

Chapter 13 Settlement and Corporate Actions

The Trading Process

1. Order entry – Order ticket details regarding how a trade is to be executed
2. Execution – Occurrence of a trade in a market center
3. Clearing – Executing firms agree to the details of a trade; any unrecognized trades may result in a DK (Don't Know) notice
4. Settlement – The day on which the customer's name is placed on or taken off the issuer's books
5. Custody – Safeguarding of client and firm assets

Settlement Dates

Unless a specific exception is made, settlement (completion of the transaction between the firms involved) will occur as follows:

- Corporate and Municipal Securities
 - One business day after the trade date ($T + 1$)
- U.S. Government Securities and Option Trades
 - One business day after the trade date ($T + 1$)
- Cash Settlement for any security
 - Same day as the trade date (both sides must agree)
- Seller's Option
 - Negotiated settlement; not earlier than two business days after the trade
- When Issued
 - As determined by the National Uniform Practice Committee

Settlement Date: Date on which a transaction must be completed between the BID's representing the buyer and seller.

Seller's Option: Seller needs additional time because of legal requirements.

- Securities may be authorized but not issued. Settles on delivery.
- Regulation T: Customer Payment (cash and margin) must be made promptly. (≤ 2 business days) following regular-way settlement. ($S+2$) or otherwise ($T+3$)
- Trade Settlement (Timing of payment and delivery between member firms) governed by FINRA.
- Regulation T Payment: Set by FRB

Activity

Match each settlement to the appropriate description.

T + 1		A negotiated settlement; not earlier than two business days after the trade
REG. T PAYMENT DATE	X	Settlement date for transactions involving U.S. government securities, corporate securities, municipal securities, and options
SAME DAY	X	Two business days after regular-way settlement (i.e., S + 2 or T + 3)
SELLER'S OPTION	X	Settlement for any securities using cash settlement

DTCC (Depository Trust Clearing Corporation) / (DTC)

Depository Trust & Clearing Corporation

The DTCC provides clearing, settlement, and information services for depository-eligible securities through its subsidiaries, including:

- National Securities Clearing Corporation (NSCC) – central counterparty for clearing, settling and guaranteeing U.S. equity trades
- Depository Trust Company (DTC) – provides custody and safekeeping services for securities

Transactions among members are completed through computerized bookkeeping entries

- Referred to as book-entry settlement
- No physical delivery of securities
ALL Electronic.

Good Delivery: A member firm's transfer agent makes the final determination as to whether a security is in good deliverable form and may be transferred to the new owner.

may be transferred to the new owner

Good Delivery Requirements	Units of Delivery	
<ul style="list-style-type: none">▪ Properly registered▪ Properly endorsed certificate▪ Signed stock power if the stock certificate is sent unsigned▪ CUSIP numbers may be used to identify and clear	<ul style="list-style-type: none">▪ Stock transactions must be delivered in multiples of 100 shares▪ Bond transactions must be in \$1,000 units or multiples thereof – 100 units adding to \$1,000 are permissible	Restricted securities are not considered good delivery

Activity

Which statements are TRUE regarding clearing trades and good delivery of securities?
Circle all that apply.

- I. Book entry requires physical delivery of securities. *Book Entry is opposite of this.*
- II. A stock power can be used in lieu of a signed certificate.
- III. Stock transactions must be delivered in multiples of 100 shares.
- X Restricted securities can be used for good delivery.

Corporate Actions

Corporate Actions Department

Responsible for handling the following corporate actions:

- Stock splits
- Rights offerings
- Proxies
- Tender offers
- Mergers and spinoffs
- Exchange offers
- Stock buybacks

Cost Basis and Capital Events

The Purpose of a Stock Split or Stock Dividend	Company's attempt to improve marketability of its stock <ul style="list-style-type: none">▪ No economic gain or loss for holders▪ No change to issuer's capitalization▪ No change to holder's percentage of equity ownership
The Two Types of Stock Splits	<ul style="list-style-type: none">▪ Forward (e.g., 2:1 or 3:2) – more shares, lower price▪ Reverse (e.g., 1:5) – fewer shares, higher price<ul style="list-style-type: none">• For both types, dividends per share are adjusted proportionately
Tax Treatment	<ul style="list-style-type: none">▪ Additional shares received are generally not taxed as income▪ Investor's total basis is unchanged, but basis per share is adjusted

Forward Stock Split:
SHARE # ↑ , PRICE ↓ (No net change.)

Reverse Stock Split:
SHARE # ↓ Price ↑

Ex. Forward Stock Split.

START

100 Shares → \$18,000
Basis/Share: \$180

END

150 Shares → \$18,000
Basis/Share: \$120

Ex. Reverse Stock Split.

START

1000 Shares → \$10000
Basis/Share: \$10

END

250 Shares → \$10000
Basis/Share: \$40

Stock Split Activity

Activity

Read each statement and determine whether it is TRUE or FALSE.

