Chapter 9. Alternative Investments.

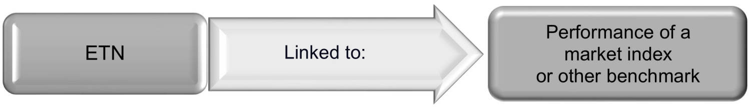
ETFs Compared to Index Funds

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

Inverse ETF: S&P500 ↓ 1.5%
inverse ETF ↑ 1.5%

Leveraged ETF: Aims to deliver 2-3x index it is tracking.
Index ↑ 1.5%
LevETF ↑ 3.0% appx.

ETN: Unsecured debt. low fees. Access to Challenging areas of market.



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

Issuer @ risk. (usually broker-dealer)

Activity

Read each statement and determine which security it describes.

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

Alternative Packaged Products.

- Hedge Funds: Fund for wealthy investors
- Private Equity
- Venture Capital Funds

- Similar to hedge fund. Raise Capital through Sale of limited partnership units.
- For accredited investors usually.
- Unregulated.

Real Estate Investment Trust (REIT): Company that manages real estate portfolio in order to earn profits for shareholders.

Types:
- Mortgage/Debt: Real estate backed issue secured loans.
- Equity: Own and operate income-producing real estate.
- Hybrid: Combination.

Tax Benefit:
- No tax on income if 90% is distributed.
  - Doesn't pass through losses (unlike limited partnership)
  - 20% of dist. income is tax-deductible. (80% taxable as ordinary income)

Characteristics:
- Shares in Secondary market.
- Subject to registration requirements SA 1933.
- Dists. don't qualify for dividend exclusion rule
- Attractive for investors seeking current income.

Offering REIT's

1. Registered.
   - Exchange-Listed, publicly traded. (most common)
   - Liquid.
2. Registered.
   - Not exchange-listed, (non-traded)
   - Lack of liquidity.
3. Unregistered.
   - Private placement.
   - Illiquid (ill-liquid)

Activity

Which statements are TRUE regarding real estate investment trusts (REITs)? Circle all that apply.

I. Hybrid REITs invest in both mortgages and properties.
II. REITs are not taxed on income if they distribute a minimum of 90%.
III. Their shares are exempt from the registration requirements of the Securities Act of 1933.
IV. Shares are not traded in the secondary market and are redeemed by the issuer.

Limited Partnership(s): Business Venture designed to pass through income AND losses to investors

Advantages of Limited Partnerships

A limited partnership is a business venture that's designed to pass through both income and losses to investors

Flow-through of income (no double taxation) and expenses	▪ Income flows through as passive income ▪ A portion is taxed as ordinary income (20% is deductible)
Limited Liability	▪ Limited partners are only liable for the amount invested and any loans assumed (i.e., the amount they have at risk)

Disadvantages of Limited Partnerships

Illiquidity
- Typically not publicly traded
- General partner's approval may be required to sell

Lack of Control
- Limited partners have limited voting power and no managerial authority

Effects of Tax Law Changes

Increased Tax Complexity

Calls to Contribute Additional Funds

General Partner
- "Manager"
- $\geq 1\%$ interest.
- Fiduciary toward limited partner.
- Last @ Liquidation.
  - Secured Lender.
  - General Creditor
  - Limited
  - General

Limited Partner
- Passive investor
- Contributors of Capital.
- Certain rights
  - Lend money to the partnership, inspect books, Compete
- Endangered by.
  - Negotiated contracts.
  - Hire/Fire employees
  - Lend name.

Direct Partner Programs.
- General Partnership
- LLC
- Subchapter S corp.

Offering Practices.

Offering Practices

Public Offering	Private Placement
▪ If a sponsor (GP) conducts a public offering of securities: • Registration is required under the Securities Act of 1933 • An underwriter is used to facilitate the offering • A prospectus is used as the disclosure document	▪ If a sponsor (GP) conducts a private placement of securities: • Securities qualify for an exemption from registration through Reg. D

2 MAIN PROGRAMS. (Real Estate/Oil and Gas)

Real Estate Programs

Category	Details
Raw Land	Speculation on land appreciation; no positive cash flow or depreciation
New Construction	Risks of overbuilding, cost overruns, long duration, etc.
Existing	Existing cash flow, but potential problematic tenant issues (e.g., long-term leases)
Low Income (Government Assisted)	Beneficial potential tax credits; little chance of appreciation; high maintenance costs

"Section 8 Housing"

Oil and Gas Programs

(L) 1 - 4 (H)

Category	Details	Risk
Exploratory	High risk with high potential reward	High Risk No product. 4
Developmental	Drilling near an existing field	Low Risk < Balanced Low Return 2
Balanced	Combination of exploratory and developmental	< Exploratory 3
Income	Purchase of existing wells; creates immediate cash flow	Lowest. 1

DPP Risk Summary.

DPPs – Risk Summary

Investors should be aware of the following risks of DPP investments:

- Management ability of the general partner(s)
- Illiquid nature and potential loss of capital
- Unpredictable income
- Potential future mandatory assessments
- Rising operating costs
- Changes in tax laws and government regulations
- Economic and environmental occurrences

> Successfully investing is about managing risk, not avoiding it.

