4

Playing Nicely: Serving Your Client’s Needs and Following the Rules

IN THIS PART . . .

Scrutinize customers' accounts and monitor market conditions that can affect their investments.

Familiarize yourself with the markets where securities trade.

Get an overview of income tax breaks and learn to distinguish long-term from short-term capital gains and losses for income tax purposes.

Review the essential rules for the care and protection of your customers' accounts.

IN THIS CHAPTER

» Understanding the information needed when opening accounts

» Knowing your customer

» Grasping the ins and outs of margin accounts

» Determining when you can call a potential customer

» Taking a chapter quiz and checking your answers

Chapter 12

Customer Accounts: Proper Handling of Accounts

If you're going to have a successful business, you have to be able to open accounts. Beyond "smiling and dialing," you need to know what to do when you hook your first whale. Next, you need to get the account form filled out. The account form and conversations with your customers and potential customers help you make appropriate recommendations. Ideally, the securities you recommend will do well, and your customers will rent a van with a huge speaker on top so they can drive through town telling everyone how great you are.

In this chapter, I cover topics related to opening accounts. First, I help you understand the information required on a new account form. Then I go over investment objectives, cover margin accounts, and finally discuss when you can call potential customers. I also include a couple of example questions throughout the chapter and more practice questions at the end to give you an idea of potential questions you may see on the exam.

Following Protocol When Opening Accounts

The SIE examiners seem to be focusing more and more on the handling of customer accounts. You need to know what to do to open accounts, how to take customer orders, the rules for sending out confirmations, and so on.

Filing the facts on the new account form

When you're opening any new account for a customer, you first need to fill out a *new account form* — an internal document used to compile basic information about customers for compliance purposes. Getting this information is your responsibility (or the responsibility of the broker–dealer).

Here's a list of the items that need to be on the new account form:

- The name(s) and address(es) of the individual(s) who'll have access to the account as well as a trusted contact person age 18 or older (especially if the person opening the account is 65 or older) (A trusted contact person isn't mandatory but is highly encouraged.)
- The customer's date of birth (The customer must be of legal age to open an account.)
- Contact telephone number(s)
- Marital status and number of dependents (if any)
- Whether the person opening the account or any immediate family member is employed or associated with the securities industry, and if so, how
- The type of account the customer is opening (cash, margin, retirement, day trading, prime brokerage, delivery versus payment [DVP]/receive versus payment [RVP], advisory or fee-based, discretionary, options, and so on)
- The customer's Social Security number (if the customer is an individual) or tax ID number (if the customer is a business)
- The customer's occupation, employer, address of employer, and type of business (Certain limitations are placed on customers who work for banks, broker–dealers, insurance companies, self-regulatory organizations [SROs], and so on)
- Domestic or foreign residency and/or citizenship (including ID info per the customer's driver's license, passport, state ID, government ID, and so on)
- Bank references and the customer's net worth, liquid net worth, tax rate, and annual income
- Whether the customer is an insider of a company (By insider, I mean a senior officer, director, or individual who owns more than 10 percent of the issuer's voting shares.)
- Financial investment experience
- The signature of a principal (manager)

Broker–Dealers may, in accordance with the Patriot Act, also require a customer to provide proof of identification. The Patriot Act was enacted in 2001 to help identify and catch terrorists. As part of the Patriot Act, broker–dealers should

- Keep records of the information used to identify the customer via customer identification programs (CIPs). Financial institutions use CIPs to verify the identity of customers who want to conduct financial transactions.
- Verify that a customer doesn't appear on any list of known terrorists or terrorist organizations. (The Office of Financial Assets Control [OFAC], which is a U.S. Treasury Department Agency, keeps this list.)

REMEMBER

If anything changes (such as a customer's address or marital status), the new account form needs to be updated. Additionally, only individuals who are legally competent may open accounts — meaning you have to pay close attention to the investor's age and/or mental or physical ability. The Financial Industry Regulatory Authority (FINRA) has additional rules specifically put in place for older people and/or those with some sort of disability; these rules, regarding "financial exploitation of specified adults," are covered in Chapter 16.

TIP

In the course of filling out a new account form, be sure to ask whether your client is accredited. (See Chapter 14 for more on the topic of accredited investors.) If a client is, in fact, accredited, they're potentially able to handle more risk than non-accredited retail investors.

The following question tests your knowledge about opening a new account.

EXAMPLE

Which of the following people must sign a new account form?

I. The customer

II. The customer's spouse

III. The registered representative

IV. A principal

(A) I and II only

(B) IV only

(C) I and IV only

(D) I, III, and IV only

The correct answer is (B). When you're opening a new account for a customer, the new account form requires only a principal's (manager's) signature. Make sure you don't assume extenuating circumstances. Surprisingly, you need the customer's signature on a new account form only if the customer is opening a margin account. Additionally, you need the spouse's signature only if the account you're opening is a joint one. Because the question doesn't say that the account is a margin or joint account, you can't assume that it is.

Gathering other important customer info

REMEMBER

You should be able to gather the information you need for making recommendations based on the customer's account form and your conversations with the person. It is your duty to know your customer (also conveniently called the "Know-Your-Customer [KYC] Rule") so you can make recommendations that are suitable and are able to handle the account effectively. Your recommendations should be fair and reasonable based on the customer's profile and within the customer's financial ability. Basically, don't recommend buying $100,000 of (extremely risky) penny stocks to a customer who's risk-averse and has limited funds. In the event that your customer doesn't provide you with enough information to make an appropriate recommendation, you can still take unsolicited orders. Some of the things you should know (or attempt to find out) to make accurate recommendations are

- The customer's age
- Other investments they might have
- Their financial situation and needs (Are they buying a house soon or paying for one or more of their kids to go to college, for example?)
- Their tax rate (Municipal bonds are more suitable for investors with a high tax rate.)
- Their investment objectives, such as retirement funding, generating current income, preservation of capital, capital growth, total return (growth and income), tax-advantaged investments, liquidity, speculation, trading profits, and long-term versus short-term risk
- Their investment experience (How much do you need to explain to them?)
- Their time horizon (expected time to reach a financial goal, if any)

» Their risk tolerance (Should you recommend speculative securities or only safer ones?)
» Their liquidity needs (Should you recommend only securities that they can get in and out of easily?)

Word on the street: Street name accounts

A *street name account* is an account registered in the name of the broker–dealer with an ID number for the benefit of the customer. Most firms put new customer accounts in street name format to make trading easier. Street name accounts give the investor a certain degree of privacy and help facilitate the trading of securities because the brokerage firm, not the customer, signs the certificates.

REMEMBER

Because the securities are still owned by the investor, any gains and losses in the account are going to be the investor's, not the brokerage firm's.

You need to know a few rules about street name accounts for the SIE:

» You need a written statement from the customer attesting to the ownership of the account.
» With the exception of margin accounts, which must be in street name, a street name account may be changed by the customer to a regular account at any time.
» All margin accounts must be in street name.

Selecting the Appropriate Type of Account

Investors can open many types of accounts through a broker–dealer. Besides knowing a customer's investment profile, you also need a basic understanding of the types of accounts for the SIE exam. Fortunately, most of them are pretty straightforward.

Single and joint accounts

Some investors prefer to share; others like to go it alone. Whatever their preference, adults can open accounts that fit their needs:

» **Single (individual) accounts:** Naturally, this account is in the name of one person. The key thing for you to remember is that individuals may not open accounts in other people's names without written permission (power of attorney).
» **Joint accounts:** This account is in the name of more than one person. All individuals named on the account have equal trading authority for the account. For SIE exam purposes, you need to be familiar with two types of joint accounts:
  - *Joint tenants in common (JTIC):* With this type of account, when one tenant of the account dies, their portion of the account becomes part of their estate, which is governed by the decedent's will or state law. JTICs are usually set up for two or more unrelated investors. JTIC accounts are often set up for estate-planning purposes.

- *Joint tenants with rights of survivorship (JTWROS):* With this type of joint account, when a joint tenant named on the account dies, their portion of the account passes on to the surviving joint tenant(s). These accounts are usually set up almost exclusively for married couples or otherwise related persons. In states where *community property laws* exist (currently, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), investments acquired during the marriage are automatically presumed to be jointly owned by both spouses.

The following question tests your knowledge of account types.

EXAMPLE

All the following people may open a joint account EXCEPT

(A) two friends

(B) a husband and wife

(C) a parent and minor son

(D) three people who work together

The right choice here is (C). A joint account is an account in the name of more than one adult. Choices (A), (B), and (D) are all possible for joint accounts, but an account opened for a minor must be a custodial account, which I discuss in the next section.

Trust accounts

Trust accounts are managed by one party (the trustee) for the benefit of another party. A specific type of trust account that you're most likely to see on the SIE exam is a custodial account. A *custodial account* is set up for a child who's too young to have their own account. A custodian (adult) makes the investment decisions for the account. Any adult can open a custodial account for a minor, so the people named on the account don't have to be related although they're typically parents.

REMEMBER

Custodial accounts for minors are trust accounts and may be referred to on the SIE exam as UGMA or UTMA accounts because they fall under the Uniform Gifts to Minors Act or Uniform Transfer to Minors Act. A *UTMA account* is an extension of the UGMA account that allows gifts in addition to cash and securities to be transferred to the minor. The additional gifts allowed are art, real estate, patents, and royalties.

Additionally, because the minor is too young to make investment decisions for themselves, some rules are specific to custodian accounts:

- There can only be one custodian and one minor per account.
- The minor is responsible for the taxes. (The minor's Social Security number is registered for the account.)
- The account is registered in the name of the custodian for the benefit of the minor. (The custodian is responsible for endorsing all certificates.)
- The account can't be held in street name (in the name of the broker–dealer with an ID number; see the earlier section "Word on the street: Offering numbered accounts").
- Because of the additional risk, securities can't be traded on margin or sold short.
- Anyone may give a gift of cash or securities to the minor. The gift is irrevocable (can't be refused by the custodian).

- If an account receives rights, the custodian can't let the rights expire. (See Chapter 6 formore info on rights.) Because rights have value, a custodian can exercise or sell the rights.

REMEMBER

UGMA accounts are for minors, so as soon as a minor reaches the age of majority, which is determined by the minor's state of residence, the UGMA account is terminated, and the account is transferred to a single account in the name of the (former) minor.

Discretionary accounts

Decision-making can be stressful, and some investors don't want to deal with it. With a *discretionary account*, an investor can give you (the registered rep) the right to make trading decisions for the account. All discretionary accounts need a *written power of attorney* signed by the investor, which gives trading authorization to the registered rep. Although this may sound wonderful, to keep reps honest, these discretionary accounts are scrutinized more than other accounts.

REMEMBER

If a customer places an order but doesn't specify the security, the number of shares or units, and/or whether the customer wants to buy or sell, you need a written power of attorney. If you don't have a written power of attorney, you can't do anything but decide when to place the order (timing). Suppose that one of your customers calls you and says that they want to sell 100 shares of ABC common stock, and you believe you can get them a better price later in the day. The customer can give you verbal permission to place the order at your discretion. This type of order is called a *market not held order* and is usually good only for the rest of the day.

Here are some specific rules for discretionary orders that you're likely to see on the SIE exam:

- Each discretionary order must be marked as *discretionary* on the order ticket.
- As with other orders, principals must sign each order ticket.
- A principal needs to review discretionary accounts regularly to make sure reps don't trade excessively to generate commissions — a practice referred to as*churning*.

REMEMBER

A *fiduciary* is anyone who can legally make decisions for another investor. Examples of fiduciaries are custodians (UGMA accounts), a registered rep having power of attorney, an executor of an estate, a trustee, and so on. Fiduciaries are subject to the *Prudent Man* or *Prudent Investor Rule*, which means that they must invest the principal client's money in securities designated by their state's *legal list*. As you can imagine, legal lists are filled with safer investments. If their state does not have a legal list, fiduciaries should invest in securities that only a prudent person who's seeking reasonable income and preservation of capital would invest in.

Corporate accounts

Only incorporated businesses can open corporate accounts. If you're opening a corporate account, you need to obtain the tax ID number of the corporation, which is similar to an individual's Social Security number. Additionally, you need to obtain a copy of the *corporate resolution*, which lets you know whom you should be taking trading instructions from (so you don't get a call like "Hi, I'm Joe Blow, the janitor for XYZ Corporation, and I'd like to purchase 1,000 shares of ABC for our company").

If a corporation wants to open a margin account (accounts that entail borrowing some money from the broker–dealer to purchase securities; see the "Cash or margin account" section later in the chapter), you also need a copy of the corporate charter (bylaws). The corporate charter has to state that the corporation is allowed to purchase securities on margin.

REMEMBER

An *unincorporated association* (sometimes called a *voluntary organization*) is a group of two or more individuals who form an organization for a specific purpose (in this case, investing). If an unincorporated association has too many characteristics of a corporation, such as having a board of directors, limited liability, and so on, it may be treated and taxed at a higher rate, as though it were a corporation.

Institutional accounts

Accounts setup by institutions such as banks, mutual funds, insurance companies, pension funds, hedge funds, and investment advisers are considered institutional accounts. Their role is to act as specialized investors on behalf of others.

Partnership accounts

Two or more individual owners of a business that's not set up as a corporation may set up a partnership account. All partnerships must complete a partnership agreement, which the broker–dealer has to keep on file. The *partnership agreement,* like a corporate resolution, states who has trading authorization for the account so you know whom you're supposed to be taking orders from.

REMEMBER

Accounts can be opened for many reasons other than to just buy and sell stocks. They may be opened to trade options (which I cover in Chapter 11), or they may be opened to provide a family member with a means to pay for their education (such as the Section 529 savings plans I discuss in Chapter 8); or maybe they're set up to provide income for retirement. (Chapter 15 has the inside information on retirement income.) In addition, if you're registered as an investment adviser, you may be setting up a fee-based account rather than one in which you make a commission on trades (see the following section). No matter which type of account you open, unless you're otherwise directed by the client, portfolio diversification is key.

Cash or margin account

When one of your clients is opening a *cash account,* it means that they must pay for each trade in full. It doesn't mean that they have to drop off a suitcase full of cash; the trades are typically paid for via check or wire transfer. When a customer opens a cash account, they cannot purchase securities on margin.

INVESTMENT ADVISERS

If you're working for a broker–dealer as an agent, you'll receive commission when one of your clients makes a trade using your expert services. However, there is a different way to make money other than commission (or markups or markdowns, if your employer trades securities from inventory). More and more broker–dealers are requiring their agents to get a Series 66 (for those with a Series 7 license) or 65 license, which allows them to receive a fee for giving investment advice. To do so, you have to pass an exam and be registered as an investment adviser under the Investment Advisers Act of 1940. Advisers must have a written contract that explains to clients how and when fees will be charged. Fees may be charged as a percentage of managed assets for every time the adviser offers services or as wrap fees, whereby a client is charged fees for unlimited trading, advice, and/or custody of funds and securities. People who provide investment advice that is incidental to their business (teachers, accountants, lawyers, and so on) do not have to register as investment advisers.

Working with Margin Accounts

You don't necessarily need to have all of the funds available to buy securities. Thanks to the wonder of *margin accounts*, you can borrow money from a broker–dealer to purchase securities or borrow the securities themselves. Margin accounts allow customers to buy more securities (or sell more securities short) from you (as a registered rep) than they otherwise would, thus leading to more money in your pocket (a greater commission). This is a great thing if the margined securities are going the customer's way because it can increase their potential profit substantially. However, margin accounts are not without an additional degree of risk (which a lot of people found out back in 1929 when the market crashed and many economists blamed the crash on the number of securities purchased on margin). Margin accounts are great if the securities held in the account are going in the right direction but horrible if they aren't.

Disclosures and agreements: Getting margin paperwork out of the way

Because purchasing or selling short on margin involves extra risk, all customers must receive a *risk disclosure document*, which outlines those risks and some of the broker–dealer's rules. Besides receiving the margin risk disclosure document, the customer must sign a *margin agreement* before any securities can be purchased or sold short on margin. The margin agreement is broken down into three main sections:

- **The credit agreement:** Because the investors are borrowing money from the broker–dealer to purchase the securities, they're going to be charged interest on the money borrowed. The required credit agreement discloses the terms for that borrowing, including the interest rate charged, the broker–dealer's method of computation, and situations under which the interest rate may change.
- **The hypothecation agreement:** This required agreement states that all the margined securities must be held in street name (in the name of the broker–dealer for the benefit of the customer). In addition, it allows the broker–dealer to use a portion of the customer's margined securities as collateral for a bank loan *(rehypothecation).* The hypothecation agreement also allows the broker–dealer to sell securities from the account in the event that the customer's equity falls below a certain level. When the securities held in a margin account go in the wrong direction, customers lose equity at a much faster rate than those who purchased the securities for cash.
- **The loan consent form:** The optional loan consent form gives permission to the broker–dealer to loan a customer's margined securities to other investors or broker–dealers, typically for the short sale of securities.

REMEMBER

Besides receiving the paperwork listed previously, investors opening margin accounts also receive a *margin risk disclosure document*. Some of the things included in that document let the client know that they can lose more money than deposited into the margin account, the firm can force the sale of securities or other assets in the account without contacting the client, the client cannot choose which securities in the account are liquidated, the firm can increase the house maintenance requirement in the account at any time, a client is not entitled to additional time to meet a margin call, and so on.

Introducing long and short margin accounts

As the heading here says, at this point, I'm only introducing long and short margin accounts. You will need to know some basics for the SIE exam, but a majority of the calculations related to margin accounts will be covered in some top-off exams like the Series 7.

In margin accounts, investors either borrow some money to buy securities or borrow the securities themselves. As a result, margin accounts come in two varieties: long and short.

As you may remember, *long* means *to buy.* With a *long margin account,* the customer buys securities by coming up with a certain percentage of the purchase price of the securities (typically 50 percent) and borrowing the balance from the broker–dealer. These optimistic investors are hoping for a bull market, because they want to sell the securities sometime later for a profit.

With a *short margin account,* an investor is borrowing securities to immediately sell in the market. The process sounds a bit backward, but the investor is selling things they don't actually own yet. Ideally, for this bearish customer, the price of the security will decrease so the investor can purchase the shares in the market at a lower price and then return them to the lender. The basics of buying low and selling high are there, but you're hoping to sell high before buying low.

REMEMBER

When a customer buys securities, they can purchase the securities in a cash or margin account, but when a customer sells short securities, the transaction *must* be executed in a margin account.

Regulation T: Following the Fed's rules for purchasing margin accounts

The Securities Exchange Act of 1934 gives the Federal Reserve Board (FRB) the authority to regulate the extension of credit to customers in the securities industry. In addition to Regulation T (see the following section), the FRB decides which securities can be purchased on margin. (Chapter 13 can tell you more about the FRB and its role in influencing money supply.)

Regulation T is the Federal Reserve Board rule that covers the credit broker-dealers may extend to customers who are purchasing securities. Currently for margin accounts both long and short, Regulation T (Reg T) requires customers to deposit at least 50 percent of the current market value of the securities purchased on margin, and the balance is borrowed from the broker–dealer.

REMEMBER

Regulation T is currently set at 50 percent; however, firms not willing to take as much risk may increase the *house margin* requirement to 55 percent, 60 percent, 65 percent, and so on. When you're taking the SIE and subsequent exams, you should assume 50 percent unless the question states a different percentage.

Regulation T applies not only to margin accounts, but also to cash accounts. (See Chapter 16.) When customers are purchasing securities in cash accounts, they have a certain number of business days to pay for the trade. This delay is an extension of credit; therefore, it falls under Regulation T.

Reg T also identifies which securities can be purchased on margin and which ones can't.

Making margin call

A *margin call* (also known as a *Fed call, federal call,* or *Reg T call*) is the broker–dealer's demand for a customer to deposit money in a margin account when purchasing or shorting (selling short) securities. If a customer is buying securities on margin, the customer may deposit fully paid securities in lieu of cash to meet the margin call.

For both long and short margin accounts, the margin call is the dollar amount of securities purchased (or shorted) multiplied by Regulation T (50 percent). So, for example, if an investor purchases $50,000 worth of securities on margin, the margin call would be $25,000. Here's how you figure that:

$$\text{margin call} = \text{the current market value of the securities} \times \text{Reg T}$$
$$\text{margin call} = \$50,000 \times 50 = \$25,000$$

Opening a margin account: The initial requirements

The initial margin requirements for short and long accounts apply to the *first* transaction in a margin account only. After the account is established, the investor can purchase or short securities just by depositing Regulation T of the current market value of the securities purchased or shorted.

For an initial purchase in a margin account, customers must deposit a minimum of equity in their margin accounts. Currently, Regulation T calls for a minimum deposit of 50 percent of the current market value of the securities purchased or sold short. However, the Financial Industry Regulatory Authority (FINRA) and the New York Stock Exchange (NYSE) call for a minimum deposit of $2,000 or for the customers to pay for the securities in full. (See the section "Starting long accounts," later in this chapter, for more on how this works.)

TIP

When you're taking the SIE, pay attention to the wording of the question. Phrases like "opens a margin account," "in an initial transaction in a margin account," and so on indicate that the question is asking for the initial margin requirement rather than a margin call. (See the preceding section for info on margin calls.)

REMEMBER

The following sections are based on the initial margin requirements for regular long and short margin accounts. If an investor wants to open a *day trading account*, the initial margin requirement is $25,000, and the investor must keep at least $25,000 in equity to continue trading. A day trading (pattern day trader) account is one in which the investor buys and sells the same security on the same day or sells short and buys the same security on the same day at least four times in five consecutive days.

Starting long accounts

To open a long margin account, the customer is required to deposit Regulation T or $2,000, whichever is greater. The exception to this rule occurs when a customer is purchasing less than $2,000 worth of securities on margin. In this case, the customer pays for the transaction in full. It certainly wouldn't make sense for a customer to purchase $1,000 of securities on margin and pay $2,000 when they could pay $1,000 if it were purchased in a cash account. Even if the customer pays in full, the account is still considered a margin account because the customer can make future purchases on margin as soon as they have more than $2,000 in equity.

Table 12-1 shows you how Regulation T and the FINRA/NYSE requirements affect how much customers have to deposit when opening long margin accounts.

REMEMBER

In short, here's how much an investor has to deposit:

Purchase Price	Amount Owed
Initial purchase < $2,000	Full purchase price
$2,000 ≤ initial purchase ≤ $4,000	$2,000
Initial purchase > $4,000	Reg T (50% of market value)

TABLE 12-1 Deposit Requirements for Long Margin Accounts

Dollar Amount of Purchase	Regulation T Requirement	FINRA/NYSE Requirement	Amount Customer Must Deposit
$6,000	$3,000	$2,000	$3,000
$3,000	$1,500	$2,000	$2,000
$1,000	$500	$1,000	$1,000

Opening short accounts

The minimum deposit for short accounts is fairly easy to remember. The $2,000 minimum required by the FINRA and NYSE applies to short margin accounts. Because of the additional risk investors take when selling short securities, the $2,000 minimum always applies, even if the customer is selling short only $300 worth of securities. In this case, the customer must deposit 50 percent of the current market value of the securities or $2,000, whichever is greater. Here's the breakdown:

Shorting Price	Amount Owed
Initial sale ≤ $4,000	$2,000
Initial sale > $4,000	Reg T (50% of market value)

Obeying the Telephone Consumer Protection Act of 1991 (Telephone Act of 1991)

Because this chapter is about opening customer accounts, it makes sense to cover the Telephone Act of 1991. So if you're opening the account, you likely called them first unless you happen to be one of those blokes or blokettes lucky enough to have a customer call you to open an account. To make sure that certain standards are used when calling potential customers (such as not calling them at midnight), the Telephone Act of 1991 was created. When you're dealing with *potential customers* on the phone, you need to know these rules:

- You can't make calls before 8 a.m. or after 9 p.m. local time of the potential customer.
- You have to give your name, company name, company address, and phone number.
- If you get a potential customer who's tired of being called, you should place that person on a *do not call list.* Each firm must maintain its own do not call list and have the U.S. government's National Do Not Call List available.
- Although fax machines are becoming more obsolete, you may not send unsolicited ads by fax machine.

REMEMBER

The Telephone Act of 1991 *does not* apply to existing customers (customers who have executed a trade or had a security in the firm's account in the previous 18 months) or calls from nonprofit organizations. Existing customers who want to be placed on the "do not call" list after opening an account cannot be solicited but can be updated on the status of their account.

Testing Your Knowledge

Okay, so you're feeling good about what you need to know for the SIE about different types of accounts. Here's a ten-question quiz to test your expertise. Good luck!

Practice questions

1. AylDec Corporation would like to open a margin account at Guess Right Broker–Dealer. To open the account, Guess Right would need

   I. to fill out a new account form
   II. a copy of the corporate resolution from AylDec
   III. a copy of the corporate charter from AylDec
   IV. a signed copy of the margin agreement

   (A) II and IV
   (B) I and IV
   (C) I, II, and IV
   (D) I, II, III, and IV

2. In an initial transaction in a margin account, Alyssa Hudson purchases 100 shares of Hopeful Corporation common stock at $12 per share. How much must Alyssa deposit to meet the margin requirement?

   (A) $600
   (B) $1,200
   (C) $2,000
   (D) Cannot be determined

3. All of the following are true about UGMA accounts EXCEPT

   (A) parents of a minor can be joint custodians.
   (B) securities held in the account cannot be sold short or traded on margin.
   (C) gifts of securities to the minor are irrevocable.
   (D) they can't be held in street name.

