Securities Industry Essentials Outline

Introduction to the Securities Industry Essentials Exam

I. Takes the common, core material from the Series 6, 7, etc.

II. Breaks out the unique material into "Top-Off" exams

III. No sponsorship is required for the SIE

IV. Sponsorship is required for the Top-Off exams (still called Series 6, Series 7, etc.)

V. Both are required to function as a Registered Rep

VI. Typically, state registration is also required (e.g, Series 63)

Important Considerations

I. Our goal is to pass the test

A. Use all testing tools at our disposal

B. "Question the Question"

C. Create an "Ah-HA! List"

II. Some Key Concepts:

A. The importance of definitions

B. Key associations

C. If it works for me, it will work for them

D. Supply and demand

E. Winners and losers

F. The principle of the exchange

G. The effect of a fingerprint

H. Taking terms apart

I. Taking words apart

Suitability Matrix

I. Suitability transcends products, services, duties, regulations, etc.

II. Each product should be evaluated against the matrix

III. Likewise, each customer should be measured

VII. When the matrix points match, suitability is established

A. Liquidity

B. Time Horizon

C. Safety or risk

1. Volatility (Timing risk)

2. Security of principal (Capital risk)

3. Security of income

4. Business risk

5. Interest rate risk

6. Inflation or purchasing power risk

7. Currency risk

8. Political risk

D. Tax Considerations

E. General Characteristics / Investor Goals

F. Concentration and Diversification

Capitalizing a Corporation

I. Only two choices are equity and debt

II. Equity is ownership

A. Stock certificate given in exchange for money invested

B. Conservative capitalization

C. Aggressive investment

III. Debt is borrowing

A. Bonds are promissory notes in exchange for money lent

B. Aggressive capitalization

C. Conservative investment

IV. Governmental units can only BORROW.

Legal Environment of the Securities Industry

I. Securities Act of 1933

A. Applies to issuance of non-exempt securities

1. Exempt securities include municipal bonds and government securities

2. Municipals have disclosure requirements, but under MSRB, not the '33 Act

B. Registration Statement filed with Securities and Exchange Commission

C. Filing starts the 20-Day Cooling Off Period

D. Prohibited Activities

1. Selling the issue

2. Advertising the issue

3. Recommending the issue

4. Soliciting the issue

E. Allowed Activities

1. Distribute Preliminary Prospectus (Red Herring)

2. Accept non-binding Indications of Interest for the new issue

3. Tombstone Ad announces issue

    a. Disclaimer as to it not being an offer to sell

    b. Directs interested persons to the syndicate for prospectus

F. All material facts are disclosed in the Preliminary Prospectus

1. Discloses that the information is subject to completion

2. SEC Disclaimer

G. Effective Date

1. Due Diligence Meeting is held just prior to the Effective Date

2. Pricing takes place just prior to effective date

3. On effective date, prospectus is completed and orders are accepted

H. Final (Statutory) Prospectus must be provided to buyers

1. Available on the effective date

2. Delivery no later than with confirmation

3. Posting on Internet constitutes prospectus delivery

4. Spread is disclosed in any negotiated offering

I. Summary Prospectus

1. Used by investment companies and ETFs

2. Information such as fees, objectives, breakpoints, etc.

3. Must point the reader to the full prospectus, which can be online

J. Green Shoe Clause - up to 15% additional to cover Overallotments

K. Other Features of Corporate New Issues

1. Employees of member firms are prohibited from purchasing IPOs

2. Syndicate can place a Stabilizing Bid

3. Always at or below the Public Offering Price

4. Penalty Bid Clause takes back compensation from syndicate participants selling to the stabilizing bid

L. Combined Primary and Secondary Offering

M. Initial Public Offering (IPO) vs. follow-on offering

N. Shelf Registration under Rule 415

1. Well-established companies only

2. 2-year period to complete the offering

O. Firm Commitment vs. Best Efforts (AON, Mini-Max)

P. Holding Companies – Own other companies' securities

II. New Issue Participants and Practices

A. The underwriting syndicate

B. Functionally, almost identical with Municipals (M) and Corporates (C)

1. Manager – M, C

a Runs books, makes allocations

b Cuts checks

c Receives entire spread when their sales force sells securities

d Receives Management Fee when others sell

2. Syndicate Members

a Put capital at risk

b Receive Total Takedown – M, or Underwriter's Concession – C when their sales force sells securities

c Receive Additional Takedown – M, or Residual – C when others sell securities

3. Selling Group

a Act as sales agents only

b Receive Selling Concession – M, C when their sales force sells securities

4. Non-Members

a Receive no allotment, as they are not part of the formal structure b Receive a reallowance when their sales force sells securities

