Stock Dividend (gets you more shares) Calculation:
An investor owns 100 shares of stock at $20/share. The investor receives a 25% stock dividend. What changes?
New price=Old price/SD Factor
New price=$20/1.25
New price=$16

Stock Spilt Calculation (Forward & Reverse is calculated the same way):
A stockholder owns 100 shares of ABC Company at a current market price of $300 per share. How will a 2:1 forward stock split impact shareholders?
SS factor=First number/Second Number
SS factor=2/1
SS factor=2
New shares=old shares x SS factor
New shares=100 x 2
New shares=200
New price= old price/SS factor
New price=$300/2
New price=$150
Put it all together and compare before and after to confirm
Before the split:

- 100 shares @ $300 = ***$30,000***

After the split:

- 200 shares @ $150 = ***$30,000***

Earnings per share = annual earnings/outstanding shares

PE Ratio = market price/earnings per share

Yields for Preferred Stock
Dividend Rate: dividend annual income/par -> never changes
Current Yield: dividend annual income/market price -> Fluctuates depending on market price
Annual Income = dividend rate * par value

Trading at…	Relationship
Discount	yield > dividend rate
Par	yield = dividend rate
Premium	yield < dividend rate

Yields for Bonds

Nominal Yield or Coupon = Annual Income/Par
Current Yield = Annual Income/Market Price
Yield to Maturity = (Coupon + (Par-market price/years))/(Par+market price/2) – inverse relation with market price (Basis also means YTM)

Bond Investor expects factoring in inflation
Real Interest Rate = Yield – Inflation Rate

Convertible Bond Formulas:
Conversion ratio = par/conversion price
Conversion price = par/conversion ratio
Stock Parity Price = bond market price/conversion ratio
Bond Parity Price = stock price * conversion ratio

Tax-free equivalent yield = corporate yield * (100%-tax bracket of investor)

Mutual funds
NAV = net assets/shares outstanding
If sales charge is in dollars
POP = NAV + Sales charge
If sales charge is in percent
POP = NAV/(100% - sales charge)
Sales charge = Pop - NAV/POP

Total Return = all gains and or losses (realized or unrealized)/original investment
Total return does not factor in inflation

Options:
Premium=intrinsic value + time value

Long Account equity
<u>Long market value – debit (borrows remaining) = equity</u> (50% or 2k investor pays)
Short Account equity
<u>Credit – SMV = equity</u>
Credit = amount being sold short
SMV = short market value (overall value of short securities in the account)
Combined
LMV + credit – SMV – debit = equity

Minimum Maintenance:
Equity%=(Equity (in $)/LMV or SMV

TERMs:

Primary market: when issuers get money from selling securities (IPOs)

Secondary market: when the sale of securities does not go to the corporation

- First Market: listed stocks trading on exchanges
- Second Market: unlisted stocks trading OTC
- Third Market: listed stocks trading OTC
- Fourth market: Institution-to-institution trading typically using ECNs – trade anonymously – retail investors can also use

- **Principal** trading is when a brokerage completes a customer's trade using their own inventory. **Agency** trading involves a brokerage finding a counterparty to the customer's trade, which can include customers at other brokerages. Principal trading allows brokers to also profit from the bid-ask spread.

Broker-Dealers:

- Broker-dealers categorized as **introducing brokers** are often smaller broker-dealers that primarily maintain relationships with customers and facilitate their trades. Introducing brokers don't maintain custody of customer assets, meaning they don't keep possession of their securities. Additionally, introducing brokers do not process their customers' trades but perform marketing services and maintain a book of customers (introducing firms can operate on a fully disclosed account which means information on customers will be transmitted to clearing firm – if omnibus they will set up account with clearing firm but maintain information on each customer)
- Many large broker-dealers are categorized as **clearing brokers**, which are broker-dealers that maintain custody, process orders, and provide clearing services in addition to facilitating trades for their customers. If a stock is trading in five different markets, the clearing broker is responsible for finding the market that can execute the trade efficiently at the best price.
- A **clearinghouse** is an organization responsible for ensuring trades are properly finalized. They're responsible for ensuring the buyer receives the security, and the seller gets the cash
- Prime brokerage account is clearing firm offered to hedge fund as well as institution and high net worth investors
- Beneficial owners: are people who have their securities that are being held by them in street name
- Non-Objecting Beneficial Owner (NOBO): if owner gives permission to BD to release her name and address to issuer they are able to provide communications directly to them
- Objecting Beneficial Owner (OBO): if person entrusts BD to keep info confidential then the issuer distributes communications in bulk to BD who distributes it to the owner

- The **Depository Trust & Clearing Corporation (DTCC)** is the primary *clearinghouse* used in the securities markets. The DTCC is a non-profit, industry-owned organization that clears most trades in the financial markets by replacing physical deliver of securities with book-entry
- The national Securities Clearing Corporation (NSCC) provides clearing services for equity securities and is a subsidiary of the DTCC
- **SEC Customer Protection Rule:** requires BDs to protect customer funds and securities, they must maintain custody, segregate assets from the firm's activities and promptly deliver based on owner's request. Applies to both cash and margin accounts and must buy-in customer if client sells securities and fails to deliver them within 10 business days of the settlement

• The registrar is responsible for ensuring that a corporation doesn't issue more shares than it's authorized to issue

<u>Settlement</u>

- **Regular-way settlement** for common stock occurs on the second business day after the transaction (known as T+2 - trade date plus two business days)
- **Cash settlement** is for investors who need their trades finalized quickly. As long as a cash settlement trade executes before 2:30 pm ET, the trade settles the same day

The price of a stock is reduced by an amount sufficient to cover the dividend.

DERP (For Dividend Dates)

- **Declaration Date:** Day the Board declares the dividend
- **Ex-Dividend Date:** First day the stock trades without a dividend. If bought on this date would receive no dividend (**One day before record date) (Investor sells on this date, he receives dividend)** (day the price is reduced of the dividend
- **Record Date:** A stock must settle on or before the record date for an investor to receive the dividend
- **Payable Date:** When the dividend is made to the stockholders – **Taxed here**
- Ex-date for cash settlement trades is one day after the record date
- Investors can't vote for dividends but can receive them
- The ex-date for a stock spilt is the business day after the payable date
- **Like stock splits, stock dividends dilute the share price because more shares have been issued so it does not increase the share price**

Due Bills: trade execute prior to ex-dividend date so buyer entitled to dividend, but seller doesn't not give security by record date but not entitled to it so good delivery rule makes do bill with stock delivery

- **The Securities Act of 1933** is a law that requires most issuers to register their securities with the SEC.
- When an investment is offered to the public, it typically requires registration with the **Securities and Exchange Commission (SEC)** before sale

- **American Depositary Receipts (ADRs)** are created by domestic financial firms with foreign branches. Stocks are placed into a trust account, then the account is sliced into "receipts" for the stock. The receipts are then **registered** with the **SEC** and sold to American investors in US markets. These facilitate US investment in foreign securities
- **Global Depository Receipt (GDR):** issued by a depository bank that purchases shares of foreign companies and trades in foreign market

- **Rights:** Given to existing shareholders the right to buy a stock at a price lower than market value normally before issuers next sale – have intrinsic value (90 days or less) **standby agreement** means the syndicate agrees to purchase any unsubscribed shares remaining after the rights offering
- **Warrants:** Offers option to buy stock at a fixed price higher than current market price. This means they have no intrinsic value but have time value – dilutive event (5-year typical life)
- When included these typically lower coupon rates for the bond offering as it is a sweetener
- They can be perpetual or last forever
- **Tender offers** are utilized when an investor, group of investors, or an organization aims to obtain a significant portion of an issuer's stock. Outside investors (those not connected to the issuer in any way) sometimes create tender offers to attempt a **hostile takeover**. May participate if investor owns security or has convertible, warrant, right, or owns a call option and exercised

- **Suitability** relates to a security's benefits and risks and is used to determine if an investment is appropriate for a particular investor.
- **B** - Benefits

- **R** - Risks
- **TI** - Typical Investor

- **Capital appreciation**, also known as **growth** or a **capital gain**, occurs when an investment's value rises above its original purchase price.

<u>Systematic Risk:</u> Beta measures this at 1 assigned to S&P beta measures stocks volatility to overall market. Less than 1 means less volatile, experience less price fluctuations compared to market as whole

- **Market risk** occurs when an investment's value declines due to a market or economic circumstance. The [Great Recession of 2008] is an excellent example of market risk.
- **Inflation risk**, sometimes referred to as **purchasing power risk**, occurs when rising goods and services prices negatively impact an investment (normally fixed income) (long term bonds low coupons have most inflation rate risk)
- **Interest-Rate Risk:** Normally affects bondholders as when rates rise prices drop but can affect stocks ex: utility stock when rates rise as they are leveraged, or defensive stocks are not affected when rates rise. Preferred stocks have an inverse relationship with rates
- **Event Risk:** Event risk is the risk that a significant event will cause a substantial decline in the market value of all securities (e.g., the 9/11 terrorist attack)

<u>Non-Systematic Risk</u>: affect specific investments or sectors, not the entire market – measured in Alpha (measured by subtracting stock actually earned - beta (expected return)

- **Financial Risk**
- **Business Risk**
- **Regulatory Risk:** new regulatory changes (FDA denies approval of new drug)
- **Legislative Risk**: new laws
- **Political Risk** (most typically overseas)
- **Liquidity Risk:** can't sell it quickly (DPPs, real estate, private placements, partnerships)
- **Opportunity (Cost) Risk:** Opportunity cost or opportunity risk represents the possibility that the return of a selected investment is lower than another investment that was not chosen.
- **Reinvestment Risk:** risk that investor will not be able to reinvest their principal at same rate
- **Currency or Exchange risk:** possibility that foreign investments will be worth less in the future due to changes in exchange rates
- **Capital risk:** risk that investors could lose all or a portion of their money (options)
- **Credit or Default risk:** risk that bond issuer will not make payments as promised
- **Call Risk:** risk that an **issuer** may decide to buy back its bond prior to maturity
- **Prepayment risk:** MBS are subject to this special type of risk when rates lower

Both the buy-and-hold and systematic rebalancing approaches assume that markets are *efficient.* Or, put another way, it's impossible to time changes in asset balances to take advantage of market movements. These passive approaches to asset allocation are in agreement with the market theory which is referred to as the ***Efficient (Capital) Market Hypothesis*** (market timing is ineffective and do indexing)
Active strategies are sector rotation, active management

<u>Fundamental Analysis</u>:
Balance sheet: (Assets=Liabilities +Stockholders Equity)

- Compares company assets and liabilities
- Indicates a company's net worth
- Assets→Includes **current assets** (cash other items converted into cash in one year), **Fixed Assets** (physical property), **Intangible Assets** (Goodwill, patents, copyrights)

- Liabilities→Includes **Current liabilities** (debts due in less than one year-payable), **long-term liabilities** (debts which are payable in more than one year)
- Shareholders Equity→Companies net worth and different classes of stock retained earnings and capital surplus

Shareholder Equity = Liabilities – Assets

Income Statement

- Displays company income and expenses (profit or loss statement)
- **Sales (revenue)** is total money received and the amounts billed but not collected yet
- **Operating Income** is EBIT
- **The operating profit** margin is used as a measurement of a corporation's profitability

Preferred Stock: (Dividends must be approved by BOD) (assume par value of a $100)

- Represents ownership and is an equity security (like common stock), but it acts like a fixed-income security (unlike common stock). This type of security is known for its **dividend income**, which is typically static (fixed) and does not change.
- Par = face value
- **NO VOTING RIGHTS**
- Market price is influenced by interest rate (when dividend and rates rise market price falls)
- Preferred stock maintains a fixed dividend rate, sometimes called a "**coupon**." The dividend rate is always based on par
- Higher risk then debt but lower than common stock as dividends can be stopped or suspended

Yield refers to the rate of return an income-producing security provides

Features of Preferred Stock:

- **Cumulative:** If company misses dividend payments, they must make up for them when they start issuing again
- **Straight:** company does not have to make up for lost dividend payments
- **Participating:** If company has profitable year, they will give out higher dividends, then the normal rate
- **Callable:** Stock can be called back depending on if favorable for company (call protection and premium could be associated)
- **Convertible:** Stock can be converted to common stock using a given conversion ratio

The more favorable the security the higher its market price

BONDS (Assume par value of $1,000)

- Fixed Income – bonds market value decreases when interest increase
- Bonds normally pay interest on the 1st or 15th of the month. Newly issued bonds pay interest from the dated date (date from which interest begins to accrue) may not fall on these dates as it is trying to sync with normal dates (long coupon is first coupon is more than 6 months)
- Par is face value of bond and represents the principal
- Terms and features of the bond are in the indenture
- Interest rate is set (coupon) it never changes
- Issued in book-entry form and ownership recorded by transfer agent
- Most make semi-annual payments
- A bondholder is a creditor
- **Level debt service refers** to a debt repayment structure where the borrower pays a consistent amount of principal and interest over the life of the loan or bond
- Longer maturity = more risk because of default risk so long-time frame = higher return
- Coupon = nominal yield = stated rate

