



## CHAPTER ONE

**PRIVATE SECURITIES OFFERINGS****Private Placements****Types of Private Placements**

Private placements can be structured in two different ways: as equity offerings or as debt offerings.

An equity offering is when a company raises money by selling part of its ownership through either shares (for C-corps) or membership units (for LLCs). Newer companies are more likely to choose equity offerings because they are not required to make regular interest payments. Instead, investors profit as the company profits.

A debt offering is when a company raises money by issuing some form of debt instrument, such as bonds. In this case, the company borrows money from investors, promising to pay their principal in the future and interest along the way. The bonds usually have a stated rate of return (coupon rate) and a maturity date when the money will be paid back. More well-established companies may prefer a debt offering because they have the income to make regular interest payments. From a taxation perspective, debt offerings are cheaper than equity offerings because companies can deduct interest payments from their taxes, but they cannot deduct dividend payments.

A debenture private placement is a bond offering that is not secured by a physical asset or collateral, but simply by the “full faith and credit” of the issuer. Generally issued by well-established companies with high credit ratings, debentures are purchased in the belief that the issuer is unlikely to default on the repayment. Less creditworthy companies may need to add protective covenants to provide assurance for the potential bondholder. Debentures often have higher interest rates than bonds that are secured by an asset. Investors in debentures have a general claim on assets not pledged to secure other debt.

**Underwriting a Private Placement**

With a private offering, the issuer selects a sort of underwriter called a **placement agent** or a **deal manager** to place the securities with investors. The placement agent is a registered investment banker or broker-dealer, and the terms under which the agent works are negotiated by the two parties and set forth in a **private placement agreement**.

The placement agent is usually employed in a “best-efforts” arrangement, where the agent is not obligated to purchase any securities or guarantee success. A **best-efforts commitment** is also called a **contingency agreement**. In this kind of agreement, the underwriter agrees to use its best efforts to sell the issuer’s securities, but the underwriter does not guarantee that all the shares will be sold. Nor is the underwriter financially responsible for the securities it doesn’t sell. The underwriter is allotted a certain period of time to sell the issue, usually between 30 and 90 days. If a required portion of the issue has not been sold by the



## *Innovative Resources for Securities Exam Preparation*

end of the subscription period, the offering will be cancelled, the securities are returned to the issuer, and the money is returned to the investors.

There are two types of best-efforts commitments.

1. In an **all-or-none (AON) commitment**, the underwriter sells all the shares in the offering or the offering is voided. More specifically, the underwriter must receive the offering by a certain date and sell it within a specified period of time. Otherwise the entire offering will be returned.
2. In a **mini-max commitment**, also called “part-or-none”, the underwriter commits to sell a minimum number of shares of the offering or the offering will be cancelled. The underwriter is expected only to use its *best efforts* to sell the remainder. A mini-max is sometimes called a part-or-none commitment.

Either of these best-efforts commitments may have a **market out clause**, where the placement agent is permitted to cancel the agreement without penalty for certain specified reasons. An unexpected downturn in the market, for example, or a looming recession would make sales of the new issue difficult or impossible at the agreed-upon price.

**Anti-fraud rules for best-efforts commitments.** Two Exchange Act rules govern the conduct of a best-efforts commitment underwriting. SEC Rule 15c2-4 requires that payments for securities in an “all-or-none” or “mini-max” offering be deposited into a separate segregated escrow account of an independent bank until the conditions of the offering are satisfied. The bank is called the **escrow agent**. This rule was put into place to ensure that purchasers will get their money back if the offering is cancelled.

An **escrow account** is an account where funds are held by a third party (the escrow agent), but the funds do not belong to this party. The funds in an escrow account cannot be commingled with the third party’s funds. Under Rule 15c2-4, the escrow agents may only invest in safe investments, such as bank accounts, bank money-market accounts, short-term CDs issued by the bank, or short-term securities issued by the U.S. government.

The following investments are specifically *not* allowed under the rule:

- Money market funds
- Corporate equity or debt securities
- Repurchase agreements
- Banker’s acceptances
- Commercial paper
- Municipal securities

SEC Rule 15c2-4 requires that all checks, drafts, and money orders received from prospective purchasers be delivered promptly to the escrow agent for deposit in an escrow account. In this case promptly means by



*Innovative Resources for Securities Exam Preparation*

noon of the next business day after receipt. The escrow agent must be a U.S. commercial bank that is unaffiliated with either the issuer or the underwriter.

SEC Rule 15c2-4 applies to best-efforts public offerings as well as private placements.

SEC Rule 10b-9 is an anti-fraud rule that prohibits any person from misrepresenting the terms of an all-or-none or part-or-none offering. For example, suppose an issuer offers a specified number of shares of common stock for sale to the public in 90 days on an all-or-none basis. It would be a misrepresentation of the offering and a violation of Rule 10b-9 if the issuer were to extend the offering period, change the offering price, raise the number of required investors, or raise the minimum amount of proceeds needed to release the funds out of escrow. That said, the offering period may be extended if the issuer extends a reconfirmation offer in which the investor has plenty of time to decide whether to accept the offer. If the investor does not reply to the new offer, the investor's subscription will be cancelled and his money will be returned.

Another type of underwriting commitment is a standby agreement. In a standby agreement, the underwriter agrees to buy up any unsold shares at a fixed subscription price, usually a discount to the offering or market price. Standby offerings guarantee that the issuer will receive a certain amount of money, and therefore tend to carry a higher underwriting fee. If a standby underwriting agreement is executed in an IPO, it usually reflects poor demand in the offering because extra shares were left over.

While standby agreements can be used in an IPO or follow-on offering, they are the most common during a rights offering. During a rights offerings, an issue of additional shares is first offered solely to existing shareholders for a limited time. An underwriter "stands by" to purchase any unsubscribed shares (usually called rights) on a firm commitment basis at the end of this period. The period usually lasts two to four weeks. In this kind of offering, the standby underwriter runs the risk of any decline in price from the right's original subscription price. This type of offering is sometimes called an "insured rights offering" because it allows the issuer to make sure that all of the shares are sold, and the required capital is raised. The agreement between the standby underwriter and the issuer is often referred to as a "standby underwriting agreement."

A more specific type of standby agreement is a Standby Equity Distribution Agreement (SEDA). A SEDA is a type of private placement in which a publicly traded company issues new stock without making a public offering. In a SEDA, a financial firm agrees to privately purchase the stock at a discount to the market price (usually 5%), and the issuer chooses whether to sell all the shares, part of the shares or none of the shares. The shares will usually be issued in groups (called tranches) and each tranche is offered for a specified period of time. An advantage of a SEDA for the issuer is that it can choose when and whether to sell its stock. The issuer will usually choose to sell when the market price is high. A SEDA will increase the shares outstanding, and dilute current shareholders' equity.

A final type of underwriting agreement is a **firm-commitment underwriting**. In this type of agreement, the underwriter will purchase all the securities at a discount and then sell the securities at a fixed **public offering price**. In this type of agreement, the underwriter is responsible for the marketing and sale of the securities and assumes all the risk of the offering, including the liability for any unsold shares. This is the most common type of underwriting commitment for a corporate public offering but rare for a private placement.



*Innovative Resources for Securities Exam Preparation*

Firm-commitment underwritings may be undertaken in one of two ways:

1. In a **competitive bidding** process, the company solicits underwriters to submit a sealed bid for the underwriting contract. The issuer awards the contract to the underwriter with the most competitive price and contract terms. **Competitive offerings** are common for new issues of municipal bonds and public utilities but rare for corporate offerings.
2. With a **negotiated bid**, the company elects to negotiate with a single underwriter for the contract. **Negotiated offerings** are the most common type of public corporate underwritings.

SEC Rule 15c2-4

**Private Placement Liabilities**

---

The placement agent is expected to conduct reasonable due diligence on the issuer, checking for misstatements or inaccuracies in the PPM, and checking on the financial state of the company. FINRA warns its members that placement agents and selling group members need to watch for and investigate issuer “red flags.” FINRA defines a **red flag** as an issue that would cause a prudent person to question it. Red flags are often financial, but they don’t have to be. A selling group member may rely on the manager to investigate the issuer, but the member must have reason to believe that the manager has the required expertise and lack of conflicts of interest to be able to engage in a proper inquiry. In addition, the member must meet with the manager and ask questions about the manager’s investigation.