Investor Considerations

Investor Certification

- Registered representatives are required to certify they have informed their customers of all relevant facts and lack of marketability
- Investors must have sufficient net worth and income to absorb a loss of the entire investment

Discretionary Accounts

- Registered representatives are not permitted to exercise discretion involving client investments in DPPs

Activity

Read each statement and fill in the blanks.

1. Limited partnerships pass through income and losses.
2. The general partner must invest no less than 1% in the partnership.
3. Limited partners do not have a fiduciary responsibility to the partnership. ← General Partners do.
4. Limited partnerships generally avoid registration by offering securities through private placements.
5. Raw Land is considered the riskiest real estate program.
6. Overbuilding is a risk in a New Construction limited partnership.
7. The riskiest oil and gas program is an Exploratory partnership.

Activity

Which statements are TRUE regarding limited partnership investments? Circle all that apply.

I. Partnerships may require limited partners to deposit additional funds.
II. Investors are not required to receive information regarding the risks of the investment.
III. Registered representatives can use discretion to purchase limited partnerships for customers.
IV. Customers must provide their RRs with written approval to purchase limited partnership interests.

Ch. 9 Quiz

ETF/N,REITS: Secondary Market.

ETN'S: Unsecured Securities. Don't make regular interest payments.

Private Equity and Venture Capital funds assist start up businesses.

ETF'S are subject to registration requirements of the ICA (1940)

Chapter 10 Options.

Option: A contract between two parties. (Calls and Puts)
- 2 parties.

Owner (Buyer)
- Long Term Option.
- Pays premium
- Acquires a right/Control

Writer (Seller)
- Short the option.
- Receives the premium.
- Assumes an obligation.

★

Types of Contracts

If an option is exercised…

	BUYER'S RIGHT	SELLER'S OBLIGATION
CALL	To buy stock	To sell stock
PUT	To sell stock	To buy stock

Standardized Components.

An equity option is a contract to buy/sell a # of Shares of a particular stock @ a fixed price over a certain period.

Option Contract.
- Name of underlying Security.
- Expiration month of the contract.
- Exercise (Strike) price
- Option Type

Example.

Exp: 3rd Friday in June

Strike Price: ($50/share)

Option to Buy

Premium of $5/share

$\boxed{\text{Buy 1 ABC June 50 Call at 5}}$

1 = 100 SHARES

NAME (ABC Stock)

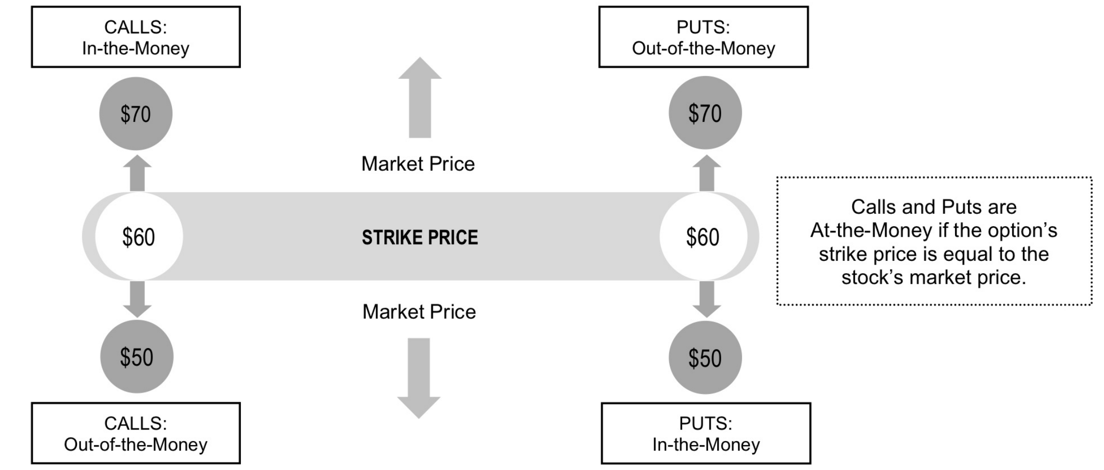
Aggregate Contract Price: 100 (Shares) × 50 (Price) = $5000

Aggregate Premium: 5 (prem) × 100 (Shares) = $500

Calls: Gives rights to buy.

Puts: Gives rights to Sell.

In-the-Money Versus Out-of-the-Money



Calls
- In the money if selling profits.
- Out if value decreases.

Puts.
- In the money if stock is > market price.
- Out if < market price

Call up someone, put down.

m.p ⇑ ⟷ m.p ⇓
in the money

Terminology

$$\text{Premium} = \underbrace{\text{Intrinsic Value}}^{\text{in-the-money amt.}} + \underbrace{\text{Time Value}}_{\text{Additional cost that exceeds intrinsic value.}}$$

- Contract has intrinsic value if in-the-money.
- Zero int. value if out-of-the-money / at-the-money.

Time Value is based on
- Time left until expiration.
- Market Volatility.

CALL OPTION: Owner buys.
PUT OPTION: Owner sells

Activity

Read each description and then match it to the appropriate term.