- **Bonds with longer maturities and lower coupons experience the most price volatility**
- Most stable bonds = short maturity and high coupon and maturity matters most
- **When interest rates rise – bonds trading at a discount will fall fastest in price**
- When a bond is quoted using yields (10% bond trading on a 4% basis) it is a **yield quote, basis or serial quote.**
- **If coupon rate is adjustable, it's called a variable or floating rate security**

Features of Bonds:

- Secured (backed by assets) and unsecured (full faith and credit) (Debentures)
- **Callable Bond:** allows issuer to pay back principal (par) early → called when interest rates fall (bonds which high coupons and low premiums are more likely to be call so it's helpful to have call protection on these bonds)
- **Put feature:** Allows bondholder to sell it back to issuer always at par value when rates rise
- Any bond that gives value to the holder (put bonds, non-callable) trade at higher market prices and offer lower returns

Some calls are in-whole which means entire issue being called at one time. Other calls are **partial (lottery calls)** means that some bonds will be retired early and some not. And some have a **catastrophe call** which is allowed if bonds collateral is destroyed (bridge). In-whole and lottery must be disclosed but not catastrophe as those is rare

Issuance

- **Term:** all bonds issued on the same day and mature on same day
- **Serial:** all bonds issued on same day, but mature on different days
- **Series:** bonds issued on different days, but all mature on same day
- **Balloon Maturity:** serial offering where bonds issued same day but mature at different points in the future – large maturity at end

Most US and government bonds are issued in term format, while municipal is in serial and construction do series

Price Quote Ex: Bond trading at 95 = $9,500

Yield Quote Ex: bond trading at 6% Yield

Basis Point = .01% so 100 basis points = 1%

A bonds basis is also known as its yield to maturity

Rate volatility measures changes in primary market rates = short-term rates are most volatile

Bond Issuers:

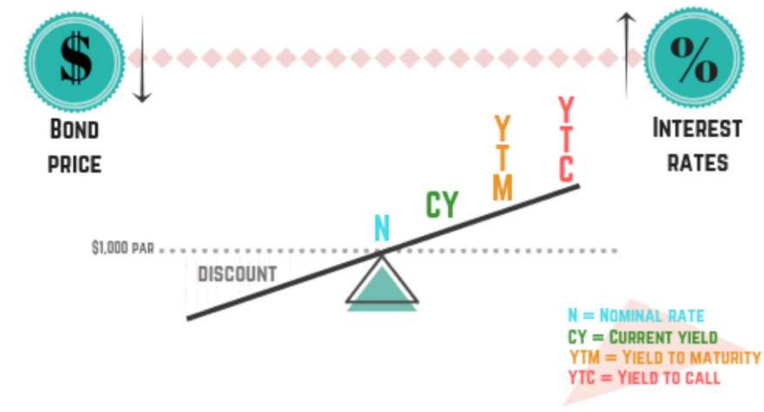
- **US Government:** (settles T+1) (settles though Federal Funds) (**actual/365 for accrued interest)**
- **Municipal and Corporate bonds:** (settles T+2) (settles through clearinghouse) (**30/360 for accrued interest)**
- **Zero coupon bonds:** trade **flat** as no coupon payments so trade without accrued interest

Bond Yields:

- Impacted by interest rate (coupon)
- Purchase price
- Length of time to maturity

A bond purchased at par means all yields are equal or equal the coupon or nominal yield

A bond purchased at par and callable at a premium means the YTM<YTC



Bond Risks:
Systematic
- **Interest rate risk:** bonds with long maturities and low coupons affected the most
- **Inflation (purchasing power risk):** Fixed income securities like bonds are particularly susceptible to this risk due to their fixed coupons. Investors who purchase bonds receive a fixed amount of interest over the bond's life (to avoid seek short term bonds)
- **Reinvestment risk:** Occurs when rates fall as money invested back in market get less as low rates = higher priced bonds – Zero coupon bonds have no reinvestment risk

Non-Systematic Risks:
- **Default risk** also known as credit and repayment risk → bankruptcy
- **Liquidity risk –** Liquidation priority is secured bonds, unsecured bonds and subordinated (junior) bonds
- **Political risk**

Bond Rating Agencies: Standard and Poor, Moody's and Fitch (Under BBB is speculative or junk bond)

Underwriting:
- **Firm Commitment Basis:** Underwriter is stuck with unsold securities
- **Best Efforts Basis:** Issuer is stuck with unsold securities

Short-Term Products:

Commercial Paper: Zero coupon (trades flat)
- Short-term unsecured funds issued at discount and maturing at par
- Normally issued at 100k or more (typically $1M)
- Most suitable for institutional investors
- Large financial institutions buy and repackage into affordable investments for small investors
- Max maturity is 270 days and are exempt from SEC registration requirements
- Quoted on a discount yield Ex: the security provides a 3% yield

Long-Term Products:

Funded debt is long term corporate debt
Debenture: long-term unsecured (naked) debt
Guaranteed Bonds
- Unsecured bonds co-signed by a parent company Ex: P&G for Crest Toothpaste

Income (Adjustment) Bonds (do not actually pay income)
- Happens when a company goes bankrupt – bondholders either can liquate company or allow them to restructure
- When they restructure the normal bonds are destroyed and income bonds are given out
- They only pay interest if the company has enough earnings again which is rare
- Different features then original failed bonds and have high yields and low market prices

Mortgage Bond
- Secured (collateralized bond) corporation pledges its real estate

- First mortgage bonds get paid first if liquidation occurs then second mortgage bonds

Equipment trust certificate

- Secured bond from equipment as collateral – **serial** format

Collateral trust certificate

- Bond secured by a markable asset – collateral would be a subsidiary

Convertible Bonds:

- Allows bondholder to convert bond to stock at any time
- Bonds yield provides a return and investor can make **capital gains** if they convert
- Issuer sets **conversion ratio and price** when issued – both stay fixed unless stock dividend or spilt
- Sold with lower interest rates and trades at a lower yield (higher price) in market
- Has to have majority approval from stockholders

Stock parity price describes the equivalent stock cost if a bond is bought and converted

Mezzanine debt

- Debt that's paid out after senior debtholders but before equity investors
- Instead of paying interest semi-annually the interest gets added to the principal of the loan each year and is paid out on maturity – called **payment-in-kind (PIK)**
- High yield potential

Corporate bonds mostly trade in the OTC market
If a corporate bond trades at 99 ½ its $955 **-> always quoted in 1/8 (eighths or reduced from eighths)**
If a corporate bond trades at 102 1/8 = 102 + 1/8 = 102.125 or $1,021.25
These quotes are percentages of par so 102 is 1,020
1 bond point = $10

<u>Bank Issues:</u>

Certificates of deposits (CDs):

- Issued by banks same as bonds with fixed rate of return – short and long term

Jumbo (negotiable) CDs:

- Very large CDs traded in the secondary market min 100k – offer higher rates and very short term as large institutions buy them

Both are FDIC insured to 250k
Bankers' acceptance:

- Used between international companies – bank acts as intermediary and holds money and sends company a post-dated check that can be sold before goods are given at less than original value
- Money market funds are normally 270 days or less to maturity to avoid SEC registration requirements

Eurodollar deposit: When a US Dollar is held in an account outside the United States
Yankee bonds: allow foreign entities to borrow money in the U.S. marketplace. These bonds are registered with the SEC and sold primarily in the United States
Central bank: An organization operating as a country's centralized financial institution; often directly connected to that country's government
For example: the <u>Federal Reserve</u> is the central bank of the United States
Eurobond is a debt security that pays interest and principal in a denomination other than the currency of the country it was issued in
Eurodollar bond is a specific type of Eurobond that pays US Dollars. Specifically, a Eurodollar bond is a debt security that pays interest and principal in US Dollars but is issued outside of the United States

Spot price: reflects today exchange rate and is used when a currency conversion must happen now
Forward rate (price): is an exchange rate agreed upon today, but for a conversion in the future

Municipal Debt:

Municipal bonds: Issued by the state, city, county, and government subdivisions to pay for roads, schools, parks – **they settle T+2 and interest accrues on a 30/360 basis**

- Municipality seeks help of underwriter to sell bond though negotiated sale (agreement among underwriters) where they appoint or pick an underwriter though competitive sale (syndicate letter) where they bid
- If though negotiated sale the offering price is set by underwriter, if competitive bidding the offering will be sold at the lowest net interest cost
- Documents used during sale are → Notice of sale →legal opinion→official statement (takes place of prospectus but not required to be filled with SEC as they are exempt) → then each customer who purchases must be provided with final confirmation and copy of official statement by settlement
- Issuer is responsible for creating official statement for municipal bond offering

General Obligation bonds: Issued to finance public non-revenue generating projects – parks, schools (long term) – needs voter approval and debt ceiling limitations

- Paid off with taxes Ex: property tax also called **ad valorem taxes**, licensing and traffic fines and income tax
- Backed by full faith, credit, and taxing authority so not secured – very safe and do not default
- State lacks funds to pay off these bonds can raise property tax with voter approval
- Exempt from SEC registration – typically issued in **serial** form
- Exempt from federal, state, and local state if a resident
- **Limited Tax Bond:** type of G.O bond that only has access to a set amount of tax – high coupons

Revenue bonds: issued to finance revenue projects, Ex: toll roads, airports, stadiums (long term)

- The city will hire an independent consultant to prepare a **feasibility study** to determine the aquarium's potential profitability
- Revenue bonds are not paid off with taxpayer funds, so they don't require voter approval
- Needs bond counsel approval on legal matter as well
- Items such as tolls, concessions, and lease rental payments use to back this bond
- **Special tax bond:** financed by a tax on certain items such as liquor, gas, and cigarettes (excuse tax)
- Facilities useful life should sufficiently exceed the maturity of the bond

Types of Revenue Bonds:

- **Housing Revenue Bond:** issued by state or local housing agencies for low income families
- **Dormitory Bonds:** Dormitory bonds are issued to build housing for students at public universities and are repaid from a portion of students' tuition payments
- **Health Care Revenue Bonds:** Health care bonds are used for the construction of non-profit hospitals and health care facilities
- **Utility Revenue Bonds**
- **Transportation Bonds**
- **Special Tax Bonds:** bonds are backed by special taxes (e.g., taxes on tobacco, gasoline, hotel/motel stay) for a specific project or purpose, but not by ad valorem (property) taxes
- **Special Assessment Bonds:** bonds are payable only from specific charge on those who directly benefit
- **Moral Obligation bonds:** first secured by revenue but if not enough state morally obligated but not legally required to provide funds – must get legislative approval
- **Double barreled bonds:** backed by specific revenue and tax dollars (rev & GO)

<u>Process</u> → financial (municipal) advisor → bond counsel (legal opinion and see if its valid/legal, if offered tax-free needs an **unqualified legal opinion**) → underwriter is hired through competitive bidding process or competitive sale (when selects underwriter for assistance in working out offering details it does so through a negotiated sale – just picks one)

Short-term notes: issued to finance activities that can be paid off in a short period of time (3M– 3Y)
- Borrow money for a short period, spend that money, and use taxes, revenues or capital received in the future to pay back the borrowed funds

Types: All Municipal Notes – short term municipal debt paid off with future cash flow
- **Tax Anticipating Notes (TANs):** allow a municipality to spend money on a public project and repay borrowed funds with future tax collections – utilize taxes throughout the year
- **Revenue Anticipation notes (RANs):** Same idea but funds are used for future revenue related projects
- **Tax and Revenue Anticipation Notes (TRANs):** combine TANs and RANs. If a municipality wants to spend money on multiple projects but only wants to issue one form of debt, TRANs can do it. Once the money is spent, the municipality uses future tax and revenue collections to repay the borrowed funds
- **Bond Anticipation Notes (BANs):** are issued before a long-term bond issuance. Assume a city plans to fund the building of a new high school by issuing a G.O. bond. A BAN could be issued before the bond offering to pay for architect blueprints and land surveys. When the bond is sold in the future, the municipality will use a portion of the bond proceeds to pay off the smaller BAN
- **Grant Anticipation Notes (GANs):** issued before a federal grant is expected to come in
- **Variable Rate Demand Notes (VRDNs) or Obligations (VRDOs):** Bond with a variable income rate – changes with the market rate and has a put feature so the bondholder can sell it back to the issuer
- **Auction Rate Securities (ARSs):** long term investments where interest rates are reset during intervals in auction

Rating: Good to bad (MG 1→MG 3 or SG speculative) (SP-1+1, SP-1,→SP -3)

Suitability for Municipal Bonds:
- Investors seek income
- Investor must be in a high tax bracket to justify as they are low rates and yields

Corporate bond interest
- Subject to federal, state, and local taxation

Municipal bond interest
- Exempt from federal taxation
- Subject to state and local taxation – unless resident

US government bond interest
- Subject to federal taxation
- Exempt from state and local taxation

An exception to the residence tax rule exists with **US territory bonds**, which are also considered municipal bonds – for territories in the US

<u>US Government Debt:</u> Quoted in **32nds** using a dash, color or period
- Has virtually no liquidity risk – most traded security worldwide
- Lack of default risk, AAA rated as it can print more
- Backed by the full and direct backing of the federal government considered the gold standard

