample question:

1.

The following statements about IAs that take custody of client funds are true, EXCEPT:

a. Each client must receive a statement of transactions in the account at least quarterly
b. The IA must be audited at least annually
c. Each client's funds must be segregated from other client's funds
d. Client funds must not be commingled from the IA's funds

The correct answer is "c" - while the funds must not be commingled with the IA's funds, there is no requirement that they not be commingled with other clients' funds.

5.4 - Restrictions on IA Recommendations

The Uniform Securities Act requires IAs to determine the suitability of investment recommendations given each client's circumstances. Failure to do so is considered an unethical business practice and is subject to the penalties referred to in previous sections.

The following practices are examples of violations of the suitability rules:

- Recommending securities without having a reasonable basis for the recommendation

- Recommending securities without taking the client's financial situation, needs and objectives into account
- Recommending the same security to all clients
- Failing to describe important facts and risks about the security to each client
- Churning in a client account (making trades too frequently in order to increase commission)
- Providing services that are not appropriate to the client's situation and needs
- Failing to inquire into a client's tax situation, risk tolerance and other assets

The Investment Advisers Act of 1940 also defines "failure to meet suitability standards" as an unethical practice.

- An IA who does not make reasonable inquiry or suitable recommendations, given the information from such an inquiry, is guilty of violating the suitability requirements.

5.5 - Prudent Investor Standards

For many years, the "Prudent Person Rule" stood as a guide for fiduciary investing. While designed to limit unsuitable investing by third parties, the rule basically placed a higher emphasis on preservation of capital than on income or growth, and looked at each investment to see if it was suitable.

- ***History:***
  - In 1994, the Uniform Prudent Investor Act was created as a model law for states to enact.
  - It essentially updated the old "prudent investing" standards to take modern portfolio theory into account.
  - As a result, fiduciary investors can take advantage of diversification and risk-reward tradeoffs and manage the portfolio as a whole.

Look Out!
While the Uniform Prudent Investor Act permits an IA to include growth investments if they are appropriate to the needs of the client, remember that the client\'s specific situation is the key factor. Look out for questions that imply that under the act stocks would be appropriate for *any* client account.

While the fiduciary role of IAs and IARs is discussed in a previous section, it's important to understand that these concepts must be considered in all dealings with the client - from investment recommendations to choice of trustees (for retirement accounts and other

trusts) and investment managers.

Exam Tips and Tricks
Suitability is one of the prime concerns of an investment adviser. Questions could focus on either the practices that violate the suitability standard or the consequences of such a violation. Consider this sample question:

1.

An IA is working with a new advisory client who is anxious to get a large sum of cash invested. When the IA tries to spend time to understand the client's financial objectives and other assets, the client tells her, "We'll do that later, just get my account invested first." Which of the following statements are true?

a. The IA should explain that it is unethical to make investment recommendations without obtaining this information.
b. The IA can make investment recommendations as long as the financial objectives are obtained within 10 days of investing the funds.
c. The IA must cancel the client's advisory contract.
d. The IA can make investment recommendations once she receives the client's other investment account statements.

The correct answer is "a". The IA must not invest the client's money until sufficient information is gathered to make suitable recommendations, and the IA should explain to the client why this is unethical and inappropriate.

6.1 Quantitative Methods of Evaluating Businesses and Investments - Introduction

As an investment adviser you must know how to evaluate the financial stability of a company issuing a particular security and how to estimate that investment's potential growth over time. It's important to have the ability to review a corporation's financial statements, especially the income statement and balance sheet.

In addition, we'll touch on the time value of money and the internal rate of return - both of which are important to consider when making investment recommendations.

6.2 - The Income Statement: Key Calculations

When evaluating companies, checking their financial statements is a good place to start. For the Series 65 exam, you should be able to identify components of the income statement that determine the health of a company.

The income statement allows you to compare revenues to expenses, among other items. The following key calculations allow an IA to determine if a company is profiting from its own operations, what its net income is, and the amount of cash a company generates and uses in a period. We will discuss each in more detail below.

7.1: Operating income = Gross income - (operating expenses + depreciation)
7.2: EBIT = Revenue - operating expenses (EBIT: Earnings Before Interest and Taxes)
7.3: Net income = Total income - depreciation, interest, tax liabilities and other expenses.
7.4: Cash flow = Net income + depreciation +/- other charges to income

Formula 7.1: Operating income does not include things such as investments in other firms, taxes, interest expenses or nonrecurring items, such as cash paid in a lawsuit settlement. Operating income is also known as operating profit or recurring profit. Gross profit is often referred to as the gross margin of a company, and operating expenses are often referred to as thecost of goods sold (COGS).

Essentially, operating income represents income received from core operations, minus the cost of day-to-day functions and the loss accumulated on tangible assets. Operating income is important for investors because it shows if a company's working base is profitable. A low operating income can raise questions over whether too much is being spent on marketing or salaries, or whether the equipment is being misused, resulting in a higher than necessary rate of depreciation.

Formula 7.2: EBIT. One of the most important figures to consider on a company's income statement, EBIT determines a company's financial performance and includes all profits (both operating and non-operating) before interest and income tax deductions.

Another EBIT measure is EBITDA, which is **E**arnings **B**efore **I**nterest, **T**axes, **D**epreciation and **A**mortization. EBITDA can be used to analyze the profitability between companies and industries because it eliminates the effects of financing and accounting decisions. However, this is a not a GAAP (Generally Accepted Accounting Principles) measure in that it allows a greater amount of discretion in what is and is not included in the calculation. This also allows the company to change the terms of its calculation from

one reporting period to the next.

A common misconception is that EBITDA represents cash earnings. EBITDA is a good metric to evaluate profitability, but not cash flow. Consequently, EBITDA is often used as an accounting gimmick to dress up a company's earnings. It is key that investors also focus on other performance measures to make sure the company is not trying to hide something with EBITDA.

The following article EBITDA: The Good, The Bad, And The Ugly sheds more light on this ratio.

Formula 7.3: Net Income is a company's total earnings, or profit. Net income is calculated by taking revenues and adjusting for the cost of doing business, depreciation, interest, taxes and other expenses. This number is an important measure of how profitable the company is over a period of time. The measure is also used to calculate earnings per share.

Formula 7.4: Cash flow is essentially the amount of cash a company generates and uses during a period, calculated by adding non-cash charges (such as depreciation) to the net income after taxes. Cash flow can be used as an indication of a company's financial strength. Cash flow is crucial to companies: having ample cash on hand will ensure that creditors, employees and others can be paid on time.

6.3 - The Income Statement: Key Ratios - Profit and Operating Margin

The following ratios are used to analyze and compare financial statements. We will discuss each in more detail below.

7.5: Profit Margin = Net income ÷ sales

7.6: Operating Margin = Operating profit ÷ net sales

7.7: Interest Coverage Ratio = EBIT ÷ annual debt interest payments

7.8: Price-Earnings Ratio = Market value per share ÷ earnings per share

7.9: Price-to-Book Ratio = Current closing price of stock ÷ book value per share.(Where book value = total assets - intangible assets and liabilities)

Formula 7.5: **Profit Margin** measures how much out of every dollar in sales a company actually keeps in earnings. Profit margin is very useful when comparing companies in similar industries. A higher profit margin, compared to other industry competitors, indicates a more profitable company that has better control over its costs. Profit margin is displayed as a percentage. A 20% profit margin, for example, means that the company

has a net income of 20 cents for each dollar of sales.**Example:** ABC Manufacturing reports quarterly net income of $4.4 million on sales of $25 million.

Profit margin = $4,400,000 / $25,000,000 = .176 or 17.6%

Look Out!**Looking at the earnings of a company often doesn\'t tell the entire story. Increased earnings are good, but an increase does not mean that the profit margin of a company is improving. For instance, if a company has costs that have increased at a greater rate than sales, it leads to a lower profit margin. This is an indication that costs need to be under better control.**

Imagine a company has a net income of $15 million from sales of $100 million, giving it a profit margin of 15% ($15 million/$100 million). If in the next year net income rose to $20 million on sales of $200 million, its profit margin would fall to 10%. So while the company increased its net income, it has done so with diminishing profit margins.

Formula 7.6: **Operating Margin** allows you to compare a company's efficiency, or quality of operations, to that of other companies. This ratio is essentially the same as Profit Margin, except only income from operations is considered. Operating margin is a measurement of what proportion of a company's revenue is left over after paying for variable costs of production, such as wages, raw materials, etc. A healthy operating margin is required for a company to be able to pay for its fixed costs, such as interest on debt.**Example:** XYZ Technology reports an annual operating profit of $89 million on net sales of $345 million. What is its operating margin?

Operating margin = $89,000,000 / $345,000,000 = .258 or 25.8%

Look Out!**Operating margin gives analysts an idea of how much a company makes (before interest and taxes) on each dollar of sales. When looking at operating margin to determine the quality of a company, it is best to look at the change in operating margin over time and to compare the company's yearly or quarterly figures to those of its competitors. If a company's margin is increasing, it is earning more per dollar of sales. The higher the margin, the better.**

The article, *The Bottom Line On Margins* takes a deeper look at a company's profitability and profit margin ratios.

6.4 - The Income Statement: Key Ratios

Formula 7.7: The Interest Coverage Ratio allows you to determine how easily a company can meet debt payment obligations. The lower the ratio, the more the company

is burdened by debt expense. When a company's bond interest coverage ratio is less than 1.5, its ability to meet coupon payment obligations may be questionable. These company's bonds would most likely have low credit ratings.
Example: Quality HomeBuilding's earnings before interest and taxation (EBIT) last year totaled $122 million, and its annual interest payments equaled $33 million. What was its interest coverage ratio?

Interest coverage ratio = $122,000,000 / $33,000,000 = 3.70

Formula 7.8: The Price-Earnings (P/E) ratio is a valuation ratio used to determine how the market has valued the share in comparison to its earnings per share. In general, a high P/E suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E.

However, the P/E ratio doesn't tell us the whole story by itself. It's usually more useful to compare the P/E ratios of one company to other companies in the same industry, or to the market in general, or against the company's own historical P/E. It would not be useful for investors using the P/E ratio as a basis for their investment to compare the P/E of a technology company (high P/E) to a utility company (low P/E), as each industry has much different growth prospects.

The P/E is sometimes referred to as the "multiple" because it shows how much investors are willing to pay per dollar of earnings. If a company were currently trading at a multiple (P/E) of 20, the interpretation is that an investor is willing to pay $20 for $1 of current earnings. It is important that investors note an important limitation when using the P/E measure and do not base their investment decision on this measure alone. The denominator (earnings) is based on an accounting measure of earnings, which is susceptible to manipulation, making the quality of the P/E only as good as the quality of the underlying earnings number.

Example: Medical Equipment Corp. last year reported earnings per share of $2.35, and its current stock price is $27.82. What is its Price-Earnings ratio?

P/E ratio = $27.82 / $2.35 = 11.84

Look Out!

You may be required during the exam to calculate a company\'s earnings per share as part of a question about its P/E ratio. To calculate earnings per share, divide net income by number of shares outstanding.

Example: Big Media Inc. had net income of $75 million last year. Its current stock price is $6.20, and it has 520 million shares outstanding. What is Big Media's P/E ratio?

1. Earnings per share = $75,000,000 / 520,000,000 shares = .14
2. 2. P/E ratio = $6.20 / $.14 = 44.29

The P/E is the most important and most widely used ratio; be sure to check out the tutorial *Understanding the P/E Ratio* to learn how to use this measure and its downside.

Formula 7.9: The Price-to-Book (P/B) or Price/Equity ratio, is a valuation ratio used to compare a stock's market value to its book value. A lower P/B ratio could mean that the stock is undervalued. However, it could also mean that something is fundamentally wrong with the company. As with most ratios, be aware that this varies a fair amount by industry.

Example: Top Notch Supermarkets Inc. has a current stock price of $55.74 and book value of $21.36 a share. What is the company's Price-to-Book ratio?

Price-to-Book ratio: $55.74 / $21.36 = 2.61

Look Out!
To calculate Price-to-Book ratio, you may be required to determine on your own a company\'s book value per share from given information. Consider the following example:

Example: New Edge Technology Inc. has assets of $991 million, liabilities of $125 million, 542 million outstanding shares and a current stock price of $8.92. What is New Edge Technology's Price-to-Book ratio?

1. Book value = $991,000,000 - $125,000,000 = $866,000,000
2. Book value per share = $866,000,000 / 542,000,000 = $1.60
3. Price-to-Book ratio = $8.92 / $1.60 = 5.58

The Price-to-Book ratio also gives some idea of whether you're paying too much for what would be left if the company went bankrupt immediately. Learn more about this ratio, including its downside, in the article, *Value By the Book*.

6.5 - Balance Sheet

The Balance Sheet
The balance sheet is simply a picture of a company's assets and liabilities at a specific point in time. It is similar to a net worth statement for an individual, except that the "net worth" is referred to as "shareholders' equity."

For a business, the following formula applies:

Shareholders\' Equity = Total Assets - Total Liabilities

Assets fall into three categories:

- **Current** - includes cash, marketable securities, accounts receivable and inventories
- **Fixed** - refers to items owned and used by the company, such as real estate, equipment and furniture. The value used on the balance sheet is the original cost minus depreciation taken in previous years.
- **Intangibles**- these are the non-physical components of the business's value, such as patents, copyrights, trademarks, franchises and goodwill.

Liabilities are defined as either current or long term.

- **Current liabilities** - amounts that must be paid within a year and include:
  - Accounts payable
  - Notes payable
  - Taxes payable
  - Interest payable
  - Dividends payable
- **Long-term liabilities** - amounts that become payable more than one year into the future and generally includebonds and long-term bank loans.

The key calculation derived from a company's balance sheet is working capital, which is obtained by subtracting current liabilities from current assets:

Working Capital = Current Assets - Current Liabilities

Look Out!
Working capital is not affected when a company buys securities with cash, since current assets include both cash and securities. A typical exam question will offer that scenario and then ask which balance sheet items are affected. Working

capital will be an incorrect answer.

Shareholders' Equity includes three components:

- **Common** and **preferred stock** - on the balance sheet, only the par value of both classes of stock is used, not the market value. (Par value is a dollar amount assigned to a security when first issued. For stocks, par value usually is a small amount that bears no relationship to its market price.) This par value is multiplied by the number of outstanding shares.
- **Capital surplus**- this refers to the premium that shareholders pay in excess of the par value, usually when stock is issued by a company. Also called paid-in surplus.
- **Retained earnings** - these are the net profits the company retains for future use rather than pay out as dividends.

Exam Tips and Tricks
You can expect only one or two questions on financial statements, such as:

1.

XYZ Corporation buys furniture for a new addition onto its headquarters. Which of these items on its balance sheet will be affected?

I.

Current Assets
- **Current Liabilities**
- **Net Worth**
- **Working Capital**

a. I and III
b. I and IV
c. II and III
d. All of the above

The correct answer is "b", since cash (a current asset) will decrease, this also decreases working capital. Furthermore, furniture is a fixed asset, not a current asset; and net worth is only affected by profit, loss or dividend payout.

6.6 - Time Value of Money

In addition to being able to understand the financial statement, IAs must also have the ability to estimate the value of an investment in the future.

Future Value
When planning investment strategy, it's useful to be able to predict what an investment is likely to be worth in the future, taking the impact of compound interest into account. This formula allows you (or your calculator) to do just that:

$$P_n = P_0(1+r)^n$$

P_n is future value of P_0
P_0 is original amount invested
r is the rate of interest
n is the number of compounding periods (years, months, etc.)

Note in the example below that when you increase the frequency of compounding, you also increase the future value of your investment.

P_0 = \$10,000
P_n is the future value of P_0
n = 10 years
r = 9%

Example 1- If interest is compounded annually, the future value (P_n) is \$23,674.
$P_n = \$10,000(1 + .09)^{10} = \$23,674$

Example 2 - If interest is compounded monthly, the future value (P_n) is \$24,514.
$P_n = \$10,000(1 + .09/12)^{120} = \$24,514$

Present Value
As part of your investment planning, you might also need to calculate the present value of investments. For example, if your clients want to retire with \$1 million in their investment accounts, it would be useful to know how much they need to save each year to reach that goal.

You can simply reverse the future value formula like this:

$$P_0 = \frac{P_n}{(1+r)^n}$$

P_n = \$23,674
P_0 is the present value of P_n

n = 10 years
r = 9%

Example: How much would somebody need to invest now if they wish to have $23,674 10 years from now based on a return of 9% compounded annually?

$P_0 = \frac{\$23,674}{(1+.09)^{10}} = \$10,000$

Exam Tips and Tricks
A typical time value of money question will look something like this:

1.

If $10,000 is invested at 6%, compounded monthly, it would be worth $18,194 in 10 years. $18,194 would be the investment's _____________.

a. Internal rate of return
b. Present value
c. Expected return
d. Future value

The correct answer is "d" - the ending value of the investment is known as the future value.
$P_n = \$10,000(1+.06/12)^{120} = \$18,194$

6.7 - Rates of Return - Internal Rate of Return

Different measures can be used when discussing potential rates of return.

Internal Rate of Return (IRR)
The IRR is essentially the interest rate that makes the net present value of all cash flow equal zero. It represents the return a company would earn if it expanded or invested in itself rather than elsewhere.

The internal rate of return used in time value of money calculations cannot be directly found by formula. It can be approximated by trial and error, but in the real world it is simply found by inputting present value, future value, and the number of compounding periods into a financial calculator.

Several measures of return can be selected for such a calculation:

- **Real return** - also known as inflation-adjusted return. By adjusting the stated (nominal) return of an investment to take inflation into account, the investor will have a more realistic assessment of return. So, if an investor were to earn 8% on an investment and inflation is 3%, the real rate of return would be approximately 5% (excluding any fees). Learn more about this in the section on Bond Yields.

- **Risk-adjusted return** - this calculation allows an investor to determine if the amount of return received is commensurate with the risk taken. There are several methods to measure risk-adjusted return that incorporate either beta (a measure of a portfolio's market risk) or standard deviation (a measure of a portfolio's total risk) and the risk-free return (typically measured by the current rate on short-term Treasury bills). The most common method of measuring risk-adjusted return is the Sharpe Ratio, which is calculated by subtracting the risk-free rate of return from the rate of return for a portfolio and dividing the result by the standard deviation of the portfolio returns.