A FORWARD OR REVERSE SPLIT
CHANGES THE TOTAL VALUE
OF SECURITIES IN THE PORTFOLIO

AFTER A 1 FOR 5 STOCK SPLIT,
AN INVESTOR WHO OWNED 500 SHARES
WILL NOW OWN 100 SHARES

AFTER A 3 FOR 2 STOCK SPLIT,
AN INVESTOR WHO OWNED 200 SHARES
WILL NOW OWN 300 SHARES

AFTER A 5 FOR 4 STOCK SPLIT,
100 SHARES AT \$50 PER SHARE WILL
EQUAL 125 SHARES AT \$40 PER SHARE

F
T
T
T

$$1 \text{ for } 5 \text{ Stock Split} \rightarrow \text{Reverse. } \frac{1}{5} = 0.2 \quad 0.2(500) = 100$$

$$3 \text{ for } 2 \text{ Stock Split} \rightarrow \text{Forward. } \frac{3}{2} = 1.5 \quad 1.5 \times (200) = 300$$

$$5 \text{ for } 4 \text{ Stock Split} \rightarrow \text{Forward } \frac{5}{4} = 1.25 \quad 1.25 \times (100) = 125$$

$$\text{or} \\ \frac{4}{5} = .80$$

$$.80(50) = \$40$$

Tender Offers

A tender offer indicates the intent to buy shares from the owner at a fixed price

- The offer may be made by the issuer or a third party (Issuer Tender Offer)
- The offer is typically made to acquire a company or a controlling position and seat on the board of directors
- The offer may be for all of the shares or a specific percentage

Shares may only be tendered if an investor is long the stock or its equivalent, such as:

- A convertible security (conversion NOT required)
- A right or warrant (exercise NOT required)
- A call option (ONLY if exercised)

Long means
I own the stock.

Short means
I borrow/don't own
the stock.

Other Corporate Actions

Preemptive Rights

- Provide existing shareholders with opportunity to purchase additional shares directly from the company
- The subscription price is set below the current market Saves \$

Mergers and Acquisitions

- Merger – the combination of two companies XM + Sirius → SiriusXM, ExxonMobil
- Acquisition – one company purchasing and assuming control of another (Disney/LucasArts)

Spinoffs

- A company may choose to spinoff a specific business unit to existing shareholders Ebay → PayPal
- Shareholders receive new shares of the business unit

Forwarding Official Communications

Beneficial Owners – Investors whose securities are held in their name and recorded on the firm's books	
Non-Objecting Beneficial Owner (NOBO)	Objecting Beneficial Owner (OBO)
<ul style="list-style-type: none">Owners who allow issuers to contact and send communications to them directly	<ul style="list-style-type: none">Owners who will not release personal information to issuers.Instead, all communications must be sent through the OBO's broker-dealer

Proxies

- A voting power of attorney; must be immediately forwarded to customers
- By signing, the beneficial owner allows another person to vote on his behalf

Forms 10-K (annual) and 10-Q (quarterly)

- Financial information that must be forwarded to all stockholders

K=Annual (1000 = K)

Q=Quarterly (250 = Quarter of K)

Charging for Services

Charging Issuers	<ul style="list-style-type: none">Member firms may charge issuers for forwarding materials to beneficial ownersRates are subject to FINRA rules
Charging Customers	<ul style="list-style-type: none">Member firms may charge customers reasonable costs/fees, but cannot discriminate between customersServices include:<ul style="list-style-type: none">Safekeeping of securitiesCollection of dividends and interestExchange or transfer of securitiesHowever, charges for forwarding proxies or other financial information is the responsibility of the issuer

Activity

Read each corporate action and indicate what it's called.

A COMBINATION OF TWO COMPANIES

Merger.

AN INTENT TO PURCHASE
SHARES OF ANOTHER OWNER

Tender Offer.

SHAREHOLDERS RECEIVE NEW SHARES
OF A BUSINESS UNIT OF A COMPANY

Spinoff.

ONE COMPANY ASSUMES
CONTROL OF ANOTHER COMPANY

Acquisition

Activity

Which statements are TRUE regarding the delivery of official communications? Circle all that apply.

- I. For OBOs, all communications must come from the OBO's broker-dealer.
- II. NOBOs don't allow issuers to contact them directly.
- III. A broker-dealer may charge an issuer when forwarding proxies to shareholders.
- IV. A broker-dealer may charge customer a fee when transferring their securities.

Chapter 13 Quiz.

Street Name:

- Broker-Dealers name appears on issuers books.
- Customer is still owner.

- When Issued: New Security. Authorized. Not issued. Security not ready.
- Sellers Option: Delivery not ready.
- Transfer Agent: Checks "good delivery"
 - Exercise Shareholder rights.

Same Day Settlement for Individual: needs buyer's agreement to the expedited settlement.

Stock or Bond power can replace a customer signature.

Settlement (usually T+1)

Payment (T+3)

A Call Option for a Stock will not allow an individual to make a tender offer for the issuers stock.

