

# SIE / CFA Course Notes

## Equities

### Class Notes

#### Common Stock

##### Definition

Share of equity or ownership in a corporation or investment company (mutual fund or real estate investment trust).

Limited liability – the most they can lose is their investment.

Negotiable - can be bought or sold

Non-callable - no provision for corporation to buy back stock at a predetermined price

##### Authorized Stock

Number of common stock shares permitted to be issued.

Recorded in corporate charter

Given an arbitrary low par value for tax purposes since some states tax based on par value.

##### Issued Stock

Corporations sell some of their authorized shares. Those sold shares are called issued shares.

Corporations usually do not issue all of their authorized shares. Authorized shares that are not issued are called unissued shares.

##### Treasury Stock

Corporation can buy its own common stock back in the market. This repurchased stock is called treasury stock. EPS will increase since there are fewer shares outstanding.

Does not vote.

Does not receive dividends.

Authorized shares = Unissued shares + ( Issued shares )

Authorized shares = Unissued shares + ( Treasury shares + Outstanding shares )

##### Outstanding Shares

Number of shares issued less any treasury shares.

## Rights of Common Stockholders/Shareholders

Right to vote – common stockholders have right to vote at annual meeting on board of directors and matters of ownership interest that effects % ownership or charter par value. Do not vote on management or dividend decisions which are done by board of directors.

Vote on stock splits (changes par value on charter), reverse stock split, issue convertible bonds (dilutive), issue reduced cost stock options (potentially dilutive if self-dealing)

Do not vote on cash dividends, stock dividends, rights distribution, repurchase shares.

1 vote per share – statutory voting (vote for each director yes or no) or cumulative voting (split votes among directors which can give more power to small shareholders)

Must attend annual meeting to vote

Proxy voting – mail in voting which allows your vote to be presented at meeting by someone who has power of attorney for you

Right to inspect records – common stockholders have right to

Right to transfer ownership – common stockholders have right to

Preemptive right - common stockholders have right to maintain % ownership, so if company decides to issue additional shares, stockholders have first right to buy them to maintain % ownership

Right to corporate distributions – common stockholders have right to cash dividends if board approves them or stock dividends or splits whenever they happen. Corporations are not required to pay dividends but if they do common shareholders have a right to them. Dividends can only be paid as cash or in shares of newly issued shares (not warrants, options, rights or tax credits).

Right to corporate assets on dissolution – common stockholders have right to the remaining assets after secured creditors, liabilities, debenture bondholders, subordinated bondholders, and preferred stockholders are paid off.

## Common stock valuation

Common formulas

Dividend Yield or Current Yield =  $\text{Annual Income} / \text{Market Price}$

Mature companies pay higher dividends and have higher dividend yields.

P/E Ratio =  $\text{Market Price} / \text{Earnings per Share}$

Growth companies have higher P/E ratios.

## Preferred Stock

### Overview

A senior security that had priority over common stock. If company pays dividend, preferred stockholders must get paid before common stock. If company liquidates, preferred shareholders are paid before common shareholders.

Usually \$100 par value with a stated, fixed annual dividend rate. Preferred dividends paid semi-annually usually like bonds but can be paid quarterly like common shareholder dividends.

### Preferred stock prices and Interest rate changes

Priced at par at issuance. Dividend rate set a rate comparable to market rate of interest at issuance.

Current Yield = Annual Income / Market Price

Theoretical Market Price = Annual Income / Market Yield

For example: = \$10 / 10% = \$100

Interest rates rise, theoretical price falls just like bonds

If market rate goes from 10% to 12%, Theoretical market price = \$10 / 11% = \$90.91

Interest rates fall, theoretical price rises

If market rate goes from 10% to 8%, Theoretical market price = \$10 / 8% = \$125

### Preferred stock features

No voting rights.

No preemptive rights to prevent dilution since issuance of new preferred shares do not dilute preferred shareholder returns.

Indefinite life.

Bondholders have priority over preferred shareholders.

Paid a dividend only if board votes to pay dividends.

Preference to dividend distributions before common shareholders.

Cumulative Preferred – omitted dividends accumulate and must be paid before any common shareholder dividends get paid

Callable Preferred – issuer has the right the call in the shares after a set date, usually at par value. Called in if interest rates drop so issuer can “refinance.”

Convertible Preferred – Preferred shareholder can convert share into common stock at a predetermined price.

Participating Preferred - participates in any extra dividends declared by board – one-time special dividends only.

### Special Securities

#### Warrants – Long term stock options

Long-term common stock option attached to new stock or bond issue to help sell new issuance.

Warrants usually have a wait period of 1 year before you can exercise them.

Long term option exercise price set higher than current market price. Exercise price is price you can buy shares at but the market price must rise to that level at a minimum to make it worthwhile to exercise right to buy shares.

Warrants usually last 5 years but perpetual warrants may be issued which then trade in market separately from the stock.

### Rights- Short term stock options

Short term stock options issued with discounted exercise price to market. Sold to existing shareholders.

See pricing example?

### American Depositary Receipts - ADR's

Makes it easier for US investors to buy and sell stocks in their home country while foreign companies do not have to go through registration process with SEC and follow SEC reporting rules.

Foreign bank holds foreign company shares and issues ADRs in US.

Owner of ADR has dividend rights but not voting rights (foreign bank has this) or preemptive rights (right to maintain % ownership). Dividends are converted to US dollars and paid to owner.

Sponsored ADR's trade on exchanges and foreign companies provide US financial statements.

### Trading of Equity Securities

Equity securities trade on exchanges if they are listed (meet listing standards) or trade OTC ) over the counter if they are unlisted – usually because they are too small to be listed. Trade settlement usually occurs in 2 business days after the trade (Regular way settlement, T+2).

## Debt

### Class Notes

### Bond Basics

#### Basic Terms

A debt or loan security that requires the issuer to pay interest and repay principal at maturity.

Par Value or face value are other names for the principal value of bond to be repaid at maturity. Par value is typically \$1,000 at minimum.

Stated Interest Rate is the annual interest rate paid to bond holders. This is similar to the annual coupon rate.

Redemption is when the issuer repays the principal to the bond holder at par value. The bond is then redeemed.

Zero-Coupon Bonds are issued with a par value of usually \$1,000 but no stated interest rate. No semi-annual payments are made. The bonds are purchased at a discount from par value and redeemed at par value at maturity.

## Bond Issue Structure

Term Bonds are a group of bonds all issued with the same interest rate and maturity.

Serial Bonds are a group of bonds with subgroups issued at different maturities and interest rates.

Balloon Maturity relates to bond issuances where the final payment is much larger than all previous payments.

Series Bonds are a group of bonds where subgroups are issued at different times but all have the same maturity.

## Bond Price Quotes

Quotes can be dollar basis (% of par value) or yield basis (YTM)

Corporate Bonds quoted as % of Par in 1/8ths (.125, .25, .375, .5, .625, .75, .875).

For example, quote of  $101 \frac{1}{8} = 101.125 > 101.125\%$  of \$1,000 > \$1,011.25

Government Bonds % of Par in 1/32nds because the market has higher trading volume than corporate bonds and dealers will trade on lower margins (bid vs. ask)

For example, quote of  $99 \frac{19}{32} = 99.59375 > 99.59375\%$  of \$1,000 > \$995.9375

Because corporate and government bonds are term bonds, they all have the same maturity and thus all have the same price.

Spread is the difference between dealer quote buy and sell prices. Think bid and ask prices.

Municipal Serial Bonds use Basis Quotes because they are usually serial bonds where the same bond issuance comes in different bond maturities and interest rate. This means each maturity has a different price. Thus municipal bonds are quoted on Yield (YTM) Basis which is known and Basis Quote.

For example, if a 2035 6.1% bond of San Francisco (matures in 2035 with a coupon of 6.1%) is quoted on a 6.10 basis. It means it is priced to provide a yield of 6.1%, which would give it a price of \$1,000.

Basis Points > 1 basis point = .01%

For example if YTM changes from 6.10% to 6.11% then the YTM went up .01% = 1 basis point.

Normally to find dollar price when given a basis quote (yield), you need to use a calculator or excel. In the SIE you are not allowed to use either.

Bonds Priced at Par will have a quote price as 100% on a par basis and a YTM=coupon rate for yield basis quote.

Bonds Priced at Discount will have a quote price <100% on a par basis and a YTM>coupon rate for yield basis.

Bonds Priced at Premium will have a quote price >100% on a par basis and a YTM < coupon rate for yield basis.

How to Estimate Bond Price for Long Term Bond (>20 years) Quoted on Yield Basis

Bond Price = approximately = (Coupon % / Yield Basis YTM%) x 1000

Example: A municipal bond dealer quotes a 30 years 4% bond on a 5.00 basis.

Bond price = (4% coupon / 5% basis YTM) = .8 x 1000 = \$800

### Effect of Interest Rate Changes on Bond Prices

Interest Rates Up > Bond Prices Down

Interest Rates Down > Bond Prices Up

Rules on which bonds change in price most when interest rates change (Look at bond volatility balance beam example to help remember above)

Longer Maturity Bonds – Greater Price Volatility

Shorter Maturity Bonds – Less Volatility

Lower Coupon – Greater Volatility

Higher Coupon – Lower Volatility

Long Term Zero Coupon Bonds – Highest Volatility

### Bond Yields

Nominal Yield = coupon rate of interest.

Current Yield = Annual interest / current price

Yield to Maturity = discount rate that makes cash flows = price, your average annual return if you hold the bond until maturity.

Yield to Maturity estimate formula (will not need to calculate on SIE):

$YTM = \frac{\text{annual income} + \text{annual capital gain or loss}}{[\text{purchase price} + \text{redemption price}]/2}$

For example estimate YTM for: 10 year, 10% bond at a price of 90.

$YTM = \frac{[(10\%)(1000) + \$100/10\text{years}]}{[900 + 1000]/2} = .1158 = 11.58\%$

How do the above bond yields compare to each other for par, discount and premium bonds?

Assume a 10 year, 10% bond at par, discount, and premium price below.

For Par bond trading at \$1,000, all the types of yields are equal.

Nominal yield = coupon rate = 10%

Current yield = annual coupon \$ / price = (.1)(1000) / 1000 = 10%

Yield to maturity = 10%, equals coupon rate when price = 1000

Yield to call = discuss more later.

For Discount bonds priced below \$1,000 (assume 900) with the same 10 years to maturity and 10% coupon rate. Yields from lowest to highest are: nominal yield < current yield < YTM < yield to call.

Nominal yield = coupon rate = 10%

Current yield = annual coupon \$ / price =  $(.1)(1000) / 900 = 11.1\%$

Yield to maturity = 10%, equals coupon rate when price = 11.7%

Yield to call = discuss more later.

For Premium bonds priced above \$1,000 (assume 1100) with the same 10 years to maturity and 10% coupon rate. Yields from lowest to highest: Yield to call < YTM < current yield < nominal yield

Nominal yield = coupon rate = 10%

Current yield = annual coupon \$ / price =  $(.1)(1000) / 1100 = 9.1\%$

Yield to maturity = 10%, equals coupon rate when price = 8.5%

Yield to call = discuss more later.

### Callable Bonds

A callable bond has a call provision in the bond contract that gives the issuer the right to redeem or call in the bond at a predetermined price after a certain date but before maturity. The issuer does not have to call in the bond.

A call schedule details possible redemption dates and the corresponding redemption price which may go down over time.

Calls Occur When Interest Rates Drop so Borrowers Can Refinance

Call Protection – Usually 10 Years from issuance before callable bonds can be called in

Call Price Sets Ceiling on Market Price – as interest rates drop and bond prices rise, callable bonds will not rise above their call price since they could be called in at that price.

Zero-Coupon Bonds Callable at Accreted Value Plus Call Premium – “accreted” or accrued value because their value goes up as get closer to maturity.

### Puttable Bonds

Puttable bonds give the bond investor the right to put or tender the bonds back to the issuer after a specified date for a specified price – usually par.

Put/Tender Option Given to Bondholder When Interest Rates are Low to entice bond investor to purchase long-term, low interest rate bonds.

Put Exercised When Interest Rates Rise so investor can invest in higher interest rate bonds.

Put Price Sets Floor on Market Price (opposite of callable bond)– price won't go lower as interest rates rise because investor can put bond back to issuer at that price.

## Bond Risks

**Credit or Default Risk** – measured by ratings agencies

Moody's or Standard & Poor's are the largest. Fitch is the third largest but much smaller.

Treasury Debt – AAA Rated – the top rating by Moody's and Fitch. S&P did downgrade US to AA in 2011.

Long-Term Bond Ratings – use the ABC system

Investment Grade includes the top four ratings AAA through BBB. There is no AAA+. Major institutional investors generally only invest in investment grade.

Speculative or Junk Grade includes BB through C rating.

S&P uses +/- Ratings tacked onto the end of the letter rating like AA+ is safer than AA which is better than AA-.

Moody's uses 1-2-3 Ratings to rank credit risk within a letter rating. Aa1 is safer than Aa2 which is safer than Aa3.

Short-Term Corporate and Municipal issues

Moody's corporate rating system below shows P1 for safest prime rating and P3 the lowest prime rating. NP mean Not Prime and is the riskiest.

Moody's municipal rating below shows MIG1 for safest Moody's Investment Grade and MIG3 the lowest Moody's investment grade. SG means speculative grade and is the riskiest.

Standard and Poor's Commercial Paper ratings

Only Top 2 Grades of Paper are Actively Traded (Moody's: P1 and P2 / S&P: A1 and A2) like for money market funds.

### **Interest Rate Risk (also called Market Risk)**

Greater Risk Longer Maturities and Lower Coupon Issues

Interest Rate Risk Only Applies to Fixed-Rate Securities and Preferred Stock with fixed dividend rates.

Variable Rate Bonds Do NOT Have Interest Rate Risk

### **Purchasing Power Risk or Inflation Risk**

Inflation erodes the purchasing power of future interest payments. Also interest rates typically rise as inflation rises which causes bond prices to do down.

### **Marketability Risk**

Marketability risk means that the issue will be difficult to sell perhaps due to the size of the issue or the number of traders. Treasury bonds are said to have no marketability risk.

### **Liquidity Risk**

The risk that the bond can only be sold with high transaction costs. High quality, short term bonds have low liquidity risk generally while low quality, long term bonds have high liquidity risk.

### **Legislative Risk**

The risk that legislated laws reduce the value of the security – perhaps by changing tax laws.

### **Call Risk**

The risk that callable bonds may be redeemed before maturity, which means investors must find a new securities to invest their money – usually at lower interest rates.

### **Reinvestment Risk**

The risk that bond investors who want to reinvest their coupon interest payments do not know what kind of interest they will be able to get in the future. Zero-Coupon bond do not have this risk because there are no coupon interest payments to reinvest.

### **International Investing Risk - Exchange Rate Risk**

As currency exchange rates change the value of foreign debt payments converted into your local currency will change.

### **International Investing Risk - Political Risk**

Usually applied to less developed countries that might make changes to bond payments without fear of legal action against them.

### **Portfolio Risks – Systematic vs. Non-Systematic**

Systematic risk is thought of as whole market risk where something happens and it effects all securities in the market.

Systematic Risk Can Not be Diversified Away – if the market crashes you will lose money.

Non-systematic risk is risk that something happens that only affect one or a few securities.

Non-Systematic Can be Diversified Away, because if you own lots of different securities, something bad happening to only one of them will not hurt your overall portfolio much.

## **Debt**

### Class Notes

## Money Market Debt

- 1 year or less maturity (Capital market – over 1 year)
- Institutional market (not individual investors who buy money market funds)
- Issued in \$1 million or \$5 million par
- Most issued at discount to par and mature at par
- Federal reserve buys and sells the safest of money market instruments through open market operations to affect the supply of cash at banks and consequently interest rates

## Types of Money Market Instruments

- Treasury Bills
- Any Treasury Note or Bond Maturing Within 1 year
- Commercial Paper, max maturity 270 Days
- Other money market instruments
- Bankers' Acceptance, Time Draft to facilitate foreign trade – seller wants assurance money is available to pay before they ship
- Prime BA (bankers' acceptance to pay something in future) – the safest BA are prime and tradeable
- Negotiable Certificate of Deposit (CD) – tradeable, jumbo with minimum \$100,000 promise to pay in future
- Repurchase Agreement
- Repos by Fed Reserve Loosen Credit
- Reverse Repos – tightens credit, matched sale
- Repurchase agreement interest rate track the fed funds rate
- Overnight repurchase agreement

## Risks

- No liquidity risk
- Purchasing Power Risk for repurchase agreements where the underlying instrument that is being sold and repurchased could be a long term with sensitivity to inflation

## Federal funds and Effective Funds Rate

- Shortest term money market instrument - overnight
- Only available to member banks of Federal Reserve System
- Reserves of these banks held on deposit by Federal Reserve Bank
- Can be lent from one bank to another for a fee to cover short term cash needs
- Effective funds rate is the daily average of these overnight loans

## Eurdollars and LIBOR Rate

- Deposits of US Dollars held in bank branches outside US
- Foreign banks trade these deposits like Federal Funds
- US banks can borrow these funds
- LIBOR rate is average rate of 5 major banks centered in London

## Long Term Certificates of Deposit (CD's)

- CD's longer than 1 year (conventional CD's are 1 year or less)
- Called Brokered CDs because brokerage buys one large CD from a bank and then chops it up into smaller units to sell to customers
- Risk disclosures for long term cds
  - CDs subject to market risk
    - Interest rate risk because maturity over 1 year
  - Pre-maturity sale price (sell before maturity) may be less than purchase price if interest rate increase – must be disclosed to clients
  - Limited secondary market
    - Hard to sell
  - Callable CD subject to reinvestment risk – must be disclosed to customer
  - Step-up / step-down CD yield
    - May not reflect current market rate (teaser rate? To get customers and then drop)
  - FDIC insured
    - Only if titled in customers name
- CDs priced at market value
  - On customer account statements but market price can be hard to get
- No prepayment penalty
  - Can not cash out CD early, instead must sell it through broker

## Debt

### Class Notes

## U.S. Government Debt

It is the largest and most traded debt market in the world at over \$35 Trillion.

Exempt From Securities Acts Regulations. SEC has no oversight, but Federal Reserve does.

EE Savings bonds are not part of this market. They are non-negotiable (can not be traded). They are bought and redeemed directly with the government.

### Issued in Book Entry form

No paper certificates that buyers get.

Instead transfer agent keeps track of owners.

### Federal Reserve auctions

Short-term Treasury Bills – Weekly

All Other Treasury Debt – Monthly

## Agency Debt Highest Rating

Government National Mortgage Association debt backed by government.

All other agencies are “implicitly” backed meaning everyone assumes the government will make good on the debts even if the government is not required to.

## Direct Treasury Debt Highest Rating

Is considered free of credit risk.

## US Government Obligations

### Treasury Bonds

- 30 year maturity
- \$1,000 par (but can be \$100)
- Quoted as Percent of Par in 32nds
- Semi-annual interest payments
- Non-Callable

### STRIPS

- “Separate Trading of Registered Interest and Principle Security”
- A Treasury Bond Stripped of Coupons
- Basically a zero coupon treasury bond
- No Reinvestment Risk (no coupons to reinvest at unknown future interest rates)
- High Level of Interest Rate Risk
  - Price is very sensitive to future interest rate changes because only 1 payment at end of maturity (more time value of money discounting to get price)

### Treasury Inflation Protected Securities (TIPS)

- Principle adjusts with inflation
- Coupon interest rate remains constant
- Coupon payment  $\$ = \text{coupon rate} \times (\text{inflation adjusted principle value})$
- Coupon interest rate is a Real Return (vs regular treasury nominal before inflation)
- Repayment of Adjusted Principle or \$1,000 par at end, whichever is higher
- Lower coupon interest rate than regular treasury bonds

### Treasury Notes

- 1 to 10 year maturity
- Quoted in 32nds
- Non-callable
- \$1,000 par usually but can be \$100
- Semi-annual coupon interest

### Treasury Bill

- Up to 12 months maturity
- Yield Basis Quote

- Issued at a discount from par
- Zero coupon bond
- \$100 minimum

### Cash Management Bill (CMB)

- 5 days to 6 months
- Not sold at regular auctions but as needed to fund cash flow needs
- \$100 minimum
- Higher interest rate than treasury bills

### Series EE Bonds

- No Stated Maturity
- Interest added to principle every 6 months
- Holder can redeem any time (but interest stops after 30 years)
- Non-Negotiable – can not sell
- Treasury direct website

## US Government Agency Obligations

Use help promote financing of farming and home ownership.