    - *Beta* is a measure of volatility or systematic risk relative to the market as a whole. If beta = 1, the security's price will move with the market. If beta < 1, the security will move to a lesser extent than the market. If beta > 1, the security will move at a greater pace than the market.

The following two articles on beta are worth a read if Beta is a new concept for you:

- *Beta - Know the Risk*

- *Beta - Gauging Price Fluctuations*

- *Standard Deviation* is a statistical concept that measures the dispersion of a set of data from its mean (average). So, if the average return for an investment over the last 5 years was 11.5%, and yearly returns for the past 5 years was 9.5%, 8.5%, 13.9%, 9.1% and 16.5%, standard deviation would measure how the return for each of those 5 years differed from the mean. Standard deviation is a measure of total risk for an individual security or an overall portfolio. Beta, on the other hand, measures only its systematic risk relative to the market.

Note that you will not have to calculate standard deviation in your upcoming Series 65 exam.

- **Total return** - incorporates the rate of return from all sources, including appreciation (or depreciation), dividends and interest. This is the actual rate of return an investment provided over a certain period of time.

Look Out!
Look for questions on both the definition of total

return and the inflation component of real return.
Hint: Any answers that involve risk are normally incorrect.

Exam Tips and Tricks
Consider this sample question:

1. **Which of the following statements is least accurate with respect to how certain factors may impact internal rate of return (IRR)?**
    a. If the required return exceeds the project's IRR, the project should be accepted.

- The higher the expected cash flows, the higher the IRR will be.
- IRR may be regarded as the expected return on a project or an investment.
- As the cost increases, the IRR will decrease, holding everything else constant.

The correct answer is "a". The IRR of the project is also the return expected from it. Therefore, if the required return exceeds the project's IRR (or expected return), the project should be rejected because it is not expected to generate return to compensate for the risk.

6.8 - Holding Period Return

The return realized by an investor during a real or expected period of time, holding period return is calculated as income plus price appreciation during a specific time period, divided by the investment's cost.

Holding Period Return = $(P_1 + D - P_0) / P_0$

P_1 = Ending Value of Investment
P_0 = Beginning Value of Investment
D = Dividend or Cash Flow

Example: Three years ago, Sally Jones paid $12.25 a share for 100 shares of First Trust Financial Services Corp. During that time, she has received 12 equal quarterly dividend payments of 8 cents a share. Today, the stock is worth $19 a share. What is Sally's

holding period return for the investment?

Holding period return = (19 + .96 - 12.25) / 12.25 = .63 or 63%

In a long position, holding period refers to the time between an asset's purchase and its sale. In a short sale, the holding period is the time between when a short seller initially borrows an asset from a brokerage and when he or she sells it back. In other words, the length of time for which the short position is held.

An investment's holding period is used for a number of different functions, including evaluating an investment's performance, calculating loss or gain from the investment and determining whether an investment is worthwhile. The holding period of an investment is also used to determine how the capital gain or loss should be taxed because long-term investments tend to be taxed at a lower rate than short-term investments.

7.1 Conflicts of Interest - Introduction

Both the Investment Advisers Act of 1940 and the Uniform Securities Act spell out a number of potential conflicts of interest and unethical behaviors. Each of these has the potential to impede the IA's ability to offer objective, unbiased advice. Therefore, an IA must disclose potential conflicts of interest in writing to each client.

7.2 - Conflicts of Interest

Churning
As we discussed in previous sections, churning or excessive trading is an unethical business practice and is subject to the penalties.

- By definition, excessive trading is also a conflict of interest, since in most cases an IA who engages in this behavior receives commissions from such trades.
- This is a clear case of conflict of interest, since an IA must always put their client's interests first.

Client Loans
It is almost always considered unethical to borrow money from or loan money to a client.

- Since the advisory relationship allows the IA to know confidential information about the client's income and assets, it is a breach of confidentiality (see page 42) to borrow money from the client.

- Furthermore, loaning money in either direction is likely to influence the advice given, thus making it almost impossible for the IA to give objective advice.

- *Exceptions:* The allowable exceptions to borrowing money from a client would be if the client:
    - is in the business of lending money, such as a bank or mortgage company
    - is an affiliate of an investment adviser
    - is a broker-dealer

The allowable exceptions to lending money to a client would be if the IA is:

- a financial institution that normally engages in lending money
- affiliated with the IA, such as an employee of the IA.

Look Out!
Remember that it is OK to borrow from or lend to someone who is an affiliate of the IA. In the test, this is often simply referred to as "an affiliate." This can be confusing, but both answers ("an affiliate" and "an affiliate of the IA") are considered correct.

7.3 - Investment Adviser Duties

Confidentiality
An IA must maintain confidentiality about all aspects of client information, unless specifically authorized in writing by the client. This includes information on the client's:

- Identity
- Investments
- Transactions
- Trust arrangements
- Legal affairs
- Tax information

However, disclosures required by governmental authorities (e.g., SEC, IRS, FINRA) are permitted, since they are required under law.

Exam Tips and Tricks
You are sure to be tested on the issue of "arm\'s length" transactions, such as borrowing money from or loaning moneyto a client. Consider this sample question:

1.

An investment adviser cannot borrow money from:

a. An affiliated investment adviser
b. An affiliated broker-dealer
c. An accredited investor
d. An unaffiliated bank

The correct answer is "c" - an IA cannot borrow money from an advisory client!

7.4 - Anti-fraud provisions and fiduciary duties

The anti-fraud provisions of the Investment Advisers Act of 1940 and Uniform Securities Act impose a duty on IAs to act as fiduciaries in dealing with clients and prohibit fraudulent behavior without exception. As the Securities and Exchange Commission states, advisers "have an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to their clients, as well as a duty to avoid misleading them."

A **fiduciary** is required to act in the best interests of the person he or she is working with. Trustees, pension administrators, custodians and investment advisers are all prohibited from engaging in any fraudulent, deceptive or manipulative behaviors when working with beneficiaries or clients.

When working with clients, investment advisers and investment adviser representatives have a much stronger fiduciary responsibility than broker-dealers and their registered representatives.

Under the Investment Advisers Act of 1940, the IA's obligations under the fiduciary role include:

- The duty to be loyal to the client
- The duty to have a reasonable and objective basis for investment recommendations

- The duty to make sure that any investment recommendations are appropriate considering the client's financial objectives, needs and situation
- The duty to ensure best execution for securities transactions, if the IA can direct such transactions

Look Out!
The IA\'s primary fiduciary obligation is to put the client\'s (or beneficiary\'s) needs before his or her own. When faced with a question on this topic, answers such as "ensuring the account does not lose money" or "investing in a fund desired by the trustee" are incorrect, since performance guarantees are prohibited and the IA\'s obligation is to the beneficiary, not the trustee.

7.5 - Other Prohibited Behaviors

Actions that are considered either unethical or conflicts of interest include the following:

- Misrepresentations - IA cannot misrepresent his/her qualifications, services, or fees to clients or potential clients

- Third-party research - IA cannot use or rely on third-party research for investment recommendations or reports without disclosing this fact to the client

- Advertisements - IA cannot use an advertisement that does not comply with the guidelines of the Investment Advisers Act of 1940

- Failure to state important facts - such as failing to state the tax implication of a transaction

- Trading equities based on information from the analyst department before his or her clients have been given the information (also known as front running).

- Failing to follow a client's instructions

- Making misleading or untrue statements, including:
    - Stating or implying that either the state administrator or the SEC approves or endorses the IA
    - Making exaggerated claims about investment performance
    - Stating or implying that either the administrator or the SEC approves of a specific investment
    - Making inaccurate statements regarding commissions or markups

- Giving inaccurate market quotations
- Misrepresenting the client's account status

The North American Securities Administrators Association (NASAA) lists fraudulent and unethical business practices for investment advisers, agents and broker-dealers in statements of policy and model rules it publishes.

Agency cross transactions
The Investment Advisers Act of 1940 sets strict standards for IA transactions with a client. Investment advisers are prohibited from to selling any security from its own account to a client without notifying the client in writing and obtaining the client's consent before completion of the transaction. The same prohibition applies to purchasing securities from a client.

STOP
Unethical Business Practices of Investment Advisers
http://www.nasaa.org/content/Files/IAUnethical091105.pdf

Exam Tips and Tricks
The exam is likely to contain a number of questions on prohibited behaviors, such as misleading statements and misrepresentations. Consider this sample question:

1.

All of the following are unethical behaviors prohibited under the Uniform Securities Act EXCEPT:

a. Deliberately failing to follow a client's instructions
b. Executing a trade, upon the client's orders, that the IA believes to be unsuitable
c. Telling a client that the IA is a registered investment adviser and has therefore been approved by the state administrator
d. Failing to tell a client that making trades recommended by the IA will subject the client to a large tax liability

The correct answer is "b" - the IA must follow client orders. It would be unethical only if the IA recommended the inappropriate trade.

Insider Trading
Investment advisers are required to establish, maintain and enforce written policies and procedures to prevent insider trading. It is illegal to make securities trades based on

material information not made available to the public. This ban applies not only to company insiders or employees but to anyone with access to nonpublic information. An amendment to the Securities Exchange Act of 1934 -- the Insider Trading Act of 1984 -- increased penalties that could be levied and clarified who could be held responsible for illegal insider trading. The amendment applies not only to those who trade based on nonpublic information but also to those who pass on such information or aid those who engage in such trading.

Conclusion
Within this section we have examined activities that investment advisers are prohibited from, such as churning, loaning money to (or borrowing from) clients and front running, among others. In addition, we've looked at how IAs must uphold the highest level of confidentiality with clients.

1. **Conflicts of Interest**

   Churning

   - Misrepresentations - IA cannot misrepresent his/her qualifications, services, or fees to clients or potential clients
   - Third-party research - IA cannot use or rely on third-party research for investment recommendations or reports without disclosing this fact to the client
   - Advertisements - IA cannot use an advertisement that does not comply with the guidelines of the Investment Advisers Act of 1940
   - Failure to state important facts - such as failing to state the tax implication of a transaction
   - Trading equities based on information from the analyst department before his or her clients have been given the information (also known as front running).
   - Failing to follow a client's instructions
   - Making misleading or untrue statements, including:
     - Stating or implying that either the state administrator or the SEC approves or endorses the IA
     - Making exaggerated claims about investment performance
     - Stating or implying that either the administrator or the SEC approves of a specific investment
     - Making inaccurate statements regarding commissions or markups
     - Giving inaccurate market quotations
     - Misrepresenting the client's account status

Client Loans

- Making more trades than necessary for the purpose of increasing commissions is unethical, since IAs must make trades in the best interests of their clients.

- **Investment Adviser Duties**

Confidentiality

- Borrowing money from a client is prohibited unless the client is a broker-dealer or an affiliate of the investment adviser or is in the business of lending money
- Lending money to a client is prohibited unless the IA is a lending financial institution or the client is an affiliate or employee of the IA

Fiduciary Duties

- All client information must be held with the strictest confidence, unless the client has authorized its release in writing or the SEC, IRS or other governmental authority requires the information by law.

- **Other Prohibited Behaviors**

- All IAs must be loyal, provide objective recommendations that are appropriate for each client and ensure best execution for securities transactions.

8.1 Cash Equivalents and Fixed Income Securities - Introduction

Cash is an essential component of any portfolio. The purpose of cash is not to maximize return but to preserve capital and keep money liquid for planned spending and investment opportunities. Certain types of investments are so easily convertible to cash that they are considered cash equivalents and often provide a higher rate of return than a savings account.

Bonds represent a long-term loan from the investor to the issuer. The issuer (corporation, federal government or municipality) pays interest during the term of the bond and then

returns the face value at maturity. Bonds are considered a lower-risk investment than stocks, since bondholders are unsecured creditors of a corporation, while stockholders are not creditors, but owners.

The information in this section presumes the reader has a basic knowledge of bonds and how they work. If you are not familiar with bonds (or just need a refresher), see the tutorial: *Bond Basics*.

8.2 - Cash Equivalents

There are several types of cash equivalents:

- **Certificates of Deposit - CDs**
  - While traditional CDs are not considered negotiable, large-denomination, short-term CDs purchased by institutional investors are often negotiable.
  - These are often issued in $1 million denominations, and there is an active secondary market.
  - Typically, the terms are from 14 days to a maximum of six months.
  - Due to their size, most individual investors take advantage of these equivalents by investing in a money market fund that buys these CDs.

Look Out!
Questions about negotiable CDs may include an option to define them as "callable." Many people with a brokerage background are aware that some negotiable CDs are callable, but for test purposes, it is assumed they are not. Any answer that includes "callable" as a characteristic is incorrect.

- **Money Market Funds**
  - These are mutual funds that invest solely in low-risk, short-term cash equivalents, such as CDs, commercial paper, repurchase agreements, government securities and other very liquid securities.
  - Since these opportunities are generally available only in very high denominations, the best way to invest in these securities is via a money market fund.
  - Because of the short duration of these instruments, money markets are considered to be very low-risk.
  - Plus, they offer the convenience of check writing, so they are extremely liquid.

For more information on money markets, refer to the tutorial: *The Money Market*.

- **Commercial Paper**
  - By definition, money market instruments mature in one year or less. But commercial paper, which is a major component of many money market funds, has a maximum maturity of up to 270 days.
  - These instruments are issued by corporations to finance accounts receivable and inventories; as such, they possess a higher risk than government securities and CDs.

- **Treasury bills**
  - These are short-term (one year or less) obligations issued by the U.S. government.
  - They are the standard for the "risk-free" return, used as a point of comparison for all other investments.
  - Since their minimum denomination is $10,000, they are a great choice for individual investors.
  - They are sold at auction at a discount to face value - basically the price you pay is the face value minus your interest. You "earn" the interest when your bill matures at face value.

8.3 - The Federal Reserve

The Federal Reserve plays an important role in the money markets, since it buys and sells many of these instruments to either reduce or increase the amount of cash available in the marketplace. However, it trades only in the safest instruments.

Note that commercial paper is NOT eligible for Fed trading.

For a better understanding as to what the Fed does and how it influences the economy, refer to the tutorial: *The Federal Reserve.*

Exam Tips and Tricks
Here is another topic that is likely to have only two questions on the exam. You might encounter a question like this one:

1. **The maximum maturity on commercial paper is:**
   a. Six months
   b. Nine months
   c. Three months
   d. Twelve months

The correct answer is "b". While other money market instruments can have a maximum maturity of 12 months, commercial paper has a maximum maturity of 270 days.

8.4 - Bond Yields

Measuring Yield

While the stated (nominal) interest rate on a bond might appear to be the only measure of a bond yield, it is only accurate if you buy a bond at **par** (or its face value) and hold it until the bond matures. However, many investors buy bonds at prices above or below par, and many sell prior to maturity.

The following measures are used to reflect these circumstances:

- **Yield to Maturity - YTM**
  - The return based on the actual purchase price of the bond
  - Takes any premium or discount over par into account and uses the actual time to maturity for the number of compounding periods
  - If an investor buys a bond at a price below its par value (at a discount), then its YTM will be greater than its stated interest rate (also known as its coupon rate).
  - If an investor buys a bond above its par value (at a premium), then its YTM will be lower than its coupon rate.
  - If the bond was purchased at par, the yield to maturity will equal the stated coupon rate.

Example:

For $976 James Smith buys a bond with a face value of $1,000 and a 6% coupon rate. What will his yield to maturity be?

a. 6%
b. Less than 6%
c. More than 6%
d. Unable to calculate based on given information

Answer: The correct answer is "c". When an investor buys a bond at a discount to its face value, the yield to maturity will exceed the coupon rate.

- **Yield to Call**
  - Similar to YTM but uses the call date for the number of compounding periods and incorporates any call premium into the future value

  - A callable bond is one that allows the issuer the right to demand the bond back from an investor prior to maturity. The investor is paid the bond's face value plus a premium to partly compensate the investor for the loss of the future coupon payments on the bond. Typically, the investor must

reinvest the proceeds at a lower rate of return than the rate of return earned prior to the call.

  - The YTC on a particular bond usually will be less than its yield to maturity because there are fewer coupon payments and fewer compounding periods.

- **<u>Current Yield</u>**
  - Simply, the annual income divided by the market value of the bond
  - If the bond is trading at a premium, the current yield will be less than the nominal yield.
  - If the bond is trading at a discount, the current yield will be greater than the nominal yield.

Current Yield = Annual Income ÷ Market Value

Example:
A bond with a $1,000 face value and a 5.5% coupon rate currently trades at $984. What is its current yield?
Current yield = $55/$984 = .056 or 5.6%.

- **<u>Real interest rate</u>**
  - The rate the investor receives after inflation is taken into account; in essence, the real interest rate equals the nominal interest rate minus the inflation rate. (This equation will give you an approximate real interest rate; the precise equation is more complicated but is not needed for the Series 65 exam.)

  - The inflation premium is typically higher for bonds with longer maturities.

Real interest rate = Nominal Interest Rate - Inflation Rate

Exam Tips and Tricks
Consider this sample question:

1. **A client buys a DEF 10% bond at 105. The bond matures in 10 years. What is the current yield?**
   a. 10.17%

b. 9.52%
c. 9.69%
d. 9.13%

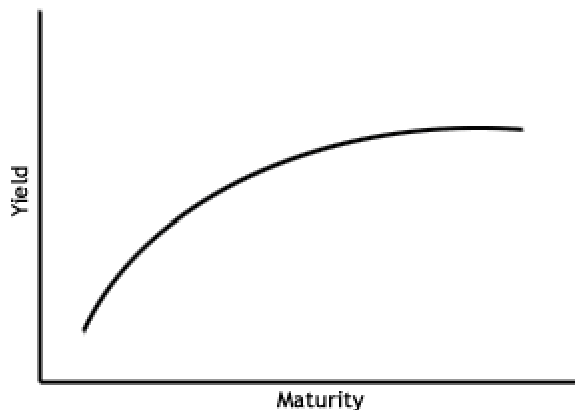
The correct answer is "b", since current yield is found by dividing the annual interest payment (in this case 10% or $100) by the current market price (in this case 105% or $1,050). Note that bond par values are most often $1,000. Whether or not you know this value, it will not affect the answer, since you can merely divide the coupon in % terms by the price in % terms.

8.5 - Yield Curves

A yield curve is simply a graph that plots bond yields against their time period to maturity. The curve will show whether short-term interest rates are higher or lower than long-term rates.