Chapter 14 Customer Accounts.

Cash

- Buyer pays full amount of trade.

Margin Account.

- Long - Client borrows funds from broker-dealer
- Short - Client borrows funds from broker-dealer to Sell Short.

} Customer pays interest.

Options Account.

Opening a Margin Account

Margin	<ul style="list-style-type: none">Increases customer purchasing powerIncreases risk of large losses due to adverse market changes<ul style="list-style-type: none">Subject to the FRB's Regulation T deposit requirement of 50%
MARGIN Agreement. Credit Agreement	<ul style="list-style-type: none">The terms of the loanDiscloses interest amount, how computed, and when charged
Hypothecation (Pledge) Agreement	<ul style="list-style-type: none">Customer hypothecates securities to B/D as collateralB/D borrows money from a bank to replace the loan that was made to the customer

SCE ON DEMAND LEARNING

Additional Margin Documents

Loan Consent Agreement (generally used for short sales)

NOT Required.

- Not mandatory for opening account
- If signed, B/D is able to lend the customer's securities to others

Margin Disclosure Document – must be provided to all customers opening a margin account and indicates:

- A customer can lose more money than deposited
- The firm can force the sale of securities or assets in the account
- The firm can sell securities from the account without notifying the customer
- The customer has no control over which assets are sold to meet a margin call
- The in-house maintenance requirement can be changed without prior written notification to the client
- The client is not entitled to an extension for a maintenance call

Activity

Read each statement and determine which document it describes.

INDICATES THAT THE BROKER-DEALER IS PERMITTED TO USE SECURITIES IN THE MARGIN ACCOUNT TO SECURE A LOAN

Hypothecation

DISCLOSES THE INTEREST RATE, HOW IT'S COMPUTED, AND WHEN IT'S CHARGED

Credit Agreement

STATES THAT SECURITIES CAN BE SOLD FROM THE ACCOUNT TO MEET A MARGIN CALL

Margin Disclosure Agreement

STATES THAT A BROKER-DEALER IS PERMITTED TO LEND SECURITIES IN A MARGIN ACCOUNT TO OTHERS

Loan Conser

Options Accounts

Opening an Options Account

Due to the high risk in option accounts, option trading may not be suitable for all clients

Firms must gather client information through **Option Account Agreement**, including:

- Names of those with trading authority
- Financial status, objectives, experience
 - Data need not be verified

If the client does not provide requested information, a note is made on the agreement

A copy is sent to the **client** for his eventual **signature** (verification) along with the OCC's options disclosure document (ODD)

Discretionary Account

Discretionary Accounts

If a client is to authorize another person to make investment decisions in her account or deposit and/or withdraw funds, the following forms/steps are required:

- An authorization form signed by the client and the person granted authorization (Power of Attorney)
 - Principal must approve the account in writing prior to its opening
 - Each order must be reviewed and approved promptly by a principal (not in advance)

Part Type: Activity must be monitored for potential churning

Limited Trading Authorization

- Allows for execution of trades

Full Trading Authorization

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

Power of Attorney

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

restrict for more than one day.

Authorized Activities	Document Required
Trades Only	Limited POA
Trading, deposits, and/or withdrawals of funds	Full POA
Not-Held Orders (for one day)	None

Churning: Excessive trading.

Not Held Orders

- Allows client to provide oral authorization for trade execution
- Avoids the need for discretionary authority if RR decisions are limited to time and/or price of execution
- Client specifies whether to buy or sell, the quantity, and the security
 - "Sell 1,000 shares of XYZ whenever you think the time and price is right"
- Not held orders are only good for one day; if longer, written authorization is required

The Three "A"s

For Not Held orders, the customer specifies the Action, the Amount, and the Asset.

Activity

Which statements are TRUE regarding options and discretionary accounts? Circle all that apply.

- X I Due to the high risk in options trading, a customer is required to provide any information requested for the account to be approved.
- J X A principal must approve a discretionary order before it is executed.
- J (II) Full trading authority allows cash and securities to be withdrawn from a discretionary account.
- J (IV) If a customer specifies the security, the quantity, and whether to buy or sell, the broker can determine when to execute the trade on that day.

Fee-Based Accounts

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

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

Suitability considerations:

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

Education Savings Plan. (2 types)

1. Coverdell Educational Savings Account. (CESA)

2. 529 Plan.

Coverdell Education Savings Account (CESA)	529 Plan
<ul style="list-style-type: none">▪ A trust or custodial account that's created for the purpose of paying the qualified education expenses of a designated beneficiary<ul style="list-style-type: none">• Maximum contribution: \$2,000 annually per child up to age 18• Contribution is non-deductible, but earnings are tax-free if used for qualified education expenses (contribution eligibility is subject to income limits)• CESAs may be used to pay for private education on any level (i.e., kindergarten through college)• Funds must be used by the child's 30th birthday or transferred to a relative's CESA	<ul style="list-style-type: none">▪ A plan that is generally operated by a state and designed to meet the costs of both college and K-12 education▪ Allows for much larger contributions than what CESAs allow▪ Covered in greater detail in Chapter 8

Question

For which type of investor is a fee-based account unsuitable? Inrequent traders (Buy and Hold)

How much and for how long can contributions be made to a CESA? \$2000/yr. 18 years

Which educational savings plan is primarily designed for higher education? 529 Plan

Customer Account Registration.