All anti-fraud regulations that apply to registered securities also apply to exempt securities such as private placement securities.

The Securities Act also stipulates that any person who sells or offers to sell an unregistered security without a proper exemption is liable in a court of law.

The purchaser of improperly sold securities may have the right to rescind her investment, often referred to as a -. In the securities world, “to rescind” means to revoke or cancel a transaction, resulting in the return of the investor’s money. The amount of rescission cannot exceed the security’s purchase price plus interest, less any income received from the purchase (such as dividends), or for damages if he no longer owns the security. If there has been a violation of the Securities Act, a purchaser has the right to rescind for one year. Occasionally, an issuer may extend a rescission offer to investors. This usually includes an offer to return the original investment plus interest. Any investor who accepts the offer gives up her right to sue the issuer.

Some examples of situations where an investor may have the right to rescind include the following:

- An issuer sells unregistered securities that don’t meet an exemption.
- An issuer hires an unregistered finder and pays the finder transaction-based fees (unregistered finders may only be paid for introducing investors and not on whether a transaction is successful).



## *Innovative Resources for Securities Exam Preparation*

- An issuer does not follow federal guidelines for private placements (examples: the issuer offers a private placement to more than 35 non-accredited investors, or an issuer publicly advertises a private placement and then sells it to non-accredited investors).
- An issuer publishes misstatements in its registration statement, offering circular or PPM.

### **Private Resales to Qualified Institutional Buyers—Rule 144A**

---

Recall that most private placement securities are restricted, meaning they cannot be resold except through some kind of exemption, such as a Rule 144 exemption. But Rule 144 requires investors to wait at least six months before selling their securities. SEC Rule 144A provides a safe harbor for brokers and investors to resell their restricted securities without being subject to these holding limits by selling to qualified institutional buyers (QIBs).

How a Rule 144A transaction generally works is that a foreign or U.S. issuer sells securities to a group of initial purchasers, who are usually broker-dealers. The broker-dealers then resell them to QIBs under Rule 144A. Under this safe harbor, the resellers are not considered to be underwriters and the offer is not considered a distribution. Issuers are not allowed to sell securities under Rule 144A, only non-issuers may take part in the resales.

SEC Rule 144A was initially implemented to make it easier for foreign companies to invest in the U.S. Since its implementation, however, it has been widely used by both foreign and U.S. companies to raise capital in U.S. markets.

Rule 144A eligible securities include both equity and debt securities issued by either U.S. or foreign companies. The following are not permitted:

- Equity securities listed on a national exchange
- Preferred stock that can be converted to exchange-listed common stock
- Open-end funds (mutual funds), unit investment trusts, or exchange-traded funds

A company may see a Rule 144A equity offering as an alternative to an IPO or as a stepping-stone to an IPO. While preparing for an IPO, a company may parlay the work it put into a registration statement for an IPO into offering documents for a Rule 144A transaction. While an offering document is recommended for a 144A transaction, it is not required by the SEC. Instead sellers in a Rule 144A transaction must provide reasonably current financial information about the issuer to investors upon request. This information includes:

- A brief description of the issuer's business, products and services
- The issuer's most recent balance sheet, income statement and retained earnings statement
- Similar financial statements for the last two years (audited if reasonably available)



## *Innovative Resources for Securities Exam Preparation*

This information is not required if the issuer is a U.S. reporting company or foreign company that already provides information to the SEC, or a foreign government.

In a typical Rule 144A transaction, investors receive a preliminary offering disclosure document, a term sheet with final pricing terms, and a purchase agreement with pricing information for them to sign. Investors then receive closing documents at the end of the offering. Closing usually occurs 3 - 5 business days after the purchase.

Qualified institutional buyers (QIBs) are institutional investors, such as insurance companies, investment companies, pension plans, or banks, that manage at least \$100 million in assets. QIBs must always be entities; they can never be individuals. The \$100 million threshold for assets under management does not include securities issued by the QIB or an affiliate of the QIB. For registered broker-dealers, the minimum amount under management is only \$10 million. To qualify as a QIB, a bank must also have a net worth of at least \$25 million.

Before selling, resellers must establish a reasonable belief that the buyer is a QIB. The reseller may rely on a:

- Buyer's most recent annual financial information (within 16 months of the sale)
- Recent publicly available information filed with the SEC or a governmental agency (within 16 months of the sale, or 18 months for a foreign issuer)
- Most recent publicly available information appearing in a recognized securities manual, such as Moody's or Standard & Poor's (within 16 months of the sale)
- Certification by the buyer's CFO or CEO specifying the amount of securities owned and invested on a discretionary basis by the buyer

Amendments to Rule 144A permit general solicitations and advertisements to persons other than QIBs, provided that securities are only sold to buyers reasonably believed to be QIBs. These changes mean that offers may be made to the public through news releases, email, print, or electronic advertisements, and trade magazines; however, the market for resold securities, for all practical purposes, remains the same.

Rule 144A creates a private market in restricted securities that otherwise would be illiquid. So instead of keeping these restricted securities locked away, investors are able to sell them under Rule 144A. Investors can trade 144A securities through the PORTAL trading platform for unregistered securities. Rule 144A has proven an especially popular avenue for non-U.S. issuers to place securities in the United States. It is also used to facilitate placement of high-yield debt.

Do not confuse the QIB buyer category with the concept of accredited investor defined under Regulation D. While QIBs would almost certainly qualify as accredited investors, the reverse is not necessarily true.

Rule 144A transactions must be reported to the over-the-counter reporting facility (ORF) by 8 pm on the same day as the transaction. Or by 8 pm on the following business day for transactions that occur on a non-business day or after 8 pm on a business day.

Most FINRA rules apply to Rule 144A transaction customers, such as they must receive a trade confirmation and a control relationship must be disclosed to a customer before entering into a contract with that customer.



## Private Investment in Public Equity (PIPE) Transactions

### SAMPLE QUESTION

Which of the following is not true about a PIPE investment?

- A. It is not a good investment for an investor who wants near-term income
- B. The PIPE transaction is typically publicly advertised
- C. Retail investors typically cannot be solicited
- D. Often the shares are sold at a discount to the market price

**Answer:** B. In a private investment in public equity (PIPE) transaction, an issuer sells publicly traded securities to accredited investors in a private placement. PIPE transactions come in several types. In one type, common stock is sold at a discount to the market price. Under a second type, the issuer sells stock at a discount to current market prices along with warrants. The warrants, usually having a five-year term, enable the holder to purchase additional shares at a price equal to or above current market prices. Most issuers will not publicly advertise the PIPE, and instead wait to announce the PIPE until after the purchase agreement is signed. After the purchase agreement is signed, the company will need to publicly disclose the transaction under Regulation FD (fair disclosure). A company typically files Form 8-K to alert its shareholders, the public, and the SEC of the transaction. PIPEs are initially “restricted securities,” so they can’t be sold freely until the holding period is up under Rule 144 or the issuer registers the securities. Most PIPE transactions include a registration rights agreement where the issuer agrees to register the securities within a certain time period after the PIPE offering has closed. This makes the securities illiquid in the short-term and near-term income may be unavailable. Most PIPEs are conducted under an exemption where only accredited investors can be sold to and solicitation of retail investors is frowned upon.

## OFFSHORE SECURITIES OFFERINGS: REGULATION S

### Rule 903: Issuer Safe Harbor

A Regulation S offering can be combined with a Rule 144A offering and sold inside the U.S. to QIBs. An issuer can sell Regulation S securities immediately on a foreign exchange, but there are restrictions on when they can be sold to U.S. residents.

Rule 903 applies to offshore offers and sales of securities by issuers, distributors, and their affiliates or anyone acting on their behalf. Rule 903 recognizes three categories of securities, and additional conditions apply to two of these categories. Which category an offering falls into depends, broadly speaking, on how likely it is that the securities will eventually find their way into the hands of investors in the United States.