4. Which of the following DOES NOT have to be included on a new account form?

   (A) The customer's signature
   (B) The registered representative's signature
   (C) The customer's marital status and number of dependents
   (D) The customer's bank references

5. According to the Telephone Act of 1991, which of the following is TRUE?

   (A) You may not make calls to potential customers before 8 a.m. or after 9 p.m.
   (B) You may not make calls to potential customers before 8 a.m. or after 9 p.m. local time of the customer.
   (C) You may not make calls to potential customers before 9 a.m. or after 8 p.m.
   (D) You may not make calls to potential customers before 9 a.m. or after 8 p.m. local time of the customer.

6. Which of the following documents are required for an investor opening a margin account?

I. A credit agreement

II. A hypothecation agreement

III. A loan consent form

(A) I and II

(B) I and III

(C) II and III

(D) I, II, and III

7. Which of the following are TRUE?

I. If an investor of a joint tenants with rights of survivorship account dies, their portion of the account is transferred to their estate.

II. If an investor of a joint tenants with rights of survivorship account dies, their portion of the account is transferred to the remaining account holder(s).

III. If an investor of a joint tenants in common account dies, their portion of the account is transferred to their estate.

IV. If an investor of a joint tenants in common account dies, their portion of the account is transferred to the remaining account holder(s).

(A) II and IV

(B) I and IV

(C) II and III

(D) II and IV

8. A customer opens a short margin account by selling short 200 shares of DIM common stock at $17 per share. What is the margin call?

(A) $1,700

(B) $2,000

(C) $3,400

(D) Cannot be determined

9. To make proper recommendations to a client, you should know their

I. age

II. time horizon

III. tax bracket

IV. liquidity needs

(A) I and IV

(B) II and III

(C) I, III, and IV

(D) I, II, III, and IV

10. The Patriot Act requires broker–dealers to identify their investors through

(A) CIPs

(B) DIMs

(C) LLPs

(D) All of the above

11. The tax ID of _______________ is required for the opening of an UTMA account.

(A) both parents

(B) at least one parent

(C) the minor

(D) the custodian

12. John Smith has a joint account with sisters Mirabelle and Elyse. If the account was set up as a joint with tenants in common, which of the following is true?

(A) Since John and siblings are not married, they could not have set up an account as joint with tenants in common.

(B) John and the two sisters must share equally in the assets of the account.

(C) If any of the siblings die, that individual's portion of the account is divided equally among the two remaining siblings.

(D) Ownership of the decedent's assets in the account are governed by their will (if any) or by the laws in the state in which they live.

Answers and explanations

1. **D.** For any new account, a new account form must be filled out by the broker–dealer. Because this is a margin account, a margin agreement must be signed and the broker–dealer must obtain a copy of the corporate charter (bylaws), which would need to state that the corporation is allowed to purchase or sell short on margin. In addition, because the account is a corporate account, you need to know who in that corporation has the authority to trade the account; that's where the corporate resolution comes in.

2. **B.** The key to this question is that it is an initial transaction in a margin account. So in this case, the customer purchased $1,200 (100 shares × $12) of securities. Reg T (50 percent) of that amount would be $600 ($1,200 × 50%). That would be the correct answer if it were an existing margin account. Because Alyssa is just opening the margin account, however, Alyssa would either have to deposit the Reg T amount if over $2,000, $2,000, or pay in full if the purchase is less than $2,000, which in this case it is. Therefore, Alyssa would have to deposit $1,200.

3. **A.** Regarding UGMA (Uniform Gifts to Minors Act), you can only have one minor and one custodian per account. So in this case, even though the minor may have two parents, they can't be joint custodians.

4. **A.** Although the registered representative's and principal's signatures have to be on a new account form, the customer's does not. This allows the registered rep to make a trade with a customer right away without having to have the customer fill out, and ideally return, the new account form.

5. **B.** The rule is that you can't call potential customers (cold calling) before 8 a.m. or after 9 p.m. local time of the customer. If a potential client doesn't want to be called anymore, you must place them on your firm's do not call list.

6. **D.** The credit agreement, hypothecation agreement, and loan consent form are all part of the margin agreement that must be signed by new clients who want to open a margin account. In the event that it is a corporation that is opening the margin account, you would also need a corporate charter (bylaws), which would spell out whether the corporation was allowed to buy or short securities on margin.

7. **C.** When an investor of an account set up as joint tenants with rights of survivorship dies, their portion of the account goes to the remaining survivor(s). This is the type of account typically set up by a married couple. If the account is set up as joint with tenants in common, if an investor dies, their portion of the account would go to their estate.

8. **B.** Because this investor is opening a short margin account, they must deposit either the Reg T amount or $2,000, whichever is greater. Because 50 percent of the Reg T amount ($3,400 × 50% = $1,700) is less than $2,000, this investor must come up with $2,000 to meet the call.

9. **D.** Besides the information required on a new account form, you should gain any knowledge about your client that you can to help you make better investment recommendations. The customer's age is important because, in most cases, the older people get, the less risk they should take. So for older investors, you may want to rebalance their portfolio so they have more debt securities than a younger investor would. The time horizon is typically the amount of time until someone retires, but it could be something like the number of years until the investor plans on buying a house and so on. The tax bracket is important because

if the tax bracket is high, you may want to recommend tax-advantaged investments like municipal bonds. Liquidity needs are how easy it is for the investor to sell the securities in a hurry if needed. In this case, you wouldn't recommend investments like limited partnerships.

10. **A.** As part of the U.S. Patriot Act, all broker–dealers are required to help identify terrorists or potential terrorists through CIPs (Customer Identification Programs).

11. **C.** An UTMA (Uniform Transfer to Minors Act) account is an account set up for a minor who (by law) is too young to make investment decisions on their own. It is an account set up for one minor and one custodian, who must make investment decisions in the best interest of the minor. All profits and/or losses in the account are the minors and, therefore, the firm is required to have the tax ID of the minor.

12. **D.** With a joint with rights of survivorship account, if one investor dies, the surviving individual(s) of the account would split the individual's portion of the account. However, with a joint with tenants in common account, if one investor dies, their portion of the account goes to their estate.

IN THIS CHAPTER

» Doing some fundamental analysis

» Showing what a technical analyst does

» Looking at the money supply

» Understanding economic indicators

» Reviewing some economic terms and principles you need to know

» Trying some practice questions

Chapter 13
Securities Analysis: Doing a Little Market Research

In terms of choosing securities, throwing darts at a list of stocks seems to have fallen out of favor. So has drawing company names out of a hat. But, hey, no problem. Your psychic powers may not be the most reliable, but you still have tons of tools that can help you get a good idea of where the market's heading and how certain securities may perform.

One of your main jobs as a registered representative is to figure out the best investments for your customers based on their investment objectives and your research. To help lead people down the path to riches, you have to analyze each customer's portfolio and the market and try to find a good fit. In many cases, firms hire analysts to provide registered reps investment information, which helps you (as the registered rep) determine the best recommendations for each customer.

In this chapter, I cover topics relating to securities analysis and money supply. The majority of this chapter is about analyzing companies and the market and seeing what happens with the money supply. Don't worry, though — I don't leave out technical and fundamental analysis. I just focus on the information that can help you get the best score on the SIE. At the end, you get to test your knowledge with a quick chapter quiz.

Getting to Know Your Securities and Markets: Securities Analysis Basics

Although many brokerage firms have their own analysts, you do need to know some of the basics of securities analysis to pass the SIE and corequisite exams. Besides, the more you know about securities analysis, the better you'll be able to understand the analysts and the more informed you'll sound when talking to your customers and potential customers. In this section, I cover investment risks that your customers face and show you the differences between technical and fundamental analysis.

Regarding systematic and nonsystematic risk

Investors face many risks (and many rewards) when investing in the market. You need to understand the risks because this knowledge cannot only make you sound like a genius, but also help you score higher on the SIE exam.

Systematic risk

Systematic (undiversifiable or market) risk is the risk that securities can decline due to political, social, or economic factors — changes in the economy, natural disasters, government policy, and so on. Examples of systematic risks are the housing crisis of 2008 and COVID-19, which started in 2020 and is still negatively affecting our economy. Systematic risk is a risk that could affect the whole market. Systematic risks include the following:

- **Market risk:** The risk of a security or securities declining due to regular market fluctuations or negative market conditions. All securities have market risk.
- **Interest rate risk:** The risk of bond prices declining with increasing interest rates. (Use the idea behind the seesaw from Chapter 7: When interest rates increase, outstanding bond prices decrease.) All bonds, even zero-coupon bonds, are subject to interest risk.
- **Reinvestment risk:** The risk that interest and dividends received will have to be reinvested at a lower rate of return; zero-coupon bonds, T-bills, T-STRIPS, and so on have no interperiod reinvestment risk (until maturity) because they don't receive interest payments.
- **Purchasing power (inflation or inflationary) risk:** The risk that the return on the investment is less than the inflation rate. As of the time of this writing, we're experiencing the worst inflation in more than 40 years. Long-term bonds (even Treasury bonds) and fixed annuities have high inflation risk. To avoid inflation risk, investors should buy stocks and variable annuities.

Nonsystematic risk

Nonsystematic (unsystematic, unique, or diversifiable) risk is more industry- or firm-specific. The good news is that this type of risk can be eliminated through diversification. You've probably heard the expression "Don't put all your eggs in one basket." Well, the same holds true for investing. Suppose that one of your customers has everything, or a large portion of their investment money, invested in DIMP Corporation common stock, and DIMP files for bankruptcy; now you have to tell your customer they've lost all (or at least a large portion of) their investment money.

- **Business risk:** The risk of a corporation failing to perform up to expectations.
- **Political (geopolitical) risk:** The risk that the value of a security could suffer due to instability or political changes in a country (such as the nationalization of corporations).
- **Default risk (Credit risk):** The risk of default or that the principal and interest aren't paid on time; Moody's, Standard & Poor's, and Fitch are the main bond-rating companies.
- **Regulatory risk:** The risk that changes in the regulatory climate (rulings by the Food and Drug Administration, Environmental Protection Agency, and so on) will have a detrimental affect on certain securities in the market.

- **Legislative risk:** The risk that changes in state or federal law will affect certain securities in the market.
- **Currency (exchange rate) risk:** The risk that an investment's value will be affected by a change in currency exchange rates; long-term investors who have international investments are the ones most affected by currency risk.

  REMEMBER

  Many investors buy and sell currencies in an attempt to take advantage of currency exchange rates. The initial currency to be traded (the base currency) would be exchanged for another currency (the counter currency). To determine the amount of counter currency they would receive, they would look at the spot exchange rate.
- **Liquidity (marketability) risk:** The risk that the security is not easily traded without affecting the price of the security; long-term bonds and limited partnerships have more liquidity risk.
- **Capital risk:** The risk of losing all money invested (for options [Chapter 11] and warrants [Chapter 6]); because options and warrants have expiration dates, purchasers may lose all money invested at expiration. To reduce capital risk, investors should buy high-quality stocks or investment-grade (higher rated) bonds.
- **Prepayment risk:** The type of risk mostly associated with real-estate investments such as mortgage-backed securities (Chapter 7); mortgage-backed securities have an average expected life when first issued, but if mortgage interest rates decrease, more investors will refinance, and the bonds will be pre-paid earlier than expected.
- **Timing risk:** The risk of an investor buying or selling a security at the wrong time, thus failing to maximize profits.

TIP

When taking the real exam and practice exams, you should always pay close attention to the investor's risk tolerance, financial considerations, nonfinancial considerations, and risk(s) mentioned in order to determine the best investment for a particular customer.

Strategies for mitigating risk

Certainly, all investments have a certain degree of risk. Younger investors, sophisticated investors, and wealthy investors can all afford to take more risk than the average investor. However, when you are talking to your clients, you should help them make decisions that will help them mitigate their risk. Those in charge of coming up with questions for the SIE exam would expect you to be able to navigate the whole risk topic effectively, so you can be sure that some questions will address the following topics directly.

Diversification

Consider again the customer mentioned in the earlier section "Nonsystematic risk" who has everything invested in DIMP Corporation common stock. All of a sudden, DIMP Corporation loses a big contract or is being investigated. Your customer could be wiped out. However, if your customer had a diversified portfolio, DIMP Corporation would likely be only a small part of their investments, and they wouldn't be ruined. This is the reason that having a diversified portfolio is so important.

There are many ways to diversify, including the following:

- **Geographical:** Investing in securities in different parts of the country or world.
- **Buying bonds with different maturity dates:** Buying a mixture of short-term, intermediate-term, and long-term debt securities.

- **Buying bonds with different credit ratings:** Purchasing high-yield bonds (bonds with a low credit rating, also known as *junk bonds*) in combination with highly rated bonds with lower returns so that you get a mixture of high returns with the safety of the highly rated bonds.
- **Investing in stocks from different sectors:** Assumingthat different sectors may perform better than others at certain times, it definitely makes sense to look at different sectors when considering which securities to buy. By spreading your investments out among these different sectors, you can manage your risk and ideally make a profit if one or more sectors happen to be performing well. Sectors include financials, utilities, energy, healthcare, industrials, technology, and so on.
- **Type of investment:** Investing in a mixture of different types of stocks, bonds, direct participation programs (DPPs), real estate, options, and so on.

TIP

There are certainly many more ways to diversify a portfolio than the ones listed previously; use your imagination. In addition, they aren't mutually exclusive. Remember that mutual funds (packaged securities) and exchange traded funds (ETFs) provide a certain amount of diversification within an individual holding. This is why smaller investors who may not be able to afford to diversify their portfolio are ideal candidates for mutual funds.

Portfolio rebalancing

Say that you and one of your clients determine that it is best for them to have a portfolio of 50 percent equity securities and 50 percent debt securities. After setting up and purchasing the portfolio, one year later, due to appreciation, your client has 60 percent in equity securities and 40 percent in debt securities. At that point, your client may decide to rebalance their portfolio by selling some equity securities and purchasing more debt securities to help maintain their original desired level of asset allocation (50–50). As a matter of fact, a subset of mutual funds known as *asset allocation funds* will rebalance the portfolio of securities held by the fund without needing to contact the shareholders.

REMEMBER

Typically, as investors age, they can't afford to take as much risk and should change their asset allocation to include fewer equity securities and more debt securities.

Hedging

I'm sure you've heard the saying "Hedge your bets." In the gamblers' world, this may mean taking insurance to protect oneself against the possibility of the dealer getting a 21 when playing blackjack. It means that you are trying to reduce your risk. The problem is that by doing so, you may be limiting your upside potential. In the investors' world, there are several ways to hedge, depending on what you're investing in.

You can hedge (protect) your investments against market volatility (the risk that the market will fluctuate in price) by having a diversified portfolio. In this case, although some of your investments may be subject to big swings in price, others will remain stable or increase when the market decreases. A well-diversified portfolio may include short- and long-term bonds of varying credit risk, cash equivalents (in other words, money market funds), all sorts of equity securities (value, growth, large-cap, small-cap, and so on), real-estate investments, commodities, precious metals, and so on.

To hedge against credit risk (the risk that bond issuers will default), you can purchase some more secure debt securities issued by the U.S. government (T-bills, T-notes, T-bonds, and so forth), debt securities issued by local governments (municipal bonds and municipal notes), debt securities by higher-rated corporations, and so on.

To hedge against the risk that a security doesn't keep pace with inflation, you can purchase stocks (best answer in for an SIE question), variable annuities, real estate, commodities (raw materials or agricultural products), or even Treasury Inflation-Protected Securities (TIPS).

REMEMBER

Just as there are many types of risk (as you can see in the previous sections "Systematic risk" and "Nonsystematic risk"), there are different ways to hedge against risk, depending on which risk you're concerned about. The preceding are just a few examples. Options can also be used to hedge against the risk of a security you own going in the wrong direction. The best way to limit risk for most investors is to have a diversified portfolio. You must also understand that in most cases, older investors can't afford to take as much risk. For SIE exam purposes, the main thing you need to remember is that *hedge* means to protect.

Deciding what to buy: Fundamental analysis

Although most analysts use some combination of fundamental analysis and technical analysis to make their securities recommendations, for SIE exam purposes, you need to be able to differentiate between the two types. This section discusses fundamental analysis; I cover technical analysis later in the section "Deciding when to buy: Technical analysis."

Fundamental analysts perform an in-depth analysis of companies. They look at the management of a company and its financial condition (balance sheets, income statements, the industry, management, earnings, and so on) and compare with other companies in the same industry. They can also compare many years of financial statements to help determine whether a company is heading in the right direction. In addition, fundamental analysts look at the overall economy and industry conditions to determine whether an investment is good to buy.

REMEMBER

In simplest terms, fundamental analysts decide *what to buy.*

A fundamental analyst's goal is to determine the value of a particular security and decide whether it's underpriced or overpriced. If they believe the security is underpriced, a fundamental analyst recommends buying the security; if they believe the security is overpriced, they recommend selling outright or selling the security short.

The following sections explain some of the fundamental analyst's tools of the trade and how to use them.

Balance sheet components

The *balance sheet* provides an image of a company's financial position at a given point in time. The SIE exam tests your ability to understand the components of a balance sheet (see Figure 13-1) and how financial moves that the company makes (buying equipment, issuing stock, issuing bonds, paying off bonds, and so on) affect the balance sheet. In general, understanding how a balance sheet works is more important than being able to name all the components.

REMEMBER

People call this statement a balance sheet because the assets must always balance out the liabilities plus the stockholders' equity.

Assets	Liabilities
Current assets Fixed assets Intangible assets	Current liabilities Long-term liabilities
	Stockholder's equity (net worth) Par value (common) Par value (preferred) Paid-in capital Treasury stock Retained earnings

FIGURE 13-1: Components of a balance sheet.

Assets are items that a company owns. They include

- **Current assets:** Owned items that are easily converted into cash within the next 12 months; included in current assets are cash, marketable securities, accounts receivable, inventory, and any prepaid expenses (like rent or advertising).

  Note: Fundamental analysts also look at methods of inventory valuation, such as *LIFO* (last-in-first-out) or *FIFO* (first-in-first-out). In addition, they look at the methods of depreciation, which are either *straight line* (depreciating an equal amount each year) or *accelerated* (depreciating more in earlier years and less in later years).
- **Fixed assets:** Owned items that aren't easily converted into cash; included are property, building(s), furniture, and equipment. Because many fixed assets wear down or become outdated over time, they can be depreciated (except for land). Therefore, accumulated depreciation is usually deducted from fixed assets.
- **Intangible assets:** Owned items that don't have any physical properties; included are items such as trademarks, patents, formulas, copyrights, goodwill, and so on. (Created when a corporation purchases or merges with another company, *goodwill* is the dollar amount paid above the fair market value to purchase that company.)

Liabilities are what a company owes. They may be current or long-term:

- **Current liabilities:** Debt obligations that are due to be paid within the next 12 months; included in current liabilities are *accounts payable* (what a company owes in bills), wages, debt securities due to mature, short-term *notes payable* (the balance due on money borrowed), declared cash dividends, and taxes.
- **Long-term liabilities:** Debt obligation due to be paid after 12 months; included in long-term liabilities are mortgages, bank loans, outstanding corporate bonds, and long-term notes.

Stockholders' equity (net worth) is the difference between the assets and the liabilities (basically, what the company is worth). This value includes

- **Par value of the common stock:** The arbitrary amount that the company uses for book-keeping purposes; if a company issues 1 million shares of common stock with a par value of $1, the par value on the stockholders' equity portion of the balance sheet is $1 million.
- **Par value of the preferred stock:** The value that the company uses for bookkeeping purposes (usually $100 per share but could be $25, $50, $1,000, or some other number); if the company issues 10,000 shares of preferred stock at $100 par, the par value of the stockholders' equity portion of the balance sheet is $1 million.

REMEMBER

Unlike common stock, preferred stock has a par value that is typically $100 and a stated dividend rate; preferred stock shareholders would also receive money prior to common stockholders in the event of corporate bankruptcy.

- **Additional paid-in capital:** The amount over par value that the company receives for issuing stock; if the par value of the common stock is $1 but the company receives $7 per share, the additional paid-in capital is $6 per share. The same theory holds true for the preferred stock.
- **Treasury stock:** Stock that was outstanding in the market but was repurchased by the company.
- **Retained earnings:** The amount of net earnings the company holds after paying out dividends (if any) to its shareholders.

Income statement components

An income statement tells you how profitable a company is currently. *Income statements* list a corporation's expenses and revenue for a specific period of time (quarterly, year-to-date, or yearly). When comparing revenue and expenses, you should be able to see the efficiency of the company and how profitable it is.

Again, I don't think you need to actually see a detailed income statement from a company, but knowing the components of an income statement is important. Take a look at Figure 13-2 to see how an income statement is laid out. Most of the items are self-explanatory.

Net sales
\- Cost of goods sold (earnings before interest, taxes, depreciation, and amortization) (EBITDA)
\- Operating expenses (including depreciation)
Operating profit (earnings before interest and taxes) (EBIT)
\- Interest expenses
Taxable income (earnings before taxes) (EBT)
\- Taxes
Net income (earnings after taxes) (EAT)
\- Preferred dividends
Earnings available to common stockholders
\- Common dividends
Retained earnings

FIGURE 13-2: Components of an income statement.

Deciding when to buy: Technical analysis

Technical analysts look at the market to identify patterns and measure indicators in an attempt to predict whether the market and/or particular securities will become or remain bullish or bearish. They look at trend lines, trading volume, market sentiment, market indices (Standard & Poor's [S&P] 500, Dow Jones Industrial Average [DJIA], and so on), options volatility, market momentum, available funds, index futures, new highs and lows, the advance-decline ratio, odd lot volume, short interest, put-to-call ratio (options trading), and so on. These analysts believe that history tends to repeat itself and that past performance of securities and the market indicate its future performance.

REMEMBER

Fundamental analysts decide *what to buy,* and technical analysts decide *when to buy* (timing).

Technical analysts chart not only the market, but also market sectors and individual securities. Technical analysts try to identify market patterns and patterns of particular securities in an attempt to determine the best time to purchase or sell. Even though a security's price may vary a lot from one day to another, the prices tend to head in a particular direction (up, down, or sideways) and create a *trend line* over a period of time.

Benchmarks and indices

If you watch news stations, read the newspaper, listen to the radio, and so on, you can't help but see or hear about the DJIA or the Nasdaq being up or down. Well, those are indices (indexes) or benchmarks. Benchmarks are typically used to evaluate the performance of individual investments or a group of investments. Most investors compare their investments with certain broad-based or narrow-based indices:

- **Narrow-based:** Narrow-based indices indicate the performance of a particular industry such as the Dow Jones Transportation Index.
- **Broad-based:** Broad-based indices are more indicative of the overall market. Broad-based indices measure securities from many industries.

TIP

There are certainly more indices than the ones listed, but for SIE exam purposes, you shouldn't need to memorize them — mainly understand what indices are and that they are often used as benchmarks.

Here are examples of some of the broad-based stock indices:

- **S&P 500 Index:** Includes 500 large-cap (companies that have a market capitalization above $10 billion) common stocks.
- **Wilshire 5000 Total Market Index:** The largest of all stock indexes; includes 5,000 listed common stocks.
- **Russell 2000 Index:** An index of 2,000 small-cap (companies that have a market capitalization between $300 million and $2 billion) companies.
- **Lipper Indexes:** Track the financial performance of different mutual funds based on their investment strategy; each Lipper Index tracks the performance of only the largest fund in each category (large-cap growth, mid-cap value, international fund, and so on).
- **Dow Jones Composite Average:** An index that tracks 65 stocks from some of the most prominent companies; the Dow Jones Composite is broken into
  - *Dow Jones Industrial Average (DJIA):* Tracks 30 stocks from the industrial sector; the DJIA is the index most commonly used to indicate the performance of the market in general.
  - *Dow Jones Transportation Average:* Tracks 20 stocks from the transportation sector
  - *Dow Jones Utility Average:* Tracks 15 stocks from the utility sector

TIP

Proponents of the *Dow Theory* believe that major market trends are confirmed if the Dow Jones Industrial Average and the Dow Jones Transportation Average are trending in the same direction (that is, both advancing or both declining). Logic dictates that if industrial companies are producing more goods, those same goods need to be transported.

Most of the indices listed here are weighted toward larger companies. This means that price movement of the larger companies has a greater impact on the particular index than a smaller company does.

Stages of the business cycle

The business cycle is the natural rise and fall of goods and services (gross domestic product, or GDP) that occur over time. The business cycle has four phases that will occur over and over:

- **Expansion** (*A* in Figure 13-3): *Expansion* is characterized by increasing demand for goods and services. During expansion, the stock market is generally increasing (bullish), property values are increasing, and industrial production is increasing. Expansion also can be characterized as recovery.
- **Peak** (*B* in Figure 13-3): The *peak* occurs at the top of the expansion phase and happens right before the economy starts to contract.
- **Contraction** (*C* in Figure 13-3): *Contraction* is characterized by higher levels of consumer debt, a stock market that is generally decreasing (bearish), a decreasing demand for goods and services, and an increasing number of bond defaults and bankruptcies.
- **Trough** (*D* in Figure 13-3): *Trough* is the lowest part of the contraction phase and happens right before the economy starts to expand (recover) again.

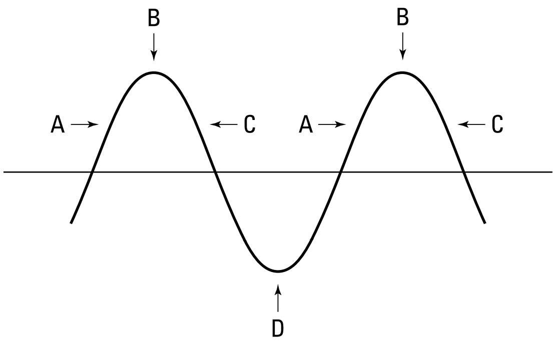


FIGURE 13-3: The four phases of the business cycle.

TIP

If asked to place these phases in order on the SIE exam, you can put them in order just as they're given in the preceding list.