✓ INTRINSIC VALUE
✓ TIME VALUE
✓ OPTION
✗ CALL OPTION
✗ PUT OPTION
✓ BUYER
✓ SELLER

- Owner has right to buy stock; seller has obligation to sell the stock at fixed price
- Pays the option's premium; is long the option
- A contract entered into by two parties
- The amount by which an option is in-the-money
- Receives the option's premium; is short the option
- Owner has right to sell stock; seller has obligation to buy the stock at fixed price
- The portion of an option's premium that exceeds its intrinsic value

Activity

Fill in the table.

Option and Premium	Market Price	In, At or Out-of-the Money	Intrinsic Value	Time Value
ABC Jun 35 Call at 3	36	IN	1	2
DEF Apr 60 Put at 7	54	IN	6	1
RST Jul 35 Put at 1.50	35	AT	0	1.5
XYZ Aug 110 Call at 2	109	OUT	0	2

July 50 CALL at 5

Basic Options: Long and Short Calls

	CALLS	
	BUYER, OWNER, LONG	SELLER, WRITER, SHORT
Rights	Buy stock at strike price (50)	None
Obligations	None	Sell stock at strike price (50)
Strategy	Bullish ↑	Bearish ↓
Breakeven	Strike price + premium	Strike price + premium
Maximum Gain	Unlimited No-Limit.	Premium
Maximum Loss	Premium	Unlimited

Receives 5point premium.

Creating a basic option position is considered speculative.

If it goes to 0:
RIGHT to buy @ 50
NOT an obligation.

Sellers want the premium.

Breakevens for Short and Long Call.

Breakeven – Long Call

When the current market value of XYZ stock is at 47:

Buy 1 XYZ Feb 45 Call at 3

Breakeven:

Strike + Premium.

45 + 3 = 48

Debit (Cash Out)	Credit (Cash In)
Premium 3.00 Buy@ 45.00	
48.00 /SHARE	

Need: $4,800 BACK

Breakeven – Short Call

When the current market value of XYZ stock is at 47:

Sell 1 XYZ Feb 45 Call at 2.50

Breakeven:

45 + 2.50 = 47.50

Still Strike + premium

Debit (Cash Out)	Credit (Cash In)
	Take in 2.50 45.00
	47.50

$4,750

July 50 PUT at 5

Basic Options: Long and Short Puts

Synonymous.

	PUTS	
	BUYER, OWNER, LONG	**SELLER, WRITER, SHORT**
Rights	Sell stock at strike price	None
Obligations	None	Buy stock at strike price
Strategy	Bearish ↓	Bullish ↑
Breakeven	Strike price – premium	Strike price – premium
Maximum Gain	(Strike price – premium) x 100 shares (50-5)100 = 4500	Premium
Maximum Loss	Premium 5 points.	(Strike price – premium) x 100 shares

Right to Sell @ 50 not an obligation.

Creating a basic option position is considered speculative.

ex. Bearish: Buy @ 45. Sell @ 50. Take the $5+

Breakeven – Long Put

Per Share.

When the current market value of ABC stock is at 92: Buy.

Buy 1 ABC Apr 95 Put at 3.50

Right to Sell @ $95

Breakeven:

95 – 3.50 = 91.50

Spent Debit (Cash Out)	Earned Credit (Cash In)
3.50	95.00
	91.50

Net: $91.50/stock

if 70 → more profit.

Breakeven – Short Put

When the current market value of DEF stock is at 32:

Sell 1 DEF Nov 35 Put at 4

As a Seller you get $4/share

Breakeven:

35 – 4 = 31

Debit (Cash Out)	Credit (Cash In)
35.00	4.00/SHARE
31.00	

If sold for <$31 lose money.

if $0, lose $3100

Hope it goes up.

Question

Which of the following statements are TRUE with regards to Long and Short Call and Puts?

I. Buyers of Calls are bullish (i.e., they want the stock to rise).
II. Sellers of Calls are bearish (i.e., they want the stock to fall).
III. Breakeven for the seller of a call is the strike price minus the premium. Strike Price + Premium.
IV. Breakeven for the buyer of a put is the strike price plus the premium.
V. The maximum loss for a buyer of a call is the premium.
VI. The maximum loss for a buyer of a put is the premium.

Speculation V. Hedging.

Speculation
- Option Sold for profit.
- Investor has no existing position in underlying Security.
- Long Calls and Short Puts are Bullish↑
- Long puts and Short Calls are Bearish↓.

Hedging
- Reduce risk by purchasing options to protect the movement of an underlying Security.
- Long puts protect long stock positions.
- "Buying insurance" Pay premium to protect.
- Long calls protect Short stock positions.

The Life of an Option

1. Expire Worthless	2. Exercised	3. Liquidated
If an option is at- or out-of-the-money on the expiration date, the holder of the contract has no incentive to exercise the contract. Also, since there would be no time remaining on the contract, the contract **expires worthless**. The expiration triggers: ▪ The maximum profit for a seller of a call or put ▪ The maximum loss for the buyer of a call or put	The investor who is long an option has the exclusive right to exercise the option at her own discretion. The two styles of exercise are: ▪ American Style – options may be exercised at any time up until expiration ▪ European Style – options may only be exercised on the day of expiration	Liquidating (closing out) an option position is essentially an alternative to exercising the option. The investor executes an opposite transaction on the same series of option. In other words, what was bought is sold or what was sold is bought.