### Federal Farm Credit System

- Loans to farmers
- Slightly higher (.25%) interest than treasuries due to only implicit government guarantee
- Quoted as a yield spread basis over equivalent treasuries
  - For example:
    - 30 years treasury yielding 2.5% and 30 year federal farm credit bond yielding 2.75%
    - Dealer will quote federal farm credit bond at “25 basis points over”

### Home Mortgages

- Agencies issue bonds to get money
- Federal Home Loan Bank (FHLB)
  - Loans funds to savings and loans banks
- Government National Mortgage Association (Ginnie Mae) (Only one directly backed by US government)
- Federal National Mortgage Association (Fannie Mae)
- Federal Home Loan Mortgage Corporation (Freddie Mac)
  - Above three sell mortgage-backed pass securities (MBS)

### Mortgage Backed Securities

- Also known as Mortgage Backed Pass Through Certificates
- Agencies continuously buy mortgages
- When enough mortgages are bought (\$1 billion) they are placed into a “pool”
- Pool is divided into \$25,000 mortgage pass through certificates and sold

- Monthly Mortgage Payments Passed Through TO The Certificate Holder
- Prepayment Risk – actual maturity of certificate depends on when mortgages are paid off and they may be paid off early so there is a risk that mortgages will be paid off early when homeowners refinance.

### Fannie Mae

- Fannie Mae Buys VA and FHA Guaranteed Mortgages and Conventional Mortgages from Banks
- Fannie Mae is privatized
- Fannie Mae Debt rated AAA Moodys or AA SP

### Ginnie Mae

- Only agency owned and backed by federal government
- Only buys government guaranteed or insured mortgages

### Federal Home Loan Mortgage Corp

- Freddie Mac
- Only Buys Conventional Mortgages that have no government guarantee
- Debt Rated AAA Moodys or AA SP

### Sallie Mae (Student Loan Marketing Association)

Buys student loans from qualified lending institutions

## Trading of Government / Agency Debt

### Over-The-Counter Trading only

- Between banks, dealers, brokers, and federal reserve – no exchanges
- Primary Dealers are the largest dealers that can deal directly with the federal reserve bank.
  - They get designated after history of helping to make an orderly market
- Secondary Dealers – most smaller banks and brokerages
- Federal Reserve as Dealer, NY Trading Desk

### Federal reserve Open Market Operations

- Loosening – buys treasury securities from primary dealers to put more cash into banking system which lowers interest rates since banks need to get people to borrow more
- Tightening – sells treasury securities to primary dealers which takes cash out of the system and banks raise interest rates since they have less cash to lend

### Quoted Electronically

Primarily dealers place quotes for US Government issues on quotations systems like Bloomberg and Reuters

### US Governments initially offered by competitive bid auctions

### Agency debt initially offered by fiscal agents

- Agency Debt trading less active than US Government
- Agencies quoted on Yield Spread Basis in basis points to equivalent maturity treasuries

## Trade Settlement

Treasuries Regular Way Settlement – Next Day – 1 business day after trade date

Agencies Regular Way Settlement – Depends

- Bonds that pay semi-annual interest – regular way is 1 business day after trade date
- MBS which pay interest monthly settle on pre-established dates each month

Cash settlement for US Gov't and Agency – Same Day before 230pm

Trades of US Gov't and Agency securities clear through Federal reserve wire system and Settle in Fed Funds payable at Federal Reserve Bank branches

## Tax Status of US Government Debt

One level of government can not tax another level of government's obligations.

Treasury Debt Interest Income

- Subject to Federal Tax
- Exempt from State and Local Taxes

Municipal Debt Interest Income

- Fed Tax Exempt
- Subject to State and Local Tax

Mortgage Backed Securities

- Subject to Federal, State and Local Taxes

# Debt

Class Notes

## Corporate Debt

Long Term Bonds, Intermediate-Term Notes or Short-Term Notes / Commercial Paper

Bearer Bond

No owner registration. Coupons and principal paid to bearer of those bonds by paying agent. Lost bearer bonds can not be replaced.

Registered to Principal Only Bond .....(but not coupon interest payment)

The \$1,000 principal repayment is registered to a specific person but the coupon payment are NOT.

Fully Registered Bond ..... (for principle and interest)

Both coupon interest and principal are registered to a specific person.

## Book Entry Bond

All bonds today in USA are issued this way. No physical certificates are issued.

Transfer agent records owner name and info.

## Transfer Agent vs. Paying Agent

Transfer agent manages ownership lists for bonds.

Paying agency – often the same financial institution – handles payments.

## Trust Indenture

This is the bond contract that details interest rate, maturity, collateral, call or put provisions, or any other requirements.

## Trust Indenture Act of 1939

Corporate issues of \$50 Million or more must have a Trust Indenture.

## Funded Debt

Long-term corporate debt. Called this because issuer has all of the principal from the beginning (versus only receiving partial amounts of the loan over time).

## Secured Corporate Debt

Mortgage Bond – Lien on specific real estate property.

- Open End + Additional Bond Test means that in the future they sell more bonds in the future secured by the same real assets with the same claim priority as long as company meets some financial tests

- Closed end means future bonds secured by same real asset will be junior to this bond's claim

- Senior/Junior Lien – senior bonds have priority over junior lien bonds in case of default

- Mortgage Bonds are the most popular form of corporate debt

- Mortgage Bonds are the main financing source for Utilities

- Mortgage Bonds have lower interest rates than unsecured debt because they are safer

- Most Utility Financing Comes From Mortgage Bonds

Equipment Trust Certificate, Commonly Issued By Transportation Companies using specific equipment as collateral

- Serial Issues are common so different series of bonds are issued with different maturities related to the equipment usage.

Collateral Trust Certificate has a portfolio of securities placed in a trust as collateral for the bond.

## Unsecured Corporate Debt

Backed by a promise to pay but still can collect as a creditor from liquidation in bankruptcy

Commercial Paper, Short-term

30 Days Most Popular but up to 270 days money market security. At or under 270 days makes it so not registered with SEC.

Discount Instrument sold below par with no coupons in increments of \$100,000 to \$1Million.

Book Entry Form (paperless), Limited Trading – bought by large institutions because too big for small investors.

Debenture – no collateral just credit of issuer

Very safe companies can issue these. If not a safe company these become Junk bonds.

Subordinated Debenture – similar to junior in claim status in default

Guaranteed Bond – subsidiary company sells debenture but parent company guarantees it

Income Bonds, Termed “Adjustment Bonds” are given to bondholders coming out of bankruptcy. These bonds only pay when company has positive income. Par value often adjusted up to compensate owners of old bonds.

Income Bonds Trade Flat because they will pay no interest until company starts making a profit.

## Convertible Corporate Debt

Convertible bonds are corporate debentures.

For example, a \$1000 par bond is convertible into stock at \$50 per share. At issuance stock price was \$40 per share. Each bond is convertible into 20 shares of stock.

$$\text{Conversion Ratio} = (\text{Bond Par Value}) / \text{Conversion price} = \$1000 / \$50 = 20 \quad (20:1)$$

In theory, price of bond and value from converting to shares should be equal.

$$\text{Parity Price of Bond} = \text{Conversion Ratio} \times \text{Stock's Market Price} = 20 \times \$40 = \$800$$

$$\text{Parity Price of Stock} = \text{Bond Market Value} / \text{Conversion Ratio} = \$900 / 20 = \$45$$

Trading Above Parity – when a bond is trading above parity value the conversion feature has no value.

**If bond is now trading for \$900, then the bond is trading above the parity price of \$800.**

Trading Below Parity- when bond is trading below parity value the conversion feature is valuable.

**If bond is now trading for \$700, then the bond is trading below the parity price of \$800.**

Arbitrage of Convertible Bonds when trades below parity

When two equivalent securities are trading at different prices, there is an arbitrage opportunity to buy the lower priced version and sell the higher priced version.

For example convertible bonds are equivalent to shares of stock because the bonds can be converted to shares of stock. However the convertible bonds might trade at a non-equivalent + price to the shares of stock.

If a convertible bond trades at \$1,100 with a 20:1 conversion ratio and the shares are trading at \$60, then the Parity Price of the Bond is  $\$60 \times 20 = \$1,200$ . So the bond is trading below parity.

The arbitrageur could buy the bond at \$1,100, convert it to 20 shares of stock and sell those shares at \$60 each. They would profit  $60 \times 20 - 1100 = 100$ .

Convertible Debt Trading Above Par \$1,000 – price changes usually driven by rising stock price

Convertible Debt Trading Below Par \$1,000 – price changes usually driven by interest rate changes

## Trade Settlement

Regular Way – corporate bonds settle “regular way” in 2 business days after trade date (T+2).

Trades can be done “for Cash” if seller does not want to wait. Done on same day as trade date by 230pm. But will have to drop price to sell this way.

## Claim Priority In A liquidation

1. Secured debt – mortgage bonds and equipment trust certificates received proceeds from sale of collateral property.
2. Other
  - a. Unpaid administrative claims – post bankruptcy claims by people and suppliers who help keep bankrupt company running
  - b. Unpaid wages (employees)
  - c. Unpaid taxes (government)
  - d. Trade creditors (suppliers)
3. Debenture bonds
4. Subordinated Debenture bonds
5. Preferred stock
6. Common stock

# Debt

## Class Notes

## Municipal Debt

Issued by states, local governments, territories, and other local districts.

- Exempt from Federal Income Tax
- Subject to State and Local Tax (unless purchased by resident of that state)
- New Issues are book entry (some older ones are fully registered or bearer)
- Legal Opinion by Bond Lawyer (Counsel) certifies bond and exemption from federal tax
  - Unqualified Opinion – federal exemption ok
  - Qualified Opinion – some issue like not sure about federal tax

- Serial Bonds – most long term municipal debt issued as serials bonds with part of the principal maturing every year for a certain number of years (different maturities)
  - pay interest semi-annually
- Short term notes issued at discount or at par plus accrued interest
- If payments are structured so they are all equal every year because a bond comes due every year, it is called Level Debt Service

### General Obligation Bonds

- Backed by issuer's ability to tax.
- Local governments have ability to tax property (Ad Valorem)
- Most municipal bonds are unlimited ad valorem meaning issuer can raise property taxes to make bond payments.
- Municipalities can also tax income but it is not as common.
- In case of default, bondholders can force additional taxes

### Limited Tax Bonds

- Means the property taxes are limited and have a cap.
- The issuer will not go above a certain property tax rate to satisfy bond payments.
- This increases risk for bond investors and thus bond interest rate must be higher.

### Mill Rate

- Ad valorem or property taxes based on mill rate.
- 1 mill = \$1 tax per \$1,000 property value
- Example: What is 10 mills tax on \$100,000 property?
  - $(10 \text{ mills}/\$1,000) \times \$100,000 = \$1,000$

### State Issued Bonds

- Backed by state income and sales tax

### Constitutional debt limits

- In some states or localities to limit debt or General Obligation bond issuances

### Capital Appreciation Bond

- Municipal zero-coupon bond where discounted principle is counted against the debt limit and not par value

### Parity Bonds

- All general obligation bonds have same claim on payment in case of default
- Corporate unsecured bonds (debentures) – first have senior claim and subsequent have junior

### Revenue Bonds

- Bonds with payments paid by revenue from a specific project, fees, rents, or non-ad valorem taxes.
- Not backed by municipal taxing authority.
- These bonds can be riskier > thus higher yields.

- Feasibility study must show that project is self-supporting such that it can afford to make future bond payments.
- Trust Indenture (from corporate bonds) often added to Revenue Bonds, although not required by law for Municipal Bonds. They are added to help sell them to investors. These are rules that issuer must follow (like maintaining certain financial ratio values).
- Bond Contract contains language for trust indenture along with other normal bond contract information like an authorizing resolution to authorize selling bonds and security agreement which says what taxing power or revenue will support bond payments.

### Other Types of Municipal Bonds

- Special Tax Bond is paid for by non-ad valorem taxes like tobacco, gas, alcohol, etc.
- Special Assessment Bond is paid for by a special assessment on some community members (not all) to pay for something that only help that special community.
- Moral Obligation Bond is issued when a municipality needs money but may not legally issue more debt. So they issue this type of bond saying they will try to pay. Legislature may consider putting budget forward to help pay bonds but not required.
  - Moral Obligation Bonds could be Revenue Bonds like those for a new sports stadium.
- Double-Barreled Bond are backed by both ad valorem taxes and a project revenue source.
- Certificate of Participation (COP) allow states to get around debt ceiling laws by issue tax exempt bonds backed by a project lease payment. The state government is responsible for making the project lease payment. The government is not legally responsible to make the payment but is almost forced because their credit rating would be hurt badly.
- Lease Rental Bonds finance state or local government office buildings where the government leases the property.
- Industrial Development Bonds finance industrial facilities with the lease payments as revenue source. They are guaranteed by private user and not issuer's liability. Credit rating based on user.
- BABs – Build America Bonds - Taxable but issuer gets 35% interest rate credit from Federal Gov't
  - For example, if municipality issues a 10% BAB, it will get payment from Fed Gov't = 3.5%, so net interest cost – 6.5%
  - Municipalities can sell bonds in the broader taxable bond market – now they can sell bonds to investors who are not worried about tax free rates
  - BABs only used for capital projects normally funded with tax free bonds – program ended 2010

### Short Term Municipal Notes

- Usually under 1 year for temporary financing of capital improvements and to even out cash flows
- Usually Issued at Par with a stated interest rate and then redeemed at par plus interest.
- Types of short term municipals
  - For a building to be replaced by long-term late
    - BANs for construction projects with unknown costs at beginning, secured by general obligation pledge

- CLN for multifamily projects. A take-out loan will eventually pay off the CLN issue. Typical CLN is for 2-3 years during high interest periods.
- Pull Forward to get monies now before collected. For example, if taxes come on April 15 but municipality needs money in February
  - Tax Anticipation Note (TAN's), anticipate future tax receipts from future property (ad valorem general obligation)
  - Revenue Anticipation (RAN's), anticipate future revenue receipts from NON-AD VALOREM but still backed by general obligation
  - Tax and Revenue Anticipation notes (TRAN's) – combine both TANs and RAN's
  - Grant Anticipation notes – in anticipation of federal grant monies to be received

### Tax-Exempt Commercial Paper – backed by bank line of credit

- So bank will pay if municipal issuer can not. Then bank will be owed by municipal.

### Variable Rate Demand Notes

- Long term debt issues at short term rates with option to redeem early

### Step-Up / Step-Down Notes

- Interest rate on note can either go up or down (variable rate).

### Variable Rate Notes Have Almost No Market Risk

- Market risk is when interest rates change which causes fixed-rate bond prices to change.
- Variable interest rate bond prices don't change with market rates because their interest changes with the market.

### Trading of Municipal Debt

- Trades over the counter through dealers
- Thin Market because bonds are best for in-state investors
- No Short sales due to limited availability to borrow
- Trade settlement – same as corporate bonds – 2 business days after trade date T+2

### Tax Status of Municipal Debt Interest

- Federal tax exempt
- Subject to state and local tax
- BUT if a local resident purchases – often triple tax exempt: fed, state, and local.
- US territories – triple tax exempt no matter where purchaser resides

Type of Debt	Tax Status of Interest Rec'd	
	Federal Tax	State Tax
U.S. Govt	Subject	Exempt
Gov't Agency	Subject	Exempt
Privatized Gov't Agency	Subject	Subject
Corporate	Subject	Subject
Municipal	Exempt	Subject*

\*But, if the bond is purchased by a State resident, then it typically is exempt

Figure 1 Tax status of bonds based on issuer.

## Packaged Products

### Class Notes

### Investment Companies

Collect funds from individuals or groups and purchase securities in line with investment company objectives.

#### Benefits

- Diversification
- Professional management

#### Types as Defined by the Investment Company Act of 1940

- Face Amount Certificate Company
  - Not used anymore but basically investor agrees to pay a certain amount every month and at maturity gets an agreed upon payoff
- Management Company
  - Organized as corporation and issues shares of stock
  - Hires an Investment Advisor to manage/buy/sell securities for fund according to fund objective
  - Sponsors a fund (underwrites)
  - Fund structures
    - Open-end fund (mutual fund)
      - Investors in fund purchase and sell their shares
      - Sponsor appoints a selling group to be sales agent like a broker (Morgan Stanley who gets part of sales charge fee) s or keeps sales in house (Vanguard)
      - When investors invest money, they buy brand new shares
      - When investors take out their money, they sell their shares and the shares no longer exist

- Total share count and money in fund goes up and down as investors buy and sell shares (continuously issued)
- Redeemable from fund at net asset value but NOT negotiable (can not sell to others)
- Closed-end fund
  - Issue stock like IPO
  - Stock trades on an exchange
  - Non-redeemable at net asset value
    - Shares are negotiable (must sell to another investor for whatever price you can get)
- Unit Investment Trust (UIT)
  - Organized as Trust Indenture (not corporation)
  - Issues “shares of beneficial interest” (not regular shares like corporation)
    - Represent a “unit” of undivided interest in specific portfolio of securities
  - Redeemable with trust sponsor at any time at NAV
  - Sponsor creates accumulation account to buy up bonds before they are placed in the trust
  - If units of UIT sell for \$5000 and a 4% load (\$200), then after load, investor will have \$4,800 invested in UIT
  - Trusts self-liquidates as bonds paid off
  - Expense ratios usually low
  - Sponsor makes a market in trust units
  - Types
    - Fixed UIT
      - Once bond portfolio is created it does not change.
      - Payments passed on to investors who bought units
      - Popular for municipal bonds
    - Non-Fixed UIT
      - Trust buys shares in a mutual fund
      - Used when investors buy mutual funds within an insurance company wrapper to buy variable annuities
        - Retirement planning investments.
        - Investor buys units up to retirement
        - At retirement, investor cashes out as lump sum or periodic payments
        - Cash out varies – hence variable based on mutual fund performance
        - Why buy these? Will cover later.

## Investment Company Structures

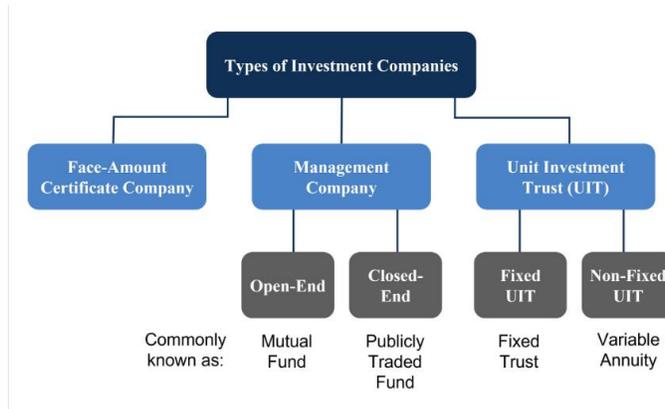


Figure 2 Investment Company Structure. This chart shows the three types of investment companies.

## Fund Prospectus

- Fund objective
- Fees
- Board of directors
- Open-End vs Closed-End
  - All open-end fund purchasers must receive prospectus (newly created shares)
  - Closed-end fund purchases – only initial purchaser must receive prospectus, later purchasers are buying existing shares from another investor
- Investment Adviser and Management Fees
  - Prospectus says which investment advisor was chosen by sponsor to manage fund
  - Investment advisor is paid a management fee – percent of assets
- Custodian Bank
  - Holds assets of funds
  - Transfer agent for fund – cancels and issues new shares
  - Shareholder list
  - Custodial fees
- Diversified Fund (75-5-10 Rule)?
  - minimum 75% of assets invested in securities
  - maximum 5% of assets in any one issuer
  - maximum 10% ownership (voting securities) in any issuer
- Non-Diversified – if not meet diversified rule above
- Temporarily funds can shift to cash but not long

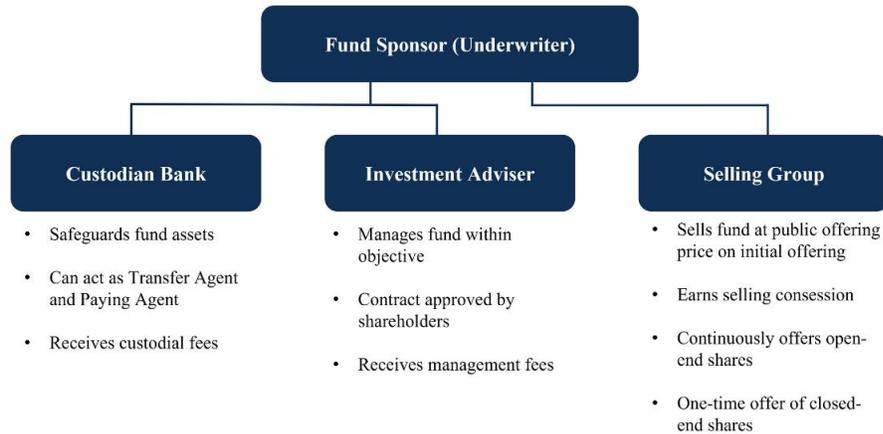


Figure 3 Advisor, custodian, and selling group structure of a fund.