- When bond is quoted in terms of price it is called dollar quote, percentage of par quote, price quote. Basis quotes are yield quotes

Treasury Products: (Minimum denominations of a $100)

Treasury Bills (T-Bills): trade flat
- Short-term zero-coupon debt issued by Treasury – issued weekly, non-callable
- Since short term (<1 year) do not pay interest, receive interest at maturity
- Maturities are 1,2,3,4,6 months and 1 year
- Quoted in yield form not with prices
- Yields and price are inversely correlated so are bid-ask spreads for T-Bills (ask-bid)

Treasury Notes (T-Notes):
- Are interest-paying, intermediate-term (2-10 years) U.S. government bonds – issued monthly

Treasury Bonds
- Are interest-paying, long-term (10-30 years) U.S. government bonds – issued monthly

STRIPS: trade flat
- Long-term (up to 30-years), zero coupon bonds issued by the US Government
- Issued at a steep discount not suitable for investor seeking income
- Pay annual taxation even though you do not receive the interest know as phantom tax
- Very high price volatility as they have long maturities and low coupons (0%)

Treasury receipts are similar STRIPS but created by a different issuer (financial institutions) then the federal government (phantom tax also) trade flat

TIPS:
- Are long-term treasury inflation projected securities
- Pay semi-annual interest and make higher payments when inflation rises
- The par values are **adjusted** every 6 months based on the CPI **coupon is fixed**
- Issued in 5,10, 30-year maturities

Cash management Bills CMBs are unscheduled, short-term debt offerings that are used to smooth out Treasury cash flows. CMBs are issued at a discount, but will mature at their face amount. The duration of CMBs may be as short as one day

Duration measures the sensitivity of a bond or portfolio of bonds to a given change in interest rates. Duration is measured in years, but for practical purposes, a bond's change in price is based on its duration Ex: a 1% increase in rates will cause a 10%, decrease in bonds with a duration of 10 years

Federal Agency Products
Are indirectly backed by the US government – not as strong as treasury backing and exempt from SEC

Federal Farm Credit Bank (FFCB)
- Us government subsidies loans for farmers at favorable interest rates
- Issue securities

Federal Home Loan Banks: provide liquidity for savings and loan institutions
Mortgage Agencies (Quoted in 32nds also)

Ginnie Mae (GNMA)
- Purchases VA and FHA insured mortgages – **directly** backed by US Government – not publicly traded
- Pay interest and principal monthly, trade average maturity on the mortgage in the portfolio when trading in the secondary market

Fannie Mae (FNMA)

- Purchases VA and FHA insured and conventional mortgages – indirectly backed by US government – publicly traded

Freddie MAC (FHLMC)

- Purchases conventional mortgages – indirectly backed by US government – publicly traded

Sallie Mae

- Former federal agency in the student loan businesses

These agencies sell **mortgage-backed series (MBS**) ($1000) and the holders of these receive **monthly** payments of varying **interest and principal** – normally issued MBS is a **Pass-Though Certificate (PTC):** pass through mortgage payments to investors which consist of interest and principal

These securities are fully taxable and subject to state and federal taxation

MBS are subject to prepayment risk (rates fall – refinance) and extension risk (rates rise borrowers hold on to debts for longer), reinvestment risk (paid out monthly) are taxed on every level

Treasury auction: Where Treasury securities are initially offered and after they trade OTC market Dutch Auction process

Competitive bids

- Typically submitted by institutional investors
- Only the bidders with the best bids win
- Highest winning bid yield sets the yield for the entire offering of non-competitive

Non-competitive bids

- Typically submitted by retail investors
- All non-competitive bids are filled and max allowed is 10M

Bid-ask quotes

- Provides both sides of dealer prices
- Bid = dealer buys, customer sells
- Ask = dealer sells, customer buys – purchases at the ask

Treasury bill quotes

- Discount yield form and reverse bid-ask spread so ask-bid

The Federal Reserve Board (FRB) or The Fed: controls monetary policy which dictates how much currency is in our financial system

Used to influence **economic growth (low unemployment) and inflation levels**

Increase money supply = which lowers interest rates know as loosening the money supply

More money in system and since money is cheap people buy more increasing GDP → this increases inflation as there is limited resources eventually creates higher prices

When inflation is on the rise FED will tighten money supply which lowers inflation and raises interest rates

Higher cost of borrowing fewer goods and services is purchased which lowers economic growth and inflation

Monetarist theory believe the Fed's actions are the primary driver of the economy-control money supply

- **M1 is money supply =** currency in circulation, demand deposits, other checkable deposits
- **M2 =** money market deposit accounts, savings and small-time deposits, balances, overnight repurchase agreements

Federal funds rate

- Rate for bank-to-bank loans, short term (money market) most volatile interest rate as shortest

Discount rate

- Rate for Fed loans to banks

Broker loan rate

- Also known as the **call money market rate**
- Rate for bank-to-broker-dealer loans

Prime rate

- Rate for large bank customer loans - Typically only available to institutions

Lowest to highest order of rates normally are Prime rate→discount rate→FED Funds Rate→Call Rate (what commercial banks charge on collateralized loans to BDs for margin purposes)

Tools of the Federal Reserve

- **D** - discount rate
- **O** - open market operations
- **R** - reserve requirements
- **M** - margin requirements (Reg T)

Discount rate

- **Only** rate set by Fed for loans to banks
- Result of lowering: Loosens money supply and Decreases interest rates

Open market operations – most popular method

- Fed buys (purchases) securities through repurchase agreements most likely are **Government securities, Agency Debt (Ginnie Mae) Prime banker's acceptances** – this gives banks more money decreasing rates
- Repurchase agreement (repo) is contract which the FED purchases US securities at a fixed price from dealers with provisions for their resale back to dealer at same price plus interest – this lends money increasing supply
- **Reverse repurchases agreements (matched sale)** - Fed sells securities to banks tightens money supply
- Executed through primary government dealers
- Overseen by the Federal Open Market Committee (FOMC)

Reserve requirements

- Banks must hold a portion of deposits in reserves – lowering reserve gives banks more money which lowers rates

Margin requirements (Reg T)

- 50% deposit for margin transactions – lower can borrow more which lowers rates

Country's exports exceed imports country has a trade surplus, opposite is a trade deficit. To correct a deficit the dollar should weaken causing US goods to become cheaper to where imports pick up.
US exporters like a weak dollar and importers like a strong dollar
US importer (acquiring good from EU) costs will rise if Euro rises so buys Euro call options to hedge

Economic Factors/Indicators

Gross Domestic Products: All goods and services produced within a country's borders

- A recession is two consecutive quarters months while a depression is six straight quarters of GDP decline
- If foreign investment in US counts towards GDP

Real GDP: inflation adjusted measured in constant dollar or base-year prices
GNP measures all goods and services produced by residents of a country, including those made outside of the country

Balance of Payments: how economists measure payments coming in and out of a country (if foreign investors buy US Treasuries it has a positive effect on balance of payments in US
Elastic goods: luxury or highly replaced – in an economic downturn demand will fall
Inelastic good: won't fall price stable
Inflation: when prices increase measure by CPI–equities and commodities are hedges, fixed income fear
Deflation: when prices of goods go down – cause by oversupply

Business cycle: Expansion→Peak→ Contraction (Recession) →Trough
Normal (ascending) yield curve: standard curve as securities with shorter maturities maintain lower yields while longer maturities reflect higher yields – times of easy money and rates are declining
Flat yield curve: shows uncertainty in the bond market as short-term debt securities yield the same as long-term debt
Inverted (descending) yield curve: indicating a pending economic recession. Short-term debt securities maintain higher yields than long-term debt securities.
Comparative yield curve (credit yield spread): compares US government and corporate yield curves. When the gap between these two curved widens it shows signs of recession as people selling corporate bonds for the safer US treasury ones

Leading Indicators – predicting where economy is going
- **S&P 500 level (Stock prices)**
- Average weekly initial claims for unemployment
- Index of new manufacturing orders
- **Number of new building permits**
- Consumer confidence index
- Interest rate spread between 10-year Treasury notes and fed funds rate

Lagging indicator - provides insight into the economy's past performance
- Changes in CPI levels
- Corporate profits
- Change in labor cost per unit of output
- Average duration of unemployment
- Average Prime rate used

Coincident indicator
- GDP
- Personal Income levels
- Employment levels
- Industrial Production

Perfect Competition: Many buyers and selling of virtually identical products – cheapest price wins
Monopolistic Competition: Many buyers and sellers but unique features play a role – not price related
Oligopoly: Many buyers but limited sellers (3-5) due to the high market entry cost Ex. Airlines
Monopoly: Many buyers but only one seller – price manipulation is easy as no competition

<u>Fiscal policy</u>: is controlled and implemented by the U.S. Congress (House of Representatives and Senate) and the President.
Majority of rev comes from IRS
IRS enforces a progressive tax system with personal income taxes (estate and gift tax is also this)
Regressive tax system is a flat tax system ex. Sales and excise tax – Part of the Department of Treasury

Keynesian (demand-side) theory: stated that increased government spending drives the economy's growth while decreasing taxes

Supply-side theorists: encourage a growing supply of goods and services across the economy through reduced taxation and reduced government spending

Fiscal policy

- Controlled by Congress and the President

Monetary policy

- Controlled by the Federal Reserve

Investment Company Act of 1940

This law formally defined investment companies and regulated their activities

Investment company classifications

Management companies

- Open-end management companies (mutual funds) shares outstanding fluctuates
- Closed-end management companies (closed-end funds) shares outstanding is fixed
- Minimum net capital required to start a management company is **100k**

Unit investment trusts (UITs)

- Fixed portfolios of securities
- At maturity, portfolio is liquidated, and proceeds passed to investors

Face amount certificates (FACs)

- Periodic payment or lump sum contribution
- Redeemable securities
- Fixed payout at maturity

Fully Paid FACs work similar to a zero coupon bond

<u>Types of Funds</u>

Growth Fund

- Seeks to attain capital appreciation often by investing in growth focused common stocks

Aggressive growth funds

- Also, growth funds with more risk, investments in common stock with higher returns such as small cap from volatile or emerging industries

Growth and Income Funds

- Focus on capital appreciation but also invest in income producing common and preferred stock

Balanced Funds

- Even distribution between **growth and income securities and debt (bonds)**

Income Funds

- Bonds, preferred stocks, and dividend-paying common stocks are the primary investments held in income funds Ex. Corporate bond funds, municipal bond funds
- Money market funds also a type of income fund by pays less income (monthly dividend payments) (NAV = $1)

Specialized Funds

- Not specific to growth or income but invest in securities from specific industry or reign
- Vary in risk and return and sometime called **sector funds**

Index Funds

- Aim to give their investors the same return as a specific index

Asset Allocation Funds

- Invest in specific asset classes depending on various factors Ex. 70% stocks 30% bonds
- Life cycle funds or target date funds are these

International/global Funds

- Seek investments outside of the US and add a layer of diversification and hedge
- Global funds invest worldwide including US-based securities

<u>Mutual Funds:</u> partial shares may be bought

Open-end management companies, known popularly as **mutual funds**, provide investors access to professionally managed portfolios

- New purchases increase outstanding shares while redemptions (share sales) decrease outstanding shares – so this value changes daily
- Most funds make dividends and cap gains distributions on an annual basis
- **Prospectus must be delivered at or prior to solicitation to sell mutual fund**
- Shareholders don't actually own the specific assets they have ownership interest
- All new purchases are considered primary market transactions so *always* involve issuer
- Maintain right to receive dividends and some voting rights
- Must publish past performance of 1,5, 10 years or up to amt it's been open
- Subject to forward pricing – do not know price per share when buying
- Mutual fund transactions are subject to sales charge not commissions
- Any sales charge is assessed based on the POP (Public Offering Price)
- POP of a mutual fund represents the NAV + sales charge
- BOD sets ex-dividend date and the settlement times
- When redeemed (sells) issuer must pay back in **7 calendar** days

Index mutual funds don't assess front-end or back-end sales charges

Fund Parties

Fund Sponsor (underwriter/sponsor/distributors)

- is responsible for establishing the fund, registering it, and creating a marketing strategy
- Needs 100k to open it and needs to be registered with the SEC

Board of Directors

- They represent shareholder interests, approve dividend payments, and are responsible for the fund's overall success

Investment Advisor and Fund Manager

- Fund sponsor hires investment advisor then appoints a fund manager to implement strategy
- Managers must follow the funds parameters – and can be fired if fund perform badly

Custodian Bank

- Sometimes called the **mutual fund custodian**, is responsible for holding, safekeeping, and recordkeeping the fund's assets

A mutual fund's **registrar** or transfer agent is responsible for keeping a register of all the fund's investors, including their contact and personal details. The registrar also handles tasks like: Updating investor records, Issuing and sending account statements

Fees:

Management fee – paid to the investment advisor due to the operating expenses
Custodian fee – paid to the institution to maintain custody of the funds assets
Legal and administrative fees that pay for legal services and other general costs like record keeping.
Expense ratio includes management fee, administrate fees, and 12b-1 fees
In order for a fund to market itself as **diversified** at least 75% of funds assets invested in such a way that no more than 10% voting power of one issuer or 5% of funds' assets in one security – investors of the fund are not interest people