- **Normal Yield Curve**
    - Most of the time, the yield curve will be positively sloped, which means lower interest rates are correlated with shorter maturities.
    - As maturity lengthens, interest rates increase.
    - For instance, if two-year Treasury notes yield 3%, five-year Treasury notes yield 4% and 10-year Treasury bonds yield 5.5%, then the yield curve will be sloped positively. This would be a normal yield curve.
    - The following diagram is of a normal yield curve, exhibiting a positive slope.

Figure 9.1: Normal Yield Curve



- **Inverted (or Negative) Yield Curve**
    - Occurs when there is weak demand for bonds with short maturities, which drives yields up, while a strong demand for long-term bonds drives these yields down

    - An inverted yield curve means short-term interest rates are higher than long-term rates. This is an unusual situation, but it does happen.

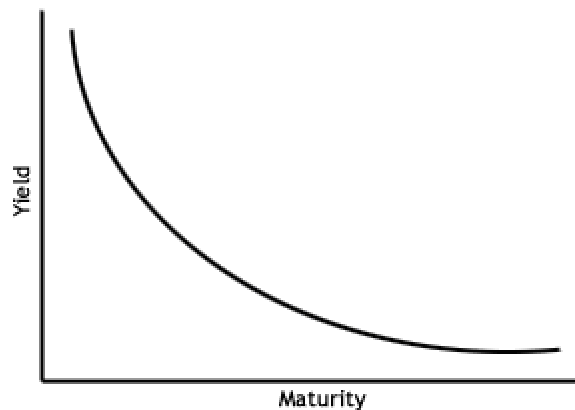
    - An inverted yield curve may be an indication of economic decline.

    - An inverted yield curve would result if the two-year Treasury note yielded 3%, the five-year Treasury note 2.75% and the 10-year Treasury bond 2.5%.

    - This would occur if rates were high but expected to fall.

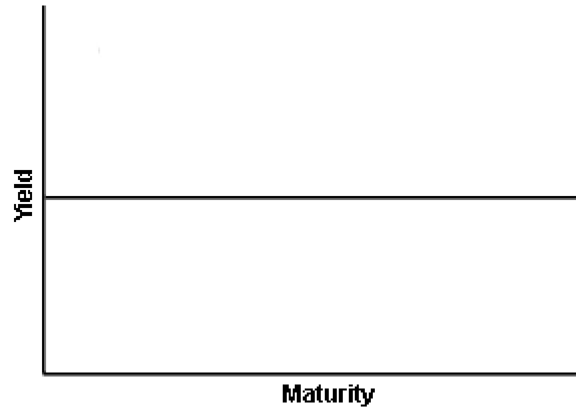
    - The following diagram represents an inverted yield curve.

Figure 9.2: Inverted Yield Curve



- **Flat Yield Curve**
    - Occurs where yields are the same for short-, intermediate-, and long-term bonds.
    - This type of curve is a rare occurrence.
    - The flat yield curve is essentially a flat line.

Figure 9.3: Flat Yield Curve



Look Out!
Generally, questions about yield curves relate either to demand or to where interest rates are heading based on the current curve. Read these questions carefully, since one of the incorrect choices may refer to where interest rates are *at the time of* the yield curve.

Yield Spreads
This refers to the difference in interest rates between different classes of bonds. For example, corporate bonds always have a higher yield than government bonds due to their higher risk. However, the spread is not constant - it can fluctuate over time, based on factors such as:

- Investor expectations about the economy
- Issuer activity when a larger or smaller than usual amount of Treasuries is issued, it affects supply, which can affect yields and spreads
- Institutional investors (such as mutual funds or pension funds) heavily buying or selling a particular type of bond, which can also affect supply. and thus spreads

Exam Tips and Tricks
You might encounter a question like this on the exam:

1.

If a bond is bought at a discount, the yield to maturity would be:

a. The same as the nominal yield
b. Lower than the nominal yield

c. Higher than the nominal yield
d. Not enough information to determine the answer

The correct answer is "c" - since the buyer paid less than par, the yield to maturity will be higher than the nominal yield.

8.6 - Corporate Bonds

Corporations issue bonds when they want to raise capital.

Corporate Issuer Requirements

- New issues must be registered as a security under the Securities Act of 1933 and are subject to the Trust Indenture Act of 1939.
- Each bond must have an indenture which spells out provisions such as term, interest rate, call provisions, etc.
- Furthermore, a trustee is named to act on behalf of the bondholders to make sure the company honors this agreement.

The Four Types of Corporate Bonds

- **Secured bonds**
  - Backed by specific collateral and therefore considered lower risk than unsecured bonds with comparable qualities
  - Examples include **mortgage bonds** (senior or junior), equipment trust certificates and collateral trust certificates
- **Unsecured Bonds**
  - Backed only by the company's commitment to pay
  - Examples include commercial paper, debentures, subordinated debentures and income bonds (also known as adjustment bonds).
- **Convertible Bonds**
  - Debentures that can be converted to shares of the issuer's common stock at the option of the owner
  - The conversion price is set at the time of issuance, usually at a price higher than the current market price.
  - The bondholder is not likely to convert to the common stock unless the market price of the stock rises above the exercise price, also known as the conversion price.

- For example, the stock of Doggie Snacks Inc. trades at $18 a share when the company issues a $1,000 convertible bond with a conversion price of $25 a share. That would mean an investor could exchange that $1,000 bond and convert it into 40 shares of the company's stock.

- The conversion ratio represents the number of shares the investor will receive for converting the bond into stock. In the example above, the conversion ratio is 40.

- Conversion ratio = Par Value of Convertible Bond / Conversion Price

- **Zero-coupon Bonds**
  - Bonds that sell at a discount to par; there are no interest payments paid to the investor. The "interest rate" is received when the bond matures at par.

  - Since the imputed interest is taxable to the investor each year, these are most attractive in tax-deferred retirement accounts.

  - Zero-coupon bonds are the most volatile type of fixed-income securities because of the lack of interest payments. When interest rates rise, zero-coupon bonds fall more dramatically than bonds making coupon payments; but they also rise more dramatically when interest rates fall.

  - Example: A one-year, zero-coupon with a par value of $1,000 might sell for $950. At maturity, the investor receives $1,000. The $50 received over the original investment represents the investor's return. In this case, the investor's return was 5%.

Look Out!
It is important to recognize secured bond types versus unsecured bonds, since exam questions may present you with four potential scenarios of how liabilities are to be paid upon corporate liquidation. In such a situation, mortgage bonds have priority over debentures (followed by preferred stock and then common stock).

Exam Tips and Tricks
On the subject of bonds, you might encounter a question like this on the exam:

1.

Which of the following would be the LEAST important in evaluating the diversification of a bond portfolio?

a. The maturities of the bonds
b. The states where the bond issuers are located
c. The credit ratings of the bonds
d. Type of bonds (secured or unsecured)

The correct answer is "b" - the location of the issuing company is the least important factor. Credit rating and maturities are of the highest importance, but it's also important that the portfolio contain some secured bonds to reduce risk.

8.7 - U.S. Government Securities

U.S. government debt is issued to raise money to run the government. In the United States, the federal government is the largest issuer of debt, and the market for U.S. government debt is the largest and most active in the world. Treasury securities are popular due to their low credit risk, as well as interest that is not taxed at the state level.

There are three main types of U.S. government securities:

1. **Treasury Bills**
   - These are short-term securities and are issued with three-month, six-month and nine-month maturities.
   - Three-month Treasury bills are considered cash equivalents.
   - Treasury bills are issued at a discount from par, and they mature at par.

2. **Treasury Notes**
   - These are intermediate-term securities and are issued with one- to 10-year maturities.
   - They are sold at par and pay semiannual interest.
   - Treasury notes are quoted as a percentage of par value in 32nds.
   - For instance, a price of 98:16 means that the price of the note or bond will be 98.5 percent of par (that is, 98 and 16/32).

3. **Treasury Bonds**
   - These are long-term securities that were issued with maturities of 30 years.
   - They have the same characteristics as Treasury notes but are usually callable five years prior to maturity.
   - The government stopped issuing 30-year Treasury bonds in February 2002, but resumed in February 2006.

In addition, there are several other debt instruments either issued or backed by the U.S. Government.

- These are short-term securities and are issued with three-month, six-month and nine-month maturities.
- Three-month Treasury bills are considered cash equivalents.
- Treasury bills are issued at a discount from par, and they mature at par.

- **TIPS**

- These are intermediate-term securities and are issued with one- to 10-year maturities.
- They are sold at par and pay semiannual interest.
- Treasury notes are quoted as a percentage of par value in 32nds.
- For instance, a price of 98:16 means that the price of the note or bond will be 98.5 percent of par (that is, 98 and 16/32).

8.8 - Mortgage-Backed Securities - MBS

There are a number of U.S. government agencies that also issue debt. While most of these are not backed by the full faith and credit of the U.S. government, they are still considered less risky than most other bonds. Yields are usually slightly higher than Treasury debt with a similar maturity. Also, like Treasury bonds, government agency bonds are tax-free at the state level (but are subject to federal income taxes).
These four agencies make a secondary market in home mortgages, thus allowing local banks to sell their loans and use the proceeds to make new mortgages:

1. **Federal Home Loan Bank - FHLB**
   - This agency loans money to savings and loans, using mortgages issued by those institutions as collateral for the loans.
   - It creates the funds to buy these loans by issuing non-callable, book-entry bonds.

2. **Federal National Mortgage Association - FNMA (aka "Fannie Mae")**
   - This agency buys government-guaranteed and -insured mortgages, such as FHA and VA, as well as conventional mortgages.
   - It creates the funds to buy the loans by issuing bonds and notes.
   - FNMA also issues pass-through mortgage certificates with minimum denominations of $25,000.

3. **Government National Mortgage Association - GNMA (aka "Ginnie Mae")**
   - Like FNMA, this agency also buys insured loans from banks, such FHA, VA and Farmer's Home Administration, but then creates pools of these mortgages.
   - It then issues pass-through certificates similar to the FNMA certificates.

- The main difference is that GNMA certificates are actually directly guaranteed by the U.S. government.
- As a result, GNMAs are considered slightly safer and therefore offer a slightly lower yield than other agency securities.

4. **Federal Home Loan Mortgage Corp. - FHLMC (aka "Freddie Mac")**
    - This agency is unique because it is privatized and its stock is traded on the NYSE.
    - It purchases conventional mortgages only and in turn issues "participation certificates".

Exam Tips and Tricks
It is important to understand the above subject, since you can expect a question that offers a number of choices of obligations that are guaranteed by the full faith and credit of the U.S. government. Typical correct answers include Treasury bills, Treasury bonds and GNMA certificates, while incorrect answers would include FNMA or FHLMC securities.
You might encounter a question like this on the exam:

1. **The Federal National Mortgage Association is involved in which of these activities?**
    a. Financing low-income housing projects
    b. Making new mortgage loans
    c. Purchasing existing mortgage loans
    d. All of the above

The correct answer is "c". FNMA buys existing mortgages from banks to provide liquidity for banks to make new loans.

8.9 - Municipal Bonds

Municipal bonds (often referred to as muni bonds) are issued by state, city, and county agencies and provide interest that is tax-free at the federal level. The interest may also be tax-free at the state level if the owner of the bonds is a resident of the state that issued the bonds.

Due to this tax-free interest, it's important to understand yield equivalence so you can easily compare tax-free versus taxable interest rates. To convert a muni bond yield to its

taxable equivalent, simply divide the interest rate by the inverse of the potential investor's marginal tax bracket.

$$\text{Taxable Equivalent Yield} = \frac{\text{Coupon Rate}}{(1\text{-marginal tax rate})}$$

For example, if a muni bond is paying 4% interest and the investor is in the 25% tax bracket, divide 4% by .75 for a taxable equivalent yield of 5.33%.

Taxable equivalent yield = .04/(1-.25) = .04/.75 = .0533 or 5.33%

You can then compare the muni to taxable (government or corporate) bonds of similar maturity and risk. If other bonds pay less than 5.33%, the muni offers an advantage.

Municipal bonds are issued as one of two types:

- **General Obligation Bonds - GO**
  - These bonds are backed by the full faith and credit of the issuer.
  - GOs carry less risk, since the issuer can collect (and thus, if necessary, raise) taxes to service the debt.

- **Revenue Bonds**
  - These are used to finance specific projects, such as an airport or sports facility.
  - Revenue bonds are backed only by the fees generated by the facility - if they are insufficient, the bonds could go into default.

NOTE:
Since 1986, some bonds issued by a municipality are no longer tax-exempt. Only those classified as public-purpose bonds offer tax-exempt interest. Others, known as private-purpose bonds, are fully taxable, unless their use is specifically exempted. Private-purpose bonds include those issued to finance convention centers, sports facilities and industrial development. Permitted private-purpose bonds that are exempt from regular federal income tax are still subject to the Alternative Minimum Tax (AMT).

Exam Tips and Tricks
Consider this sample exam question:

1. **Which of the following types of municipal bonds would probably not offer tax-exempt interest?**
   a. To fund a new bridge
   b. To fund a new school
   c. To fund a new convention center

d. To fund a new sewer system

The correct answer is "c", since this is an example of a private-purpose bond

9.1 Stocks and Mutual Funds - Introduction

Introduction
Common stocks are a core component of most portfolios and can help investors maximize their return. For those without the time to choose individual stocks, mutual funds are a great substitute..

The information in this section presumes the reader has a basic knowledge of stocks and how they work. If you are not familiar with stocks (or just need a refresher), check out the tutorial *Stock Basics*.

9.2 - Types of Stocks

- **Authorized stock**
    - When a corporation is formed, it authorizes a fixed number of shares of stock in the company.
    - The stock is assigned a "par" value that is quite low, such as 10 cents or a dollar per share.
    - There is no correlation between the par value of a stock and its market value.

- **Issued stock**
    - A corporation typically issues only a fraction of the number of shares that were authorized at the time it was created.
    - This permits the corporation to issue new stock as needed.

- **Outstanding stock**
    - The number of shares actually trading in the market
    - Outstanding stock is equal to the amount of issued stock minus any Treasury stock.

- **Treasury stock**
    - Any shares of issued stock that the corporation repurchases; a company might "buy back" its own shares for any of these reasons:
        - The market price of the stock is depressed, and the company can repurchase the shares at an effective discount.
        - Repurchasing the shares will increase the earnings per share since there will be fewer outstanding shares.
        - The Treasury shares can be used instead of cash to make required employee stock options or retirement plan contributions.

Look Out!
It\'s important to be able to distinguish between authorized, issued, outstanding and Treasury stock.

9.3 - Common Stock Benefits

Stockholders enjoy significant benefits, including:

- **Proportionate share in the company profits** (in the form of dividends and capital gains)

- **The right to vote**on matters, such as the selection of the board of directors and other ballot issues; one vote is allowed for each share of stock owned (see below):
    - **Statutory voting -** with this most commonly used system, stockholders are allowed the number of votes per shares of stock owned times the number of open board of director positions. However, one can't vote more than their number of shares for any one director (for example, if you own 50 shares of stock and there are six open positions, you could cast 50 votes for each director).

    - **Cumulative voting -** with this system stockholders get the same number of votes as in statutory voting but can cast a disproportionate number of votes for any one director (for example, one could cast all 300 votes for a single director).

    - **Proxy voting -** if stockholders are unable to attend the annual meeting in which the voting is held, they may vote in advance on a proxy ballot sent in prior to the meeting.

Exam Tips and Tricks
Consider this sample exam question:

1.

The correct definition of Treasury stock is:

a. Outstanding stock minus authorized stock
b. Issued stock minus outstanding stock
c. Authorized stock minus outstanding stock
d. Issued stock minus authorized stock

The correct answer is "b", since Treasury stock is made up of issued shares that have been repurchased, so they are no longer outstanding shares.

9.4 - Preferred Stock

Preferred stock is considered a senior equity, since preferred stockholders would be paid out prior to common stockholders in the event of liquidation. The term "preferred stock" refers to the fact its holders receive preferential treatment over common stockholders in the event of liquidation and when dividends are paid. Preferred stock actually has many characteristics of bonds, including:

- **Fixed dividend rate -** unlike common stock, whose dividend rate may rise or fall based on company profits, preferred stock is issued with a set rate based on the par value (usually $100, $50, or $25 per share).

- **Interest-rate sensitive -** due to the fixed dividend rate, the market price of preferred stock tends to increase when interest rates decline and decrease when they rise. And because there is no set maturity date, the price fluctuations are more dramatic.

- **No voting rights -** only common stock owners have voting rights in the corporation. Owners of bonds and preferred stocks do not.

- **Callable -** most preferred stocks can be called away after a set date. The corporation would tend to exercise this right if interest rates have fallen.

- **Convertible -** like some bonds, some preferred stocks are issued in convertible form. The conversion ratio is used to calculate the number of shares of common stock to be received upon conversion:

Conversion Ratio = Par Value of Convertible Bond
Conversion Price of equity

For example, an investor buys a convertible preferred stock at $100 par, which is convertible to the common at $25 a share. At that time, the market price of the common is $20 a share. The investor wouldn't choose to convert until the market price of the common equals or exceeds $25 a share (also called the parity price). To calculate how many shares of common stock would be received upon conversion, the investor would use the formula above: $100/$25 = 4. Therefore, the investor would receive four shares of common stock for each share of preferred stock converted. If the market price of the stock rose above the conversion price, the investor obtains the stock at a discount.

In the example above, if the stock's market price rose to $30 a share, the holder of convertible preferred stock could still acquire the common stock at a price of $25 a share.

Convertible preferred securities offer an answer for investors who want the profit potential of stocks but not the risk. Read more about these securities in the article *Introduction to Convertible Preferred Shares*.

Cumulative vs. Noncumulative Preferred Shares
Preferred stocks are issued as either cumulative or noncumulative. This refers to the payment of the dividend.

- It is possible that a corporation may not have the funds during some quarters to pay the expected dividend.
- When this occurs, noncumulative preferred stock holders have no rights to be paid the "skipped" dividends when dividends resume.
- However, cumulative preferred stock does pay these dividends when dividends resume; essentially, the missed dividends accumulate on the investor's behalf.

Exam Tips and Tricks
Consider this sample exam question on cumulative preferred stocks:

1.