## *Innovative Resources for Securities Exam Preparation*

- **Category 1 – Low-risk offering:** This category includes securities issued by foreign issuers with “no substantial U.S. market interest” in their securities, securities sold in an overseas directed offering, securities backed by the full faith and credit of a foreign government, and securities issued under a foreign employee benefit plan. There are no significant additional conditions for this category of securities.
- ☒ **Example:** Nichtsehr gut GmbH, a German company that has no substantial U.S. market interest in its securities, issues equity securities traded on a European exchange. It does not direct any selling efforts to the United States. A few U.S. citizens vacationing in Europe purchase shares. Nichtsehr gut is not required to register its offering with the SEC.
- **Category 2 (Certain Foreign Issuers) – Mid-risk offering:** The second category of securities includes equity securities of reporting foreign issuers and debt securities of both reporting and non-reporting foreign issuers. These securities are subject to conditions beyond the general Regulation S conditions, including notification and legending requirements and a prohibition on offers or sales to U.S. persons (i.e., U.S. residents or U.S.-organized entities) during a 40-day “distribution compliance period.”
- **Category 3 – High-risk offering:** This category encompasses all securities that do not fall within either of the first two categories. Securities in this category are subject to all the conditions of Category 2, plus additional potentially onerous requirements that depend on whether the security is a debt or equity security. Debt securities cannot be sold to U.S. residents for 40 days. For foreign non-reporting companies, equity securities cannot be resold to U.S. residents for one-year (6-months for foreign reporting companies).

**Integration with other offerings.** Regulation S allows transactions to occur contemporaneously with other domestic offerings. As long as the offshore transaction complies with Regulation S, there is no threat of integrating with another private or public offering.

**Disclosures of Regulation S offerings.** Reporting companies are required to disclose their offshore offering on Form 8-K within 15 days of the offering.

A Regulation S offering can be combined with a Rule 144A offering and sold inside the U.S. to QIBs. An issuer can sell Regulation S securities immediately on a foreign exchange, but as mentioned before, there are restrictions on when they can be sold to U.S. residents.

## **THE FAST ACT EXEMPTION – SECTION 4(A)7**

In 2015 the Fixing America’s Surface Transportation Act, or “FAST” Act, was signed into law to improve funding for transportation infrastructure projects. The FAST Act also created a new registration exemption





## *Innovative Resources for Securities Exam Preparation*

from the Securities Act of 1933 for the private resale of unregistered securities. This exemption made it easier for early stakeholders and investors to sell their unregistered shares in a new company.

The FAST Act amended the Securities Act with the introduction of Section 4(a)(7) which exempts the resale of unregistered securities as long as the following conditions hold:

- Purchasers must be accredited investors (or the seller has a reasonable belief they are)
- Securities have been authorized and outstanding for at least 90 days
- No general solicitation or advertising can be used when offering or selling the securities
- Seller is not the issuer, a subsidiary of the issuer or an underwriter
- Seller or any person receiving a commission for the sale is not a “bad actor,” defined under Regulation D
- Issuer is not a blank check, blind pool, or shell company
- Is not part of an unsold allotment to an underwriter
- For non-reporting companies, the seller must provide the purchaser with general information about the issuer, including:
  - ▶ Name, address of the issuer
  - ▶ Description of the business
  - ▶ Title and class of the securities
  - ▶ Most recent balance sheet and income statement, and similar statements for the two preceding fiscal years, prepared in accordance with GAAP or International Financial Reporting Standards
  - ▶ If the seller is a control person, a certification that it has no reason to believe that the issuer is in violation of any securities laws or regulations

Securities acquired under a Section 4(a)(7) exemption are considered “restricted securities” and therefore cannot be transferred except through registration or another exemption from registration.

Securities sold under Section 4(a)(7) are “covered securities” and not subject to state blue sky laws.

Unlike the Rule 144 safe harbor, the FAST Act exemption sellers don’t have to wait six months to sell their unregistered securities. Also, unlike Rule 144, for affiliates there are no volume restrictions, as well as no requirement to notify the SEC. In addition, the FAST Act exemption allows the seller access to a wider pool of investors than Rule 144A since Section 4(a)(7) is limited to accredited investors rather than the mega-money QIBs.



## EXEMPT CLASSES OF SECURITIES UNDER THE 1933 SECURITIES ACT

### SUMMARY OF REGISTRATION EXEMPTIONS

SUMMARY

	Dollar Limit	Type of Offering	Issuer Requirements	Investor Requirements
Reg A	Tier 1—\$20 million  Tier 2—\$50 million	Public offering	U.S. or Canadian companies that are not registered with the SEC (non-reporting companies)  Has a legitimate business plan  No bad actors involved	Unlimited number of investors  All investors are eligible
<b>Rule 504</b>	\$5 million	Private placement	Non-reporting company  U.S. or foreign company  No bad actors involved	Unlimited number of investors  All investors are eligible
<b>Rule 506(b)</b>	Unlimited	Private placement	U.S. or foreign company  SEC registered or private companies  No bad actors involved	Each non-accredited investor must be sophisticated  No more than 35 non-accredited investors  Number of accredited investors is unlimited
<b>Rule 506(c)</b>	Unlimited	Private placement  U.S. or foreign company	U.S. or foreign company  SEC registered or private companies  No bad actors involved	All accredited investors are eligible



## SUMMARY

### SUMMARY OF REGISTRATION EXEMPTIONS

	Dollar Limit	Type of Offering	Issuer Requirements	Investor Requirements
<b>Crowd-funding</b>	\$1 million + inflation	Public offering	U.S. or Canadian companies that are not registered with the SEC (non-reporting companies)  No bad actors involved	Aggregate amount sold cannot exceed a given percentage of investor's annual income or net worth (greater of 2% or \$5,000 for investors with annual income or net worth less than \$100,000, and 10% but not exceed \$100,000 for all other investors)
<b>Rule 147</b>	Does not apply	Public offering to in-state residents	Principal place of doing business must be in the state  Must meet at least one: <ul style="list-style-type: none"> <li>• 80% of revenues must come from within the state</li> <li>• 80% of business assets must come from within the state</li> <li>• 80% of proceeds must be used in-state</li> </ul>	Must be in-state residents to purchase security

### INTEGRATION AND AGGREGATION

**Regulation A.** According to Regulation A's integration safe harbors, a Reg A offering *will not be integrated* with another offering if:

- The other offering ends before the Reg A offering starts
- The other offering starts after the Reg A offering ends *and* the other offering is a registered offering, Reg S offering, or crowdfunding offering

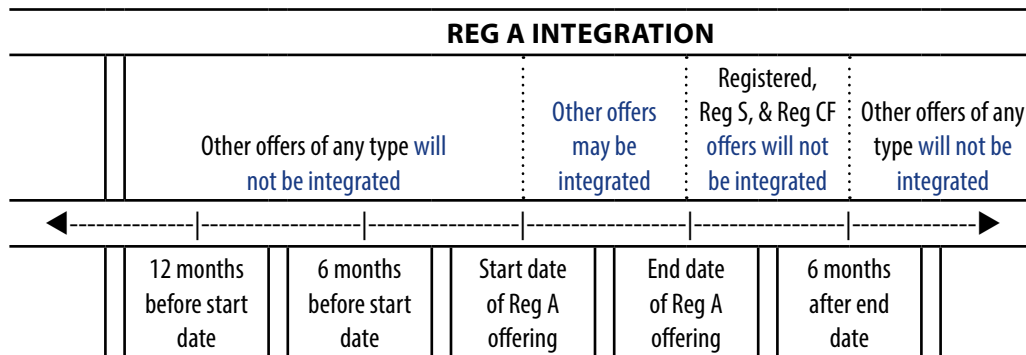


## Innovative Resources for Securities Exam Preparation

- The other offering starts more than six months after the Reg A offering ends

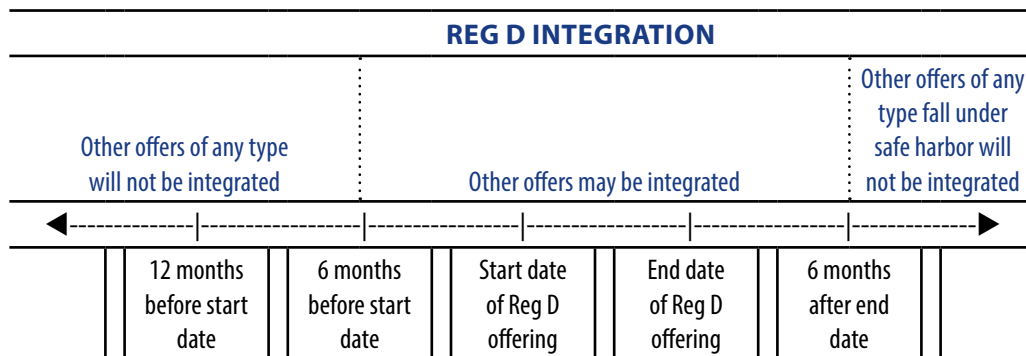
These safe harbors are the same for Tier 1 and Tier 2 offerings.