<u>Rights for mutual fund owners</u>

- Right to vote for the Board of Directors – oversees funds investment advisor
- Right to vote on fund-specific matters
- Right to pro-rata share of dividend and capital gain distributions
- Right to fund disclosures'

Statutory prospectus
Primary fund disclosure document
Information disclosed includes investment objective, Shareholder fees, Past performance, risks
Statement of additional information (SAI)
Provides micro-details on fund operations – must be sent to any party who is interested
Annual SEC report
Semi-annual shareholder report

- Buying mutual funds is at the POP and the transaction only occurs with the issuer – through forward pricing and sold at NAV
- Sometimes when buy from another BD they put a sales charge on the transaction
- Must be fulfilled within seven days
- Capital gains occur once per year and the BOD sets the ex-dividend date (typically settle same day as purchase/redemption)

Investors buy mutual fund shares at the ask price and redeem or sell at the bid price.
Investors get worse deal they buy at the high price (ask) and sell at the low price (bid)
Switching from one fund

The maximum allowable sales charge is **8.5% of POP**.
If a fund assesses the highest possible sales charge, it must offer a few extra to its investors.
The customer must be allowed to reinvest their dividends and capital gains at the NAV

Share Classes for Mutual Funds
Class A shares
- Front-end loaded funds
- Sales charge assessed at purchase
- Subject to breakpoint schedules
- Low or no 12b-1 fees
- Suitable for:
- Longer-term investors
- Larger investments of money

Class B shares
- Back-end loaded funds (Contingent Deferred Sales Charge or CDSCs)
- Sales charges assessed at redemption (selling)
- Moderate 12b-1 fees
- Suitable for:
    - Longer/moderate-term investors
    - Smaller investments of money

Class C shares (Level Load/on-going fee)
- No sales charge or a 1-year CDSC
- High 12b-1 fees
- Suitable for:
    - Short-term investors

Letter of Intent (LOI) for Class A
- Pledge to deposit breakpoint shortfall to get better breakpoint rate immediately in 13 months can be backdated – fund can place some funds purchased in escrow to protect failure to fulfill the letter of intent

Combination privilege
- Allows merger of multiple purchases for lower sales charge

Householding
- Allows for families under one roof to add purchases together for a lower breakpoint

Conversion (exchange) privilege

- No new sales charge is assessed if an investor sells their shares and uses the proceeds to purchase a new fund within the same fund family but this is a taxable event

Rights of accumulation (ROA):

- Are rights that allow a mutual fund shareholder to receive reduced sales commission charges when the amount of mutual funds purchased plus the amount already held equals a right of accumulation (ROA) breakpoint (includes growth, capital gains, and dividends on portfolio)

Breakpoint sales

- Failure to notify investors of breakpoint gives FINRA violation subject to penalties

12b-1 fees

- Marketing and promotion fees used to reduce expense ratio
- Maximum fee of 1%
    - Distribution fee max = 0.75%
    - Service fee max = 0.25%
- Funds limited to 7.25% loads if charging maximum 12b-1 fee
- **Cannot market fund as "no load" if charging higher than 0.25% of funds annual net assets**

Subchapter M, also referred to as the **"conduit rule,"** allows funds to avoid taxation. This tax-based rule requires funds to distribute at least 90% of their net investment income (NII) to shareholders to qualify.

- Investors are taxed on the gains and only realized gains matter
- Funds that engage in this are also called regulated funds

Closed-end management companies (only full shares may be purchased)

- Traded in the secondary market (**negotiable**)
- No prospectus delivery is required

Closed-end fund transactions

- Purchased at market price – supply and demand
- Subject to commissions
- NAV represents the fund's book value
- **Market price could be higher, lower or same as NAV**

ETFs: exchange-traded fund (ETF) is technically structured as an open-end management company, but it's not a mutual fund

- Lower expenses ratios as they track indexes passively
- Trade secondary market and are negotiable
- Price normally always match's NAV which is calculated daily
- Can be bought with margin, sold short and has commissions

Specific ETFs

- "Spyders" = S&P 500 ETF
- "DIAmonds" = Dow Jones Industrial Average ETF
- "Qubes" = Nasdaq 100 ETF

Actively Managed ETFs or Active ETFs

Inverse (bear) ETFs provide the inverse (opposite) return of the index they track.

Leveraged ETFs provide amplified gains and losses to their investors Ex. 200% leverage factor of 2

Leveraged inverse ETFs: Leveraged and inverse ETFs molded together as one. Huge risk

Leveraged ETFs should only be for short term trading

Exchange traded notes (ETNs)
- Debt instruments
- Promise to pay the return of an index
- Subject to **default (credit) risk – unsecured**, do not make regular interest payments
- Negotiable securities, can be bought on margin, can be sold short

Unit investment trusts (UITs)
- Fixed portfolios of securities – represent undivided interest in fixed portfolio
- No ongoing portfolio management
- No management fees but have sales charge, operating expenses and creation and development fee
- Redeemable with the issuer before maturity at NAV if desired
- Some UITs may trade in the secondary market but rare

REITS: not categorized as an investment company, not redeemable and dividends taxed as ordinary income – deductions and revenues do not flow through trust – Must have **100** shareholders
Equity: Investors in real estate – money made from leases or selling property
Mortgage: Buy and offer mortgages on commercial property – interest from mortgage is passed through to investors
Hybrid: Both equity and mortgage
There are non-listed REITS (OTC) and private REITS for select investors and no SEC oversight
Subchapter M or conduit rule apples (75% of assets in real estate and 90% of income must pass through to avoid tax)

Hedge funds
- Unregulated investment funds (Only wealthy investors participate)
- High risk and high gain potential
- Subject to **lock-up periods** (liquidity risk) and legislative risk

Direct participation programs (DPPs) are investments in businesses that allow the investor to "directly" participate in the profits and losses of the business – not taxed as entities so can pass on more money to investors - cannot be sold to more than 35 non-accredited investors and passes 100% of its profits through as distributions
The defining feature of a DPP is its ability to pass through losses to its owners.

Limited partnerships (liquidation: secured credits→unsecured creditors→limited partner→general)
- Most sensitive to regulatory risk
- The most common form of DPP
- Must contain: At least one general partner and at least one limited partner
- Investments in DPP can deduct passive losses from passive activities

General partners
- Manage and run the business and must invest **1% of programs capital and participate in profit of losses**
- Have unlimited liability and have fiduciary relationship to limited partners
- Cannot invest in another DPP that competes with yours

Limited partners
- Provide funding for business – have right to inspect books
- Have limited liability – passive investor and illiquid investment normally
- May lend money to partnership but can't hire, raise capital, negotiate contracts

Real estate limited partnerships (RELPs)
- Invest in commercial properties
- Can pass through losses and pursue unique tax credit and deduction strategies
- Can invest in raw land (risky), new construction, existing properties and gov assisted housing

Oil and gas programs
Gain tax deductions through: Intangible drilling costs (IDCs – no value after drilling, fuel labor insurance) and Depletion allowances
Income (stripper) wells
- Proven oil wells
- Low risk, Low return, No IDCs

Developmental (step-out) wells
- Drill near proven oil fields
- Intermediate risk, Intermediate return, Intermediate IDCs

Exploratory (wildcat wells)
- Drill in unproven lands
- High risk, High return, High IDCs

Options:
- Derivative securities
- Provide the right to perform a transaction at a fixed price
- Derivative securities: Obtain value from the underlying asset
- Standard options have expirations of up to 9 months
- ALL options expire at 11:59pm ET on the third Friday of expiration month AND stop trading at 4PM ET on the expiration date

Option buyers
- Obtain the right to perform a transaction at a fixed price

Option sellers/writers
- Have an obligation to perform a transaction at a fixed price

LEAPS: Long-term options of up to three years
Equity (stock) options: Derive value from stock prices
- Expire 11:59PM ET on expiration date and may be traded in the secondary market until 4PM ET on expiration date
- Must exercise by 5:30PM ET day of expiration

Stock Index options: Derive value from index levels

Long options
- Right to exercise the contract or let expire if out-of-the money (OTM)
- Bought option contract (debit)
- Investors are "holders"
- Seek intrinsic value

Short options
- Obligation to do the transaction if assigned (exercised)
- Sold option contract (credit)
- Investors are "writers"
- Want to avoid intrinsic value – want contract to expire OTM so holder doesn't exercise

Options Clearing Corporation (OCC): Standardizing options, issues options, and guaranteeing option transacted properly - Clearing trades – ONLY issuer
Options trades after OCC issuance
- Occur on Chicago Board Options Exchange (CBOE)
- Premiums are determined by supply and demand
- Settle in one business day **(T+1)**

Option exercises: Settle in two business days **(T+2)**

Options Transaction:
Open purchase
- Investors who establish long positions (buy long)

Opening Sale
- Investors that open short positions

Closing Sale
- Investors who are long on an option can sell the contract before expiration
- "closing because" they got out of position and sale because sold to another investor

Closing Purchase
- Short writer can get out of contract by finding another investor to take over their obligation
- "closing" because they got out of a position and purchase because they bought an option to exit the contract

When an investor buys or sells an option as an initial transaction, they can close the position out before exercise or expiration. Option holders (the long side) sell their contracts to close their positions, while option writers (the short side) buy their contracts to close their positions.

EX: Long 1 ABC Jan 40 call @ $5
This investor is long one contract that gives them the right to buy 100 shares of ABC stock at $40 per share. The cost of the contract was $500 (5*100 shares)

Option contracts cover 100 shares of stock
Intrinsic value:
- Is good for the long holder bad for the seller/writer –
- Value doesn't always mean profit if the premium is more than the intrinsic value on a cost basis

Calls:
- Calls are contracts that provide the right to buy an asset at a fixed price. If you were to purchase an equity call, you would gain the right to buy stock at the strike price. This right will only be exercised if the stock's market price rises above the strike price
- **Calls gain intrinsic value if the market price > strike price (Call Up)**

Puts
- Puts are contracts that provide the right to sell at a fixed price. Investors who buy equity put contracts gain the right to sell stock at the strike price. Puts are exercised if the stock's market price falls below the strike price
- **Puts gain intrinsic value if market price < strike price (Put Down)**
- Sellers of options contracts creates credits

The **premium** reflects the current market value of an options contract and is directly influenced by demand. If more investors purchase an options contract, the premium rises. If more investors sell an options contract, the premium falls

Time value represents the time left until an option expires. The longer the time until expiration, the more potential for the market to move. Therefore, more time value creates a more valuable option with a higher premium.
Premium=intrinsic value + time value

Writers demand higher premiums for options with longer lifetimes. Bottom line - the longer the time until expiration, the more expensive the option

American style options allow for exercise to occur at any time. Equity (stock) options are American-style.
European style options only allow exercise to occur at expiration. Index options, which derive their value from fluctuating index values, are almost always European-style.

Option Stock Splits:
Even stock spilt:
- Stock spilt ratio ends in 1 it's an even stock spilt
- Even stock splits adjust the number of contracts and strike price, but shares delivered remains same

Uneven Stock Splits:
- Stock spilt that does not end in 1
- Uneven stock splits adjust the strike price and the number of shares delivered at exercise – contracts stay the same

Stick Dividend
- Only the strike price and shares delivered at exercise is adjusted – number of contracts stays the same – Same as uneven

Cash dividends do not adjust option prices but **special dividends** do which are unexpected dividends
- Special dividends reduce the strike price by what the dividend is

Long Calls: (Call Up – mtk > strike price has intrinsic value)
- Bullish Investment
- Right to buy the stock at the strike price
- Max gain = unlimited, max loss = premium
- Breakeven = strike + premium

Short Calls: (Call Up – mtk > strike price has intrinsic value)
- Bearish Investment
- Selling option – results in an obligation to sell at strike price (hopes no intrinsic value, expires worthless)
- Max loss = unlimited, max gain = premium this is a short naked call – no hedge
- Breakeven = strike price + premium

Long Put: (Put down – mtk < strike price has intrinsic value)
- Bearish Investment
- Investor pays premium (long option)
- Max gain = strike price – premium, Max loss = premium
- Breakeven = strike price – premium
- Expiration is worst case scenario as investor loses his premium paid

Short Put: (Put down (mkt < strike price)
- Obligation to buy at the strike price
- Bullish Investor
- Gets Premium
- Max loss – strike price – premium, max gain = premium

All calls (value is mkt>strike price)
All puts (mkt<strike price), have same breakeven
Long options can only lose the amount spent on the premium
Everything with "short" in the option call receives premium
Everything with 'long' in it pays premium

Long call (right to buy) Bullish MG = unlimited ML = premium B/E = strike + premium Hedge for short stock	Short call (obl to sell) Bearish MG = premium ML = unlimited B/E = strike + premium Income w/ long stock
Long put (right to sell) Bearish MG = strike - premium ML = premium B/E = strike - premium Hedge for long stock	Short put (obl to buy) Bullish MG = premium ML = strike - premium B/E = strike - premium Income w/ short stock

Hedging Strategies:

1. Owning shares and long put – unlimited return, limited risk
2. Short stock position and a long call hedge – limited risk, limited return

Income Strategies: sell options against stock positions, collect premium – used in flat markets

- Long stock & short call (covered call) – limited risk and limited return
- Wants stock to remain flat to collect premium and then have the short call not get exercised
- When market price rises significantly investor experiences opportunity cost as they would have made more without selling the short call
- Short stock & short put (covered put) still unlimited risk and limited return based off put
- Market sentiment is bear/neutral
- Short acts as partial hedge

Index Options:

- All are European style (only exercised at expiration date) except for OEX
- When exercised shares are not bought or sold so **all options for indexes settle in cash**
- **Since settle in cash settlement times are T+1**
- Ex of Index options: SPX (S&P 500), OEX (S&P 100), DJX (Dow Jones Industrial Average),
- RUT (Russell 2000), VIX (Volatility Index)

Taxes: When an investor makes money on an investment he is taxed on them

Cash dividends:

- Income received from equity investments such as stock, preferred, mutual funds, closed-end
- Taxed at lower rate than bond interest
- Rate paid is investors annual taxable income

Qualified Dividend: (Assume 15% if not specified in question)

- Distributed by a US corporation or qualified foreign corporation (US territory, trades on stock exchange in the US, subject to US tax treaty)
- The investor must meet a specific unhedged** holding period
- Tax rates for qualified are 0% (low income), 15% (moderate income), 20% (high income)

Non-qualified (ordinary) Dividend:

- Tax rate is equals the investors federal marginal income tax bracket (up to 37%)
- Ex: an individual making $50,000 would pay a 10% tax on the first $11,600 earned, a 12% tax on additional income up to $47,150, and a 22% tax on the remaining income received.