Customer Account Registrations

opened by 1 person.

For 1 person. INDIVIDUAL

> 1 owner

JTWROS.
TEN COM.

JOINT

CUSTODIAL (MINOR)

FIDUCIARY

CORPORATE

PARTNERSHIP

Individual Account

- Opened by, and for, one person
- Only the account owner can dictate trades
 - Third party authorization may be granted to another person
- Numbered or Nominee accounts are permitted
 - The account may be opened under a number or code name
 - Provides privacy for the individual
 - Customer Identification Procedures (CIP) requires firms to maintain records of the beneficial owners

Joint Accounts

- New account information is obtained for each owner
- Any owner may initiate activity
- When signatures are required, all owners must sign
- Checks are made payable to all parties

JOINT TENANTS WITH RIGHTS OF SURVIVORSHIP (JTWROS)

- Common for spouses
- Each tenant has equal ownership
- If one owner dies, ownership passes equally to surviving tenant(s) without probate

JOINT TENANCY IN COMMON (JTIC)

- Each tenant owns a specified amount
- If one owner dies, decedent's portion is transferred to her estate
- Common for business partners

Trust Accounts

Trust – a legal arrangement in which an individual (creator) gives fiduciary control of property to a person or institution (trustee) for the benefit of beneficiaries

Revocable – also referred to as living or inter vivos trusts

- A person has the ability to revoke or change any terms in the trust
- Does not reduce estate taxes, but avoids probate if funded prior to donor's death

Irrevocable

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

Accounts for Minors – UGMA/UTMA

Custodial Account – Uses a standard new account form titled “custodian for minor”

ONE MINOR (Legal Owner)	<ul style="list-style-type: none"> ▪ Responsible for taxes; minor's Social Security number ▪ If child dies without a will, state law determines asset distribution
ONE CUSTODIAN (Any Adult)	<ul style="list-style-type: none"> ▪ Has authority to initiate activity (prudent investments) ▪ Under the Uniform Prudent Investor Act (UPIA), a custodian may delegate investment functions to a third party
GIFTS	<ul style="list-style-type: none"> ▪ Irrevocable; may be cash and/or securities ▪ Covered options and penny stock transactions may be permitted ▪ No margin (i.e., no uncovered options, short sales, commodities) ▪ No limit on number of donors or on the value of gifts ▪ Taxes may be due from donors if gifts exceed \$19,000 per year

Other Forms of Registration

FIDUCIARY	<ul style="list-style-type: none"> ▪ A fiduciary is defined as a person or organization that owes to another the duties of good faith and trust ▪ Documentation is often filed with a court in order to get court approval of the actions of the fiduciary
CORPORATE	<ul style="list-style-type: none"> ▪ Always examine Corporate Resolution ▪ To open an option or margin account, the Corporate Charter must also be examined
PARTNERSHIP	<ul style="list-style-type: none"> ▪ Partnership agreement specifies persons authorized to execute trades ▪ Information must be collected on each managing partner

Activity	Corporate Resolution	Corporate Charter
Cash Account Trading	Yes	No
Margin Trading	Yes	Yes
Options Trading	Yes	Yes

Activity

Match each type of account to the appropriate description.

REVOCABLE		Only the account owner can dictate trades
<u>UTMA</u>		If a tenant dies, the decedent's portion is transferred to her estate
INDIVIDUAL		If a tenant dies, ownership passes equally to the surviving tenants
JTWROS		The terms of the trust account can be changed
JTIC		There is only one custodian and gifts are irrevocable

Retirement Accounts.

Traditional IRAs and ROTH (IRAs)

Roth IRA's Benefit from:

- Tax-Free Growth
- Long-Term Compounding
- Time in market.

Traditional and Roth IRAs

	Traditional	Roth
Similarities	100% of earned income, up to a maximum of \$7,000	100% of earned income, up to a maximum of \$7,000
Differences	Spousal option: extra \$7,000	Spousal option: extra \$7,000
May be a deductible contribution	Contribution is NEVER deductible	
Contribution is always allowed (regardless of age if still working)	Higher income individuals may not contribute	←
Required Minimum Distribution (RMD) by Apr. 1 of the year after owner reaches age 73 (tax penalty for failure)	No withdrawal requirement	
Withdrawals are subject to tax	Qualifying withdrawals are tax-free	

Traditional IRA Benefits from:

- Tax Deductible Contributions
- Tax Deferred Growth
- Lower Tax Bracket @ Retirement.
- Immediate Tax Savings

Favorable bc...
b/c. qualified withdrawal
is tax free.