5. Municipal issuers use a Financial Advisor to help structure the deal

a Term vs. Serial

b Sinking Fund

c Maturity date/schedule

d Double Barreled or Moral Obligation if applicable

6. Municipals can be revenue bonds or general obligation (GO) bonds

a Revenue bonds require a feasibility study

b GOs are tax supported

C. Exempt securities under the 1933 act

1. "a GOVERNMENT

2. REGULATOR's

3. list of CHARITIES

4. is SHORT"

5. No security is exempt from anti-fraud provisions of the appropriate law

D. Municipal, Treasury and Agency Securities are exempt from registration

1. Never have a "Prospectus"

2. Municipals have Official Statements

a Preliminary

b Final

3. Treasury securities are offered by competitive bid auction

4. Agency securities have a standing underwriting distribution network

E. Certain transactions are also exempt from registration

1. Intrastate issues

a Principal offices and all buyers in one state

b 80% rules

c 9-month lockup rule

2. Private placements

a Institutions

b Accredited Investors

i. $200,000 income last 2 years

ii. $300,000 for joint accounts OR

iii. $1 million net worth OR

iv. Officer or director of the issuer

c Maximum of 35 non-accredited investors

3. Regulation A+ Small Dollar Offerings

a Tier 1 – Up to $20 million

b Tier 2 – Up to $50 million

c Offering circular is made public

d 15% maximum of secondary shares

4. Rule 144

a Restricted stock

i. 1-year holding period

ii. Volume restrictions in second year

iii. No volume restrictions for non-affiliates after two years fully paid

iv. No volume restrictions for estates

b Control Securities (“Control persons”)

i. Officers, directors, 10% shareholders

ii. Volume restrictions at any time

c Volume restrictions – Rule name gives quantities

i. 1: GREATER of 1% of outstanding shares, or

ii. 4: The average of the last 4 weeks' volume, and

iii. 4: Can be sold 4 times a year, i.e., a 90-day period

5. Rule 144A

a Sales of restricted securities among Qualified Institutional Buyers (QIBs)

III. Securities Exchange Act of 1934

A. Secondary Market Trading

1. Defined various market participants

a Broker – acts on behalf of others in an agency transaction, and receives commissions

b Dealer – acts for its own account and risk in a principal transaction, and receives markups or markdowns

c Issuer

d Person

2. Defined various securities, marketplaces, etc.

a Self-Regulatory Organizations (SRO)

i. Sometimes referred to as Registered Securities Associations

ii. Member and Non-member

iii. Associated person

b Equity securities

c Exchanges, which became Self Regulatory Organizations

B. Created Securities and Exchange Commission

C. Purpose of act is to prevent market manipulation and deception

1. Wash Trades, "Painting the Tape"

2. Short Tenders

3. Pump and dump, front running, freeriding, pegging

4. Backing away

5. Acting as a broker and a dealer on the same transaction

a Capacity disclosed on principal transactions

b Commission disclosed on agency transactions

c All confirmations must include trade, customer and B-D information

6. Catch-All Fraud Rule

D. Insider Trading – 1934 Act and ITSFEA

1. '34 Act ("Technical") definition of Insiders: Officers, Directors, 10% shareholders and spouses