Assume most stocks, mutual funds pay qualified dividends unless otherwise stated

REITs are always considered non-qualified so must offer higher rates of return to offset this

Dividends are reported on the tax form **1099-DIV. Dividend must be paid in that year to be on form**
Cash dividends are taxable, but **stock dividends and splits are not.**
Although funds received interest from bond portfolio, disbursement to its own shareholders is considered a dividend and mutual fund income is always a dividend

Portfolio Income
Income: Interest earned from a debt security (bond)
- Varying tax status depending on if US government, municipal, corporate
- Tax rate is federal marginal income bracket (same as non-qualified)Report on tax form **1099-INT**

Capital Gains:
- Securities sold for more than the basis
- Cost basis (amt paid + commissions), Sales proceeds = (Amt sold – commissions) and holding proceeds
- Reported on tax form **1099-B**

Long-term capital gain
- Gain on security held more than 1 year
- Tax rate: 0%, 15%, or 20%

Short-term capital gain
- Gain on security held for 1 year or less
- Tax rate: up to 37%

Inherited securities
- Cost basis is stepped up to the value on the date of death
- Holding period is always long term

If capital losses exceed capital gains, an investor is able to use a maximum of **$3,000 of the excess losses to reduce taxable ordinary incom**e. Any remaining capital losses are **carried** forward to the subsequent year(s)

Primary Market:

Is defined by sales of securities for the first time. While there are various forms of the primary market, all transaction proceeds go back to the issuer
Issuers
- Sell securities to raise capital

Underwriters/Investment Banks
Group is an underwriting syndicate (sign syndicate letter or agreement)
If syndicate recruits other BDs to assist these firms are selling group members and have no financial liability and must sign selling group agreement and known as distribution partners
The syndicate guarantees an offering. **The BDs syndicate desk assists in the price of the offering, helps build the bool of orders and markets issues, and allocates stock to investors**
- Hired by issuers to sell new issues
- Underwriting spread/total takedown = difference in amount paid by investing public and amt received from issuers also refers to commissions earned
- Concessions are the commissions earned by selling securities to investors
- If a BD acts as the underwriter also it can't make money by publishing a quote, act as market maker, submit app in connection with market maker but can make money with underwriting fees and reimbursement for registration fees that paid to SEC

Market-out clause: provision that protects underwriters from having to purchase and sell securities if market conditions are beyond their control
Securities Exchange Commission (SEC)
- Requires issuers to register securities unless an exemption exists

A firm underwriting is also known as a **principal** or **dealer** transaction. When a customer is sold a security from the inventory of a financial firm, a principal (dealer) transaction occurred
A best-efforts underwriting is also known as an **agency transaction**. When a financial firm acts as a middleman and connects buyers and sellers, an agency transaction occurred

Types of best-effort Underwriting
- **Mini-max underwriting** is one that specifies a minimum and maximum amount of shares
- **All or none underwriting commitment**. The underwriter must sell all of the securities in order for the sale to go through

Types of Offerings:
- **IPO**: Issuer sells security for the first time in the market (if customer purchases must be given a statutory prospectus) (preliminary prospectus is for before its sold during cooling off period)
- **APO** (Additional Public Offering): Also known as *follow-on-offer* allows more shares to be sold in the primary market after the IPO

Both are primary distribution as it's an offering in which the proceeds of the deal are paid to the issuer
For an unlisted IPO must deliver prospectus prior to 90 days, unlisted follow-on offering is 40 days, IPO to be listed on NYSE its 25 days and follow-on offering for NYSE is zero days

Secondary distribution: Sales proceeds go to a party other than the issuer normally directors selling shares
- A spilt offering is this where some shares offered by issuer and some by the shareholders

Process:
- Once the issuer hires underwriter, they guide them through the due diligence phase
- Once they file for registration with the SEC the **20-day cooling off period starts** where SEC reviews
- During this period they cannot sell or take deposits for future sales – all sales related of limits
- During this period they can give out a **preliminary** prospectus which can be given to potential investors on a solicited or unsolicited basis- this prospectus is not guaranteed accurate by the SEC
- Sometimes referred to as the "**red herring**," this form is considered preliminary until the SEC officially registers the security – enclosed in it is # of shares being issued, its business, financial statements, risk disclosures and ownership structure – not include effective date or POP
- If something is wrong from the registration form, the SEC sends a **deficiency letter**
- To estimate demand for the IPO, the underwriter may solicit or receive **indications of interest** from potential investors during the 20-day cooling off period
- **Tombstone** may be published to notify public of the new issue – which are the only form of legal advertising the SEC allows during the cool off phase: includes the types of securities that are offered, the date they are available, the number of shares or bonds to be sold, and how the securities can be purchased

Effective date
- The first day the new issue can be legally sold

Common stock IPO investor restriction (FINRA Rule 5130)
- Industry insiders may not purchase common stock IPOs
- Industry insiders are known as "restricted persons"

Restricted persons
- Member firms
- Member firm employees

- Immediate family members, spouse, children, siblings, in-laws (has to provide material support to immediate family members or live in same household) if not they good
- Dependents

Exception to common stock IPO restriction

- Accounts (Investment club) not exceeding 10% ownership by a restricted person

New issues are sold at the **Public offering price (POP)**

Exempt SEC Securities:

- Government securities and municipal
- Insurance company securities (unless a variable contract)
- Bank securities (not bank holding company securities)
- Non-profit securities
- Commercial paper and banker's acceptances
- Railroad ETCs (Common Carrier)

Ways non-exempt securities get exemption:

Regulation A

- Sell only up to $75M of securities in 12 months, small dollar offering rule

Regulation D (no registration or prospectus is required to be filled)

- Unlimited securities may be sold in private placements to accredited investors only
- Can have 35 or less non-accredited investors but they need an **offering memorandum**
- Accredited investors are banks or BDs or a person with CFP, series 7, 65 or 82, 1M more in assets excluding home and 200k per the past two years)
- Shares that are acquired through this offering carry restrictive legend

Rule 147 offering:

- Avoid SEC regulation if only sold in that state
- Have to have HQ in state and 80%: businesses revenue collected in state, issuers assets in that state, offering proceeds will be spent in that state
- Restricted period of resales to persons outside of state of 6 months, none for in state

Uniform Securities Act: Is the state's own registration process also know as the **blue sky laws**

Three types of registration at the state level (must registerer with SEC if has more $400M AUM)

Registration by Filing (notice filing)

- Large establishments do notice filing also known as federal-covered securities. Mutual funds and exchange listed securities file here no state registration, but a notice filing is done to notify that the security will trade in the administrators state but regulated by the SEC

Registration by Coordination

- This process involves securities being registered with the SEC and the state administrator. Registration by coordination is reserved for companies that trade in multiple states, but don't meet the requirements to qualify as a federal-covered security. These tend to be securities from smaller and lesser-known entities

Registration by Qualification

- This form of registration is available to issuers selling their securities in one state only. Securities claiming a Rule 147 federal exemption will likely register their securities by qualification. Registration by qualification involves registration with the state administrator only and does not include SEC registration

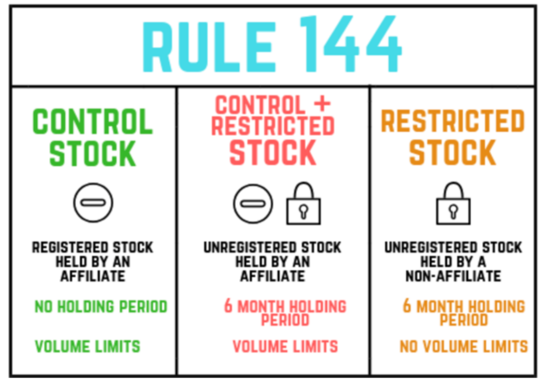
Rule 144:

Restricted Stock: stock not registered with SEC and bought during private placements – 6 month holding

Control Stock: Insider (affiliate, officer, 10% shareholder), trading volume no holding period

Trading volume is either 1% of the outstanding shares or the four-week trading average to be sold every 90 days whichever is **higher**

Control + Restricted: both holding and volume limits



Form 144: must be filed when an investor (affiliate or non-affiliate) intends to trade control or restricted stock at any point in the next 90 days. All that's required for Form 144 to be filed is an *intention* to trade a control or restricted stock; there is no requirement for a transaction to actually occur

****Form 144** must only be filed if an investor plans to sell more than 5,000 shares or $50,000 of total stock.

Form 4: must be filed when an affiliate actually trades control stock. Known as the form that reports beneficial changes in ownership for insiders, Form 4 must be filed within **two** business days of the transaction

Rule 144A: If a sale of restricted or control stock occurs with a **Qualified Institutional Buyer (QIB),** the requirements of Rule 144 do not apply. A QIB is defined as an institution with $100 million or more of investable assets. Creates more liquid market for restricted securities and applies to equity and debt

QIBs cannot be a person and for banks must have net worth of at least $25 million

Shelf Registration Rule

- Allows issuers to quickly offer securities
- Issuer files "blank" registration form that is reviewed by the SEC
- The security may be sold quickly within the next **3 years**
- When the security is ready to be sold:
  - Issuer contacts SEC, provides information left "blank"
  - The security can then be sold **48 hours** later
  - Allows avoidance of the 20 day cooling off period

Regulation M: SEC restricts underwriters and issuers from bidding on or making purchases in the secondary market of the stock that's currently being offered. Restricting is in place for a limited time. BDs and underwriters also cannot promise to repurchase shares of an IPO at no less then original sales price (used to have prearranged purchase orders from customers called tie-in arrangements or laddering)

One condition of this rule is they can stabilize the price at or below POP so new issue doesn't drop crazy

<u>Secondary Market:</u>

Principal/Dealer: Firm can sell stock to investor from his own supply – market maker – mark-ups/downs

Agency/Broker: Connects buyers and sellers for stocks – collects commissions – middleman's

Traders

- Buy and sell securities for clients
- Typically work on behalf of large portfolios (e.g. mutual funds, hedge funds)

Broker-dealers

- Buy and sell securities for clients

- May act in an agency or principal capacity

Market makers

- Buy and sell securities with the public
- Acts only in a principal capacity (liquidity makers) (markdown when buying from investors and markup when selling to investors)

Bid-Ask Spread

- Market makers buy at the bid and sell at the ask (offer)
- Bid is the price where a security is sold by the investor and purchased by the market dealer
- Ask is price where security is purchased by the investor and sold by the market dealer

Round lot: 100 shares of stock; common denomination for stock trading. **Odd lots** less than 100 shares
Efficient market is defined as one with active trading and small spreads

Exchanges:

New York Stock Exchange:

- The NYSE operates as an auction market, where a **designated market maker (DMM) (**sometimes referred to as the **'specialist')** facilitates all trading for a stock
- Operate principal or agency transaction
- Any trade on this exchange is part of the first market

Dual-listed stock: Listed on a national and regional exchange

NASDAQ:

- Negotiated market where there are many numerous market makers
- Considered an OTC market

Self-regulatory organizations (SROs)

- Granted the power to regulate markets

Now FINRA

- A self-regulatory organization (SRO)
- Regulates financial professionals (not law enforcement or a government agency)

OTC Markets Group (Second Market Trades) (Bonds and penny stocks trade here)

- OTC market trading non-listed stocks
- Made of three sub-markets:

OTCQX

- Highest listing standards of OTC Markets Group
- Financial and reporting requirements exist