## Types of Funds (fund objective)

- Growth Fund – high growth companies for capital gains
- Growth and Income Fund – growth companies with dividend income
- Income Fund – fixed income securities like preferred shares and bonds, perhaps some derivatives if in prospectus
  - US Government fund
  - Municipal fund
  - Preferred stock fund
  - Corporate bond fund
  - Money market fund
- Balanced Fund – equities and fixed income – capital gains and income
- Index Fund – follows a recognized index
- Specialized or Sector Fund – invests in a specific industry or geographic region
- Special Situations Fund – invests in bankruptcy or merger/takeover targets
- Target Date Fund – invests in a portfolio of equities and fixed incomes. The ratio of fixed income increases as it gets closer to the target date to reduce risk. It provides automatic portfolio allocation changes.

## Net Asset Value (NAV)

- Computed Daily
- $NAV = (\text{Market value of assets} - \text{Liabilities}) / \# \text{ shares}$
- Money market funds – constant \$1.00 NAV, pay dividends and any increase in Net Assets results in issuance of more \$1 shares to shareholders

## Mutual Funds

### Loads

- No load – no sales charge and customers can buy at NAV. No-load funds sold directly by sponsors like Vanguard with no outside selling groups (brokers).

- Money market funds – almost all are no-load since they are temporary places for money
- No discounting POP offering price – must follow prospectus
- Maximum sales charge = 8.5% of Public Offering Price (POP)
  - Sales charge compensate selling group
  - Public offer price = NAV + sales charge = ASK price
- Offer Price (1 – sales charge) = NAV
  - If NAV = \$100 and sales charge = 8%, then sales charge = ?
    - Sales charge = (Sales charge %)( offer price)
    - Sales charge = (Sales charge%)(NAV + sales charge)
    - Sales charge = .08 NAV + .08 sales charge
    - .92 Sales charge = (.08/.92) NAV = (.08/.92)(100) = 8.7
- Forward pricing – you place an order to buy or sell during day but order not transacted until end of day when NAV is calculated – so you place an order before you know what NAV will be
  - Payment with 7 calendar days of redemption (selling of your shares)
- Redemption fee – charged upon redemption (selling)
  - Still subject to max 8.5% rule for max upfront and redemption fees
  - If NAV = \$100 and 1% redemption, then customer receives \$99
- In-Kind Redemption
  - If mutual fund manager has too many shareholders trying to sell and does not have enough cash on hand to redeem sell orders, then fund manager may give shareholders their share of portfolio securities
- Contingent Deferred Sales Charge (CDSC)
  - Sales charge on incurred if shareholder sells shares before a stated time period
  - Sales charge drops the longer the customer owns their shares
- Maximum 8.5% sales charge allow if fund offers
  - Breakpoints
    - Reduced sales charge for higher dollar purchases
    - FINRA sets maximum breakpoints
      - \$0-10,000 > 8.5% sales charge
      - \$10,001 – 25,000 > 7.75% sales charge
      - \$25,001 – over > 6.5% sales charge
    - Example: Compute offer price (what customer pays)
      - \$15,000 purchase, \$14.75 NAV, reduced 7.75% sales charge
      - Offer Price (1 – sales charge) = NAV
      - Offer price = NAV / (1 – sales charge)
      - Offer price = 14.75 / (1 – .0775)
      - Offer price = 15.99
    - Breakpoints applied on a customer by customer basis, may not get a group discount like for an investment club
    - Households can count as one customer
    - Investments in funds under same sponsor can count for breakpoints
  - Letter of intent
    - May be used to give customers credit for breakpoint savings for large purchases placed over time

- Can last for 13 months including 90 day backdate period
    - Increase in assets cannot be used for LOI, only purchases
  - Rights of accumulation
    - For new purchases, can use total of current investment (purchased at higher breakpoint) to achieve reduced fee breakpoints
- Dividend reinvestment allowed at NAV
- Cannot recommend to customer they sell shares and use money to rebuy same shares to meet a breakpoint
- Fund families not charge to switch between funds in same family
- Rule 12b-1 distribution fees
  - Fund can charge existing investors this fee to market fund to new customers
  - Allows ongoing compensation of sales group
  - 0.5% typical (0.25% goes to representative)
    - 0.75% maximum
    - 0.25% maximum for no-load funds
  - If 12b-1 fees charged,
    - Sales charge maximum = 7.25% with no account maintenance fees
    - Sales charge maximum = 6.25% with account maintenance fees

## Mutual Fund Share Classes

- One fund can have different share classes
- Each share class can have different sales charges and 12b-1 fees
- A, B, C are common

### Class A Shares

- Higher up-front sales charge
- Low or no 12b-1
- Best for long-term investors

### Class B Shares

- No up-front sales charge
- Contingent deferred sales charge that goes to 0 over time
- Higher 12b-1 fee (.5%)
- Best for Intermediate term investors

### Class C Shares

- No Up-front sales charge
- No CDSL or very low
- High 12b-1 fee (.75%)
- Best for short-term investors

## Prohibited Mutual Fund Sales Practices

Not telling customers when they are close to a Breakpoint

Trading mutual fund shares

- Redeemable through fund not negotiable/sellable to other investors

Inappropriate Class B share recommendations

- Customers may think they are cheaper due to no up-front sales charge
- But – higher 12b-1 will be higher cost over time

## Closed-End Funds

- One-time stock issuance (IPO)
- Publicly traded in markets (negotiable security) (non-redeemable)
- NAV still published – can be different than market sell price
  - Can trade at a discount or premium to NAV
- Closed-end structure good for holding illiquid securities
  - Municipal bonds, developing markets
  - In Open-end fund, investors buying and selling forces fund manager to buy and sell securities, because if all investors sell, open-end fund will have no assets
  - In Closed-end fund, investors buy and sell between themselves not affecting securities that fund owns

## Exchange Traded Funds (ETF's)

- Open-end funds mostly because additional shares can be made
- But similar to closed-end fund because they trade on exchanges
- ETF feature allows institutional investors to exchange ETF shares for underlying stocks in portfolio
  - This feature keeps market sell price very close to NAV
  - Called an arbitrage mechanism where if market price gets well below NAV then institutional investors can exchange their ETF shares for underlying stocks which will be worth more.
- Mostly index funds
- ETF advantages of compared to regular Open-end mutual funds
  - Priced continuously versus once per day
  - No sales charges, but pay commissions to buy and sell
  - Can be bought or margin and shorted
  - Expenses like or lower than mutual funds, no 12b-1 fees
  - Tax efficient – no capital gains until you sell (mutual funds distribute capital gains annually even if you do not sell)
- Buyers must be delivered prospectus or similar like open-end mutual funds.

## Exchanged Traded Note (ETN)

- Synthetic, exchange listed security with par value increase linked to equity index
- No portfolio securities backing ETN
- Zero coupon bond-like, no interest payments
- Fixed-maturity
- Redemption value at maturity is variable according to equity index returns

- Capital gain = Sell Price – Purchase price = Redemption value at end – Purchase price
- Capital gains tax rate lower than income tax on dividends for high income tax brackets
- Credit risk dependent on issuing bank
- ETF versus ETN
  - Structure
    - ETF - open-end fund
      - ETN – bond like
  - Maturity
    - ETF - none
      - ETN – fixed date by issuer
  - Trading
    - ETF – trades like stock
      - ETN – trades like stock
  - Return
    - ETF – linked to index
      - ETN – linked to index
  - Ownership
    - ETF – shareholder owns part of portfolio of securities
      - ETN – loan that is backed by credit rating of bank
  - Tax efficient
    - ETF – Yes (dividends + capital gains only when sell)
      - ETN – Yes (no dividends + all capital gains when sell/at end)

## Fund Income and Taxation

Management companies must send semi-annual financial statements sent to shareholders under Investment Company Act of 1940

- Income statement of fund
- Balance sheet of fund
- Listing of fund portfolio holdings

### Example

- Fund ABC has \$100,000 of Net Assets invested
- Achieved \$10,000 of gross income (10% of net assets)
- Income Statement
  - Investment Income \$10,000
  - Expenses
    - Management fee
    - Shareholder servicing fees
    - Custodial fees
    - Printing
    - Legal and audit
    - Administrative
    - 12b-1 distribution fees

- Total Expenses \$2,500
- Net Investment income (NII) \$7,500
- Distributed to shareholders \$7,425
- Retained earnings (1% of NII) \$75

### Expense Ratio

- Expense ratio = (Total expenses) / (Total net assets)
- Expense ratio = \$2,500 / \$100,000 = 2.5%

### Distribution to shareholders

- Subchapter M of IRS code
  - Regulated funds must distribute 90% of NII
    - Fund does not pay taxes on distributed profits which flow through to shareholders who pay taxes
    - Fund pays taxes on retained earnings
  - Unregulated funds pay tax on all NII
  - If not distribute at least 97% of NII and 98% of capital gains, fund has other tax surcharges
- Capital gains distributed once per year
  - Capital losses not distributed – fund retains to offset future capital gains
- Mutual Fund Ex-Date
  - Date when shareholder list is used to record who will receive capital gains distribution
  - Try not to buy fund just before this date or will pay capital gains on money you did not make

## Fund Investor Considerations

### Fund Shareholder rights

- Vote for board of directors
  - 40% of Board must be Non-Interested (not insiders)
- Vote for change in fund investment objective
  - Requires majority vote of shareholders
- Vote annual for investment advisor
- Receive annual and semi-annual reports

Investment Advisor Contract – specifies management fees paid to adviser

Fund Sponsor – minimum \$100,000 to start fund

Prospectus Paper Delivery – with each purchase

Cannot buy mutual fund shares on margin – must be paid in full

- Once held for 30 days mutual fund shares marginable at 50% (margin loan)

## Real Estate Investment Trust (REIT)

- Invest in real estate and mortgages

- Similar to Closed-end fund
- Shares of beneficial interest
- REIT does not pay taxes as long as 90% of income paid out as dividends
- Trust run like a company with high debt
- Invest in when stocks stagnant and interest rates low
- Equity REIT – borrow to invest in real properties
- Mortgage REIT – borrow to invest in mortgages, MBS
- Combination REIT – does both

## Business Development Companies (BDC)

- Publicly traded investment companies
- SEC required publicly available financial information
- Invest in private start-up companies
- Average investors can participate in these private equity deals

## Venture Capital Fund (VC)

- Private limited partnership
- No public financial information
- Wealthy accredited investors
- Not liquid (10 year tie up) with calls for more capital
- Carried Interest
  - Fund structured so investors get favorable tax treatment as carried interest
  - Annual profits paid to investors taxes as capital gains not ordinary income tax

## Hedge Funds

- Private, lightly regulated
- No public financial information
- Wealthy accredited investors
- Fees = 2% of assets and 20% of profits, but often lower now with competition
- Not liquid

## Funds of Hedge Funds

- Registered closed-end fund but NOT on exchange
- Easier, lower minimum investment than regular hedge funds
- Wealthy accredited investors
- Not liquid
- Two layers of fees, hedge fund and fund of funds
- Portfolios do short-term trading making them NOT tax efficient

## Direct Participation Programs (DPP)

- Directly participate in profit and loss of business
- Tax shelter investments often set up as Limited Partnerships

- At least one general partner (GP)
  - Manages everything
  - Unlimited liability
- At least one limited partner (LP)
  - Passive investor
  - Liable up to investment
- Private placement to wealthy accredited investors
- 7-10 year life, partnership liquidated at end
- Not liquid, do NOT trade
- Non-correlated assets to stock market
- Types
  - Real Estate Program Tax Benefits
    - Depreciation tax write-off every year
    - Straight-line 27.5year
    - Highly leveraged
    - Interest tax deductible
    - Tax credits for low income housing development
  - Oil and Gas Program, Depletion Deduction
    - Oil and gas production costs depleted or depreciated over time as expenses when oil pumped out
    - Sometimes drilling costs immediately tax deductible
    - Oil pump out costs are depleted over time

## Trading Markets

### Class Notes

#### Brokers and Dealers

- Make sure that investors can always buy or sell.

#### Dealer Quotes

- Bid Price – Lower Price you can sell to dealer
- Ask Price – Higher price you can buy from dealer
- Spread = Ask – Bid = dealer profit
- More active and liquid markets have narrower spreads

#### NYSE uses Specialist/DMM

- Dealer on stock exchange floors (first market)
- Designated Market Makers (DMM) for each security
- Do not deal with public, wholesalers who deal with retail brokers

## NASDAQ uses Competing Market Makers

- NASDAQ is also a first market
- Market makers may act as brokers or dealers

## Second Market is Negotiated

- Over-the-Counter (OTC) Markets Group not electronically linked
- Used to be called Pink Sheets
- Display facilities show market maker quotes for unlisted stocks
- To trade, you must negotiate with market maker posting the quote
- No rule that quotes be posted in real-time
- Internet based trade negotiation app can be used
- Thin trading
- Market makers can act as brokers or dealers

## Brokers vs. Dealers

- Brokers earn a commission
- Dealers earn a mark-up
- OTC transactions by Brokers or Dealers

## Trading Markets

- Negotiable securities trade in specific markets
- Primary market – new issues
- Secondary market – trading of issued securities
  - First market - Exchanges
    - NYSE Trading on exchange floors
      - Very active markets
      - NYSE American – ETF's and smaller companies
      - Dual Listing - All NYSE stocks can trade in multiple exchanges to promote competition
      - Consolidated Quotation Service(CQS)
        - Centralized quotation system for all NYSE and NYSE American to promote competition between market centers (other regional exchanges)
        - Quotes not actual prices
        - **Actual trades of NYSE listed stocks reported on Network A no matter where they traded - NYSE, NYSE American or OTC**
        - **Actual trades of NYSE American listed stocks reported on Network B "tape" no matter where they happened - NYSE American or OTC**
    - NASDAQ
      - Computer network, not physical exchange
      - UTP – Unlisted Trading Privileges
        - Trading of NASDAQ Listed Issues by exchanges and ECN's

- NASDAQ trades about 40% NASDAQ listed shares similar to NYSE
  - Competition from regional exchanges and OTC market makers
  - Electronic order matching services (Elect CN)
  - UQDF – UTP Quote data feed, quotes for NASDAQ issues to promote competition
  - **Network C tape – records trades of NASDAQ listed shares no matter the market center**
- Options Trading
  - Can trade on an exchange
  - CBOE, Philadelphia Stock Exchange, AMEX, NYSE ARCA
- NYSE Bond Trading
  - Bonds usually trade OTC
  - NYSE does some trading of bonds of companies listed on NYSE
- Second market
  - Trading of stocks NOT listed on NYSE, NYSE American, NASDAQ, or regional exchanges.
  - Over-the-counter (OTC) trading of unlisted stocks
  - Run by OTC Markets Group over the internet
    - Displays quotes
    - Does NOT do trades
    - Not self-regulating (SRO)
    - Trades negotiated dealer – to – dealer
    - Three Sub-Markets based on level of financial disclosure
      - OTCQX (mature companies – highest quality)
      - OTCQB (less mature)
      - OTC Pink Open Market (Speculative)
    - No OPTIONS trading
  - Most corporate debt traded OTC
  - All Government debt traded OTC
  - All municipal debt traded OTC
  - Primary market is OTC (new issues like IPO's) but then may switch to exchange
- Third market
  - OTC trading of exchange listed securities using brokers
  - Open 24 hours for trading
  - Bernie Madoff – invented payment for order flow (giving back some of market maker's profit)
  - Better prices (lower spread than exchanges)
  - NYSE, NYSE American, NASDAQ moving toward 24 hour trading, paying for order flow and reduced execution prices because of this competition
  - Payment for order flow
    - SEC requires members to route order to the market with best available price (but if all the same will go to market with payment for order flow which is okay as long as customers told)

- Most Third market – market makers will follow quoted prices of dominant market maker in First market and pay more for order flow
  - Fourth market
    - OTC trading between Institutions without brokers
    - Shifted to facilitating large international trades when brokers stopped charging commissions in USA, which hurt their business
    - ECN – electronic communications network ~ 50% market share
      - Match buyers and sellers 24 hours a day
      - Instinet – bought by NASDAQ
      - Archipelago – bought by NYSE
      - After-hours trading market
        - Thin trading
        - Higher price volatility

## Orders and Trading Practices

### Types of Orders

- Market order
  - Filled immediately, not held
  - No price specified
  - Filled at whatever time and price the trade thinks best – as long as it is that day
  - Do not carry-over to the following day
- Limit order
  - Specifies a price
  - Buy limit – price specified below current market
    - Buy 100 AAPL @ 300 GTC
  - Sell limit – price specified above current market
    - Sell 100 AAPL @ 310 GTC
  - Given to a specialist (Designated market makers – DMM) in stock
    - Broker's broker
  - NASDAQ keeps a book of limit orders
- Stop orders
  - Stops a loss at a trigger price
  - Sell stop – sells when stock price goes down to a certain price you set
    - Sell 100 AAPL @ 280 **Stop** GTC
  - Sell stop limit
    - Sell 100 AAPL @ 280 Stop Limit 275
  - Buy stop – buys when stock price goes up to a certain price you set
    - Close out a short sale
    - Buy 100 AAPL @ 330 **Stop** GTC
  - Buy stop limit
    - Buy 100 AAPL @ 330 **Stop** Limit 335



Figure 4 Which orders are placed above the market price and which orders are placed below the market price?