2. Insider Trading and Securities Fraud Enforcement Act (ITSFEA) definition: Anyone with material non-public information

3. Tippers and Tipees both liable

4. Criminal penalties

a Up to $5 million fine ($25 MM for non-natural persons

b Up to 20 years prison

5. Civil penalties

a Disgorgement

b Treble Damages

6. Contemporaneous Traders

7. Insider Transactions must be reported

8. Insiders cannot short their own stock

9. Chinese Walls

E. OTC Trading Rules

1. Firm bids; firm offers or asks

2. May specify quantities

3. Inside market

4. Backing away

F. Short Sale rules – now revoked, but possibly still tested

1. Short position in stock is bearish

2. Uptick or zero plus tick required

3. Short Exempt

G. Proxy Solicitations

1. If in street name, B-D sends to Beneficial Owners

2. B-D reimbursed for expenses

3. Not required if customer is overseas

H. Exchange and Member Registration

1. Exchanges became Self-Regulatory Organizations

2. Members and Affiliated Persons must register

I. Commingling is prohibited

J. Reporting Requirements

1. Publicly traded companies must file 10-Q and 10-K reports

2. 13-D filings when 5% ownership acquired

3. Members must maintain books and records and make timely reports

a Trading

b Financial Condition

K. Margin Rules

1. Prohibition of extension of credit to executives

2. Prohibition of borrowing, except from a lending institution

L. Stabilization of New Issues in the Secondary Market

M. Other provisions

1. Penny Stock rules

2. Confirmation rules

IV. Securities Investor Protection Corporation (SIPC)

A. Protects investors against broker/dealer bankruptcy losses

B. One coverage per Separate Customer

C. $500,000 total, of which $250,000 can be cash

1. Figures current as of the date of this outline

2. Check this an all amounts which can be indexed for inflation

D. Commodities are not covered

V. Federal Deposit Insurance Corporation

A. Insures bank deposits

B. Currently $250,000 per customer, per bank, per account type

VI. Patriot Act and Money Laundering

A. Purpose of the "Anti-Terrorism" Act

B. Placement, Layering and Integration – Three stages of money laundering

C. Currency Transaction Report (CTR) required on cash transactions over $10,000; wire transfers over $3000 (AKA FINCen Reports)

D. Structuring should be reported as suspicious

E. Suspicious Activity Reports (SAR) required as needed

1. Inability to produce valid ID

2. Inability or unwillingness to explain source of funds

F. Financial institutions can exchange personal information

G. Office of Foreign Asset Control (OFAC) maintains list of Specially Designated Nationals (SDN) and Blocked Persons

VII. Investment Company Act of 1940; Investment Advisors Act of 1940

A. Company Act governs investments

B. Advisors Act governs people and businesses controlling investments

C. Discussion of products will functionally define provisions

VIII. Trust Indenture Act of 1939

A. Covers non-exempt debt securities

B. Requires bond indenture

1. Lists borrower's obligations

2. Provides protection for lenders (investors)

IX. Uniform Securities Act

A. "Blue Sky" or State regulations

B. Generally covered in the Series 63, 65 and/or 66

X. Regulation S-P

Regulatory Environment of the Securities Industry

I. General conduct, records, and reportable events

A. Form U4 completed at registration

1. Misleading registration statements prohibited

2. Background to include felony convictions, bankruptcy, liens, "money misdemeanors"

3. Member firms of SROs are obligated to confirm information

B. Form U5 provided at separation from firm

C. Outside business interests

D. Private Securities Transactions or "selling away" generally discouraged and often prohibited

II. Securities and Exchange Commission

A. Purpose: Fairness and honesty in business dealings

1. Disclosure in new offerings

2. Honorable business practices by secondary market participants

B. Jurisdiction and authority

1. Registration required for non-exempt securities for which there is no other exemption

2. Regulation of market players and providers of market services and products

3. Regulatory authority vs. criminal authority

III. Self-Regulatory Organizations (SRO)

A. Purpose is to execute the intentions of

1. Laws

2. SEC rules and regulations

B. Specific jurisdiction, e.g., CBOE, MSRB

C. Require membership for market participants

1. Advantage of membership is discounts, member to member

2. Non-members treated like the general public

3. Members, reps agree to abide by rules, policies, disciplinary actions

a Suspensions, criminal proceedings, civil judgments or settlements and arbitration rulings become public record