OTCQB

- Also known as a venture market
- The trading market for smaller developing companies

OTC Pink Market – quotation system for securities not listed on NYSE or Nasdaq

- Least prestigious of OTC Markets Group
- No listing or financial requirements
- Market for bankrupt and distressed companies

Securities Exchange Act of 1934

- Regulates the secondary market - Applies to non-exempt securities
- Margin requirements were created under this rule
- Created the SEC: Rule 10b-5 if they prove fraud can come after anyone
- Required broker-dealers to provide:
  - Balance sheets
  - Net capital computations

Insider rules:
- Cannot sell short company stock
- Must return **short swing profit (Cap gains made in last 6 months)**

Act of 1934 Regulates Penny Stocks (less than **$5** a share)
- Investors must receive risk **disclosure document** and suitability statements
- Issued monthly statements as super high risk

Established Customer (No suitability disclosure needed)
- Account open for more than one year or 3 unsolicited penny stock trades

Penny Stocks normally have lower dividends then blue chip stocks

Customer Orders:
Market orders:
- Immediate execution does not specify a price and goes through at the next available market price
- Must specify day orders (cancelled at end of day if remain unexecuted) or good-till-cancelled (only when a customer request good be days weeks months) – default to day orders
- Market orders always go through instantly, so broker-dealers automatically default their timeframe to day orders

Buy Limit Order:
- Specifies specific price to buy at or better (buy 100 shares @ $50 = $50 or less)
- Guarantees execution will happen at specific price but does not guarantee execution

Sell Limit Order:
- Specifies specific price to sell at or better (sell 100 shares @ $50 = $50 or more)
- All limit orders are day orders or GTC orders

Sell Stop Order:
- Primarily used to hedge long stock – nothing guaranteed price or execution
- Trigger or elects at the price specified or lower then becomes market order and fills at next available price
- Used to protect from long stock positions

Buy Stop Order:
- Tigger's when market price rises to stop price or better then becomes market order fills at next price
- Used to protect from short stock positions

Sell Stop Limit Order:
- Triggers when market price falls to or below the stop price and then the sell limit kicks in and the order fills as long as the price is at or above stop price

Buy Stop Limit Order:
- Triggers when market price falls to stop price or higher and then limit order kicks in and needs to go to stop price or lower

Orders placed below the market are adjusted by the amount if there is a cash dividend as it will naturally lower the stock price but not by market forces unless has **DNR (Do not reduce)**

Sell Limit Buy stop

SL o BS
BL i SS

Buy Limit Sell Stop

Order Specifications:
All or none (AON)
- Fill all shares or none allowed (multiple attempts to do so)

Immediate or Cancel (IOC)
- Immediate purchase of as many shares at the price specified and then cancel rest of order

Fill or kill (FOK)
- Fill the order completely or it gets canceled (one attempt allowed)

Order ticket: Required beforehand for each order placed, principal or boss reviews it by EOD and can edit it after submission
- Included on the ticket is: Type of order, price, number of shares specified, Day order, account #
- If client wants an unsuitable trade, you have to explain why it's bad but then do it

Sell Order ticket: does not include investors original purchase price
- Includes whether discretion was used, if solicited, if selling sort or long and if long where the securities are being located

5% Markup Policy: guideline outlying excessive markups/downs and commissions on customer trades May be justified by: type of security, availability, amt of money disclosure. Not if have history or can't prove why it is justifiably = Exempt securities are IPOs, municipal bonds, mutual fund shares (primary issues and any security with a prospectus)
Trade taking as recommendation is marked as **discretion not exercised** if in discretionary account**,** if placing trade was clients idea it is market as unsolicited and solicited if trade was recommended
Proceeds transaction: when a person sells securities and then intends to use the proceeds of that transaction to purchase additional securities, the compensation on both is combined and is referred to as a proceeds transaction.
Inside market: Highest bid and lowest ask out of any of the broker dealers

Trading, Clearing and Settlement:
- Settlement represents the day the buying firm must pay for securities
- Two firms agree on details of the trade referred to as clearing or affirming the trade
- For corporate and municipal T+2 for Gov and options trades T+1
- **Special settlement:** if either party seeks to alter timing of settlement (buyer needs same day)
- **Cash settlement is always same day and pays same day**
- **Seller's option:** when seller needs more time to make good delivery – agreed on transaction
- **Reg T** says corporate bonds and options customer has to pay T+4, Muni and treasury are exempt
- DTCC simply journals the movement of security positions and monies between each clearing firm's account. This process is referred to as *book-entry settlement-must happen for depository-eligible securities*
- **Paper settlement** is when physical securities may be delivered for settlement – not DTCC eligible and referred to as good delivery (transfer agent determines if good delivery or not)
- Delivery to be in good delivery must be in units of delivery (stock 100, bond 1000)
- If securities carry restrictive legend not in good delivery form, only transfer agent may remove
- **CUSIP Numbers** is like a bar code for securities assigned to each maturity–essential to clearance

Spinoffs: In some situations, a company may want to spin off a business unit to existing shareholders. Examples eBay's spin off of PayPal shares will trade when-issued and settle after the shares become available for delivery (when-used means share or stock has official permission to be bought or sold but is not yet officially available for sale, although unofficial trading has begun.

<u>Brokerage Accounts:</u>

- Maintained by broker-dealers, investors use these accounts to buy/sell securities
- Best execution means BD must use reasonable diligence to assist customers in obtaining the best prices on purchase and sales which includes price and volatility, size and order type, general character of the market

Account Statements

- Issued **quarterly** unless penny stocks held then monthly (send by E-mail if requested)
- If account is active, it receives **monthly account statements**
- Mail can be held for customers if submitted in **writing for 3 months** hold for any reason or indefinitely if a legitimate reason

Trade confirmations

- Provides trade details after the transaction, sent by completion of transaction
- Include: Customer name, account number, security bought, # of shares, date/time of transaction, fees and/or commissions, agency or principal, accrued interest (if applicable for bonds)

Complaint

- Dissatisfaction submitted in writing
- Forwarded to a principal for review
- Representative and principal work together to resolve
- Must be kept on file for 4 years at Office of Supervisory Jurisdiction (OSJ)

Four critical pieces of information (Patriot Act) (Customer Identification program - CIP)

- Name
- Date of birth (DOB)
- Address
- SSN or TIN

Verified through:

- Valid government-issued ID
- Credit bureau database

Customer occupation: Must confirm if the customer is:

- An affiliate of a publicly traded company
- A registered financial representative

If employee of BD opens a brokerage account at another BD must obtain written approval from employer, notify when account is open and provide them with duplicate statements and trade confirmations within 30 days

Suitability questions

- Not required to be answered
- Firms cannot make recommendations without this information

FINRA has established the following three main suitability obligations:

1. The **reasonable basis obligation** – Requires a member firm and its RRs to have a reasonable basis to believe that a recommendation is suitable for at least some investors. If the firm or its RRs don't understand a product, it should not be recommended to customers.
2. The **customer-specific obligation** – Requires a member firm and its RRs to have a reasonable basis to believe that a recommendation is suitable for a particular individual based on the customer's investment profile
3. The **quantitative obligation** – Requires a member firm and its RRs to have a reasonable basis to believe that a series of recommended transactions, even if they're suitable for a customer, are not excessive when considering the customer's investment profile

Account opening:

- Customers name and residence, if of legal age, and name of reregistered rep for account is needed
- Educational background is not needed

- Only signature legally required to open is principals
- Must confirm customer info within 30 days of account opening and every 3 years
- When opening account asked to sign an **arbitration agreement –** voluntary but if sign disputes between customer and firm are binding arbitration – can't sue in court but does arbitration which is a faster and more efficient process than a lawsuit

Individual Accounts
- Accounts owned by one party and subject to probate without TOD

Probate court
- Determines the distribution of estate assets

Dying testate
- A person dies with a valid will in place
- Will appoints estate executor
- Executor petitions probate court for letters testamentary
- Letters testamentary confirm executor's status to firm maintaining custody

Dying intestate
- A person dies without a valid will in place
- Probate court appoints estate administrator
- Letters of administration confirm administrator's status to firm maintaining custody

Death reporting to firm
- All open orders canceled, and account marked as deceased and restricted
- Firm awaits death certificate and estate documents (if necessary)

Joint Accounts:
- Any joint owner can trade, receive mail and manage the accounts (do not need approval)
- But checks must be made out to all owners
- Just need names of people in account to open

Joint with rights of survivorship (WROS):
- Account provides equal ownership rights to all owners (one dies, other one owns account)
- May contain TOD, which only applies if all account owners pass away

Tenants in Common (TIC):
- Provides specific ownership allotments (40% to one, 60% to another)
- One passes away their ownership becomes property of the estate

Power of attorney (POA)
- Allows a third party to act on behalf of account owner(s)
- Referred to as trading authorization
- Ceases at account owner's death and can be revoked at any time

Limited POA: Third party can place trades in the account but cannot request withdrawals
Full POA: Third party (attorney-in-fact) can place trades and can request withdrawals
Non-durable POA: Ceases at account owner incapacitation
Durable POA: Survives account owner incapacitation

Discretionary Account provides a financial professional with trading authority over an account
- Makes the firm the POA of your own account (Accounts supervised more)
- Discretionary order is where a financial professional is making a decision on the (AAA Rule)
    - **Asset** of the security being bought or sold
    - **Action** if the security is being bought or sold
    - **Amount** how many shares if units are being bought or sold

Financial professionals can make choices such as **<u>price and time of trade without POA</u>**

A not-held order is an order that's gives the rep discretion to find the best possible price/not discretionary order
Many of these accounts are considered **wrap accounts:** accounts come with a list of services provided and the whole cost is wrapped into one fee where the firm is the POA of your account

Custodial accounts (only account application to open no supplemental documentation)
- Are opened for minors under the age of 18. Custodian opens it and manages but assets are the minors (1 minor per account and 1 custodian per account)
- No short sales or margin trading, options (these are fiduciary accounts)
- All gifts made **cannot be taken back (irrevocable)** but can be withdrawn to directly benefit the child (non-essential items, summer camp, education) (any adult can make gifts)
- Taxes reported under minors SSN (little or no tax as no reported income)
- Owner is always the minor and they can donate
- Donor can make may give gifts of cash and securities (unlimited contributions)

Two Types:
UGMA (Uniform Gifts to Minors Act): Gives control of account at age of maturity (18 or 21)
UTMA (Uniform Transfer to Minors Act): Allow custodians to delay transfer of assets (up 25 or more)

Guardianship accounts
- Accounts for the incapacitated
- Managed by court-appointed guardians (require supplemental documentation)
- Type of fiduciary account

Trust: Legal entities involving three distinct parties with varying responsibilities
- Grantor: Creates and funds trust using legal services such as a **trust agreement**
- Trustee(s): Manage trust according to the instruction's provider by grantor
- Beneficiary: Exist to receive the benefits of the trust – no legitimate power over trust
- Could have more risker investing strategies if the grantor allows it (margin)
- Revocable trust – can be changed at any time, irrevocable cannot

Business Accounts:
Partnership agreement: must be submitted along with an account application for a limited or general partnerships – general manager must submit name, address, citizenship, and tax number
Corporate Accounts: S and C-corporations (C Corp is not a pass through entity but an S Corp is)
Need a **corporate resolution** (names of employees who act on behalf of business account) **and a corporate charter** (Confirms corporation legal status) with corporations seal

Prime brokerage accounts provide services to large customers (normally hedge funds) they maintain custody and record keeping but send trades to various firms – comes with lower interest charges on borrowed funds

Cash accounts require investors to pay for 100% of any purchases made

Opening a **Margin** account:
- **Hypothecation agreement:** investor pledges securities as collateral (MUST sign) – broker dealers rehypothecate securities to bank for loans up to 140% of debit value → Regulation U
- **Credit agreement:** Contains details for margin loan specifics (terms of loan – MUST sign)
- **Loan consent form:** Allows BD to lend out customers margin securities to other customers (NOT required to sign)
- Margin accounts allows for commingling securities while cash accounts does not

Reg T 50% or more requirement (broker-dealer and customers)
FINRA requires margin levels of $2000
Must either deposit $2,000 or 50% of total transaction cost - whichever is greater
If purchasing less, then $2,000 the investor only has to deposit 100% of the transaction (Ex $1400)

Purchase amount	Deposit amount
$2,000 or less	Entire amount
$2,000 - $4,000	$2,000
$4,000 or more	50% (Regulation T)

Since short sells have unlimited risk investor is always required a minimum deposit equaling the greater of 50% or $2,000
Securities that are Marginable (can be bought with margin)

- Exchange listed stocks
- Federal reserve approved OTC stocks (as riskier must be approved)
- Debt securities (US government, municipal, corporate)
- Primary offerings after 30 days of ownership (IPOS and mutual funds can't be purchased with margin but can act as collateral)
- Warrants

Securities that are not marginable

- OTC stocks not approved by the Federal Reserve
- Primary offerings held less than 30 days
- Any option with 9 months or less to maturity
- Insurance products (e.g., annuities)
- Rights