### Prohibited Trading Practices

- Members must obtain best available price in the market (if all prices across markets the same broker can send to market with highest payment for order flow as long as disclosed)
- Customer order have priority over firm's own account
- No acting as broker and dealer
- No interposition – use a second firm to deal with market maker to earn double commissions
- No trading ahead of a retail customer
- No Front Running of large institutional /block orders
- No trading ahead of research to be released (can trade after)
- No splitting large orders to get more payment for order flow (trade shredding)
- No market manipulation
  - Trading pools to push price up
  - Wash trades – buying and selling to make volume look high
- No marking the close – trading at close or falsely reporting trades at close to affect close price
- No market the open – trading at open or falsely reporting trades at open to affect open price
- No private trading for customers within the firm – must send to markets
- Must disclose payment for order flow to customer

### Order Ticket Information

- Type of order
  - Buy (Buy long) – buy (all buys defined as long automatically)
  - Sell (Sell Long) – sell long
  - Sell short – sell short
    - Subject to Regulation SHO
    - Every sell ticket marked as “sell long” or “sell short”

ACME Securities, Inc.			ORDER TICKET		
<b>Buy</b>		<b>Size</b>	<b>Day</b>	Spec.	Inst.
<b>Sell</b>		100	<b>GTC</b>		
Long	Short	Exempt	<b>DNR</b>	<b>Discret.</b>	
<b>Name of Security</b>			<b>Price</b>	<b>Stop</b>	
ABC Common			Mkt	Stop Limit	
<b>Customer Name</b>			<b>Account Number</b>		
Smith			01487		
<b>RR Number</b>	<b>Date</b>	<b>Manager Approval</b>			
333	3/17/2022				

Figure 5 Sample Order Ticket

- Order Size – if greater than 100 (round lot) then it is assumed customer will accept partial order fill
- Duration
  - Day Order (default)
  - Good 'Til Cancel (GTC) (broker must manage multiple days of submitting orders)
  - Discretionary – security name and size not specified but order placed by registered representative under power of attorney given by customer (Discretionary accounts)
- Security Name – show the ticker symbol
  - Pfd – listed if preferred shares
  - Wts – listed if warrants
- Execution Price
  - Mkt listed for a Market Order
- Limit Order
- Stop order or stop limit order is noted if appropriate
- Solicited or Unsolicited is noted so solicited orders can be checked for FINRA suitability requirements
- Customer Name
- Account Number
- Registered Reprehensive Number – to give credit for order
- Manager Approval

#### Ticket rules

- Order ticket must be completely filled out
- Alterations to Executed order tickets prohibited unless manager approves
- Canceled trades written down
- Re-Boll trades moved between accounts must be written down

#### Customer Long Sale

- Based on if customer is owns the stock, convertible, or rights/warrants and can deliver them upon sale

- Based on if customer is currently NET LONG (owned – shorted)
- “Short against the box”
  - Short stock that you own to lock in profit and delay legal sale of owned stock
  - Shift taxes to next year to go to long term capital gains or shift loss
  - If sell shares and Net LONG = 0, then recorded as sell short

#### Depository Trust Corp (DTC)

- Owned by FINRA member clearing firms
- Depository where securities of member firms are held
- Owns National Securities Clearing Corp (NSCC)
  - Clears (approves) and settle (stock for money) trades

#### Optional Clearing Corp (OCC)

- Records member options trades
- Removes positions when closed
- Assign exercise notices to writers (when you buy a call option from the sell (writer) and later decide to exercise your option to buy the stock)

### Customer Disclosure and Settlement Rules

- Confirmations sent no later than completion of transaction
  - Regular way – confirmation sent 1 day after trade date (T+1)
    - Trade settles in 2 days
  - Cash settlement – confirmation sent on trade date (T)
- Confirmations must contains lots of information

### Settlement Dates

- Regular way – Stocks, corporate and municipal bonds
  - 2 business days (T+2)
- Regular way – US government bonds and options
  - 1 business day (T+1)
- Cash
  - Same day before 230PM ET (T)
- Seller’s Option
  - Seller gets an extra time to deliver
- When, As, and If Issued (WAI)
  - Trading on securities that have not been issued yet
  - If no assurance, trades are later canceled
- T = transaction date
- S = settlement date
- R = receipt of confirmation or other notice

#### Comparisons Dealer to Dealer

- Comparison form sent to broker on other side of trade (each broker on each side sends on to the other)
- DK – don't know notice – sent if comparison form does not match what one broker thought

### Good Delivery of Physical Security Certificates

- Back of security must be endorsed or assigned to buyer or buyers broker
  - Sometimes use Stock Power or Bond Power to record chain of ownership, so physical certificate can last forever
- FINRA broker firm must guarantee your signature
- Deliver in round lots – 100 shares, \$1,000 bonds

### DRS – direct registration system – book entry registration

- Paperless recording of security ownership

### Accrued Interest of Coupon Bonds

- Since bonds only pay interest semi-annually, seller has right to accrued but not yet paid interest
- Paid from buyer to seller on settlement
- Accrued interest calculated up to day before settlement (does not include settlement day)
- Assume 30 days/month and 360 days/year for Corp and Municipal Bonds
- Assume actual/actual days/month and days/year for US Government Bonds

### Trading Flat – Zero coupon bond

- No accrued interest to worry about

### Ex-Dates

When companies make a distribution of a cash dividend, stock dividend or preemptive rights offering

#### Cash Dividends

- Declaration date – decision announced
- Record date – end of day corporation take list of shareholder from transfer agent
  - To get dividend you must buy 2 business days before record date (T+2)
  - Up to and including 2 days before record date stock trade cum dividend – with dividend
    - Afterward stock trades ex-dividend or without the coming dividend
    - Ex-Date is 1 business day before record date
    - FINRA tells firms to set opening price after this at previous minus dividend
  - Cash settlement can buy stock same day as record date
    - Ex-date is day after record date
- Payable date – checks mailed
- Orders adjusted for dividend if GTC

#### Stock Splits and Stock Dividends

- Ex-date is day after Payable date
- If buy up to and including payable date get split or dividend
- Orders adjusted for stock split if GTC
  - Except Reverse stock splits GTC orders canceled

## Basic Tax Rules for Equities

- Cost basis – included commissions
  - Adjustments for stock splits and dividends
  - Spin-offs value subtracted from parent stock cost basis
- Sale Proceeds – less commissions
  - FIFO – if you do not specify which shares to sell – first in, first out
  - Specific identification (consider short vs long term capital gains)
- Short term – held for 12 months or less, taxed like regular income or offset losses
- Long term – held for more than 12 months – max 15% income tax bracket or 20% very high earners
- 1099-B Tax form report to IRS
  - Cost basis
  - Sale proceeds
  - Holding period
  - Taxes withheld
- 1099-DIV
  - Cash dividends and mutual fund capital gains
- Inherited securities - Stepped up cost basis
  - New cost basis – based on day of death

## Options

### Class Notes

### Option Basics

- Option = like an insurance contract for a security
- Buyer of contract = holder = long position on option
- Seller of contract = writer = short position on option

### Call contract

- Buyer or holder of call contract has right to buy a security from the seller or writer at a fixed price (strike price) during the life of the contract.

### Put contract

- Buyer or holder of put contract has right to sell a security to the seller or writer at a fixed price (strike price) during the life of the contract.

### Strike Price (XP)

- Same as exercise price.
- Price specified by contract at which the holder can buy (call) or sell (put) at.



## Intrinsic Value = “In the Money” amount

- Call option intrinsic value = Amount current stock price above strike price
  - 1 ABC Jan 50 Call, current stock price = \$52, intrinsic value = \$2
  - 1 ABC Jan 52 Call, current stock price = \$52, intrinsic value = \$0
- Put option intrinsic value = Amount current stock price below strike price
  - 1 XYZ Jan 40 Put, current stock price = \$38, intrinsic value = \$2
  - 1 XYZ Jan 40 Put, current stock price = \$40, intrinsic value = \$0
- Intrinsic value = “In the money” amount
- Buyers want more intrinsic value
- Sellers want 0 intrinsic value

## Extrinsic Value = Time Premium = Time Value = Premium – Intrinsic value

- Part of the premium buyer pays for excluding intrinsic value
- Premium = Intrinsic Value + Extrinsic Value
- 1 ABC Jan 50 Call, current stock price = \$52, intrinsic value = \$2
  - If premium = \$5, then extrinsic value = \$3
- Extrinsic/Time Value goes to zero on last day of trading.

## “At the Money”

- Stock price = strike price

## “Out of the Money” from buyers perspective

- Call option: stock price < strike price
- Put option: stock price > strike price

## Parity

- Premium = Intrinsic value
- No extrinsic/time value
- 1 ABC Jan 50 Call, current stock price = \$55, intrinsic value = \$5
  - If premium = \$5, then extrinsic value = \$0

## Speculative Strategies

- Breakeven means when profit = 0

## Bull strategies make money when price goes up

- Long call (buy call option)
  - Unlimited upside
  - Maximum loss = premium paid
  - Breakeven stock price = strike price + premium
- Short put (sell put option) (Naked/uncovered put writer)
  - Maximum gain = premium received
  - Maximum loss = Strike price – premium
    - When stock price goes to 0
  - Breakeven stock price = Strike price - premium

## Bear strategies make money when price goes down

- Short call (sell call option) (Naked/uncovered call writer)
  - Maximum gain = premium received
  - Maximum loss = unlimited
  - Breakeven stock price = strike price + premium
- Long put (buy put option)
  - Maximum gain = Strike price – premium
    - Stock goes to 0
  - Maximum loss = premium
  - Breakeven = strike price - premium

## Hedging Strategies

- Like buying insurance to protect from losses

### Long stock position hedged by long put

- Long stock? Protect against falling stock price (market risk) by buying a put option.
- Maximum loss = premium paid + difference in stock cost and strike price
- Maximum gain = unlimited (less premium)
- You are giving up some of your potential gain to cover your downside

### Short stock position hedged by long call

- Short stock? Protect against rising stock price by buying a call option
- Maximum loss = premium paid + difference in short stock price and strike price
- Maximum gain = price goes to 0 (value of short stock) - premium

## Income Strategies

### Sell/write call and put contracts on stocks you already own to earn premiums

- The premiums you receive are your income
- Enhances dividend yield on stock
- Can supply your own stock which you already have when options exercised – so do not have to buy stock on the market > you are covered from market risk > “covered writer”
- Neutral outlook – think market price will be stable

### Sell a call option against a long stock position (neutral market outlook)

- Give up your stock upside to earn the premium in the short term
- Covered call
  - Sell out of the money call options to allow for some stock price rise

### Sell a put option against a short stock position (neutral market outlook)

- Give up potential short sale profits when stock goes down to earn the premium in the short term
- Covered put

## Equity (Stock) Options

- Most stock options trade on CBOE, but not all (ASE, NYSE Arca, Phila Stock Exchange)

### Options Clearing Corporation (OCC)

- Contracts traded on exchanges are standardized under OCC rules (part of CBOE)
- OCC issues contract, guarantees contracts, and acts as clearinghouse
- Standardization makes contracts easier to trade, only premium in set by market

### OCC Contract Specifications

- **Contract size** (equities) = 100 shares
- **Strike price** increments set at nearest round numbers +/- \$2.5, \$5 or \$10
  - If stock trading at \$51, contracts established at \$45, \$50, \$55 to bracket current price
- **Premiums** – quoted in increments of \$0.05 (stock price < \$3) or \$0.10 (stock price >= \$3)
- **Expiration date** – third Friday of each month at 11:59pm ET.
- **Maximum contract life** – 9 months in the future, but 8 months is more common
- **Trading hours** – 930am-4:00pm ET (830am-4:00pm CT)
- **Trading cut off** – last day to trade is third Friday of the expiration month at 4:00pm ET (3:00pm CT)
- **Exercise cut off** – last day to exercise if third Friday of the expiration month at 530pm ET (430pm CT)

### OCC Options Disclosure Statement

- Must be given to each customer before they can open an options account
- Contains rules for customers and registered representatives
- Date at which this is given to customer is entered into New Account Form
- Rules:
  - **Next day settlement** - (T+1)
  - **Maintenance of Records** - by OCC based on settlement updates from brokers for their customers
  - **Contract Style**
    - **Stock options** are “**American Style**”
      - Exercise at **any time**
    - **Index options** are “**European Style**”
      - Only exercised **at expiration**
  - **Assignment of Exercise Notices**
    - When you exercise an option, OCC picks a short contract to exercise randomly, broker of that short contract can select a customer to be exercised either randomly or FIFO
  - **Settlement when Exercised**
    - Assignment of exercise notices are based on positions from close of previous day.
    - If exercise occurs > regular way (T+2) stock trade must occur
    - If call writer is exercised, stock must be delivered two business days after exercise date

- Index options are cash settled (not stock settled as above)

## Customer Accounts

- Class Notes

### Customer Accounts

#### New Account Form – Required Information

- \*Customer name\* – all in a joint account
- \*Address\*
- Cash or margin account? Cash paid in full / margin paid in partial with loan from broker
- \*Date of birth\*
- \*Social security or Tax I.D. number\*
- Occupation – employed by another financial services firm?
- Non-US citizen?
- Officer, director or 10% shareholder?
- \*CIP\* 4 pieces of information required for Customer Identification Program (CIP)
  - Info obtained BEFORE account opening
  - Independent verification of customer identity WITHIN REASONABLE TIME AFTER account opening
  - At account opening all customers must be notified that the firm has a CIP that will request info to fight money laundering, etc.
- Valid government issued ID – match customer info provided above to passport or driver's license (not expired)
  - OR non-documentary verification using commercial database (most common method)
- FINRA - Name of registered representative assigned to account
  - Required by FINRA
  - If a team, name all in team with their responsibilities
- SIPC – Securities Investor Protection Corp
  - Customer must be notified in writing at account opening that account is covered by SIPC
  - Saying where they can get more info (address and phone of SIPC)
  - SIPC contact info then provided every year
- Arbitration agreement – not required but...
  - If signed customer must get copy within 30 days

#### Business Disruption Procedures (BCP)

- FINRA required
- Account opening – give to customers
- Website – post it
- Mail – to customers on request

## SEC Regulation Best Interest (BI) requires BDs and IAs to

- put customer interests first
- minimize conflicts of interest

## Broker-Dealers (BDs) – Suitability Standard

- Conflict of interest okay if investment is suitable
- For example, selling stock out of brokers inventory to customer is conflict of interest

## Investment Advisers (IAs) – Fiduciary Standard

- States regulate small advisers (<https://dfpi.ca.gov/state-licensed-investment-adviser/#:~:text=The%20SEC%20requires%20an%20investment,SEC%20Rule%20203A%2D1>.)
- SEC regulates large advisers
- Investment adviser must always take same side of trade as customer
- Cannot recommend customer buy stock that adviser sells to them
- Cannot charge commissions and mark-ups to customers
- Can only charge fixed fees

## Some firms are both BDs and IAs

- Different subsidiaries for each
- Depends on type of account opened for a customer
- Makes situation complicated with potential conflicts of interest

## Form CRS (customer relationship summary)

- Is firm acting as a BD (commissions) or IA (fixed fees)
- BD Firm must adhere to suitability standard
- IA Firm must adhere to fiduciary standard
- Fees and costs outlined
- Conflicts of interest outlined
- Firm had any reportable disciplinary events?
- Form CRS must be first form in packet of forms given to client and posted prominently on website
- Required to be given to retail clients (not institutional clients)

## FINRA Suitability - Know Your Customer Rules

- FINRA/MSRB/CBOE required any security recommended to customer be a “suitable” investment for that person.
- Make reasonable effort to know “Essential Facts” on all customers
  - To provide effective service
  - To act in accordance with special account handling instructions
  - Understand authority of people acting on behalf of customer
  - Comply with law, regulations, and rules

## SEC New Customer Information required to be collected

- \*Customer name
- \*Address

- \*Date of birth
- \*SSN or Tax ID Number
- Telephone number
- Occupation
- Employer (if affiliated with a financial firm, special procedures then followed)
- Annual income
- Net worth (excluding primary residence)
- Investment objectives
- Signature of associated person responsible for account
- Signature of customer, if a discretionary account
- \* critical pieces of information for CIP (customer identification procedures)
- If customer refuses to disclose any non-critical information, firm has no obligation to get that information, and can still open account
- Registered representative signature, if they perform a suitability determination
  - If self-directed online account and customer enters in suitability info, then no representative signature is required
- NO customer signature required, info can be taken over phone
  - BUT with discretionary accounts (where rep can make trades), customer must sign power of attorney
- SEC requires customer approves account profile within 30 days of account opening.
  - May not have seen if opened over phone
  - Also send account profile every 36 months for review

### FINRA Suitability standard

- Firm or rep must have a reasonable basis to recommend a transaction or investment strategy is suitable for customer based on customer's investment profile

### FINRA Investment Profile Information

- Investment objectives
- Investment experience / other investments
- Customer age
- Financial situation and needs
- Tax status
- Investment time horizon
- Liquidity needs
- Risk tolerance
- Any other information disclosed by customer

### FINRA Suitability Components

- Step 1 - Reasonable Basis Suitability
  - Makes sense to the right investor from big picture point of view
  - Firm or associated person must review and assess comparing potential risk and returns
  - Firm prepares recommended list of products and strategies where firm has done review and assessment

- Then registered representative must understand each security and strategy to recommend to any one customer
- Step 2 - Customer specific suitability
  - Done after a reasonable basis suitability standard has been done
  - Customer's investor profile must be used to determine if suitable
- Step 3 - Quantitative suitability
  - Can recommendation be done just once or multiple times (churn?)
- Once all 3 steps above are completed in sequence, a recommendation can be made

### Customer's Personal Balance Sheet

- Customer recommendation can only be made if registered rep has reasonable basis to believe customer has financial ability to make the commitment
- Liquid net worth needed to determine if customer has immediate funds to commit to an investment

### Options Accounts Procedures

- Separate "Options New Account Form" often used to meet CBOE requirements
- Before account opened with date sent to customer – ODD – options disclosure document must be given to explain risk and uses of options
- Account opened – when first trade is made

### Options account information to be asked of customer

- Not required, approving manager must just approve any "not disclosed" items
- Based on below info given, customer qualified for a "level" of options trading
  - Little experience – limited to buying calls and puts only
  - Whatever is appropriate to customer
- Investment Objective
- Investment experience
- Financial situation
- Financial needs
- Marital status
- Net worth
- Liquid net worth
- Estimated annual income

### Customer Options Agreement required by CBOE

- Customer must get options agreement for signature
  - **Account profile with "Level"** qualified for
  - Customer agrees to abide by level and OCC rules (position limits, exercise limits)
- Customer must return **signed options agreement to firm within 15 days of account opening**
- If financial status changes, must amend options agreement
- Registered Rep (RR) and Registered Options Principal (ROP) must Sign New Account Form
  - Before more options trading

## Municipal Securities Suitability (MSRB) Rules

- Similar to FINRA “Know your customer rule”
- Registered Rep must have knowledge of customer to make recommendation
  - Financial background
  - Tax status
    - Tax bracket
    - State of residence
  - Investment objectives
  - Etc.
- **If customer refuses to disclose financial status > NO RECOMMENDATION under MSRB Rules**
  - **But customer can still do trade, but mark it “unsolicited”**

## FINRA Senior Citizen Suitability Rules

- Age and life stage should be factors in determining suitability
  - As investors age, investment time horizons, goals, risk tolerance, tax status, liquidity needs change
  - Seniors can assume risk **if they understand recommended products**
  - Warning products that might be unsuitable
    - Variable annuities
    - Equity indexed annuities
    - Real estate limited partnerships
    - Variable life settlements
    - Complex structured products (CDO’s)
    - Mortgage residence to use funds to invest
    - Use retirement savings or early IRA withdrawals for high-risk investments
- Prohibited actions
  - Bogus certification “Retirement specialist” “Certified Senior Advisor”
  - High pressure, “free lunch” seminars for seniors to promote products not suitable to all
- Seniors with diminished mental capacity
  - Representative should document and escalate within firm
  - Firm stop trading in account
  - Communicate with customers designated emergency contact or power of attorney person
  - Maintain contact with person to reassess situation
  - Follow state rules for next steps
- Financial exploitation of seniors
  - FINRA allows members to put temporary holds on disbursements if fraud suspected
    - Age 65 or older
    - Age 18 or older with mental or physical impairment
- Fraud suspicions and account hold on disbursements
  - 15 day hold, if review supports fraud + 10 days +30 if federal investigation
- Trusted contact person
  - Account holds must be documented and notified to “trusted contact person”
  - “Trusted contact persons” – firms make reasonable effort to identify

- Customer must authorize contact of this person for
  - Possible financial exploitation
  - Confirm current contact info or health status
  - Get legal guardian, executor, trustee, power of attorney information

### New Account Approval Required

- New accounts approval depends on securities to be traded
- FINRA Branch manager 9/10 can approval all types
- FINRA General principal 24 can approval all EXCEPT Options
- Options account approved by ROP 4 or 9/10
- Municipal bond (MSRB) accounts approved by municipal principle – series 53, 9/10, or 24
- No customer signature required on new account form

### Margin Accounts Documentation

- Cash accounts only require new account form – customer agrees to pay in full for all purchases
- Margin accounts require additional documentation
  - Since customer only pays for part of securities and get a loan from broker for the rest, broker needs collateral – securities in the account are that collateral
  - This securities held in street name or in the name of broker so they can take the securities over to repay loan

### Customer Signs

- Margin Agreement (also called Customer Agreement) at or before settlement of first trade in margin account
- Customer loan consent agreement gives broker right to lend shares to short sellers

### Customer receives

- Credit disclosure agreement that explain how interest and balance calculated (truth in lending statement)
- Margin risk disclosure statement explain extra risk in leverage and firm can sell shares for margin call

### Joint Accounts – more than one party named – need information on all parties

- Joint tenancy with rights of survivorship (undivided interest)
  - Everyone owns the whole account so if one dies, the other owns it all (common for married couple)
- Tenancy in common (divided interest)
  - Each party owns part of the account – if one dies their interest goes to their estate and passed on to someone named in will (common for business partners)

### Transfer on Death (TOD) account registration

- Really an individual account
- Better than naming a child or someone as joint account holder where issues of divorce exist
- Avoids probate since estate is bypassed

### Convenience Account

- Elderly parent with many children
- One child assigned to manage account to parents benefit only
- Upon death account goes to estate and then to will
- Better than joint account with one child where ownership might transfer to just one child

### Corporate Account

- Proof of existence of corporation required – corporate resolution to open the account with designated trader
- Corporate charter suggested but not required

### Partnership Account

- Copy of partnership agreement must be obtained as often as it is amended (often annually)
- Only general partner must sign

### Prime Brokerage Account

- Single broker that consolidates custody for all other brokers used by an institutional investor
- Get lower interest on margin loan when consolidated but can still use different brokers who are better at different securities
- Used by hedge funds (private placement partnerships for wealthy investors)

### Third Party Trading Authorization

- Written authorization (Power of Attorney) signed by customer to allow someone else to trade on account
- Limited trading authorization – buy and sell orders can be entered but funds not withdrawn
- Full trading authorization – buy, sell, withdraw funds but checks must be signed by customer

### Durable vs Non-Durable Power of Attorney

- Durable – maintains power if customer becomes mentally incompetent
- Non-durable – power stops if customer becomes mentally incompetent
- On Death – all stop power

### Void Power of Attorney

- To open account with power of attorney must be
  - Legally competent
  - Legal age
- Common for incarcerated individuals or someone going into dangerous situation (war) to grant power of attorney

### Duplicate Confirmations

- Customer can authorize in writing that third party get confirmation or duplicate confirmations

### Fiduciary Accounts

- Account where 3<sup>rd</sup> party is acting for and in best interest of owner.
  - Trust accounts

- Copy of trust agreement must be obtained
      - Will specify transactions allowed
      - Registered Rep cannot act as trustee (unless special actions)
      - Trustee is often bank or investment advisor who are already under fiduciary obligation
  - Guardian account
    - Legal guardian appointed by court to protect assets of minor or incompetent
    - Legal court order must be obtained
    - Account only opened in name of minor or incompetent
  - Administrator of Estate
  - Conservator for incompetent
  - Executor of Estate
  - Receiver in bankruptcy
- Requires proper documentation
- Only fiduciary may trade in account (unless approved in fiduciary documents)
- Cash accounts only – no margin accounts (unless approved in fiduciary documents)
- Prudent Man Rule – only invest in a legal list of state approved investments
  - Legal list – often debt rated in top 4 rating (investment grade - BBB or better)
  - Prudent Investor Rule – newer – instead approved investments can use modern portfolio theory – best investments for a level of risk

### Discretionary Accounts

- Customer gives broker trading authorization
- Requires signed Trading Authorization/ Written Power of Attorney before any trades
- Discretionary trade if size and/or security chosen by broker
- Market orders (Not Held Order) – must be executed that day (or power of attorney needed)
- Principal must review all orders by end of day
- Prohibited
  - Churning – excessive trading
  - Too large of orders
  - Disciplined by brokerage and orders reversed – put into house account

### Accounts for Employees of Financial Services Firms

- Rules does not apply to investment company fund investing since employee does not pick securities
- Employee must notify executing member (new account firm) in writing that he is an employee with another finance firm
- Employer must give written consent to executing member
- Duplicate confirmations sent to employer on request
- MSRB municipal security firm employee trade duplicates must be sent to employer
- CBOE firm employee prior consent and duplication confirmations and statement must be sent.