b Available through FINRA BrokerCheck

IV. Other regulatory bodies

A. Department of the Treasury and IRS

B. NASAA – State Administrators

C. Federal Reserve Board

1. Regulation T – for initial margin requirements

2. Ongoing maintenance requirements set by exchanges

D. SIPC

1. Not a governmental entity

2. Firms can indicate membership, but not imply endorsement

3. Coverage of up to $500,000 per customer, of which up to $250,000 can be cash

E. FDIC

F. Depository Trust and Clearing Corporation (DTCC)

G. Options Clearing Corporation (OCC)

H. Federal Trade Commission – Telemarketing rules

V. FINRA

A. Originated from merger of NASDR and NYSE Regulation

B. Non-partisan; no conflicts of interest by governors

C. Qualification and Registration Requirements

1. FINRA maintains Central Records Depository (CRD)

2. Form U-4 – Entry into affiliation with a member firm

3. Form U-5 – Termination from a member firm

4. Registration required unless duties are administrative

a Rule of thumb: Participation in a sale = registration

b Non-registered persons may still have public contact

5. Background checks required

6. Fingerprinting required

7. Statutory disqualification

a Conviction of any felony in the last 10 years

b Conviction of a "money misdemeanor" in the last 10 years

c Pending charges are a disclosure item

8. Failure to register results in fines, suspensions

D. Continuing Education

1. Firm Element – "Compliance meeting"

    a Annual, variety of topics, drawn from Needs Analysis

    b Attendance recorded per FINRA procedures

2. Regulatory Element – now taken online

    a Second anniversary

    b Every third anniversary thereafter

    c More than 120 days late, license is suspended

    d Unable to receive compensation for any activity requiring a license

E. Disciplinary Proceedings

1. For alleged violations of regulations

2. Procedures include hearings

3. Penalties include censure, fines, suspension, revocation, but not prison

F. Rules for compliance with AML laws

1. Written procedures required

2. Designated AML officers

3. Annual testing of the efficacy of procedures

4. Training for personnel required

G. Numbered accounts allowed

1. Confidentiality only – not for purposes of tax evasion

2. Beneficial owner must be known by member firm

H. Business Continuity (succession, disaster recovery) plans

I. Discretionary Accounts

1. Discretionary trade if security, buy/sell or quantity not specified by customer

2. Price of execution or time of execution do not constitute discretion

3. Written authority must be in hand before order is entered

J. Promotion of fair dealings with customers and among members

1. Misleading information in registration documents prohibited

2. Fiduciary information is to be protected

3. Manipulative and deceptive actions prohibited

a Transparency in trade and quote publications

b Price fixing or manipulation among members prohibited

c Backing away

d Front Running

e Trading ahead of research reports or customer orders

f Best executions; interpositioning

g Uniform price quotations in multiple media

h Bona fide quotations only

i Reported transactions must be bona fide

j Payment for publications specifically designed to influence market prices of securities is prohibited

k Payment for market making is prohibited

l Fees for recommendation of a security must be disclosed

m Member or rep accounts at other firms generally prohibited

4. Know Your Customer; Suitability

a Communications must be fair and balanced

b Vulnerable adults have greater protections

c Margin account disclosures

5. Commissions, charges and markups must be reasonable

a 5% Policy is a guideline for maximum commissions, markups

b Based on the current "inside market"

c Illiquid securities or small transactions are examples where more can be charged

d Members can charge for clerical, custodial or administrative services, if reasonable

6. Disclosure of arbitration in disputes

    a Member with member or member with representative

    b Customer with member or representative

7. Lending to or borrowing from customers is prohibited

    a Margin accounts

    b Lending institutions (banks, credit unions, etc.)

8. Sharing in accounts by members or reps is generally prohibited

9. Segregation and identification of customer assets is required

    a Statements must be sent monthly if activity; quarterly if none

    b Statements cannot be sent to rep

        i. Written instructions for address change

        ii. Statements can be held during extensive travel

        iii. Duplicate statements can be sent on request

    c Specific written consent to cut checks to someone other than person on the account

10. Proxy materials must be forwarded to beneficial owners

a Street name securities

b Broker Dealer can be compensated for expenses incurred

c Not required if the beneficial owner is overseas

11. Confirmations must be sent by completion of trades

12. If in doubt, disclose

a Required annual disclosures

i. Financial condition of member firm

ii. FINRA BrokerCheck Hotline number, FINRA web site address and advice of investor brochure

b Financial relationship to issuer

c Specific suitability and disclosure requirements for DPPs and REITS

d Non-cash compensation

13. Specific suitability and disclosure requirements for variable annuities

14. Allocation of equity Initial Public Offerings (IPO)

a Member firms

b Affiliated persons, including immediate family members

c “Free riding and withholding”

VI. Municipal Securities Rulemaking Board (MSRB)

A. No enforcement capabilities

1. Broker-Dealers: FINRA and SEC

2. Bank Municipal Dealers: FDIC, FRB and Comptroller of the Currency

B. Municipals are exempt securities

1. MSRB cannot require registration

a Never a "prospectus" but always an official statement

b Always a preliminary, but not necessarily a final official statement

c If prepared, final official statements must be delivered to buyers

2. Rules apply to market participants, not issuers, and promote fairness and transparency, and mirror other laws and rules regarding manipulation, deception, etc.

C. Priorities must be set and communicated in new issues, and generally favor public investors over dealers

D. CUSIP numbers must be assigned to each individual bond issue and in most cases, disclosed to potential buyers

E. Pricing (i.e., including markups) and commissions must be reasonable

1. Not as rigid as with equities, due to the fragmented and relatively illiquid nature of the marketplace

2. Considers several factors

a Fair market value of the securities

b Total dollar amount of the transaction

c Any special difficulties in trade execution

d The fact that the broker-dealer is entitled to a profit

3. Municipal Fund Securities

a A classic example of reading the term backwards: Securities in the form of Mutual Funds, issued by Municipal entities – 529 Plans

b Reporting requirements and other operational details specified by MSRB

c Specific details such as state tax considerations are established on a state-by-state basis