Accounts that cannot utilize margin

- Custodial accounts (UGMA & UTMA)
- Guardianship accounts
- Trust accounts **unless** specifically authorized in the trust agreement
- Education plans (529 and Coverdell)
- Retirement accounts (qualified, non-qualified, IRAs)

Regulation T also relates to settlement for both margin and cash accounts. **Regulation T settlement** is always two business days after regular-way settlement (T+4) customers makes payment then
If do not have cash requirements in margin account by the right time BD can request an extension from FINRA for the customer or freeze account (90 days) and liquidate position

Opening an **Options Account: FINRA Rule 2360 Steps**

1. Customer fills out new account form (with personal info and some suitability questions)
   - Approval goes to registered options principal (ROP – **Series 4**) first or general securities sales supervisor (**series 9/10**) if approved customer gets copy and no response means negative confirmation or an affirmation and the account is opened
2. Financial representative provides Options Disclosure Document (ODD) to investor prior
3. Account is approved by an options supervisor (depending on suitability questions answered may be allowed to only covered call or long options or may be allowed to do all strategies
4. First trade "opens" account

5. Customer returns signed options agreement within 15 days – trades can occur with this signed but if not returned in 15 days customer is restricted to closing trades

Minimum maintenance for long accounts

- 25% equity requirement
- If falling below, must: Deposit cash, Deposit fully paid securities, Sell securities

Restricted accounts

- Below 50% equity
- Half of sales proceeds must pay down debit balance

Minimum maintenance for short accounts

- 30% equity requirement
- If falling below, must: Deposit cash, Close short position

Securities Investor Protection Corporation (SIPC) is an industry-funded non-profit organization that provides insurance to brokerage firm **customers** in the event of a broker-dealer's bankruptcy if held under street name

- Insures up to 500k of the account value of **securities and cash** per registration but no more than 250k in cash (cash is priority covered first then securities)
- If customer has margin account, only equity is covered
- New coverage is provided for each separate registration (new person)
- SIPC insurance is provided at or prior to opening account then annually after
- Does not have to provide name of SIPC trustee
- Stocks held under customers names are not protected
- SIPC does not cover commodities and future positions

Business continuity plans (BCPs)

- Protocols during business disruptions
- Provided to customers:
  - Upon account opening
  - Upon written request
  - On the firm's website

<u>Retirement Plans:</u>

Retirement account contributions: Must be made in cash

Retirement account suitability

- Avoid strategies with unlimited risk, no short sales, no margin and Municipal bonds are unsuitable

Excess contribution penalty: 6% on the amount over-contributed for IRAs and Roth

Early withdrawal penalty

- Retirement distributions before 59 ½ are subject to a **10% penalty**

Required minimum distributions (RMDs): Retirement withdrawal requirement

- Applies at age 73 - 25% penalty if not taken (10% if taken within 2 years)
- The first RMB can be postponed until April 1st of the following year
- Can be delayed forever if you are still working above 73

Q**ualified retirement plan** (tax deductible contributions and taxable withdraws (base and growth)

- Must be governed by the Employee Retirement Income Security Act (ERISA)
- Written to protect non-governmental employee retirement assets from employer mismanagement
- More money placed in this plan, the less taxable income to report
- Must be offered to everyone at the company (minimum participation) and vest in 5 or less years
- **Eligible if you are at least 21 years old and 1,000 hours of annual service**

Qualified Defined benefit Plan: (pension)
- Plan involving varying employer contributions and a specific retirement benefit that is defined
- An **unfunded pension liability** is when future payout is more than amount set aside
- 100% taxable to retiree as ordinary income

Qualified Defined Contribution Plans:
- Maintains specific defined contributions and an unknown retirement benefit
- Plans allows employees to contribute to a specific amount of salary and some match
- All plans are either, Pre-tax (deductible) contributions, Tax-deferred growth, Distributions taxable as ordinary income

401k plans:
- Available to private non-government for profit companies
- Allows employees to have pre-tax money for retirement – subject to 10% withdraw fee

403(b) Plans (can be an annuity)
- Similar to 401k but for non-profits orgs, schools and religions.
- Sometimes referred to as tax-sheltered annuity as they can take money from account, roll over to another retirement account or turn it into an annuity that will pay them till death

Keogh (HR-10) plans (limit is lesser of 35% of income or 69k)
- For smaller profession practices (dentist office or law firm)
- Employer makes max contribution to their plan must make matching to employees plans

Profit-sharing plans: business offer plans provide extra incentives, contributions not required, BOD determines amt
Money purchase plans: contributions made every year and not based on profitability
SEPP and SIMPLE IRAS: qualified plans for small business owners with higher contribution limits
Non-qualified plans: not governed by ERISA and can discriminate on who gets them
Deferred comp plans: defer comp to reduce tax burden
457 plan: non-qualified plans for government and certain non-profit – has tax deductible and tax deferred growth

A lump-sum withdrawal from a corporate pension plan, Keogh, or IRA is deposited in an IRA, it is referred to as a **rollover**. If the rollover is done within **60 days**, the investor will avoid a taxable event. **Only one** rollover is permitted each year

<u>**Individual Retirement Accounts (IRAs)**</u> (Potentially tax-deductible and fully taxable distributions)
- Traditional IRAs are **non-qualified** retirement plans because they're not workplace-sponsored, although they function similarly to qualified plans
- Contributions are deductible against earned income
- Max to contribute is 7k for 2024 – need earned income for the year (earn 3k can only put in 3k)
- An investor can contribute towards 2023's contribution limit until April 15th, 2024
- **Spousal IRA contribution:** partner can fund IRA if they have no reportable income
- Older then 50 can add $1000 extra a year to catch up

Traditional IRA contributions are not always deductible.
Investor is not covered by a qualified workplace plan
- Contributions are always deductible

Investor is covered by a qualified workplace plan and low income (<77k)
- Contributions are always deductible

Investor is covered by a qualified workplace plan and high income (>87K)
- Contributions are partially deductible or not deductible

<u>**ROTH IRAs**</u> (After tax contributions and potentially tax-free distributions)
- Contributions are made after-tax, which means they are not deductible. Roth IRA assets grow tax-sheltered and can be withdrawn in retirement tax-free
- 7k limit per year max and high earners cannot contribute

- investors must wait until 59 ½ to withdraw and account must be open for 5 years/ **five-year** aging period starts on the first day of a contribution -partial tax deductions if break 5 year (tax on growth above basis but no penalty)
- There is no required minimum distributions (RMDs) and for Roth 401(k)s

Roth 401(k)s same as Roth IRA but difference is they are qualified workplace plans and are ERISA governed

An investor can take a tax-reported withdrawal (distribution) of funds from a retirement plan and avoid tax if the funds are returned to same plan or similar plan within 60 days

Rollovers move retirement assets to an IRA from a 401k or different assets – ocan do **once** per year

The 10% tax penalty is waived for withdrawals for an IRA if they use to pay for qualified education expenses for account owner, owners spouse or their child or grandchild, used to pay for purchase of first time house and disability of account owner but the distribution is still taxed as ordinary income

Variable Life Insurance: offers coverage throughout the insured person's life, regardless of whether they're the policyholder or not. As long as required premiums are paid, a payment (known as a 'death benefit') is delivered to beneficiaries upon the insured person's death

- Coverage for the entire life of the policyholder
- Are subject to registration and securities regulations
- Fixed premiums
- Guaranteed death benefit
- Cash value invested in the separate account
- Cash value grows based on investment performance
- Policyholder subject to investment risk

Cash value may be:

- Withdrawn or borrowed
- Returned to the insurance company upon death
- Kept upon surrender of the policy
- Retained and potentially paid with a death benefit
- Considered a security

Variable Annuities: type of investment company product regulated by Investment Company Act of 1940 that can provide life income to a person in retirement.

- They allow unlimited contributions (prem payments) and make fluctuating payments until death
- Non-qualified retirement plan which means contributions are not tax-deductible
- Investor assumes investment risk (opposite for fixed annuity)
- They have contingent deferred sales charge at redemption/surrender/withdraw
- Broker dealer has **7 bus days** to determine if variable annuity purchase is suitable for investor
- Sales charges imposed as contingent deferred sales charge, expense, management fees
- Subject to 10% tax if he withdraws to early and pays tax on growth
- Can **1035 exchange** funds into annuity without a taxable event

Immediate Annuity:

- One large lump sum payment called a **single premium immediate annuity**
- Start to receive retirement income immediately, provides income for life, no need for build up
- Risks are need a large sum, large sum hard to get back once deposited, low or negative return if die sooner than expected, high fees up front

Deferred Annuity:

- Requires time to grow investors assets – contributions are invested and then once in retirement have the ability to annuitize their account
- Longer period allows more growth, provides income for life if annuitized, no large initial sum

- Risks are assets might grow much or lose value if perform poorly, income not received for long time, low or negative return if death occurs early, High up-front fees

Accumulation Phase:

- Could last a day (immediate) or several decades (deferred)
- Money received during this phase is placed into a **sperate account** where investor buys **accumulation units.** Shows amount invested and can buy stocks, funds...etc
- Assets in separate account grow tax-deferred and no taxes or cap gains are realized until withdrawals are made which have to be 59 ½ or 10% penalty
- If cancel (surrender) their variable annuities during this phase receive annuity's current value, can also take partial surrender. May be subject to surrender charges and tax on growth
- **Death benefit** if person dies before annuitizing contract the beneficiary would receive either the amount invested (investments declined) or the total amount (portfolio grew)
- Insurance companies have **M&E (mortality & expenses) charges (1.25%)** for if person dies earlier than expected and they have to pay difference or unexpected claims arise

Distribution Phase (Annuity Period): no longer surrender or freely withdraw money

- Insurance company converts all accumulation units to annuity units
- Investor can take a lump sum payout or can take random or systematic withdrawals
- Only growth is taxed on the contributions as invested amount was post-tax dollars
- If lump sum or periodic withdrawals are taken from a deferred annuity the investor is not guaranteed income for life
- If amount is not annuitized growth is distributed first and taxed on growth while invested is tax-free
- If account is annuitized, payments received are taxed on a **pro-rata (exclusion) basis** which means each payment is same tax for growth and some not taxed initial invested

To calculate the annuitants payments they take: age, gender, life expectancy, assume interest rate, settlement option selected

Four specific annuitization structures to be aware of;

(Straight) Life Annuitization:

- Pays for life, once investor dies payments stop and insurance company keeps assets
- Insurance company makes payouts representing estimate of investors life expectancy (longevity risk is if thy live longer than expected)

Life with period Certain:

- Guaranteed payments **for life**, regardless how long you live – less risk smaller rate
- Ex: 10-year period dies at year 8 gets 2 more years of payments to beneficiary

Joint with last survivor:

- Pays two account owners until both pass away – one annuitant dies payments reduced a bit
- Can be established between any two individuals

Unit Refund

- This type of annuity makes payments for life, but "refunds" the account owner's beneficiary if they pass away before receiving their basis
- Ex: Investor puts in 100k then annuitizes and gets 70k in payments then dies he is owed 30k to his beneficiary

All of these are non-qualified annuities where money in is post-tax with taxes on growth only for deductions and unlimited contributions

Rare circumstance there is a qualified annuity which means funded with pre-tax money and all future withdraws are taxed as ordinary income and have required minim distributions

Equity-Indexed Contracts: combine both fixed and variable have a minimum floor

- Must be for long term investors as early year fees cut into returns

Local Government Investment Pools: LGIPs are trusts that are established by state and local governments and offer municipalities a place to invest their money →only state, county and city investors

Educating Plans:

<u>Coverdell Education savings accounts (ESAs</u>): provide tax friendly way to save for child's education

- Annual non-deductible contribution limit of 2k per child per year till child is 18
- High earners prohibited from investing
- Assets grow tax sheltered, and distributions used to pay for educational expenses are not subject to tax – all distributions must be distributed by the time beneficiary reaches 30
- Anyone can donate even own kid – can change beneficiary to someone in family who is under 30

<u>529 Plan</u> (qualified tuition programs (QTPs) (Not unlimited contribution amount just very high)

- Utilized for college expenses – each state has own unique 529 plan
- Frequent changes to these plans are not allowed to encourage long-term mindset (2 changes per year) **(beneficiary can be changed as many times as long as apart of family)**
- **Donor and beneficiary can be the same person if of age**
- These plans are subject to gift tax (18K per person)
- Plan participant manages plan for the beneficiary – **plan participant fully owns** the account and does not have to give it to beneficiary ever if they do not go to college
- Contributions are made with after tax money and the limit per year is super high
- Assets grow tax free and reinvested automatically in the plan
- Anyone can invest in this from low to high earners
- Subject to 10% tax penalty plus ordinary income on growth if not used for education (unless gets scholarship) **– but 10k a year can be used for tuition expenses below the college level**

Prepaid tuition plans: (most times donor or beneficiary has to be a resident)

- Prepay for tuition today at today's rates instead of assessed later on with rising college costs
- Account owner may lose financial if student does not attend public school in that state
- No distributions on this plan the owner gets credit toward tuition at state school

College savings plans:

- Invest in state approved funds similar to mutual funds
- Most do target date funds for the year child is off to college