ABC Corporation has a cumulative preferred stock outstanding that pays a $4 dividend each year. Due to low sales, the dividend was not paid last year. Now that sales have improved, ABC is able to resume dividends this year. How much will the preferred stockholders receive this year?

a. $4
b. $8
c. $12
d. $16

The correct answer is "b", since it is a cumulative preferred stock. If it were a non-cumulative preferred, the correct answer would have been "a".

9.5 - Common Stock Valuation Methods

There are two basic approaches to valuing common stock. The first is the fundamental approach, which looks at the actual financial status of the corporation, such as the financial statements we studied in the Quantitative Methods section. The second is the technical approach, which relies on charts and patterns to forecast future stock movements.

1. ***Fundamental analysis***
   This approach focuses on factors such as:

   - Experience of the company's management
   - Overall outlook for the industry sector
   - Current and pipeline product lines of the company
   - Market share
   - Balance sheet and income statement

The fundamental analyst tries to assess whether a company's stock is undervalued or overvalued based on its business prospects.

   - The **dividend discount model** (DDM) is a tool used by fundamental analysts to calculate what the market price of a stock should be.
     - DDM uses a present value calculation based on a stock's estimated future dividends.
     - The stock is considered undervalued if the market price is less than this calculated amount.
     - One difficulty of using this model is that projected future dividends may be higher or lower than those that actually occur over time.

The dividend discount model is one of the oldest and most conservative methods of stock valuation. The article *Digging Deeper Into the Dividend Discount Model* examines the assumptions underlying the DDM.

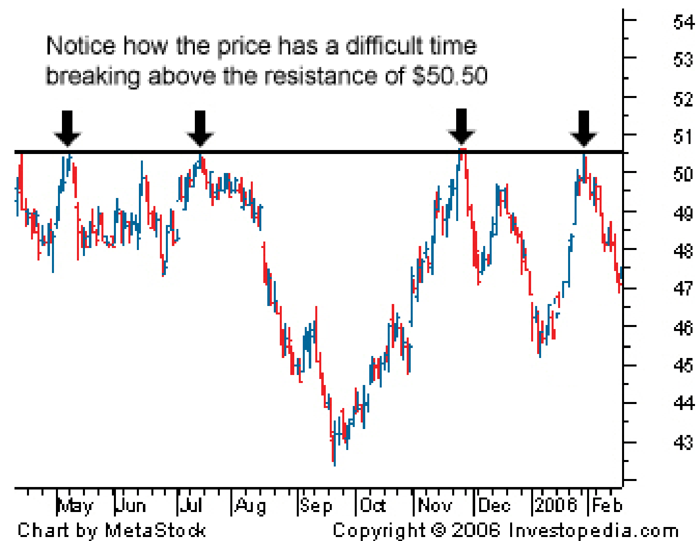
2. ***Technical analysis***
   This approach relies on charts and patterns to project the future movements of a

particular stock or market index. These are the major measures used by technical analysts:

- **Volume -** the number of shares trading is considered a signal of strength or weakness. For example, if a stock price increases on strong volume, this is considered more significant than a price increase on weak volume.
- **Advance/Decline Ratio -** this measures the overall health or "breadth" of the market by comparing the number of issues that increased in price against the number that decreased in price.
- **Support and Resistance -** this refers to the levels where a stock price comes under pressure. The support level is the "bottom" line in a typical chart, while the resistance level is the "top" line. The following charts illustrate the support and resistance lines for typical stock charts.

Figure 9.1: Support

Figure 9.2: Resistance



See the *Technical Analysis* tutorial for an easy-to-understand outlook on the various tools used in technical analysis, including moving averages, relative strength index (RSI), Bollinger bands, stock chart patterns and much more.

Here are two sample exam questions on stock valuation:

1. **Those who predict stock values based on calculations of the present value of future dividends are using which stock valuation tool?**
   a. Technical analysis
   b. Dividend correlation model
   c. Dividend discount model
   d. Expected return model

   The correct answer is "c".

2. **Using technical analysis, if XYZ stock is trading near its resistance price, it is said to be:**
   a. Oversold
   b. Overbought
   c. Head and shoulders
   d. Inverse

   The correct answer is "b". If the stock were trading near its support price, it would be described as oversold.

9.6 - Mutual Funds

Mutual funds, more accurately known as Investment Companies, are a wonderful

diversification tool for the smaller investor since they serve as pooled funds where many investors can take advantage of small minimum investments and professional management.

If you need a refresher on the different types of mutual funds, costs and other mutual fund basics, the *Mutual Fund Basics* tutorial will be helpful.

Classes of Mutual Funds
Mutual funds are regulated under the Investment Company Act of 1940 and are classified as one of four types:

1. ***Unit Investment Trusts (UITs)*** - a pool of unmanaged investments where a fixed portfolio of income-producing securities are purchased and held to maturity; UITs typically invest in corporate or government bonds or mortgages. Units in the trust usually are sold to the public at a price of $1,000 per unit.

2. ***Face-amount certificates*** - essentially function like a bond, where the issuer pays coupons until maturity and pays the holder the face value at maturity or a surrender value if the certificate is presented prior to maturity

3. ***Closed-end management companies*** - where a mutual fund issues a fixed number of shares, which are then traded in the secondary market (usually on a major stock exchange). After the shares are first issued, the investor must buy closed-end shares from another investor on the open market, not from the investment company. The value of shares is determined by supply and demand, meaning they may trade at a discount or premium to the Net Asset Value of the fund.

4. ***Open-end management companies*** - most mutual funds are open ended. Investors buy or sell units at the fund's current Net Asset Value**,** or NAV. The number of shares outstanding depends on investor demand. When an investor wishes to purchases shares in an open-end fund, the fund issues new shares. When an investor sells shares, the number of outstanding shares is reduced. Open-end shares are bought and sold at the NAV (plus any sales load that may apply). The NAV is calculated daily - usually at the end of the day after markets close - by subtracting total liabilities from total assets and dividing by the number of outstanding shares.

9.7 - Mutual Fund Benefits and Types

Mutual Fund Benefits
Mutual funds offer the following advantages to investors:

- **Diversification -** investing in mutual funds reduces risk in a portfolio, since the investor is able to own a proportional share of the many securities in each fund.

- **Professional management -** each mutual fund has a full-time portfolio manager, who can devote more time than most investors in deciding what securities to buy and when to sell.
- **Liquidity -** mutual fund shares can be sold at any time, and proceeds are usually received within a week or less.
- **Flow-through of dividends and capital gains and losses -** a mutual fund that distributes at least 90% of net investment income is treated as a conduit - meaning that the mutual fund itself is not taxed, and the investors report the dividends and capital gains on their personal returns. If the fund distributes at least 97% of dividends and 98% of capital gains to investors, it is not subject to tax surcharges, so this higher amount is almost always distributed.

Exam Tips and Tricks
Most of the questions on the exam are concerned with open-end management companies or mutual funds.

Mutual Fund Types
Although many people think mutual funds are always composed of common stocks, the fact is that a mutual fund can be made up of any traded securities that suit the fund's objectives. Here are some examples of different types of mutual funds:

- **Stock funds -** growth, value, large-cap stock, small-cap stock, international stock, sector funds
- **Bond funds -** corporate, government, municipal, convertible
- **Money market funds -** general, government, municipal
- **Balanced funds -** a mix of stocks and bonds, sometimes known as asset allocation funds
- **Real estate funds** - invest in a mix of real estate investment trusts (REITs), giving smaller investors a chance to gain exposure to the real estate sector in small amounts without high transaction costs.

9.8 - Mutual Fund Classes, Sales Charges and Expenses

Share Classes
What's another way to classify different types of mutual funds? By looking at sales charges - specifically, whether or not there is a sales charge paid to a financial adviser as

a result of the investment. If there is no such charge, the fund is known as a no-load fund.

For funds with a sales load, there are typically several classes of shares, each with a different set of sales charges and other expenses:

- **"A" shares**
    - These have "front-end" loads and are sold at the public offering price (POP),which consists of the net asset value (NAV) of the fund plus the sales charge.
    - This charge is calculated by subtracting the NAV from the POP, and then dividing that number by the POP.
    - As an example, if the fund has an NAV of $20 per share and a POP of $21.50 a share, the sales charge is $1.50 divided by $21.50, which equals a 6.9% sales charge.
    - Breakpoints are discounts available to those who invest large amounts within a single mutual fund family. They apply to "A" shares only.
        - Typically, the amount of the discount increases as the amount invested increases.
        - The large amount does not have to be invested all at one time; an investor can take advantage of breakpoint discounts by signing a letter of intent stating that the investor will reach the breakpoint level within 13 months of the initial investment.
        - Another option is the right of accumulation (ROA), which allows the investor to use amounts invested in the past to calculate the breakpoint discount.
- **"B" shares**
    - Are referred to as "back-end" load funds
    - In essence, the investor purchases the funds at NAV, but the financial adviser is paid a commission as if the investor paid a front-end load.
    - If the investor sells the fund within a set number of years (typically five to eight years), then a sales charge is applied.
    - This is known as a contingent-deferred sales charge**.**
- **"C" shares**
    - Known as "level-load" funds, for which investors pay an annual asset-based fee
    - There is usually a 1% or 2% back-end load if the investor withdraws money from the fund during the first year.
    - After the first year, no additional sales charges apply.

Sales Charges and Expenses

- **12b-1 fees**
  - The annual fee for marketing fund shares, which is permitted by the SEC but must be approved and adopted by the shareholders
  - While this amount was traditionally quite small (typically about 0.25% in "A" shares and no-load funds), mutual fund families use a larger fee (typically about 1% of the NAV) when offering "B" and "C" shares.
  - So while advisers may tout such shares as being similar to no-load funds, in fact, there is a higher cost to own the funds each year.

- **Management Expense Ratio (MER)**
  - The cost of managing the mutual fund
  - Independent of the sales charge on the fund (if any), the expense ratio includes all costs to operate the fund, including:
    - investment advisery fees
    - rent and utilities
    - salaries
    - shareholder services

The expense ratio is deducted from the income of the fund and is expressed as a percentage of the NAV. The amount must be disclosed in the prospectus.

Look Out!
You can expect several questions about fund expenses, including 12b-1 fees. Remember that 12b-1 fees are not part of the expense ratio.

Exam Tips and Tricks
Here is a sample exam question about 12b-1 fees:

1. **In order for a mutual fund to utilize a 12b-1 fee, the plan must be approved by the:**
   a. SEC
   b. FINRA
   c. Mutual fund family
   d. Shareholders of the fund

The correct answer is "d". The shareholders must agree to adopt the 12b-1 fee. These fees are permitted by the SEC, but not approved by them.

10.1 Alternative Investments - Introduction

There are a number of alternative investments of which an investment adviser should be aware. The number of Series 65 exam questions on these topics will be limited, therefore, this section will cover the issues most likely to be tested on the exam.

10.2 - International Investing

Risks
Stocks and bonds issued in countries outside the United States are considered riskier than domestic issues, but adding these investments to a portfolio can actually decrease the overall risk of the portfolio through added diversification. Here's what you need to know:

- ***Emerging vs. developed markets***
  - Developed markets include those countries with an established economy and securities market, such as most of Western Europe, Japan and Australia.
  - Stocks and bonds purchased from developed countries offer less risk than those from emerging markets, such as Latin America, Southeast Asia and much of Eastern Europe.
  - The potential returns from emerging market countries are attractive to investors with a tolerance for elevated risk.

The article *What Is An Emerging Market Economy* details emerging market economies and the potential rewards for investors willing to accept the additional risks.

- ***Currency risk***
  - Since foreign currencies can fluctuate against the U.S. dollar, an American investor may find the actual return on foreign investments to be enhanced or decreased.
  - When investors have assets in international investments, they face currency risk unless their positions are hedged.
  - The return earned by a U.S. investor with international investments is affected by both the change in the price of the investments and the foreign currencies' fluctuation against the dollar.

    - If the dollar strengthens compared to the foreign currency, the investor's returns suffer.
    - Since these exchange fluctuations are difficult to predict, currency exchange is an inherent risk in international investing.
- ***Political risk***
    - Foreign investments can be affected by wars and government actions, such as taxes or restrictions on currency exchange.
    - These factors tend to be a bigger risk in emerging market countries.
- ***American Depository Receipts (ADRs)***
    - Foreign corporations may choose to "list" their shares on U.S. stock exchanges by issuing ADRs.
    - This allows American investors to purchase the companies' shares without the companies having to register with the SEC.
    - Typically, a large U.S. bank with offices in the foreign country will purchase a large quantity of the stock, hold it in trust and then issue the ADRs, which are backed by the shares held in trust.
    - ADR purchasers receive no voting rights.
    - Dividends are declared in the foreign currency but converted and paid in U.S. dollars.

Thanks to ADRs, investors now have a world of investing opportunities to choose from. The tutorial *ADR Basics* examines these securities, as well as the associated risks and how their prices are determined.

Look Out!
Expect at least two questions on ADRs: typical incorrect answers include: "dividends are paid in the foreign currency", "ADR holders have voting rights like holders of any other stock" and "shares are held in trust at a foreign bank".

Exam Tips and Tricks
Consider this sample exam question:

1.

The following statements about ADRs are all true, EXCEPT:

a. They trade on U.S. stock exchanges.
b. They enable U.S. investors to easily purchase international stocks.
c. They pay dividends in the currency of the originating country.
d. They represent shares of foreign securities held in trust in U.S. banks.

The correct answer is "c". ADRs pay dividends in U.S. dollars.

10.3 - Real Estate Investments

Real estate is an asset class that offers protection against inflation, as well as potential tax benefits. However, lack of both liquidity and diversification are drawbacks to investing directly in real estate.

Real Estate Investment Trusts (REITs).
REITs work much like closed-end mutual funds, but instead of owning a portfolio of securities, the REIT owns a portfolio of real estate properties and/or mortgages.

REITs are registered securities under the SEC and trade in the secondary market, like stocks. As a result, investors get the benefit of diversification (since most REITs own a large number of properties) and liquidity.

Unlike mutual funds, REITs are permitted to use leverage - the income from the properties within the REIT is then used to pay the costs of any loans involved.

There are two main types of REITs:

- **Equity REITs -** these invest mainly in actual real estate properties, such as office buildings, apartment complexes, warehouses and shopping centers. Equity REITs are usually not highly leveraged.

- **Mortgage REITs -** these invest mainly in mortgages and construction loans for commercial properties and tend to use leverage to a greater degree than equity REITs.

The following series of articles contain valuable information about REITs, such as how to analyze them, advantages and disadvantages, how to pick the right REIT and more:

- *What Are REITs?*
- *The REIT Way*
- *Basic Valuation of a REIT*
- *The Impact of Interest Rates on REITs*

REIT Taxation
Similar to mutual funds, REITs may qualify for conduit taxation on distributed net income. To qualify, an REIT must obtain at least 75% of its income from real estate-related activities and must distribute at least 90% of investment income to shareholders. There is no minimum distribution requirement for capital gains, but the REIT must pay taxes on the capital gains if they are retained rather than distributed.

> ***Look Out!***
> **REIT taxation is similar to that of mutual funds, but not identical. Note that mutual funds must distribute 97% of net income and 98% of capital gains, while the REIT requirements are much lower.**

Real Estate Limited Partnerships
These real estate investments are set up with a general partner, who manages the properties and makes investment decisions, and a number of passive "limited partners", who simply enjoy the income and tax benefits of the real estate within the partnership.

Since partnerships are not taxable entities, each limited partner claims a pro-rated portion of income or losses on his/her own personal return. As a result, most real estate limited partnerships are created as tax shelters, so investors get the benefits of:

- **Depreciation deduction** - on a straight-line basis over a life of 27 and a half years
- **Mortgage interest deduction** - if property is leveraged
- **Long-term capital gains** - when property is sold

> ***Exam Tips and Tricks***
> **Consider this sample exam question about REITs:**

1. **The following statements about REITs are all true, EXCEPT:**
   a. They can be traded on the NYSE.
   b. 75% of their assets must be invested in real estate.
   c. 75% of their gross income must be from real estate-related investments.
   d. 90% of their net investment income must be distributed to shareholders to qualify for conduit tax treatment.

The correct answer is "B". REITs have no requirement for the percentage of assets invested.

10.4 - Variable Annuities

Annuities are issued by insurance companies and offer two special benefits: tax-deferral of earnings and guaranteed income for life. A fixed annuity offers a guaranteed rate of return to the investor, and the investment risk is assumed by the insurance company. Thus, it is not considered a security and is regulated by insurance laws, not securities regulations.

Variable annuities do not offer a set rate of return but instead fluctuate in value in tandem with their underlying investments. The investor may choose from one or more accounts with different investment objectives, similar to mutual funds, but known as "separate accounts." Variable annuities are regulated under both the Securities Act of 1933 and the Investment Company Act of 1940.

While a fixed annuity offers a high degree of certainty, a variable annuity does not. As a result, variable annuities are not appropriate for investors with a low risk tolerance.

The following two articles on variable annuities contain valuable advice and information, such as their benefits, consequences and possible hidden costs:

- *Getting the Whole Story on Variable Annuities.*
- *Passing the Buck - The Hidden Costs of Annuities*.

Annuity Structure
There are two distinct phases of an annuity: accumulation and withdrawal.

- Accumulation: During the accumulation stage,the investor receives accumulation units, rather than shares in the separate accounts. These units have an NAV that is calculated each day, just like mutual fund shares.

- Withdrawal (Annuity): When the investor wants to withdraw from a variable annuity, one of their options is to exchange accumulation units for annuity units.

    - The number of annuity units remains unchanged, but the value of the units varies based on the performance of the underlying investments.

    - As a result, the monthly income from the annuity may rise or fall over time.

    - While an investor can choose an annuity period of a set amount of years, a lifetime option is more typically chosen. That way, an investor need not worry about running out of money if he or she lives longer than planned.

Exam Tips and Tricks
Typical variable annuity questions may ask whether the price and amount of accumulation units and annuity units are fixed or variable. The correct answers would be:

- **the number of accumulation units and their value are variable**
- **the number of annuity units is fixed, while the value of annuity units is variable.**

Annuity Taxation
Both fixed and variable annuities offer tax-deferral of earnings. Withdrawals made are taxed as follows:

- Annuity withdrawals are treated as LIFO (last in, first out), meaning that withdrawals are considered to be from earnings *first*.
- Earnings are taxed at the investor's ordinary income rate.
- Earnings withdrawn prior to age 59 and a half are subject to a 10% penalty tax, unless an exception applies (such as death or disability).
- No tax or penalty is applied to the investor's principal, since this amount was taxed prior to the investment.