• No Retirement Tax Bill.

details: Pages 188-190

• Anyone can convert traditional IRA to ROTH IRA.

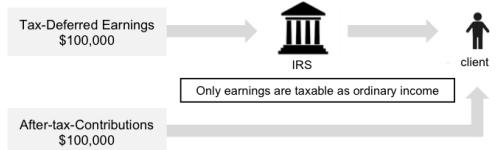
Traditional and Roth IRAs

For both Traditional and Roth:

- Early withdrawal penalty:
 - Before age 59 1/2 and 10% of taxable amount
 - In a Roth IRA, the first contribution must have been made at least five years prior
 - Exceptions: death, disability, qualified higher education expenses, up to \$5,000 for expenses associated with the birth or adoption of a child, or qualified first-time homebuyer distributions (\$10,000 lifetime limit)
- Rollovers and Transfers (no penalty)
 - Rollover:
 - Owner receives proceeds
 - Once per year (rolling 12 months); completed within 60 days
 - Trustee-to-Trustee Transfer:
 - Owner does not have access to the funds
 - May be more than one per year

Taxation of Traditional IRAs

(Funded with after-tax contributions)



Activity

Read each statement and determine whether it is TRUE/FALSE.

IF AN INDIVIDUAL HAS EARNED INCOME, HE CAN CONTRIBUTE TO A TRADITIONAL IRA
REQUIRED MINIMUM DISTRIBUTIONS MUST BE MADE FROM A ROTH IRA AFTER THE OWNER REACHES AGE 73
EARNINGS CAN BE WITHDRAWN FROM A TRADITIONAL AND ROTH IRA WITHOUT PENALTY FOR FIRST-TIME HOMEBUYERS
QUALIFYING DISTRIBUTIONS FROM A ROTH IRA ARE TAX-FREE

T
F
T
T

ONLY APPLIES
to Traditional.

Without 10%
Penalty.
Still Taxed.

Employee Retirement Income Security Act (ERISA)

Prevent misuse and mismanagement of pension plan funds.

- Rules apply to private sector defined benefit and defined contribution plans
- Determines qualified status
 - Employer and employee contributions are tax-deductible
 - Earnings are typically tax-deferred
- Plans must not be discriminatory and offered to all employees who:
 - Are age 21 or older
 - Have at least one year of full-time service (1,000 hours)
- An approved vesting schedule must be followed
 - Specifies the percentage of the employer's contributions to which the employee is entitled when withdrawing from the plan
 - Employees are 100% vested in their own contributions

If established correctly, a qualified plan will have the following characteristics:

- Pre-tax contributions: Employer and employee contributions to a qualified plan are generally able to be made on a pre-tax basis. In other words, no income tax is paid on the amounts contributed by employers until the money is withdrawn from the plan.
- Tax-deferred growth: Investment earnings (e.g., dividends and interest) on all contributions are tax-deferred; therefore, income tax is not paid on the earnings until the money is withdrawn from the plan.
- Non-discrimination: Qualified plans cannot discriminate in favor of only highly compensated employees.

Taxation of Retirement Plans

Tax status of contributions:

- Pre-tax contributions have a zero-cost basis (taxable at withdrawal)
- After-tax contributions are part of cost basis (tax-free at withdrawal)

Earnings typically grow tax-deferred

Tax status of distributions:

- Any portion representing pre-tax contributions is taxable as ordinary income
- Any portion representing after-tax contributions is a return of capital and not taxed
 - Earnings are typically taxed as ordinary income
- Subject to required minimum distributions (RMD)

They GROW.
But aren't listed as
Capital gains.

Retirement plans never generate
capital gains or losses

Contributions vs. Earnings

Contributions = Your Money.

Earnings = The money your money makes.

3 Stages

① Contribution.

② Growth.

③ Distribution.

401(k) and Profit-Sharing Plans.

401(k) PLANS

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

PROFIT-SHARING PLANS

- Contributions are discretionary, decided by the board of directors
- Contributions are subject to maximum annual amounts
- Allocation of contributions to employees is based on a predetermined formula

401(k) = paycheck deferrals + employer involvement + tax advantages.

- Employer Sponsored, qualified retirement plan.
- Allows employees to save for retirement w/tax advantages.
- Only non-deductible (after-tax) contributions.

Roth 401(k): Excluded from federal tax.

- Don't have to pay taxes on:
 - Capital Gains.
 - Bond Interest.
 - Dividends.

Activity

Which statements are TRUE regarding ERISA and distributions from retirement plans? Circle all that apply.

- (1) ERISA requires plans to allow all employees who are at least age 21 and have one year of full-time service to be eligible to contribute to a plan.
- (2) Distributions from retirement plans as a result of appreciation of securities are taxed as capital gains.
- (3) An employee must be vested to receive the benefits of the employer's matching contributions in a 401(k) plan.
- (4) Contributions to profit-sharing plans are decided by the board of directors.

Chapter 14 Quiz.