ABLE Accounts (Achieving a Better Life Experience):

- Expense account for people with a disability
- Assets held in ABLE accounts are not factored into eligibility requirements for benefits like Medicaid so they can receive them
- Contributions are made with after-tax dollars that are non-deductible (are for some states)
- Assets are invested and grow on a tax-sheltered basis
- Person must be disabled by age 26 to open account

<u>Regulators:</u>

The SEC:

- Independent agency of the US government
- Created by the Securities Exchange Act of 1934
- Goal is the protect investors, maintain fair orderly and efficient markets, and facilitate capital info

FINRA (Financial Industry Regulatory Authority)

- FINRA is a self-regulatory organization (SRO)
- Broker dealers are member firms that are registered with FINRA
- Any associated persons are offers, directors, employees of firm

- FINRA handles lower-level priorities related to firms and reps while the SEC oversees securities markets (primary and secondary markets)
- To register with FINRA an individual must file and complete Form U-4, 5 years residence history, 10 years employment, any felonies have to be disclosed but only convictions in felonies and security misdemeanors in the past 10 years result in a statutory disqualification and must disclose bankruptcies and lien
- Fingerprints needed in 30 days unless only selling mutual funds or variable annuities and if person comes in contact with funds, securities or firms' book and records need it
- Convictions may prevent a career in the securities field – known as **statutory disqualifications**
- **These are:** felony in last 10 years, conviction of securities related misdemeanor last 10 years, suspension of registration from securities regulator (SEC or FINRA) proof of false statements made to securities regulators – all felonies and misdemeanor convection or charge must be noted
- Exceptions can be made through eligibility proceeding filed with FINRA and forward to SEC but if hired the person must face heightened supervisory
- RRs need to be properly registered as agents in which they conduct business, must take state exams but only once
- Once background check comes back applicant signs U-4 and agrees to a pre-dispute arbitration agreement can't sue employer unless in harassment or discrimination – which FINRA helps administer but does not determine outcome as the arbitrators do that
- Once signed firm submits to FINRAs Central Registration Depository (**CRD**) which is a database
- U-5 is signed when employee leaves, U-6 is filed by FINRA if rep subject to disciplinary action or arbitration awards
- When person regions or is terminate firm must notify FINRA in 30 days and provide former employee with copy of the form

FINRA's Investor Education and Protection Rule requires member firms, at least once every calendar year, to provide to each customer, in writing FINRAs BrokerCheck hotline number, FINRAs website address and a statement on availability of an investor brochure that includes Information on BrokerCheck

- MSRD has an investor education rule where the regulated entity is registered with the MSRB and the SEC, MSRB website and investor brochure available on MSRB website – annual notice

Municipal Securities Rulemaking Board (MSRB):

- Is an SRO that governs the municipal bond market (no real power to enforce rules so SEC does it)
- MSRB limits political contributions made by firms to municipal finance professions to $250 per **campaign**/**election** so there is no scratch my back activity (Rule G-37) (If broken can't do business with them for 2 years) – check from joint account must be spilt, spouse can give any $$
- Does not regulate the issuers as a private non-government org wouldn't regulate the gov
- An official statement created by the MSRB that provides details on the security being sold is not required but if a professional must deliver it to investors purchasing municipal securities in primary market if created

North American Securities Administrators Association (NASAA) represents the group of state securities administrators "state version of SEC" – enforces Uniform Securities Act (blue sky laws)

Market Manipulation Types:

Painting the tape (matched orders/wash trades): when groups sell and buy stock between themselves to increase activity and then sell it when price goes up do to activity

Marking the open or close: act of placing trades prior to the market open or close to influence the price. If stock were to open higher and they sell it that's prohibited

Spreading Rumors:

Pump and Dump: embellishing truths to gain demand and then cashing out

Unethical Activities:

Interpositioning: Creating an unnecessary middleman to add extra fees on top (third-party)
Backing away: Providing firm quote, but not fulfilling it
Frontrunning: Placing a personal order just prior to a large customer order
Trading ahead: Placing a personal order just prior to a research report release
Free Riding: Purchase securities they rise in value and then liquidate a portion of the securities to pay for funds without having to deposit anything – as normally if not paid by Reg T date 90 day freeze on account, assets are sold and customer must pay for all purchases in advance
Anti-Intimidation/Coordination Interpretation: coordinate prices, trades with other member person, to request they alter price, to threaten
Insider trading involves trading on material, non-public information. Material information is any information that can drive someone to make an investment decision. Non-public information is not widely available or disseminated. Must have system to monitor employees personal trading, and restricting or monitoring the trading of securities in which firm has access to insider information

- Both the tipper and tippee are liable for penalties such as $5M fine and 20 year jailtime if found criminally guilty
- If just sued on behalf of investors and found liable they pay up to 3x the profit made or loss in civil court know as treble damages
- For widespread firm problem the firm is tipped $25M which goes to the SECs Fair Fund

Representatives are obligated to protect **specified adults** from financial exploitation

- Any person older then 65
- Any person aged 18 or older who member firm has mental or physical impairment

Protecting specified adults is accomplished through these best practices:

- **Adding trusted contact persons** (FINRA Rule 2165 adds trusted contact person to account)
- Trusted contact must be a person not a firm
- **Enacting a transaction & fund disbursement hold -** 55 **business** days (15 initial + 10 additional + 30 more days if authorities are notified)
- Must provide no later than two business days notification of hold to all parties authorized to transact business and trusted contact person unless they suspect them of financial exploitation
- **Avoiding red flag investments** (borrowing against mortgage, complex products and risky investments)
- Using legitimate titles & certifications only (RR should only use designations if passed them)

Patriot Act was signed into law and the **bank Secrecy Act** was amended after 9/11 used financial accounts to address anti-money laundering
Money laundering has three stages:

1. **Placement**: when you place illegal funds in the bank. Currency transaction reports (CTRs) measure this and report anything above 10K deposited. If person reduces transaction to avoid CTR report its known as **structuring** and is illegal
2. **Layering**: Many transactions to and from different accounts – more transactions makes it harder for authorities to follow the paper trail
3. **Integration**: transfer layered funds into legitimate sources

Suspicious activity reports (SARs): Filed with FinCEN if suspicious activity is identified within **30** days – must be filed when a transaction or group equals or **exceeds 5,000** and suspects something
The Bank Secrecy Act Current Transaction Report (BCTRs) is filed for all cash transactions that exceed $10,000 and are executed by a single customer during one business day. It is also triggered if a customer places multiple, smaller transactions in a single day that, in the aggregate, exceed $10,000

AML program must contain policies, procedures, and internal controls that are designed to comply with the Bank Secrecy Act (BSA) such as if maintaining records if wire transfer are over 3k
Violating AML laws are high under criminal law it is a fine up to 500k per transaction or twice the amount of the funds involved whichever is greater and up to 20 years in prison
Broker Dealers must conduct test of AML procedures at least **annually**

Specifically designated nationals (SDN) list: List of people identified as:

- Controlled by hostile countries
- Terrorists
- Drug traffickers

Regulation S-P

- Safeguards non-public customer info
- Firms must disclose when giving non-public info to third parties
- Privacy notices provided: At account opening, Annually after
- Firms must provide easy "opt-out"
- Includes policies to protect the security of nonpublic information
- Consumer is a person who is in process of providing info to firm in connection with transaction, a customer is a person who has an on-going relationship with the firm

Telephone Consumer Protection Act (TCPA): Prevents unwanted phone calls

- Financial professional must check to see if cold call recipient is on the **national do-not** call list as well as their firms **do-not call list –** if are cannot call
- If customer requests they place her name on DNC must be there indefinitely and must be completed in 30 days
- If not can only call between 8am-9pm in time zone of customer
- Must disclose firms name, phone number or address calling from
- **TCPA rules do not** apply to any customer that was done business with the firm in the past 18 months or if the customer requests for call to be made to them
- Non-profits are exempt from this rule and does not apply to mail as well

Public Communication

- Any written or electronic communication sent to 25 or fewer retail investors within a 30-day period is considered **correspondence –** not required to file with FINRA and no principal oversight but review by principal
- When any written or electronic communication is sent to more than 25 retail investors within a 30-day period, it's considered a **retail communication**. FINRA is a little more concerned about these communications because of how many people see them – must file copies of these commination's to FINRA and firm principals must pre-approve them
- **Institutional communications** – communication with large institutions supervised by the firm but not required to file with FINRA - reviewed by principal

Proxy Rules: certificate which gives a person other than the stockholder right to vote

- When broker dealers is the owner on record for the stock while an investor owns it, it is known as holding the security in **street name**
- Broker dealers are required to forward the proxy (voting) material to investors where they initially pay to mail them and then get reimbursed
- If investor doesn't vote on proxy broker dealer can vote on their behalf but only for minor issues
- If proxy is returned signed but not voted the firm votes as per issuers recommendations
- BD may charge Issuers for forwarding material to beneficial owners and may charge customers for safekeeping securities but cannot charge customer for forwarding proxies

Licenses
After passing the appropriate licensing exams, filing the U-4, and FINRA confirming registration as effective, a person is considered a **registered representative**
Representatives must continue education two ways
- **Regulatory Element:** Can complete through most internet connected devices through FINRAs financial professional gateway (FINPro) **annually** or registration is inactive
- **Firm Element:** Delivered by member firms (BDs) on ethics and prohibited actions **annually**

If not completed the representative's registration becomes inactive until completed and they cannot do actions of a registered representative unless they get a **special inactive status** for military duty
- 30 day wait if did not pass one exam, 180 day wait for fail three times
- Each RR is assigned a specific supervisor or principal

Financial license lapse
- Occurs if out of the industry for more than 2 years (most licenses)
- SIE exam license lapses after 4 years out of the industry

Maintaining Qualifications Program (MQP)
- Extends lapse period on FINRA licenses to 5 years
- NASSA license such as state licenses are not eligible

Requirements:
- Must be registered for at least one year before termination
- Must participate within two years of termination
- CE must be completed by due dates

Unregistered Reps can only set meetings, provide general account and market information they **cannot** discuss specific or general investment products, pre-qualify clients for suitability, solicit new accounts and orders

Registered Representative Rules: may not offer to pay commissions or fees to non-registered Rep
Outside brokerage accounts:
- When joining broker dealer must disclose if you have any other brokerage accounts held out of the firm within 30 days – if allowed must supervise accounts by duplicate statements and trade confirmations from the firm holding account

Outside Business Activities (OBA): Passive losses/gains don't count
- Registered representatives must notify their firm in writing when engaging in a money-making opportunity outside the firm
- If the employer feels they're engaging in activity detrimental to the firm, they can deny the OBA but technically reps are not asking for permission they are only notifying

Private securities transactions
- If registered representative is performing a private securities transaction (helping a friend sell stock in small business) must notify firm in writing explaining their role, dynamics of transactions, securities involved, compensation received if any
- Firm must also maintain a record of transaction on its own books and give written approval
- No written approval is needed if rep is not compensated but still must provide written notification but if rep does not fulfill obligation they are **selling away** and subject to penalties

Gifts
- Firms and RRs cannot give gifts worth more than **$100 per person, PER YEAR to the other firm's employees –** goes by face or cost value whichever is higher
- Business entertainment is not part of rule (tickets, dinners) as long as not excessive – be present

Borrowing from or lending to customers
- Generally speaking, representatives are prohibited from engaging in loans with most customers
- Reps may borrow from customers in the business of lending money (if they work at a bank) or if their customers are family members or in personal relationships

- Or if both parties are registered with the same firm, loan is based on personal relationship between customer and RR, loan is based on businesses relationship independent of customer-broker dealer the firm must approve prior to execution of loan in **writing**

Sharing accounts with customers:
- Reps cannot share accounts with customers unless they are immediate family members
- Unless: rep gets written approval from firm and customer, and gains/losses are shared
- And then sharing has to be proportionate to the RRs contributions unless family members

Disputes with employing firms
- Except for workplace discrimination or sexual harassment, employees cannot sue their employing firms. However, they can bring them to binding arbitration facilitated by FINRA, which is similar to court (but generally more efficient and quicker)

Continued compensation to ex-employees
- Some cases reps can continue to collect comp if they retire or leaves due to disability and maintains written agreement with former firm
- Former rep cannot solicit new business, open new accounts, service old accounts – retired

Record Retention Requirements

3 Years
- Employee records: U-4, U-5, fingerprints
- Trade confirmations, statements and public communications (correspondence, retail, institutional)
- Trail balances (money in and out of firm's business)

4 Years
- Customer complaints for FINRA rules – provided to FINRA Quarterly

5 Years
- Currency transactions reports (CTRs)
- Suspicious activity reports (SARs)
- Customer identification program (CIP) information – retain records for transfers of funds >3k

6 Years
- Customer account records: new account forms, customer agreements, trading authorization forms
- Customer complaints (**MSRB**)
- Blotters (internal trading records keep track of securities BD bought and sold)

Lifetime (SPAM)
- Stock certificates
- Partnership agreements
- Articles of incorporation
- Meeting Minutes

Each record must be readily available if the document was created within the previous 2 years