Liquidate, Trade, Close-Out.

Opening Transaction.	Closing Transaction.
Opening Purchase (Long/Buyer)	Closing Sale
Opening Sale (Short/Seller)	Closing Purchase

Example: Exercise Versus Close-out

When ABC's current market value is 64, an investor buys:

1 ABC May 65 Call at 3

Later, ABC increases to **72**.
Now, the May 65 Calls are trading at **8**.

Scenario #1: Exercised, stock sold	
DEBIT (CASH OUT)	CREDIT (CASH IN)
300 6,500	7,200
6,800	7,200
	+400

BAM! profit

more money

But...

Scenario #2: Closed out at new premium	
DEBIT (CASH OUT)	CREDIT (CASH IN)
300	800
300	800
	+500

Includes $100 of time value

Stock $↑ → Premium↑

The OCC and Options Trading

The Options Clearing Corporation:

- Issues and guarantees listed option contracts
- Eliminates counterparty risk by acting as the third party in all option transactions
    - Acts as the buyer for all sellers and the seller for all buyers
- Deals directly with broker-dealers, not customers
- Creates and requires the distribution of the Options Disclosure Document (Characteristics and Risks of Standardized Options)
- Regulates exchange-traded options

Trade settlement between broker-dealers and the OCC is next business day (i.e., T + 1).

Options expire @ 11:59 ET on exp. date.

Deadlines for Equity Options

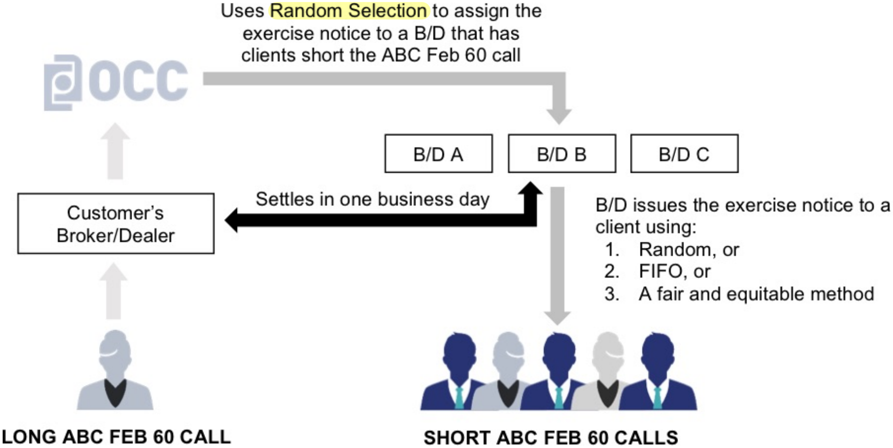
OCTOBER						
SUN	MON	TUES	WED	THURS	FRI	SAT
		1	2	3		
6	7	8	9			
13	14	15	16	17	18	19
20	21	22			25	26
27	28	29				

Trading ceases at 4:00 pm ET

Options expire at 11:59 pm ET

Buyer must submit exercise notice to her broker by no later than 5:30 pm ET

Exercising an Equity Option



Index Options
- Provide hedging/speculation opportunities on the market, rather than singular stock movement.
- SPX tracks S&P 500 index.
- Unlike equity options, these are cash settled.
  - Seller is obligated to deliver in-the-money amount (closing index value / strike price)

Question

Which of the following statements are TRUE with regards to options trading? Circle all that apply.

I. The OCC issues and guarantees all contracts and deals directly with broker-dealers, not customers.
II. Trade settlement between broker-dealers and the OCC is same business day. Next business day.
III. Equity options expire at 11:59 pm ET on the third Friday of the expiration month.
IV. Index options provide the opportunity to hedge against the movement of the market, rather than movement of a specific stock.

Hedging Long and Short Positions.

If investors have either long or short stock positions and want to hedge or protect against potential risk, they may **purchase options**.

To protect (or hedge) stock in a volatile market:
- When long stock: Buy a put
  - If the stock decreases, the gain on the put can offset the loss on the stock
- When short stock: Buy a call
  - If the stock increases, the gain on the call can offset the loss on the stock

Uncovered Options: Margin Account. Covered: Margin/CASH Account.

Covered and Uncovered Positions

Covered Call: Selling (GAIN PREMIUM) ▪ A call is written against stock that's already owned ▪ The sale of the call generates income, thereby increasing the yield on the underlying security ▪ Considered a conservative option strategy	**Uncovered Call:** ▪ A Call is written against stock that's not owned ▪ Considered the most speculative option position with unlimited potential risk
Covered Put: ▪ A put is written when the investor has a sufficient amount of cash to satisfy the obligation of being exercised against on the put	**Uncovered Put:** ▪ A Put is written without having sufficient cash to meet the obligation of being exercised against on the put ▪ There is significant risk if the underlying security falls

Quiz 10.

Exercise listed equity option positions w/member firms by: 5:30pm ET on option exp. date.