SEC Rule 251(c)



**Regulation D.** Regulation D’s integration safe harbor is the same for Rule 504, 506(b), and 506(c) offerings. Another offering will not be integrated with the Reg D offering if two conditions are met. First, there must be an uninterrupted period of more than six months between the Reg D offering and the other offering (e.g., six months and one day). It doesn’t matter if the other offering comes before or after the Reg D offering. Second, this period is interrupted and must start over if securities similar to those in the Reg D offering are offered or sold by the issuer.

SEC Rule 502(a)



**Regulation S.** A Regulation S offering does not integrate with either registered offerings or other exempt offerings.



## Aggregation Rules

☒ **Example:** There is a Rule 504 offering in July, and another Rule 504 offering in December. The proceeds from the July offering will count against the December offering's dollar cap. This is because Rule 504 says that any other Rule 504 offerings in the previous 12 months will count against the December offering's dollar cap.

## Exemption from State Registration Requirements

**Blue sky laws** are the state regulatory requirements for securities offerings. These requirements may pertain to registration, qualification, and filing requirements. Because these requirements vary from state to state, issuers may have to comply with a crazy-quilt of inconsistent state regulations in addition to federal requirements.

In 1996, the **National Securities Markets Improvement Act of 1996 (NSMIA)** was enacted to ease the state regulatory burden. NSMIA exempts certain “covered securities” from state registration requirements and from most state regulatory hurdles. These “covered securities” specifically include:

- Securities listed on a national exchange, such as the NYSE, American Stock Exchange, or NASDAQ.
- Registered investment companies, such as mutual funds
- Sales to “qualified purchasers,” a term that is left to the SEC to define
- Government securities
- Municipal securities
- Bank securities
- Commercial paper
- Regulation D 506 private placements
- Rule 144A distributions
- Crowdfunding offerings
- Tier 2 Regulation A offerings

Although NSMIA essentially eliminated state authority to substantively regulate large national offerings, it allows states to require notice filings and payment of registration fees. NSMIA also specifically preserves the ability of state regulators to enforce state laws prohibiting fraudulent, deceptive, or unlawful conduct in connection with securities transactions.

States may still require registration for small or intrastate offerings of securities that do not fall under the definition of “covered securities.” Thus, issuers of non-covered securities will probably need to adhere to the blue sky laws for the states in which they are selling securities. Some relevant types of offerings that may be subject to blue sky laws are Regulation A Tier 1 offerings, Regulation D 504 offerings, and Rule 147 offerings.



## CONDUCT RULES

### **Research Reports by Broker-Dealers Not Participating in an Issuer's Distribution**

A research report is a written communication that includes information, opinions, or recommendations with respect to an issuer's securities or an analysis of a security or an issuer, whether or not it provides sufficient information upon which to base an investment decision.

Publishing or distributing research reports about the securities in an offering *shall not* be considered an offer if:

- The author of the report has not participated and does not propose to participate in the distribution of the securities.
- The author of the report is not receiving or acting under any direct or indirect understanding with the issuer or any participant in the distribution.
- The research report is conducted in the regular course of business.
- The broker-dealer receives no compensation from the issuer (except the regular subscription price for a research report).
- The issuer is not currently or hasn't been in the last 3 years a blank check company, shell company or penny stock company.

SEC Rule 137

### **Liabilities for False Communications**

The Securities Act of 1933 lays out the consequences of misleading customers or potential customers with respect to offering and selling a security. Untrue statements of a material fact or the omission of a material fact in a written prospectus or oral communication whose result is to mislead a customer are subject to civil prosecution in a court of law.

Anyone who offers or sells a security misleadingly, bears the burden of proof that she did not know and could not have known of the untruth or the omission. If the accused person cannot provide a convincing argument that she did not know or could not have known, she will be liable to anyone who purchased the security.

The Securities Act also stipulates that any person who sells a security from a new issue before a registration statement is in effect or who offers to sell a security before the registration becomes effective is also liable in a court of law.

In either of these cases, the purchaser may have the right to rescind her investment, often referred to as a rescission right. In the securities world, "to rescind" means to revoke or cancel a transaction, resulting in the return of investor's money. The amount of rescission cannot exceed the security's purchase price plus interest, less any income received from the purchase (such as dividends), or for damages if he no longer owns the security. If there has been a violation of the Securities Act, a purchaser has the right to rescind for



## *Innovative Resources for Securities Exam Preparation*

one year. Occasionally, an issuer may extend a rescission offer to investors. This usually includes an offer to return the original investment plus interest. Any investor who accepts the offer gives up his right to sue the issuer.

If the person who sold the security can prove that any portion of the recoverable amount does not represent a depreciation of the security's value resulting from the untruth or omission, then that portion shall not be recoverable. Again, the burden of proof is on the seller.

Some examples of situations where an investor may have the right to rescind include the following:

- An issuer sells unregistered securities that don't meet an exemption.
- An issuer hires an unregistered finder and pays the finder transaction-based fees (unregistered finders may only be paid for introducing investors and not on whether a transaction is successful).
- An issuer does not follow federal guidelines for private placements (examples: the issuer offers a private placement to more than 35 non-accredited investors, or an issuer publicly advertises a private placement and then sells it to non-accredited investors).
- An issuer publishes misstatements in its registration statement, offering circular or PPM.
- An issuer misrepresents its financial statements in its registration statement, offering circular or PPM.

Securities Act Section 12



CHAPTER TWO

**OPENING AND MAINTAINING CUSTOMER ACCOUNTS**

**OPENING AN ACCOUNT**

---

**Verification of Accredited Investors and QIBs**

The SEC requires an issuer of a Reg D, Rule 506 private placement to take reasonable steps to verify that the purchasers are accredited investors. Verification is usually done through a questionnaire, plus additional supporting documents. While the issuer is required to do this, the principal of the placement agent or investment banking firm must keep records of these verification documents. In addition, the SEC suggests one of the following methods (but none of these methods is required):

- Verification based on income can be accomplished by reviewing copies of any IRS forms that report income, such as Form W-2, Form 1099, Schedule K-1 of Form 1065, and a filed Form 1040, and a representation from the purchaser that he expects to continue to make this amount in the future
- Verification based on net worth can be achieved by reviewing specific types of documentation dated within the prior three months, such as bank statements, brokerage statements, certificates of deposit, tax assessments for assets, and a credit report from at least one of the nationwide consumer reporting agencies for liabilities
- A written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney or a certified public accountant stating that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the last three months and has determined that such purchaser is an accredited investor

The issuer must have a method for verifying the accredited investor status of persons who had invested in the issuer's Rule 506(b) offering as an accredited investor before September 23, 2013 and remain investors of the issuer.

Before completing a Rule 144A transaction, the firm will need to determine whether the purchaser is a QIB. Recall that the firm can rely on the following:

- Purchaser's most recent annual financial information (within 16 months of the sale)
- Recent publicly available information filed with the SEC or a governmental agency (within 16 months of the sale, or 18 months for a foreign issuer)





## *Innovative Resources for Securities Exam Preparation*

- Most recent publicly available information appearing in a recognized securities manual, such as Moody's or Standard & Poor's (within 16 months of the sale)
- Certification by the purchaser's CFO or CEO specifying the amount of securities owned and invested on a discretionary basis by the purchaser

While a representative may collect this investor information, it is the principal's responsibility to determine whether the firm has a reasonable basis to believe that the buyer is an accredited investor, qualified purchaser or QIB.

