### Knowledge of Capital Markets

Types of Markets:

**Primary** – issuers sell securities to raise capital

**Secondary** – transactions between investors:

Recall: A primary offering is one in which the proceeds raised go to the issuing corporation, municipality, or government. For example, a corporation's senior management chooses to *issue* additional bonds to the general public. This corp. looks to increase its liquid capital by offering bonds. Primary offerings of bonds may be made by an issuer publicly, as is the case, or privately.

\*\*Look for the key word – *issue*

Investors purchasing secs from *issuer* - primary

Investors purchasing secs from anyone else - 2ndary

Market Centers:

**Exchanges** – physical location, an auction market with designated market makers, listed secs

**OTC** – decentralized trades between dealers/market makers

**Third Market** – exch.listed secs trading OTC

**Fourth Market** – trading between inst. Via ECNs

UW Commitments:

**Best Efforts (As Agent, Broker)**

* All or None (AON) – all or cancel the UW
* Mini Max – UW sells between a min and max set by Issuer

**Firm Commitment (As Principal, Dealer, Market Maker)**

Investors:

Institutional – QIB, min of $100mm

Retail

Accredited *(Rule 501 Reg D, 1933 act)*

* Insiders of securities issuer
* income >= $200k, joint=$300k
  + or net worth >= $1m
* holders in good standing of series 7,65,82

Final Prospectus Delivery:

|  |  |  |
| --- | --- | --- |
|  | **NMS** | **Non-NMS** |
| **IPO** | 25 | 90 |
| **APO** | 0 | 40 |

Types of Broker Dealer:

**Carrying (clearing)** – carries customer accnts, accepts funds and secs

**Introducing (fully disclosed) firm** -introduces its customers to a clearing firm

**Prime BD** – handles custody of securities and other services utilizing other BDs for execution services

**Economics:**

Leading Indicators:

* M2
* Building Permits
* Avg weekly initial claims for state unemp. Compensation
* Avg work week in manufacturing
* new orders for consumer goods
* machine tool orders
* changes in inventories of durable goods
* changes in sensitive materials prices
* stock prices (S&P 500)
* changes in business and consumer borrowing

Coincident Indicators:

* # hours worked/psnl income
* emp. Lvls
* Non agricultural emp.
* Industrial production
* Manufacturing & Trade Sales
* GDP

Lagging Indicators:

* Corporate Profits
* Avg duration of unemp.
* Labor cost per unit of output
* ratio of inventories to sales
* commercial & industrial loans outstanding
* ratio of consumer installment credit to psnl income

Balance Sheet:

* Assets
  + Current Assets
  + Fixed Assets
  + Other Assets
* Liabilities
  + Current Liabs
  + Long Term Liabs
* Net Worth
  + *Preferred stock*
  + *Common Stock*
  + *Capital in excess of par* – moneys received from the sale of common stock in excess of the par
  + *Retained earnings*
* **Ratios**
  + Working Capital = Current Assets-Current Liabs
  + Current Ratio = Curr. Assets/Curr. Liabs
  + Quick Ratio/Acid Test = (Curr. Assets – Inventory)/Curr/ Liabs
  + Debt Ratio = LTD/(LTD+Net Worth)

Exchange Rates:

When the value of the dollar *declines* against another currency, the price of U.S. products decreases in terms of the foreign currency. Exports will tend to increase and imports decrease.

When the value of the dollar *strengthens* against another currency, the price of U.S. products increases in terms of the foreign currency. Exports will tend to decrease and imports increase.

Interest Rates:

**Fed Funds** – the rate fed. Member banks charge each other for overnight loans (set by the bank making the loan, *not* the Fed Reserve)