Note that the value of the tax-deferred earnings may not outweigh the cost of subjecting those earnings to ordinary income tax. A similar investment in mutual funds would have the potential benefit of long-term capital gains rates and/or special dividend rates.

Look Out!
This differential (and possible disadvantage) of income tax rates is essential to understand. The question may come in the form of "an investor who is now in a low-income tax bracket but expects to be in a higher tax bracket at retirement" - in this scenario, a variable annuity would *not* be a suitable investment.

Exam Tips and Tricks
Consider this sample exam question:

1. **Investment income earned within a variable annuity is:**
    a. Tax-exempt
    b. Tax-free
    c. Tax-deferred
    d. Tax-deductible

The correct answer is "c", since the earnings will be taxable when withdrawn.

10.5 - Derivative Securities

What is a Derivative?
A derivative is basically a financial instrument whose value is derived from the value of an underlying security. Examples of derivatives include:

- Options - A privilege sold by one party to another offering the holder the right, but not the obligation, to buy (call) or sell (put) a security at the strike price at a certain time.

- Futures contracts - A financial contract that obligates the buyer to purchase (or in the case of a seller, to sell and deliver) the assets underlying the contract at a certain future date. Since they trade within secondary markets, the contracts are standardized.

- Forward contracts - A cash market transaction where the delivery of the asset underlying the contract is deferred until a future date. Contracts are not standardized, as they are an agreement between two parties.

- Swaps - The exchange of one security, currency or interest rate for another.

- Collateralized mortgage obligations (CMOs) - A type of mortgage-backed security that creates separate pools of pass-through rates for different classes of bondholders with varying maturities, called tranches. Bonds are retired (from repayments from the pass-through pool) in the order specified on their prospectus.

- Rights - A security that gives shareholders the right to purchase new shares from the company at a specific price, in proportion to the number of shares held.

- Warrants - Derivatives often attached to bond issues as a sweetener. Warrants give the holder the right to purchase securities - usually stock -- at a specific price within a certain period of time that is longer than the timeframe on options or rights.

The most commonly used derivatives are options. If you are not familiar with options trading, you can read more in the tutorial *Options Basics*.

Buying Options
Options are classified as either puts or calls. When you purchase an option, you pay a premium to the option writer. Options are complex securities that can carry significant risks.

- Buying a call gives you the right to buy a stock from the writer at a specific price during a specific period of time, while buying a put gives you the right to sell the stock to the writer.
- You would purchase a call if you expect the market price of the stock to rise and purchase a put if you expect the price to fall.
- If prices move as expected, you would then profit by buying the stock at a below-market price, or selling it above the market price.
- A call is similar to a long position in a stock, increasing in value as the stock's price rises. A put is similar to a short position that gains value as the stock's price declines.

Selling Options
The motivation to sell (write) options is to earn the premium. Most investors who sell options hope the purchaser will not exercise those rights. The safest form of option writing is a covered call because the worst outcome would be to have shares already owned called away. A much riskier choice is selling naked options**.**

A naked option is an option for which the buyer or seller has no underlying position in the stock. A writer of a naked call option does not own the stock on which the call has been written. Therefore, if the stock rises and the holder of the call decides to exercise the option, the writer of the naked call will have to buy the stock at the higher price and sell it at a loss to the option holder.

Example: An option writer sells a naked call option at $25 a share of ABC Technology Inc. without owning the shares. ABC's stock then rises to $32 a share, and the option buyer decides to exercise the option. That forces the writer to buy the shares at $32 each and then sell them to the option holder at $25 - a loss of $7 a share. If the option writer had owned the shares prior to selling the option, he or she could have just turned over those shares to the option buyer.

The writer of a naked put option that does not own a short position in the underlying stock faces the same risk.

Exam Tips and Tricks
Consider this sample exam question about

options:

1. **A client sells a right to buy 100 shares of XYZ stock at $50 three months from now. The client is a:**
   a. Holder of a put option
   b. Writer of a put option
   c. Holder of a call option
   d. Writer of a call option

The correct answer is "D" - the client has written a call option.

11.1 Analyzing Your Client's Financial Profile - Introduction

In the Handling Client Funds section, the concept of suitability was discussed. The best way to ensure that your investment advice or financial planning recommendations are suitable is to develop a client profile. Be sure to collect the following information at the beginning of your advisory relationship and to update the profile as your client's situation changes over time:

1. Type of client
2. Current status
3. Financial goals
4. Capital and other needs
5. Current investments
6. Risk tolerance
7. Non-financial considerations

As fiduciaries, investment advisers owe their clients a duty to provide only suitable investment advice. The SEC says, "This duty generally requires an investment adviser to determine that the investment advice it gives to a client is suitable for the client, taking into consideration the client's financial situation, investment experience and investment objectives."

Ensuring investments are suitable for a particular client comes into play during the investment recommendations phase of an investment adviser's work. Suitability rules require that investors have the financial means to assume the risks involved with a particular investment.

The exam is likely to pose questions about suitability under different investor scenarios that use the above factors.

11.2 - Client Type

In addition to individuals and married couples, there are many other potential client types. Because the goals of an organization are likely to be very different from those of an individual, you should be familiar with these other client types:

Sole proprietorship
A sole proprietorship is a business organization that is unincorporated and has just one owner. The finances of the sole proprietor business and the owner are one and the same. The sole proprietor has unlimited liability and is responsible for all business debts. For tax purposes, all business income or losses flow through directly to the owner.

Partnerships

- **Business partnership** - all partners are equally responsible for business debts and share equally in business profits (which pass through to be reported on each partner's personal income tax return).
- **Limited partnership -** the general partner is responsible for managing the business and has unlimited liability for its debts, while the limited partners are not responsible for any of the debts.
- **Family limited partnership -** this arrangement is used primarily as a means of minimizing estate and gift taxes but must have a legitimate business purpose (such as managing investment real estate, family business, etc.).

Corporations
The main advantage of all types of corporations is that the owners are not personally liable for the corporation's debts. There are three types:

- **C Corporation -** thesecorporations must pay corporate income tax on their income, and the owners pay personal income taxes on profits received as dividends (known as double taxation).
- **S Corporation -** this arrangement is suitable for small companies (no more than 100 shareholders) that want the legal protection of a corporation but the flow-through taxation of partnerships (corporate losses are applied to personal income tax returns).
- **Limited Liability Corporation -** this type of structure allows protection from debts but is taxed more like a sole proprietorship.

Look Out!
You are likely to be given a description of a new business and asked which type of corporation it most resembles. If the question states that losses are expected in the first years, "S Corporation" is the correct answer. If it is a single owner and losses are not mentioned but protection from liabilities is noted, "LLC" is usually the correct answer. (Sole proprietorship is usually the fourth choice.)

Other Entities

- Estates **-** an estate account is typically open only a short time, until the estate assets are distributed to beneficiaries. Consequently, long-term or speculative investments are usually not appropriate.
- Trusts **-** the IA must recommend investments that are suitable for the beneficiaries of the trust, not for the trustee.

Exam Tips and Tricks
Consider these sample exam questions about client types:

1. **Which business entity would provide a flow-through of business income or losses as well as limited liability to the owners?**
   a. Sole Proprietorship
   b. General Partnership
   c. C Corporation
   d. S Corporation

The correct answer is "d" - only the S Corporation offers both these advantages.

2. **Which investments would be considered suitable for an estate account?**
   a. Treasury bonds
   b. Options
   c. Money market fund
   d. Growth-stock mutual fund

The correct answer is "c", since Treasury bonds, growth-stock mutual funds and options are not suitable for an account with a short time horizon.

11.3 - Current Status and Financial Goals

Current Status
Before you can begin to help clients meet their goals, you must have a good grasp of their current financial situation. It can be useful to create worksheets to capture the following information:

- Income
- Expenses
- Assets
- Liabilities
- Tax issues

Financial Goals
"Financial goals" refers to general investment objectives, not the client's specific needs, such as retirement at a certain age or college plans for his/her children (see the next section on capital needs).

However, there is certainly a correlation between the two, and it is useful to know the characteristics of each of these investment goals:

- **Preservation of capital** - the investor is more concerned with safety than return. Treasury bills and money market funds may be most appropriate.

- **Current income** - the investor needs a portfolio that produces steady income for current living expenses. Bonds, annuities and stocks with high dividends (such as utility stocks) may be appropriate.

- **Growth and income** - the investor is looking for a portfolio that generates some amount of income, but he/she is looking for capital appreciation as well (often for protection against inflation). Appropriate investments could include a mix of bonds and stocks.

- **Growth** - the investor's goal is likely retirement or another event in the future, where current income is not needed. A diversified stock or mutual fund portfolio is appropriate.

- **Speculation** - the investor is looking for high-risk investments with a potential for very large returns. This is rarely the goal for an entire portfolio, but rather for a specific portion of assets. Aggressive growth funds and small-cap issues may be most appropriate.

Exam Tips and Tricks
Consider this sample exam question:

1. **Each of the mutual funds below might be suitable for an investor primarily seeking income investments EXCEPT:**
    a. Government bond fund
    b. Balanced fund
    c. Sector fund
    d. Money market fund

The correct answer is "c", since sector funds contain only stock investments and are primarily growth-oriented.

11.4 - Capital and Current Investments

Capital and Other Needs

The client's specific goals should be discussed in detail. While retirement and college funding are nearly universal, be sure to probe for other goals, such as starting a business, helping other family members or buying a vacation home.

A key consideration for any of these goals is the time horizon, which affects both the choice of investment strategy and the amount of annual savings needed to reach the goal. Other needs must be discussed and planned for as well, including:

- **Emergency reserves** - while three to six months of living expenses is considered standard, other factors could dictate a larger or smaller need for liquid savings.

- **Life insurance** - if the client has a family whose income needs cannot be met through current assets, life insurance is needed. The total amount and type of insurance would depend on client circumstances.

- **Other insurance** - the IA should review the client's disability and health insurance coverage, since any investment or estate plans could be disrupted if this coverage is inadequate.

Current Investments

Before making investment recommendations, it's important for the IA to understand the client's current holdings and what strategies were used to create them. The client may

wish to liquidate some or all of these holdings and reinvest in a new portfolio, or he/she may want to retain all current holdings. The IA must take these choices into consideration before making recommendations.

11.5 - Risk Tolerance and Non-Financial Considerations

Risk Tolerance
A primary consideration in recommending suitable investments is an understanding of the client's risk tolerance. If a particular client is uncomfortable with the inherent risk of a growth portfolio or a specific investment option, it is not suitable - even if it appears to match the client's time horizon and financial goals. Of course, an IA may try to educate the client as to risk/reward tradeoffs and the history of similar investments, but the client is the final arbiter of how much risk he or she is willing to take on.

Non-Financial Considerations
A number of non-objective issues can impact what investments and strategies are appropriate for a particular investor, such as:

- Investor knowledge and sophistication
- Client values
- Client demographics

Exam Tips and Tricks
Consider this sample exam question:

1.

The risk tolerance of the client is NOT a factor to consider when making investment recommendations to which client type(s):

I. **Trusts**
II. **Estates**
III. **Limited partnerships**
IV. **Accredited investors**

a. IV only
b. I & II only
c. I, II, III & IV
d. None of the above

The correct answer is "d" - risk tolerance must be considered for all investors, even institutional ones.

12.1 Portfolio Management - Introduction

Introduction
Once you have obtained information about your client's goals and financial situation, you can begin making investment recommendations. This process begins with choosing an appropriate asset allocation.

12.2 - Asset Allocation

What is Asset Allocation?
In simple terms, asset allocation refers to the balance between growth- and income-oriented investments in a portfolio. This allows the investor to take advantage of the risk/reward tradeoff and benefit from both growth and income. Here are the basic steps to asset allocation:

1. Choosing which asset classes to include (stocks, bonds, money market, real estate, precious metals, etc.)
2. Selecting the ideal percentage (the target) to allocate to each asset class
3. Identifying an acceptable range within that target
4. Diversifying within each asset class

If you are unfamiliar with asset allocation, see the tutorial: *Asset Allocation*.

In addition, the article *Achieving Optimal Asset Allocation* contains further pointers on how to appropriately allocate assets to the various asset classes.

Of course, the appropriate mix for a particular client depends upon many of the factors discussed in section 12, including risk tolerance, time horizon and financial goals. For example, an IA with a client who owns commercial real estate properties or a number of rental homes would probably not recommend REITs or other real estate securities in the portfolio.

Risk Tolerance
The client's risk tolerance is the single most important factor in choosing an asset allocation. Most IAs will create a risk-tolerance questionnaire (or use one provided with

their financial planning software) to make sure they have an accurate measure of risk. At times, there may be a distinct difference between the risk tolerance of a client and his/her spouse, so care must be taken to reach consensus on how to proceed. Also, risk tolerance may change over time, so it's important to periodically revisit the topic.

Time Horizon
Clearly, the time horizon for each of the client's goals will affect the asset allocation mix. Take the example of a client with a very high tolerance for risk. The recommended allocation to stocks will be much higher for the client's retirement portfolio than for the money being set aside for the college fund of the client's 13-year-old child.

12.3 - Strategic vs. Tactical Asset Allocation

- **Strategic asset allocation** calls for setting target allocations and then periodically rebalancing the portfolio back to those targets as investment returns skew the original asset allocation percentages.
    - The concept is akin to a "buy and hold" strategy, rather than an active trading approach.
    - Of course, the strategic asset allocation targets may change over time as the client's goals and needs change and as the time horizon for major events, such as retirement and college funding, grows shorter.
- **Tactical asset allocation** allows for a range of percentages in each asset class (such as stocks = 40-50%).
    - These are minimum and maximum acceptable percentages that permit the IA to take advantage of market conditions within these parameters.
    - Thus, a minor form of market timing is possible, since the IA can move to the higher end of the range when stocks are expected to do better and to the lower end when the economic outlook is bleak.

The article *Asset Allocation Strategies* contains information on the various asset allocation strategies, from strategic and tactical, to other strategies such as constant-weighting, dynamic and insured.

Look Out!
On the test, strategic asset allocation may be linked with a "passive" investment style (see the Portfolio Styles section below), while tactical asset allocation is linked with an "active" investment style.

12.4 - Diversification

Once the target asset allocation percentages have been defined, the next step is to diversify. For example, within the bond or fixed-income class, investment options include corporate bonds, government bonds, municipal bonds and so on. Further choices within the corporate bond category alone include short-term vs. long-term, investment-grade vs. high-yield (or junk) bonds, convertible, etc.

The range of options for stocks or stock funds is even wider. The information below refers to both individual stocks and mutual funds:

- ***Market capitalization*** **-** market cap simply refers to the total dollar value of a company's outstanding common shares, calculated by multiplying the total number of shares outstanding by the current market price of a share. Stocks are classified based on size as follows:
    - **Large-cap stocks,** $5 billion or more
    - **Mid-cap stocks,** $1 billion to $5 billion
    - **Small-cap stocks,** less than $1 billion
    - **Micro-cap stocks,** less than $50 million

Diversifying across stocks with different market capitalizations is recommended. Typically, a larger allocation is made to large-cap stocks and smaller percentages to small- or mid-cap stocks.

- ***Growth vs. value*** **-** stocks also differ by style. Typically, stocks (and mutual funds) are categorized as either growth or value oriented. Both styles have advocates who believe one is likely to outperform the other for different reasons.
    - Growth stocks are those whose earnings have been higher than average in the past and are expected to continue at a higher-than-average rate in the future.
        - They typically pay low or no dividends and often trade at high P/E ratios.
        - They tend to do well when the overall market is rising and over the long term tend to outperform slower-growing or stagnant stocks.
        - They are riskier than average stocks because of their high P/E ratios and the fact they pay little or no dividends.

- Value stocks generally have a strong balance sheet and higher dividends, and are undervalued in the market given their earnings and asset values.
  - Value stocks tend to outperform growth stocks during a falling market.
  - Characteristics include a high dividend, low price-to-book ratio and a low P/E ratio.
  - Value investors believe markets are not always efficient and that it is possible to find companies trading for less than their true value.

As in other contexts, diversification helps to reduce risk in a portfolio. Since different types of stocks have different characteristics, their rates of return will differ throughout the economic cycle. For example, if a portfolio is composed of 50% stocks, and a large-cap stock fund is the only investment, it may perform better during a downturn in the market than a small-cap fund; but the small-cap may outperform the large-cap during a market rally.

Although diversification is an important method of optimizing a portfolio's performance, it is possible to become over-diversified. For more, see the article *The Dangers of Over-Diversification*.

Exam Tips and Tricks
Consider these sample exam questions about asset allocation:

1. **Strategic asset allocation refers to the selection of:**
   a. Specific securities to purchase
   b. Variation allowed within an asset allocation range
   c. Asset classes to invest in
   d. Target asset allocation for each selected asset class

The correct answer is "d", since "b" refers to tactical asset allocation.

2. **A value manager would consider all of the following in choosing a stock EXCEPT:**
   a. Price/book value ratio
   b. Stock price growth rate
   c. Market share
   d. Price/earnings ratio

The correct answer is "b" - value stocks are evaluated based on the company's financials, including balance sheet ratios and market share. The growth rate of the stock is a factor that growth investors would use to evaluate a stock.

12.5 - Active vs. Passive Portfolio Styles

There are two basic approaches to investment management:

1. Active asset management is based on a belief that a specific style of management or analysis can produce returns that beat the market.

    - The active approach seeks to take advantage of inefficiencies in the market and is typically accompanied by higher-than-average costs (for analysts and managers who must spend time to seek out these inefficiencies).

    - Market timing is an extreme example of active asset management. It is based on the belief that it's possible to anticipate the movement of markets based on factors such as economic conditions, interest rate trends or technical indicators. Many investors, particularly academics, believe it is impossible to correctly time the market on a consistent basis.

2. Passive asset management is based on the belief that:
    - Markets are efficient.
    - Market returns cannot be surpassed regularly over time.
    - Low-cost investments held for the long-term will provide the best returns.

Stock Selection
For those who favor an active management approach,stock selection is typically based on one of two styles:

- The active approach seeks to take advantage of inefficiencies in the market and is typically accompanied by higher-than-average costs (for analysts and managers who must spend time to seek out these inefficiencies).