## **TYPES OF CUSTOMER ACCOUNTS**

---

### **Individual Accounts**

Most accounts will be opened by individuals and will be plain vanilla accounts. Individuals must fill out the new account form to open the account. An individual account has only one owner. A representative may not give account information to anyone else, including the spouse of the account owner.

The owner is the only one who can trade in the account, unless third-party trading authorization has been granted. There are three kinds of third-party trading authorization:

1. **Limited trading authority** allows a third party to trade in the account, but the third party cannot make withdrawals.
2. **Full trading authority** gives a third party both authority to trade and to make withdrawals.
3. **Discretionary authority** gives the representative authority to trade in the account without prior permission by the customer.

Without discretionary authority, a representative needs three pieces of information from the customer to make a transaction in the account:

1. The name of the security
2. Whether to buy or sell the security
3. The amount of the security to be transacted

For more details for more details on discretionary accounts continue reading.



## Other Account Documentation

- ▶ **Accredited investor questionnaires**—a questionnaire the firm will have the customer fill out if a customer plans to invest in a private placement. This should be kept in the customer's file. See Chapter One for the accredited investor criteria.



## EXERCISE

---

### ANSWER TRUE OR FALSE.

1. \_\_\_ Records relating to the verification of identification must be kept at least three years.
2. \_\_\_ Full trading authority allows a third party to trade in an account without prior permission from the account owner.
3. \_\_\_ A customer's age is required information to complete a suitability questionnaire.
4. \_\_\_ After a married couple signs a joint party agreement upon opening a joint account, both parties are able to make transactions in the account without permission from the other.

### ANSWERS

1. **False.** Records relating to the verification of identification must be kept at least five years.
2. **True.** Full trading authority allows a third party to trade and make withdrawals, and make trade decisions without prior permission from the account owner.
3. **True.** The required information for a suitability questionnaire includes age, time horizon, liquidity needs, risk tolerance, tax status, current and future financial needs, and investment experience.
4. **True.** The joint party agreement specifies that each owner can make transactions in the account.



## CHAPTER THREE

## Provides Customers with Information About Investments, Makes Suitable Recommendations, Transfers Assets, and Maintains Appropriate Records

---

### 1. Provides Customers with Information about Investments, Makes Suitable Recommendations, Transfers Assets, and Maintains Appropriate Records

*13 out of 50 questions on the exam*

## TYPES AND CHARACTERISTICS OF SECURITIES AND INVESTMENTS

When a company would like to raise money by issuing a security, it has two general options.

First, the company can sell partial ownership in the business to others. The company does this by issuing tiny equal portions of ownership called “shares” or “stock” (the terms are used interchangeably and mean the same thing). Investors buy these shares and become partial owners of the company. The more shares an investor purchases, the larger the portion of the company they will own. In an accounting context, equity means what is left over after all debts have been paid, so equity financing can be seen as selling a stake in “what’s left over”: ownership in the business. What is being purchased by investors—tiny equal portions of ownership called shares or stock—is called **equity securities**.

The second primary method for a company to raise money is by issuing **bonds**. Bonds are promises by the company (the issuer) to pay the bond purchaser a specific amount of money in the future and also to pay periodic interest along the way. Conceptually, a bond is like a loan or an IOU. Because equity financing (selling ownership) is not generally available to governments, bonds are issued by many different types of governmental organizations. For example, a bond issued by the federal government is called a **Treasury bond**, a bond issued by a municipality is called a **municipal bond**, and a bond issued by a corporation is



## *Innovative Resources for Securities Exam Preparation*

called a **corporate bond**. Raising money by issuing corporate bonds is called **debt financing**, because the borrower (the company/issuer) will have to pay back money to the lender (investor) in the future.

The above represent the two ways a company can raise money through the securities markets. Issuing stock means selling equity in the business; equity equals ownership, and buying an **equity security** means purchasing ownership. Issuing bonds means issuing debt securities, and buying a debt security means lending money to the issuer.

From an investor's perspective, a **debt security** is a certificate acknowledging that money has been borrowed by the issuer and must be repaid to the bondholder. It contains terms defining the amount borrowed, the interest rate on the loan, and the repayment date. Debt securities include government and corporate bonds, certificates of deposit, and collateralized debt obligations. Once investors buy debt securities, they can sell them to others in a secondary market. The price of debt securities is usually determined by the rise and fall of interest rates.

**Equity securities** are certificates representing ownership interest in a public or private corporation. Equity securities include common stock, preferred stock, warrants, rights, American Depository Receipts, and REITs. Equity securities are also traded on secondary markets. Unlike debt instruments, however, which promise only interest and the repayment of principal, owners of equity securities are able to profit in a company's financial gains. When a company does well, or at least is perceived to be doing well by investors, the price of the equity security will go up in the secondary market. The investor will make money through the gain in the security's value, always hoping to buy at a low price and sell at a higher price. In fact, the gains on equity securities are potentially without bound. Equity investors also risk sharing in a company's financial losses; those losses, however, are limited to the owner's investment in the company.

## EQUITY SECURITIES

When a corporation is formed, common stock is usually the only class of stock issued. Common stock offers a pro rata share of the corporation's profits, meaning that an investor will own a portion of the company that is proportional to the amount invested. Other classes of ownership rights, such as preferred stock, may come later. Common stock represents the primary ownership of a corporation, and it offers investors the greatest potential reward. However, bondholders and preferred shareholders are paid before common shareholders, and in the event of dissolution, common stockholders have the last claim on the distribution of assets.

## ISSUANCE OF COMMON STOCK

When a corporation is organized, the corporate charter must state how many shares of each class of stock are authorized. Typically a new corporation will authorize more shares than it needs initially so that it will have a reserve of shares to draw on if it needs to raise additional capital. Otherwise, in the future, if it needs



## Innovative Resources for Securities Exam Preparation

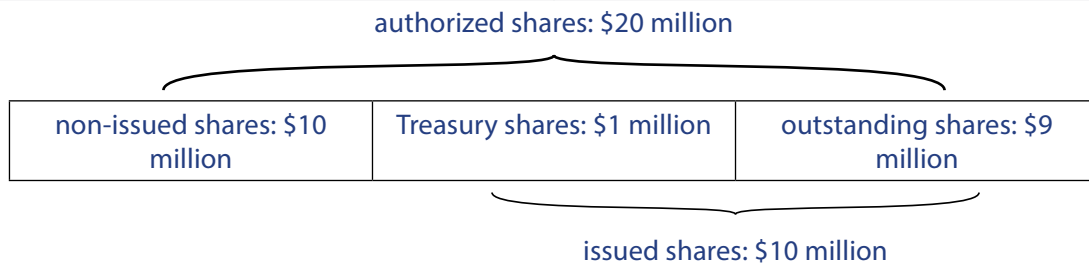
more stock than is authorized, the corporation will have to amend its charter by shareholder vote and also get approval to authorize more shares from the secretary of state. This can be time-consuming and expensive.

The amount of stock authorized for issuance is, not surprisingly, called **authorized stock**, or authorized shares. The portion of authorized stock that has been sold to shareholders is called **issued stock**, or issued shares. **Treasury stock** represents shares of issued stock that have been repurchased by the company and removed from public circulation.

### EXAMPLE QUESTION

**The current share price of XYZ Corporation is \$10. XYZ has authorized 20 million shares. It has issued 10 million shares and has repurchased 1 million of those shares (illustrated in the diagram below). How many outstanding shares does XYZ have, and what is XYZ's market capitalization?**

**Answer:** 9 million, \$90 million. Outstanding shares = issued shares – Treasury shares, or 10 million – 1 million = 9 million. To calculate the market capitalization, multiply the outstanding shares by the current share price (9 million shares x \$10 per share = \$90 million).