Chapter 15 Compliance Considerations

Cash Account Rules (FINRA)

- Req.
 - Customer name.
 - Numbered / Coded is OK.
- Address
 - NO P.O box. (except military)
 - Legal age or not.
 - RR(s) of record.
 - Signature of Supervising principal.
- Copy of info ↑ Sent every 36 mo(2yr)
- **Customer not required to sign.** (Margin/Options Accounts Require Signature)

Additional Information

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

Tax I.D./ Social Security number	Occupation as well as name and address of employer	Whether associated with another member firm
If a client refuses to provide any requested information, the RR should document the refusal		

Recordkeeping Requirements (SEC)

According to SEC Rule 17a-3 broker-dealers are **required** to maintain the following records:

- Name and tax ID number
- Address, telephone number and date of birth
- Employment status and whether associated with another broker-dealer
- Information to assist in determining suitability
 - Income
 - Net Worth (excluding principal residence)
 - Risk Tolerance
 - Objectives

Activity

Match the information to the FINRA rule.

①	REQUIRED
②	REASONABLE EFFORT

①	Name and address
②	Social Security number
③	Name and address of employer
④	Signature of principal
⑤	Whether client is of legal age

Updating Client Information

Failure to update client information on a timely basis may result in the execution of unsuitable transactions or regulatory issues

- If a client moves to a new state, both the firm and the RR must be registered in that state in order to continue conducting business with the client
- Changes in the financial background of a client (for better or worse) must be documented
 - A different pattern of transactions may indicate a change
- Objectives are typically adjusted as customers age

FINRA rules require firms to send a copy of updated changes to a customer within 30 days or at the time the next statement is mailed.

Suitability

Suitability

The Basics of Suitability
Suitability is based on the client's profile when an account is opened
<ul style="list-style-type: none">▪ Applies to recommended transactions and investment strategy▪ Suitability is not determined by gains and losses▪ RRs may not place their own interests ahead of the client's, such as:<ul style="list-style-type: none">• Recommending one product over another to generate a larger commission

Institutional Suitability
Institutional suitability – The extent of the obligations is based on: <ul style="list-style-type: none">▪ Those servicing the account having a reasonable belief that the client is capable of evaluating investment risks▪ The institutional client affirmatively stating that it's exercising independent judgement

FINRA's Suitability Rules

Under FINRA's three main suitability obligations, a member firm and its registered representatives must have a reasonable basis to believe that:

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

of potential violations of the suitability rule include:

- RRs making recommendations of one product over another in an effort to generate large commissions
- RRs making mutual fund recommendations that are designed to maximize their commissions rather than to establish a portfolio for their customers
- RRs attempting to increase their commissions by recommending the use of margin
- RRs recommending a new issue that's heavily promoted by their firm in an effort to keep their jobs

Activity

Read each statement and determine whether it is TRUE/FALSE.

THE SEC REQUIRES A BROKER-DEALER TO
MAINTAIN THE CUSTOMER'S SOCIAL
SECURITY NUMBER AND DATE OF BIRTH

T

ONLY A BROKER-DEALER MUST BE REGISTERED
IN THE CLIENT'S STATE OF RESIDENCY,
NOT THE REGISTERED REPRESENTATIVE

F

SUITABILITY IS ~~NOT~~ BASED
ON GAINS AND LOSSES

T
F

SUITABLE RECOMMENDATIONS
ARE NEVER CONSIDERED EXCESSIVE

USA Patriot Act.

Implement Customer Identification Program (CIP)

- BID's must verify identity of EACH customer within a reasonable time from account opening.
- BC OF terrorism, money laundering.

Three stages of money laundering:

1. Placement	2. Layering	3. Integration
Illegal cash is placed in the broker-dealer's business	A series of transactions are executed which are meant to avoid detection (e.g., structuring)	Proceeds from the previous transactions are put back into the stream of commerce

FinCEN's Reports

Under the Bank Secrecy Act (BSA), certain reports are sent to the Financial Crimes Enforcement Network (FinCEN), which is a bureau of the U.S. Department of Treasury

Bank Secrecy Act Transaction Report (BCTR)

- Filed for all cash transactions executed by a single customer during one business day that exceed \$10,000 (also filed for structured transactions)
- Filed within 15 calendar days

A violation could result in a 20-year prison term and the greater of a \$500,000 fine per transaction or twice the amount of the funds involved.