### Custodial Accounts

- UGMA – uniform gift to minors act

- Minors cannot legally have accounts opened in their name
- But custodial accounts can be opened in their name by any adult
- Custodian has trading authorization (no other third party trading authorization)
- When minor becomes adult, account becomes their property
- Money must be invested – no cash, money market okay
- Covered calls – income strategy okay but other option strategies not okay
- One custodian to one minor
- No margin trading
- Gifts irrevocable
- Social security number of minor is on own and liable for taxes
- Prudent man rule for custodian
- Must exercise rights or sell them – cannot let them expire
- UTMA – uniform transfers to minor act
  - New version of UGMA that supersedes them
  - Also allows real estate, fine art, copyrights, patents (in addition to UGMA call, securities, insurance)
  - Transfer age set to 21 (instead of state legal age which is usually 18)
- Omnibus Managed Account for customers of Investment Advisors
  - New account form for each customer required
  - Third party trading authorization also required (power of attorney)
  - All advisor clients grouped under a “master account” or “omnibus account”
  - Annual management fee
  - Wrap accounts – trades – asset allocation – portfolio rebalancing
  - Confirmation of trades sent to customer and advisor
  - Investment Advisor license needed (Series 65 or 66) in addition to series 7

## Numbered Accounts

- Customer keeps name confidential
- Broker must keep name on record of who owns account with signed written record

## Account Maintenance

### Continuing Maintenance of Accounts

- Customer order verification
  - Call with rep who knows customer
  - Answer verification question
  - Password protected website
  - Texts, emails not acceptable way to place orders
- Confirmations of trade sent next day
- Monthly statements if trading occurred
- Quarterly statement if NO trading
- Physical mail OR email okay
- Account statement discrepancies reported to someone other than personal representative
- Customer mail cannot be held unless customer requests in writing for 3 months or longer if good reason

- Records to be kept by representative
  - New account form
  - Chronological record of trades
  - Current account statement
  - Info used to make suitability recommendations
- Accounts are property of broker-dealer NOT representative
- When rep inherits an account, the account documents must be updated
- Customers can get account transferred at their wish to another rep
- If confirmation wrong, corrected confirmations must be send to customer
- Error in execution, customer gets price at which trade could have been executed
- Written complaints must be forwarded to manager for resolution.

#### Brokerage Firm Types and Departments

- Three types of brokerage firms
  - Clearing firms – hold customer cash and securities and generate account statements
  - Introducing firm –smaller broker, use clearing firms
  - Clearing prime broker – consolidate trades among diff brokers for institutional clients
- Brokerage departments
  - Order department
    - Receives orders from registered reps, verifies, transmits for execution, sends executed order info back to registered rep and Purchase and Sales Dept
  - Purchase and Sales departments
    - Sends out customer confirmation by day after trade date
    - Records trade in ledger
    - Removes trade from ledger on settlement
    - Information after settlement moved to customer account
  - Cashier
    - Receives and delivers cash and securities
  - Proxy department
    - Sends voting proxies to margin account share owners since those shares are held in “street name”
  - Reorganization department
    - Notifies share owners of tender offers or takeovers, bonds being called

#### Anti-Money Laundering (AML) Rules

- Patriot Act
  - Firms must have written anti-money laundering programs
    - AML compliance officer
    - Independent annual testing of program
  - Employee training to detect and prevent money laundering
  - Report suspicious transaction and activity
  - Know your customer – put higher scrutiny on customers who...
    - Risk based customer identification program
    - No citizens of 29 FATF countries

- Reside in countries with bank secrecy laws
  - Operate cash intensive businesses
  - Wire transfers, deposits, monetary instruments
- Central system to store/review SAR's (see below)
- Name and Address Verification
  - Non-resident aliens – need passport and all us tax forms
- OFAC List of SDNs
  - Office of Foreign Assets Controls list of countries, organizations, individuals can not do business with
  - Specially designated Nationals list
- Terrorist watch list
  - must check new account name on list and not open new accounts for them
- Suspicious activity report (SAR) – 30 days to report
  - Brokers must file with FINCEN (treasury Dept)
- Currency transaction report (CTR) – 15 days to report to Treasury Dept
  - CTR filing if over \$10,000 in a single day
- SAR and CTR can be filed if person suspicious and did \$10000
- Money Laundering Phases
  - Placement – initial placement of dirty money into the financial system
    - Small cash deposits, purchasing gambling chips, repaying loans with cash
  - Layering – wire deposited cash to a foreign account, then to another and then another countries foreign account
    - To make it hard to trace – layering
  - Integration – funds returned to criminal from apparently legitimate sources

#### Regulation SP – statement of privacy

- Retail customers get copy of brokers Statement of Privacy – firm must give notice that broker can give info to third party unless customer opts out
- Delivered at account opening and annually thereafter
- FINRA or SEC may request info as needed

#### Margin Rules

##### **Reg T - Federal Reserve** Margin Rules only for Non-Exempt Securities (corporate stocks, bonds, options)

- Does not apply to US Gov't, Agency, Municipal Debt, Commercial paper
- Federal Reserve is first level of margin regulation
- Controls credit from broker to customer
- **Initial margins** set ( but Fed does not do for Corporate bonds since price stable)
- Procedures for collection
- Only actively traded securities marginable (Fed requirement)
  - Marginable Non-exempt securities
    - Securities listed on an exchange
    - High volume OTC
    - Mutual funds held for 30 days or more

- Non-marginable issues
  - New issues in first 30 days
  - Non-marketable securities
  - OTC not approved on OTC margin list
  - Mutual funds not held for 30 days or more

#### **FINRA – sets minimum maintenance margin** (second level of margin regulation)

- After initial margin Reg T requirement are met

#### Margin Agreement

- Hypothecation = customer pledges securities purchased to broker
  - Broker loans customer % of purchase price in exchange for pledge of securities
  - Loan to customer = debit balance
- Rehypothecation – Regulation U (broker can pledge, shares pledged to broker, to the bank)
  - Margin agreement says broker will hold securities as capital in street name
  - Broker can repledge (rehypothecate) securities to a bank
  - **Reg U - Federal reserve controls bank lending on pledged securities**
- Funds borrowed from Bank by Broker at Broker Loan Rate
  - Short-term money market rate
  - Broker loan rate + 2%, for example to customer
  - Broker loan rate = call loan rate (because bank can call loan anytime)

#### Regulation T Account Types

- Cash account
  - Reg T requires payment collection settlement +2 days (S+2) = (T+4)
    - Remember settlement two days from trade (T+2)
  - Reg T extension may be given for 2 more days in exceptional circumstances
  - If customer not pay by S+2 or extension, broker must sell position and freeze account for 90 days
    - Customer must give broker cash to buy/sell or wait 90 days
  - In sale, if customer not deliver shares, broker must buy back position in S+10
- Margin account
  - Buy or sell short a security if Reg T initial margin met
  - If exempt securities, then firm minimum maintenance margin must be met
  - Non-marginable securities must be paid in full
  - Payment S+2
- Arbitrage account
  - Simultaneous buying and selling of same security
    - You want to sell your shares but can't for tax purposes, so borrow some from your broker to short. May be cheaper than buying put options.
  - Net position is zero, so no risk
  - No initial margin set by Fed Reserve for arbitrage transactions
  - FINRA requires minimum maintenance margins apply
- Initial margin = 50% on long and short trades

- Based on NET purchase that day so purchases offset by sales
- Cannot proceeds from sale the next day to pay for purchases the previous day
- Buy day 1, sell day 2 > cannot use cash from day 2 sale to cover day 1 purchase
- If done, customer account frozen for “free ride”

#### Minimum Maintenance Margins (FINRA)

- If minimum is higher than Fed Reserve Reg T 50%, then higher amount applies when trade settles
- Minimum margin to open a new long account = \$2,000.
  - If this is more than 50% maintenance margin, must put in higher \$2000
- Minimum margin to open a new short account = \$2,000
  - Short account can never have less than 2000 equity since potential loss unlimited.
  - If short \$3000 of stock and need \$1500 margin, must put in \$2000 since new account
    - Existing account put in \$1500
- Day trading accounts minimum = \$25,000
- Cheap stock rule shorting - additional margin requirement since cheap stocks can rise high and cause customer to lose a lot
  - **Under \$5/share? Minimum margin to short = greater of 100% of sale OR \$2.50/share**
  - **At or over \$5/share? Minimum margin to short = greater of 30% of sale OR \$5/share**
    - Initial transaction in new account – short 1000 shares at \$2
      - Margin call = greater of 2000 or  $2.5 \times 1000 = 2500$
      - Margin call for 1000 shares short at 6
        - Reg T requires 50% or 3000
        - Maint margin requires 30% or 5/share > 1800 or 5000, margin call = great or 5000
- **REG T Initial margin**
  - Long 50%
  - Short 50%
- **FINRA Minimum maintenance margin**
  - Long 25%
  - Short 30%
    - Cheap stock
      - <5, greater of 100% or \$2.5/share
      - >=5, greater of 30% or \$5/share
- Cash and margin account can buy stock and sell covered options
- Only margin account can short stock and sell naked options

## Retirement and Healthcare Plans

### Class Notes

## Variable Annuities (UITs)

### Variable Life Insurance (premium paid by customer is fixed but payoff is variable)

- Hybrid insurance/security product
- Customer's insurance fixed premium is split between cost of insurance and the rest invested in a separate account or subaccount instead of the insurance companies general account
- Within separate account, mutual fund shares are purchased
- Growth of mutual fund determines death benefit, but there may be a minimum promised amount which will be less than premiums paid
- Prospectus must be given to customer
- "Permanent Insurance" because as long as premium is paid by customer, policy will continue
- Cash value of account builds based on mutual fund performance in separate account
  - Amount that can be borrowed against
- Premiums paid by customer go to following costs
  - Mortality and expense risk charges – life insurance component
  - Sale fees - agent commission
  - Administrative fees – insurance company charge
  - State premium fees – state tax on insurance company passed onto customer
  - Investment management fees – mutual fund fees
  - Rider fees – cost of add-ons to policy like higher Guaranteed Minimum Death Benefit

### Fixed Annuity

- Guaranteed rate of return
- Insurance company takes on risk of investing, so this is NOT a security
  - It is an insurance product regulated by insurance laws

### Variable Annuity

- No guaranteed rate of return
- Investor take on risk of investing, so this is a security
  - Regulated by Securities Act of 1933
    - New non-exempt securities must be sold with Prospectus
  - Regulated by Investment Company Act of 1940
- Structure
  - Trust created that collects customer premiums
    - Can only invest in open-end funds (stock fund or bond fund)
- Assumed interest rate (AIR)
  - Estimated annual return on mutual fund investments
  - Used to show customer growth of investment over time
- Separate Account to collect customer premium
  - Basically a portfolio run by a management company
  - Board of Manager oversees account (not Board of Directors like with mutual fund)
- Accumulation Units
  - Customer buys accumulation units in the separate account (not shares of the separate account)

- NAV per unit is calculated daily
  - Automatic Reinvestment of interest, dividends, and capital gains from mutual funds held in separate account – cannot distribute until contract completed – taxes deferred
  - Death Benefit Before Contract End (during accumulation phase)
    - If customer dies before annuity payments begin, insurance company will pay actual dollar amount invested to contract beneficiary.
    - Once contract is annuitized and customer starts receiving payments, death benefit ends
  - Annuity Units
    - Assume customer premiums of 120 payments of \$100 each are complete when customer reaches retirement age (59.5 or later).
    - Then accumulation units purchased plus additional units purchased with interest, dividends and capital gains are CONVERTED to annuity units (“annuitization”)
    - Number of annuity units received depends on life expectancy risk factors (sex, age, smoking, etc.) and annuity payment option selected by customer
      - Periodic annuity payment = number of annuity units x annuity unit value
      - Annuity unit value will fluctuate > monthly check will vary
  - Inflation Effects
    - Variable annuities perform better than Fixed annuities in times of inflation because equity return based values will keep up with inflation
  - Annuity Payment Options
    - Variable Payments (covers you if you outlive insurance company’s estimate)
      - Life annuity – annuity payment continues to end of customer life – this usually gives the highest periodic payment
      - Life annuity with certain period – payments for life BUT if customer early, payments continue for a certain amount of time for a beneficiary – payments lower than with life annuity
      - Joint and Last Survivor Annuity – if customer (annuitant) dies, then payments continue for the life of another person – payment even less since they cover lives of two persons
      - Unit Refund Life Annuity – if customer dies before receiving full investment value of separate account, estate receives remaining value
    - Fixed Payments
      - Take lump sum payment of separate account value and purchase fixed annuity contract
      - Fixed Annuity Contract Options
        - Installments for designated period
          - Specify how long to receive payments which will be computed based on account value and number of payments
        - Installments for designated amount
          - Specify amount of each payment which will continue until account used up
      - Risk is that customer outlives payment options below
    - Combined Fixed and Variable Annuity
- Purchasing/Selling Variable Annuities

- Seller needs Securities and State Insurance licenses
  - SEC consider variable annuities to be securities
    - Series 7 – General securities or Series 6 Investment companies license
- Lump-sum purchase through a “contractual plan”
  - Must sign a long-term investment contract
  - Contractual plans provide commissions to sales people like insurance product commissions
  - Insurance Agents are primary salespeople of variable annuities who also usually have Series 6 license
- Maximum sales charge must be fair and reasonable – FINRA rules
- Recommendations of Variable Annuities only to Customers that benefit from features
  - Suitability rules for selling variable annuities
    - Customer informed of features
    - Customer benefits from one or more features
    - Underlying separate accounts to which premium allocated and the riders to the policy are suitable (mutual funds invested in separate account are suitable)
    - Representative signs suitability determination statement
      - Age, annual income, financial situation, investment experience, investment objectives, intended use of deferred annuity, investment time horizon, existing assets including life insurance, liquidity needs, liquid net worth, risk tolerance, tax status, and any other information needed to make recommendation.
- Guaranteed Minimum Income Benefit (GMIB)
  - Popular optional Rider
  - Guarantees that separate account is annuitized at guaranteed minimum rate if mutual funds in the separate account did not grow enough (guarantees a minimum rate of return on separate account investments)

## Retirement Plans

- Tax deferred plans for holding investments (don't pay income tax until withdrawal)
- Individual plans
  - IRA – individual retirement account
    - Traditional IRA (no tax up front, pay tax at withdrawal)
    - Roth IRA (pay tax upfront, withdrawal tax-free)
  - Keogh Plans
- Employer plans
  - Regulated under ERISA (Employee retirement income security act) law
    - Private plans only (not US or state governments employees – these plans are exempt from ERISA)
    - Profit sharing plans
    - Defined contribution plans (401k)
    - Defined benefit plans (pensions)
    - Tax-deferred annuity plans (403(b))

- Payroll deduction savings plans
- Tax Qualified (all ERISA plans)
  - Deductible against employee income – paycheck deductions for these plans are taken out before tax
- Non-Tax Qualified
  - Non-deductible against employee income – paycheck deduction for these plans are taken after tax
  - After tax money goes into the plan is not taxable at withdrawal but gains may be taxable

## Individual Retirement Accounts

- Must be employed, but not covered by employee plan to be 100% tax deductible
- Contribute up to lesser of \$6,500 (2023) or 100% of income **per year**
  - Married couple can contribute double if joint tax return and put into separate accounts – only one needs to be employed
  - Based on earned income – not investment income
  - Can be made up to April 15 for previous year (no extensions)
- IRA Catch-up for 50 or older
  - \$1,000 extra each individual
- If covered by employee plan and income too high tax deductibility phased out
  - Single return income above 83000 not eligible
  - Single return income 73000 – 83000 partial
  - Joint return income above 136000 not eligible
  - Joint return income 116000 – 136000 partial
- If too much contributed, 6% annual tax on excess contribution until withdrawn and then income tax on it must be paid
- Traditional IRA – before tax contribution as described above but all taxed on distribution min 5 years and age of 59.5
- ROTH IRA – after tax contributions so distributions not taxed if held 5 years and until 59.5
  - Same contribution limits as above but withdrawals (distributions) are NOT taxable
  - If max contribution made to Traditional IRA then no contribution can be made to ROTH IRA
  - High income phase out
    - Individuals partial phase out above 129000, full phase out 144000
    - Couples 204000 to 214000
- Permitted investments
  - Stocks, bonds, unit trusts, mutual funds, government securities, annuities, gold, silver, coins
- Not-Permitted investments
  - Insurance policy, term insurance, art, collectibles
- Early Withdrawal – before 59.5 pay 10% penalty + income tax
  - If person dies or is disabled before 59.5
    - Distribution can be taken out early without penalty but pay income tax
  - Qualifying education expenses and first time \$10,000 home purchase expenses
    - Must still pay income tax but no penalty

- Distributions after 59.5 are regular withdrawal, no penalty, but still taxable
- Payout of distributions **must begin April 1<sup>st</sup> of year after turning age of 72**
- Required minimum distributions (RMD) from IRA by December 31 of each year
  - Comes from IRS life expectancy tables
  - 50% penalty on amount of RMD not taken
- Roth IRA's – not subject to age 72 withdrawal requirement, can even put more in
- Rollover IRA – move employer retirement plan into rollover IRA, if done within 60 days and employee did not cash check then not a taxable event (check must go to Rollover IRA company)

### Keogh (HR 10) Plans

- For self-employed individuals
- Max legal contribution of 25% of after Keogh deduction earnings with cap of \$66,000/year
- Max effective contribution of 20% of before Keogh deduction earnings with cap of \$66,000/year
  - “Before” Earnings                      100      (before Keogh deduction)
  - Keogh Contribution                      -20      (20% of before earnings= 25% of after earnings)
  - “After” Earnings                          80      (after Keogh deduction)
- Full-time employees must get same contribution rate as employer
- If employer earns \$330,000 or more must contribute 25% for employees
- Same age and penalty withdrawals as IRA's
  - Except Keoghs buy cash value of life insurance as investment (buy life insurance before tax and death benefit is not taxed)
- SEP IRA's more common now (self-employed IRA)

### ERISA Plans

- Created to equalize retirement benefits between employers and employees and protect pensions from employer mismanagement.
- Requirements
  - All employees treated equally – non –discrimination
  - Vesting – benefits earned over a reasonable period of time, once fully vested it belongs to employee fully
  - Fiduciary responsibility for plan trustee, assets segregated from firm
  - Permitted investments – broad including covered call writing, not whole life, must meet prudent man rule
  - Categories of Pension Plans
    - Defined contribution (money purchase – like IRA, Keogh)
    - Defined benefit (formula calculates retirement benefit)
- Unfunded pension liability
  - Minimum funding requirements every year
  - Must meet unfunded amount over time.
- Profit sharing plan
  - Tax qualified, defined contribution plan
  - % of income based
  - 25% of income statutory / 20% max effective of gross income
  - Tax deferred earnings