4. Records maintenance and retention

a Trade blotters, whether acting as a principal or an agent

b Confirmations

c Inventory

d Broker-dealer financials

e Account information

f Written customer complaints (MSRB Investor Brochure delivered to customer)

g Records of political contributions by dealers or associated persons

h Gifts, gratuities and compensation

i Generally, four to six year retention, the first two readily available

j Electronic records are allowable

5. Quotations must be bona fide prices

a Can be subject to prior transaction

b Can be labeled as nominal, i.e., bid wanted or offer wanted

6. Transactions, if reported, must represent bona fide trades

7. Confirmations must be provided at or prior to completion of trades

a Broker-dealer name, address, telephone

b Customer name

c Detailed description of the security

i. Issuer, interest rate and maturity

ii. CUSIP

iii. Callable or non-callable

iv. Amount purchased, price, extended price and transaction total

v. Yield / dollar price

vi. Capacity of broker-dealer and commission if brokered

vii. Dated date if a new issue

viii. Disclosure if called or pre-refunded

ix. Any special factors (escrowed, ex-legal, taxable, etc.)

d Obligation to use the best execution price available

e Advertising must be truthful and not misleading

f No guarantees of profits or against losses; customer assets must be segregated from firm assets (not comingled)

g Telemarketers calling prospects must comply with FTC regulations

h AML procedures must be followed

i Disclosure of all material factors regarding a bond is required prior to the transaction

8. Registration required for representatives and principals

a Generally, non-clerical staff

b Background information on Form U4 (U5 at separation)

c Series 52 or 7 for representatives

d Series 53 for municipal principals

e 90-day apprenticeship period

i. No sales to the public

ii. Can function dealer to dealer and receive salary

9. Gifts

a Gifts over $100 per year are not allowed

b Occasional tickets, etc. are allowable, but not season tickets

c Sponsorships are allowable

10. Political Contributions in excess of $250.00

a Firm is prohibited from negotiated offerings with recipient issuer for two years

b Firm or representatives are included

c Does not include competitive bid issues

VII. Chicago Board Option Exchange (CBOE)

A. Rules governing options trading

B. Registration procedures comparable to other SROs

1. Background disclosure

2. Fingerprinting

3. Separate new account documents for option trading

C. Options Clearing Corporation Disclosure Document

Economic Environment of the Securities Industry

I. Macroeconomic factors

A. Monetary Policy

1. Determines the direction of the economy by controlling the money supply

a M-1: Aggregate cash and checkable deposits

b M-2: M-1 plus time deposits

c M-3: M-2 plus negotiable CDs

2. Federal Reserve Board

a Open market activities

i. Repos add money to the economy

ii. Reverse repos take money from the economy

b Discount rate

i. Set by Federal Reserve Board

ii. Fed Funds Rate is determined by market forces, and is the most volatile of all interest rates c Regulation T

d Bank reserve requirements

e Other interest rates

i. Prime rate – set by banks, charged to most creditworthy customers

ii. Broker call loan rate – to finance margin loans at brokerage firms

iii. Commercial Paper rate – set by supply and demand, and by the quality of the paper