Suspicious Activity Report (SAR)

- Filed whenever a transaction (or group of transactions) equals or exceeds \$5,000 and the firm is suspicious
- Filed within 30 calendar days
- Suspicious activity should also be reported to a principal

AML Compliance Program

A member firm must establish an AML program to detect money laundering schemes and suspicious transactions

- Program requirements include:
 - Appointing an AML compliance officer
 - AML officer must be identified to FINRA and be knowledgeable about the Bank Secrecy Act (BSA)
 - Creating written procedures, including training for personnel
 - An independent audit function to test the program's effectiveness
 - However, there's NO requirement to file reports with a regulator

Customer Identification Program

Required Identifying Information	<ul style="list-style-type: none">▪ Name▪ Legal address (residence or business)▪ Date of birth▪ Identification number (which may be different for U.S. persons compared to non-U.S. persons)
Identification Number for U.S. Persons	<ul style="list-style-type: none">▪ Taxpayer ID or <i>Corporation.</i>▪ Social Security number <i>Individual.</i>
Identification Number for Non-U.S. Persons	<ul style="list-style-type: none">▪ One or more of the following:<ul style="list-style-type: none">• Taxpayer ID• Passport number• Alien ID Card number• Any other government-issued document establishing residence and identity
Office of Foreign Assets Control (OFAC)	<ul style="list-style-type: none">▪ An OFAC list is maintained to identify the names of terrorists and/or criminals▪ If a client's name appears on the OFAC List, transactions are blocked and law enforcement is notified▪ Also known as the Specially Designated Nationals of SDN list

(BSA is an AML law.)

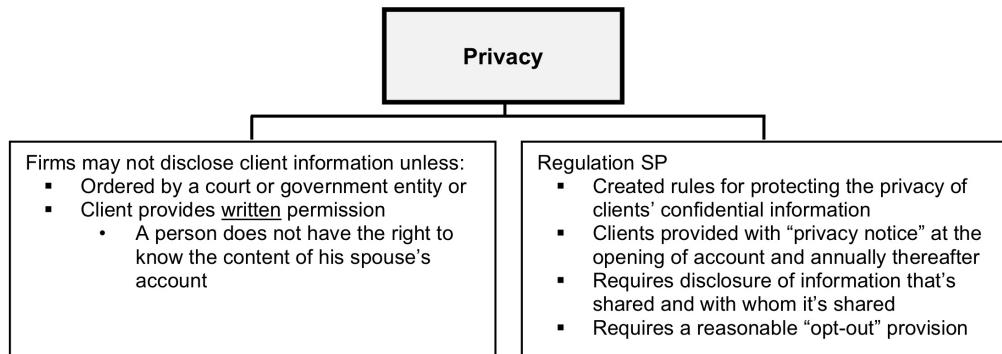
Activity

Which statements are TRUE regarding the USA PATRIOT Act and AML rules? Circle all that apply.

- I. Broker-dealers must verify the identity of a customer prior to opening an account.
- II. An SAR is filed for all cash transactions equaling or exceeding \$5,000, even if it is not suspicious.
- III. The Bank Secrecy Act requires that a report be filed for all cash transactions that exceed \$10,000 during one business day.
- IV. All transactions must be blocked if a customer's name appears on the OFAC list.

Not Prior.
can be reasonable
period of time.

Protecting Client Information



SIE On-Demand Learning Guide

Identity Theft Prevention

Federal Trade Commission's (FTC) Red Flag Rules

- Financial institutions must create and implement policies and procedures to detect and address identity theft
- Intent is to protect the client's assets

Use of Stockholder Information for Solicitation

- Firms are prohibited from using client information for solicitation purposes
- Permitted if specifically directed to do so and it is for the benefit of the corporation

Permitted if specifically directed to do so and it is for the benefit of the corporation.

Customer Statements and the Holding of Mail

Account Statements

- Sent by broker-dealers at least quarterly
- For active accounts, sent monthly

Holding customer mail

- Firm must receive written customer instructions
- Instructions must include the time period during which the mail will be held
 - If the requested time exceeds three consecutive months, customer instructions must include a valid reason
- Whether the customer's instructions still apply must be verified at reasonable intervals

Trade Confirmations

Sent on, or before, settlement of the transaction **(SEC RULE)** **(Email, Mail)**

Confirmation Information

- Execution details:
 - Name of customer
 - Buy/sell
 - Price and quantity
- Trade and settlement dates
- Firm capacity (agent or principal)
- For bonds, dollar price and yield information
- Name of contra party or a statement of the availability of the information upon written request

Definition of Communications

Correspondence	Retail Communication	Institutional Communication
<ul style="list-style-type: none">▪ Written or electronic communication that a member firm distributes or makes available to 25 or fewer retail investors (prospective or existing) within any 30-calendar-day period▪ Subject to review and supervision	<ul style="list-style-type: none">▪ Written or electronic communication that a member firm distributes or makes available to more than 25 retail investors within any 30-calendar-day period▪ Often subject to preapproval and filing	<ul style="list-style-type: none">▪ Written or electronic communication that a member firm distributes or makes available only to institutional investors (NOT to any retail investors)▪ Subject to review and supervision

≤ 25

> 25

1. and 3 are Subject to Review and Supervision.

Activity

Read each statement and fill in the blanks.