- 401k – payroll deduction savings plan, tax qualified (before tax)
  - For-profit companies can MATCH what employees put in
  - Max contribution 22,500
  - 7500 catch up provision for over 50
  - Distributions must start by 72 subject to RMD
  - Employer can offer own stock as long as publicly traded and employee get voting rights

## Non-ERISA Plans

- Private sector plans
  - Deferred compensation plans – get money later based on performance targets, lost if leave early or bankruptcy
  - SEP IRA – employer makes contribution to employee account
    - Less paperwork for small businesses vs qualified ERISA plans
    - Employer makes contribution to each employees SEP IRA
    - Max 20% contribution effective rate of gross up to 66,000
    - Can change % each year but use same % for all employees (not available with other plans)
  - Simple IRA
    - For companies up to 100 employees
    - Less costly than offering 401(k)
    - Employee max contribution of 15,500 with 3,500 catch up for 50+
    - Employer must make matching contribution
      - 2% of salary regardless if employee made contribution
      - 3% of salary for employees that made contributions
    - No employer flexibility – must be made in good and bad times
    - Higher contribution amount than Traditional IRA
    - Smaller contribution amount than SEP IRA
- Public sector plans
  - Tax deferred annuity (TDA) / 403(b)
    - Qualified (before tax money) or non-qualified
    - No direct stocks but annuities or mutual funds
  - 457 plan
    - Offered in addition to 403b for high salaried or long serving government employees, police, firemen,
    - Non-qualified (after tax money)
    - Distributions prior to 59.5 without 10% penalty but still income tax

## Education and Health Savings Plans

### Coverdell Education Savings Account (CESA)

- For almost all educational expenses
  - **Elementary through College expenses**
- **After-tax, maximum contribution \$2,000 per child per year for 2023**
  - **Contributions must stop after child reaches 18**
  - **\$2,000 max is per child even if multiple CESA**

- If mom sets up CESA and grandmother sets up another CESA, the combined amount going into both CESA's is \$2,000
- High-income earners phased out of CESA (like with Roth IRA)
- **Distributions tax-free**
  - Qualified educational expenses (more allowed than 529)
  - All tuition K-12, college like 529
  - But also K-12 misc. expenses like uniforms, books, tutoring (529 does not do)
  - <https://www.savingforcollege.com/>
- Contributions are not tax-deductible but money “grows” tax free
- Funds should be used by age 30
  - Funds leftover
    - Not to be used by beneficiary (unless disability)
    - May be rolled over into a family member CESA
    - If withdrawn and not used for education, funds taxable to beneficiary child at ordinary tax rates

### Section 529 Plan Education Savings Account (529)

- Also called “Municipal fund securities” because they are created by each state
  - Mutual funds within a state-issued wrapper
- Many state 529 plans allows both residents and non-residents
- Set up by adult for another adult, a minor child, or yourself
- Contributions not deductible from federal taxes (must be after-tax)
- Contributions over \$17,000 (34000 married) subject to gift tax to beneficiary
- A one-time contribution of 5x annual 17000 allowed without gift tax BUT it is prorated over the following years and more cannot be put in that exceeds 17000 a year over next 5 years
- **Most states allow tax deductible contributions (before tax)**
- Distributions from plan directly to financial institution
- Higher education expenses paid to approved schools
- K-12 up to \$10,000/year
- Lifetime max of \$10,000 used to pay off qualified education loans
- Unused funds can be transferred to another beneficiary without tax due
- Distributions due to beneficiary death, disability, scholarship are not taxable????
- 529s can be transferred to different state plans, but any deductions taken might be “clawed back” or taken back

### LGIPs (local government investment pool)

- Another municipal fund security
- Investment pool for states, towns, etc. to invest their public funds
- Marketed to state and local governments
- Not subject to MSRB, unless marketed by a broker-dealer

### ABLE Accounts

- Max \$17,000 non tax deductible contribution for care of disabled person
- If current state does not offer ABLE account you can set one up in another state

- Beneficiary must be disabled before 26
- Distributions are tax free if used for qualified expenses

### Health Savings Accounts (HSAs)

- Only allowed if you have high-deductible health insurance
- Employer set up
- Contributions tax deductible (before tax)
  - Max of 3850 per year (7750 family)
- Employee chooses investments
- Distributions tax free if for qualifying medical expenses

## New Issues

### Class Notes

### Corporate Underwritings of New Issues

- Covered by Securities Act of 1933
- Letter of Intent (signed by issuer and underwriter)
  - Type of security to be sold – common stock
  - Size of issues – 20,000,000 shares
  - Total amount - \$5,000,000,000
  - Estimated public offer price - \$25 – per share – or a range of prices
  - Underwriter spread - \$1 – on each share sold so corp nets \$24 per share
  - Underwriter commitment – firm - or best effort (all or none vs. mini-maxi vs. stand-by rights offering)

### Investment Banking Relationship

- Company or government solicits different investment banks for proposals to raise money
- Investment bank chosen and offering details selected with Signed Letter of Intent
  - Negotiated underwriting – syndicate or network of investment banks, corporate securities and municipal revenue bonds
  - Competitive bid underwriting – municipal general obligation bonds

### Types of Underwriting Commitments

- Firm commitment – underwriter buys all securities and resells (acts as principal or dealer)
  - Underwriter takes on risk of not reselling all
- Best Efforts – underwriter just sells securities and tries to sell all (acts as agent)
  - Issuer take on risk of not selling all
  - All or none Best efforts – sell all or give buyers money back and withdrawal
    - For risky companies where investor demand unknown
  - Mini-Maxi best efforts

- Specifies minimum amount to be sold, if not met, offering is withdrawn and investors refunded
  - After mini is reached, rest is handled as regular best efforts
- Stand By best efforts
  - Used I rights offerings to existing shareholders
    - Underwriter stands by as firm commitment to buy any unsold rights
- Negotiated underwriting
  - Final terms of letter of intent are negotiated

## Formation of Syndicate of Investment Banks

- Lead (or Managing) underwriter invites others
- Spread risk
- Agreement Among Underwriters (or syndicate agreement)
  - Managing underwriter allocates shares to each investment bank

## Due Diligence Process

- Managing underwriter responsible for researching background of issuer and conducting due diligence required by Sec. Act of 1933
  - Full and fair disclosure

## Management Fee

- Manager runs syndicate account and determine each underwriters share of profit or loss
- Manager earns management fee for doing this

## Syndicate Account Types – profit sharing arrangements

- Western Account Syndicate (divided allocation) (most common for corporate underwritings)
  - Shares to be sold assigned to each member
  - Each member only responsible for selling their allocated shares
- Eastern Account Syndicate (undivided)
  - Members share in responsibility to sell all shares

## Selling Groups

- Extra agents outside of syndicate appointed (by the manager?) under each syndicate member
- These agents have no liability to sell a certain number of shares
- Selling Group Agreement
- Earn a selling commission

## Issuers Responsibilities

- Done while underwriter manager forms syndicate
- Non-Exempt securities follow Sec. Act of 1933 – corporate stocks and bonds
  - Exempt are Treasuries and Municipals do not follow these rules
- Registration Statement filed with SEC

- Mostly a copy of prospectus
- 20 day cooling off period follows
  - Cannot sell shares (need final prospectus to do that)
  - Preliminary prospectus (red herring) can be distributed to interested customers for indications of interest with a possible price range but no final price
- Prepare book entry certificates
  - Have shares ready for issuance once registration becomes effective
  - Wait for final price of shares
- Market out clause
  - Syndicate meets during 20 day cooling off period with investors who show indications of interest
  - Offering price adjusted based on level of interest
  - If market problems due to unforeseen events, underwriter can use “market out” clause from underwriter agreement to be released from underwriting
- Road Show
  - Informational (not promotional) presentations about company for investors run during cooling off period
- Final Price Meeting
  - After cooling off period
  - SEC has no issues with registration statement
  - Set public offer price (POP)
- Final price amendment to registration statement filed with SEC
  - Next day registration is “effective”
  - Issue can be sold now with final prospectus and offer price
- Tombstone Announcement in news media
  - Limited because it cannot be considered an advertisement or offer
  - ONLY Prospectus can be an official offer
  - Issuer, type of security, size of issue, POP, names of syndicate (but not selling groups)
- Prospectus sent at or prior to confirmation of sale
  - Can be delivered electronically with trade confirmation
  - If not all shares sold immediately, final prospectus must be given to all initial purchaser for the 90 day period following effective date
    - If first offering of the company quoted OTC or 40 days if others shares already on OTC or 25 days if other shares already on exchange
- Spread is disclosed
  - Prospectus discloses the underwriter spread on first page
- Syndicate disbanded and profits/losses of each calculated

## Trading of newly issued shares in secondary market

- Primary market
  - If new issues being sold into primary market (previously unissued shares sold for the first time), securities are free to trade in secondary market once registration is effective
- Secondary market

- Most new issue start trading in OTC market because they do not meet exchange listing requirements
- When issue starts trading, price can change
- If price deviates too far from offer price, there will be consequences
  - POP = \$20/share, trading on NASDAQ now at 28-29
- FINRA prohibits insiders from buying an IPO
  - Broker can see that if he showed interest for 10,000 shares but was only allocated 500 shares, then it is a hot issue and broker will buy them for themselves to profit. So broker buying is illegal.
  - Persons restricted from buying IPO
    - FINRA member firms, employees, immediate family
    - Fiduciaries to FINRA firms (lawyers, accountants, consultants)
    - Portfolio managers for their personal accounts (but can purchase for portfolios they manage)
    - If offered to public can't be just given to insiders
- Green Shoe Clause (hot issues)
  - Underwriters may up to 15% additional share if "hot issue" and more people want to buy it
- Sticky Issue (cold issues)
  - What if stock price immediately drops from POP on immediate trading?
  - Issue stuck in hands of underwriters
  - Manager of syndicate may place a stabilizing bid at or just below offer price in market
  - May not issue a price above which would cause a hot issue and promote short term traders
- Penalty bid clause
  - To promote sales to long-term investors
  - Syndicate penalty bid clause in syndicate agreement
  - If manager or member buys back too many shares in a stabilizing bid, that member loses his underwriters concession on those shares

## Secondary Offering

- Sale of some currently trading securities require a prospectus offering
  - Officer of a company wants to sell a large block of shares
  - Shares must be sold slowly and registered, sold with prospectus, and managed by an underwriter

## Combined Primary and Secondary Offering

- Company insiders sell their shares along with the company during the offering

## Follow-on offering

- Already public company decides to sell more new shares to the public to raise money

## Shelf Registration Rule 415

- Established companies can issue new shares as they want over a 3 year period
- No need for 20 day cooling off period
- Issuers can “time the market” more easily

## Municipal Official Statement

- New municipal securities are exempt from SEC registration
  - No requirement to give prospectus.
  - Disclosure document call OFFICIAL STATEMENT
    - Not subject to SEC rules but still provides full and fair disclosure

## Investment Banking Terms

- Merger and Acquisition (M&A)
  - Investment bankers give advice to companies on buying other companies or being bought by another company
  - Horizontal merger – merger of two companies in same industry / same products
  - Vertical merger – merger of a company with a supplier to that company
- Divestiture / Spin-Off
  - Investment bank helps companies sell part of their business
- Leveraged buyout (LBO)
  - Private investors borrow money to buyout all shares of public company to take the company private
- Holding company
  - Another way for companies to merge
  - Holding company buys shares in both companies
  - Allows companies to get their representatives on the board of directors of other company to exert control or influence

## U.S. Government and Agency Underwritings

### US Treasury Debt

- Sold at auction by Federal Reserve for the Treasury department.
- No underwriter used.
- Yield auctions because bids made in terms of interest rates with the lowest rate winning
  - Lowest YTM > Highest Price bond
  - Yield basis bids to 2 decimal places
    - 2.10 or 2.11 okay (2.111 not accepted)
  - Fed allocates securities from lowest yield bid to highest yield bid until the entire issue has been allocated
- Treasury Bills
  - Weekly auctions for 4, 8, 13, 26 week T-Bills
  - Monthly auctions for 52 week T-Bills (bills mature 351 days later)
  - Discount bid from par auction, 2.11% = 2.11% discount from \$100 = \$97.89

- Lowest discount bids win
- Dutch auction – all winners get = highest discount bid of all winners
- Treasury Notes, Bonds, TIPS
  - Yield auction
  - Monthly auctions
  - No separate auction for STRIPS
    - All Treasury notes and bonds issued eligible for STRIPS program
  - CMB only sold when Treasury needs extra cash (cash mgmt. bill)
- Auction Bidding Choices
  - Competitive bid – bidder specifies interest rate. Lowest rates win.
  - Non-competitive bid – bidder agrees to accept average of winning competitive bids. These bids are always filled.
- Competitive bidders
  - Usually primary dealers and large institutions (money fund investment companies)
    - 20 or so Primary dealers designated by Fed
    - Fed buys and sells government securities through primary dealers to change money supply
- Monday Auction, Thursday Issuance and payment due
  - **T-Bills** pay \$100 face amount **less discount specified by winning bid**
  - Example: If \$100,000 of 91 day T-Bills auctions
    - Dealer Bids sorted from lowest discount from par (preferred by Fed) to highest and then Non-competitive which always get filled with winning group of bids
 

Dealer	% Bid	Amount	Accepted?
• Dealer A	2.10%	20,000	Accepted
• Dealer B	2.12%	20,000	Accepted
• Dealer C	2.14%	20,000	Accepted
• Dealer D	2.16%	20,000	
• Dealer E	2.18%	20,000	
• Non-Competitive Bids		40,000	Accepted
    - **Results \$100,000 sold to Dealers A, B, C, D and Non-competitive bidders at 2.14% the highest winning discount bid (Dutch auction for T Bills)**
  - Minimum non-competitive bid is \$100 and max \$10,000,000
  - Minimum competitive bid is \$5,000,000 and no max
  - Treasury notes, bonds TIPS get yield auction.
    - Lowest yield bids win
    - Average yield of those allocated notes is used to set coupon of issue
  - All securities are issued and paid for on Thursday after Monday auction

## Federal Agency Securities Underwritings

- Negotiated offerings to sell debt
- Agencies
  - Fed Natl Mort Assoc
  - Govt National Mort Assoc

- Fed Home Loan Bank
- Fed Home Loan Mort Corp
- Fed Farm Credit Banks
- Selling Groups Appointed by Agency
- Exempt from Securities Act of 1933 – no SEC registration, no prospectus
- Offered at close to par
- Selling Concession paid from par to Selling Group (discount from par?) then selling group resells to public at par
- 

## Regulations

### Class Notes

### Securities Act of 1933 – Regulates New Issues in Primary Markets

#### Applies to these issues (Non-Exempt)

- Corporate stocks, bonds, rights, warrants
- Options
- Investment companies and variable annuities
- Limited Partnerships
- Excludes US, agency, and municipal securities.

#### Registration Statement must be filed before sales can take place

- Includes proposed prospectus
- Description of business
- Use of proceeds
- Historical financial statements
- Officers and directors of company
  - Background info on
  - Percentage holding

#### 20 Day cooling off period

- SEC reviews for full and fair disclosure
- Deficiency letter if SEC want more disclosure
- Issue may not be sold, advertised, recommended or orders solicited
- What can be done during this time?
  - Distribute preliminary prospectus (red herring)
  - Indications of interest taken

#### Effective Date

- Registration effective once SEC approves and 20 days ends

## Prospectus Delivered at or Prior to Confirmation

- Prospectus delivered for a 90 day period following effective date
- After 90 days for primary distributions (IPO), no more prospectus needed since issuer does first SEC financial filing
- After 40 days for secondary distribution (SEO) of OTC firm, no more prospectus
- After 25 days for secondary distribution (SEO) of Exchange/NASDAQ listed firm, no more prospectus

## Internet Access to Prospectus = Delivery

- Only allowed when firm knows customer has internet access
- Like by checking a box on the internet
- But if never emailed firm or used website can not assume internet access

## “Omission or Misstatement of Material Fact is Fraud”

- In registration statement or prospectus
- Fraud by issuer, underwriters, accountants, lawyers
- **Due Diligence** at multiple reviews by all parties above to ensure full disclosure

## Shelf Registration

- Allows company that had their IPO at least 1 year ago, to
- Companies can register additional offerings with one registration state to cover the next 3 years
- Company gives SEC 2 day notice of sale and can use a Prospectus Supplement
- No 20 day cooling off period

## Exempt Issues from Securities Act of 1933

- Securities not subject to SA 1933
- (1) Government obligations
  - Treasuries
  - Agencies (Fannie Mae, Freddie Mac, Fed Home Loan Bank)
  - Municipals
  - Foreign Government debt
- (2) Issuers regulated under other laws
  - Insurance company offerings – state insurance laws predate 1933
    - Except Variable Annuities, which are regulated
  - Bank issues – state banking laws predate 1933
  - Transport/carrier/railroad/trucking issues – interstate commerce commission laws predate 1933
- (3) Non-profit issues
  - Non-profit corporations like farmer cooperatives
  - Educational or charitable organizations
- (4) Other exemptions
  - Money market – bankers’ acceptance and commercial paper with maturity <= 270 days
  - SBIC issues – minority businesses set up under SBA rules

## Exempt Transactions from SA1933

- NOTE: If any of these securities are not offered in exempt TRANSACTIONS then must be registered and offered through a prospectus under SA1933.
- Rule 147 - Intrastate (within a state) offering exemption
  - 100% of issue sold to residents of a state (cannot be sold to non-residents)
  - Issuer must have principal place of business in that state
  - First 6 months can only be resold to state residents
  - After 6 months can resell outside of state (interstate)
  - Must comply with state "blue sky laws"
- Regulation D - Private placement exemption
  - Maximum 35 non-accredited investors
  - Unlimited accredited investors
    - ( individual with \$1Million net worth excluding home or \$200k annual income past 2 years or \$300k couple) or officer/director of company or financial institution or fund with min \$5million assets.
    - Fill out accredited investor questionnaire, checking off and signing
  - No dollar limit, no # shares or units limit
  - "Offering Circular" given to investors for full disclosure (though official prospectus not required) – also called "Offering Mem" or PPM – private placement memo.
  - Restricted stock - only resold in a private trade without broker (to friend) or in public market using Rule 144
- PIPE transactions (private investment of public equity)
  - A way for an already public company to quickly raise capital without time and expense of SA1933 registration
  - Public company sells discounted shares to accredited investor in private placement
  - Public company does shelf registration for the shares so accredited investor can sell them in public markets over next 3 years
- Rule 144 – would otherwise require prospectus
  - Allows holders of restricted shares (never registered for public sale because this specific share class was not registered for IPO) to sell them after company goes public if those shares have been held for at least 6 months
  - Seller must file Form 144 to sell no more than 1% of outstanding shares at a time
  - Can file to sell up to 4 times per year
  - "Dribble rule" since must sell in small lots over time
  - Control stock of insiders
    - Must sell via 144 or SA1933 with register and prospectus
    - No subject to 6 month holding requirement for insiders
  - Very small offerings – Rule 144 waived – up to 5,000 shares worth no more than \$50,000 every 90 days
- Rule 144A – tradeable private placements
  - Trading between large institutional investors only
  - Purchasing unregistered securities from brokers
- Regulation S

- Exemption from Registration/Prospectus for US issuers who set up foreign subsidiaries that sell shares to foreigners
- Rules 145 Corp Reorganization
  - Reorganization required to file registration statement and get majority shareholder vote approval
    - Substituting one security for another
    - Merger or consolidation of corporations into one new entity
    - Transfer of asset from one person to another in consideration for issuance of new securities
  - Rule 153A Prospectus delivery required before shareholder vote
  - Rule 145 Exemptions - Reorganization NOT required to file registration statement
    - Stock split or reverse split
    - Par value of stock change
    - Stock dividend

## Securities Exchange Act of 1934 – Regulates Secondary Markets

- Regulates (corporate?) trading markets
- No formal regulation of government securities markets though – just oversight of federal reserve board.
- MSRB rule later regulates municipals markets.
- Requires exchanges to register with SEC and become self-regulatory organizations (SRO)
  - FINRA is the SRO merged from NYSE and NASD (NADAQ+OTC) since 2007.
- Does not apply to exempt issuers, except for manipulation
  - US Government does not need to file annual or quarterly reports with SEC
  - Municipals not subject to Reg T margin rules
  - Agency debt not subject to short sales rules of Reg SHO
- MISS PERMS
  - M - manipulation - becomes fraud
  - I - insiders - defined and prohibited from insider trading
  - S - SEC - created to regulates markets
  - S - short sale - rules
  - P - proxy rules - to make takeover attempts fair to shareholders
  - E - exchanges - must register with SEC and regulate themselves per SEC guidance
  - R - reports – public companies must file quarterly and annual reports
  - M - margin – federal reserve controls credit on securities
  - S - stabilization – new issue price support is permitted