**Prime** – the rate large US money center banks charge their best corporate customers

**Discount** – the rate charged by FRB for loans to depository institutions

**Broker call loan** – the rate banks charge broker dealers for funds borrowed to lend to mgn accnt customers

Securities Acts:

|  |  |
| --- | --- |
| **Act** | **Purpose** |
| Securities Act of 1933 | Governs the new issuance (primary) market, which involves the money-raising activities of issuers. Requires issuers to register their securities when selling to the public |
| Securities Exchange Act of 1934 | Governs trading markets for existing securities and registration requirements of BDs, BD employees, and exchanges |
| Investment Company Act of 1940 | Governs the regulation of packaged products such as mutual funds,closed-end funds, and unit investment trusts |
| Investment Advisers Act of 1940 | Governs the regulation of firms that earn fees for providing investment advice |
| Securities Investor Protection Act of 1970 | (SIPA)Covers the protection thresholds for customers in the event of a BD’s bankruptcy |
| Insider Trading and Securities Fraud | Enforcement Act of 1988Defines penalties for the misuse of material, nonpublic information by both firms and individuals |
| The USA PATRIOT Act of 2001 | (Partially based on the Bank Secrecy Act of 1970)Covers anti-money laundering (AML) policies and procedures that must be followed by financial firms |
| TIPC (1991) | Administered by FCC, protects consumers from unwanted telephone solicitations |
| Bank Secrecy Act | Establishes US Treasury as the lead agency for developing AML programs, requires currency transaction reports (CTRs) to be filed for amts > $10k |
| Uniform Secrecy Act | Establishes framework for state registration, applies to secs, BDs, Rrs, Inv. Adivsers, and IA reps |

Record Keeping:

Life:

* Partnership Agreement
* Corp[orate charter or articles of incorporation
* Stock cert. Books
* Minutes of BOD meetings
* Amendments to records
* Organizational records

Six Years:

* Blotter (record of original entry)
* General ledger
* Stock record
* Customer Ledger
* Cust. Acct. Rcds.
* Designation of principals

Four Years:

* Written complaints

Three Years:

* Almost all the other records that don’t fit in the above:
* Advertising
* Forms U4/U5 for terminated personnel
* Cust. Confirmations
* etc.

#### Things to Remember:

The ***transfer agent*** for a corporation is responsible for:

* ensuring that its securities are issued in the correct owner's name canceling old certificates and issuing new ones;
* maintaining records of ownership; and handling problems relating to lost, stolen, or destroyed certificates.

It is the ***registrar*** who is responsible for ***registering*** the corporation's securities with the state.

Regulators:

The Office of the Comptroller of the Currency:

* supervises nearly 1,400 national banks,
* federal savings associations, and federal branches
* and agencies of foreign banks operating in the United States.

The mission of the comptroller is to:

* ensure that national banks and federal savings associations operate in a safe and sound manner,
* provide fair access to financial services, treat customers fairly,
* and comply with applicable laws and regulations.
* The comptroller also serves as a director of the Federal Deposit Insurance Corporation ***(FDIC)***.

Investment Companies:

Investment companies registered under the ***Investment Company Act of 1940*** offer securities that are deemed to be federally covered, and states do not have jurisdiction over the registration requirements of these securities. (Uniform Secs Act provides the state secs registration).

Note that the National Securities Markets Improvement Act of 1996 designates certain securities to be federally covered, meaning that the states do not have registration jurisdiction over them.

The ***UPC*** established uniform trade practices and other guidelines for broker-dealers to follow when they do business with other member firms:

* transaction settlement
* good delivery
* ex-dates
* trade confirmations
* DK procedures

### Understanding Products & Risks

***(Focus on QuickSheet)***

**Municipal Bonds:**

**GO:** Munis issued for Capital improvements that benefit the entire community. These projects do not produce revenues, so principal and interest must be paid with taxes collected by the issuer.

* GO bonds are known as full faith and credit issues backed by the muni’s taxing power

**Revenue:** Used to finance any municipal facility that generates sufficient income. Considered self supporting bc Principal and int. pmts are made exclusively from the revenues generated:

* Utilities, Housing, Transportation, Education, Health, Industrial, Sports (stadium facilities)
* Not supported by issuer’s auth. To tax. So not subject to statutory debt limits, do not require voter approval

**Investment Company Products:**

The portfolios of both face-amount certificate companies and UITs are ***non-managed***. The closest they come to management is when the securities to make up the portfolio are selected. After that, the portfolio does not change.

Closed-end companies have an investment adviser who actively manages the portfolio, buying and selling securities.

#### Things to Remember:

***Unsolicited transactions:*** those not recommended by the broker-dealer or registered representative, exempt from the penny stock rules.