Listed Equities Stop trading @ 3:00CT / 4:00pm ET on exp. Date.

Listed equity options Stop trading @ 4:00pm ET on Exp. Date.

Covered Call:

- Investor owns the stock → long the stock
- Sells a call option → short the call.

Opening Transaction	Closing Transaction
Opening Purchase (Long/Buyer)	Closing Sale
Opening Sale (Short/Seller)	Closing Purchase

Types of Financing Transactions

	Public Offerings ('33 Act)	Private Offerings (Reg. D)
Timing	Initial Public Offering (IPO) Subsequent Raises (Follow-on offerings)	Exempt offering that does not involve a public distribution
Proceeds	Primary and/or secondary	

A Private Investment in Public Equity (PIPE) is the private raising of capital by a company that's publicly traded

Underwriting Commitments

Types of Underwriting	Comments	Unsold shares are directed to:	Principal/Agent
Firm Commitment	Syndicate "takes down" the entire offering	Syndicate	Principal (Dealer: own account)
Best Efforts	Syndicate sells what it can	Issuer	Agent
Best Efforts All-or-None	Offering is cancelled if all shares are not sold	Issuer	Agent
Best Efforts Mini-Maxi	Offering is cancelled if a set minimum is not sold	Issuer	Agent.
Stand-By	Syndicate agrees to buy any shares that are not bought through a rights offering	Syndicate	Principal

"Best Efforts"

Additional Underwriting Issues

Shelf Registration	▪ Gives certain issuers the flexibility of selling new issues on a delayed or continuous basis ▪ May be permitted for up to three years ▪ Issuer and underwriter can adjust the terms of the offering to reflect the market conditions at the time of the sale
Market-Out Clause	▪ Provides the underwriter with the ability to cancel the agreement ▪ Based on events that make marketing the issue difficult or impossible • Reasons are limited and disclosed in the clause

Question

As it relates to financing and underwriting issues, which of these statements is/are TRUE? Circle all that apply.

I. Public offerings are only used for primary offerings (Primary or Secondary)
II. The underwriter in a firm commitment underwriting is acting as a principal
III. The underwriter in a best efforts underwriting is acting as an agent
IV. Shelf registration allows an underwriter the ability to offer securities once within a 3-year period

Primary Market.

Funded through investors.

Issuer
- Needs Capital
- Hire U.W.

↓

Underwriting Manager
- Facilitates distribution.
- Assumes liability that varies w/ offering type.
- Signs U.W.ing agreement w/ issuer.

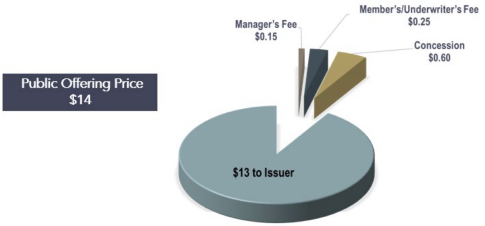
↓

Syndicate Members
- B/D's assisting in Selling and Sharing liability.
- Signs syndicate agreement w/ manager.

↓

Selling Group
- B/D's helping w/ Sale.
- No liability
- Signs Selling agreement w/ manager.

The Underwriting Spread



Distribution of the Spread

Underwriter purchases from issuer at $13 and sells at the POP of $14

Manager's Fee	Member's U/W Fee	Concession
$.15	$.25	$.60

Example: 1,000 shares are sold to a customer at $14 per share

	Manager sells from its allocation	Member sells from its allocation	Selling Group sells
Customer pays:	$14,000	$14,000	$14,000
Issuer receives:	$13,000	$13,000	$13,000
Manager:	$1000 (All 3)	$150	$150
Member:	$0	$850	$250
Selling group:	$0	$0	$600

Question

Check the participant(s) that may have liability for unsold portions of a new issue.

I. Managing underwriter
II. Syndicate member
III. Selling group

Activity

For a new offering, identify how the underwriting spread is distributed for sales that are credited to the different market participants.

	1 The Managing Underwriter	2 The Syndicate Member	3 The Selling Group
Manager's Fees	✓		
Member's Fee	✓	✓	
Concession	✓	✓	✓

Securities Act of 1933
- Full and Fair disclosure.
- Helps informed decisions.
- SEC "no approval clause"
- Prospectus must precede or accompany any Solicitation of a new issue (no altering)

Requires SEC registration of new issues.
- Registration Exemptions to issuers of certain Securities.

Liability
- Unconditional for issuers regarding information to investors
- Conditional for the underwriters that are required to perform:
  - Reasonable investigation
  - "Due Dilligence"

The Registration Process

Pre-Registration Period	Cooling-Off Period	Post Registration Period
▪ Document preparation and due diligence begins ▪ Registration statement is completed ▪ B/Ds and RRs may have no communication with the public	▪ File the registration statement with the SEC ▪ Issuer distributes preliminary prospectus (Red Herring) ▪ "Blue Sky" the issue ▪ Final due diligence meeting held	▪ Effective date ▪ Sales confirmed and Final Prospectus delivered ▪ Must contain the SEC no-approval clause

Prospectus Information

After-Market Prospectus Requirements

Distribution participants that sell securities in the after-market must provide purchasers with a copy of the prospectus for a specific period from the effective date.