Bullish versus bearish

When thinking of whether the market is bullish or bearish, think of the terms. You can think of bullish as charging ahead. So, if the market is bullish, it is generally increasing in value. If the market is bearish, it is generally hibernating or sleeping. When the market is bearish, it is generally decreasing in value.

Individuals can be bullish or bearish on the market in general or bullish or bearish on certain securities.

- **Bullish** strategies include buying individual stocks, buying mutual funds, buying call options, selling uncovered (naked) put options, and so on.
- **Bearish** strategies include selling short individual stocks, buying bearish funds (funds that generally increase in value in a declining market), buying inverse exchange-traded funds (ETFs), selling uncovered (naked) call options, buying put options, and so on.

Following the Green: Money Supply and Monetary Policy

The money supply heavily affects the market. If the money supply is higher than average, typically interest rates go down, people usually borrow more money, and people spend more money. That all sounds great, but the situation can lead to some negatives, such as higher inflation and the weakening of U.S. currency in relation to foreign currency. The Federal Reserve Board (the Fed or FRB) tries to do a balancing act to help the economy grow at a slow and steady rate. This section deals with how the money supply affects the market and the tools that the Fed uses to control the money supply.

REMEMBER

The Fed controls the monetary policy, but the *fiscal policy* is controlled by government politicians (the House, the Senate, and ultimately signed by the president). The fiscal policy is typically included in budget decisions and includes how much the U.S. government will borrow (and how), how much it will spend (and on what), how much money will be raised through taxes, and so on.

TIP

To put it in a nutshell, so to speak, you can think of monetary and fiscal policies like this:

- Monetary policy = money supply, interest rates
- Fiscal policy = borrowing, spending, taxes

Influencing the money supply

Changes in money supply can affect rates of economic growth, inflation, and foreign exchange, so knowing a bit about monetary policy can help you predict how certain securities will fare and how interest rates will change. Take a look at Table 13-1 to see what easing and tightening the money supply can do.

TABLE 13-1 Effects of Easing and Tightening the Money Supply

Category	Easing the Money Supply	Tightening the Money Supply
Economy	Easy money helps the United States avoid or get out of a recession. Consumers can borrow money at lower interest rates.	High interest rates slow the economy down because people aren't spending and investing as much money; the rate of small-business failure increases.
Market	As a result of lower interest rates, investors have more money to invest and can purchase more goods. Additionally, businesses don't have to pay as much interest to borrow money, which increases their profits. Both elements can lead to a bullish market.	High interest rates hurt the market because investors don't have extra money to invest. Additionally, corporations have to pay higher interest on loans and, therefore, report lower earnings. The market becomes bearish.
Inflation	Lower interest rates lead to higher inflation. If companies see that customers are spending money freely, they raise their prices.	A tighter money supply helps curb high inflation.
Strength of the U.S. dollar	The U.S. dollar weakens. U.S. exports increase because foreign currency strengthens (people can trade fewer units of foreign currency for more dollars); therefore, buying U.S. products is cheaper for foreign consumers. However, the U.S. dollar loses value for purchasing foreign goods, so foreign imports decrease.	The value of the U.S. dollar rises in relation to foreign currency. The U.S. dollar is subject to supply and demand, so if our money supply is tight, the value of our currency increases. Because the U.S. dollar is strong, importing foreign goods is cheaper for U.S. companies. However, U.S. exports decline because buying U.S. goods becomes more expensive for foreign companies.

When the money supply is eased (resulting in *easy money*), interest rates in general decrease. The Fed can ease the money supply by

- Buying U.S. government securities in the open market
- Lowering the discount rate, reserve requirements, and/or Regulation T (although changing Reg T isn't likely)
- Printing U.S. currency

Occasionally, the Fed has to tighten the money supply. (Remember that the Fed wants the U.S. economy to grow at a slow, steady pace.) When the money supply is tightened (resulting in *tight money*), interest rates across the board increase. The Fed can tighten the money supply by

- Selling U.S. government securities (pulling money out of the banking system)
- Increasing the discount rate, increasing reserve requirements, and/or raising Regulation T

The following section tells you more about these tools.

Opening the Federal Reserve Board's toolbox

The Fed has the authority on behalf of the U.S. government to lend money to banks; it determines the interest rate charged to banks for these loans. You probably remember the chairman of the Fed (currently, Jerome Powell) coming on TV to announce an increase or decrease in the *discount rate* (the rate the Fed charges banks for loans) and what a big deal it was. The rate the Fed charges affects the rates banks charge one another and their public customers. Because banks charge customers higher rates than the Fed charges banks, the Fed policy affects consumers as well (through credit card fees, mortgage loans, auto loans, and so on):

Fed \$ → banks \$ → customers \$

The Fed has a few tools in its arsenal to help control the money supply. (The preceding section explains the effects of tightening and easing the supply.) Here's what you need to understand about these tools for the SIE:

- **Open market operations:** Besides the printing of money, this is the tool the Fed uses most often. *Open market operations* are the buying or selling of U.S. government bonds or U.S. government agency securities to control the money supply. Open market operations are performed by the Federal Open Market Committee (FOMC). If the Fed sells securities, it pulls money out of the banking system; if the Fed purchases securities in the open market, it puts money into the banking system.
- **The discount rate:** This value is the rate that the 12 Federal Reserve Banks charge member banks for loans. If the discount rate increases, the money supply tightens; by contrast, if the discount rate decreases, the money supply eases.
- **Reserve requirement:** The *reserve requirement* is the percentage of customers' money that banks are required to keep on deposit in the form of cash. In line with the theory of supply and demand, if the Fed increases the reserve requirement, banks have less money to lend to customers, so interest rates increase.
- **Regulation T:** *Reg T* is the percentage that investors must pay when purchasing securities on margin (see Chapter 12 for details). Regulation T is currently set at 50 percent, and it doesn't change very often. If the Fed raises the rate, investors have less cash, which tightens the money supply.

HOW THE FED IS SET UP

Here's a quick lesson in government: Congress established the Federal Reserve System in 1913 to stabilize the country's chaotic financial system. The Fed controls our money supply and, therefore, our economy.

The nation is divided into 12 Federal Reserve Districts, each with its own bank. Each bank prints currency to meet the business needs of its district, and each district is distinguished by a letter printed on the face of the bill.

The Federal Reserve Board in Washington is the parent organization that oversees and controls each of the 12 Federal Reserve District Banks. The members of the board, including the chairman, are nominated by the president of the United States, subject to confirmation by the Senate.

Exchange rates

Exchange rates are the rates at which one currency can be converted to another. As you can imagine, exchange rates are constantly changing as the value of currency in different countries appreciates, stays the same, or depreciates. Some investors even speculate in foreign currencies, hoping to be able to purchase a foreign currency when its value is low in the hope that it will appreciate so that they can sell it at a higher value. Certainly, many things can affect the value of a currency, such as a change in a country's social policies, taxing policies, economy, government, and so on.

TIP

You can assume for SIE exam purposes that the value of the U.S. dollar and foreign currency go in opposite directions. The exchange rate is considered to be a *floating rate* because it changes constantly.

U.S. balance of payments

The U.S. *balance of payments* (BoP) is an accounting of the United States' economic transactions with the world over a given period of time (typically quarterly or annually). The balance of payments may show a deficit (more money flowing out of the United States than in) or a credit (more money flowing into the United States than out). As such, the value of our currency (strong or weak dollar) greatly affects our balance of trade and, thus, the U.S. BoP.

If the U.S. dollar is strong in comparison with other currencies, it will be cheaper for Americans to buy foreign goods and services. Thus, more money will likely be going out of the United States.

If the U.S. dollar is weak in comparison with other currencies, it will be cheaper for foreign corporations, governments, individuals, and so on to purchase U.S. goods and services. As a result, more money will be flowing into the United States.

Reading Economic Indicators

Economic indicators are statistics that help show the performance or direction of the economy and help predict the direction of the economy in the near future. The economic indicators are broken into leading indicators, coincident indicators, and lagging indicators.

TIP

For the following section, you should pay attention to the indicators toward the top of each indicator list because those are the ones most likely to be tested.

Leading indicators

Leading indicators are statistics that indicate how the economy is going to (or likely to) do in the future. Leading indicators include

- M2 money supply — the Federal Reserve's estimate of cash people have on hand plus, money available in checking accounts, savings deposits, money market instruments, and so on
- Stock prices
- Fed funds rate (rates that depository institutions [banks and credit unions] charge each other for overnight loans)
- Discount rate (the rate the Fed charges banks for loans)
- Reserve requirements (the percentage of customer deposits that the banks must hold)
- Housing; new construction (building permits)
- Unemployment claims
- Average hours per workweek
- Orders for durable goods (those not for immediate consumption)
- Consumer sentiment
- Yield curves (lines that plot interest rates for bonds of different maturities)

Coincident (coincidental) indicators

Coincident (coincidental) indicators are statistics that indicate how the economy is performing right now. Coincident indicators include

- Industrial production
- Personal income
- GDP
- Number of employees on nonagricultural payrolls and employment levels
- Retail sales

Lagging indicators

Lagging indicators are statistics that mirror leading indicators but reach their peaks and troughs somewhat later. Lagging indicators include

- The prime rate (the rate that banks charge their best customers for loans)
- Outstanding industrial and commercial loans

- Corporate profits
- Ratio of consumer credit to personal income
- Duration of employment — in other words, how long people stay at their jobs before they retire, become unemployed, or move on to a new job
- Unemployment rate
- Ratio of inventories to sales

GDP and GNP: Measuring goods and services

As you can imagine, gross national product (GNP) and gross domestic product (GDP) are closely related terms. When you are taking the SIE exam, you should understand the difference between the two. Because the SIE is mainly taken by U.S. residents, I focus on the GDP and GNP in U.S. terms. Certainly, the better the GNP and the GDP, analysts would see that as a good sign.

- **GDP:** To cut the information down to what you need to know for the SIE exam, think of the GDP as the total of all goods produced and all services provided by the United States in a one-year period.
- **GNP:** GNP includes the GDP plus the investments made by U.S. businesses and residents inside and outside the United States. However, the GNP doesn't count income earned by foreign businesses or residents in the United States. It also excludes products from overseas firms manufactured in the United States.

Because inflation occurs over time, the GDP and GNP are measured in *constant dollars,* which includes the cost of inflation. This is necessary to help determine whether the economy is expanding or contracting from year to year.

How Economic Factors Affect Securities

Economic factors affect securities differently. When taking the SIE exam, you are expected to understand how the economy affects *cyclical, defensive,* and *growth* companies.

Cyclical

A *cyclical* corporation is one in which the performance depends on the economy. If the economy is expanding, cyclical companies will do well. If the economy is contracting, cyclical companies will be heavily affected. Some examples of cyclical corporations are household appliances, automobile companies, tourism, construction, and manufacturing. Obviously, when the economy is not doing well, people will wait to buy that new refrigerator or that new car, wait to go on vacation, and so on. As such, cyclical companies' stock will likely decrease, and these companies may have problems paying interest on their debt securities.

Countercyclical stocks such as fast food, auto parts, discount retailers, and other investments such as precious metals may actually do better as the economy gets worse.

Defensive

Defensive corporations are ones whose sales remain relatively stable no matter how the economy performs. The corporations offer products or services that people will purchase even in a contracting economy. Examples of defensive companies include utilities, food, clothing, alcohol, tobacco, and cosmetics.

Growth

Growth companies, such as technology companies, are ones that are growing at a more rapid pace than comparable companies or the market as a whole. Growth companies are typically the newer companies and are more likely to do extremely well during periods in which the economy is expanding, but they underperform other stocks, such as value stocks, when the economy is contracting and the market is bearish. Because growth companies invest a lot of money back into their business, they typically don't pay much (or anything) in dividends.

Your Principal Economic Theory Primer

Economists follow principal economic theories. These theories are important because the administration that's in power typically nominates people to help run our economy who share their same beliefs. Economists typically believe in one of these theories, and there has been much debate about which one is best for the economy. Fortunately for you, you don't have to figure that out; you only need to understand the basics of each theory to help you pass the SIE exam. This list describes the three main economic theories that economists usually follow.

- **Keynesian (demand side):** The basis of the Keynesian theory is that government intervention through fiscal policy is good to help stimulate consumer demand for goods and services. Keynesian policy typically involves raising taxes, enabling deficit spending, borrowing money, and printing currency.
- **Supply side (Reaganomics):** Supply-side economics is the theory that the government should remain relatively inactive and the economy will grow by itself. According to this theory, the less regulation and the lower the taxes are, the more businesses will reinvest and the more people they will hire.
- **Monetarist:** Monetarists believe that the economy's performance is largely determined by the money supply (controlled by the Fed). The money supply can be used to fight inflation or to stimulate the economy.

Testing Your Knowledge

This chapter, probably more than any other one, requires you to think about what happens. What happens, for example, if the Fed raises interest rates? Or what happens if a company's liabilities increase? This type of analysis is important because it helps analysts and investors decide which securities to buy or sell.

As with other chapter questions, I try to give you a wide variety of potential questions you may see on the exam.

Practice questions

1. Which of the following are defensive industries?

   I. Utilities
   II. Tourism
   III. Household appliances
   IV. Food

   (A) I and IV
   (B) II, III, and IV
   (C) II and III
   (D) I, II, III, and IV

2. All of the following are examined by a fundamental analyst EXCEPT

   (A) earnings per share
   (B) balance sheets
   (C) the industry
   (D) timing

3. All of the following are bearish positions EXCEPT

   (A) buying inverse ETFs
   (B) selling uncovered call options
   (C) selling short
   (D) selling naked put options

4. Which of the following best describes the discount rate?

   (A) The interest rate that banks charge one another for overnight loans
   (B) The interest rate that the banks charge their best customers for loans
   (C) The interest rate that the Fed charges banks for loans
   (D) The interest rates charged in margin accounts

5. Melissa wants to invest in a retirement plan that protects against purchasing power risk. Which of the following would be the most suitable investment?

   (A) Municipal bonds
   (B) Common stock
   (C) Variable annuities
   (D) Fixed annuities

6. Looking at the stages of the business cycle, if the economy is expanding, what stages would you expect to follow, in order from first to last?

I. Trough
II. Peak
III. Contraction

(A) I, II, III
(B) II, III, I
(C) III, II, I
(D) I, III, II

7. Which TWO of the following actions may the Fed take to ease the money supply?

I. Purchase T-bills
II. Sell T-bills
III. Increase reserve requirements
IV. Decrease reserve requirements

(A) I and III
(B) I and IV
(C) II and III
(D) II and IV

8. All of the following are leading indicators EXCEPT

(A) the prime rate
(B) M2 money supply
(C) the discount rate
(D) stock prices

9. Which of the following is measured in constant dollars?

(A) The Fed funds rate
(B) The M2 money supply
(C) The prime rate
(D) GDP

10. Proponents of the Dow Theory look at

(A) the Dow Jones Composite Average and the DJIA
(B) the Dow Jones Utility Average and the Dow Jones Transportation Average
(C) the DJIA and the Dow Jones Transportation Average
(D) the Dow Jones Composite Average and the Dow Jones Utility Average

11. Zero-coupon bonds have no

(A) reinvestment risk
(B) purchasing power risk
(C) market risk
(D) interest risk

12. All of the following can be found on a corporation's balance sheet EXCEPT

(A) fixed assets
(B) long-term liabilities
(C) retained earnings
(D) net income

13. Which of the following is a way an investor can diversify investments?

(A) Geographically
(B) Investing in stocks from different sectors
(C) Purchasing bonds with different maturity dates
(D) All of the above

14. A holder of which of the following securities is the most exposed to inflationary risk?

(A) U.S. Treasury bonds with ten years until maturity
(B) U.S. Treasury bills with one year until maturity
(C) Stocks issued by a utility company
(D) Pharmaceutical stocks

15. A registered representative from Missed Again Securities is reviewing one of their client's portfolios. They see that the client has 35 percent invested in TUV Energy Company, 15 percent invested in ETFs tracking the S&P 500, 35 percent in LMN Healthcare Company, 15 percent in U.S. government securities, and 10 percent in money market funds. Which of the following risks are built into this portfolio?

(A) Liquidity risk
(B) Political risk
(C) Credit risk
(D) Nonsystematic risk

16. Which of the following risks apply to both domestic and foreign debt securities?

(A) Regulatory
(B) Political
(C) Interest rate
(D) All of the above

17. The greatest investment risk that an investor would face when purchasing a variable annuity is

(A) interest rate risk
(B) market risk
(C) purchasing power risk
(D) credit risk

Answers and explanations

1. **A.** Defensive industries are ones that are pretty much resistant to economic downturns. These include utilities, food, clothing, alcohol, tobacco, cosmetics, and so on. Tourism and household appliance–related companies suffer during economic downturns and, therefore, are considered to be cyclical companies.

2. **D.** Fundamental analysts look at and compare companies. They do an in-depth analysis to help professionals decide which companies would be good or bad investments. So fundamental analysts help decide what to buy, whereas technical analysts look at the market and help professionals decide when to buy (timing).

3. **D.** Bearish strategies are ones in which you want the price of the security to decrease. Bearish strategies include selling short, buying bearish funds, buying inverse exchange-traded funds, selling uncovered (naked) call options, and so on. Selling naked (uncovered) put options is actually a bullish strategy because the investor who holds that position wants the price of the underlying security to increase.

4. **C.** The discount rate is the rate that the Fed charges banks for loans. These loans are typically overnight loans taken by banks to help them meet their reserve requirements.

5. **C.** You can cross off (A) and (B) right away because stocks and bonds are not retirement plans. Out of the two annuity plans, variable annuities do not have purchasing power (inflation) risk because the return is based on the performance of the securities held in the separate account. Ideally, the securities will outperform the rate of inflation.

6. **B.** If the economy is expanding, you would expect it to hit a peak at some point. After reaching the peak, the economy would start to contract until hitting the lowest point, which is the trough. After that, you would expect it to start all over again.

7. **B.** The Fed has a few tools to help ease or tighten the money supply including open market operations, adjusting the discount rate, changing reserve requirements, and raising or lowering Regulation T requirements. Of the choices given, the two that would ease (add money to) the money supply would be inserting money into the system by purchasing U.S. government securities like T-bills and lowering reserve requirements (the percentage of customer deposits banks have to hold each night).

8. **A.** Leading indicators are those that help give an indication of how the economy is going to do. The main leading indicators are M2 money supply, stock prices, the Fed funds rate, and the discount rate. The prime rate — the rate that banks charge their best customers for loans — is a lagging indicator. Lagging indicators go the same direction as the leading indicators but arrive a little later.

9. **D.** Both the GDP and GNP are measured in constant dollars. When measuring in constant dollars, they are factoring inflation into the equation to see whether the economy is actually expanding or contracting year to year.

10. **C.** Proponents of the Dow Theory logically believe that major market trends are confirmed if both the DJIA and the Dow Jones Transportation Average are going the same direction. In other words, companies not only have to be making a lot of goods, but also have to be transporting those goods to be considered a positive sign.

11. **A.** Reinvestment risk is the additional risk taken with interest or dividends received. Zero-coupon bonds are issued at a discount and mature at par value. These bonds do not make interest payments along the way, so there is nothing to reinvest.

12. **D.** The balance sheet is just a snapshot of the net worth (stockholders' equity) of a company. The balance sheet includes the company's assets, liabilities, and stockholders' equity. Net income is derived from a company's income statement. The income statement looks at a company's income minus expenses.

13. **D.** Diversification helps investors mitigate investment risk. All the choices listed are ways investors can lessen risk. When dealing with clients, you should always help them diversify their portfolio. It's the old "don't put all of your eggs in one basket" theory.

14. **A.** Inflationary risk (purchasing power risk) is the risk that inflation can pose to a security or portfolio over time. Treasury bonds (T bonds) have a longer maturity, and if inflation kicks in, the Fed is likely to raise interest rates. If interest rates increase, outstanding bond prices decrease. Longer-term bonds are affected more than shorter-term bonds, like Treasury bills.

15. **D.** This investor has 70 percent of their portfolio invested in two different companies (35 percent in TUV and 35 percent in LMN). Therefore, this customer has nonsystematic (unsystematic or diversifiable) risk built into their portfolio. Nonsystematic risk is the risk that a particular company or industry might do poorly and bring the value of the portfolio down substantially. Obviously, you would look at this portfolio and say that the investments in U.S. government securities, money market funds, and ETFs provide a certain degree of safety. However, those investments are only 30 percent of their portfolio. Therefore, you would likely recommend that the other 70 percent should be spread out to more than two companies.

16. **D.** All of the choices listed can apply to both domestic and foreign debt securities. Regulatory risk is the risk that law changes will affect the market. Political risk is the risk that politics in a particular country could negatively affect securities. Interest rate (money rate) risk is the risk that bond prices will decline due to increasing interest rates.

17. **B.** The greatest investment risk that an investor will face when purchasing a variable annuity is market risk. Variable annuities have a separate account where an investor chooses the securities held. The securities held in the account are subject to market risk, which is the risk that the securities can decline due to negative market conditions.

IN THIS CHAPTER

» Understanding the differences between the primary and secondary markets

» Comparing stock exchanges to the over-the-counter market

» Seeing the role of the broker–dealer

» Looking at order qualifiers

» Getting to know market participants

» Taking a chapter quiz

Chapter 14
Securities Markets: Taking Orders and Executing Trades

Part of your function as a registered rep will be to understand and explain to customers (and potential customers) how the stock market works. I designed this chapter with that in mind (along with the fact that you need to know this stuff for the SIE, of course).

In this chapter, I cover the basics of exchanges and the over-the-counter (OTC) market, along with some of the active participants who help the market run smoothly (at least most of the time). Pay particular attention to the sections "Reviewing basic order types" and "Factoring in order features," because you'll definitely use that information every day after you pass the SIE and corequisite tests. The chapter wraps up with a short quiz.

Shopping at Primary and Secondary Markets

Depending on whether the securities are new or outstanding, they trade in either the primary or secondary market. This section deals with the differences between the two.

Buying new in the primary market

The primary market (new issue market) is where the issuer receives the proceeds from the sale of securities. This market's offerings are broken into two categories, depending on whether the company has ever issued securities before. A security that has never been offered or sold to the public is considered a *new issue.* Here are the three types of offerings on the primary market:

- **Initial public offering (IPO):** An IPO is the first time a corporation ever sells stock to the public to raise money. When a corporation is in the process of issuing securities for the first time, it's said to be *going public*. So, an IPO is the first primary offering.
- **Primary offering:** A primary offering is the issuer market, where the issuer is selling shares to raise money. Certainly, an IPO falls into that category. However, the corporation usually holds shares back for future use; it later pulls those securities out of storage and sells them in a subsequent (add-on, additional, or follow-up) offering, which is also a primary offering. A corporation may be authorized to sell 2 million shares of common stock, but in its IPO, it may sell only 800,000. At this point, 1.2 million new shares remain that have never been offered to the public. One year later, when the company needs to raise additional capital to build a new warehouse, it can sell some of the remaining 1.2 million shares in a subsequent primary offering.
- **Combined (split) offering:** This type of offering is a combination of new securities and a large block of outstanding or previously outstanding securities.

When securities are sold in the primary market, the bulk of the sales proceeds goes to the issuer and the balance goes to the entity or entities responsible for selling the securities to the public — the underwriter(s) and selling group members (if any) in other words.

Buying used in the secondary market

When the securities are already trading in the market, the sales proceeds go to another investor instead of to the issuer. The securities sold in a secondary distribution consists of selling already issued and outstanding shares. The secondary market, also called the *aftermarket*, consists of the following categories (see the following section for info on trading on exchanges versus OTC markets):

- **Second market:** Issued securities trading on an exchange. Auction market.
- **Third market:** The third market is the over-the-counter (OTC) market, where prices are negotiated, and there is no central location for trading. Any securities that can trade in the second market can also trade in the third market.
- **Fourth market:** The fourth market is the trading of securities between institutions without the use of a brokerage firm. Fourth-market trades are typically executed through electronic communication networks (ECNs) such as Instinet.

TIP

You're more likely to get a question on the third or fourth market than the first or second.

Making the Trade

After securities are issued publicly, they may trade on an exchange or on the OTC market.

Auctioning securities at securities exchanges

Exchanges are auction markets, where bidders and sellers get together to execute trades. I'm sure you've seen movies or TV shows featuring the NYSE. It definitely looks very chaotic (and like it's a good place to have a heart attack or develop an ulcer). However, some sort of order is definitely there:

- All exchanges have a trading floor where all trades are executed.
- Each security listed on an exchange has its own *trading post* (location) on the floor where the auction takes place.
- Brokers looking to purchase shout out and/or make hand signals to indicate the price they're willing to spend to buy a particular security.
- Sellers in turn shout out the price they're willing to sell a security for.
- If buyers and sellers can come to an agreement, a trade is made.

The main exchange that the SIE tests you on is the NYSE, also known as the Big Board or Exchange, but there are others, such as NYSE Amex Equities (formerly the American Stock Exchange [AMEX]), Nasdaq, Chicago Board Options Exchange (CBOE), Boston Stock Exchange (formerly BSE, now Nasdaq OMX BX), and so on.

Listed securities are ones that satisfy minimum requirements and are traded on a regional or national exchange like the NYSE. Listed securities may trade on the exchange or in the OTC market discussed in the following section.