## Manipulation = fraud (Section 10 rule) for exempt and non-exempt securities

- Wash Trades – buying and selling same security to create appearance of trading volume activity
- *Front running ?- Placing an order for a security upon knowledge of orders that have been or will be place at substantially the same price.*
- *Effecting transactions to create a impression of rising or falling prices – offering to buy a security for a customer giving information that price will likely rise or fall because of what that person is doing*

- *Inducing sale of security by using false or misleading statements*
- *Accepting payment for disseminating info that price of a security is likely to rise or fall*
- *Pegging (stabilizing) the price of a security in ways not prescribed by SEC rules*
- Trading pools – work together to bid prices up on a security only to sell after other traders start buying
- Underwriting trading before effective date of IPO to increase POP and thus underwriter spread
- Tender offers by outsider to buy up stock of company to gain control
  - SEC says offer must be held out or made available to shareholders for minimum 20 days
  - Offers usually conditioned on minimum number tendered shares
  - If insufficient shares tendered, may revise tender offer price which extends offer 10 days
  - Maker of offer can only buy stock via the offer, not in the market
  - Maker of offer and agents treated as insiders
  - Only Net-Long shareholders may tender shares
- Rule 10b-1
  - Manipulation rules apply to both exempt and non-exempt securities
- Rule 10b-3
  - Illegal for BD to use any deceptive or manipulative device
- Rule 10b-5
  - Fraudulent activities open to undefined wrongful activities
- Lawsuits must be brought within 2 years of discovery
  - 5 year statute of limitations

## Insider Trading Laws

- Insider definition according to SE1934
  - Officer, Director, 10% shareholder
  - Must report trades within 2 days
  - Prohibited from trading on insider information
  - Short swing trade profits within 6 months must be paid back to company
  - Insiders prohibited from short-selling company stock
- Insider definition according to Courts
  - Anyone with material, non-public information that can be expected to influence the stock price, who trades on that information (Rule 10b-5)
- Giving insider information not a violation, but using the information to profit is a violation
- Tipper, who gives info, and Tippee, who uses info for profit, are both in violation.
- Inside information is public after news media release
- Broker/Dealers must have enforced, written procedures to prevent insider trading
  - BD departments like Investment Banking, Mergers & Acquisitions, Trading, and Retail **must have information barriers** between them to prevent insider trading
- Penalties (paid to Treasury)
  - Civil Penalties for insider trading up to 3x profit or loss prevented
  - Criminal penalties up to \$5,000,000 for each inside trade and up to 20 years in jail for each trade

- If insider is “controlled” – employee of BD, then liable under SE1934 and \$25,000,000 fine
  - But must prove person knew, recklessly disregarded, and failure to do anything contributed to the insider trading
- Bounty for informants = 10-30% of recovered amount over \$1million civil penalties
- Insiders can be sued by other traders who lost, but must do within 6 years
- Rule 10b5-1 – pre-arranged trading plan
  - Insiders (officers, directors, 10% shareholders) can make a pre-arranged trading plan for “safe-harbor” from being accused of insider trading
  - Plan specifies how much and when securities will be bought or sold
- Rule 10b5-2 misappropriation theory for non-insiders
  - If person steals insider info to trade or trades on info told in private then this is misappropriation and person will be liable
  - If person “stumbles upon” information and trades on it, they cannot be liable
- Regulation FD (fair disclosure)
  - Prohibits issuers from giving selective disclosure to favored groups or individuals – like giving guidance to just some analysts
  - Tipper/Tippee rule applies
  - Forced analyst meetings to be open to all

### SEC created to regulate markets

- Regulates securities and security markets
- DOES NOT regulate insurance products, commodities, or futures contracts.

### Short sale rules (Regulation SHO)

- Every order ticket to sell be marked long or short
- Sale of borrowed securities to be delivered on settlement in 2 days
  - Broker must locate and deliver shares on settlement
  - If broker fails, mandatory buy in
- “Up Bid” rule – if equity shares drop by 10% or more during a day, they can only be sold short on an up bid for rest of day and next day

### Proxy rules - to make takeover attempts fair to shareholders

- Shareholders must be given fair chance to vote for regular corporate decisions like board of directors and takeover offers
- Proxy materials (information about what is being voted on) must be complete and not misleading
- Proxy materials files with SEC 10 days before mailed to shareholders
- Control seeking person who owns more than 5% of stock does 13D Filing within 10 days of reaching 5%
- Passive investor who owns more than 5% of stock with intent to control does 13G Filing within 45 days after year-end of reaching 5%

## Exchanges and member firms- must register with SEC and regulate themselves per SEC guidance

- When trading non-exempt securities
- FINRA – self regulatory organization that regulates security markets and firms.
  - FINRA rules approved by SEC
- BD registration with SEC
  - BD must meet minimum net capital requirement for adequate liquidity
  - Clearing BD have higher net capital requirements since holding customer funds and securities
  - Introducing BD have lower net capital requirements
  - Buy in if customer fails to deliver sold security in 10 days after settlement
  - Segregation of securities on more than 140% margin so not rehypothecated to a bank for dealer margin loans
  - Notification of client free credit balances (amount of client uninvested cash) given quarterly, fact that funds available upon request, and fact that funds not segregated.
  - Notification of broker-dealer financial condition with semi-annual balance sheet and net capital computation that shows BD Net capital.

## Reports – public companies must file quarterly and annual reports

- 10Q (unaudited) and 10K (audited) reports
  - Income, balance sheet, retained earnings change, and cash flow statements
- 8K – filed with SEC if ... within 4 days of an event
  - bankruptcy declared
  - board composition changes
  - proposed merger or divestiture
  - other major corporate event

## Margin – Federal Reserve controls credit on securities

- Reg T – controls credit on securities (margin loan) from broker to customer
  - Exchanges impose margin requirements stricter than Fed
- Reg U – controls credit on securities from bank to broker
- Applies to non-exempt listed securities
- Credit not allowed on non-exempt securities

## Stabilization – new issue price support is permitted

- Underwriter may maintain a stabilizing bid until offer complete in secondary market
- Stops other market makers from knocking down price and hurting new purchasers (??)
- Regulation M covers this
  - Deals with market manipulation during 20 day cooling off period for add-on securities (and IPOs later added)
  - Prevents syndicate market makers from pushing price up to increase POP and thus spread compensation
    - Limits on syndicate members who are also market makers

- Either resign as market maker for 20 days or act a passive market maker to limit buying and trading volume in those shares so they can not drive price up
- Stabilization is NOT market manipulation when ...
  - Notice of stabilization must appear on inside front cover of prospectus
    - Says underwriter may stop at any time and price may then drop
    - Only 1 stabilizing bid per market or market maker
    - At or below POP, never above
    - Must stop when manager disbands syndicate
      - But to time limit otherwise

### Penny Stock Sales

- Solicited transactions of BD to prequalify new customers wanting to buy penny stocks.
- Designed to prevent high pressure telephone sales tactics when selling low price securities
- Where BD penny stock transactions are more than 5% of revenues
- Designated securities = Unlisted, NON-NASDAQ equities under \$5/share
- If firm want to sell designated securities to new customer they must:
  - Detailed customer suitability information – financial situation, investment experience, investment objectives
  - Suitability determination – if suitable AND customer has knowledge and experience to evaluate risks
  - Written suitability statement – delivered to customer – **unlawful to trade before signature**
  - Existing customer exemption – not required if 1 year funds with BD or 3 other purchases over separate days
- Risk Disclosure – 15g-2
  - Customer right to know of risk
    - Current best bid and ask
    - BD compensation in transaction
    - Account statement monthly within 10 days of month end
    - Shares owned, issuer name, number shares, estimated market value
      - (non-designated shares minimum quarterly statements unless transaction in a month)

### Trust Indenture Act of 1939 – Regulates Compliance with Corporate Bond

#### “Trust Indenture”

- Passed because SA1933 did not adequately protect bondholders after offering
- All interstate offering of “non-exempt” bonds of \$50,000,000 or more must be made with a trust indenture
- Appointment of a “substantial” trustee to protect bondholder interests
  - Trustee makes sure requirements in indenture are followed by issuer
  - No conflicts of interest with issuer allowed
  - Commercial banks act as trustee for corporate bond issues

## Investment Company Act of 1940 – Regulate Investment Company Securities

- Investment companies must register with SEC
- Initial offering of securities be registered with SEC
- Types allowed
  - Face amount certificate company
  - Management company
  - Unit investment trust
- Management structure
- Reporting requirements to shareholders
- Offering price computation

## Investment Advisers Act of 1940

- Someone who gives investment advice to a client for a fee
- Goal was to register investment advisors with an investment company and place limits on compensation
- Must register with SEC if advice is interstate
- BD, banks, newsletters, newspapers are NOT investment advisors
- **Market letter that gives advice based upon a customer's specific situation is considered Investment Advisor**
- BD that offer wrap accounts that charge a single fee are investment advisors
- Non-managed flat fee account is considered an advisory product
- Investment advisor categories:
  - Federal covered investment advisor
    - Assets > \$100 million
  - State registered advisor
    - Anyone who does not qualify as federal covered advisor
    - Assets < \$100 million
    - Register in each state

## Securities Investor Protection Act of 1970 – SIPC insures investor funds and securities from Broker Failure

- Insures \$500,000 per customer for equity and cash.
  - Maximum \$250,000 in cash holding coverage.
- Equity valued at date of bankruptcy
- Assets of BD distributed in bankruptcy as follows:
  - Securities registered in customer name are returned to customer with no dollar limit
  - Street name registered securities (margin account) are distributed among beneficial owners on a pro-rata basis up to \$500,000 each
  - If distribution of securities does not meet customer claim, SIPC coverage steps in up to \$500,000 inclusive of \$250,000 cash
  - Claims above \$500,000 customer becomes general creditor

- Claims applied per customer even if they have multiple accounts

## Federal Telephone Consumer Protection Act of 1991

- Cold call rules for unsolicited commercial phone calls
  - Only 8am-9pm
  - Caller identifies name, firm, address or telephone number
  - If caller says they do not wish to receive calls they must be put on do not call list
    - Person stays on do not call list forever
  - Any communications over phone lines including fax
- FINRA and MSRB also require do not call lists
- FTC enforces act
  - Does not apply to not for profit organizations
- FINRA do not call rules
  - Can call outside 8am-9pm if...
    - Established business relationship
    - Received written consent to call anytime
- **If person on Firm do not call list, solicitation calls prohibited**
  - **But non-solicitation calls allowed**
- **If person on National do not call list, solicitation call prohibited unless....**
  - **Established business relationship**
  - **Express written consent**
  - **Personal relationship with representative**
- **If person not on any list, can only call 8-9**

## Sarbanes-Oxley Act of 2002

- Auditing accounting firms may not provide other services to issuer
- Accounting firm must report to independent audit committee
- CEO and CFO of issuer cannot have been employed by audit firm in preceding 1 year
- CEO and CFO must annually certify appropriateness of 10Q and 10K reports subject to criminal penalties
- Issuers cannot extend credit to officer or director
- 8K reportable events must be reported within 4 days
- Insiders prohibited from trading during blackout periods established by issuer
- Insiders must report their trades within 2 business days of the event

## Blue Sky (state) Laws

- Securities to be sold to state residents must be registered in the state
- BD, agents (reg reps), and investment advisors and their reps must register in each state
- Natural person = real person, Legal person = corporation or entity
- When filed with SEC also coordinated with individual state filings
- Exemption from SA1933 does not give exemption from state registration which is still required
- State Registration Methods
  - Registration by Coordination

- Coordinates state registration application with federal SEC registration application
  - Registration by Qualification
    - For companies that never filed in the state before. Lots of work.
  - Registration by Filing (notification)
    - Company filed in state before – like a renewal – so easy to do.
- Securities Exempt From state registration
  - Blue chip exemption
  - Federal covered securities exemption
  - Investment company securities exemption

### Broker-Dealer (BD) State Registration

- State registration of broker-dealers if they have an office in the state or any communication to/from that state
- BD must also be federally registered
- **Sales individuals – registered Series 63 Exam – Uniform State Law Agents Exam**
- **Investment Adviser Reps (wrap accounts) – registered Series 65 exam – Registered Investment Advisor Exam**
- Series 66 Exam – combined Series 63 and 65

### Investment Advisor Representatives (who work for State or Federal Registered Advisor Firm)

- All reps must register in state (no federal registration of investment advisor reps) where they reside and each state they solicit business

### FINRA Registered Representative Rules

- People who must be registered
  - Accepts or solicits orders to buy or sell securities for the accounts of customers must be registered
  - Makes a recommendation to a customer must be registered
  - Makes a suitability determination must be registered
  - Operating officers of BD (but not officers who are passive owners)
  - Securities traders
  - Client facing back office personnel
- NOT required if doing clerical work like reporting completed trades
- SIE and representative exams passed to be registered
  - SIE first
  - + Series 6 or 7 then to be registered
- U4 Form to be registered
  - Finger print (not just reps, traders, advisors, officer, but also cash handlers, book keepers and supervisors) and background check
  - Convictions (felony conviction is disqualification – DUI is a felony)
  - Check if you should be disqualified

- Amended whenever anything changes, including outside work which has to be approved by BD
- Fidelity bond insurance coverage paid by BD against employee theft requires background check
- Statutory automatic disqualification
  - Suspended by another SRO (FINRA or NFA – national futures association, etc.)
  - SEC suspension or registration revoked
  - Willfully Filed misleading application
  - Willfully violated federal securities laws or aided or failed to supervise others
  - Convicted of money related misdemeanor (petty larceny) or felony (DUI felony but not DUI misdemeanor) within past 10 years
  - Not allowed to engage in securities business (temp or permanently)
- CRD – central registration repository
  - Database of U4 forms run by FINRA (broker check to get some info)
- After registration rules for reps
  - Dispute between rep and BD firm goes to arbitration with no appeal
    - Except for discrimination, sex harassment and whistleblower can sue
  - Customer disputes handled by arbitration if customer signed arbitration agreement
  - Outside business activities – rep to notify firm and follow instructions
    - Excludes Charitable work for no compensation
    - Outside work on U4 and broker check report
  - Continuing Education (CE) requirements
    - Annual Regulatory - computer training sessions, if not do become inactive and not paid
    - Annual firm training - products, regulations and compliance issues
    - BD Firm annual compliance review meetings – nothing on sales – just compliance
- U5 form – termination form within 30 days
- If no job with firm for 2 years, must requalify with exams
  - MQP (maintain qualification program) FINRA program allow you to extend period to 5 years
  - Cannot just hang your registration at BD to keep current without working
- Reportable events
  - If getting into trouble must notify FINRA within 30 days of event
  - Found to have violated security law
  - Subject of written complaint for theft, misappropriation or forgery
  - Defendant or respondent in legal proceeding on securities acts violations
  - Denied registration or expelled from other SRO
  - Indicted, convicted or plead guilty to criminal offense except misdemeanor traffic or misdemeanor dui but felony dui reportable
  - Associated with BD, or investment related company expelled, reg denied, or guilty to felony or misdemeanor
  - Defendant or respondent in securities civil litigation for amount \$15k individual or \$25k firm
  - Subject to BD discipline like suspension firing or fines in excess of 2.5k

- BrokerCheck website
  - FINRA
  - Uses forms U4 and U5
    - 10 year employment history
    - Securities licenses and state registrations
    - Complaints and disciplinary record
    - Outside business activities
    - Exclude personal info like height, SS#, and address.
- Rules for dealing with public
  - Customers must be treated fairly and equitably
  - Compliance with firm's written procedures
  - Entertainment expenses per firm policy
  - \$100 gift limit per person per year (unless personal friend)
    - Gifts recorded for 3 years
  - Non-cash compensation prohibited
  - Cash compensation for work okay if written agreement and BD firm approved
  - Approval and record of correspondence to 25 or fewer people (before or after)
  - Cannot guarantee customer against loss (except repurchase agreements on exempt securities)
  - Cannot share in gain or loss with customer unless capital contributed and shared profit is proportional to capital (unless immediate family)
    - Joint accounts with customers allowed if approved by firm
  - Cannot lend to or borrow from a customer unless immediate family or lending institution
  - Need firm approval for rep to borrow/lend with...
    - 2 reps of same firm
    - Customer with personal relationship but not immediate family
    - Customer with business relationship
  - Cannot share commissions with an unregistered person
    - But can with a registered person with firm approval
    - Okay with retired reps call continuing commissions in retirement
  - Cannot do private trades (selling away) by doing a trade for a customer with another firm unless firm receives and gives written notice

## Customer Account Rules

- Know Your Customer due diligence on orders, cash and margin accounts, goals and situation
- Approval required for new accounts by branch office manager

## Accounts

- Numbered accounts – okay if customer signs statement attesting to ownership which is kept on file
- Discretionary accounts – need signed power of attorney from customer
  - All orders marked discretionary
  - All orders approved end of day by branch manager

- NOTE: if trade only gives rep choice on price/time of execution for 1 day it is NOT discretionary (longer than 1 day requires written customer approval)
- Employee from another firm account
  - Employee from another firm must give written notice to their firm
  - Employee must receive written consent from their employer before account opening
  - BD sends confirmations/statements to employer BD ON WRITTEN REQUEST
- Joint account between Rep and customer – only with written approval from firm

## Account rules

- Cannot change order ticket after execution unless written manager approval
- Cannot guarantee against loss or from sharing in gain/loss
- Time stamping of orders when sent to exchange and when executed or when canceled.
  - Copies of order tickets kept for 3 years.
- Trade execution error – must be corrected and resent
  - Customer pays or receives corrected amount
- Statements mailed quarterly or monthly if trading in that month
  - Only to customer specified written address
  - Only held up to 3 months out of 12 on written customer request
    - Anymore must have valid reason in writing
- Customer complaint – any received in writing – must be forwarded to branch manager
- Proxys must be sent to customers free of charge. If customer does not return, firm cannot vote proxy.
- Options transaction costs in options accounts – must tell customer since they can be high
- BD balance sheet and Net capital computation on customer request from SEA1934
- FINRA manual on customer request in each branch or web link to FINRA
- Customer information received in fiduciary capacity cannot be used to solicit sales except with consent of customer
- If BD own a control position in a stock, must tell customer who is buying or selling it that at time of order and in writing by settlement
- If BD publicly traded, cannot recommend their own stock, but can accept unsolicited orders
- BD or Rep cannot charge for investment advice, unless working for an Reg Investment Advisor entity of BD and individual registered in state as investment adviser rep
- Can charge for fair and reasonable clerical services under 5% policy
- Recommendations of NON-NASDAQ OTC low-priced stocks
  - Solicitations of penny stocks  $\leq$ \$5
  - BD must first do the following:
    - Customer financial situation, investment objective, investment experience
      - BD must determine if customer has sufficient knowledge and experience to evaluate risk
      - Suitability determination must be delivered to customer in writing
        - Says unlawful for BD to affect transaction without prior written consent of customer
        - Customer must sign, date and return written statement before transaction can be effected

- Private placement offering, member must perform due diligence
  - Issuer/mgmt./business prospects/assets/claims/intended use
  - NOT required for registered (IPO) securities – just private placement
- Customer disputes – handled by arbitration only if customer agrees
  - If not arbitration agreement signed, customer can sue
  - 3 person panel of at least a majority of public arbiters (not in securities industry)
  - Mediation heard by a single mediator can be used if both customer and firm approve to save time
    - Non-binding and if not abandoned, goes back to arbitration queue with FINRA

## FINRA Trading and Market Rules

Also in trading markets and new issues

- Need reasonable assurance customer can settle (pay \$ or deliver shares) in 2 days before accepting buy or sell order
- BD using another firm to trade (interpositioning) not allowed unless can be shown to improve order execution.
- Bona fide quotes only – no backing away
- 5% policy – suggested max commission/mark-up on exchange or OTC transactions
  - Does not apply to new issues and municipals (prospectus offering)
  - Does not apply to mutual funds (8.5% max sales charge – since mutual funds are all a new offering)
  - Does not apply to limited partnership (10% max sales charge)
- No purchases of IPOs by industry insiders (excludes debt, preferred stock – only equity)
  - No BD or employee or friends and family (unless from another BD unrelated offering and not related to employee)
  - No Lawyers, accounts to BD firms.
  - No investment managers buying for personal accounts
  - No Investment clubs/pooled accounts.
  - New customer must say not restricted shareholder (insider)
    - And confirm unrestricted status every year

## FINRA prohibited Acts

- Causing customer to do excessive trading (churn)
- Executing trades for customer at higher and higher or lower and lower prices to create misleading activity
- Manipulative activities like manipulative bids
- Circulating rumors which must be reported to FINRA
- Loan funds to others using securities as collateral – unless margin agreement signed by customer
- Borrowing or lending funds to a customer unless under Reg T provisions
- Blanket recommendations of low priced speculative stocks
- Recommending purchases beyond customer capacity
- Misappropriating customer funds

- Trading customer account without authorization
- Lending out customer securities without a signed consent form or rehypothecating unreasonable amount of customer securities in excess of 140% debt
- Payments to media to affect stock prices
- Telling investors that new issue POP is market price unless there is an independent market for security
- Payments designed to influence stock price where finra member is participating in underwriting. Can not illegally try to raise POP.
- Manipulative or deceptive practices used on customers.
- Giving discount to POP
- Accepting gift of more than \$100 from investment company (mutual fund). Fund can not give extra commissions above and beyond sales charge.
- Selling mutual fund shares just below the breakpoint where customer sales charge would have been less if above the breakpoint.
- Telling customer to buy stock just before the dividend ex date.
- Trading mutual fund shares (can only issue and redeem with the fund directly)
- Not sending mutual fund prospectus with other written communications excluding a little form letter with fund objective and management structure.