**Treasury stock is treated as though it is still in the hands of the shareholder, in this case the corporation, so it is still considered issued stock; however, it has no voting rights and pays no dividends. Corporations may acquire Treasury stock to serve several purposes. It may be employed for executive stock options or bonuses, or for employee stock purchase plans. It may be used to acquire the assets of another corporation by an exchange of stock tender offer, or to thwart a hostile takeover. It may be used to boost the price of the company's stock or to invest its excess cash. When Treasury stock is withdrawn from its issued stock, the amount of stock remaining in circulation is the number of shares outstanding. Shares outstanding represents all shares in circulation, and it is this number that is used to determine market capitalization (share price x shares outstanding) and earnings per share (net income – preferred dividends (if any) / shares outstanding). Common shares outstanding can usually be found in the shareholders' equity section of the balance sheet and also on Forms 10-Q or 10-K.**

Market capitalization:

$$\text{market capitalization} = (\text{market share price}) \times (\text{number of shares outstanding})$$



## *Innovative Resources for Securities Exam Preparation*

If the share price is \$500 and there are 600 shares outstanding, then the market capitalization is \$500 x 600, which equals \$300,000.

Earnings per share:

$$\text{earnings per share} = \frac{\text{net income} - \text{preferred shareholder dividends}}{\text{shares of common stock outstanding}}$$

If a company's net income is \$50 million, it pays out \$2 million in preferred dividends, and it has 12 million shares outstanding, then earnings per share is (\$50 million - \$2 million) divided by 12 million shares, which equals \$4.

## **Common Stock Shareholder Rights**

Ownership comes with certain rights, and the rights of common stockholders, the primary owners of a corporation, are broad. The nature of these rights may vary according to a company's bylaws and the laws of the state in which it is incorporated, but the following characteristics generally hold true.

### **Right to Inspect Records**

---

Common stockholders have the right to examine the company's books and financial records, obtain a list of all shareholders, and examine the minutes of shareholder meetings.

### **Voting Rights**

---

Holders of common stock have voting rights as a privilege of ownership. They can vote to elect the corporate board of directors and to approve corporate resolutions, such as stock splits, mergers and acquisitions, and changes of business direction. They may vote in person at shareholder meetings or by proxy.

A proxy is a person authorized to vote on behalf of the shareholder. Prior to a shareholders' meeting, holders of common stock will receive a proxy statement describing the issues up for vote and a ballot. They may then return the ballot, authorizing a designated company manager to cast their vote as indicated.

Shareholders are allowed one vote per share. In votes to elect candidates for the board of directors, however, the right may come in one of two forms. In **statutory voting**, shareholders may vote no more than their number of shares for or against each of the candidates. In **cumulative voting**, shareholders may vote their total voting shares (number of shares times number of candidates) for a single candidate. Suppose, for example, that an upcoming shareholder meeting presents candidates to fill three open positions on the board of directors. Under **statutory voting**, a shareholder having 500 shares of common stock may give up to 500 votes, yay or nay, to each of the three candidates. Under **cumulative voting**, the shareholder would



## *Innovative Resources for Securities Exam Preparation*

be able to offer up to 1,500 votes to a single candidate. In this way, cumulative voting allows smaller shareholders to have a greater influence on the makeup of the board.

Another way for shareholders to increase their voting power is to join a **voting trust**. With a voting trust, an individual shareholder transfers his legal title and voting rights to a trustee. The trustee will then control a unified voting block and have a stronger voice in matters of corporate governance. Voting trusts are created for a specified period of time, with a maximum period often designated by the state in which the business is incorporated.

A voting trust is controlled by a **voting trust agreement**, in which shareholders endorse their stock certificates to the voting trustee. The voting trustee exchanges these certificates with the corporation for new certificates issued in the name of the trustee. The voting trustee will vote the shares as a principal, rather than as an agent (which is the case with proxies). The **trustee** holds legal title to the trust certificates, holding them on behalf of the **beneficiaries**, who are said to have a **beneficial interest** in the trust property.

### **Dividends**

---

A **dividend** is the payment of a portion of a company's earnings to its shareholders. Payments usually are made in cash, as a fixed amount of money per share, but they may also be distributed in additional shares of stock. Holders of a company's common stocks may or may not receive dividends, because a corporation is not obligated to issue them. But when it does, dividends are usually paid quarterly.

When a company announces its decision to offer a dividend, it stipulates the date on which the dividend will be paid and the date by which an investor must own the stock to be eligible to receive the dividend. The date of the announcement is called the **declaration date**. The date of payment is called the **payable date**, or **payment date**. The date by which an investor must own the stock to receive the dividend is called the **record date**. The record date may be set several days or weeks before the payment date, at the company's sole discretion.

Another critical date, the **ex-date**, or **ex-dividend date**, determines which investor—the buyer or the seller—receives the dividend. The ex-date occurs one business day prior to the record date. The seller receives the dividend when the transaction occurs on the ex-date or after. The buyer receives the dividend when the transaction occurs before the ex-date. The reason for this is that a buyer only becomes the owner of the security on the **settlement date**. **Settlement** refers to the process whereby a security is paid for and transferred to a new owner. The settlement date for most securities is two business days after the trade date. This is abbreviated by T + 2. In order for the transaction to settle by the record date, the security has to be bought at least two business days before the record date.

The ex-date is one business day prior to the record date and, therefore, the date at which the buyer will *not* be the owner of record in time to receive the dividend. If the exam asks you to figure the ex-date, simply count one business day backward from the record date. When figuring the ex-date, remember to exclude any weekends and national holidays.



## *Innovative Resources for Securities Exam Preparation*

### DERP

Declaration Date	Ex-Date	Record Date	Payment Date
The date a company (1) declares it will pay a dividend and (2) sets the record date and payment date	Also known as ex-dividend date; the date, calculated backward from the record date, that determines which investor (buyer or seller) receives the dividend (usually one business day before the record date)	The date, set by the company, on which owners of outstanding shares receive a dividend	Also known as payable date and pay date; the date, set by the company, on which a declared stock dividend is scheduled to be paid

#### EXAMPLE QUESTION 1

**Mark decides to purchase 250 shares of GOOG. If the record date is on Wednesday, March 11, by what date must he purchase the shares to receive the dividend?**

**Answer:** Monday, March 9. Monday, March 9 is two business days before Wednesday, March 11. The ex-date is Tuesday, March 10. On or after the ex-date, Mark would no longer receive the dividend.

#### EXAMPLE QUESTION 2

**Jon uses cash to purchase 100 shares of MSFT on Thursday, July 3. The board of directors has declared a dividend. The record date is Monday, July 7. Will Jon receive the dividend?**

**Answer:** No. Jon's stock purchase will settle on July 8, which is one day past the record date. Remember to exclude July 4, which is a national holiday. Jon purchased the stock on the ex-date, July 3, so he does not receive the dividend. He would have had to purchase the stock by July 2 to have received the dividend.

### Limited Liability

A defining feature of a corporation is that it offers limited liability to its investors, meaning that investors are held liable only for the amount of money they invest in the company. All stock certificates have the words "fully paid and non-assessable" printed on them to assure stockholders of this right. Their other personal assets are not at risk for the company's debts, nor are investors personally liable for any lawsuits that might be brought against the company. The most they can ever lose by the purchase of a company's stock is its purchase price. This is true not just for holders of common stock but for any investor.





## Other Rights

---

Other rights of common stockholders include the right to sell or transfer their shares in the public market at will. Once a stock has been issued and purchased in the primary market, it may be freely traded in the secondary market. Here, stocks may be bought and sold at auction on an exchange, such as the New York Stock Exchange, or they may be bought and sold at negotiated prices in the over-the-counter market.

If the corporation happens to offer an additional issue of common stock, stockholders may have the right to maintain their current share of ownership by purchasing a proportionate amount of the new issue before it is offered to the public. This is a stockholder's **preemptive right**. In order to meet this obligation to existing shareholders, companies carry out a **rights offering** in which the current shareholders are offered enough new stock to keep their proportionate ownership. This rights offering further entitles stockholders to buy these proportionate shares at a discount from the offering price. Moreover, the rights themselves are transferable, allowing the owner to sell them in the open market.