1. Regulation SP establishes rules to protect the privacy of clients' confidential information.
2. A privacy notice must be provided to clients when open accounts and annually after.
3. The FTC's Red Flag Rules requires financial institutions to create policies to detect identity theft.
4. Account statements are sent quarterly for inactive accounts, but monthly for active accounts.
5. Customer mail can be held for 3 months at the broker-dealer.
6. Trade Confirmation must be sent on, or before, settlement of a transaction.
7. Correspondence is communication that's distributed to 25 or fewer retail investors within a 30-calendar-day period.
8. Retail communications are sent to > 25 retail investors within a 30 day period.

Telephone Consumer Protection Act

Telemarketing calls may be made on any day, but **only from 8:00 a.m. to 9:00 p.m.** local time of the person being called (residential only)

Exclusions:	The time-of-day restriction doesn't apply if the person: <ul style="list-style-type: none">▪ Has made any unsolicited inquiry of the firm▪ Has engaged in a transaction with the firm within 18 months
Information Provided:	The caller must provide: <ul style="list-style-type: none">▪ Both his name and his employing firm's name▪ The firm's phone number or address▪ The purpose for the call
Do-Not-Call List: <small>Nation-wide and Firm wide.</small>	If requested, a client must be placed on the firm's "Do Not Call List" within 30 days and will remain there indefinitely <ul style="list-style-type: none">▪ Before placing a call, a firm must review the FTC's National Do-Not-Call Registry

Transmitting unsolicited advertisements to fax machines is prohibited.

Customer Protection Rule

On a **daily basis**, broker-dealers are required to obtain and maintain physical possession or **control** of all fully paid and **excess margin securities** belonging to **customers**

Control	Excess Margin Securities	Customers
<ul style="list-style-type: none">▪ Good control locations include an SEC-approved depository (domestic or foreign) such as the DTC or in-transit between the offices of a broker-dealer	<ul style="list-style-type: none">▪ The value of margined securities that exceeds 140% of a customer's debit balance	<ul style="list-style-type: none">▪ Any person for whom the B/D holds funds or securities or any omnibus account that is maintained by a B/D on behalf of its customers▪ Excludes B/Ds, general partners, directors, principal officers, or subordinated lenders

Customer Free Credit Balances

A free credit balance represents customer proceeds resulting from sales, dividends, or interest payments that have not been withdrawn or invested

- A statement must be sent to customers at least quarterly
- The statement must indicate the total amount due and that it's payable on demand
- If statements are sent more frequently than quarterly, a notice of free credit balance must be included

Fidelity Bond

Broker-dealers must obtain a fidelity bond as insurance coverage against losses as a result of:

- Fraudulent trading, loss of securities, or forgery
- NOT errors and omissions or B/D bankruptcy

If the bond is substantially modified, terminated, or cancelled, FINRA must be notified immediately.

Business Continuity Plan (BCP)

- Plan to be followed in case of emergency or significant business disruption.
- Made available to FINRA promptly on request. (Not Required)

(Made available to FINRA promptly on request.)

Regulatory reporting	Communication with regulators (e.g., SEC and FINRA)	Communications between firms and clients and between firms and employees
A BCP must address each of these points		
Emergency contact information of two persons (one must be a member of senior management and a registered principal)	Alternative locations for employees to continue working	Ensuring that mission-critical systems (computers) continue to process transactions promptly

Retention of Books and Records

After account is closed. ↗

Lifetime	Six Years	Three Years
Corporate and partnership documents	Blotters (records of original entry), ledgers, new account forms, account statements, powers of attorney, municipal complaints*	Order tickets, confirmations, Forms U4 and U5, employee records, all forms of communication, trial balances

* FINRA requires complaints to be maintained for four years

All records must be maintained in an easily accessible place **for the first two years.**

Activity

Which statements are TRUE regarding requirements to protect customers? Circle all that apply.

- Telemarketing calls can only be made between the hours of 9:00 a.m. and 8:00 p.m. local time.
- Free credit balance represent customer proceeds that have not been withdrawn or reinvested.
- The fidelity bond protects customers in the event of a broker-dealer's bankruptcy.
- The Business Continuity Plan is not required to be filed with FINRA unless requested.

Quiz 15.

SDN and Blocked Persons List: May not engage in ANY business.

Needs Approval or Principal.

Retail > 25 RETAIL INVESTORS Institutional: To banks, insurance companies, etc. ONLY!
Comms.

Correspondence ≤ 25 RETAIL INVESTORS
Comms.

CRS Form is ALWAYS < 2 pages.

FINRA Suitability.

- Reasonable Basis
- Customer-Specific
- Quantitative Obligations.

Money Laundering Punishment.

\$500K / Transaction
or
2 x (amt. Funds involved) } Greater
of

3 Money Laundering Stages.

1. Placement.
2. Layering
3. Integration.

At least.

Established Business Relationship: Past 18 mo's.

Retail Customer = Natural Person (Regulation B1)

Individual is to be placed on the do-not-call list within 30 days

Suitability

- Financial Situation and needs.
- Risk Tolerance.
- Investment Objectives and time horizon.

CIP: Verify customer identity within a reasonable period before/after account opening.

Broker Dealers Must compute fully paid and excess margin Securities in its possession every day.