- Market timing is an extreme example of active asset management. It is based on the belief that it's possible to anticipate the movement of markets based on factors such as economic conditions, interest rate trends or technical indicators. Many investors, particularly academics, believe it is impossible to correctly time the market on a consistent basis.

Within the tutorial *Guide to Stock-Picking Strategies* we explore the art of stock picking, with the aim of achieving a rate of return that is greater than the market's overall average.

Passive management concepts to know include:

- Markets are efficient.
- Market returns cannot be surpassed regularly over time.
- Low-cost investments held for the long-term will provide the best returns.

Within the tutorial *Index Investing*, we discuss some of the major stock indexes and explain how one can invest in the stock market through index funds:

When choosing index funds, it's important to realize that not all index funds are created equal. Read more on this topic within the article *You Can't Judge an Index Fund by It's Cover*.

Consider these sample exam questions:

1. **The efficient market theory states that:**
    a. Future market prices are determined by the discounted value of future dividends.
    b. Technical analysis tools cannot be used to beat the market, since current prices already reflect all available information about previous price patterns.
    c. Current market prices already reflect all available information.
    d. Market prices are determined by supply and demand.

The correct answer is "c"; "b" is incorrect, since the efficient market theory is not concerned with technical analysis.

2. **Passive asset management involves:**
    a. Using index funds as the investments for each asset class
    b. Choosing the stocks or mutual funds to be purchased for each asset class
    c. Buying securities for each asset class and holding them until the funds are needed
    d. Buying securities for each asset class and selling them when they reach their price targets

The correct answer is "a" - while index funds are not a requirement of passive management, they are a frequently used tool. "c" is incorrect because passive management does not preclude making portfolio changes. For example, periodic rebalancing is performed, and changes can be made in response to changes in the client's risk tolerance, financial situation, goals and so forth.

13.1 Taxation Issues - Introduction

Income taxation can have a significant impact on your client's portfolio and financial plans. It is crucial that you fully understand the tax implications of the recommendations you make.

13.2 - Individual Income Tax Issues

Types of Income Tax
An individual may be subject to one of the following four types of income tax:

1. **Ordinary income - ** this includes all income earned from salary, commission and business income. Some investment gains, such as bond interest and withdrawals from traditional IRAs and company retirement plans, are taxed at "ordinary income" rates.

2. **Capital gains - ** this refers to income resulting from the appreciation of a capital asset (e.g., stocks, real estate, coins). Capital gains are not realized until the asset is sold. Capital gains are classified as either short- or long-term:
    - Short-term **-** assets held for 12 months or less are considered short-term capital gains and are taxed at ordinary income rates.

    - Long-term **-** assets held for longer than 12 months benefit from reduced tax rates (based on your marginal tax bracket). In 2013, taxpayers within the 10 to 15 percent bracket foot a bill of 10% on long-term capital gains while taxpayers above that bracket (25%+) are taxed at a rate of 20%.

3. **Dividends - ** prior to 2003, dividends were taxed at ordinary income rates along with bond interest. In 2013, "qualified" dividends are taxed like capital gains, with taxpayers within the 25 to 35 percent bracket required to pay 15% while those under 25 percent receive a tax bill of 0%.

4. **Passive income - ** income from sources - such as real estate limited partnerships or directly owned (but professionally managed) real estate - is taxable at ordinary income rates and can only be reduced by passive losses, not by capital gains losses.

13.3 - Holding Period and Cost Basis

Since the difference between short- and long-term capital gains taxation rates is so significant, you need to understand exactly when a security is considered purchased and when it is considered sold.

- The holding period begins the day after the security is purchased (not the settlement date).
- The holding period ends the day of the sale.
- It is important to keep detailed records of these dates, to ensure that a security is not sold too soon and thus qualifies for preferential tax treatment.

Cost Basis
Merely knowing the tax rates is not enough for an investment adviser. A key concept to understand is cost basis, since the amount of capital gains to be taxed is calculated by subtracting the investor's cost from the sales proceeds. To determine the cost basis of an investment, start with the original price (plus any transaction costs). Next, add the dollar value of dividends that were reinvested. This would apply to both stocks in a dividend-reinvestment program and mutual funds where dividends are automatically reinvested. Reinvested capital gains are also added to the cost basis for mutual funds.

Cost basis = Original Price + transaction costs + reinvested dividends

- If you inherit an investment

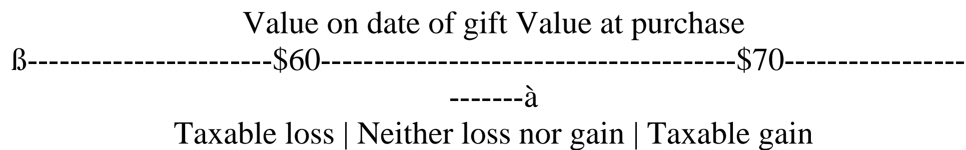
, your cost basis is the value of the asset as of the decedent's date of death. This is known as a stepped-up cost basis. Also, the holding period is always considered long term, even if the deceased hadn't owned the investment for 12 months before death.

- If you receive an investment as a gift, there are actually two different cost bases that apply:

1 - The actual cost basis of the giver; and
2 - The market value on the date of the gift.

1. The actual cost basis of the giver transfers to the receiver if the value of the asset is equal to or greater than what the giver first paid for it. This is known as carryover basis.

2. The market value on the date of the gift comes into play if the investment had declined in value since the giver acquired it. For "loss property", there is what is known as double basis. The best way to explain how this works is to use an example. Let's say you are given shares of stock, and the original owner's cost basis was $70 a share. On the date of the gift, the shares are trading at $60. If you sell the shares in the future, the basis for a gain is $70 a share, and the basis for a loss is $60. If you sell the shares for a price between $60 and $70, you have neither a taxable gain nor a taxable loss. See the illustration below.



13.4 - Netting Capital Gains and Losses and Wash Sales

Netting Capital Gains and Losses
If an investor makes a number of trades in a particular year, the end result could be a mix of long- and short-term capital gains and losses. The IRS is specific as to how these gains and losses are to be netted against each other. Here are the steps:

- Net short-term gains against short-term losses.
- Net long-term gains against long-term losses.
- If both holding periods result in gains (or both in losses), they are reported separately on Schedule D.
- If one holding period results in a gain and the other in a loss, they are then netted against each other.
- If capital losses exceed capital gains, up to $3,000 can be deducted against ordinary income in any one year.
- Unused capital losses can be carried forward indefinitely to future years - each year, unused capital losses will first be netted against the current year's capital gains, followed by the $3,000 deduction against ordinary income.

Wash Sales
If you own a stock that has gone down in value, but you believe it will rise significantly in the future, it could be tempting to sell the stock and enjoy the resulting capital loss and then buy it back so you can enjoy the future capital gain. But the IRS does not permit you to take the loss if you buy the same (or similar) security back within 30 days of the sale. This is known as a "wash sale".

There are several ways to avoid the "wash sale" rule and still take advantage of the underlying strategy:

- Wait more than 30 days to buy back the security; or
- Buy a security with similar characteristics (e.g., sell shares of ABC growth mutual fund and buy shares of XYZ growth mutual fund)

The wash rule applies to transactions before and after the sell date. For example, you cannot buy additional shares of the security on October 1, sell the original shares on October 20 and then buy more shares of the same security on November 10. In essence, the wash sale rule covers a period of 61 days: the sell date plus 30 days before and 30 days after.

Look Out!
Don\'t be confused by the prohibition against buying back the"same (or similar) security" and the strategy of "buying a security with similar characteristics." In the first instance, "similar security" refers to securities that are convertible to the sold security, (such as call options, rights, warrants or convertible bonds), which can result in owning the security at a later date.

The article *Selling Losing Securities for a Tax Advantage* contains valuable information on how to perform tax-loss harvesting to help reduce taxes on portfolio gains:

Exam Tips and Tricks
Consider these sample exam questions:

1. **Your client bought 100 shares of ABC stock on June 30. What is the first day of the following year the stocks could be sold for a capital gain?**
   a. June 1
   b. July 1
   c. July 2
   d. June 30

The correct answer is "c", since the holding period begins July 1 (the day after the purchase). Long-term capital gains are only permitted if the holding period is greater than one year, so the correct answer is July 2.

2. **Your client has a net short-term gain of $3,000 and a net long-term loss of $8,000. Which of the following statements are true?**
   I. **The short-term gain is fully taxable**
   II. **$3,000 of capital loss is deductible against earned income**
   III. **There is a long-term loss carried forward of $2,000**

IV. **There is no loss carried forward**

e. I & III
f. I & IV
g. II & III
h. I, II, & III

The correct answer is "c". The gain and the loss are netted and result in a $5,000 long-term loss. $3,000 of that can be used in the current year as a deduction against earned income, and $2,000 will be carried forward.

13.5 - Corporate and Trust Income Tax

Corporate Income Taxes
Corporations get a tax break for investing in common and preferred stocks (of companies other than their own).

- There is a dividend exclusion of 70% that applies to corporations that own less than 20% of the other company. (In order words, 70% of dividends received from another corporation are tax-free.)
- If the company owns more than 20%, the dividend exclusion is 80%.
- Since there is no corporate tax break on bond interest (for corporate or government bonds), there is no incentive for corporations to purchase these. However, there is an incentive for corporations to purchase stocks because of the dividend exclusion.
- Of course, municipal bond interest is not taxable to the corporation (unless it is a private-purpose bond, which would be taxable to an individual as well).

Trust Income Taxes
The income tax rate that applies to a trust depends on what type of trust it is:

- **Revocable trusts** - these trusts manage assets that the owner ("grantor") has placed in the trust during his or her own lifetime.
  - The grantor has the right to change or terminate the trust at any time and can serve as the trustee of the trust.
  - The trust becomes irrevocable upon the grantor's death.
  - Revocable trusts are taxed at the grantor's personal income tax rate - currently a maximum of 35%.
- **Irrevocable trusts** - these trusts may be created during the grantor's lifetime or may be contained within a will and become active only upon their death.

- Unlike revocable trusts, the grantor is unable to make changes without the permission of the beneficiary.
- Irrevocable trusts are taxed at special trust income tax rates.
- In 2007, the maximum rate is 35%, but since the income brackets are smaller, this rate is applied to a larger amount of income.
- For example, a single individual will have a tax rate of 35% applied to taxable income in excess of $349,700 while the special trust tax rate of 35% is applied to taxable income in excess of $10,450. As a result, there is a distinct tax disadvantage to placing income-producing assets into an irrevocable trust.

13.6 - Estate and Gift Taxes

Unified Estate and Gift Tax
The total of all taxable gifts given during a person's lifetime plus taxable amounts transferred upon death are subject to a unified estate and gift tax. Estate taxes and gift taxes are interrelated, since the federal government applies the Unified Estate and Gift Tax Credit (also known as the Unified Credit) to both types of transfers of property. Because this area of tax law is complex, clients with large estates should be advised to work with an estate planning specialist to create an estate plan that minimizes potential taxes.

While income taxes are paid by the person who receives the income, gift and estate taxes are paid by the person or entity that transfers the money. Gift taxes are paid by the donor, and estate taxes are paid by the estate. These taxes are progressive, meaning the tax rate increases with the size of the gift or estate.

Unified Estate and Gift Tax Credit
This amount has changed significantly over the years and is scheduled for additional changes in the future.

- The Unified Credit stayed at $600,000 for many years, until a tax-law change set it to increase to $1 million over a period of years.
- Another tax-law change in 2001 made a significant change to the schedule. Essentially, it dramatically increases the amount of an estate that is excluded from taxation from 2001 through 2009, and then it entirely repeals the tax in 2010.
- However, due to budget pressures, this entire schedule is effectively repealed in 2011! Unless additional legislation passes before then, the Unified Credit amount will revert to the amount under the original schedule for 2001. This makes estate planning for the wealthy client quite a challenge.

- See the following page for a table displaying current exclusion limits.

Gift tax exclusion
The gift tax exclusion allows individuals to give away assets up to a certain value without being subject to the gift tax. For 2007, the limit is $12,000. Individuals can gift up to this amount each year to an unlimited number of people. This is one way for wealthy people to reduce their estate prior to death. A married couple can gift $24,000 per year per beneficiary.

> ***Look Out!***
> **This gift limit is indexed for inflation. It had been at $10,000 for many years before an indexing factor was permitted. As a result, the exam refers to the gift tax exclusion as "$10,000 indexed for inflation annually."**

Gifts in excess of this annual amount may still be given free of tax. However, a gift tax return must be filed, showing the amount of the gift and the amount of the Unified Credit that is being taken. The maximum amount of lifetime gifts that can be given tax-free under the Unified Credit is $1 million. This is a lower amount than the basic Unified Credit (see the table below).

Estate tax exclusion
The maximum amount of estate value (including lifetime taxable gifts) excluded from taxation is shown in the following table:

YEAR	Amount Excluded
2007 & 2008	$2 million
2009	$3.5 million
2010	Tax Repealed
2011	$1 million

Marital deduction
Not all transfers upon death are taxable. There is an unlimited marital deduction that applies to direct transfers or certain transfers in trust to the surviving spouse. Such amounts would then be subject to estate tax when the second spouse dies, unless they

were gifted away or spent prior to the surviving spouse's death. The unlimited marital exclusion also applies to lifetime gifts.

Exam Tips and Tricks
Consider these sample exam questions:

1. **Which of the following gift given in one year from an aunt to her nieces would NOT be subject to gift tax?**
    I. **One $24,000 gift to one niece**
    II. **Two $12,000 gifts to two nieces**
    III. **Two $24,000 gifts to two nieces**
    IV. **One $10,000 gift to one niece**
    e. I only
    f. II & IV
    g. II & III
    h. I, II, III, & IV

The correct answer is "b" - since there is no indication that the aunt is married, the transfers of $24,000 would be subject to gift tax.

14.1 Retirement Plans - Introduction

There are several types of individual and employer-based retirement plans that may be available to your clients. The Series 65 exam will test you on your knowledge of the eligibility and tax treatment of these plans, as well as the suitability of the plans for different types of clients.

14.2 - Traditional Individual Retirement Accounts (IRAs)

There are two types of Individual Retirement Accounts (IRAs) - Traditional and Roth. Each has unique eligibility rules and tax treatment, but the contribution limits are

identical. Catch-up limits also apply to both IRA types and are available to those aged 50 and older.

These amounts are scheduled to rise over time as shown below:

YEAR	Contribution	Catch-up
2007	$4,000	$1,000
2008	$5,000	$1,000
2009	Indexed for inflation	$1,000

Look Out!
The limits above apply *jointly* to both Traditional and Roth IRAs. For example, a 40-year-old client can contribute a total maximum of $4,000 in 2005 - so he/she could contribute $1,000 to a Traditional IRA and $3,000 to a Roth IRA, but not $4,000 to each.

Not all types of investments are permitted within IRAs. Permissible investments include stocks, bonds, mutual funds, annuities, government securities, and gold or silver coins minted by the U.S. Treasury. Other investments, such as collectibles, insurance policies, art, and other types of coins, are not permitted.

Traditional IRA
Any employed person is eligible to contribute to a Traditional IRA. However, the ability to deduct that contribution is subject to the following eligibility rules:

- If a person is not currently covered by a retirement plan at work, IRA contributions are deductible in full.
- If a person is currently covered by a retirement plan at work, IRA contributions are deductible only if income is less than the limits shown below:

YEAR	Single Return	Joint Return
2007	$50,000-$60,000	$80,000-$100,000

- If income falls between the limits shown above, the contribution will be partially deductible - the deduction is "phased out" in proportion to the amount by which the income exceeds the lower limit in the range.

- For a married couple, if only one spouse is covered by a pension plan, a different phase-out rule applies:
  - If combined income is $150,000 or less, the contribution for the non-covered spouse is fully deductible.

  - If combined income is between $150,000 and $160,000, a proportional phase-out applies.

  - If combined income is $160,000 or higher, no deduction applies.

  - These rules apply only to the non-covered spouse; contributions by the covered spouse are not deductible.

Look Out!
On the exam, you will not be tested on the actual dollar values for the phase-out. However, you will need to know that clients with high incomes are subject to different phase-out rules.

Traditional IRA Specifics:

- Earnings are tax deferred until withdrawn.

- If deductible contributions are made, 100% of withdrawals are subject to taxation at ordinary income rates.

- If non-deductible contributions are made, a portion of each withdrawal is not taxable.

- Withdrawals made prior to age 59 and a half are subject to a 10% penalty, unless one of the following exceptions applies:
  - Death
  - Disability
  - Eligible education expenses
  - First-time home-buying expenses (up to $10,000)
  - Distributions made over the life expectancy of the IRA owner

- Contributions may not be made after the IRA owner turns 70 and a half - even if he or she is still employed.

- Distributions made over the life expectancy of the IRA owner must begin no later than April 1 of the year following the year in which the owner turns 70 and a half.

- If a person fails to withdraw any amount that should have been distributed under these mandatory minimum requirements, a 50% tax penalty applies to the amount not distributed.

14.3 - Roth Individual Retirement Account

Roth IRAs have a very different tax structure than Traditional IRAs. Contributions are *not*deductible. However, earnings may be withdrawn tax-free (rather than tax-deferred) if the following conditions are met:

- Withdrawals do not occur until the account has been open at least five years; AND
- Withdrawals do not occur until the Roth IRA owner reaches age 59 and a half

This is a very powerful vehicle, since virtually all other retirement accounts offer only tax-deferral on the earnings. However, income limits do apply. The chart below shows the maximum amount of income permitted to make the full contribution, as well as the phase-out income range for a partial contribution:

Filing Status	Full Contribution	Partial Contribution
Single or Head of Household	Up to $110,000	$110,000-$125,000
Married Filing Jointly	Up to $173,000	$173,000-$183,000

Roth IRA Specifics:

- Contributions are permitted after age 70 and a half (assuming there is earned income).
- There are no mandatory minimum required distribution rules at any age.
- Withdrawals are made on a FIFO basis (first in, first out) - so any withdrawals made come from contributions first. Therefore, no earnings are considered withdrawn until all contributions have been withdrawn.
- Withdrawals of contributions are not taxable or penalized - even if they are made before age 59 and a half or before the account has been open for five years.
- Withdrawals of earnings are taxed but not penalized under the same exceptions listed for Traditional IRAs.