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

Types of Prospectuses

A prospectus is any communication, written or broadcast, that offers a security for sale

Statutory Prospectus	Condensed form of the registration statement that provides detailed information on the offering
Preliminary Prospectus	Also referred to as a Red Herring; used during the cooling off period ▪ Omits the offering price, underwriting and dealer discounts, and proceeds to the issuer ▪ Once final offering price is set, a final statutory prospectus is filed
Summary Prospectus	Short-form prospectus typically used for mutual fund offerings ▪ Investor must be informed of statutory prospectus
Free Writing Prospectus	Any communication that does not meet the standards of a statutory prospectus ▪ Includes a legend recommending that investors read the statutory prospectus • Examples: offering term sheets, e-mails, press releases, and marketing materials

Pick up @ 55:05

Exempt Securities.

- Certain Issuers dont have to register Securities w/SEC.
- Time/Cost Savings
- Examples.
  - US.Gov and U.S Gov. Agency Securities.
  - Municipal Securities.
  - NonProfit Issued.
  - Short-term debt instruments. ≤ 270 days maturity.
  - Domestic Bank and Trust.
  - Small busineces investment Companies

Regulation D: Manner used, not issuer type.
(Private-Placement)

Rule 144: Regulate Sale of restricted and Control (affiliated) Stock.

restricted:
- unregistered.
- Private placement.

Control (affiliated):
- Registered
- Acquired by control (affiliated) person in Secondary Mar.

- Holding Period.
  - Issuer Type
    - Reporting Company: 6 mo
    - Non-Reporting Company: 1yr
  - Control Stock.
    - No holding period.

- File w/SEC. (Res. and Con.) when Selling.
  - If < 5000 Shares or \$ < 50,000. No Notice Required.

- Volume Limit: (Doesn't Apply to Non-Affiliated Seller)

max is: 1% of total Shares outstanding or Stocks average weekly trading volume

Rule 144A: Permit Sales of restricted Securities to sophisticated investors w/o being subject to the Conditions of 144A.

- Securities may be Sold to QIB's

Rule 145

- Certain Securities reclassifications are considered sales and are subject to reg. and prospectus req's of the Act.

Subject to:
- Substitutions.
- Mergers/Consolidations
- Transfers of Assets.

Not Subject:
- Par Value Change
- Stock Split.
- Reverse Stock Split.

Rule 147(A) Intrastate Offering.

Rule 147 and 147A

Intrastate Offering

Provides an exemption for the sale of securities to residents of one state if:

- The corporation has its principal place of business in the state and meets **any one of the following four requirements:**
    1. 80% of the assets located
    2. 80% of the revenues generated
    3. 80% of the proceeds used, or
    4. A majority of issuer's employees are based in the state
- Resales to non-residents are prohibited for **six months** from the end of the distribution

Activity

Identify whether the statement applies to Rule 147 or Reg. D. Read each statement and fill in the blanks.

147	Investors must be residents of one state.
Reg. D	Sales are limited to a maximum number of non-accredited investors. (35 max)
147	Non-residents cannot purchase stock for six months after the last sale of the offering.
Reg. D	An offering memorandum is the disclosure document.

Activity

Match each description to the appropriate Rule.

RULE 144	Sales of restricted and control stock
RULE 144A	Reclassifications of securities
RULE 145	Qualified institutional buyers

Issuance of Municipal Bonds (G.O and Revenue)

- Municipal Debt: exempt from registration and prospectus requirement.

GO
- Voter Approval.
- Debt Limitations.
  - Limits ability to debt above its Ceiling.

Revenue Bonds.
- Doesn't require voter approval since theyre backed by fees that are paid for use of facility/service.
- Consultant hired to produce a feasibility study.

Selecting Underwriter.

- Competive Sale: Bidding. Winning Bid: Lowest Interest.
- Negotiated Sale: Issuer Appoints the managing underwriter.

Municipal Advisor: Employed by muni. to help Select underwriter.

Underwriting Documents.

- Official Statement.
  - Used by muni. issuers as a disclosure doc.
- Legal opinion
  - Prepared by Bond Counsel. Renders its opinions as to
    - Issuers legal, valid, and enforceable obligation.
    - Tax Exempt status of issue.
- New Issue Confirmation.
  - Provided to purchasers, along w/copy of the official statement, by no later than settlement date.
- Committee on Uniform Securities Identification Procedures (CUSIP)
  - U.W's expected to apply for CUSIP numbers that are used to identify unique securities. (ex. By Maturity)

Electronic Municipal Market Access (EMMA)

Electronic Municipal Market Access (EMMA)

MSRB website used by issuers and underwriters to submit documents

Electronic Access
- Provides electronic public access to information about the municipal market
  - Trade activity
  - Market statistics

Documents
- Various documents:
  - Pre-sale documents
  - Official statements
  - Continuing disclosures

Plan Info
- Includes 529 plan information

Question

Circle the statement(s) that is/are TRUE regarding municipal documents?

Voluntary to prepare. Mandatory to distribute.