Although thousands of people may seem to be on the floor of the exchange, you don't need to be aware of too many titles. Most of the people on the floor of the exchange fall into one of three categories:

- **Floor brokers:** These individuals act as agents in executing buy or sell orders on behalf of their firms' customers. A floor broker may also facilitate buying and selling for their firm. Floor brokers receive buy or sell orders from their firms and either transfer the orders to a designated market maker (see below) or trade with another floor broker.
- **Two-dollar brokers (independent brokers):** These brokers assist other floor brokers in getting their orders executed on busy days. (By the way, they're called *two-dollar brokers* because many, many years ago, they used to receive $2 per trade. Commissions may have gone up a bit since then.)
- **Designated market makers (DMMs; formerly specialists):** These market professionals manage the auction market trading for a particular security (or for a few securities, if not actively traded). Their purpose is to maintain a "fair and orderly market" in one or more securities. A DMM can act as a broker or a dealer (trading out of their own account) to help keep trading as active as possible. An important function of a DMM is to keep track of and execute limit orders on behalf of other exchange members.

Negotiating trades over the counter

Unlike exchanges, the OTC market is considered a negotiated market. Instead of yelling out bid and ask prices, traders buy and sell securities by way of telephone or computer transactions.

There's no central location for trading OTC securities. Instead, traders use the Over the Counter Bulletin Board (OTCBB), which is a quotation service operated by FINRA for unlisted (non-Nasdaq) securities. OTCBB shows bid and ask prices of securities unable to meet the listing requirements for Nasdaq.

Corporations too small to be placed on the OTCBB may still sell their securities in the *Pink Market* (better known as *Pink Sheets* to some). Corporations on the Pink Market are not required to meet the listing requirements or file with the SEC.

Thousands of securities — both listed and unlisted — are traded OTC. In fact, *unlisted securities,* which aren't listed on an exchange, can only trade OTC. Unlisted securities are ones that either don't meet the listing requirements of the exchanges or that the corporation decided it didn't want to list for whatever reason.

REMEMBER

U.S. government and municipal bonds trade only OTC.

OTC market makers

Unlike exchanges where they have designated market makers, the OTC market has none. However, some firms (dealers) will make a market for particular securities and be willing to trade to and from their own inventory. If they wish to make a market in a security, they must receive FINRA's approval. OTC market makers create the inside market by offering to buy and sell securities. The inside market is the highest bid price (the most a market maker is willing to pay) for a security and the lowest ask or offer price (the most a market maker is willing to accept) for a security. In the NASDAQ system, you typically have several market makers for one security. Take a look at what happens when you have several market makers entering quotes for ABCD common stock:

Market Maker	BID	ASK	Size
DK Broker-Dealer	18.30	18.75	5 x 10
Golden Hammer BD	18.25	18.80	20 x 3
Cardinal Wing Securities	18.35	19.05	7 x 14

By looking at this chart, you can see that three market makers have entered quotes for LMNO Common stock as well as the size (how many round lots they're willing to buy and/or sell). To determine the inside market, look at the highest bid price, which was entered by Cardinal Wing Securities, and the lowest ask price, which was entered by DK Broker-Dealer. For LMNO, the inside market is currently 18.35–18.75. Looking at a Level I machine in the brokerage firm, you would see only the name of the security and the inside market price. If you were to give a quote to customers, you would have to let them know it's a subject quote (subject to change) because as buy and sell orders are placed, the inside market will change.

REMEMBER

If you were placing an order to buy, you would buy at the lowest ask price. If you were placing an order to sell, you would sell at the highest bid price. The size of the market relates to how many round lots (100 shares) each market maker is willing to trade. So, if you look at DK Broker-Dealer, they're wanting to purchase five round lots (500 shares) and sell ten round lots (1,000 shares).

Understanding the Role of a Broker–Dealer

I would guestimate that a large percentage of people taking the SIE exam will be working for a broker–dealer. For a firm to be considered a broker–dealer, it must buy and sell securities from its own account and act as a middleman for securities not in inventory. Here are the differences between brokers and dealers:

* **Broker:** A firm is acting as a broker when it doesn't use its own inventory to execute a trade. A broker charges a *commission* (sales charge) for acting as a middleman between a buyer and a seller.

  REMEMBER

  For SIE exam purposes, the terms *broker* and *agent* may be used interchangeably. A registered representative is sometimes called an agent or stockbroker because they act as an intermediary between buyers and sellers.

* **Dealer:** A firm is acting as a dealer when it uses its own inventory to execute a trade. When a dealer sells securities to a customer using its own inventory, it charges a *markup* (sales charge). When a dealer buys securities from a customer for its own inventory, it charges a *markdown* (reducing the price a customer receives by charging a sales charge). A firm becomes a dealer in the hopes that the securities it has in its own inventory will increase in price so that the dealer can benefit from the appreciation and subsequent sale of the securities.

  The terms *dealer, principal,* and *market maker* may be used interchangeably on the SIE and corequisite exams.

Capacity refers to whether a firm is acting as a broker (agent) or dealer (principal), and it must always be disclosed on the *confirmation* (receipt of trade). If a firm is acting as a broker, the commission always needs to be disclosed on the confirmation. However, if a firm is acting as a dealer, the markup or markdown doesn't always have to be disclosed.

REMEMBER

A firm can't act as a broker and a dealer for the same trade. In other words, charging a markup (or markdown) and a commission on the same trade is a violation. (For info on rules and regulations, see Chapter 16.)

TIP

To help you remember the differences between a broker and a dealer, think of a real-estate broker. A real-estate broker (or agent) acts as an intermediary between sellers and buyers and charges a commission, just like a stockbroker does. Conversely, a dealer, like a used-car dealer, sells from their own inventory, charges a markup, and buys in the hopes of making a profit on that inventory.

An introducing broker

An introducing broker (IB) is a person or business that does not actually handle the transactions but just provides investment advice or counsel to investors. In general, an introducing broker will recommend trades to clients while handing over the job of executing the trade to a clearing firm. (See the next section.) In general, the IB and the clearing firm that executes the trade split the trading fees and/or commission.

A clearing (carrying) broker

Clearing brokers (clearing firms) handle orders to buy and sell securities. In addition, clearing brokers maintain custody of clients' assets (securities and cash). Clearing firms are responsible for segregating (separating) clients' cash and securities held in their custody.

A prime broker

Prime brokers are used mainly by institutional accounts or large retail clients. Prime brokerage accounts are ones set up for individuals or entities with more-complex financial needs. Besides helping the client combine information from all firms they are using into one statement, they also provide services such as lending, leveraged trade execution, and cash management. Often, hedge funds use a prime brokerage account.

Receiving and Executing Customer Orders

Here's where the rubber meets the road. You can receive several types of orders from customers along with numerous order qualifiers. This section explains the types of orders and how to execute them.

REMEMBER

Unlicensed associated persons *cannot* receive or execute orders for customers. In addition, they cannot discuss securities, recommend securities, talk about investment objectives, and so on. However, they may send out paperwork, answer phonecalls, and so on. In order to discuss investment objectives, take orders, execute trades, and so on, the person must be licensed.

Reviewing basic order types

You can definitely expect a question or two on the SIE exam relating to *orders* (you know, the buying and selling kind). The following sections explore the most common order types.

Market order

A market order is for immediate execution at the best price available. A majority of the orders that you'll receive will be market orders. Here are the varieties they come in:

- **Buy order:** When an investor places a market order to buy, they're not price-specific; the investor purchases the security at the lowest ask price (the lowest price at which someone's willing to sell the security). An investor who's purchasing a security wants the price to increase (after the sale, of course) and is establishing a bullish position.
- **Sell order:** When an investor places a market order to sell, they're not price-specific; they sell the security at the highest bid price (the highest price someone's willing to pay for the security).

Note: As with exchanges, the difference between the highest bid price and lowest ask (offer) price in the OTC market is known as the *spread*. Typically, the narrower the spread, the more actively traded the security.

REMEMBER

For investors looking to make a profit when they believe the price of a security is going to drop, there's always *selling short*. Selling short occurs when an investor sells securities they don't actually own. (The investor is actually borrowing securities from a lender to sell.)

Here's how selling short works: Say an investor borrows 100 shares of ABC stock and sells them short at $40 per share, thus receiving $4,000. The borrower doesn't owe the lender $4,000; they owe the lender 100 shares of ABC stock. After a month or two, when ABC is trading at $20 per share, the borrower can purchase the 100 shares for $2,000 and return them to the lender, making a nice $2,000 profit (excluding commission costs).

A short seller is bearish (wants the price of the security to decrease). If the price increases instead, the short seller has to buy the stock in the market at a higher price, thus losing money. Remember that all short sales must be executed in margin accounts. Short sales are subject to short-sale regulations under Regulation SHO. (See the nearby sidebar.)

Note: Investors may sell short for *speculation* (believing the price of the security will decrease), *hedging* (protecting a security or several securities in the event of a market decline), or *arbitrage* (taking advantage of a price disparity on the security in different markets).

REGULATION SHO AND SHORT SALES

According to Regulation SHO, which covers the short sale of securities, all order tickets must be marked as *short sale* rather than *long sale*. (In this context, a long sale is one in which a customer is selling securities they actually own, rather than securities they've only borrowed.) Additionally, all brokerage firms must establish rules to locate, borrow, and deliver securities that are to be sold short. Brokerage firms must be sure that the security can be located and delivered on the date the delivery is due before executing the short sale.

REMEMBER

When you purchase a security, the most you can lose is the amount you invest. When you short a security, your maximum loss potential is unlimited because the price of the stock could keep climbing, in which case you'd have to spend more money to cover your short position. Additionally, because of the additional risk, all short sales must be executed in a margin account. Chapter 12 tells you a little more about margin accounts.

Stop order

A stop order is used for protection; it tries to limit how much an investor can lose. (On the other hand, it can also be used to lock in gains.) Depending on whether an investor has a long or short stock position, they may enter a buy stop order or a sell stop order:

- **Buy stop orders:** These orders protect a short position (when an investor sells borrowed securities). A buy stop tells you to buy a security if the market price touches a particular price or higher. Investors who are short the stock make money when the price of the stock decreases; however, if the price increases, they lose money. An investor who's short ABC stock currently trading at $25 could enter a buy stop order on ABC at $30. If ABC reaches $30 or more, the order is triggered, and the order becomes a market order for immediate execution at the next available price.
- **Sell stop orders:** These orders protect a long position (when an investor owns the stock involved); they tell you to sell a security if the market price touches a particular price or lower. Investors who are long stock make money when the price of the stock increases; if the price decreases, they lose money. Say an investor who is long DEF stock currently trading at $50 enters a sell stop order on ABC at $45. If DEF reaches $45 or below, the order is triggered, and the order becomes a market order for immediate execution at the next price, whether higher or lower than $45.

Limit order

A customer who's specific about the price they want to spend or receive for a security places a limit order; this order says the customer doesn't want to pay more than a certain amount or sell for less than a certain amount. Depending on whether an investor is interested in buying or selling, they can enter a buy limit or a sell limit order:

- **Buy limit orders:** Investors who want to purchase a security place these orders. A buy limit order is a directive to buy a particular security at the limit price or lower. Suppose DEF stock is trading at $35 per share but one of your customers doesn't want to pay more than $30 per share. You could place a buy limit order at $30. If the price of DEF ever reaches $30 or less, chances are good that your customer will end up with the stock.

- **Sell limit orders:** Investors who want to sell a security place sell limit orders. A sell limit order is a directive to sell a particular security at the limit price or higher. Suppose one of your customers owns LMN stock, which is currently trading at $62 per share, but they want to receive at least $70 per share if they're going to sell it. This customer could place a sell limit on LMN at $70 per share. If LMN touches or goes above $70 per share, chances are good that the stock will be sold.

Stop limit order

A *stop limit order* is a combination of a stop and limit order (see the preceding sections); it's a buy stop or sell stop order that becomes a limit order after the stop price is reached. An order that reads "sell 1,000 HIJ at 41 stop, 40.75 limit" means that the sell stop order will be triggered as soon as HIJ reaches $41 or below (the stop price). If this were just a stop order, the stock would be sold on the next trade (no matter what the price). But because this is a stop limit order, after the order is triggered, it becomes a limit order to sell at $40.75 or above (the limit price). In other words, this customer is interested in selling their stock if it drops to $41 but wants to receive at least $40.75 per share.

REMEMBER

Because stop and limit orders are price-specific, they may or may not be executed. Additionally, even if limit orders do reach or surpass the limit price, the order may not be executed if more orders were placed ahead of the investor's order.

Factoring in order features

Besides knowing the basic types of orders (market, stop, and limit; see "Reviewing basic order types"), you should have a handle on some additional features that may be added to the order to make your customers happy. A lot of them exist, but for the most part, the name of the order feature pretty much explains what it is:

- **Day:** If a day order hasn't been filled by the end of the trading day, it's canceled. All price-specific orders (stop and limit) are assumed to be day orders unless marked to the contrary. Most of the orders you'll receive will be market orders for immediate execution at the best price available (highest bid and lowest ask prices).
- **Good-'til-canceled (GTC):** Good-'til-canceled orders are also called *open orders* because the order is kept open until executed or canceled. Say that an investor wants to purchase ABC stock at $30. While the price of ABC is at $35, they enter an open buy limit order for ABC at $30. If the price of ABC ever hits $30 or below, the order will likely be executed; however, if the price of ABC never hits $30 or below, the order stays open until canceled.

  Note: An investor may specify that they want the order canceled next week, next month, in two months, and so on. Many exchanges no longer take GTC orders, but customers can place them with their broker–dealers, and they will handle it internally. In actual practice, because customers may forget about their GTC orders, many broker–dealers will set them to expire in 30 days, 60 days, 90 days, and so on.
- **Not held (NH):** This order gives the broker discretion about when to execute the trade. Typically, investors use not held orders when the broker believes they can get the customer a better price later in the day.

  Not held orders deal only with timing. For registered reps to choose the security, number of shares, and/or whether to buy or sell, the customer needs to open a discretionary account, which requires a written power of attorney. See "Discretionary versus nondiscretionary orders," later in this chapter, for details.

- **Fill or kill (FOK):** This order instructs a floor broker either to immediately execute an entire order at the limit price or better or to cancel it.
- **Immediate or cancel (IOC):** These limit orders are similar to FOK orders except that the order may be partially filled. Any portion of the order that's not completed is canceled.
- **All-or-none (AON):** These limit orders have to be executed either in their entirety or not at all. AON orders don't have to be filled immediately (several attempts to fill the order completely are allowed) and may be day orders or good-till-canceled orders.
- **At-the-open:** These orders are to be executed at the security's opening price. At-the-open orders can be market or limit orders, but if they aren't executed at the opening price, they're canceled. These orders allow for partial execution.
- **At the close (market on close):** This order is to be executed at the closing price (or as near as possible). If this order isn't completed, it's canceled.
- **Do not reduce (DNR):** This order says not to reduce the price of a stop or limit order in response to a dividend. Say that QRS stock is currently trading at $50 on the day prior to the ex-dividend date (the first day the stock starts trading without a previously declared dividend). If QRS previously announced a $0.50 dividend, the next day's opening price would be $49.50. If a customer had placed a DNR limit order to buy 1,000 shares of QRS at $45, the order wouldn't be reduced by the $0.50 dividend.
- **Alternative:** The alternative order is also known as a *one cancels the other order* or an *either/or order*. This type of order instructs the broker to execute one of two orders and then cancel the other. Say Smith owns stock at $60 per share. They enter a sell stop order at $55 for protection and a sell limit order at $70 in the event that the stock price increases. If one of the orders is executed, the other order is canceled immediately.
- **Bid wanted:** This order is an indication or notice that an investor or broker–dealer wants to sell a security at a specific price. Bid wanted is used most often when no current buyers of a security are available.
- **Offer wanted:** This order is an indication or notice that an investor or a broker–dealer wants to buy a particular security at a specific price. Offer wanted is used particularly when no current sellers of a security are available.

Following customers' orders or using your discretion

No matter whether a buy or sell order is involved, some customers will be willing to give you a little more input and freedom to make choices for them than others. Other customers are going to provide you with every detail of a trade (security, price, dollar amount, the whole shebang) without needing your input at all, which actually is a good thing.

REMEMBER

No matter what the type of order, or how it's communicated to you, your job and your firm's job is to get your customers the best price available for their orders. As such, your customers' orders cannot be split into multiple smaller orders for execution with the primary purpose of maximizing the amount of money (credits, commissions, gratuities, fees, and so on) that you or your firm makes. In addition, "reasonable diligence" must be used to get the customer the best price. Here are some of the factors involved to determine if reasonable diligence was used: the price of the security, the volatility of the security, the liquidity of the security, the size and type of transaction, the number of markets checked, and accessibility of the quotation.

Discretionary versus nondiscretionary orders

To be sure, most of the orders you will receive from your clients will be nondiscretionary orders. If one of your clients tells you to purchase 100 shares of ABC common stock, they are giving you a nondiscretionary order. It is nondiscretionary because they are giving you all the components of an order: purchase or sell, how many shares or dollar amount, and what security. If the client does not provide that information, it is considered discretionary, meaning that you must use your discretion. Here are some examples of discretionary orders:

> "*Buy or sell* 100 shares of ABC common stock"
>
> "Buy *as many shares* of ABC common stock as you think I should own"
>
> "Buy 100 shares of *pharmaceutical stock*"

REMEMBER

Discretionary orders may be executed by a registered rep or brokerage firm without prior verbal permission from the client. Because they don't require verbal approval, the registered rep is required to have a written power of attorney signed by the customer prior to executing any discretionary orders. The power of attorney remains in effect until the discretionary account is closed or the power of attorney is removed by the client. As you can imagine, discretionary orders must be marked as such on the order ticket. In addition, these accounts must be closely watched by a principal of the firm to make sure that there's no excessive trading (churning) for the purpose of generating commission.

TIP

A client may give you approval to place the order at a later time in the day without discretionary authority. Say a client tells you to purchase 100 shares of DIM stock at the market price. You may tell your client that you believe that the price will drop later in the day and you may be able to get him a better price. This is allowed as long as the customer gives verbal approval, and it's not considered a discretionary order.

Solicited versus unsolicited orders

As with nondiscretionary orders, most of the orders you receive from clients will be *solicited* by you, meaning that you may call up one of your clients and say, "DEF Corporation seems to be on the move, so I think it would be wise for you to buy 100 shares of DEF common stock." Because you called and suggested what the client should buy (or sell), you actually solicited that order.

Unsolicited orders are ones in which your client tells you what they want to buy or sell. You may not think that this is the best idea for them and may tell them that, but you are not going to turn down the order and lose commission. In this case, because it was not your suggestion, you need to mark the order ticket in the box that says "unsolicited." This basically takes you off the hook in the event that the client loses money on that particular investment.

It Takes All Kinds: Recognizing Different Types of Investors

As a financial professional, you'll be working with all different types of investors: some smaller investors, some larger investors, corporations, and so on. Part of the SIE exam is knowing that you understand who's who when it comes to these different types of investors.

Retail investors

You are more likely to deal with retail investors than accredited or institutional investors. These guys (or gals) are nonprofessionals who trade (buy or sell) for their own accounts. Retail investors typically purchase or sell a much smaller number of securities than accredited or institutional investors.

Accredited investors

Some investors just have access to more money or are considered more knowledgeable than other investors. The bigger investors are called accredited investors. As such, they are typically able to handle more risk than retail investors. Accredited investors include

- Financial institutions (banks, insurance companies, pension funds, and so on)
- Insiders (officers, directors, or owners of 10 percent or more of the outstanding shares of the corporation and their immediate family members)
- Investors who have an annual income of at least $200,000 (joint $300,000) for the previous two years and are expected to meet that requirement this year
- Investors who have a net worth of at least $1 million excluding primary residence
- Reps registered and in good standing with the U.S. Securities and Exchange Commission (SEC), FINRA, and/or at least one state who have passed the Series 7, Series 65, Series 66, and/or the Series 82 exams
- Knowledgeable employees of private funds (hedge funds, private-equity funds, and so on) who have the ability to raise money privately
- Rural business investment companies (investment companies that raise money to invest in small rural businesses)
- Limited liability companies (LLCs) with more than $5 million in assets
- Family offices with at least $5 million in assets under management
- Corporations, partnerships, or organizations with a net worth of at least $5 million

Institutional investors

Institutional investors are the big guys. They are the ones that invest a lot of money on behalf of their entity. They are generally considered to be knowledgeable about the market. Institutional investors include

- Commercial banks
- Mutual funds
- Pension funds
- Insurance companies
- Real-estate investment trusts
- Hedge funds
- Endowment funds

DEPOSITORY TRUST AND CLEARING CORPORATION

The DTCC provides safeguards to the world's financial markets. Its role is to provide clearing, settlement, institutional matching, asset servicing, collateral management, global data management, information services, and so on for equity securities, corporate bonds, municipal bonds, government securities, mortgage-backed securities, mutual funds, money market instruments, derivatives, and so forth. The DTCC is absolutely massive and processes more than 100 million financial transactions each trading day. Its key roles are to provide reliability to the global financial system, to provide after-trade services, to limit risk, to lower cost, to provide transparency, and to promote greater market efficiency. The services offered by the DTCC are

- Clearing services
- Matching, settlement, and asset services
- Collateral management
- Wealth management services
- Derivative services
- Data services

Testing Your Knowledge

So, you just learned about market participants and types of orders; it's time to see questions like those you'll experience on the SIE exam. Here's a small sampling of questions for you to ace.

Practice questions

1. Which two of the following are TRUE?

   I. Dealers charge a markup or markdown for trades.
   II. Dealers charge a commission for trades.
   III. Brokers charge a markup or markdown for trades.
   IV. Brokers charge a commission for trades.

   (A) I and III
   (B) I and IV
   (C) II and III
   (D) II and IV

2. Which of the following best describes a third market trade?

   (A) Exchange-listed securities trading OTC
   (B) Exchange-listed securities trading on the exchange floor
   (C) Unlisted securities trading OTC
   (D) Institutional trading without using the services of a broker–dealer

3. Which of the following orders would protect a short position?

(A) Buy limit

(B) Sell limit

(C) Buy stop

(D) Sell stop

4. If an at-the-open order is not executed at the opening price, what happens to the order?

(A) It is canceled.

(B) It becomes a market order.

(C) It becomes a day order.

(D) It becomes a limit order.

5. An investor with no other positions would like to purchase ABC common stock, which is currently trading at $30.80. If this investor is interested in purchasing the stock for $28 or less, you should suggest the investor enters a

(A) buy stop limit order

(B) buy limit order

(C) buy stop order

(D) market order

6. Which of the following would be considered accredited investors?

I. Banks

II. An individual investor with a net worth of $2 million, excluding her primary residence

III. A corporation with a net worth of $10 million

IV. Insurance companies

(A) II and IV

(B) I and IV

(C) I, III, and IV

(D) I, II, III, and IV

7. Which TWO of the following are TRUE of short sellers?

I. They are taking a bullish position.

II. They are taking a bearish position.

III. They have a maximum gain potential that is unlimited.

IV. They have a maximum loss potential that is unlimited.

(A) I and III

(B) I and IV

(C) II and III

(D) II and IV

8. A not-held order gives a broker discretion as to

(A) which security is traded
(B) the time at which a security is traded
(C) whether to purchase, sell, or sell short a security
(D) all of the above

9. Which of the following order features allows for partial execution?

(A) FOK
(B) AON
(C) IOC
(D) All of the above

10. Which TWO of the following are FALSE regarding unsolicited orders?

I. They cannot be accepted without prior approval from a principal.
II. They can be accepted without prior approval from a principal.
III. They must be limited in size.
IV. They are not limited in size.

(A) I and III
(B) I and IV
(C) II and III
(D) II and IV

11. Which of the following order features allows for partial execution?

(A) Sell 2,500 shares at $18.10 and buy 2,000 shares at $18.30
(B) Buy 2,000 shares at $18.10 and sell 2,500 shares at $18.30
(C) Sell 250 shares at $18.10 and buy 200 shares at $18.30
(D) Buy 200 shares at $18.10 and sell 250 shares at $18.30

12. Mary and John have been married for several years. They have a combined income that has exceeded $300,000 per year for the last four years and is expected to at least be that much for the current year. They would be considered a(n)

(A) qualified institutional buyer (QIB)
(B) accredited investor
(C) institutional investor
(D) bank qualified investor

13. WXY Broker-Dealer charges a commission on a securities transaction. WXY Broker-Dealer has acted as a(n)

(A) agent
(B) principal
(C) market maker
(D) dealer

14. "Spread" in the over-the-counter (OTC) market refers to the difference between the

(A) highest bid and lowest ask price

(B) lowest offer price and highest ask price

(C) the opening and closing prices of a particular security

(D) the "when issued" ask price

15. Marvin Plimpton is an associated person but is not a licensed registered representative. Which of the following activities is Marvin permitted to engage in?

(A) Accepting unsolicited orders from a customer who resides in the same state

(B) Discussing the plusses and minuses of a particular investment to an existing customer of the firm

(C) Forwarding account opening forms to a new customer

(D) Discussing investment objectives with a potential customer prior to handing the customer over to a licensed registered representative

Answers and explanations

1. **B.** Most brokerage firms are broker–dealers, meaning that they act as a middleman and deal out of their own inventory. When acting as a broker, a firm is buying or selling a security for a customer through another dealer. If executing a trade as a broker, the firm charges the customer a commission. Firms also act as dealers if they are buying and selling out of their own inventory. If acting as a dealer, the firm charges a markup when the customer buys and a markdown when the customer sells.

2. **A.** A third market trade is a trade of exchange-listed securities trading OTC. This type of trade takes place all the time.

3. **C.** Remember, stop orders are used for protection. So, in this case, you're looking for a stop order. Because the investor is short the security, they would have to buy themselves out of that position if the price of the security went in the wrong direction (up in this case). To protect a short position, an investor could enter a buy stop order.

4. **A.** At-the-open orders must be executed at the opening price; otherwise, the order must be cancelled. At-the-open orders allow for partial execution.

5. **B.** Because this investor would like to purchase the stock at a particular price or better and is not currently short the stock, you should enter a buy limit order for ABC common stock at $28.

6. **D.** Actually, all of the choices listed are considered accredited investors. Accredited investors are able to handle more financial risk than average investors.