Determining which IRA is best for a client is an important decision. Deductibility, contribution age and income limitations, tax treatment of distributions and minimum distribution are some of the many factors to consider. We detail these factors within the article *Roth or Traditional IRA... Which Is The Better Choice?*

Exam Tips and Tricks
Consider these sample exam questions about IRAs:

1.

Which of the following statements about Traditional IRAs are TRUE?

I.

Contributions are allowed based on earned income only
- **Contributions always reduce taxable income**
- **Contributions may be made even if the individual is covered by an employer's retirement plan**
- **Contributions may not be made after age 70 and a half**

a. I & II
b. II, III, & IV
c. I, III, & IV
d. I, II, III, & IV

The correct answer is "c", since contributions may not reduce taxable income if the person is not eligible to deduct the contribution.

2. **Which of the following clients is best suited for a Roth IRA instead of a Traditional IRA?**
   I. **Someone who is in a high tax bracket now and expects to be in a much lower tax bracket in retirement**
   II. **Someone who is in a low tax bracket now and expects to be in a much higher tax bracket in retirement**
   III. **Someone who is covered by a retirement plan at work and can only make a non-deductible contribution to a Traditional IRA because of a high income**
   IV. **Someone who is in a moderate tax bracket now and expects to be in a lower tax bracket in retirement**
      e. I & II
      f. II & III

g. II, III, & IV
h. I, II, III, & IV

The correct answer is "b" - the Roth IRA is the better choice for client II, since the IRA deduction is worth less to someone in a low bracket and the tax-free withdrawals will be more valuable to someone in a higher bracket. Also, it's always better to make a non-deductible Roth IRA contribution than a non-deductible Traditional IRA contribution. The clients described in I and IV expect to be in a lower tax bracket at retirement, so they may be better off taking the tax deduction now.

14.4 - Qualified Retirement Plans

What is a Qualified Retirement Plan?
If it meets certain criteria, a qualified retirement plan is permitted to take advantage of special tax treatment. One key requirement for qualification is that the plan must not discriminate in favor of the employer's key employees. The special tax benefits include the following:

- The employer may take a tax deduction for contributions made to the plan
- Employees may take a tax deduction on their own contributions to the plan
- Earnings on all contributions are tax deferred until withdrawn

There are two types of qualified plans: defined benefit and defined contribution plans**.**

Defined Benefit Plans
Defined benefit plans are traditional pension plans, where benefits are based on a specific formula. Most formulas use the number of years of service times a salary factor (often an average of the highest three, or highest five, years of salary history). An age factor is used as well, so a worker retiring at 65 receives a higher monthly benefit than one retiring at 62.

Characteristics:

- Employer makes all contributions
- Employer makes all investment decisions and bears the risk if investments perform badly
- Less popular since the rise of defined contribution plans

Defined Contribution Plans
Rather than basing plan benefits on a specific formula as defined benefit plans do, defined contribution plans allocate money to plan participants based on a percentage of each employee's earnings. The longer the employee participates in the plan, the higher the account balance grows, based on the amounts contributed and the investment earnings.

Most defined contribution plans allow employees to choose their own investment mix

from the specific funds made available through the employer.

Types of Plans:

- Profit-sharing plan - this allows the employer to contribute a percentage of salary each year, but the percentage can vary each year based on corporate profits. However, contributions can be made even when there are no profits, at the employer's discretion.
- 401(k) plan **-** this form of profit-sharing plan allows employees to reduce their taxable income by deferring a percentage of their salary into the plan. For 2007, the contribution limit is $15,500, with an additional catch-up contribution of up to $5,000 allowed for workers 50 and over.
- 403(b) plan - these plans are also known as tax-sheltered annuities.
- Money purchase pension plan - this requires the employer to contribute a set percentage of salary each year regardless of corporate profits.

Look Out!
The main thing to know about the various defined contribution plans is that 403(b) plans are available only to employees of schools, hospitals and certain nonprofit organizations. They are analogous to corporate 401(k) plans.

If you are interested in learning more about the different types of retirement plans, the tutorial, *Introductory Tour Through Retirement Plans* will walk you through them.

14.5 - ERISA Issues

The Employee Retirement Income Security Act (ERISA) was enacted in 1974 to protect the rights of employees under retirement plans offered by their employers.
In addition to safeguarding retirement funds from employer mismanagement, ERISA requirements also cover the following:

- **Fiduciary responsibility** - the plan's trustee must manage plan assets and make decisions in the best interests of the plan participants. The trustee cannot sell assets to the plan or earn commissions from plan investments. Also, plan assets must be kept separate from company assets. Regarding investment options under ERISA:

- Fiduciaries for the plan must follow the Prudent Investor standard discussed in the Handling Client Funds section.
- Sufficient investment options must be available under the plan so that plan participants can create an adequately diversified portfolio.
- An investment policy statement is recommended to serve as a guideline for investment decisions to be made. The statement may include comments on risk tolerance, investment philosophy, time horizons, asset classes and expectations regarding rates of return.

Look Out!
It is essential for an IA to understand investment policy statements. Either the plan participants or the plan trustees may sue an IA who does not follow the guidelines of this statement. The IA could be liable for breach of fiduciary duty, even if the plan assets have outperformed the market.

- **Nondiscrimination** - all plan participants must be treated equally under the plan, and highly compensated employees must not benefit to a greater degree than non-highly compensated employees.
- **Vesting** - plan benefits may require a vesting period before the employee earns the right to the benefit if he/she leaves the company. ERISA regulations limit the length of such a vesting period to a reasonable schedule.

Not all employer plans are subject to ERISA. For example, governmental retirement plans are exempt from ERISA requirements. IRAs are not subject to ERISA, since an IRA is not considered an employer plan. Also, nonqualified plans, which do not qualify for tax-deductible contributions, are not subject to ERISA.

14.6 - Nonqualified Retirement Plans

Unlike qualified plans, such as defined benefit and defined contribution plans, some plans are nonqualified, meaning they do not meet ERISA guidelines and the employer therefore may not deduct contributions.

However, earnings on these plans are tax deferred until withdrawn.

- 457 plan **-** The most common nonqualified retirement plans are deferred compensation plans set up under IRS Code Section 457. These plans are available to state and local government workers and employees of certain nonprofit

employers. Like 401(k) and 403(b) plans, a 457 plan allows employees to reduce their taxable income by setting aside a portion of their salary for retirement. A 457 plan may be offered to workers in addition to other defined contribution plans.

Exam Tips and Tricks
Consider these sample exam questions about retirement plans:

1. **A retirement plan is qualified if it:**
    a. Is established by an employer instead of an individual
    b. Qualifies for special tax treatment
    c. Provides special benefits for highly paid employees
    d. Is part of an IRA

The correct answer is "b", since qualified plans must be established by the employer, but not all employer retirement plans are qualified.

2. **If a retirement plan is nonqualified, which one of the following statements is always TRUE:**
    a. The plan is illegal and should be terminated
    b. Investment earnings accumulate tax-free
    c. The employer may not deduct the plan contributions
    d. It is a defined benefit plan

The correct answer is "c", since nonqualified plans never permit deductibility of the employer's contributions.

3. **The investment policy statement under a qualified plan can best be described as:**
    a. A required document that contains the "legal list" of permissible investments in the plan
    b. A written document that outlines the plan's investment objectives and guidelines
    c. The list of prohibited transactions that the fiduciaries must not permit
    d. A written document provided to the plan participants, to limit the trustees' legal liability for poor investment decisions

The correct answer is "b", since the document is designed to provide guidance on investment decisions - not give a list of required or prohibited investments.

14.7 - Education Plans

529 Plan
Named for the section that describes them in the Internal Revenue Code, these plans are a type of municipal fund security. Such arrangements enable families to save for education on a tax advantaged basis and to a significantly greater degree than a Coverdell account or UTMA/UGMA account. Most of the time, investors in one state may invest in another state's 529 plan which does not affect the school that one chooses to apply for and matriculate at. Almost every state has a 529 plan. Major plan benefits include, to wit:

- Contribution amounts are substantial (up to $300,000 per beneficiary) and neither income limitations nor age restrictions exist.
- Investment grows on a tax-deferred basis.
- Withdrawals to pay for college costs are tax-free
- Donor may change beneficiary.
- Some states may offer tax benefits as well.
- The donor retains control of the funds. Earnings on non-qualified withdrawals are subject to ordinary income tax and a 10% withdrawal penalty.
- Simplicity. Enrollment in and contributions to the plan are easy to accomplish. Either the state treasurer's office or an outside investment management company (mutual fund) manage the plan's assets.
- Tax Reporting: Form 1099 to report (non) taxable earnings is mailed only in the year that the withdrawals are made.
- Flexibility in allocating assets are rolling over from one plan to another is afforded the investor. Each plan's rules differ, however, and should be consulted.

Coverdell Education Savings Accounts
While other education savings accounts (such as state-sponsored 529 plans) are not covered on the Series 65 exam, the Coverdell ESA is tested. Formerly known as the Education IRA, it had been included with other IRAs in the testing process. Therefore, basic questions about the Coverdell are likely to be found on the exam. Make sure you know the following information:

Annual contribution limit is $2,000; up from the $500 limit for the old Education IRA

- This limit is *per student*, so it is not possible for two sets of grandparents to each contribute $2,000 to two different Coverdell ESAs for the same student
- No tax deduction is available for the contribution, but earnings grow tax deferred
- Withdrawals of earnings are tax free, if used for qualified education expenses
- Withdrawals of earnings not used for qualified education expenses are taxed at the student's ordinary income tax rate and will also be subject to a 10% penalty

15.1 Basic Economic Concepts - Introduction

A good grasp of how the economy works and what factors influence market cycles is essential for the investment adviser, as its effect on stock and bond prices will most likely affect the value of securities within your client's portfolio.

Within this section we will discuss the various factors that affect the health of the economy, such as government fiscal and monetary policy, interest rates and inflation.

15.2 - Economic Indicators

Basic Indicators
The following basic economic indicators are important to understand:

- **Gross Domestic Product (GDP)** - is the total amount of all goods and services produced in the country. This includes consumer spending, government spending and business inventories. Real GDP is a variant that takes out the impact of inflation, so that GDP can be compared over time. Real GDP is the basic measure of business activity and tracks the business cycle.

- **Consumer Price Index (CPI)** -is a measure of the price of a basket of goods and services; increases to this index indicate an increase in inflation.

- **Producer Price Index (PPI)** -is a measure of the price of commercial items, such as farm products and industrial commodities. PPI indicates the cost to produce items and is the leading indicator of inflation.

- **Trade deficit -** resultswhen a country's imports exceed its exports. The United States usually has a trade deficit.

- **Trade surplus -** resultswhen a country's exports exceed its imports.

- **Balance of payments (BOP) -** is the amount of foreign currency taken in minus the amount of domestic currency paid out; the United States usually has a balance of payments deficit.

- **Unemployment rate -** the Bureau of Labor Statistics releases employment numbers each month that note the number of employed and unemployed people in the United States, as well as the percentage of unemployed. Increases in the unemployment rate tend to occur when the economy declines and vice versa.

Exam Tips and Tricks
The number of unemployed and percentage of unemployed may seem redundant, but they are very different. If the population increases, the number of unemployed may increase, but the percentage could remain the same.

Leading, coincident and lagging indicators
Certain economic indicators serve as barometers of economic activity. These are divided into three categories: leading indicators, coincident (or current) indicators and lagging indicators.

Leading indicators preview signs of improvement or decline in economic conditions. Some of these leading indicators include plant and equipment orders, money supply, stock prices, consumer expectations, average work week for production workers and average weekly claims for unemployment insurance.

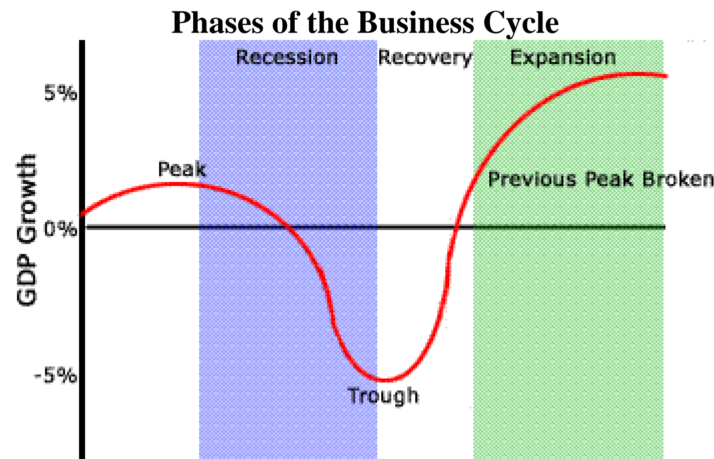
Coincident indicators coincide with current economic activity. Examples include nonfarm employment, industrial production, manufacturing and trade sales, and personal income minus transfer payments such as Social Security, disability benefits and unemployment compensation.

Lagging indicators are signs that do not emerge until after a change in economic conditions. They include the unemployment rate, business spending, labor costs, bank loans outstanding and bank interest rates.

15.3 - Business Cycle

Changes in the business cycle impact the return on securities in different asset classes. We'll discuss the business cycle's effect later in this section.
The business cycle has four phases:

- **Expansion -** this phase begins after a low point in the economy and is characterized by increased economic activity and real GDP increases.
- **Peak -** this is the period where the growth rate of the expansion slows, and the economy is in a period of prosperity.
- **Contraction -** this follows the peak and is characterized by a reduction in GDP, as well as other business indicators. Also known as recession.
- **Recovery -** this is where the contraction reaches bottom (also called a trough) and may be stagnant for a time before starting the next expansion.



Look Out!
The term recession may refer to the contraction stage in the business cycle, but it also refers to a prolonged drop in GDP that lasts at least two quarters.

An understanding of the business cycle can help one to cope with an economic decline. Check out the article *Recession - What Does It Mean to Investors* for more information.

15.4 - Economic Growth Factors

Here are some factors that can impact the growth rate of the economy:

- **Fiscal policy -** this refers to government actions (approved by Congress) that may influence economic activity. These would include changing tax rates, increasing Social Security payments, and increasing or decreasing government spending.

Learn how governments adjust taxes and government spending to moderate the economy within the article *What is Fiscal Policy?*

- **Monetary policy -** this refers to actions taken by the Federal Reserve to either increase or decrease the money supply in the economy. The Fed uses the following strategies to expand or contract funds in the banking system:
  - Buying or selling government securities in the open market. Buying government securities increases the money supply by injecting cash into

the economy and helps lead to lower interest rates; selling securities decreases the money supply by removing cash from the economy and helps to raise interest rates.

  - Increasing or decreasing member bank reserve requirements. Higher reserve requirements tighten the money supply; lower reserve requirements loosen the money supply.
  - Increasing or decreasing the discount rate to member banks who borrow reserves from the Fed. A higher discount rate tightens money supply; a lower discount rate loosens money supply.
  - Changing the percentage of credit required to buy securities on margin.

Look Out!
The Fed can expand the money supply so that credit is easier to obtain and interest rates are lowered, which increases spending. When it tightens the money supply, the reverse occurs.

Learn about the tools the Fed uses to influence interest rates and general economic conditions within the article *Formulating Monetary Policy*.

15.5 - The Effect of the Business Cycle on Stock Markets

The stock market tends to be a leading indicator of the business cycle, since investors look to other indicators and tend to exit the market at or before an economic contraction and return to the market during recovery.

Sources of the Business Cycle's Impact

- Investor Expectations: Essentially, investors move money based on where they see future profit (or loss) potential. Such movements can then affect the overall market itself, since more dollars entering the market tends to drive stock prices higher.
- Inflation expectations are another source of business cycle impact on the stock market.

- If it is assumed that inflation will rise in the near future (see the sections below), interest rates tend to rise, and this has a negative impact on stock (and bond) prices.
- Ironically, people look to stocks as an inflation hedge, but stocks actually do poorly during periods of high inflation.
- Of course, over long periods of time, the return on stocks does beat the general rate of inflation.

Inflation
Inflation refers to a general increase in the price of goods and services. This occurs when demand for these items grows faster than the supply. The result is more money chasing fewer goods, and therefore prices increase. Ensuring that your client's investments outpace the rate of inflation over the long haul is one of the major challenges for an IA.

The most important measure of inflation is the Consumer Price Index (CPI). The stock and bond markets are very sensitive to changes in the CPI because when inflation rises, purchasing power is eroded. The ensuing drop in consumer spending has a negative effect on stock and bond prices.

For more on the CPI, such as how it is constructed, its uses and how it can be used to protect against inflation, refer to the article *Why the CPI Is a Friend to Investors*.

The rate of inflation tends to increase during economic expansions and decrease during recessions. Inflation tends to be moderate during expansions, and high inflation rates tend to hasten the transition from peak to recession. Deflation is rare and occurs only during recessions.

What causes inflation? How does it affect your investments and standard of living? The *All About Inflation* tutorial has the answers.

15.6 - Interest Rates

Typically, when the supply of money increases, interest rates fall. And when the supply of money tightens, interest rates increase. So, the Fed actions discussed earlier have an impact on the following:

- Consumer spending
- Interest rates on newly issued bonds
- Market prices of existing bonds: when interest rates rise, the prices of bonds with lower coupon rates decrease and vice versa

Fed actions can also indirectly impact stocks:

- When monetary policy expands credit, lower interest rates make bonds less appealing as investments, and stocks more appealing.
- From the corporate perspective, company earnings may rise because of lower interest expense, which may cause the market price of the stock to rise.
- Of course, when the opposite occurs and monetary policy tightens credit, interest rates will rise, earnings will decrease, and the market price of the stock is likely to decrease as well. As interest rates rise, bonds become more attractive to investors.

Consider these sample exam questions:

1. **Which of the following short-term effects could result from increases in the money supply?**
   I. **Interest rate increases**
   II. **Bond price decreases**
   III. **Stock price increases**
   IV. **Inflation**
      e. I & II
      f. I & IV
      g. III & IV
      h. I, III, & IV

The correct answer is "c": increases in the money supply would decrease interest rates, not increase them, and bond and stock prices would both increase. Inflation does not always follow an increase in the money supply, but it usually does if the increase in the money supply is not accompanied by an increase in real output.