I. When an official statement is prepared by an issuer, it must be provided to any purchaser of the new issue.
II. A legal opinion guarantees the payment of principal and interest on a bond.
III. The bond counsel for the issuer prepares the legal opinion.
IV. The MSRB requires the preparation of an official statement.

MSRB has no authority on issuers of MB's.

Quiz 11.

Unlisted IPO has 90 days to deliver prospectus.

Underwriters total Compensation is the spread.

An offering where some Shares are sold by the issuer and some are offered by Selling Shareholders is a Split Offering.

Rule 144A.

IPO : Initial Public Offering - Raise Capital by issuing Securities to the public.

Rule 144: Determines amount of stock an individual may Sell @ any given time.

Disclosure for private placement: Offering memorandum.

Chapter 12.

Remember.

How Broker-Dealers Function

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

Agency
Broker
Commission

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

Dealer Quote: \$19.90 – \$20.25 : Buy @ \$19.90 Sell @ \$20.25. Ask (Offer) – Bid

Fair Prices and Commissions

Inside Market: Highest Bid.
Lowest Ask.

The Policy	▪ FINRA has established a 5% Policy • The policy is not a rule, but rather a guideline for commissions, markups, and markdowns – Certain transactions may justify a higher markup/markdown – Other transactions may justify a lower markup/markdown
The Factors That Influence the Charge	▪ Influential Factors • Type of security involved (equity or debt) • Availability of the security • Price • Amount of money involved • Pattern of markups • However, the type of client or whether the firm will profit is NOT relevant

The 5% policy : (Guideline. Not a Rule)

- Applies To
  - Markup
  - Markdown
  - Commissions
  - Proceeds Transactions
- < 5% (Typically)
  - Common Stock
  - Limited Partnership
  - Low-Availability.
  - Cheap Transaction.
  - Nature of B/D business (Research)

Proceeds Transaction: A Client directs a B/D to liquidate Securities and use the proceeds to buy other Securities.
- Markup calculated based on one trade. (As if done for Cash)

Exempt from 5% policy.
- "Delivered Prospectus"
- IPO, Mu.Bonds, MFS's.

Activity

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

A MARKUP IS APPLIED TO THE ASK PRICE WHEN A MARKET MAKER SELLS TO A CUSTOMER	T ✓
TOTAL PRICE PAID BY CUSTOMERS IS THE ASK PRICE	F ×
FINRA'S 5% POLICY ALLOWS A BROKER-DEALER TO CHARGE ENOUGH TO MAKE A PROFIT	F ✓
THE 5% POLICY APPLIES WHEN A CUSTOMER SELLS A SECURITY AND USES THE PROCEEDS TO PURCHASE ANOTHER SECURITY	T ✓

MARKUP! ASK + MARKUP.

FINRA protects customer.

Proceeds Transaction.

Discretionary Orders: When discretion is granted to a RR, it must be documented when used.

Discretionary Account.

- Execute w/Customer Consent: "Discretion not exercised"
- Trade decision was made by the rep. w/o consent to the Specific trade, the order ticket must State that it is discretionary.

Non-Discretionary Account.

- Order ticket must indicate Solicited or Unsolicited.
  - If Trade was RECOMMENDED by agent and accepted by customer, it is marked as SOLICITED.
  - w/o Rec. it is UNSOLICITED.

Transactions.

Types of Transactions

When an order is placed, it must be identified as either a:

Purchase	Trade may be paid in full or purchased on margin
Own **Long Sale**	Sale of securities that are owned by the customer
don't own **Short Position Created By:**	Sale of securities that are not owned by the customer ▪ Customer borrows from the firm and sells ▪ Must deposit the appropriate amount of margin to borrow securities ▪ Risk is on the upside and unlimited Covered and uncovered options (i.e., the sale of call or put options) ▪ If covered, no margin is required and risk is generally limited ▪ If uncovered, margin is required and risk may be significant

Activity

Which of the following must be documented on an order ticket? Circle all that apply.

I. The order ticket must indicate if discretion was not exercised for orders executed in a discretionary account.
II. A trade recommended by an RR and accepted by a customer can be marked unsolicited. X (Solicited)
III. A sale of securities that are not owned by a customer is documented as being sold short.
IV. All sales of options must be done in margin account. Margin or CASH
only uncovered options

Types of Orders.

Types of Orders

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

Execution Guarantee. Immediate

No Execution Guarantee.

Examples (Limit Order)

SIE On-Demand Learning Guide

Buy Limit Order

An investor is interested in ABC stock, which is currently trading at 30.75. Rather than placing a market order, she enters a buy limit order

- Buy 1,000 ABC at $30

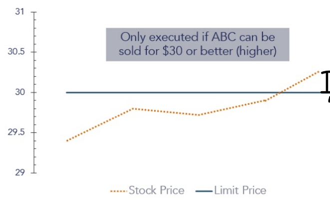
Executes.

No Profit Guarantee.

Sell Limit Order

ABC is currently trading at $29.40 and an investor who is long the stock is willing to sell her shares. Rather than placing a market order, she enters a sell limit order

- Sell 1,000 ABC at $30



Executes

Threshold.

Activity

Match each type of order with the appropriate description.