7. **D.** Short sellers are bearish because they want the price of the security they're purchasing to decrease. Because short sellers can lose money if the price of the security increases, their maximum loss potential is unlimited because there is nothing from keeping the price of the security from increasing more.

8. **B.** Not held orders have to do with the timing of an order. So, for not-held orders, the customer must agree to whether they want to buy, sell, or sell short a security as well as the number of shares. A not-held order is one in which the customer is giving you, their registered rep, discretion as to the time an order is placed. This may be a situation in which you think that you can get the customer a better price later in the day.

9. **C.** If you remember what the initials stand for, it makes the question a lot easier. FOK stands for fill or kill, which means that the entire order must be either filled immediately or killed (canceled). AON stands for all-or-none, which means that the entire order must be filled entirely (but not immediately) or none of the order gets executed. The one that allows for partial execution is an IOC (immediate or cancel) order, which means that the broker has to execute as much of the order as possible immediately and cancel the rest.

10. **A.** Remember, you're looking for false answers to this question. Unsolicited orders are ones in which the investor tells the registered rep which securities they want to purchase, sell, or sell short. Although orders must be approved by a principal, they don't have to be approved prior to the order being placed. In addition, there are no limits to the size of the order regarding unsolicited orders; they are only limited based on the investor's ability to pay.

11. **B.** The first price (18.10) is the bid price (the price at which the market maker is willing to purchase the security). The second price (18.30) is the ask price that the market maker is willing to accept when selling the security. The "20x25" represents the number of round lots the market maker is willing to buy or sell. Unless told differently, a round lot is 100 shares. Therefore, the market maker is willing to buy up to 2,000 shares at $18.10 and sell up to 2,500 shares at $18.30.

12. **B.** As a married couple, accredited investors are ones that have a joint income of at least $300,000 for the previous two years and is expected to be at least $300,000 for the current year.

13. **A.** Brokers act as middlemen in a securities transaction. They're putting a buyer and seller together to make a trade. As such, they charge a commission. A good way to remember this is to think of a real estate agent or broker. Real estate agents or brokers charge a commission for selling someone else's house to a buyer.

14. **A.** The term "spread" refers the difference between the highest bid price (the most a market maker is willing to pay to purchase the security) and the lowest ask (offer) price (the least a market maker will take when selling the security). Typically, the narrower the spread, the more actively traded the security.

15. **C.** Since Marvin is not licensed, he cannot discuss anything relating to investments with an existing customer or potential customer. If he cannot do that, he certainly cannot accept orders (whether solicited or not) from a customer. However, he can do things such as sending account opening forms to a new customer.

IN THIS CHAPTER

» Outlining the breakdown of taxes and income

» Seeing how the IRS taxes securities

» Comparing the different types of retirement plans

» Taking a practice quiz

Chapter 15 Making Sure the IRS Gets Its Share

Yes, it's true what they say: The only sure things in life are death and taxes. Although taxes are an annoying necessity, investors do get tax breaks if they invest in securities for a long period of time — which means you, as a rep, need a good understanding of the tax discounts investors could potentially receive. Additionally, the SIE exam tests your ability to recognize the different types of retirement plans, the specifics about each one, and the tax advantages.

In this chapter, I cover tax categories and rules, from distinguishing among types of taxes to types of income. And although enjoying retirement isn't quite as certain as pushing up daisies, I explain Uncle Sam's claim on the cash investors put into 401(k)s, individual retirement accounts (IRAs), and other retirement plans. As always, you can count on some example questions and an exam at the end of the chapter to wrap it up.

Everything in Its Place: Checking Out Tax and Income Categories

The many lines you see on tax forms clue you in to the fact that the Internal Revenue Service (IRS) likes to break things into categories. The following sections explain progressive and regressive taxes, as well as types of personal income.

Touring the tax categories

The supreme tax collector (the IRS) has broken taxes into a couple of categories, according to the percentage individuals pay. Your mission is to understand the different tax categories and how they affect investors:

- **Progressive taxes:** These taxes affect high-income individuals more than they affect low-income individuals; the more taxable income individuals have, the higher their income tax bracket. Progressive taxes include taxes on personal income (see the next section), gift taxes, and estate taxes. The SIE contains more questions on progressive taxes than on regressive taxes.
- **Regressive taxes:** These taxes affect individuals earning a lower income more than they affect people earning a higher income; everyone pays the same rate, so individuals who earn a lower income are affected more because that rate represents a higher percentage of their income. Examples of regressive taxes are payroll taxes, sales taxes, property taxes, excise taxes, gasoline taxes, and so on.

Looking at types of income

The three main categories of income are earned, passive, and portfolio. (If you're especially interested in the details of how investments are taxed, you can find more information at `www.irs.gov`.) You need to distinguish among the different categories because the IRS treats them differently:

- **Earned (active) income:** People generate this type of income from activities that they're actively involved in. Earned income includes money received from salary, bonuses, tips, commissions, and so on. Earned income is taxed at the individual's tax bracket and based on their filing status.
- **Passive income:** This type of income comes from enterprises in which an individual isn't actively involved. Passive income includes income from limited partnerships (see Chapter 10) and rental property. When you see the words *passive income* on the SIE exam, immediately start thinking that the income comes from a direct participation program (DPP). Individuals can write off passive losses against any passive income to determine the net taxable income.
- **Portfolio income:** This type of income includes interest, dividends, and capital gains derived from the sale of securities. The following section tells you more about taxes on portfolio income. Portfolio income may be taxed at the investor's tax bracket or at a lower rate, depending on the holding period.

Noting Taxes on Investments

You need to understand how dividends, interest, capital gains, and capital losses affect investors. To make your life more interesting, the IRS has given tax advantages to people who hold onto investments for a long period of time, so familiarize yourself with the types of taxes that apply to investments and how investors are taxed.

Interest income

Interest income that bondholders receive may or may not be taxable, depending on the type of security or securities held:

- **Corporate bond interest:** Interest received from corporate bonds is taxable at all levels (federal, state, and local, where local taxes exist).
- **Municipal bond interest:** Interest received from most municipal bonds (except taxable municipals) is federally tax-free; however, investors may be taxed on the state and local levels, depending on where the investor lives and the municipality of the issuer of the bonds. (See Chapter 8.)
- **U.S. government securities interest:** Interest received from U.S. government securities, such as T-bills, T-notes, T-STRIPS, TIPS, and T-bonds, is taxable on the federal level but exempt from state and local taxes.

REMEMBER

Even though T-bills, T-STRIPS, and any other zero-coupon bonds don't generate interest payments (because the securities are issued at a discount and mature at par, which is the face value of the security), the difference between the purchase price and the amount received at maturity is considered interest and is subject to taxation.

Dividends

Dividends may be in the form of cash, stock, or product. The following sections discuss dividends in cash, in stock, and from mutual funds.

Cash dividends

Qualified cash dividends received from stocks are taxed at a maximum rate of 0 percent, 15 percent, or 20 percent, depending on the investor's adjusted gross income (AGI). Qualified dividends are ones in which the customer has held onto the stock for at least 61 days (91 days for preferred stock). The 61-day holding period starts 60 days prior to the *ex-dividend date* (the first day the stock trades without dividends). If the investor has held the stock for less than the 61-day holding period, the dividends are considered *nonqualified,* and investors are taxed at the rate determined by their regular tax bracket.

Note: There is currently an additional net investment tax of 3.8 percent for individual investors with a modified adjusted gross income above $200,000 ($250,000 for married couples).

Stock dividends

Stock dividends don't change the overall value of investment, so additional shares received are not taxed. (For details, see Chapter 6.) However, stock dividends do lower the cost basis per share for tax purposes. The cost basis is used to calculate capital gains and losses.

Dividends from mutual funds

Dividends and interest generated from securities that are held in a mutual fund portfolio are passed through to investors and are taxed as either *qualified* (see the earlier section "Cash dividends") or *nonqualified*. The type(s) of securities in the portfolio and the length of time the fund held the securities dictate how the investor is taxed. Here's how mutual fund dividends are taxed:

Federally Tax-Free	0, 15, or 20 Percent	Ordinary Income
Municipal bond funds	Stock funds	Corporate bond funds
	Long-term capital gains	Short-term capital gains

REMEMBER

One of the great things about owning mutual funds is that they're nice enough to let you know what taxes you're going to be subject to. At the beginning of each year (usually in January), you receive a statement from the mutual fund that lets you know how much you received the previous year in dividends, in short-term capital gains, and in long-term capital gains. The mutual fund also sends a copy of the statement to the IRS.

The mutual fund determines the long-term or short-term gains by its holding period, not the investors'. Also, remember that you're subject to capital gains tax and taxes on dividends each year even if the money is reinvested in the fund.

At the sale: Capital gains and losses

Capital gains are profits (*realized gains*) made when selling a security, and *capital losses* are losses incurred when selling a security. To determine whether an investor has a capital gain or capital loss, you have to start with the investor's cost basis. The *cost basis* is used for tax purposes and includes the purchase price plus any commission (although on the SIE exam, the test designers usually don't throw commission into the equation). The cost basis remains the same unless it's adjusted for things like stock splits, stock dividends, accretion, amortization, and so on.

REMEMBER

Accretion and amortization come into play when an investor purchases a bond at a price other than par. The bond cost basis will be adjusted toward par over the amount of time until maturity. You won't be asked to calculate it on the SIE exam.

Incurring taxes with capital gains

An investor realizes capital gains when they sell a security at a price higher than their cost basis. Capital gains on any security (even municipal and U.S. government bonds) are fully taxed on the federal, state, and local levels.

REMEMBER

A capital gain isn't realized until a security is *sold.*

Note: If the value of an investment increases, it's considered *appreciation* or an *unrealized* gain, and if the investor doesn't sell, the investor doesn't incur capital gains taxes. Mutual fund shareholders would be subject to taxation if the issuer sold securities held by the fund at a profit, even if the shareholder didn't sell any shares.

Capital gains are broken down into two categories, depending on the holding period of the securities:

- **Short-term capital gains:** These gains are realized when a security is held for *one year or less.* Short-term capital gains are taxed according to the *investor's tax bracket.*

- **Long-term capital gains:** These gains are realized when a security is held for *more than one year.* To encourage investors to buy and hold securities, long-term capital gains are currently taxed at a rate in line with cash dividends (0, 15, or 20 percent depending on the investor's adjusted gross income). For more information on capital gains and losses, visit the IRS website at `www.irs.gov/taxtopics/tc409`.

Note: If an investor purchased 100 shares of a particular security for $4,000 and later sold those shares for $6,000, the original $4,000 purchase price would be considered a *return of capital*. Only the $2,000 capital gain ($6,000 selling price minus the $4,000 purchase price) would be taxable. So, the taxes would be based upon the profit made (how much was made above the investor's cost basis).

Offsetting gains with capital losses

Certainly, no matter how much research has been done, not every investment is going to be profitable. An investor realizes a capital loss when selling a security at a value lower than the cost basis. Investors can use capital losses to offset capital gains and reduce the tax burden. Like capital gains, capital losses are broken into short-term and long-term:

- **Short-term capital losses:** An investor incurs these losses when they have held the security for *one year or less.* Investors can use short-term capital losses to offset short-term capital gains.
- **Long-term capital losses:** An investor incurs these losses when they have held the security for *more than one year.* Long-term capital losses can offset long-term capital gains.

When an investor has a net capital loss, they can write off up to $3,000 per year on their federal taxes against their earned income and carry the balance forward to the following year. Married couples filing jointly can write off $3,00 per year, and married couples filing separately can write off $1,500 per year each. For test purposes, assume $3,000 per year.

The following question involves capital-loss write-offs.

EXAMPLE

In a particular year, Jones realizes $30,000 in long-term capital gains and $50,000 in long-term capital losses. How much of the capital losses would be carried forward to the following year?

(A) $3,000

(B) $17,000

(C) $20,000

(D) $30,000

The correct answer is (B). Jones has a net capital loss of $20,000 (a $50,000 loss minus the $30,000 gain). Jones writes off $3,000 of that capital loss against the earned income and carries the additional loss of $17,000 forward to write off against any capital gains they may have in future years. In the event that Jones doesn't have any capital gains the following year, they can still write off $3,000 of the $17,000 against any earned income and carry the remaining $14,000 forward, which can be used to offset any capital gains the following year. The loss can be carried forward to subsequent years until used up or the investor dies.

The wash sale rule: Adjusting the cost basis when you can't claim a loss

To keep investors from claiming a loss on securities (which an investor could use to offset gains on another investment; see the preceding section) while repurchasing substantially (or exactly) the same security, the IRS has come up with the *wash sale rule.* According to this rule, if an investor sells a security at a capital loss, the investor can't repurchase the same security or anything convertible into the same security for 30 days prior to or after the sale and be able to claim the loss. An investor doesn't end up in handcuffs for violating the wash sale rule; they simply can't claim the loss on their taxes.

However, the loss doesn't go away if investors buy the security within that window of time; investors get to adjust the cost basis of the security. If an investor were to sell 100 shares of ABC at a $2-per-share loss and purchase 100 shares of ABC within 30 days for $50 per share, the investor's new cost basis (excluding commissions) would be $52 per share (the $50 purchase price plus the $2 loss on the shares sold), thus lowering the amount of capital gains they would face on the new purchase.

The following question tests your understanding of the wash sale rule.

EXAMPLE

If Melissa sells DEF common stock at a loss on June 2, for 30 days they can't buy which of the following securities without being subject to the wash sale rule?

I. DEF common stock
II. DEF warrants
III. DEF call options
IV. DEF preferred stock

(A) I only
(B) I and IV only
(C) I, II, and III only
(D) I, II, III, and IV

The answer you want is (C). You need to remember that Melissa sold DEF at a loss; therefore, they can't buy back the same security (as in statement I) or anything convertible into the same security (as in statements II and III) within 30 days to avoid the wash sale rule. Warrants give an investor the right to buy stock at a fixed price (see Chapter 6), and call options give investors the right to buy securities at a fixed price (Chapter 11). However, statement IV is okay because DEF preferred stock is a different security and is not convertible into DEF common stock (unless it's convertible preferred, which it isn't; if it were convertible, the question would have told you so). For Melissa to avoid the wash sale rule, they can't buy DEF common stock, DEF convertible preferred stock, DEF convertible bonds, DEF call options, DEF warrants, or DEF rights for 30 days. However, they can buy DEF preferred stock, DEF bonds, or DEF put options (the right to sell DEF).

REMEMBER

Putting it in simple terms, the cost basis is the price an individual paid for an investment after taxes. This cost includes brokerage fees, trading costs, and loads (sales charges for mutual funds). Now, things can get a little more complex in the event of stock splits, mergers, and dividend payments. The main thing that you need to know for the SIE exam is that the cost basis is used for calculations to determine an investor's tax liability when selling securities. More recently, brokerage firms, mutual funds, and so on are required to provide investors information on their tax liability, such as the amount of short-term capital gains, long-term capital gains, dividends, interest, and so on.

Estate taxes

Estate tax is a tax on property that is passed along to someone's estate when the person dies. Inheriting securities is a little more straightforward than receiving gifts of securities. When an individual receives securities as a result of an inheritance, they *always* assume the fair market cost basis of the inherited securities on the date of the owner's death. Additionally, securities received by inheritance are always assigned a long-term holding characterization for tax purposes when sold. Estate taxes are covered a little more in depth in the Series 7 book.

Exploring Retirement Plan Tax Advantages

I place retirement plans with taxes because retirement plans give investors tax advantages. When you're reviewing this section, zone in on the differences and similarities among the different types of plans. The contribution limits are important but not as important as understanding the plan specifics and who's qualified to open which type of plan.

Qualified versus nonqualified plans

The IRS may dub employee retirement plans as qualified or nonqualified. The distinction concerns whether they meet IRS and Employee Retirement Income Security Act (ERISA) standards for favorable tax treatment.

Tax-qualified plans

A *tax-qualified plan* meets IRS standards to receive a favorable tax treatment. When you're investing in a tax-qualified plan, the contributions into the plan are made from pretax dollars and are excluded from your taxable income. Not only are contributions into the plan excluded from income, but the account also grows on a tax-deferred basis, so you aren't taxed until you withdraw money from the account at retirement. IRAs are examples of tax-qualified retirement plans. The two types of corporate tax-qualified retirement plans are defined contribution and defined benefit plans. These include 401(k)s, profit-sharing plans, and money-purchase plans. Most corporate pension plans are tax-qualified plans.

REMEMBER

Because investors don't pay tax on the money initially deposited or on the earnings, the entire withdrawal from a tax-qualified plan is taxed at a rate determined by the investor's tax bracket, which is normally lower during retirement. Additionally, distributions taken before age 59½ are subject to a 10 percent tax penalty (10 percent additional tax on early distributions) except in cases of death, disability, first-time home buying, educational expenses for certain family members, medical premiums for unemployed individuals, and so on.

Nonqualified plans

Obviously, a nonqualified plan is the opposite of a qualified plan. *Nonqualified plans,* such as deferred compensation plans, payroll deduction plans, and 457 plans, do not meet IRS and ERISA standards for favorable tax treatment. If you're investing in a nonqualified retirement plan, deposits are not tax-deductible (they're made from after-tax dollars); however, because you're dealing with a retirement plan, earnings in the plan do build up on a tax-deferred basis. People may choose to invest in nonqualified plans because either their employer doesn't have a qualified plan set up or the investment guidelines are not as strict (investors may be able to contribute more and invest in a wider choice of securities).

REMEMBER

Because investors have already paid tax on the money initially deposited but not on the earnings, withdrawals from nonqualified plans are only partially taxed at the rate determined by the investor's tax bracket. The investor is taxed only on the amount that exceeds the amount of the contributions made.

IRA types and contribution limits

You'll likely be tested on a few different types of retirement plans and possibly the contribution limits. When you're looking at this section, understand the specifics of the types of plans and view the contribution limits as secondary. The contribution limits change pretty much yearly, and the SIE questions may not change that often. If you have a rough idea of the contribution limits, you should be okay. For updates and additional information, you can go to `www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-ira-contribution-limits`.

Traditional IRAs

IRAs (Individual Retirement Accounts or Individual Retirement Arrangements) are tax-qualified retirement accounts, so deposits in the account are made from pretax dollars. (They're tax-deductible.) IRAs are completely funded by contributions that the *holder of the account* makes. Regardless of whether individuals are covered by a pension plan, they can still deposit money in an IRA. Here's a list of some of the key points of IRAs:

- IRAs may be set up as *single life* (when the owner is the beneficiary of the account), *joint and last survivor* (when the sole beneficiary of the account is their spouse and the spouse is more than ten years younger than the owner), or *uniform lifetime* (when the spouse is not the sole beneficiary or the spouse is not more than ten years younger than the owner).
- Permissible investments for IRAs include stocks, bonds, mutual funds, U.S. gold and silver coins, and real estate.
- The maximum contribution per person as of 2024 (which increased from $6,500 from 2023) is $7,000 per year, with an additional catch-up contribution of $1,000 per person allowed for investors age 50 or older. Excess contributions are taxed at a rate of 6 percent per year until the excess is withdrawn.
- As of 2024, a husband and wife under age 50 can have separate accounts with a maximum contribution of $7,000 per year each, whether both are working or one is working.
- Contributions to the IRA are fully deductible for individuals not covered by employer pension plans.

  If investors are covered by a workplace retirement plan, deposits into an IRA may or may not be tax-deductible. Although I think that the chances of your being tested on the values are slim, as of 2024, if an individual is covered by a workplace retirement plan and earns up to $77,000 per year ($123,000 jointly), deposits made into an IRA are fully deductible. The deductions are gradually phased out and disappear when an individual earns more than $87,000 per year ($143,000 for married couples filing jointly).
- When an investor starts to withdraw funds from an IRA, the investor is taxed on the entire withdrawal (the amount deposited, which was not taxed, and the appreciation in value). The withdrawal is taxed as ordinary income.
- Withdrawals can't begin before age 59½, or investors have to pay an early withdrawal penalty of 10 percent added to the investor's rate according to their tax bracket. An investor isn't

subject to the 10 percent tax penalty in cases of death, disability, first-time homebuyers, and a few other exceptions. (Obviously, dead retirees won't be making withdrawals, but their beneficiaries will be; in this case, the beneficiaries aren't hit with the 10 percent penalty.)

- Withdrawals must begin by April 1 of the year after the investor reaches age 73 (the *required beginning date*, or RBD). Investors who don't take their *required minimum distribution* (RMD) by that time are subject to a 50 percent tax penalty on the amount they should have withdrawn. The IRS provides minimum distribution worksheets to help you determine the amount that needs to be withdrawn in order to avoid the penalty; you can find them at `www.irs.gov/retirement-plans/plan-participant-employee/required-minimum-distribution-worksheets`.
- Deposits in IRAs are allowed up to April 15 (Tax Day) to qualify as a deduction for the previous year's taxes.

Roth IRAs

Anyone whose income is below the IRS modified adjusted gross income limit can open a Roth IRA. The key difference between a traditional IRA and a Roth IRA is that withdrawals from a Roth IRA are not taxed. However, deposits made in the Roth IRA are not tax-deductible (made from after-tax dollars). Provided that the investor has held onto the Roth IRA for more than five years and has reached age 59½, they can withdraw money from the Roth IRA without incurring any taxable income on the amount deposited or on the appreciation in the account. So, in this case, all qualified distributions are excluded from federal income tax.

REMEMBER

As of 2024, the maximum that an individual may contribute to a traditional IRA and Roth IRA is $7,000 per year combined. There is also a catch-up contribution of $1,000 allowed for individuals age 50 and older, which means they can contribute up to $8,000 per year.

As of 2024, investors who have an adjusted gross income of more than $161,000 per year ($240,000 married, filing jointly) can't contribute to a Roth IRA.

Simplified employee pensions (SEP-IRAs)

An SEP-IRA is a retirement vehicle designed for small-business owners, self-employed individuals, and their employees. SEP-IRAs allow participants to invest money for retirement on a tax-deferred basis. Employers can make tax-deductible contributions directly to their employees' SEP-IRAs. As of 2024, the maximum employer contribution to each employee's SEP-IRA is 25 percent of the employee's compensation (salary, bonuses, and overtime) or $69,000 (subject to cost-of-living increases in the following years), whichever is less. Employees who are part of the plan may still make annual contributions to a traditional or Roth IRA.

401(k) and 403(b)

There are certainly a number of qualified retirement plans besides IRAs. 401(k)s and 403(b)s are two that you should know a little about before taking the SIE exam.

401(k) plans

As stated previously, a 401(k) is a corporate retirement plan. With this type of plan, employees can contribute a percentage of their salary up to a certain amount each year (as such, it's a defined contribution plan). Because it's a qualified plan, the amount contributed by the employee to the 401(k) is excluded from the employee's gross income. In addition, in most cases, the employer matches the employee's contribution up to a certain amount (for example, 25 percent, 50 percent, and so on). The account grows on a tax-deferred basis, so everything withdrawn from the account at retirement is taxable.

Roth 401(k) plans

A Roth 401(k) has similarities between traditional 401(k) plans and Roth IRAs. As with a traditional 401(k), the contribution limits, which adjust yearly, are the same as well as the fact that they are both employer-sponsored plans. However, like a Roth IRA, contributions are made after taxes. So, withdrawals of contributions and earnings are not taxed as long as the account has been held for at least five years and the holder is at least 59½ years old (except in cases of death or disability). Unlike Roth IRAs, required minimum distribution (RMD) rules apply.

Note: Roth 401(k)s are like Roth IRAs because qualified distributions are excluded from federal income tax.

403(b) plans

These are salary reduction plans for public school (elementary school, secondary school, college, and so on) employees, tax-exempt organizations, and religious organizations. These plans are also known as tax-sheltered *annuities*. As with 401(k)s, employees can elect to have a portion of their pay put into the retirement plan that's tax deferred. Like 401(k)s, the employer may match a percentage of the contributions. To be eligible, employees must be at least 21 years old and have been working for the employer for at least a year.

REMEMBER

Because the IRS wants to be able to collect taxes, the holders of IRAs (except for Roth IRAs) and other qualified-plan participants must start withdrawing money at a certain point. Plan participants must take a required minimum distribution (RMD) by April 1 of the year after they turn age 73, whether they need the money at that point or not. In addition, they must continue to take additional minimum distributions each subsequent year until all the money is out of the account.

Testing Your Knowledge

Following is a small sample of questions you may see related to taxes and retirement plans on the SIE exam. Read each question carefully. Good luck!

Practice questions

1. Which of the following are regressive taxes?

   I. Sales

   II. Income

   III. Gasoline

   IV. Alcohol

   (A) III and IV

   (B) I, II, and III

   (C) I, III, and IV

   (D) I, II, III, and IV

2. All of the following are types of tax-qualified retirement plans EXCEPT

(A) 401(k)

(B) profit-sharing

(C) IRA

(D) deferred compensation

3. Which of the following are TRUE regarding Roth IRAs and Roth 401(k)s?

(A) Withdrawals from both are tax-free provided that investors have held the accounts for at least five years and have reached the age of 59½.

(B) There are no contribution limits.

(C) Contributions made to both are made pretax.

(D) All of the above.

4. An investor buys 1,000 shares of a stock at $30. If the stock increases in value to $50, how would the result be categorized?

(A) Profit

(B) Appreciation

(C) Capital gain

(D) Investment income

5. An individual investor who lives at home with their parents is covered by an employer pension plan. However, they would like more coverage at retirement and decides to put the maximum allowable contribution in an IRA. If their salary is $52,000 per year, which of the following is TRUE?

(A) Contributions to the IRA are fully deductible.

(B) Contributions to the IRA are partially deductible.

(C) Contributions to the IRA are not deductible.

(D) Cannot be determined.