***Solicited transactions:*** nonexempt from penny stock rules.

***Established Customers:*** An established customer is someone who has held an account with the broker-dealer for at least one year (and has made a deposit of funds or securities); or has made at least three penny stock purchases of different issuers on different days.

* Established customers are exempt from the suitability statement requirement but not from the disclosure requirements when penny stocks are being solicited.

Equity:

**Common Stock** – issued to raise capital

**Preferred Stock** – Issued to raise capital

* **NonCum** – missed divs not payable
* **Cumulative** – missed divs paid in arrears
* **Callable** – issuer may buy back shares after a specified date & price
  + When a corporation calls in preferred shares, the shares stop trading and dividend payments cease on the call date.
* **Participating:** issuer may pay more than stated dividend
* **Adjustable-rate** preferred dividends are tied to benchmark interest rates such as Treasury securities. As these rates fluctuate up and down, so do the dividends on the adjustable shares.

***Rule 144 (part of the Securities Act of 1933)*** applies to shares that are sold through a

nonstandard offering and are subject to resale restrictions and to sales by persons who are classified as control persons (insiders) of the issuer.

**Restricted Stock**: (acquired through private placement)

* may not be sold until they’ve been fully paid for 6mo. Then selling can begin
* Buyers of stock that was subject to rule 144 when issued and first sold are *not* subject to any restrictions if they choose to resell

**Control stocks** are those owned by directors, officers, or persons who own or control 10% or more of the issuer’s voting stock. (famillies aggregate)

***Control Person = Affiliate***

When a control person wants to sell shares (over 90 day period):

* complete form 144
* Max(1% O/S shares of Co.,avg weekly trading vol. Over the most recent 4 weeks)

Control stock would be registered shares held by an affiliate. There is no holding period, but there will always be volume limits for as long as the individual is an affiliate.

Debt Securities

Bond Maturities – Term, Serial, Balloon

**Bond Features**:

* **Callable** (Issuer pers.) - beneficial to issuer, bad for investor, tends to have slightly higher coupon rt. Allows issuer to lower the cost of borrowing
* **Puttable** (Investor pers.) - put bonds back to issuer in anticipation of current IR rising, allows investor to reinvest at higher curr. rt.
* **Convertible** – convert to equity, Although convertible debentures have many positive features for the investor, the major negative is that, in exchange for those benefits, the investor accepts a lower rate of interest.

**Money Market Securities**

* T-Bills
* REPO
* BA
* Commercial Paper/Promissory Note
* A ***negotiable CD*** is an *unsecured* money market instrument issued by banks. Negotiable means that it can be traded in the secondary market and unsecured means that it is backed only by a promise to pay—a bank's good faith and credit.

**Munis**

* Interest from a GNMA certificate is taxed at all levels.
* Municipal bonds are tax free at the federal level.
* Treasury issues are tax free at the state level, taxed at federal level
* Issues from a territory of the United States (like Puerto Rico) produce interest that is tax free at the federal, state, and local level.
* Municipal bond interest is tax free at the federal level and tax free at the state level if the bondholder is a resident of the same state as the issuer.

**Investment Company Products (\*\*):**

* **Closed-end** investment companies are often called publicly traded funds. After the stock is sold in the initial offering, anyone can buy or sell shares in the secondary market (i.e., on an exchange or over the counter) in transactions between private investors.
* **A bond mutual fund** invests in the bonds of other companies. It may not itself issue bonds or preferred stock. They can only issue common shares. Closed-end companies are much like any other company. They may issue bonds and preferred stock, once they have sold common stock and become a publicly traded company.

Sales loads go to the underwriters or broker-dealers selling the shares for the fund. Therefore, they are subtracted from the dollars invested and in that light reduce possible returns for investors.

Management fees and operating expenses are ongoing costs to the fund and, therefore, reduce the dollars that can be invested, again reducing potential returns.

Class C shares have no sales charge levied at the time of purchase but rather levy a withdrawal from the customer's account every quarter. They would be most suitable for an investor intending to redeem the shares relatively soon.

Mutual funds are not intended for the speculative investor, those who might trade in and out frequently, and no particular share class is especially suited to the inexperienced investor.