B. Fiscal Policy

1. Taxation and spending policies

2. Set by Congress

3. Increased spending or decreased taxes expand the economy

4. Increased taxes or decreased spending contract the economy

II. Economic cycle

A. Expansion (prosperity), peak, contraction (recession/depression), trough

1. Recessions are mild, six months of contracting GDP

2. Depressions are extended, six quarters of contracting GDP

B. Stocks do best in extended periods of expansion and moderate inflation

C. Bonds do best when interest rates decline over time

III. Economic indicators

A. Leading, coincident and lagging

B. Index of Leading Economic Indicators

1. Investor anticipation: Stock prices (S&P 500)

2. Fuel: M2 money supply

3. Willingness to burn fuel: Consumer sentiment

4. Things that happen before people are hired or fired:

a Building permits

b Average workweek

c Initial unemployment claims

d New durable goods orders

e Delivery times

f Sensitive material prices

IV. Major economic theories

A. Keynesian

B. Monetarist (Friedman)

C. Supply Side

V. International Economic factors

A. GDP/GNP

B. Trade surplus/deficit and balance of payments

C. Exchange rates

Securities Markets Structure and Participants

I. Market Structure

A. Primary Market

B. Secondary Market

1. Exchanges – Agents, auctions, commissions

2. Over the Counter (OTC) – Principals, negotiated, markup/markdown

3. Market, limit, stop, stop-limit orders

4. Day vs. GTC duration

5. Solicited vs. unsolicited orders

6. Trade date vs. settlement date; cash trade

7. Physical delivery vs. book entry

C. Third Market

D. Fourth Market

II. Market Participants

A. Issuers

B. Underwriters

1. Managers

2. Syndicate Members

3. Selling Group

C. Municipal Advisers

D. Broker-Dealers

E. Market Makers

F. Specialists, Floor Traders

G. Investment Advisers

H. Custodians, Registrars, Trustees, Transfer Agents

I. Depositories and Clearing Corporations

J. Investors, including accredited investors and institutions

III. Accounts for customers

A. Types of accounts

1. Cash accounts

2. Margin accounts

3. Options accounts

4. Fee-based (wrap accounts) vs. transactional

B. Types of customers

1. Individual and joint (JTWROS, TIC)

2. Corporate, partnership or institutional

3. Trust accounts

4. Custodial (UGMA or UTMA)

5. Retirement plans – IRA, Qualified plans

a Contributions generally tax deductible, except Roth

b Accumulation tax deferred

c Withdrawals – premature, regular and RMD

Types of Securities and Their Characteristics

I. Equity securities

A. All forms represent ownership of the corporation

B. Common stock

1. Basic form of ownership

2. Fully paid and non-assessible

3. Authorized, issued, outstanding and treasury shares

4. Voting rights for board and major corporate events

   a Statutory – one vote per open board seat per share

   b Cumulative – can cast votes any way desired

5. Rights to dividends, if paid (cash and/or stock dividends)

6. Calculation of ex-dividend date

7. Preemptive rights via rights distribution

   a Maintain proportional ownership (prevent dilution)

   b One right per share (rounded up)

   c Multiple rights plus subscription amount yields one share

   d Priced at a discount to the market price

   e Short-term, exercised through rights agent

8. In liquidation, common shareholders are the last to paid

C. Preferred Stock

1. Preferred over common with regard to dividends and proceeds of liquidation in bankruptcy only

2. Typically a fixed dividend

a Usually purchased for income

b Prices move with the bond market; variable rate issues remain close to par

c Dividend can be cumulative

d Theoretical market value can be calculated by $Div/Rate

3. Typically (for test purposes) $100 par value

4. Typically non-voting

5. Sometimes convertible (see discussion below, in bonds)

D. American Depository Receipts (ADR)

1. Facilitates trading in foreign companies by US investors

2. Actual shares escrowed by a foreign bank

3. Sponsored and unsponsored

4. Dividends converted to and paid in dollars

5. Currency risk in addition to “normal” stock risks

6. Typically no voting rights

E. Rights – see discussion above

F. Warrants

1. Offered as a "sweetener" to an otherwise too risky or expensive offering

2. Can trade attached to another security or on their own

3. Long-term expiration

4. Priced at a premium to the market

G. Corporate actions that can affect corporate securities

1. Splits and reverse splits – calculations

2. Buybacks, tender offers, exchange offers

3. Mergers and acquisitions

4. Proxy voting

II. Debt Securities

A. General Characteristics and terminology

1. Any debt security has priority over any equity security in liquidation due to bankruptcy

2. Par Value – Face amount of the instrument -- $1000.00

3. Registered – Certificate has owner's name

a Fully registered

b Registered as to principal only

c Bearer – Ownership established by possession of the bond

4. Maturity Date – Date the principal amount must be paid

5. Coupon or Nominal Rate

    a Debt securities pay interest, never dividends

    b Typically a fixed rate, typically pays semi-annually

6. Callable – Can be retired by issuer prior to maturity

    a Terms found in Trust Indenture

    b REFunding = REFinancing

    c Redemption is paying off with surplus funds

7. Sinking Fund – Required annual redemptions

8. Term Bond – All bonds mature on the same day

9. Serial Bond – Bonds mature sequentially

10. Series Bonds – Bonds issued sequentially

11. Zero Coupon Bond Pays no current interest

    a Pays no current interest

    b Purchased at discount, matures at par

12. Flat – trades without accrued interest (in default, zero coupon, settlement on payment date)

13. Point – 1% or $10.00 per thousand

14. Priced at Par

15. Priced at Discount

16. Priced at Premium

17. Price quotations

    a Bonds prices are quoted as a percentage of their $1000 par value

    b Fractional points in eights (corporate, muni) or thirty-seconds (Treasuries)

18. Inverse relationship of price and interest rate movement

19. Measures of yield

    a Coupon, Nominal or Stated rate or yield

    b Current Yield – interest/market price

    c Yield to Maturity – Takes time into account

    d Yield to Call – Takes shorter maturity into account

    e Sequence of yields is always the same

20. Ratings help measure default risk

    a Standard and Poor's; Moody's

    b Investment grade

c Speculative or junk

21. Factors affecting price volatility

a Maturity

b Coupon rate

c Most volatile are long term, zero coupon bonds

d Variable rate bonds stay close to par

B. Characteristics specific to corporate bonds

1. Convertible feature

a Optional benefit to reduce interest cost and attract buyers

b Relationship of par/market value, conversion ratio, market value of underlying stock

c Conversion premium

d Arbitrage

e Forced conversion

f Instrument remains a debt security until conversion

g [Convertible preferred stock has same characteristics except par value and that the preferred is equity, not debt]