## FINRA communications rules with the public

- Correspondence
  - **To 25 or fewer retail investors** – customers or not customer - in any 30 calendar day period
  - **Does not required principal BD approval**, but subject to review and approval later.
  - NOT subject to FINRA filing rules as long as BD has correspondence compliance program.
- **Retail Communication (investors <\$50 million)**
  - **To more than 25 retail investors within any 30 day calendar period.**
  - **Must be approved by principal of BD before distribution.**
  - May need to be filed with FINRA.
  - Can only say firm is FINRA member, not say approved
  - FINRA must be smaller than firm name
  - FINRA – hyperlinked to FINRA site
  - BrokerCheck – hyperlined to brokercheck website for advertised brokers
  - No predictions of future
  - Testimonials allowed and if compensated more than \$100
  - 3 year record retention
  - Types
    - Advertising in mass media
    - Sales literature - websites, etc. for > 25 retail investors
    - Independently prepared reprint if sent to > 25 retail investors
- Institutional communication
  - To large (>=\$50 million) institutional investors, advanced principle approval not needed

- NOT need to be filed with FINRA
- Procedures for later review if needed should be in place
- Public appearance or public forum
  - No pre-approval or FINRA filing needed
  - Subject to later review if needed

## FINRA Code of Procedure

### Complaint handling

1. Complaint filed with FINRA Dept of Enforcement, if they feel it has merit it is passed onto next step
2. Complaint forwarded to FINRA office of hearing officers, who gets response from FINRA firm within 30 days, and decides if violation occurred and penalties
3. If complainant not satisfied, they can request FINRA hearing panel
  - a. First appeal if not happy with FINRA hearing panel National Adjudicatory Council run by FINRA
  - b. Second appeal – go to SEC
  - c. Third appeal – federal court

### Penalties

- FINRA decides penalty like censure, suspension, expulsion, fines
- Minor complaints – mx \$2,500 fine, signed Minor Rule Violation letter

### Record Retention

- Advertising , Correspondence, Customer Orders – 3 years
- Written customer complaints - 4 years
- Customer account statements – 6 years

## MSRB Rules

- Municipal securities rulemaking board
- Rules for municipal market participants because municipals exempt from SEA 1934
- DOES NOT regulate new issues or issuers
- Regulates – Banks, brokers, dealers in municipal trading activities
- Municipals trade over the counter so exchanges have NO oversight
- DOES not enforce rules
  - Relies on others
    - Banks – federal reserve, FDIC, office of comptroller of currency
    - Broker Dealer – SEC, FINRA

### Registered Rep Rules

- Reps involved in trading must be registered with MSRB
- Take exam – 30 days wait retake, 3 fails wait 6 months
- Not allowed to share exam questions
- Follows SEC requirement that disqualifies registration) statutory disqualification) if...
  - Suspended or expelled from another SRO (CBOE, FINRA, etc.)

- SEC suspension or expelled
- Caused firm's suspension
- Filed a false or misleading Securities Registration Application
- Convicted of an securities or money offense (petty larceny or any felony in last 10 years)
- Series 53 Municipal Principal must perform all supervision for BD
- Prohibited unfair dealing practices
  - Not delivering securities promptly
  - When bond called, must allocate called bonds across all customers and BD's own positions
  - Taking early payment for securities without giving interest
  - Not telling customers about call or put features of mun. bonds
  - Refusing to submit to arbitration
- Gift limit = \$100 for BD giving gifts to others
  - Unless involves work with prior written agreement
  - Written consent of that persons employer (BD)
  - Meals and entertainment okay as long as not excessive or too frequent
- Copy of MSRB manual in each office and made available to customers
  - Or giving customers access to MSRB website

### MSRB customer account rules

- Opening an account > access suitability and approved in writing by principle before opening
  - Can open account without SS# and birthdate but can not trade
  - Account form required Reg Rep signature + supervising principal
- Required customer account info BEFORE trading
  - Normal stuff + customer written authorization for margin account
  - Discretionary accounts – written power of attorney on file and discretionary order ticket approved by principal, each transaction suitable,
    - Discretion over price and time – no power of attorney
    - Discretion over security and size – requires power of attorney
    - If BD has control position over security need extra customer approval
- Recommendations
  - Reg rep must have reasonable grounds to recommend investments
  - Suitable
  - **No recommendation if customer refuses to disclose financial status, but can still open account**
- Can execute unsuitable trades at direction of customer
- Investment seminars / Inquiries from Advertising
  - Rep must know customer before making recommendation and have reasonable basis
- Other rules
  - Cannot guarantee against loss
  - Employee of another firm wishes to open account
    - Employee's employer be given written notice
      - Must sent duplicate trades to employer (different than FINRA)
      - Written instructions of employers be followed by firm

- Cannot share in gain and loss of customer account unless rep puts money in too and they share proportionately
- Annual – once per year customer notice of ...
  - Statement that BD registered with SEC and MSRB
  - Website address of MSRB
  - MSRB investor brochure availability with info on protections and complaint filing
- Financial Advisor to municipality CANNOT also act as Underwriter
- New Issues of Disclosures, BD rules
  - Official statement for MSRB is like proxy for SEC
  - Send final official statement to customer by settlement or a notice that no final official statement is coming or it is still being worked on
  - **Disclose spread for negotiated offerings** (negotiated between municipal and underwriter) (many revenue bonds) like what on front cover of prospectus on corp offerings
  - Competitive bid offering – no spread disclosure (general obligation bonds)
    - Just total amount offered and yield
  - Cannot act on fiduciary info like big sale coming
  - Complaints in writing
    - Resolution by principal (Series 53) with their signature
    - Written record of complaints kept for 6 years (FINRA rule 4 years)

### MSRB trading and market rules

- All quotes bona fide and priced to reflect dealer best judgement of fair market value
- Fair market value
  - Inventory position overall and in that security
  - Anticipation of price movement
  - Knowledge of facts about issuer
  - No quotes out of thin air, need reasonable basis
- Security does not have to be owned to be quoted
- BW – bids wanted and OW – offers wanted are acceptable quotes
- Nominal quote
  - Informational purposes only, dealer saying not willing to trade at those prices. Shopping for workable bids until ready to negotiate for firm bid.
- Only true trades may be reported and all reported to MSRB's RTRS reporting system
- Short sales are reported by BD (not issuers)
- BD Obligation to obtain fair and reasonable price (not best price)
  - Based on current market value and not dealers cost
  - Dealers entitled to make profit
  - Issuer liquidity has impact on pricing

### Advertising and Other Rules

- Advertising is for dissemination to public, even reprints, but not internal memos

- Excludes official statements, offering circulars (done by lawyers) but summaries or abstracts of these could be advertising
- Cannot be false or misleading
- New issue ads
  - May show reoffering yields as long as date is shown
  - Must state securities have been sold after ad and price or yield changed
  - Must be really available (not faked to get calls)
- If advertised tax free – must be really – and say if subject to AMT (alternate minimum tax)
- Approval in advance by principal
- Retained for 4 years (FINRA 3 years)
- New issues given CUSIP numbers and communicated to syndicate
- Political contributions
  - No pay contributions political officials to get municipal new issue business
  - Municipal finance professional MFP – financial advisor to municipalities who is also registered rep
  - MFP can give 250 in each political campaign in which entitled to vote without 2 year ban
  - Competitive offerings not subject to this rule
- Required arbitration to settle disputes
  - One BD vs another BD
  - Customer against BD
  - BD against customer (only if customer signed arbitration agreement and if not then court)
- Electronic municipal market access (EMMA)
  - For retail customer use with documents
    - Official statements (prospectus) bonds, notes, 529 plans
    - Details of bonds that have been pre-refunded(?)
    - Ongoing reports on municipal financials
  - Real time price and yields for bond trades

## CFA Ethics and IPS

### Class Notes

### Chartered Financial Analyst (CFA)

- Must pass 3 levels of exams to be CFA charter holder.
- Compared to SIE and CFP, more focus on investment and portfolio analysis.
- Some on financial planning but this part is growing with potential to split at higher levels.

### CFA Level 1 Curriculum

1. Ethical and Professional Standards 15-20%
2. Tools

a. Quantitative Methods	8-12%
b. Economics	8-12%
c. Financial Statement Analysis	13-17%
3. Portfolio Management and Analysis	
a. Corporate Issuers	8-12%
b. Portfolio Management	5-8%
4. Assets	
a. Equity Investments	10-12%
b. Fixed Income	10-12%
c. Derivatives	5-8%
d. Alternative Investments	5-8%

## CFA Ethical and Professional Standards

- Candidate Body of Knowledge for all 3 levels
  - Code of Ethics
  - Standards of Professional Conduct
  - Global Investment Performance Standards (GIPS)
    - Presentation of Performance Results
  - Asset Manager Code of Professional Conduct (Level 3)
- Ethics content at each level
  - Level 1 15-20%
  - Level 2 10-15%
  - Level 3 10-15%
- You are expected to know the codes and standards, as well as the enforcement, application and procedures recommended.

## CFA Level 1 Ethical and Professional Standards

- Code of Ethics
- Standards of Professional Conduct
- Global Investment Performance Standards (GIPS)
- Multiple choice questions based on scenarios.

## The Code of Ethics

- Code tells you overall goals or **how to be ethical**.

Members and candidates of CFA Institute must:

- Act with integrity, competence, diligence, respect and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.
- Place the integrity of the investment profession and the interests of clients above their own personal interests.

- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
- Promote the integrity and viability of the global capital markets for the ultimate benefit of society.
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

## Standards of Professional Conduct

- Standards get into more details about **what you should do**.

### 1) Professionalism

#### a) Knowledge of the Law

- i) Comply with all CFA rules and government laws. If there is a conflict, follow the stricter rule or law.

#### b) Independence and Objectivity

- i) Do not offer to others or accept gifts or compensation that could compromise your independence or objectivity in professional activities.

#### c) Misrepresentation

- i) Do not any misrepresentations related to investment analysis, recommendations, or other professional activities.

#### d) Misconduct

- i) Do engage in dishonesty, fraud, or any act that hurts professional reputation.

### 2) Integrity of capital markets

#### a) Material Nonpublic information

- i) Do not act or cause others to act on material nonpublic information that could affect the value of an investment.

#### b) Market manipulation

- i) Do not do things to distort prices or artificially inflate trading volume.

### 3) Duties to clients

#### a) Loyalty, prudence, and care

- i) Be loyal to clients and act with prudence and care, and place client interests before yourself or employer

#### b) Fair dealing

- i) Deal fairly with all clients in professional activities. Don't treat some clients better than others.

#### c) Suitability

- i) Ask client about investment experience, risk and return objectives, other financial constraints before making an investment recommendation. Update this information regularly.
- ii) Determine if investment suitable for client given written objectives and constraints before recommendation or trade
- iii) Determine if investment suitable for client given total portfolio

- d) Performance presentation
  - i) Make effort to ensure communicated investment performance is fair, accurate and complete
- e) Preservation of confidentiality
  - i) Unless illegal activities of client or prospective client
  - ii) Unless disclosure required by law
  - iii) Unless client or prospective client authorizes disclosure
- 4) Duties to employers
  - a) Loyalty
    - i) Do not deprive employer of your skills, do not divulge confidential information, and do not harm your employer.
  - b) Additional compensation plans
    - i) Do not accept gifts or compensation that competes with your employer or creates a conflict of interest with your employer unless you get written consent from all parties involved.
  - c) Supervisor responsibilities
    - i) Make a reasonable effort to ensure that someone that your supervise follows CFA codes and government laws.
- 5) Investment analysis, recommendations, and actions
  - a) Diligence and reasonable basis
    - i) Be diligent and independent in making investment recommendations and taking investment actions
    - ii) Have a reasonable basis to support your recommendations and actions
  - b) Communication with clients and prospective clients
    - i) Tell clients principles and process to choose investments and build portfolios and promptly tell them when you change this process.
    - ii) Tell clients limitations and risks with your investment process.
    - iii) Use reasonable judgement in identifying factors important to recommendations and tell clients.
    - iv) Tell clients what is fact and what is opinion in presentations.
  - c) Record retention
    - i) Develop and maintain records to support recommendation and actions as well as investment related client communications
- 6) Conflicts of interest
  - a) Disclosure of conflicts
    - i) Disclose clearly anything that could affect your independence and objectivity to clients, prospective clients, or employer.
  - b) Priority of transactions
    - i) Client and employer transactions should have priority over your own transactions or where you are a beneficial owner
  - c) Referral fees
    - i) Tell employer, clients, and prospective clients about any compensation or benefits received from or paid to other for the recommendation of products or services.
- 7) Responsibilities as a CFA Institute member or CFA candidate
  - a) Conduct as participant in CFA institute programs

- i) Do not do anything that hurts reputation of CFA institute, designation, or programs.
- b) Reference to CFA institute, CFA designation, CFA program
  - i) Do not exaggerate meaning of CFA Institute membership, the designation, or candidacy

## Global Investment Performance Standards (GIPS)

- Candidates responsible for Preface, Introduction, and Section 3a.
- Ethical standards for calculating and presenting investment performance based on principles of fair representation and full disclosure.
  - Optional for firms to adopt, but if adopted, must be applied firm-wide.
- Objectives
  - Promote investor interests and instill investor confidence
  - Ensure accurate and consistent data
  - Obtain worldwide acceptance of a single standard for calculating and presenting performance
  - Promote fair and global competition among investment firms
  - Promote industry self-regulation on a global basis
- Overview
  - Standards separated into Must Do and Recommended
  - Firms create and maintain Composites for all strategies for which firm manages separate accounts
    - Include all actual, fee-paying, discretionary segregated accounts in at least one composite defined by an investment strategy
    - Pooled funds must also be included in any composite for which the fund meets the investment strategy
    - Make available all information about all strategies they manage using composites or pooled funds
    - Designed so companies cannot just pick best account and only show its results while ignoring other worse performing accounts
  - Integrity of input data is critical to creating accurate performance presentations.
    - Must use certain calculation methodologies so investors can compare results of different firms
- Historical performance record
  - Initially present minimum of 5 years of GIPS compliant returns
  - If composite or pooled fund less than 5 years old, present data since inception date
  - Update every year and add one year to historical data every year up to a minimum of 10 years of data
- Compliance statement on communications
  - “[Insert firm name] has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS).”

## GIPS 9 Standards

- 1) Fundamentals of compliance
  - a) Must do

- i) GIPS standard, if adopted, applied firm-wide
- ii) Firm defined as investment firm or division portrayed to public as distinct business entity
- iii) Need 5 years of data before can claim compliance
- iv) Provide GIPS reports to all prospective clients or pooled fund investors
- v) Follow laws
- vi) Information presented must NOT be false or misleading
- vii) All discretionary accounts must be put in at least one composite
- b) Should do
  - i) Be verified out auditors
  - ii) Broadest definition of the firm possible
- 2) Input data and calculation methodology
  - a) Consistent data needed
  - b) Consistent and standardized methods to calculate returns
- 3) Composite and pooled fund maintenance**
  - a) Composite of one or more portfolios managed by a similar objective**
  - b) Composite return is asset value weighted average of all portfolios in the composite
  - c) Pooled funds should be included in the composite if they meet the composite definition
- 4) Composite                    time-weighted return report    (Geometric mean returns)
- 5) Composite                    money-weighted return report (IRR cash flows returns)
- 6) Pooled fund                time-weighted return report
- 7) Pooled fund                money-weighted return report
- 8) GIPS advertising guidelines optional but required if want to claim GIPS compliance in an advertisement

### Standard 3a - Composite and Pooled Fund Maintenance Requirements

- 3.A.1 The firm must create composites for the firm's strategies that are managed for or offered as a segregated account.
- 3.A.2 All actual, fee-paying, discretionary segregated accounts must be included in at least one composite. Non-discretionary portfolios must not be included in composites.
- 3.A.3 All actual, fee-paying, discretionary pooled funds must be included in at least one composite if they meet a composite definition. The firm is not required to create a composite that only includes one or more pooled funds unless the firm offers the strategy as a segregated account. The firm may terminate any composite that was created solely to include one or more pooled funds if the composite is not representative of the firm's strategy offered as a segregated account.
- 3.A.4 Non-fee-paying discretionary portfolios may be included in a composite. If the firm includes non-fee-paying discretionary portfolios in a composite, those portfolios must be subject to the same policies and procedures as fee-paying portfolios.
- 3.A.5 Composites must be defined according to investment mandate, objective, or strategy. Composites must include all portfolios, including segregated accounts and pooled funds that meet the composite definition. The firm must not exclude portfolios from composites based solely on legal structure differences.
- 3.A.6 Any change to a composite definition must not be applied retroactively.

- 3.A.7 Composites must include new portfolios on a timely and consistent composite-specific basis after each portfolio comes under management.
- 3.A.8 Composites must include only those portfolios that are managed for the full performance measurement period for which the composite return is calculated. Portfolios that are not managed for the full performance measurement period must not be included in the composite.
- 3.A.9 Terminated portfolios must be included in the historical performance of the composite up to the last full measurement period that each portfolio was under management and for which the firm has discretion.
- 3.A.10 Portfolios must not be moved from one composite to another unless documented client-directed changes to a portfolio's investment mandate, objective, or strategy or the redefinition of the composite make it appropriate. The historical performance of the portfolio must remain with the original composite. Portfolios must not be moved into or out of composites as a result of the firm's tactical changes.
- 3.A.11 If the firm sets a minimum asset level for portfolios to be included in a composite, the firm:
  - a. Must not include portfolios below the composite-specific minimum asset level in that composite.
  - b. Must not apply retroactively any changes to that composite-specific minimum asset level.
- 3.A.12 A firm that removes portfolios from composites because of significant cash flows must define "significant" on an ex-ante, composite-specific basis and must consistently follow the composite-specific policy.
- 3.A.13 A firm that uses temporary new accounts to remove the effect of a significant cash flow must establish policies on an ex ante, composite-specific basis. Temporary new accounts must not be included in composite performance.
- **Wrap Fee**
- 3.A.14 The firm must include the performance record of actual wrap fee portfolios in appropriate composites in accordance with the firm's established portfolio inclusion policies. Once established, these composites (containing actual wrap fee portfolios) must be used when presenting gips composite reports to wrap fee prospective clients.
- **Carve-Outs**
- 3.A.15 Any carve-out included in a composite must include cash and any related income. Cash may be:
  - a. Accounted for separately, or
  - b. Allocated synthetically to the carve-out on a timely and consistent basis.
- 3.A.16 Any carve-out included in a composite must be representative of a standalone portfolio managed or intended to be managed according to that strategy.
- 3.A.17 When the firm creates a carve-out of a particular strategy, allocates cash to the carve-out, and includes the carve-out in a composite, the firm must create carve-outs with allocated cash from all portfolios and portfolio segments within the firm managed to that strategy and must include those carve-outs with allocated cash in the composite.

- 3.A.18 When the firm has or obtains standalone portfolios managed in the same strategy as the carve-outs with allocated cash, the firm must create a separate composite for the standalone portfolios.
- 3.A.19 The firm must not combine different composites, pooled funds, or carve-outs to create a simulated strategy and present it as a composite.