In case of a company's liquidation, common stockholders have a **residual claim** to corporate earnings after all debt obligations have been satisfied. If stockholders feel aggrieved by corporate actions, they may file a **derivative suit** on behalf of a corporation against its officers and directors to defend their shareholder rights. Derivative suits are generally brought to address fraud or mismanagement that has been ignored by the officers of the corporation. These suits generally seek to protect shareholders' long-term interests by imposing corrective changes in governance, not by obtaining monetary damages. In the rare event of a monetary award, the money will go to the firm, not to the plaintiffs.

---

### BASIC STOCKHOLDER RIGHTS

---

- Right to inspect records
  - Right to vote on relevant matters
  - Right to receive dividends
  - Right of limited liability
  - Transfer rights
  - Preemptive rights
  - Right to sue for wrongful acts
- 

SUMMARY



## Non-Voting Common Stock

Occasionally, corporations will issue a class of common stock that has no voting rights. These securities are identical to ordinary shares in terms of dividends, residual claims, and other rights, but their owners cannot vote to elect directors or approve company policies. Non-voting stock allows a company to raise additional capital while maintaining the existing voting power of its current ownership. By state law, it can generally be issued only where a class of common stock is already on the market having full voting rights.

Sometimes a class of stock will have a weighted voting right, for example, 10 votes per share. **Super-voting common stock**, as it is known, achieves the same purpose as non-voting stock, keeping control of a company in the hands of its founders or a contained group of investors. It is also called **control stock**. For example, Dow Jones' Class B shares (10 votes per share) represent 20% of its common stock issue but over 70% of its voting power.

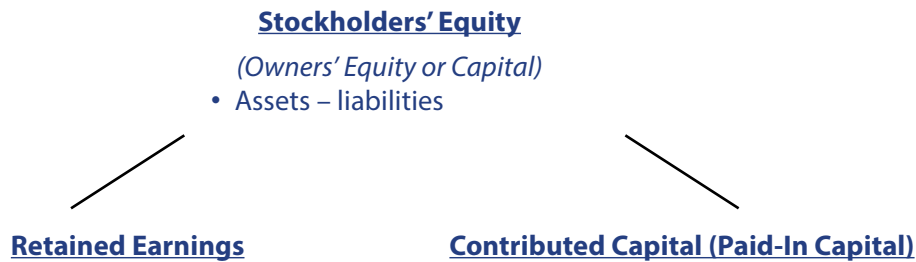
**Note:** Control stock can also refer to ordinary common stock when held in an amount sufficient to give a single shareholder a controlling influence on the company's decision making.

## Value at Issuance

Historically, par value was the price at which a company initially sold its shares. The concept of par value was much more important in the unregulated equity markets of the past than in the regulated markets of today. Today companies may set par values at \$.001 per share or even lower. Some states allow companies to issue shares with a zero par value. In general, today par value is an accounting artifact with little relevance for the investor and virtually no influence on the price of a stock.

For accounting purposes, par value multiplied by the number of shares of outstanding stock equals legal capital. The difference between a stock's issue price and its par value is called paid-in surplus and is recorded on the balance sheet as additional paid-in capital. Together, legal capital and additional paid-in capital equal the total investment by the company's owners, or, in other words, the value of the stock that has been bought directly from the company.

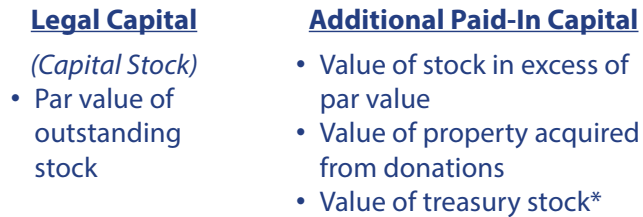
### ELEMENTS OF A CORPORATION'S STOCKHOLDERS' EQUITY





## Innovative Resources for Securities Exam Preparation

- Assets – liabilities – paid-in capital



\*Purchase will be a negative number whereas sale will be a positive number

For the exam, know that for investors in common stock, the par value of a share is set arbitrarily, has no relation to market value, and thus has little to no significance.

### Transfer of Common Stock

These days, securities may be held in one of three ways. They may be held by:

1. **Physical certificate.** The stock is registered in the owner's name on the issuer's books, and a stock certificate is delivered to the door of the owner or his broker.
2. **Street name registration.** The security is registered on the issuer's books in the name of the owner's brokerage firm, and the brokerage holds the security in book-entry form.
3. **Direct registration.** The security is registered on the issuer's books in the owner's name, and either the company or its transfer agent holds the security in book-entry form on the owner's behalf.

Because the physical transfer of stocks is unwieldy in a market where millions of shares are traded every day, the ownership of physical stock certificates is being phased out. Today most common stock shares are held in street name.

For those who still hold physical certificates, the transfer of ownership is done by **endorsing** and **assigning** the certificate to the new owner. The seller must fill out an **assignment and power of substitution** form located on the back of the certificate. This identifies the name of the new owner, the number of shares being transferred, and the broker who will have power of attorney for the purchaser in the transfer process. Assignment to a power of attorney makes the certificate negotiable only by the brokerage firm, which allows it to be safely mailed. The certificate must be signed by the seller exactly as his name appears on the certificate.

Stocks that have been bought by a customer but left in the broker's name are said to be left in (Wall) **street name**. The customer is said to be the **beneficial owner** and the broker is the **record owner**. This greatly



## *Innovative Resources for Securities Exam Preparation*

simplifies the transfer process, as the shares do not have to be shipped back and forth. Instead, transactions are settled in securities depositories like the Depository Trust Company, which registers and holds securities for financial institutions, such as brokers and banks, and facilitates the transfer of securities via computerized book-entry systems. All securities held in margin accounts, in which the customer invests money loaned by the broker, must be held in street name.

The **Direct Registration System (DRS)** allows investors to be registered directly on a company's books, whether stocks are bought through a broker or directly from the company. Owners get the benefits of direct ownership by receiving reports, dividends, and proxies directly from the issuer. They also benefit from the ease of a paperless electronic transfer. However, there is a downside. Transfer is made by sending the issuer instructions to sell or to move the security electronically to one's broker to sell. Shares may not get sold immediately, as the company will pool its direct requests and may respond slowly to a request for transferring the stock to a broker. Also, not all companies offer direct registration, so the pool of stock choices can be limiting.

Companies typically keep track of their securities issues by hiring a **transfer agent**, usually a bank or trust company. The transfer agent keeps records on who owns stocks and in what form, recording changes of ownership as they occur. It cancels stock certificates surrendered by the seller and issues new ones in the name of the buyer. It also may pay out dividends and send out proxy materials on behalf of the company.

Companies also hire a **registrar** to monitor and audit the transfer agent. The registrar makes sure that the transfer agent cancels old stock certificates whenever it issues new ones so that the company will always have the proper number of shares outstanding. Registrars also ensure that the company's files are kept current as to the owners of an issue. Registrars are usually banks.



## EXERCISE

### ANSWER TRUE OR FALSE.

1. **True or false. For equity investors, potential gains equal potential losses.**
2. **True or false. Treasury shares are a type of common stock that has voting rights and pays dividends.**
3. **True or false. The right of limited liability applies to only preferred stockholders of a corporation.**
4. **True or false. If common stock is held by direct registration, the security is listed on the issuer's books in the owner's name, and either the issuer or its transfer agent holds the security in book-entry form on the owner's behalf.**



## *Innovative Resources for Securities Exam Preparation*

5. **True or false. A stock bought by a customer and registered in the broker's name is said to be held in street name, with the broker as the beneficial owner and the customer as the record owner.**

### **ANSWER THE FOLLOWING QUESTIONS.**

6. **The current share price of Big Corporation is \$100. Big has authorized 10 million shares. It has issued 5 million shares and has repurchased 1 million of those shares. How many outstanding shares does Big Corporation have, and what is Big's market capitalization?**

- A. 5 million shares outstanding, \$500 million capitalization
- B. 4 million shares outstanding, \$40 million capitalization
- C. 1 million shares outstanding, \$5 million capitalization
- D. 4 million shares outstanding, \$400 million capitalization

7. **Put the following dates in the correct order in time:**

- I. Ex-date
  - II. Declaration date
  - III. Payment date
  - IV. Record date
- A. I, II, III, and IV
  - B. II, I, IV, and III
  - C. II, IV, III, and I
  - D. IV, I, II, and III

8. **If an investor wants to be eligible for a dividend previously declared with a record date of Friday, June 13, by what date should she purchase the common stock, and what is the ex-dividend date?**

- A. Purchase by Monday, June 9; ex-date Tuesday, June 10
- B. Purchase by Wednesday, June 11; ex-date Thursday, June 12
- C. Purchase by Tuesday, June 10; ex-date Tuesday, June 10
- D. Purchase by Tuesday, June 10; ex-date Wednesday, June 11

9. **If the par value of an equity security is set arbitrarily, has no relation to market value, and has little to no significance, why might a company set a positive (non-zero) par value anyway?**

- I. The level of the par value has accounting consequences.
- II. A non-zero par value can reduce a company's liability to its stockholders.
- III. It might be required by the law of the state the company is registered in.
- IV. It is used in the calculation of paid-in surplus.