2. Mortgage Bond – Secured by real estate

3. Equipment Trust Certificate – Secured by equipment

4. Collateral Trust Certificate – Secured by securities

5. Debenture – Unsecured bond

6. Subordinated – Lower priority or claim

7. Typically brought to market in a negotiated underwriting

C. Characteristics specific to municipal bonds

1. Issued by state and local governments and authorities

2. Interest exempt from federal taxation

3. Exempt from state tax to in-state buyers

4. General Obligations (GOs)

a Backed by full faith, credit and taxing power of the issuer

b Schools, roads, etc.

c Typically brought to market in a competitive bid underwriting

5. Revenue Bonds

a Backed only by the income from a specific project

b Toll roads, power plants, etc.

c Typically brought to market in a negotiated underwriting

6. Industrial Development Revenue Bonds (IDR)

a Issued by a municipal authority, but backed by a corporate Guarantor

b Always subject to Alternative Minimum Tax

7. Other types of municipals

a Taxable municipals

b Short term notes

c VRDNs

8. Taxable Equivalent Yield

a Interest needed from taxable investment to keep what the muni bond pays

b Solve for the tax-free yield given in the question

D. Characteristics specific to Treasury and agency securities

1. Treasury securities are issued via auctions, where the low interest cost bid wins

2. Treasury bills

a Less than one year to maturity

b Priced at a discount, matures at par

c Priced with a “basis quote”

3. Treasury notes

    a Two years to ten years maturity

    b Priced at par, pays semiannual interest

4. Treasury bonds

    a Greater than ten years and up to 30 years maturity

    b Priced at par, pays semiannual interest

5. STRIPS (direct issue) and Treasury Receipts (repackaged)

6. GNMA, FNMA

    a Securitized mortgage pools

    b Pay combination of principal and interest monthly

    c Can be repackaged into Collateralized Mortgage Obligations (CMO)

E. Characteristics specific to money market instruments

1. High quality paper with less than a year to maturity

2. Treasury Bills and any Treasury in its last year

3. Commercial Paper

4. Negotiable CDs

5. Bankers Acceptances

F. Measurement of returns for all securities

1. Current yield

2. Total return

3. Realized vs. unrealized gain/loss

4. Cost basis

5. Benchmark indicies

III. Options

A. Contract to create a future transaction in an underlying stock

1. Each contract has a buyer and a seller

2. Buyers have rights to take action, but do not have to act

3. Sellers have obligations to be the contra party for the buyer

4. Future actions are determined by the type of option

a Call options – buyer of option buys underlying stock

b Put options – Buyer of option sells underlying stock

5. Contracts can be terminated in three ways

a Closed in the open market

b Exercised, creating a transaction in the underlying stock

i. Stock is "in the money"

ii. American style exercise can be done at any time prior to or at expiration

c Allowed to expire

i. Stock is "out of the money"

ii. No residual value after stated expiration date

B. Parameters defining an option contract

1. Underlying security or index, interest rate

a Stock options are settled with the delivery of 100 shares of the underlying stock when exercised (adjusted for splits and stock dividends)

b Index options (S&P 500, etc.) are settled in cash when exercised

c Unlike equity options, index options are only exercisable at expiration (European style – except "OEX")

2. Type of option – Call or Put

3. Expiration date

a Monthly, on the third Friday, in lower volume options

b Weekly on higher volume options

4. Strike or exercise price

5. Premium

a Determined by market forces

b Intrinsic value

c Time value

C. Positions and strategies

1. Long – owns the options, can choose to act

a Call – can buy the stock – bullish or optimistic

b Put – can sell the stock – bearish or pessimistic

c Speculation

d Lock in a purchase (call) or sale (put) price for the future

e Hedging or protecting against adverse movements

2. Short – create or “write” the option and sells it, resulting in a negative quantity owned

a Call – must deliver the stock if the option is exercised – neutral to bearish

i. Covered – owns the stock or can contractually obtain the stock – locks in a known transaction if exercised

ii. Uncovered or naked – does not own or cannot contractually obtain the stock to deliver – unlimited potential loss