A closed-end fund does not offer redemptions. Shares must be liquidated in the secondary markets. Rights of accumulation, like breakpoints, allow an investor to qualify for reduced sales charges. The major differences are that:

* rights of accumulation are available for subsequent investments (the reduced sales charges will not apply to initial transactions),
* allow the investor to use prior share appreciation to qualify for breakpoints,
* and do not impose time limits.

Rights of accumulation allow an investor to combine previous investments in the fund with today's investment to determine today's sales charge.

When investors deposit money into the fund they buy more shares, so the assets and number of shares increase proportionately and the NAV per share is unchanged.

In a similar way, when shareholders redeem shares the assets in the fund go down but the number of shares also decrease proportionally, so the NAV per share is unchanged.

The basic formula is NAV + SC = POP. SC is expressed as a percentage of POP

**General Partner/Limited Partner (\*\*)**

All tax consequences of the business flow through proportionality to the investors. All partners will have some tax impact, not just the general or just the limited partners.

**Understanding Trading, Customer Accounts, & Prohibited Activities**

When a customer owns a position and then sells that position, that is referred to as selling long or selling to close.

|  |  |  |
| --- | --- | --- |
| **Type of Settlement** | **Type of Security** | **Settlement** |
| Regular Way | Corporate | T+2 |
| Regular Way | Municipal | T+2 |
| Regular Way | Gov’t | T+1 |
| Cash | (All) | T+0 (Same Day) |

Any entity wishing to solicit proxies to vote a stockholder's shares must register with the SEC.

All those participating in the solicitation of proxies, whether directly to obtain proxies themselves, or to provide unsolicited advice to shareholders regarding how to vote must register with the SEC.

In an UTMA account, only one adult can be the custodian for one minor. Joint custodians or joint beneficiaries to a single account are not permitted.

In a defined benefit plan, the employee is promised a certain amount at retirement and the employer has to put in enough money to meet that promise. Changing rates of return can require changing deposits to meet the promised amounts at retirement.

Qualified plans require IRS approval and the contributions are tax deductible. Because non-qualified plans' contributions are not deductible they do not require IRS approval.

A customer may grant trading authority to an RR to place trades in their account without pre-authorization from the customer. Exercising discretion requires specific authorization to place such trades. Discretionary authority is a type of POA granted by the customer to the RR. These trades must be marked as discretionary; failure to

do so is a serious violation.

All trades have three key elements (RR just chooses >=1 of the below):

* An action (buy or sell)
* The amount of the trade (shares or dollars)
* The specific asset to be traded (what you are buying or selling)

It is important to note that discretionary trading is allowed as long as proper authorizations have been received. In order for a discretionary trade to be properly entered:

* the client must agree, in writing, to grant a representative discretionary trading authority
* a principal of the firm must, in writing, approve the discretionary trading authority.
* Discretionary trades must be approved by a principal promptly after entry.

Regulation T, the initial margin requirement currently at 50%, is set by the Federal Reserve Board (FRB).

Option contracts—calls and puts—are among those securities products that cannot serve as collateral for a margin loan and, therefore, may not be purchased on margin. In the case of options, their unpredictable intrinsic value, diminishing time value, and limited life make them inappropriate for securing any kind of loan.

For the risk disclosures found in the margin agreement, all of the following would be accurate disclosures:

* customers can lose more money than initially deposited.
* customers are not entitled to an extension of time to meet a margin call.
* firms can increase their in-house margin requirements without advance notice.

Note: If a maintenance call is not met it is the broker-dealer who determines which securities to sell, not the customer.

The Conduct Rules permit several types of lending arrangements. Among them;

* an immediate family relationship exists between the representative and the customer,
* the customer is in the business of lending money, the customer and the representatives are both registered persons with the same firm,
* the customer and the representative have a personal relationship or a business relationship outside the broker-customer relationship.
* Lending securities for use in short sales can only be done with a signed consent agreement from the customer.

Regulation T governs customer payment and the extension of credit to clients in margin accounts. An exchange-traded fund (ETF) is a security that is eligible for purchase on credit. IPOs and other new issues—such as mutual fund purchases—may only receive loan value (and credit) after 30 days from issuance. Annuities may not be purchased with margined funds.

Under Rule 2210, institutional communication may allow the firm to require pre-use approval or allow for postuse review.

If the firm allows post-use review, then the associates must receive education and training on communications with institutions.

### Overview of Regulatory Framework (\*\*)