2. **All of the following are tools used by the Federal Reserve to control the money supply EXCEPT:**
   a. Setting the Fed funds rate
   b. Setting the discount rate
   c. Changing reserve requirements
   d. Buying and selling government securities in the open market

The correct answer is "a". All the other actions are tools used by the Federal Reserve, but it does not have the ability to set the Fed funds rate. That rate responds to Fed actions but is not directly set by the Fed.

16.1 Portfolio Risks and Returns - Introduction

A client's idea of risk is usually limited to concerns about market risk. But there are many different types of investment risk. Investment advisers should understand these risks, as well as common risk measures and ways to protect clients.

16.2 - Bond Risks and Duration

Types of Risk
While more publicity is given to risk in the stock markets, there are a number of risks associated with investing in bonds:

- **Call risk** - when interest rates fall, a callable bond is more likely to be called in; the investor would then have to replace it with a lower-coupon bond.

- **Reinvestment risk** - this can refer to reinvestment of principal after a bond is called, as well as reinvestment of the dividends from a high-coupon bond into a lower-rate investment.

- **Credit risk** - this refers to the possibility that the bond issuer will not be able to make expected interest rate payments and/or principal repayment.

- **Interest rate risk** - if interest rates rise, the market value of the bond will decline. This is less of an issue if the investor can hold the bond until it matures.

- **Purchasing power risk** - also referred to as inflation risk, this refers to the very real possibility that as inflation increases the purchasing power of the bond income will decrease.

- **Liquidity risk** - this refers to the marketability of the bond. Certain issuers may be less marketable than others.

- **Event risk** - any number of events can impact the creditworthiness of the issuer. Leveraged buyouts, corporate restructurings, mergers and acquisitions, and bankruptcies can all have a negative impact on a bond's price.

- **Opportunity risk** - this refers to the potentially higher rate of return an investor could earn if the money used to purchase a bond were placed in an alternate investment.

- **Currency risk** - also known as exchange risk, this was discussed in section 12 and applies only to foreign bonds.

Duration
The primary measure of bond price volatility is duration. It takes into account both the

length of time to maturity and the difference between the coupon rate and the yield to maturity. Here are some of the most important facts about duration:

- The longer the duration of a particular bond, the more its price will fluctuate in response to interest rate changes.
- Duration is always equal to or less than the years to maturity of the bond.
- Duration can help to calculate the impact of interest rate changes on the price of the bond. For example, a bond with a duration of 8 is likely to decrease 8% for every100-basis-point increase in market interest rates.
- Duration is a weighted average term to maturity.
- As payment frequency increases, duration decreases.

Look Out!
A zero-coupon bond, with only one payment (at the end of the term), has the highest duration of any bond and is therefore the most sensitive to price changes due to interest rate changes. You are very likely to be tested on this on the Series 65 exam.

16.3 - Stock Risks

Types of Risks
Here are some risks associated with investing in the stock markets:

- **Systematic risk** - also known as market risk, this is the potential for the entire market to decline. Systematic risk cannot be diversified away.
- **Unsystematic risk** - the risk that any one stock may go down in value, independent of the stock market as a whole. This risk may be minimized through diversification. This also incorporates business risk and event risk, as described in the "Bond Risks" section.
- **Other risks -** opportunity risk and liquidity risk (as described in the "Bond Risks" section) may also apply to stocks in a portfolio.

Quantitative Analysis
One of the concepts used in risk and return calculations is standard deviation**,** which

measures the dispersion of actual returns around the expected return of an investment. Since standard deviation is the square root of the variance, this is another crucial concept to know. The variance is calculated by weighting each possible dispersion by its relative probability (take the difference between the actual return and the expected return, then square the number).

The standard deviation of an investment's expected return is considered a basic measure of risk. If two potential investments had the same expected return, the one with the lower standard deviation would be considered to have less potential risk.

Standard deviation takes into account both systematic risk and unsystematic risk and is considered to be a measure of an investment's total risk.

Risk measures
There are three other risk measures used to predict volatility and return:

- **Beta -** measures stock-price volatility based solely on general market movements. Beta is a relative measure of systematic risk. Typically, the market as a whole is assigned a beta of 1.0. So, a stock or a portfolio with a beta higher than 1.0 is predicted to have a higher risk, and potentially, a higher return than the market. Conversely, if a stock (or fund) had a beta of 0.85, this would indicate that if the market increased by 10%, this stock (or fund) would likely return only 8.5%. However, if the market dropped 10%, this stock would likely drop only 8.5%.

- **Alpha -** measures stock-price volatility based on the specific characteristics of the particular security. As with beta, the higher the number, the higher the risk.

- **Sharpe ratio -** a more complex measure that uses the standard deviation of a stock or portfolio to measure volatility. It is a measure of risk-adjusted return. This calculation measures the incremental reward of assuming incremental risk. The larger the Sharpe ratio, the greater the potential return. The formula is: Sharpe Ratio = (total return minus the risk-free rate of return) divided by the standard deviation of the portfolio.

Look Out!
Of course, the reverse of "the larger the Sharpe ratio, the greater the return," is that the lower the ratio, the lower the potential return. If a security\'s Sharpe ratio were equal to "0", there would be no reward for taking on the higher risk, and the investor would be better off simply holding Treasuries (whose return is equal to the risk-free return component of the equation).

16.4 - Risk-Reduction Strategies for Stocks

Given the risks outlined above, an IA can take advantage of the following risk-reduction strategies to help protect his or her clients' portfolios:

- **Diversification** - diversification was discussed in section 13 as a way to include different types of investments within an asset class. Here, diversification refers to investing in a sufficient number of different issues to minimize systematic (market) risk.

- **Dollar-cost averaging** - this strategy calls for a fixed dollar amount to be invested in the shares of a stock or mutual fund on a periodic basis (typically, monthly or quarterly). Therefore, the investor receives more shares when the security price is lower and fewer shares when the security price is higher. Assuming share prices fluctuate during the investment period, the end result is a lower overall cost per share over time compared to the average market price at the time of the purchases.

- **Income reinvestment -** interest and dividends from stocks, as well as all types of mutual funds, may end up sitting in a money market account earning very low interest until an amount accumulates that is sufficiently large to be invested.

- A better strategy is to set up automatic income reinvestment programs, such as:
  - **Mutual fund reinvestment -** when investing in mutual funds, you can set dividends and/or capital gains to be automatically reinvested in additional shares.

  - **Dividend reinvestment plans (DRIPS)** - some companies offer shareholders a plan to automatically reinvest dividends into additional shares of stock without paying brokerage commissions.

Look Out!
Be prepared for a question about dollar-cost averaging that may ask about the benefits to investors or calculate cost per share compared to average purchase price.

16.5 - Measuring Portfolio Returns

There are a number of ways to calculate the investment return of an account. We discussed some of these (real return, total return and risk-adjusted return) in the

Quantitative Methods section, and bond yields (yield-to-maturity, yield-to-call and the real interest rate) were discussed in the Fixed Income Secutities section. You will not be tested on the actual formulas, so we have not included them here (other than those provided for clarity). In this section we'll focus on return measures:

Return Measures

- **Return on investment (ROI)** - this is the classic measure of performance, taking into account all cash flows (including dividends, interest, return of principal and capital gains). To calculate, simply divide the sum of all cash flows by the number of years the investment is held and then divide that amount by the original amount invested.

- **Risk premium** - the risk premium is the higher return that is expected for taking on the greater risk associated with investing in a growth stock, versus a stock from a more established company.

- **Risk-free rate of return** - the current rate for Treasury bills is typically used in calculations, such as risk-adjusted return and the Sharpe ratio.

- **Expected return** - since the expected return is the average of the probability of possible rates of return, it is by no means a guaranteed rate of return. However, it can be used to forecast the future value of a portfolio and also provides a guide from which to measure actual returns.
    - It is an integral component of the Capital Asset Pricing Model, which calculates the expected return based on the premium of the market rate over the risk-free return, as well as the risk of the investment relative to the market as a whole (beta).

- **Benchmark portfolios -** a common way to evaluate portfolio returns is to compare them to a benchmark, such as an index. These are the most common benchmarks:
    - **Standard & Poor's 500** - for large-cap stocks
    - **Russell 2000 -** for small-cap stocks
    - **Europe, Australia and Far East Index (EAFE) -** for international stocks

- **Holding period return -** this refers to the return for the period of time the investment was actually held. This can be more meaningful than an annualized rate of return, particularly for investments held short term. However, the standard deviation of returns depends on the holding period, since stock returns are more volatile over shorter periods of time. As a result:
    - the shorter the holding period, the greater the variability of the return
    - the longer the holding period, the smaller the variability of the return

- **Excess returns** - this is the amount of return over and above what is expected based on the beta of the stock or portfolio.

- **Internal rate of return (IRR)** - this is the interest rate that makes the net present value of a series of cash flows equal to zero. The internal rate of return can only be calculated by trial and error (or with a financial calculator) unless the investment has only a single cash flow, such as a zero-coupon bond. In that case the calculation is:

Internal rate of return = (Payoff/Investment) - 1

An example of this would be an investment of $1,000 that would return $1,100 in one year. The formula would produce (1100/1000) - 1, which equals 1.10 - 1, which equals 0.10 (10%).

Look Out!
The fact that internal rate of return presumes that the net present value of the inflows and outflows equals zero seems counterintuitive. It may be helpful to think of IRR as the discount rate at which the expected returns equal the initial investment. However, on the exam, the "net present value equals zero" will be the correct answer.

Exam Tips and Tricks
Consider these sample exam questions:

1. **An investor owns a small-cap stock with very low trading volume. The investor has a high level of:**
   a. Business risk
   b. Market risk
   c. Liquidity risk
   d. Purchasing power risk

The correct answer is "c" - while there is also the potential of business risk, the best answer is liquidity risk because the question focuses on the low trading volume.

2. **Assuming that prices fluctuate throughout the investing period, the use of dollar-cost averaging results in a:**
    a. Lower average cost per share
    b. Higher average cost per share
    c. Lower market price per share
    d. Higher market price per share

The correct answer is "a" - when prices are lower, more shares are bought, which results in a lower average cost per share.

3. **The Sharpe ratio measures:**
    a. Risk-adjusted rate of return relative to portfolio volatility
    b. Level of portfolio volatility relative to a benchmark portfolio
    c. Level of investment return relative to the dollar amount invested
    d. Risk-adjusted rate of return relative to the risk-free rate of return

The correct answer is "a" - options "b" and "c" are clearly wrong. While "D" refers to the risk-free rate of return, which is a component of the Sharpe ratio, the definition is not correct.

4. **The method of evaluating investment returns that calculates the interest rate which discounts cash inflows and outflows to a present value of zero is called:**
    a. Inflation-adjusted return
    b. Internal rate of return
    c. Total return
    d. Net present value

The correct answer is "b". Answer "d" is incorrect because the method referred to incorporates the concept of net present value, but it is not a definition of that term.

17.1 Trading Securities - Introduction

Introduction
Whether an IA is trading securities directly for a client or simply placing orders with a brokerage, a firm understanding of issues pertaining to securities trading is required.

This is the last section of the Series 65 study guide. A sample final exam is also provided.

Be sure to review the topics underlying any questions you've answered incorrectly. Good Luck!

17.2 - Securities Terminology

Securities Markets
Securities trade in different markets, and the IA should understand the differences between them:

- **Primary markets** - this is where new issues are sold for the first time, such as IPOs (Initial Public Offerings).
  The tutorial, *IPO Basics* on IPOs examines how these securities are issued, as well as their potential benefits.

- **Secondary markets** - the general term for all the markets where previously issued securities are traded:
  - **First market -** refers to the exchanges, such as the New York Stock Exchange, the American Stock Exchange, etc. Each exchange has specific requirements that a security must meet in order to be listed.

  - **Second market** - refers to securities that trade OTC (over the counter). The NASDAQ (National Association of Securities Dealers Automated Quotations) system is computerized and is much larger than any of the other exchanges.

  - **Third market** - refers to the OTC trading of NYSE-listed stocks, typically after the exchange is closed.

  - **Fourth market -** refers to the direct trading of large blocks of stocks between institutions, such as mutual funds, pension plans, etc. No brokers are involved; trading happens through an electronic network known as Instinet.

17.3 - Trading Terminology

You should also be familiar with the following terms used in trading securities:

- **Bid** - for the purposes of the exam, the bid only refers to the price a market maker will pay for a security; it's the price an investor would receive if selling the security.

- **Ask** - also called the offer, this is the price an investor would pay when buying the security.

- **Spread** - the difference between the bid and the ask price; the spread provides compensation to the market maker.

- **Trade date** - you should be aware of the difference between the trade date and the settlement date. The trade is the date on which a security trade actually takes place.

- **Settlement date** - this is the date by which the securities trade must be completed. Note that government securities and options must settle by the day after the trade.

- **Cash transactions** - this refers to securities that must settle on the trade date. It is rare for a trade to require a same-day settlement, but a test question might refer to this.

- **Regular way settlement** - the completion of a securities transaction by the purchasing broker; while the current regular way settlement is three full business days after the trade date, this can be changed. Before computers were as efficient as they are today, regular way settlement was the trade date plus five days.

- **Record date** - the date set by the issuer to determine the holders of record (i.e., thoseeligibleto receive a dividend payment). This date is necessary to know in order to determine the ex-dividend date.

- **Ex-dividend date** - this is the date when the buyer of a stock will not be entitled to an upcoming dividend. It occurs two business days before the record date.

Look Out!
You will probably have to identify either the ex-dividend date or the record date on a test question. The question is likely to ask what day the investor should buy the stock to still receive the dividend.

- **Specialist** -works at the NYSE and serves as an auctioneer for the stocks assigned to him/her. The specialist sets the opening price each day and must maintain a fair and orderly market in those stocks. The specialist may also buy and sell for his/her own account but may never compete with public orders.

- **Floor broker** - these NYSE brokers handle only very large orders, such as 10,000 shares or more.

- **Market maker** -works within the over-the-counter (OTC) market; they are the equivalent of specialists on the NYSE. Market makers are always prepared to buy or sell shares of assigned securities for their own accounts.

- **Day order** - all orders are considered day orders unless marked otherwise.

- **Good-till-cancelled (GTC)** - an order that remains in effect until it is executed or the investor decides to cancel it. If the order does not have an instruction, the order expires at the end of the day on which it was placed. GTC orders typically are cancelled by the broker-dealer after 30 to 90 days.

- **Short sale** - refers to selling shares borrowed from the broker-dealer. If the price drops, the investor then buys the shares at a lower price and returns them to the broker-dealer.

If you are unfamiliar with short selling, you can find out more in the tutorial *Short Selling*.

17.4 - Order Types

There are four different types of orders:

- **Market order -** this order is designed to be executed immediately, at the current market price - no price is specified on the order.

- **Limit order -** this order does specify the price desired; however, there is no guarantee that the order will be filled. There are two types of limit orders:
    - **Buy limit order -** this order is entered at a price *below* the current market price (since it would not make sense to specify a higher-than-market price!).

    - **Sell limit order -** this order is placed above the current market price.

- **Stop order -** this order is used to trigger an execution only if the market reaches a certain level; when this limit is reached, the stop order becomes a market order. As a result, there is no way to predict the actual price the security will receive. As with limit orders, there are two types:
    - **Buy stop order -** these are used to limit losses on short stock positions and are always placed above the current market price and filled only if the market rises.

- **Sell stop order -** these are used to limit losses on long stock positions and are always placed below the current market price and filled only if the market falls.

> ***Look Out!***
> **Note that stop orders become market orders once the stop price has been reached, but there is no guarantee that the market price at execution will be close to the stop price. For example, an investor could place a sell stop order at 45 when the market is at 50; if the market drops quickly, the stop could be triggered at 45 but executed at 42.**

- **Stop-limit order -** this order is used to ensure that a specific price is received, but the order is only placed when a specific stop price is reached. The stop price and the limit price do not need to be the same. However, there is a risk that the stop price could be reached, but the market never reaches the limit price. In that case, the order will never be filled.

17.5 - Account Types

There are three types of brokerage accounts available to investors:

- **Cash accounts -** there is no type of credit available in a cash account, so the customer must pay in full for securities that are purchased. Also, only long positions can be sold in a cash account - no short sales are permitted.

- **Margin accounts -** with a margin account, an investor can use credit to pay for a percentage of the securities purchased. The brokerage extends the credit and uses the securities as collateral. Interest is charged on the borrowed funds. Investors can buy either long or short positions in a margin account. The Federal Reserve requires a minimum deposit of 50% of the purchase price be deposited in cash or securities before a margin transaction can take place. Broker-dealers can set higher margin requirements.

  Refer to the tutorial, *Margin Trading*, for more on what margin is, how margin calls work and how leverage can be advantageous.

- **Options accounts -** puts and calls can only be traded in an options account. A separate account must be opened for this purpose. A client must provide information about his/her financial situation, investment objectives and previous investment experience before an options account can be opened, since options are not suitable for all clients.

Commissions
There are three types of compensation that a broker-dealer may charge when making securities trades for clients:

- **Commissions -** this fee is charged when the broker-dealer is acting as the agent for the client. The size of the commission depends upon the number of shares purchased.

- **Markup -** this is the compensation received when a broker-dealer is acting as a principal and sells a security from its own account to a client - the markup is the difference between the market price and the price charged to the client.

- **Markdown -** this is the compensation received when a broker-dealer is acting as a principal and buys a security from a client for its own account.

Exam Tips and Tricks
Consider these sample exam questions:

1. **A client has a significant gain in his holdings of ABC stock (a long position) and wants to protect that gain from a drop in the market. The appropriate order to place is:**
    a. Market order
    b. Buy stop order
    c. Sell stop order
    d. Sell limit order

The correct answer is "c", since the client would need to sell the stock before the market price falls beneath a certain level. A sell stop would become a market order if the stock reached that price. "d" is not correct, since it would not guarantee execution, and the client would not be protected.

2. **Short sales of stocks may be purchased in what type of account(s)?**
    a. Only in cash accounts
    b. Only in options accounts
    c. Only in margin accounts
    d. Either in an options or margin account

The correct answer is "c", since only options may trade in an options account, and securities cannot be borrowed in a cash account.

3. **A market maker in the over-the-counter market must be ready to purchase the security at the:**
    a. Bid
    b. Ask
    c. Offer
    d. Spread

The correct answer is "a", since the market maker must sell at the ask price (also known as offer), and the spread is the difference between the two.