6. Which of the following is taxable for an investor for the year in which it occurs?

I. Stock dividends

II. Cash dividends

III. Interest received from corporate bonds

IV. Interest received from U.S. government bonds

(A) I, II, and III

(B) II and III

(C) II, III, and IV

(D) I, II, III, and IV

7. A customer purchased 100 shares of ABC stock at $40 per share on March 24. On March 24 of the following year, the customer sold the stock at $46 per share. Which TWO of the following are TRUE regarding these transactions?

I. They would be taxed as a short-term capital gain.

II. They would be taxed as a long-term capital gain.

III. The gain would be taxed at the customer's tax bracket.

IV. The gain would be taxed at 0 percent, 15 percent, or 20 percent, depending on the customer's adjusted gross income.

(A) I and III

(B) I and IV

(C) II and III

(D) II and IV

8. According to the wash sale rule, if a customer sold a security at a loss, which of the following is TRUE?

(A) The customer cannot purchase call options on the same security for 30 days before or after the sale and be able to claim the loss.

(B) The customer cannot purchase bonds by the same issuer for 30 days before and after the sale and be able to claim the loss.

(C) The customer cannot sell short the same security within 30 days before or after the sale and be able to claim the loss.

(D) The customer cannot purchase mutual funds holding the same security for 30 days before and after the sale and be able to claim the loss.

9. Which of the following types of retirement plans is a salary reduction plan set up for public school employees?

(A) SEP-IRAs

(B) 401(k)s

(C) 403(b)s

(D) Keogh plans

Answers and explanations

1. **C.** Regressive taxes are ones in which all individuals are charged the same percentage regardless of their income. Sales tax, gasoline tax, and alcohol tax are all regressive taxes. Income tax is a progressive tax because the higher your income, the higher the tax bracket.

2. **D.** Tax-qualified plans are ones that meet IRS standards for favorable tax treatment. If the plan is tax-qualified, contributions are made from pretax dollars. However, when the money is withdrawn, the entire amount, including the initial contributions plus any gains, is taxable. Tax-qualified plans include IRAs, 401(k)s, profit-sharing, money-purchase, and so on. Nonqualified plans are funded from after-tax contributions and include deferred compensation, payroll deduction, 457 plans, and so on.

3. **A.** Contributions to both Roth IRAs and Roth 401(k)s are made from after-tax dollars. So, withdrawals are tax-free provided that investors have held the accounts for at least five years and are at least 59½ years old.

4. **B.** In this case, because the investor didn't sell the security at a profit, in which case it would've been a capital gain, it is categorized as appreciation.

5. **A.** An investor can always contribute money to an IRA even if covered by an employer pension plan. However, whether it's deductible depends on the investor's earnings. As of 2024 (the amount increases yearly), an investor who makes up to $77,000 can contribute to an IRA and be able to deduct the full amount from their taxes.

6. **C.** Cash dividends, interest from corporate bonds, and interest from U.S. government bonds are all taxable for the year in which they occurred. However, stock dividends are not taxable because the investor didn't receive a payment, just more shares of stock, which lowered the cost basis.

7. **A.** This is a short-term capital gain because when a security is sold up to and including one year from the purchase date, it would be a short-term capital gain or loss. Because it is short-term, the gain would be taxed at the investor's tax bracket.

8. **A.** According to the wash sale rule, an investor who is selling a security at a loss cannot purchase the same security or anything convertible into the same security for 30 days prior or 30 days after the sale and be able to claim the loss. However, the loss isn't gone completely; it just means that the cost basis for the new securities purchased will be adjusted for the loss. So, if the investor sold ABC common stock at a loss, they wouldn't be able to purchase ABC call options on the stock because call options give the investor the right to purchase the underlying security.

9. **C.** 403(b) plans are set up for public school employees (elementary, secondary, college, and so on). They are considered salary reduction plans because the amount contributed by the employee reduces their salary so that they aren't taxed on the money contributed until it's taken out at retirement.

IN THIS CHAPTER

» Meeting the self-regulatory organizations

» Opening and handling customer accounts

» Playing by the rules

» Reviewing additional topics tested

» Checking your knowledge with a chapter quiz

Chapter 16
Rules and Regulations: No Fooling Around

First off, I'd like to apologize for having to include this chapter. Unfortunately, rules are a part of life and part of the SIE. When you're reading this, please remember that I didn't make the rules — but I do my best to make them as easy to digest as possible. Rules have become increasingly important on FINRA securities exams like the SIE, especially since the Patriot Act came into the picture.

In this chapter, I cover topics related to rules and regulations. First, I help you understand who the guardians of the market are and their roles in protecting customers and enforcing rules. I also place considerable emphasis on opening, closing, transferring, and handling customers' accounts. And, of course, I provide practice questions to guide you on your way. At the end, I give you a 30-question chapter quiz to help you test your knowledge.

Meeting the Market Watchdogs: Securities Regulatory Organizations

To keep the market running smoothly and to make sure investors aren't abused (at least too much), regulatory organizations stay on the lookout. Although you don't need to know all the minute details about each of them, you do have to know the basics.

The Securities and Exchange Commission

The U.S. Securities and Exchange Commission (SEC) is the major watchdog of the securities industry. Congress created the SEC to regulate securities markets and to protect investors from fraudulent and manipulative practices. All broker–dealers who transact business with investors and other broker–dealers must register with the SEC. And that registration means something: All broker–dealers have to comply with SEC rules or face censure (an official reprimand), limits on activity, their own suspension or suspension of one or more associated persons (such as a registered rep or principal), a fine, and/or having their registration revoked.

REMEMBER

SEC investigations may lead to a civil (financial) complaint being filed in a federal court. The SEC may seek disgorgement (taking away) of ill-gotten gains, civil money penalties, and injunctive relief (a cease-and-desist order from the court). If the matter is criminal in nature, the investigation is conducted by the U.S. attorney's office and the grand jury.

Among its other numerous functions, you need to be aware that the SEC also enforces the following acts:

- **The Securities Act of 1933:** The Act of 1933 requires the full and fair disclosure of all material information about a new issue.
- **The Securities Exchange Act of 1934:** The Act of 1934, which established the SEC, was enacted to protect investors by regulating the over-the-counter (OTC) market and exchanges, such as the New York Stock Exchange (NYSE). Chapter 14 tells you more about markets. In addition, the Act of 1934 regulates
  - The extension of credit in margin accounts (see Chapter 12)
  - The registration and regulation of brokers and dealers
  - The registration of securities associations
  - Transactions by insiders
  - Customer accounts
  - Trading activities
- **The Trust Indenture Act (TIA):** This act, formerly called the Trust Indenture Act of 1939, prohibits bond issues valued at more than $50 million (originally $5 million) from being offered to investors without an indenture. The trust *indenture* is a written agreement that protects investors by disclosing the particulars of the issue (the coupon rate, the maturity date, any collateral backing the bond, and so on). As part of the Trust Indenture Act, all companies must hire a trustee who's responsible for protecting the rights of bondholders.
- **The Investment Company Act of 1940:** This act regulates the registration requirements and the activities of investment companies.
- **The Investment Advisers Act of 1940:** This act requires the registration of certain investment advisers with the SEC. An investment adviser is a person who receives a fee for giving investment advice. Any investment adviser with at least $25 million of assets under management or anyone who advises an investment company must register with the SEC. All other investment advisers have to register on the state level. The Investment Advisers Act of 1940 regulates
  - Record-keeping responsibilities
  - Advisory contracts
  - Advertising rules
  - Custody of customers' assets and funds

Self-regulatory organizations

As you can imagine, due to the unscrupulous nature of some investors and registered representatives, the SEC's job is overwhelming. Fortunately, a few self-regulatory organizations (SROs) are there to take some of the burden off of the SEC's shoulders. Although membership isn't mandatory, most broker–dealers are members of one or more SROs. SRO rules are usually stricter than those of the SEC.

The four types of SROs you need to know for the SIE are the FINRA, MSRB, NYSE, and CBOE:

- **Financial Industry Regulatory Authority (FINRA):** FINRA is the SRO responsible for the operation and regulation of the OTC market, investment banking (the underwriting of securities), NYSE trades, investment companies, limited partnerships, and so on. FINRA was created in 2007 and is a consolidation of the National Association of Securities Dealers (NASD) and the regulation and enforcement portions of the NYSE. FINRA is responsible for making sure that its members follow not only FINRA rules, but also the rules set forth by the SEC. Additionally, the FINRA is responsible for handling complaints against member firms and may take disciplinary action if necessary. FINRA is also responsible for administering securities exams such as the SIE. (Now you know who to blame.) FINRA has strict rules (as the other SROs do, I suspect) regarding filing of misleading, incomplete, or inaccurate information concerning membership, the firm's registration, and the registration of member associates.
- **Municipal Securities Rulemaking Board (MSRB):** The MSRB was established to develop rules that banks and securities firms have to follow when underwriting, selling, buying, and recommending municipal securities. (Check out Chapter 8 for info on municipal bonds.) The MSRB is subject to SEC oversight but does not enforce SEC rules.

  REMEMBER

  The MSRB makes rules for firms (and representatives) who sell municipal bonds but don't enforce them; it leaves enforcement up to FINRA.
- **NYSE:** The NYSE is the oldest and largest stock exchange in the United States. The NYSE is responsible for listing securities, setting exchange policies, and supervising the exchange and member firms. The NYSE has the power to take disciplinary action against member firms.
- **Chicago Board Options Exchange (CBOE):** The CBOE is an exchange that makes and enforces options exchange rules.

REMEMBER

Although SROs may be independent, they work together creating and enforcing rules. FINRA and NYSE can fine, suspend, censure (reprimand), and expel members; however, the FINRA and NYSE can't imprison members who violate the rules and regulations.

TIP

Look at SIE questions with the words *guarantee* or *approve* in them very carefully. The FINRA, SEC, NYSE, and so on do *not* approve or guarantee securities. Any statement that says that they do is false. In addition, because a firm is registered with (or didn't have its registration revoked by) an SRO, it does not mean that the SRO approves of the firm, its financial standing, its business, its conduct, and so on. As such, member firms and their associates may not claim that they've been approved by the SEC or any SRO.

State regulators

The North American Securities Administrators Association (NASAA) is devoted to investor protection. It is a voluntary association that consists of 67 regulators. NASAA even predates the creation of the SEC. Its key roles include

- Licensing stockbrokers, smaller investment adviser firms (ones managing less than $100 million in assets), and securities firms conducting business in the state.

- Registering securities on the state level.
- Investigating customer complaints and possible cases of investment fraud.
- Enforcing state securities laws. As such, the NASAA may fine, penalize, provide restitution to investors, assist in prosecuting investment-related criminals, and impose new conduct laws to correct problems as they arise.
- Examining investment adviser firms and broker–dealers to ensure compliance with securities laws and making sure they keep accurate client records.
- Reviewing offerings that are not exempt from state law.
- Providing education to investors regarding their rights and providing information so that they can make more informed financial decisions.
- Advocating for the passage of state securities laws.

TIP

When it comes to the SIE exam, don't go crazy trying to remember every minute detail regarding the NASAA; you'll have to know more when taking the Series 63, Series 65, or Series 66. Get a general feeling for what they do so that you're able to recognize them in a question.

Department of the Treasury/IRS

The U.S. Department of the Treasury (USDT) was established to manage U.S. government revenue. As such, the USDT oversees the printing of all paper currency and minting of all coins. In addition, it is responsible for collecting taxes through the Internal Revenue Service (IRS); it is responsible for managing U.S. government debt securities (T-bonds, T-notes, T-bills, and so on); it licenses banks; and it helps advise U.S. government branches regarding fiscal policy.

FINRA Registration and Reporting Requirements

Unless an individual is exempt from registration requirements, all brokerage firms have registration and reporting requirements that must be followed for their employees. Financial professionals must fill out U4 forms, be fingerprinted, pass necessary exams, take continuing education, and so on.

Filling out the U4 form

Persons wanting to register as financial professionals with FINRA (like you) must submit a *U4 form*. The application includes things like a ten-year employment history and a five-year residential history; if you're registered with another firm, how you're registering (Securities Trader, Financial and Operations Principal, General Securities Representative, and a slew more); states you want to be registered in; and so on. In addition, applicants must submit their fingerprints.

All U4 forms (`www.finra.org/sites/default/files/form-u4.pdf`) must be thoroughly reviewed by a principal of the firm. *Background checks* must be performed, and the applicant's employers for the previous three years must be called to verify the applicant's employment history. The calls must be made within 30 days of the firm receiving the U4 form. Special scrutiny of the applicant is required if the applicant has previously worked in the securities industry. Information contained in the U4 form must be complete and not misleading.

The U4 form also contains an *arbitration disclosure*, which states that disputes between the applicant and the member firm will be settled by arbitration (essentially, you won't take the firm to court).

TIP

Although a lot of information listed here can disqualify a person, most of the information follows a common theme —which makes sense; you shouldn't have to memorize it all, in other words. However, I suggest you be aware of the ten-year disqualification rule if an individual has been *convicted* (not charged or accused) of a felony or certain misdemeanors. In addition, if a registrant includes misleading information or omits information, their registration will be denied.

Note: *Nonregistered (unregistered) persons* may not solicit customers or take orders. In addition, member firms are prohibited from paying commissions, fees, concessions, discounts, and so on to any person who is not registered. The failure of a member firm to register someone who should be registered will likely end in disciplinary action by FINRA. Nonregistered persons may handle basic questions. (What is your location? Can I leave a message? What are your hours?) In addition, they may send out literature, transfer calls, set up appointments, let customers know about upcoming seminars, and such. They can't be directly involved in securities business (opening accounts, taking trade orders, soliciting trades, giving quotes, and so on). In the event that a nonregistered person is to handle securities and/or money, they must be fingerprinted.

Missing the mark: Grounds for disqualification

A person will be *statutorily disqualified* from membership from FINRA under the following circumstances:

- If they had a felony criminal conviction or certain misdemeanor convictions within the last ten years.
- If they have had a temporary or permanent injunction (no matter what the injunction's age) issued by a court involving a long list of unlawful investment activities.
- If they have been expelled, barred, or are currently suspended from membership or participation in another self-regulatory organization. This holds true even if the person has been barred with the right to reapply.
- If they have been barred or current suspension orders are coming from the SEC, Commodity Futures Trading Commission (CFTC), or any other appropriate authority or regulatory agency. As with the preceding rule, this holds true even if the person has been barred with the right to reapply.
- If they have been denied or had their registration revoked by the CFTC, SEC, or any other appropriate authority or regulatory agency.
- If it has been found that a member or person has made certain false statements in their application, in reports, or in proceedings before the SEC, SROs, or any other appropriate regulatory authority or agency.
- If any final order from a state securities commission (or from any agency or state officer performing similar functions), savings association, credit union, any state authority that examines or supervises banks, state insurance commission (or any office or agency performing similar functions), an appropriate federal banking agency, or the National Credit Union Administration.
  - Bars said person from association with an entity (such as a broker–dealer, investment advisory firm, and so on) regulated by such commission, agency, authority, or officer, or from engaging in the business of banking, insurance, securities, savings association activities, or credit union activities.

- Constitutes a final order based on violations of any regulations or laws that prohibit manipulative, fraudulent, or deceptive conduct.

» If the SEC, CFTC, or any SRO finds that a person
  - "Willfully" violated federal securities laws, "willfully" violated commodities laws, or "willfully" violated MSRB rules.
  - "Willfully" aided, commanded, induced, abetted, counseled, or procured violations as set forth in the preceding rule.
  - Failed to supervise another person who committed violations as set forth in rule number one.

Handing over your fingerprints

Under SEC Rule 17f-2 (you don't have to remember the rule number), all employees of a brokerage firm are required to be fingerprinted if they are involved in any of the following activities:

» Making sales

» Handling assets (cash and/or certificates)

» Accessing original books and records

» Supervising any of the preceding activities

Fingerprints are always required when a person is applying for registration. The fingerprints must be submitted as well as the U4 form. If FINRA doesn't receive the fingerprints within 30 days of the U4 being submitted, the applicant's registration will be deemed inactive.

REMEMBER

The information you provide and your investment professional history don't remain in a bubble. The Central Registration Depository's (CRD's) BrokerCheck (`https://brokercheck.finra.org/`) allows investors access to vital information that they may need to help them pick the right firm and the right professional, like you. Don't worry; it won't disclose your address, Social Security number, and the like. However, it will disclose complaints against you and your employer, where you and your employer are registered, exams you passed, how many years you've been in the business, if you were convicted or pled guilty to a crime, if you or your broker have been expelled from an SRO, and so on. If a member maintains a website, the site must provide a link to BrokerCheck.

Continuing education

Yes, even after you've passed your securities exams like this one, you're not done. You're required to take continuing education programs as required by FINRA. These are to make sure that you are up-to-date with any new laws and that you remember the existing ones. Two elements of continuing education are required: the firm element and the regulatory element.

Firm element

Member firms must have annual meetings covering the services and strategies offered by the firm. In addition, the meeting must cover any recent regulatory developments, if any. The meetings must be interactive and allow people to ask questions. All registered persons who have direct contact with the public must attend the meeting. All firms must have continuing and current education programs for their covered employees.

Regulatory element

All registered persons are required to take a computer-based training session covering FINRA regulations by December 31st of each year. In the event that the training isn't taken within the required period, the person's securities license(s) will be deactivated until it's completed. If the registered person's licenses have been deactivated for two years, the individual will be administratively terminated. If administratively terminated, the person must reapply for registration.

What happens when a rep resigns or is terminated

If you leave your firm for whatever reason, the member firm you were working for has to file a U5 form with the CRD within 30 days of the date you resigned or were terminated. You will also receive a copy for your records. The U5 form requires the member firm to provide an explanation of why you left or why you were terminated. If you're moving to a new member firm, your new employer must file a new U4 form and receive a copy of the U5 filed by your former employer.

REMEMBER

Things sometimes change, so if something on your U4 or U5 form is or becomes inaccurate, your firm must update the information on the CRD. This could be something as simple as an address change or something a tad more complex — a violation of some kind or (Heaven forbid) a felony conviction.

TIP

Don't wait too long going from one firm to another. After a U5 form has been filed on your behalf, you have up to two years to get registered with another firm or you'll have to take your securities exams all over again. You certainly don't want that to happen.

Skipping a step: Who's exempt from FINRA registration

Certain individuals who work for a member firm are exempt from FINRA registration. These include

- Persons whose functions are solely clerical or ministerial
- Persons solely affecting transactions on the floor of a national securities exchange and who are registered with that exchange
- Persons whose function is solely and exclusively involved in transactions of municipal securities
- Persons whose function is solely and exclusively involved in transactions of commodities
- Persons whose function is solely and exclusively involved in transactions in securities futures, as long as that person is registered with a registered futures association

Adhering to reporting requirements

Under FINRA Rule 4530, member firms must report specified events, including quarterly statistical and summary information regarding customer complaints as well as copies of certain civil and criminal actions. Members must report promptly (no later than 30 days after the member knows or should've known about the event) if the member (or associated person of the member)

- Has been found to have violated any securities-related or non-securities-related investment laws or standards of conduct by a U.S. or foreign regulatory organization.
- Is the subject of a written customer complaint involving allegations of theft or misappropriation of funds or securities.
- Is the subject of a written customer complaint involving allegations of forgery.
- Has been named as a defendant or respondent in a proceeding brought by a U.S. or foreign regulatory body alleging a violation of rules.
- Has been denied registration, suspended, expelled, or disciplined by a U.S. or foreign regulatory organization.
- Is indicted, convicted of, or pleads guilty to any felony or certain misdemeanors in or outside the United States.

REMEMBER

The preceding list includes firm reporting requirements under Rule 4530, but firms are required to report certain other events, too. These include

- Outside business activities (covered in the following section).
- Private securities transactions — transactions outside the broker–dealer's normal business, in other words. For argument's sake, say that an associate of a firm has a client who wants to trade options but their firm doesn't trade options because it doesn't have an options principal. In this case, with the permission of their firm, they can accept the order from their client and do the trade through another firm.
- Political contributions and consequences for exceeding dollar contribution thresholds (see "Avoiding violations" later in the chapter).
- Felonies, financial-related misdemeanors, liens, bankruptcies.

Outside business activities

While you're building your business and getting new clients, you may feel the need to make a few extra bucks working another job. If so, you must notify your brokerage firm in writing. However, you don't need to receive written permission to work the other job. Your member firm may reject or restrict your outside work if it feels there is a conflict of interest. (Volunteering does not require written notification.)

Accounts at other broker–dealers and financial institutions

Although you probably won't do this, persons associated with a member firm may open an account at another member firm (executing firm) with prior written permission from the employing firm. The associated person must also let the executing firm know that they are working for another member firm. Duplicate confirmations and statements must be sent to the employing firm if requested.

Private securities transactions

When involved in a private securities transaction, associated persons must provide written notice to their employing firm. These take place when an associated person is involved in a securities transaction outside of their normal business and outside of their employing member firm.

If an associated person would like to enter into a private securities transaction, they must:

- Provide written notice to their employing firm
- Explain their role in the possible transaction
- Describe complete details of the possible transaction
- Disclose whether they will receive compensation (what type and/or dollar amount) for the transaction

Whether the associated person receives compensation or not, the employing firm must provide approval. Transactions for immediate family members in which the associated person does not receive compensation *are not* considered private securities transactions.

Trading by the Book When the Account Is Open

After you've opened a new account, you have to follow additional rules and regulations to keep working in the business. You need to know how to receive trade instructions and how to fill out an order ticket, as well as settlement and payment dates for different securities.

Filling out an order ticket

When you're working as a registered rep, completing documents such as order tickets will become second nature because you'll have them in front of you. When you're taking the SIE, you don't have that luxury, but you still need to know the particulars about what to fill out.

Getting the particulars on paper (or in binary form)

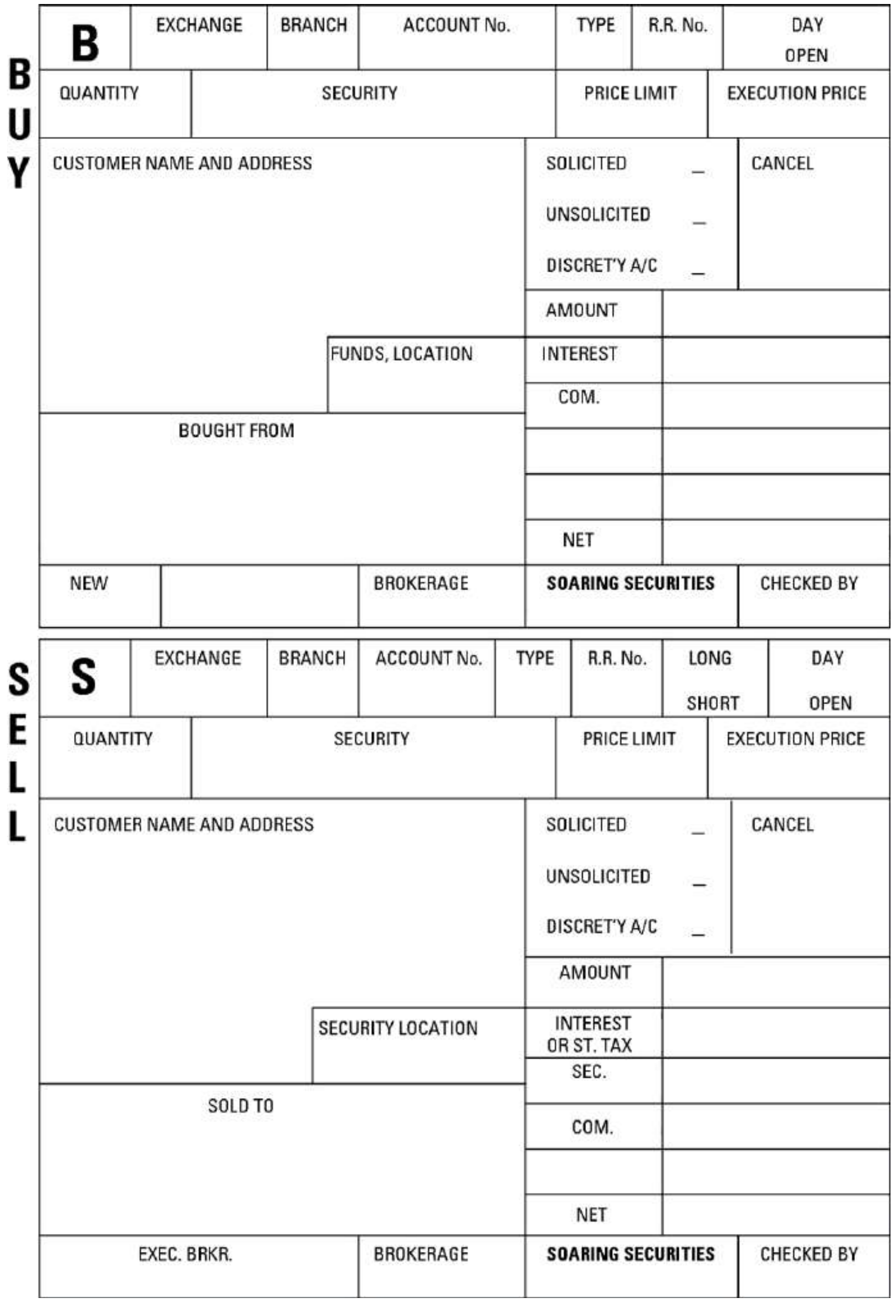
When your customer places an order, you have to fill out an order ticket. Order tickets may be on paper or entered electronically, which happens more often. Regardless of how you enter the order, it needs to contain the following information:

- The registered rep's identification number
- The customer's account number
- The description of the security (stocks, bonds, symbol, and so on)
- The number of shares or bonds that are being purchased or sold
- Whether the registered rep has discretionary authority over the account
- Whether the customer is buying, selling long (selling securities that are owned), or selling short (selling borrowed securities; see Chapter 12)
- For option tickets, whether the customer is buying or writing (selling), is covered or uncovered, and is opening or closing (see Chapter 11 for info on options)
- Whether it's a market order, good-till-canceled (GTC) order, day order, and so on
- Whether the trade is executed in a cash or margin account
- Whether the trade was solicited or unsolicited

» The time of the order

» The execution price

Figure 16-1 shows you what standard paper order tickets may look like.