b Put – must purchase the stock if the option is exercised – neutral to bullish

c Speculation

d Potentially lock in a satisfactory sale or purchase price if exercised against

e Income

D. Options Clearing Corporation

1. Serves as the issuer of options

2. Clears transactions and exercises

3. Creates required disclosure document

IV. Packaged products

A. Investment Companies

1. Investment Company Act of 1940

2. Types of Investment Companies

a Face Amount Certificate Companies

b Unit Investment Trusts

i. Fixed portfolio, typically self-liquidating, or with a fixed termination date

ii. No management; no management fee

iii. Shares of Beneficial Interest

c Management Companies

i. Diversified vs. non-diversified management companies

(a) All have diversification

(b) 75-5-10 Rule

ii. Open-end (Mutual Funds) characteristics

(a) Continuous offering of new shares

(b) Prospectus must be provided to all buyers

(c) Price based on Net Asset Value NAV

(d) Buyer pays a Sales Charge (load) or has Contingent Deferred Sales Charge (CDSC)

(e) Redemptions must be at NAV

(f) Can only issue common stock

(g) Cannot be purchased on margin

iii. Closed-end (publicly traded funds) characteristics

(a) One-time offering of new shares

(b) Prospectus provided only at time of IPO

(c) Price determined by supply of and demand for shares

(d) Buyer pays a commission

(e) Seller pays a commission on open market sale

(f) Can issue common stock, preferred stock or bonds

(g) Can be purchased on margin 30 days after IPO

B. Mutual fund share classes, fees, expenses

1. Class A shares – front loaded

2. Class B shares – no front load, typically 7 year CDSC

3. Class C shares – no front load, typically 1 – 2 year CDSC

4. Reduction of Class A sales charges

a Breakpoints – reduction in charge due to volume purchases

b Letters of Intent (LOI)

i. Gives an investor 13 months to reach a breakpoint

ii. Can be backdated up to 90 days

iii. Satisfied only by new money purchases c Rights of Accumulation (ROA)

i. No time limit

ii. Includes purchases and market appreciation

iii. Can be combined with LOI

d Breakpoint sales are prohibited

e Fund management can offer shares at no sales charge if allowed in the prospectus

5. Other fees and expenses

a 12 (b)-1 Distribution charge

b Management fee (except UIT)

i. Lower with passively managed funds such as index funds

ii. Higher with actively managed funds

c Custodian and Transfer Agent fee

C. Variable annuities

1. Issued by insurance companies

2. Tax-deferred accumulation

3. Premiums invested in separate accounts

4. Designed to provide a lifetime income stream

5. Monthly income increases or decreases due to performance, compared to the Assumed Interest Rate (AIR)

6. Variable life insurance also has a death benefit in excess of the value or premium paid

D. Exchange Traded Products

1. Have characteristics of open end funds (creation and redemption of shares) and closed end funds (secondary market transactions)

2. Generally track an index, although probably do not own an exact replica of the index

3. Exchange Traded Funds follow stock indices

4. Exchange Traded Notes follow bond indices

5. Generally low fees, as secondary market trading reduces the necessity for transactions

E. Municipal Fund Securities or 529 Plans

1. Issued by states, and state rules (especially tax rules) should be checked carefully for suitability purposes

2. Owned by someone of the age of majority

3. Beneficiary is often a minor (Not an UGMA/UTMA account

4. Contributions limited to the gift tax limit

5. Tax free growth

6. Tax free withdrawal if used for qualified educational expenses

    a Prepaid tuition

    b Savings plans

7. ABLE Plans for persons with disabilities

8. May be direct or advisor sold

F. Local Government Investment Pools

G. Real Estate Investment Trusts (REIT)

1. Equity REITS

2. Mortgage or debt REITS

3. Pass through treatment of earnings avoids double taxation

4. Listed (publicly traded) or unlisted

V. Direct Participation Programs

A. Syndication of any type of direct business venture

1. Businesses, oil and gas operations, equipment

2. Most common is real estate in various stages of development

B. Typically set up as a limited partnership

1. Provides limited liability for investors or limited partners

2. Can be set up as other business structure that provides for pass through taxation

C. Essentially no secondary market for units – suitability factor

VI. Hedge funds

A. Not a "mutual fund" – can establish short positions, employ option strategies, etc.

B. Private equity pool with little if any secondary market

C. High minimum investments, set by management

Risks Encountered in the Securities Industry

I. Systematic (systemic) vs. Unsystematic (selection) risk

A. Diversification and rebalancing can be used to counter unsystematic risk

B. Hedging strategies counter systematic risk

II. Specific types of risks

A. Refer to the suitability matrix discussed at the beginning of class

B. Capital risk

C. Credit risk

D. Interest Rate or Reinvestment risk

E. Inflation or Purchasing Power risk

F. Liquidity risk

G. Currency risk

H. Prepayment risk

I. Political risk