✓ MARKET	A buy or sell order that may not be executed
✓ SELL LIMIT	An order that will only be executed at a specific price or lower
LIMIT	A buy or sell order that will be immediately executed
BUY LIMIT	An order that will only be executed at a specific price or higher

More Types of Orders.

Stop Orders
- May be used to limit loss or protect a gain.
- Contingent: Doesn't guarantee a specific price when buying/Selling.
- Stop Price: Price Set by investor.

If Long Stock (BULLISH)	▪ Hope – Stock rises in value ▪ Fear – Stock falls in value ▪ Need – Limit downside risk (enter sell stop order below current market value)
If Short Stock (BEARISH)	▪ Hope – Stock falls in value ▪ Fear – Stock rises in value ▪ Need – Limit upside risk (enter buy stop order above current market value)

Bullish: Rise

Bearish: Fall

StopPrice: $20

$25

AT → $20 Through

$15

Stop and Stop-Limit Orders.
- Both are triggered when a trade occurs at, or through, the stop price.

Stop and Stop Limit Orders

Both stop and stop limit orders are "triggered" (activated) when a trade occurs at, or through, the stop price
- Sell stop orders will activate at the stop price or lower Protect Profit: Long position.
- Buy stop orders will activate at the stop price or higher Protect Profit: Short Position.

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

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

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

Activity

Read each statement and indicate to which order it applies.

CAN BE USED TO HEDGE A LONG POSITION	Sell-Stop Order
ONCE ACTIVATED, IT MAY NOT BE EXECUTED	Limit Order
ONCE ACTIVATED, IT WILL BE IMMEDIATELY EXECUTED	Market Order
CAN BE USED TO HEDGE A SHORT POSITION	Buy-Stop Order.

Buy/Sell - Stop Order usage and Examples.

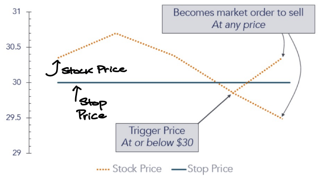
Sell Stop Order

An investor's long position in RST has risen in value; however, he's afraid of a potential decline. To limit downside risk, he enters a sell stop order

- Sell 1,000 RST at $30 stop

"When it hits $30, get me out"

No Guarantee on price @ execution



Sell Stop Order Example

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

- The stock starts trading at lower prices
- Afraid of a large loss, she enters an order:

  Sell 1,000 DEF at 30 stop

- Today's transactions:

  Trigger Price   Execution Price (Next step after trigger)

  30.35…30.70…30.38…29.87…29.85

  Trigger Price? 24.87   Execution Price? 24.85

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

Buy Stop Order

An investor's short position in ABC has fallen in value; however, he's afraid of a potential increase. To limit upside risk, he enters a buy stop order

- Buy 1,000 ABC at $30 stop

Liquidate @ $30

Buy Stop Order Example

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

- The stock starts trading at higher prices
- Afraid of a large loss, he enters an order:

  Buy 1,000 DEF at 30 stop

- Today's transactions:

  Trigger   Execute

  29.75…29.60…29.70…30.12…30.15

  Trigger Price? 30.12   Execution Price? 30.15

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

No Guarantee.

Order Qualifiers.

Order Qualifiers

Different qualifiers can be used to influence when and if an order is executed

Two of the more popular are:

1. Day Order – unless otherwise indicated, all orders are day orders and are cancelled at day's end if not executed
2. Good-'Til-Cancelled (GTC) or Open Order – stays on the book until it expires, is executed, or is cancelled
    - May be placed for one week, one month, or other specified period
    - Entering firm should periodically check with the exchange on which the order was entered
    - May be adjusted for distributions on the security or partial execution

Activity

Which of the following is/are TRUE regarding stop and other order qualifiers? Circle all that apply.

X I. A day order that's not executed on a specific day will be carried over to the next day. ← INTRA-DAY

X II. A buy stop at $17 will be triggered if the stock trades at or below $17.

III. A sell stop at $37 will be triggered if the stock trades at or below $37.

IV. A GTC order is adjusted if the underlying stock is the subject of a stock dividend.

Buy Stop:

Quiz 12. Review Page 166-167. Stop Orders.

Core Rule.

- Buy Stop ABOVE market. "Get me in if price rises"
- Sell Stop BELOW market. "Get me out if it drops"

Buy Stop → CALL → BULLISH.

- Benefit: Price ↑

Sell Stop → PUT → BEARISH

- Benefit: Loss Limit.

Quote: 15 - 15.75 Inside Market: 15.15 - \$15.65 Sold @ \$16.20

Markup: $\frac{\text{Sale Price} - \text{PMP}}{\text{PMP}}$ PMP: Inside Market Price.

$$= \frac{16.20 - 15.65}{15.65} = \frac{0.55}{15.65}$$

Buy Stop Limit Order: Enter position after upward breakout.

1. Trigger: At or above Stop Price.
2. Execute: At stop price OR lower.

After 1. Becomes limit order to buy @ \$45.00

Sell Stop Limit Order: limit loss and avoid execution at unacceptable prices.

1. Trigger: At or BELOW stop price.
2. Execution: At or above stop price.

MARKET ORDERS have priority. (bc. Immediate Execution)