BUY

B | EXCHANGE | BRANCH | ACCOUNT No. | TYPE | R.R. No. | DAY OPEN

QUANTITY | SECURITY | PRICE LIMIT | EXECUTION PRICE

CUSTOMER NAME AND ADDRESS | SOLICITED _ | UNSOLICITED _ | DISCRET'Y A/C _ | CANCEL

AMOUNT

FUNDS, LOCATION | INTEREST

COM.

BOUGHT FROM

NET

NEW | BROKERAGE | SOARING SECURITIES | CHECKED BY

SELL

S | EXCHANGE | BRANCH | ACCOUNT No. | TYPE | R.R. No. | LONG SHORT | DAY OPEN

QUANTITY | SECURITY | PRICE LIMIT | EXECUTION PRICE

CUSTOMER NAME AND ADDRESS | SOLICITED _ | UNSOLICITED _ | DISCRET'Y A/C _ | CANCEL

AMOUNT

SECURITY LOCATION | INTEREST OR ST. TAX

SEC.

SOLD TO

COM.

NET

EXEC. BRKR. | BROKERAGE | SOARING SECURITIES | CHECKED BY

FIGURE 16-1: Buy and sell order tickets have spaces for the info you need to make a trade.

Designating unsolicited trades

Normally, you'll be recommending securities in line with a customer's investment objectives. If, however, the customer requests a trade that you think is unsuitable, it's your duty to inform them about it. You don't have to reject the order. (It's the customer's money to do with is they see fit and, when all is said and done, you're in the business to generate commissions.) If the customer still wants to execute the trade, simply mark the order as *unsolicited,* which takes the responsibility off your shoulders.

A trip to the principal's office: Securing a signature

Principals are designated managers of a firm. All brokerage firms must have *at least two principals* (unless the firm is a sole proprietorship). When you open or trade an account, you have to bring the new account form or order ticket to a principal to sign. Principals need to approve all new accounts, all trades in accounts, and all advertisements and sales literature; they also handle all complaints (lucky break for you!), oversee employees, and watch for potential red flags. (***Note:*** A principal doesn't have to approve a prospectus or your recommendations to your customers.)

REMEMBER

Although you'll generally bring an order ticket to a principal right after taking an order, the principal can sign the order ticket later in the day. If you're questioned about this on the SIE exam, you want to answer that the principal needs to approve the trade on the same day, not before or immediately after the trade.

Proportionate sharing

Members or associated persons are prohibited from sharing in the profits or losses in a customer's account. An exception to this rule is if the associated person contributed to the account. In that case, the associated person needs a written authorization from the customer and principal and the profits and/or losses are shared by the customer and associated member based on the percentage contributed. Exempt from the rule of proportional sharing are accounts of immediate family (parents, mother-in-law, father-in-law, spouse, or children) of the associated member.

Checking your calendar: Payment and settlement dates

Securities that investors purchase have different payment and settlement dates. Here's what you need to know:

- **Trade date:** The day the trade is executed. An investor who buys a security owns the security as soon as the trade is executed, whether or not they have paid for the trade.
- **Settlement date:** The day the issuer updates its records and the certificates are delivered to the buyer's brokerage firm.
- **Payment date:** The day the buyer of the securities must pay for the trade.

TIP

Unless the question specifically asks you to follow FINRA or NYSE rules (which I doubt it will), assume the Fed *regular way* settlement and payment dates as they appear in Table 16-1. The FINRA and NYSE rules both require payment for securities to be made no later than the settlement date, but the Federal Reserve Board states that the payment date for corporate securities is four business days after the trade date.

REMEMBER

Cash trades (which are same-day settlements) require payment for the securities and delivery of the securities on the same day as the trade date.

In certain cases, securities may not be able to be delivered as in the preceding chart. In these cases, the seller may specify that there's going to be a *delayed delivery*. There can also be a *mutually agreed upon* date in which the buyer and seller agree on a delayed delivery date prior to or at the time of the transaction.

TABLE 16-1 Regular Way Settlement and Payment Dates

Type of Security	Settlement Date (in Business Days after the Trade Date)	Payment Date (in Business Days after the Trade Date)
Stocks and corporate bonds	2 (T+2 — two business days after the trade date)	4
Municipal bonds	2 (T+2)	2
U.S. government bonds	1 (T+1)	1
Options	1 (T+1)	4

The *when, as, and if issued (when-issued transaction)* method of delivery is used for a securities issue that has been authorized and sold to investors before the certificates are ready for delivery. This method is typically used for stock splits, new issues of municipal bonds, and Treasury securities (U.S. government securities). The settlement date for when-issued securities can be any of the following:

- A date to be assigned
- Two business days after the securities are ready for delivery
- On the date determined by FINRA

Safeguarding investor info: Regulation S-P

According to Regulation S-P, broker–dealers, investment companies, and investment advisers must "adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information." This means that members must provide a way for securing customers' nonpublic personal information, such as Social Security numbers, bank account information, or any other personally identifiable financial information. Members must provide customers a notice of their privacy policies. Members may disclose a customer's nonpublic information to unaffiliated third parties unless the customer *opts out* and chooses not to have his information shared. A firm must include their policies to protect to the security of a customer's nonpublic information in their customer privacy and opt-out notices. Members must make every effort to safeguard customers' information, including securing computers, encrypting emails, and so on.

Confirming a trade

A *trade confirmation* (receipt of trade) is the document you send to a customer after a trade has taken place. You have to send out trade confirmations after each trade, at or before the completion of the transaction (the settlement date). Here's a list of information included in the confirmation:

- The customer's account number
- The registered rep's ID number
- The trade date
- Whether the customer bought (BOT), sold (SLD), or sold short
- A description of the security purchased or sold
- The number of shares of stock or the par value of bonds purchased or sold

- The yield (if bonds)
- The Committee on Uniform Security Identification Procedures (CUSIP) number (a security ID number, in other words)
- The price of the security
- The total amount paid or received, not including commission or any fees
- The commission, which is added on purchases and subtracted on sales (if the broker–dealer purchased for or sold from its own inventory, the markdown or markup doesn't have to be disclosed)
- The *net amount,* or the amount the customer paid or received after adding or subtracting the commission (if the investor purchased or sold bonds, the accrued interest is added or subtracted during this calculation)
- Whether the trade was executed on a principal or agency basis (the capacity)

REMEMBER

You should recognize the items listed in the preceding list, which are required for most securities trades including municipal bonds. However, the MSRB tends to be a little stricter and also requires the following information:

- Whether the member acted as an agent for both the customer and another person for the same trade
- The time of execution for institutional accounts or transactions in municipal fund securities
- The settlement date
- Yield-to-maturity or yield-to-call, whichever is lower
- Final monies, including the total dollar amount of the transaction and accrued interest if applicable
- Whether there's any credit backing the securities (for revenue bonds, the source of revenue; or if there's insurance backing the bonds)
- Any special features of the bonds (callable, puttable, stepped coupon, book entry only, and so on)
- Information on the status of the securities (pre-refunded, called, escrowed to maturity, securities in default, and so on)
- Tax information (taxable, nontaxable, subject to alternative minimum tax, original issue discount)

PHYSICAL VERSUS BOOK ENTRY

Although many years ago almost all delivery of stock certificates and debt securities (bonds) was in physical form (meaning you actually received the certificate), most delivery and settlement now is in book-entry form. Even though you don't get to actually hold your oft-times cool-looking certificates, book entry helps save money and makes trading much easier. When purchasing securities via book entry, you will receive a receipt of trade, showing you own the securities but will not receive the actual certificates. A record of your trading activity is kept on the financial institution's books. When it comes time to sell the securities, nothing has to be transferred; it is just changed on the institution's books, and you receive confirmation (receipt) of the trade.

Acting in your customers' best interest

As part of your job, your clients' interest has to come before your own. So besides understanding your clients' needs, you need to follow and understand regulatory rules as well.

SEC Regulation BI (Best Interest) - Rule 15i-1

SEC Regulation BI was established recently to enhance the Securities Exchange Act of 1934. All broker–dealers are required to act in the best interest of their customers. In that regard, broker–dealers are required to comply with the following rules:

- They're required to disclose all relationships with their clients in writing. This includes letting clients know whether they're acting as a broker or dealer in a trade, disclosing fees for non-trade related services, the services they provide, and any potential conflicts of interest.
- They must provide a *Form CRS* (customer relationship survey) to each client prior to the initial recommendation to that client.
- They must use reasonable care, skill, and diligence when making recommendations to clients.
- They must establish procedures to disclose potential conflicts of interest to customers when making recommendations.
- They must establish procedures to enforce compliance with Regulation BI.

Financial exploitation of specified adults

With people living longer and the number of seniors increasing, FINRA recently created rules to help curb or handle cases of financial exploitations of specified adults (seniors — natural persons (living human being) aged 65 or older — and natural persons aged 18 or older who have mental or physical impairments that render them unable to protect their own interests). For specified adults, financial institutions must obtain the information of a trusted contact person whom they can contact regarding unusual trading activity in the account.

FINRA defines the term *financial exploitation* as

(A) "the wrongful or unauthorized taking, withholding, appropriation, or use of a Specified Adult's funds or securities"; or

(B) "any act or omission by a person, including through the use of a power of attorney, guardianship, or any other authority regarding a Specified Adult to:"

- **(a)** "obtain control, through deception, intimidation or undue influence, over the Specified Adult's money, assets, or property"; or
- **(b)** "convert the Specified Adult's money, assets or property."

In the event that a member believes that the financial exploitation of specified adults has or may be taking place, Rule 2165 allows the member to place a temporary hold on the disbursement of the specified adult's funds or securities. If a temporary hold has been put in place, the member has up to two business days to contact all parties involved in the transaction as well as the trusted contact person (unless the member believes that they are involved in the exploitation) to describe the reason(s) for the temporary hold. The hold typically lasts up to 15 business days, which may be extended, while being reviewed.

The SIE and other FINRA exams cover topics related to protecting seniors, including

- Firms' marketing and communications to investors age 65 and older
- Information required when opening an account for a senior
- Any disclosures provided to senior investors
- Complaints filed by senior investors as well as how the firm handles the complaints
- Supervision of registered reps as they communicate with senior investors
- The suitability and types of securities marketed and sold to senior investors
- The training of a firm's representatives as to how they are to handle the accounts of specified adults

FINRA recently created a helpline (844-57-HELPS) for seniors to provide support and assistance.

Borrowing from or lending to

Registered persons associated with a member firm are prohibited from borrowing money from a customer or lending money to a customer unless the member firm has written procedures allowing borrowing and lending money between registered persons and customers and one of the following applies:

- The customer is a member of the registered person's immediate family (spouse, mother, father, mother-in-law, father-in-law, children).
- The customer is a financial institution such as a bank that is in the business of providing credit, financing, or loans.
- The customer and the registered person are both registered under the same member firm.
- The customer and the registered person have a personal relationship outside the broker–customer relationship.
- The customer and the registered person have a business relationship outside the broker–customer relationship.

REMEMBER

This only works if the member firm allows borrowing from or lending to customers. The registered member would have to notify and get written approval from their firm prior to entering into a buying or lending arrangement unless it's not required in the firm's written rules.

Following up with account statements

An *account statement* gives the customer information about their holdings in the account along with the market value at the time the statement was issued. Customers are required under FINRA rule 2231 to receive account statements quarterly (once every three months). The account statement needs to include all account activity, securities positions, and money balances during the period from the time the customer received the previous account statement. For mutual funds, no matter how much (or little) trading was done, a customer needs to receive an account statement semiannually (every six months).

REMEMBER

Customers may want to know how their accounts are doing, and they may wonder about the condition of the firm that they're working with. So upon request by a customer, a member firm must disclose its financial condition by delivering its most recent balance sheet (not income statement). The balance sheet may be delivered in paper form or in electronic form (email) if the customer agrees to the electronic delivery.

Keeping your dividend dates straight

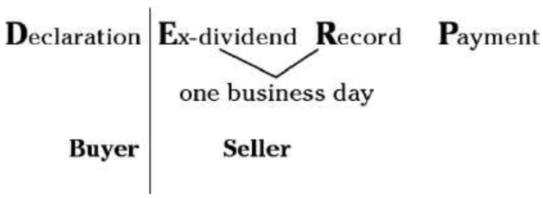
When customers are purchasing securities of a company that's in the process of declaring or paying a dividend, you need to be able to tell those customers whether they're entitled to receive the dividend. Because stock transactions settle in two business days, the customers are entitled to the dividend if they purchase the securities at least three days prior to the *record date.* Here's a list of the four need-to-know dates for the SIE exam:

- **Declaration date:** The day that the corporation officially announces that a dividend will be paid to shareholders. On the declaration date, the dividend amount, the record date, and the payment date, will be announced.
- **Ex-dividend date (ex-date):** The first day that the stock trades without dividends. An investor purchasing the stock on the ex-dividend date isn't entitled to receive the dividend; because stock transactions take two business days to settle, the ex-dividend date is automatically one business day before the record date.

  REMEMBER

  The ex-dividend date is the day that the price of the stock is reduced by the dividend amount. (Chapter 6 tells you more about dividends and related calculations.) When a stock is purchased ex-dividend (on or after the ex-dividend date), the seller is entitled to the dividend, not the buyer. Because the dividend may not be paid for up to a month and sometimes longer, the buyer is required to sign a *due bill* indicating that the dividend belongs to the seller. In the case of a cash dividend, the due bill is in the form of a *due bill check,* which is payable on the date the dividend is paid by the issuer. In addition, if an investor buys a stock on time to receive a dividend but for some reason will not receive the certificates on time (by the record date), the seller must send a *due bill* to the buyer. A due bill states that the buyer is entitled to the rights of ownership even though they've not yet received the certificates.
- **Record date:** The day the corporation inspects its records to see who gets the dividend. To receive the dividend, the investor must be listed as a stockholder in company records.
- **Payment (payable) date:** The day that the corporation pays the dividend to eligible stockholders.

As you can see from the diagram, the buyer receives the dividend if they purchase the stock before the ex-dividend date. If the stock is purchased on or after the ex-dividend date, the seller receives the dividend.



TIP

To help you remember the sequence of dates, use the phrase *Don't Eat Rubber Pickles.* I know it sounds ridiculous, but the more ridiculous, the easier it is to remember.

REMEMBER

The board of directors must announce three dates: the declaration date, the record date, and the payment date. The ex-dividend date doesn't need to be announced because it's automatically one business day before the record date. However, mutual funds have to announce all four dates because they may set their ex-dividend date at any time (even on the record date).

The following question tests your ability to answer a dividend question.

EXAMPLE

Wedgie Corporation has just announced a 50-cent cash dividend. If the record date is Tuesday, March 9, when is the last day an investor can purchase the stock and receive the dividend?

(A) March 4

(B) March 5

(C) March 7

(D) March 8

The answer you're looking for is (B). For an investor to purchase the stock and receive a previously declared dividend, they must purchase the stock at least one business day before the ex-dividend date. This question is a little more difficult because you have a weekend to take into consideration.

The ex-dividend date is March 8, which is one business day prior to the record date. This investor has to buy the stock before the ex-dividend date in order to receive the dividend, so they have to buy it March 5 or before (because the 6th and 7th are Saturday and Sunday). The last day an investor can purchase the stock and receive the dividend is March 5.

REMEMBER

If a stock is sold short (if the investor is selling a borrowed security), the lender of the stock sold short is entitled to receive the dividend. (See Chapter 9 for details on margin accounts.) Also, the trades in the example problems are *regular way settlement* (three business days after the trade date); remember that cash transactions settle on the same day as the trade date. In the case of dividends, if an investor purchases stock for cash, they receive the dividend if they purchase the stock anytime up to and including the record date.

Handling complaints

It's bound to happen sooner or later, no matter how awesome you are as a registered rep: One of your customers is going to complain about something (like unauthorized trades, guarantees, and so on). Complaints aren't considered official unless they're in *writing.* If necessary, FINRA wants you to follow the proper procedure for handling complaints. The following sections cover formal and informal proceedings.

Code of procedure (COP)

The *code of procedure* is FINRA's formal procedure for handling securities-related complaints between public customers and members of the securities industry (broker–dealers, registered reps, clearing corporations, and so on). The public customer has the choice of resolving the complaint via the formal code of procedure or the informal code of arbitration. (See the next section.) All complaints going through code of procedure must be responded to by the firm within 25 days after receipt of the customer complaint.

In the code of procedure, the FINRAs's Department of Enforcement (DOE) is responsible for investigating suspected violations. In the event that the investigation leads to what the DOE believes is a violation, the DOE will hold a hearing. If the customer or member isn't satisfied with the results, they can appeal the decision to the FINRA board of governors. Decisions are appealable all the way to federal appellate courts.

Code of arbitration

The *code of arbitration* is an informal hearing (heard by neutral arbiter or a panel of arbiters) that's primarily conducted for disputes between members of the FINRA. Members include not only broker–dealers but also individuals working for member firms.

If you (a registered rep) have a dispute with the broker–dealer that you're working for, you can take the broker–dealer to arbitration. If a customer has a complaint against a broker–dealer or registered rep, the customer has the choice of going through code of procedure (see the preceding section) or code of arbitration, unless the customer has given prior written consent (usually by way of the new account form) stating that they will settle disputes only through arbitration.

REMEMBER

The decisions in arbitration are binding and nonappealable, so they're less costly than court action. If a member firm or person associated with that member firm fails to comply with the terms of the arbitration (in the case of a loss) within 15 days of notification, FINRA reserves the right to suspend or cancel the firm's or person's membership.

Mediation

If an investor and/or broker–dealer are looking for a more informal way to handle disputes, they may voluntarily decide to go to mediation. Disputes settled through mediation are heard by an independent third party. Unlike arbitration, mediation is nonbinding.

REMEMBER

Not all complaints end up going to arbitration, to mediation, or go through the code of procedure. Sometimes, the complaints are the result of miscommunication, such as instances in which the customer made a mistake, a customer feels they were charged too much commission, and so on. A lot of these complaints can be handled internally without the need for progression. However, all complaints need to be kept on file along with any action taken.

Disseminating info: Appropriate communications

To help promote their business and to keep customers up-to-date, member firms continually send out sales literature, publish ads, run commercials, send out research reports, have scripted seminars, and so on. As you can imagine, ads and such cannot omit material facts, exaggerate, or be fraudulent or misleading, and must also explain the potential risks along with the potential benefits. You've probably heard the disclaimers "Past performance does not indicate future performance" and "People can and do lose money" in radio ads. Believe me, they wouldn't put those in unless they had to.

FINRA divides communication into three categories:

- **Correspondence:** Any written communication (including electronic) distributed or made available to *25 or fewer* retail investors (ones that are not institutional investors) within a 30-calendar-day period.
- **Retail communication:** Similar to correspondence (see the preceding bullet) but made available to *more than 25* retail investors within a 30-calendar-day period.
- **Institutional communication:** Any written communication (including electronic) distributed or made available only to institutional investors, but not including a member's internal communications. Institutional investors include government entities, member firms and registered persons, employee benefit plans, a person acting solely on behalf of any such institutional investor, and so on.

REMEMBER

As with just about everything that happens at a brokerage firm, retail communications must be approved by a qualified principal of the firm. Research reports on particular securities must be approved by a supervisory analyst who has expertise in the particular product. Testimonials (if any) must be made by a person who has the knowledge and experience to have a valid opinion. Member firms are in many cases required to file retail communications with FINRA ten business days prior to first use. Members are required to keep the communications for a minimum of three years.

Keeping clear records

As you can imagine, member firms must keep certain records on file. Depending on which records they are, there are certain SEC retention requirements. The records do not necessarily need to be kept in printed format; they can be kept digitally as long as they are in a nonerasable format.

Corporate or partnership documents of the member firm must be kept for the *lifetime* of the firm. The documents must contain the list of officers, partners, and/or directors of the firm. Additionally, U4 forms of all active employees must be kept as long as the firm is in business.

The following records must be kept for a minimum of *six years:*

- **Blotters:** Blotters are records of original entry relating to the purchase and sale of securities, the receipt and deliver of securities, as well as the records of receiving or delivering cash.
- **Ledgers:** Customer account statements, which include trade settlement dates.
- **General ledgers:** A firm's financial statements, which must be updated monthly. A general ledger includes the firm's assets, liabilities, and net worth.
- **Position record:** A record of all the securities owned by the firm and its location.
- **Account record:** Terms and conditions of margin accounts and cash accounts.
- **Closed accounts:** Records of customers who've closed accounts.

Note: Like FINRA rules, MSRB rules require blotters, ledgers, closed accounts, and position records to be kept for six years. However, MSRB also requires records relating to the underwriting of municipal securities, complaints (FINRA, four years), supervisory records, and gift records to be kept for six years.

The following records must be kept for a minimum of *three years:*

- U4 forms, U5 forms, and fingerprints of former employees
- Trade confirmations
- Order tickets
- Advertisements
- Sales literature
- Dividends and interest received in each account
- Powers of attorney
- Speeches/public appearances
- Compliance procedure manuals
- Gifts
- Compensation records of associates

Note: MSRB rules require members to maintain certain records for *four years*. These include subsidiary ledgers, trades, confirmations, terms and conditions of customer accounts, checkbooks and canceled checks, delivery of official statements, public communications, and so on.

REMEMBER

Whether the records have to be kept for three years, six years, or whatever, they have to be easily accessible for two years (FINRA and MSRB).

As you can imagine, strict penalties are enforced for falsification, improper maintenance, or improper retention of records. FINRA reserves the right to inspect the books, records, and accounts of all member firms and their associates. All regulatory requests by FINRA for specified books, records, or accounts should be supplied by the member firm *promptly.*

Committing Other Important Rules to Memory

Brokers and investors must follow numerous rules to keep themselves from facing fines or worse. In this section, I list a few of the more important rules.

Sticking to the 5 percent markup policy

The 5 percent policy (FINRA 5 Percent Markup Policy) is more of a guideline than a rule. The policy was enacted to make sure that investors receive fair treatment and aren't charged excessively for broker–dealer services in the OTC market. The guideline says that brokerage firms shouldn't charge commissions, markups, or markdowns of more than 5 percent for standard trades.

The following trades are subject to the 5 percent markup policy:

- **Principal (dealer) transactions:** A firm buys securities for (or sells securities from) its own inventory and charges a markdown or markup.
- **Agency (broker) transactions:** A firm acts as a middleman (broker) and charges a commission.

- **Riskless (simultaneous) transactions:** A firm buys a security for its own inventory for immediate resale to the customer (riskless to the firm).
- **Proceeds transactions:** A firm sells a security and uses the money to immediately buy another security. You must treat this transaction as one trade. (You can't charge on the way out and on the way in.)

REMEMBER

The 5 percent markup policy covers *over-the-counter trades of outstanding, nonexempt securities with public customers.* If securities are exempt from SEC registration or if they're new securities that require a prospectus, they're exempt from the 5 percent policy. Additionally, if a dealer pays $20 per share to have a security in inventory (dealer cost), and the market price is $8 per share, the dealer can't charge customers $20 per share so that it doesn't take a loss.

Under extenuating circumstances, the brokerage firm may charge more. Justifiable reasons for charging more (or less) than 5 percent include

- Experiencing difficulty buying or selling the security because the market price is too low or too high.
- Handling a small trade. If a customer were to place an order for $100 worth of securities, you'd lose your shirt if you were to charge only 5 percent ($5); in this case, you wouldn't be out of line if you were to charge 100 percent. By the same token, if a customer were to purchase $1 million worth of securities, 5 percent ($50,000) would be considered excessive.
- Encountering difficulty locating and purchasing a specific security.
- Trading nonliquid securities.
- Executing transactions on foreign markets.

Note: The 5 percent markup policy is a guideline that member firms should use when making trades. However, firms may also charge customers for services performed other than trading securities. These services include collection of monies due for principal, interest, or dividends. They may also charge for the exchange or transfer of securities or the safekeeping of customers' securities. The main thing for you to remember is that the charges should be reasonable and not unfairly discriminatory.

Avoiding violations

It's up to your firm and you to understand violations and avoid them. FINRA expects its members and their representatives to "observe high standards of commercial honor and just and equitable principles of trade."

REMEMBER

You need to be aware of some violations not only for the SIE exam but also so you stay out of trouble. Of course, the entire book and this chapter are filled with rules and violations. However, some violations can be summed up in a sentence or two (or three); that's what this section is for. Some of the violations are more connected with broker–dealers, some with registered reps, and some with investment advisers. Violators are subject to sanctions such as fines, censures, suspensions, expulsions, and so on.

- **Commingling of funds:** Combining a customer's fully paid and margined securities or combining a firm's securities with customer securities
- **Interpositioning:** Having two securities dealers act as agents for the same trade so that two commissions are earned on one trade

- **Giving (or receiving) gifts:** Giving or receiving a gift of more than $100 per customer per year. Non-cash business expenses (lunch, dinner, hotel rooms, travel expenses, occasional tickets to a sporting event, and so on) are exempt from this rule.
- **Making political contributions (paying to play):** Under the Investment Advisers Act of 1940, investment advisers are prohibited from providing investment advisory services for a fee to a government client for two years after a contribution is made. This rule applies not only to the adviser, executives, and employees making contributions to certain elected officials, but also to candidates who may later be elected. In addition, investment advisers are prohibited from soliciting contributions for elected officials or candidates if the investment adviser is seeking or providing government business.
- **Falsifying or withholding documents:** Firms cannot make up information or withhold needed documents from customers or any SRO.
- **Signatures of convenience:** Basically, forging a customer's signature even if approved by the customer is a violation.
- **Guarantees:** Members and associates are prohibited from making guarantees against loss in any securities transaction or in any securities account of a customer.
- **Improper use:** Members and associates are prohibited from making improper use of a customer's securities or funds.
- **Freeriding:** Allowing a customer to buy and then sell the same securities without paying for the purchase. Under Regulation T, if a customer purchases and sells the same security in a cash account without paying for the security, their account will be restricted for 90 days. For that 90-day period, the customer will have to pay in full before purchasing securities.
- **Backing away:** Failure on the part of a securities dealer to honor a firm quote.
- **Churning:** A violation whereby a registered rep excessively trades a customer's account for the sole purpose of generating commission.
- **Use of manipulative, deceptive, or other fraudulent devices:** Members are prohibited from inducing the sale or purchase of any security by means of manipulation, deception, or any other fraudulent device or contrivance.
- **Trading ahead of research reports:** No member shall trade a security based on information received from a research report prior to that research report being released publicly.
- **Trading ahead of customer orders:** Members are prohibited from placing their order ahead of a customer's order. Their job is to get their customer the best price, and placing their order ahead of the customer's will likely cause the customer to get a worse price.
- **Not disclosing a financial relationship with the issuer:** It is a violation to not disclose if your firm has a financial relationship with the issuer, where *financial relationship* is defined as being controlled by, having a controlling interest in, or being under common control with the issuer. In the event that there is a financial relationship, it must be disclosed (given to or sent to) the customer prior to the completion of the transaction.
- **Frontrunning:** A violation in which a registered rep executes a trade for themselves, their firm, or a discretionary account based on knowledge of a block trade (10,000 shares or more) before the trade is reported on the ticker tape.
- **Prearranging trades:** A prearranged trade is an illegal agreement between a registered rep and a customer to buy back a security at a fixed price.
- **Paying for referrals:** Members or persons associated with a member (for example, registered reps) are prohibited from paying cash or noncash compensation to any person except those registered with the member firm or other FINRA members. A violation occurs in the event that compensation is paid to a nonmember for locating, introducing, or referring a client.

Some violations include some sort of *market manipulation.* These include

- **Market rumors:** Members are prohibited from spreading false market rumors that may prompt others to either buy or sell a security.
- **Pump and dump:** This is fake news that most often happens with penny stocks. In this case, the promoters send out mass emails or regular mail to paint a glowing report on a particular security, thus pumping it up. Because of the positive reports, many investors purchase the security and drive the price up. At that point, the promoters sell (dump) their shares for a nice profit.
- **Excessive trading:** A violation whereby a trader places both buy and sell orders on the same security around the same time, thus making it look like there's a lot of trading activity on that security.
- **Marking the open/marking the close:** Executing a series of trades within minutes of the open or close to manipulate the price of a security.
- **Matching orders:** Illegally manipulating the price of a security to make the trading volume appear larger than it really is, such as two brokerage firms working in concert by trading the same security back and forth.
- **Painting the tape:** Creating the illusion of trading activity due to misleading reports on the consolidated tape, such as reporting a trade of 10,000 shares of stock as two separate trades for 5,000 shares each.
- **Paying the media:** A violation in which brokerage firms or affiliated persons pay an employee of the media (website, newspaper, magazine, radio, TV show, and so on) to affect the price of a security, such as paying a TV stock expert to recommend a security that the firm has in its inventory.
- **Anti-intimidation/Coordination:** Members may not intimidate (threaten, harass, coerce, and so on) other members into changing their price(s) on a security. In addition, a member may not coordinate with another member to adjust the price of a security.

It is also considered a violation for a member firm to distribute cash or noncash compensation to the employees of another member firm regarding the sale and distribution of securities unless all of the following apply:

- The compensation is not conditional on sales by the other firm.
- It has prior approval from the other member firm.
- The total amount of compensation does not exceed the limit of $100 per year.

Noncash compensation could be season tickets for the Jets, sending someone on vacation, gift certificates, and so on. Providing an occasional meal, ticket to a sporting event, and such are considered acceptable business entertainment expenses as long as they're neither too expensive nor too frequent. And certain noncash expenses are considered okay as long as they're business-related — paying for a business dinner, paying for a seminar, providing airline tickets, and so on. In addition, you don't have to keep track of things that provide advertising, such as pens with your name on them, coffee mugs with your picture, and so on.

Also, FINRA wants to make sure that members and their associates are making recommendations based on their belief that they fall in line with their customer's investment strategy and their belief that the product(s) recommended is/are the right one(s). So to curb potential conflict of interest, similar cash and noncash compensation rules are put in place for program sponsors, such as investment companies. FINRA just wants to make sure that recommendations are not based on the fact that members or their associates owe someone.

Following the money: Anti-money-laundering rules

The *Bank Secrecy Act* establishes the U.S. Treasury Department as the regulator for anti-money-laundering (AML) programs. All broker–dealers are required to develop programs to detect possible money-laundering abuses. In addition, all broker–dealers must review the Office of Foreign Asset Control's (OFAC) Specially Designated Nationals (SDN) list to make sure that they're not doing business with individuals or organizations that are on the list. Anti-money-laundering programs are designed to help prevent dirty money that has been cleaned (made to look like it came from a legitimate source) from being used to fund terrorist activities, illegal arms sales, drug trafficking, and so on. Here are three stages of money laundering that you must be aware of for the SIE exam (please, don't try this at home):

1. **Placement**

   In this initial stage of money laundering, the funds, derived from criminal activity, are transferred into the financial system (typically via banks and broker–dealers).

2. **Layering**

   Layering is the money launderer's attempt to disguise the source of the funds, usually by moving the funds from one place to another through a series of transactions.

3. **Integration**

   Integration is the final stage of money laundering, when illegal funds are mixed *(commingled)* with legitimate funds. Launderers usually accomplish this step through businesses that operate using cash, importing and exporting companies, and so on.

REMEMBER

Broker–dealers and other financial institutions must report any cash deposits, withdrawals, or transfers of more than *$10,000* in a single day through a *Currency Transaction Report* (CTR) to *FinCEN* (the U.S. Treasury Financial Crimes Network). An institution must report suspicious activity of *$5,000 or more of any type of transaction* to FinCEN by filing a Suspicious Activity Report (SAR).

Here are some indications of money laundering at the opening of the account:

- Concern with U.S. government reporting requirements
- Reluctance to reveal information about business activities
- Suspect ID such as a license or passport that looks like it was made in someone's basement
- Irrational transactions that are inconsistent with objectives
- A fiduciary (the person who can legally make decisions for another investor) who's reluctant to provide information about the customer
- An individual's lack of general knowledge of their industry

And here are some shady signals to look out for after the account is open:

- Irregularly making deposits of large amounts of cash or money orders
- *Structuring* — making cash or cash-equivalent deposits (such as money orders) of just under $10,000 to avoid having them be reported to the U.S. government
- Making wire transfers to non-cooperative countries (Iran, North Korea, Nigeria, and so on) who do not work with the US to try to curb money laundering
- Engaging in sudden and unexplained wire activity

- Making a deposit and transferring it to another party without any business purpose
- Buying a long-term investment and liquidating it in the short term
- Making transfers between multiple accounts for no apparent reason
- Depositing bearer bonds and requesting the money immediately
- Displaying a total lack of concern about risks and commissions

TIP

The signs of money laundering tend to make sense, so when answering an SIE exam question about money laundering, think to yourself, "If it looks like a duck and quacks like a duck, it's probably a duck" — or in financial terms, "If it looks and seems like money laundering, it's probably money laundering."

Complying with AML rules

Under the *Bank Secrecy Act*, which is enforced by FinCEN, all financial institutions, including broker–dealers, must develop and carry out anti-money-laundering (AML) programs. These programs must be approved in writing by a firm's senior management. Financial institutions and broker–dealers must do the following:

- Initiate and carry out policies and procedures designed to detect and report suspicious transactions
- Initiate and carry out policies, procedures, and internal controls that are designed to comply with the Bank Secrecy Act's regulations
- Set up annual independent testing to make sure that the firm is complying with the AML rules under the Bank Secrecy Act
- Appoint and indicate to FINRA (by name, title, email address, phone number, and so on) the person (a *designated AML compliance officer*) or people responsible for implementing and overseeing the daily internal controls of its AML program

REMEMBER

AML programs are not necessarily static and are subject to change. Each firm is responsible for making sure that its AML programs remain current.

Working with public info: Following insider trading rules

Insider trading is a violation that occurs when an individual trades a particular publicly traded security based on information that has not been released (or adequately released) to the public (known as *material nonpublic information*). According to the Insider Trading and Securities Fraud Enforcement Act of 1988, both the tipper (the one who shared the nonpublic information) and the tippee (the one who traded based on the tip) are liable.

REMEMBER

There is no violation of insider trading rules *unless a trade takes place* based on that inside information. If a registered rep or anyone working at a firm receives what they believe to be inside information, they should immediately report it to a principal of the firm.

Charges of insider trading have been brought against

- Officers, directors, and employees of a corporation who traded the corporation's securities after learning of important, confidential corporate developments

- Family members, friends, business associates, and other people (tippees) who received tips from the officers, directors, and employees who traded the corporate securities based on confidential information received
- Government employees who traded based on confidential information received because of their employment with the government, which has not (or not yet) been released to the public
- Employees of brokerage, banking, law, and printing firms who executed trades based on confidential information received as part of their job
- Political consultants who have given tips or traded based on material nonpublic information they received from government employees
- Other persons who have taken advantage of or traded on confidential information they received from employers, friends, family, and others

REMEMBER

Putting it in simple terms, material nonpublic (inside) information is information that could affect the market value of a security but the information has not been released (or adequately released) to the public.

Penalties for insider trading

As you can imagine, the penalties for insider trading are pretty severe:

- The maximum criminal fine for an individual is $5 million per violation and $25 million per business per violation.
- The maximum prison sentence is 20 years per violation.
- The maximum civil sanctions are three times the gain or three times the loss avoided plus disgorgement of profits.

Contemporaneous traders

Persons who enter orders at or about the same time as the person trading on inside information on the opposite side of the market are called contemporaneous traders. So, for argument's sake, if the person with inside information sold shares of ABC common stock due to inside information, a contemporaneous trader would be one who bought shares of ABC common stock at or about the same time (and vice versa). In this case, the contemporaneous trader may actually sue the person who violated the insider trading rules. The suits may be initiated up to five years after the occurrence.

The Investor's Bankruptcy Shield: FDIC and SIPC Coverage

The Federal Deposit Insurance Corporation (FDIC) provides deposit insurance, which guarantees a certain level of safety to people who have money on deposit at a bank. FDIC protects accounts from bank failure (bankruptcy). At the present time, each depositor is protected up to $250,000.

The Securities Investor Protection Corporation (SIPC), which was created under the Securities Investor Protection Act of 1970, protects the customer against broker–dealer bankruptcy. Although it's not a government agency, this private, nonprofit organization was created by the government in 1970. The SIPC protects each separate customer's assets (securities and cash) up to $500,000 total, of which no more than $250,000 can be cash.

Although brokerage firms are required to follow *net capital rules* — specifically, SEC Rule 15c3-1 — that are designed to minimize the chances of broker–dealer failure and protect customer assets, broker–dealers occasionally (too often) declare bankruptcy.

All members must advise clients at the opening of the account about SIPC protection and must provide an SIPC brochure and info on contacting SIPC, including the SIPC's web address and telephone number. In addition, clients must receive all that same info in writing at least once a year.

The following question concerns SIPC coverage.

EXAMPLE

Steve Fredericks has a cash account with $150,000 in securities and $300,000 cash and a margin account with $50,000 in equity. Additionally, Steve has a joint cash account with his wife Melissa with $250,000 in securities and $300,000 cash. If Steve's broker–dealer goes bankrupt, what is his coverage under SIPC?

(A) $450,000

(B) $500,000

(C) $850,000

(D) $950,000

The right choice is (D). If one of your customers has a cash and margin account titled under one name, as Steve does, it's treated as though it belongs to one customer. Therefore, Steve's cash and margin account is covered up to $500,000, of which no more than $250,000 can be cash. He's covered for the $200,000 in securities ($150,000 in securities plus the $50,000 equity) and $250,000 of the $300,000 cash for a total of $450,000. Next, the joint account with his wife is treated as though from a separate customer. Therefore, that account is covered for the $250,000 in securities and $250,000 in cash. Add the two together, and you see that Steve is covered for a total of $950,000 ($450,000 plus $500,000).

REMEMBER

If an investor is not fully covered under SIPC, the investor is still owed money by the bankrupt broker–dealer; therefore, the investor becomes a *general creditor* of the firm for the balance owed.

Holding a customer's mail

If one of your customers is not receiving mail at their usual address because they are traveling, moving, or whatever, your firm can hold their mail for a specified time period up to three months (or longer if for safety or security concerns). This typically has to do with confirmations and account statements that the firm would normally mail. The member firm must have a way to contact the customer in a timely manner (by phone, email, and so on), and the firm must provide a way for the customer to receive information regarding their account (typically via email or through the member's website). In addition, the member firm must verify at reasonable intervals that the customer's instructions still apply.

Business continuity plans and emergency contact information

FINRA requires that all member firms must set up and maintain business continuity plans (BCP) to deal with the possibility of a business disruption. The idea is to make sure that customers will still be able to contact the firm and be able to access their securities and funds during an emergency. Although the plan is somewhat flexible depending on the member's business, some of the items the plan should address include the following:

- Hard copy and electronic data back-up and recovery
- Alternative communications between customers and members
- Alternative communications between members and their employees
- Alternative physical locations of employees
- Regulatory reporting
- Communication with regulators
- How the member firm will ensure that customers will be able to have prompt access to their securities and funds in the event that the member is unable to continue business

TIP

A few other things could be on this list such as "all mission-critical systems" (ways they would be able to handle customers' orders and such), "financial and operational assessments" (how a member's operations would change), and so on. However, the preceding list should be able to get you through SIE exam questions related to what needs to be on a firm's business continuity plan.

Members are required to have a member of senior management (who must be a principal) approve of their business continuity plan. That member is also responsible for conducting an annual review. The member's plan must be disclosed to customers in writing at the opening of their account, posted on the firm's website (if any), and mailed to customers upon request. In addition, besides providing the plan info to FINRA, they must also provide emergency contact information to FINRA. (FINRA must receive the names of two principals and members of senior management to contact in the event of an emergency; if the contact info changes, it must be updated within 30 days.) In the event that any info changes regarding the business continuity plan, the firm is responsible for updating its customers, employees, and FINRA.

Testing Your Knowledge

This chapter was jam-packed full of rules. Unfortunately, there wasn't too much I could do about that except to make them as easy to understand as possible. As you can imagine, because of the size of this chapter, I've given you the most chapter questions . . . oh, joy. Good luck!

Practice questions

1. Which of the following need to be included on a stock order ticket?

   I. The customer's signature
   II. The time of the order
   III. The number of shares
   IV. Whether the trade is solicited or unsolicited

   (A) I, II, and III
   (B) II and III
   (C) II, III, and IV
   (D) I, II, III, and IV

2. All of the following are self-regulatory organizations EXCEPT

(A) NYSE
(B) SEC
(C) MSRB
(D) FINRA

3. Declan Smith has an account at Ayla Broker–dealer. Declan has not traded any securities at Ayla Broker–dealer for over three years. How often is Ayla Broker–dealer required to send an account statement to Declan?

(A) Monthly
(B) Quarterly
(C) Semiannually
(D) Annually

4. The ex-dividend date is ___________ business day(s) before the record date.

(A) one
(B) two
(C) three
(D) five

5. Which of the following is a violation that includes a form of market manipulation?

(A) Commingling
(B) Frontrunning
(C) Pump and dump
(D) Interpositioning

6. Which of the following are subject to the FINRA 5 percent markup policy?

I. Principal transactions
II. Agency transactions
III. Riskless transactions
IV. Proceeds transactions

(A) I and III
(B) II, III, and IV
(C) I, III, and IV
(D) I, II, III, and IV

7. Which of the following is an indication of money laundering when a customer opens an account?

(A) Concern with U.S. government reporting requirements
(B) Reluctance to reveal information about business activities
(C) Questionable ID
(D) All of the above

8. A person will be statutorily disqualified from membership from FINRA under which of the following circumstances?

I. If they had a felony conviction within the last 15 years

II. If they have been barred from membership in an SRO

III. If they have made false statements on their application

(A) I and III

(B) II and III

(C) I and II

(D) I, II, and III

9. If you resign from a brokerage firm, how long do you have to register with another firm so that you don't have to take your securities exams again?

(A) 90 days

(B) 6 months

(C) 1 year

(D) 2 years

10. Which of the following are violations?

(A) Commingling of funds

(B) Interpositioning

(C) Signatures of convenience

(D) All of the above

11. Which of the following securities transactions settle in two business days after the trade date?

I. Stock and corporate bond transactions

II. Municipal bond transactions

III. U.S. government bond transactions

IV. Option transactions

(A) I, III, and IV

(B) II and III

(C) I and II

(D) I, II, III, and IV

12. Broker–dealers, investment companies, and investment advisers must have written policies designed to protect customers' records and information. This rule falls under

(A) Regulation S-P

(B) Regulation D

(C) Regulation M

(D) Regulation T

13. All of the following must be included on a trade confirmation EXCEPT

(A) a description of the security

(B) the markup or markdown

(C) the registered rep's ID number

(D) the commission

14. Zimbot Corporation has just announced a 30-cent dividend to shareholders of record. If the record date is Friday, October 8, when is the first day an investor can purchase the stock and not receive the dividend?

(A) Wednesday, October 6
(B) Thursday, October 7
(C) Friday, October 8
(D) Monday, October 11

15. In which of the following procedures for handling complaints is the decision binding and cannot be appealed?

(A) Code of procedure
(B) Mediation
(C) Arbitration
(D) Both (B) and (C)

16. Which of the following types of transactions are subject to the 5 percent markup policy?

I. Proceeds transactions
II. Riskless transactions
III. Agency transactions
IV. Principal transactions

(A) I, III, and IV
(B) II and III
(C) I and II
(D) I, II, III, and IV

17. Under FINRA rules, all of the following brokerage firm records must be kept for a minimum of three years EXCEPT

(A) ledgers
(B) trade confirmations
(C) order tickets
(D) U4 forms of former employees

18. Broker–dealers, banks, investment advisers, and so on must report a possible money-laundering transaction to

(A) FINRA
(B) FinCEN
(C) FBI
(D) SEC

19. Which TWO of the following are the maximum penalties for insider trading violations?

- **I.** 20 years in prison per violation
- **II.** 25 years in prison per violation
- **III.** $5 million per individual per violation
- **IV.** $25 million per individual per violation

(A) I and III

(B) I and IV

(C) II and III

(D) II and IV

20. A violation in which a firm attempts to drive up the price of a stock based on false or misleading information so that the firm can later sell their shares at a higher price is known as

(A) churning

(B) trading ahead

(C) frontrunning

(D) pump and dump

21. Mr. Slick purchased 400 shares of ZIP Corporation common stock and sold it at a profit prior to paying for the purchase. This is a violation known as

(A) freeriding

(B) frontrunning

(C) trading ahead

(D) interpositioning

22. As part of FINRA's business continuity plan, member firms must provide the emergency contact information for _______________ principal(s) of the firm to contact in the event of an emergency.

(A) one

(B) two

(C) three

(D) all

23. Which TWO of the following are TRUE?

- **I.** FDIC covers each individual up to $250,000.
- **II.** FDIC covers each individual up to $500,000, of which no more than $250,000 can be cash.
- **III.** SIPC covers each individual up to $250,000.
- **IV.** SIPC covers each individual up to $500,000, of which no more than $250,000 can be cash.

(A) I and III

(B) I and IV

(C) II and III

(D) II and IV

24. Under FINRA rules, which of the following records must be kept by a brokerage firm for a minimum of six years?

I. Customer account statements

II. U5 forms

III. Records of all trades executed

IV. Sales literature

(A) I, II, and III

(B) II, III, and IV

(C) I and III

(D) I, II, and IV

25. Which of the following records must be kept for the lifetime of a broker–dealer?

(A) Records of closed accounts

(B) General ledgers

(C) Partnership documents

(D) All of the above

Answers and explanations

1. **C.** The items required on an order ticket are the rep's identification number, the customer's account number, a description of the security, the number of shares, whether the account is discretionary, whether the customer is buying or selling, whether it's a market order or GTC order, whether the trade is for cash or on margin, whether it's solicited or unsolicited, the time of the order, and the execution price. Remember that when an order is placed, it's usually for immediate execution, so getting a customer's signature would be nearly impossible.

2. **B.** The SEC is a government agency and is not a self-regulatory organization. SROs include the MSRB, NYSE, CBOE, and FINRA.

3. **B.** For accounts like Declan Smith's, the brokerage firm must send out account statements at least quarterly (every three months); for mutual funds, every six months.

4. **A.** The ex-dividend date is the first day that the purchaser of a stock will not receive a previously declared dividend. The ex-dividend date is one business day before the record date. As a reminder, Saturday and Sunday are not considered business days. So if the record date was on Monday, the ex-dividend date would be on the previous Friday.

5. **C.** All of the choices listed are violations. However, pump and dump is the only violation listed that is a form of market manipulation. Pump and dump is fake news typically regarding penny stocks that is designed to drive the price of a particular stock up so that the firm can sell their stock at a large profit.

6. **D.** All of the choices listed are subject to the FINRA 5 percent markup policy (5 percent markup policy or 5 percent policy). This means that, under normal circumstances in which you have an average-sized trade and you don't have to jump through hoops to execute the transaction, you shouldn't charge more than 5 percent to execute the trade. Now certainly if the trade is extremely small, you would be able to charge a higher percentage so your firm doesn't lose money. Also, if a trade is extremely large, 5 percent would be considered excessive.

7. **D.** Certainly all of the choices listed would be considered indications of money laundering.

8. **B.** Answers II and III are definitely reasons why a person would be statutorily disqualified. However, answer I doesn't fit because the person would be statutorily disqualified if they had a felony conviction in the last 10 years, not 15.

9. **D.** If a securities licensed individual leaves a brokerage firm, that person has up to two years to get registered with another firm or they will have to take their license exams again.

10. **D.** All of the choices listed are violations. Commingling of funds takes place when a firm combines a customer's fully paid securities with margined securities, or when a firm combines its own securities with a customer's securities. Interpositioning is when two securities broker–dealers act as agents for the same trade, thus requiring the customer to pay more than one commission. Signatures of convenience are ones in which a customer's signature is forged.

11. **C.** Stock, corporate bond, and municipal bond transactions settle in two business days after the trade date (T+2). U.S. government bond and options transactions settle in one business day after the trade date. As a reminder, cash trades settle the same business day as the trade date.

12. **A.** Under Regulation S-P, all broker–dealers, investment companies, and investment advisers must have written policies to protect customer's records and private information. This would include things like Social Security numbers, bank account numbers, and so on.

13. **B.** Although a commission must be included on a trade confirmation for an agency trade, a markup or markdown does not need to be included for a principal transaction. Remember, a principal transaction is one in which the dealer is buying for or selling from its own inventory. Therefore, the price the customer pays or receives already includes a markup or markdown.

14. **B.** The first day the stock trades without the dividend is on the ex-dividend date. The ex-dividend date is one business day before the record date — in this case, Thursday, October 7.

15. **C.** Arbitration decisions are binding and non-appealable. Arbitration is certainly less formal and less costly than going through the court system. As a matter of fact, many brokerage firms have customers sign an arbitration clause as part of a new account form stating that the customer agrees to have disputes handled through arbitration.

16. **D.** All of the choices listed are subject to the 5 percent markup policy. The 5 percent markup policy is designed to help curb overcharging customers for trades. It just means that for standard-size trades with no other contributing factors that make the trade more difficult, customers should not be charged more than 5 percent.

17. **A.** Ledgers, which are customer account statements, must be kept on file for a minimum of six years, not three. As a reminder, all records must be easily accessible for two years.

18. **B.** Under the USA Patriot Act, if financial institutions are concerned about the possibility of money laundering, they must report the transaction(s) to the U.S. Treasury Financial Crimes Network (FinCEN).

19. **A.** The maximum penalties for insider trading are $5 million per individual per violation ($25 million per business) and up to 20 years in prison per violation. Although not part of this question, the maximum civil sanctions are three times the gain or three times the loss avoided plus disgorgement of profits.

20. **D.** Pump and dump is a violation in which a firm promotes a security that they own using false or misleading information to try to pump up the price of the security. After the price has been driven up, they dump their stock at a profit.

21. **A.** Freeriding is a violation that takes place when a customer places an order to purchase a security and sells it at a profit prior to paying for it. Freeriding is not permitted under Regulation T, and it may require the brokerage firm to freeze the customer's account for 90 days.

22. **B.** Because of the possibility of an emergency, all firms are required to have business continuity plans and provide emergency contact information. In addition, all firms must provide the emergency contact information for two principals to FINRA.

23. **B.** The FDIC covers each depositor up to $250,000. The SIPC covers each investor up to $500,000, of which no more than $250,000 can be cash.

24. **C.** Blotters, which includes records of all trades executed by the brokerage firm; ledgers, which include customer account statements; general ledgers; position records; account records; and information on closed accounts must be kept for a minimum of six years. U5 forms and sales literature must be kept for a minimum of three years.

25. **C.** Corporate or partnership documents of the member firm must be kept for the lifetime of the firm.