## Innovative Resources for Securities Exam Preparation

- A. I and III
- B. I and IV
- C. I, III, and IV
- D. I, II, III, and IV

### ANSWERS

1. **False.** For equity investors, upside potential is theoretically unlimited, while downside risk is limited to the amount invested.
2. **False.** Treasury shares have no voting rights and pay no dividends.
3. **False.** The right of limited liability is a right of common stockholders also.
4. **True.** When common stock is held by direct registration, the security is listed on the issuer's books in the owner's name.
5. **False.** The broker is the record owner and the customer is the beneficial owner.
6. **D.** Outstanding = issued – Treasury (5 million – 1 million = 4 million), and 4 million x \$100 = \$400 million capitalization.
7. **B.** Remember DERP: Declaration, Ex, Record, Payment
8. **B.** The record date is Friday, June 13. Count back one business days for the ex-date, Thursday, June 12. The purchase date is the day before the ex-date, Wednesday, June 11.
9. **C.** As listed in I, the level of the par value has accounting consequences, as it is used in calculating paid-in surplus, recorded on the company's balance sheet as additional paid-in capital. As listed in III, state laws differ, but some states require that corporations registered there set a positive par value. As listed in IV, par value is used in the calculation of paid-in surplus.

---

## PREFERRED STOCK

---

Preferred stock is an equity security that looks in many ways like a debt security. It is an equity security because it represents an ownership share in a company. Like a debt security, however, preferred shares generate income from a fixed, regular monetary payment rather than a company's financial gains. Like a bond, a preferred stock's market price fluctuates with interest rates and creditworthiness, rather than a company's earnings and losses. As a result, preferred stock is *less* risky than common stock, but it offers less growth potential. It is *more* risky than debt, because companies can miss their regular dividend payments without being in default.



## *Innovative Resources for Securities Exam Preparation*

Preferred stock is “preferred” in the sense that it has a higher claim on a corporation’s dividends and residual assets than common stock. Dividend payments are distributed to preferred stockholders before any dividends are paid to common stockholders. When a company liquidates, preferred stockholders have first claim to its remaining assets compared to other equity holders. The price for these enhanced privileges is that preferred stocks generally come without voting rights and have no real share in the company’s profits.

### **Dividends**

As with common stocks, dividend payments for preferred shares are received quarterly. Unlike common stocks, dividend payments for preferred shares are determined when the stock is issued. A **fixed rate preferred stock** may set its dividend payment at a fixed dollar value (\$5), or it may be based on a percentage of the par value of the stock as stated on the stock certificate (5%). A **floating rate or adjustable-rate preferred stock** will have an adjustable dividend based on some formula, such as 1% above the interest rate on 90-day Treasury bills.

Dividends are not a fixed obligation of the company, like the interest rate on a bond: they come out of earnings and a company may elect not to pay them. However, if common stockholders are offered a dividend, the preferred shareholders will receive their stated amount before the common shareholders receive their first dime.

#### **EXAMPLE QUESTION**

**XYZ issues preferred stock with a 10% annual dividend. The par value on the preferred stock is \$100 per share. The share price of the preferred stock is \$110, and the share price of the common stock is \$200. What is the quarterly per-share dividend on the preferred stock?**

**Answer: \$2.50.** The annual dividend would be par value times dividend rate ( $\$100 \times 0.10 = \$10.00$ ). The quarterly per-share dividend will be \$2.50. The current price of the preferred stock and common stock are irrelevant to calculating the dividend.

### **Liquidation**

Chances are excellent that the liabilities of a company in Chapter 7 bankruptcy exceed the value of the company’s assets. Therefore, when those assets are liquidated, at least some creditors are going to receive less than they are owed—and in some cases, nothing at all. The bankruptcy priority rules prescribe the order in which creditors are paid and thus determine which creditors get made whole and which are doomed to the land of cliché (taking a haircut, holding the bag, coming up short, or getting stiffed).

A “claim” in bankruptcy is, broadly speaking, a right to payment, including disputed or contingent rights



*Innovative Resources for Securities Exam Preparation*

to payment. Claims in bankruptcy are either secured or unsecured, and the rights of a creditor or investor depend on which of these categories its claims fall into.

A **secured claim** is a claim that is secured by a perfected lien, a security interest, or pledge of collateral, which might be real estate, equipment, cash, receivables, or other assets. A perfected lien is a lien that has been filed with the correct legal authority, typically a county or a court, giving the lien priority over other potential claimants to a property. **Secured creditors** enjoy the highest priority status of any creditor: they are paid from the collateral securing their claims before any unsecured creditor gets paid. Where there are multiple secured creditors, the creditors with senior claims—a first lien position, for example—are paid before secured creditors with a more junior position.

From a creditor standpoint, **senior secured debt** is the best class of corporate debt to hold. A company’s primary credit facility, such as a revolving line of credit, is typically senior secured debt that may be secured by a lien on all corporate assets. If the company owns real property, the mortgage on the property may be senior secured debt. In a liquidation, senior secured creditors get paid first.

**Junior secured creditors** also have secured claims in bankruptcy, but their claims have a lower priority than, and are thus subordinated or “junior” to, those of senior secured creditors. This subordinated status may be simply a function of timing, or may be the result of a subordination agreement. In either case, although junior secured creditors are paid off after senior secured creditors, they are repaid before, and thus are senior to, all unsecured creditors. For this reason junior secured debt is sometimes referred to as **senior subordinated debt**.

All other claims made in a bankruptcy are unsecured claims. Unsecured claims are in turn divided into **priority claims** and **general unsecured claims**.

The following are the priority unsecured claims most relevant to business liquidations, in descending order of priority (i.e., claims higher on the list get paid first):

- Claims for **administrative expenses** of the bankruptcy, including trustee fees, legal and other professional fees.
- Claims for **unpaid wages, salaries, and commissions** due workers, if earned within 180 days before the bankruptcy filing, up to a maximum of \$10,000 per person.
- Claims for **unpaid contributions to employee benefit plans** arising for services performed within 180 days before the bankruptcy filing, subject to a maximum of \$10,000 per employee covered by the plan, less the claims for unpaid wages to be paid to such employees in the bankruptcy.
- Claims for **customer deposits** for goods or services intended for personal, family or household use, up to a maximum of \$1,800 per person.
- **Taxes** due to a government agency. (If the IRS filed a tax lien prior to a bankruptcy filing, however, the IRS is treated as a secured creditor.)

All other unsecured claims are non-priority, or general unsecured claims. General unsecured creditors are





## *Innovative Resources for Securities Exam Preparation*

near the bottom of the bankruptcy food chain, and their claims get paid only after all secured and priority unsecured claims are satisfied. Within the general unsecured class, some bonds, such as non-convertible debentures, may be senior and others—convertible debt, for example—may be subordinated.

If there is money left over after all higher-priority claims, including general unsecured claims, are paid off, the debtor's owners are paid. Preferred stockholders are paid first, up to the amount of the par value of the issue. In the unlikely event money remains after everyone else has been made whole, the claims of common stockholders are paid last.

---

### **PRIORITY IN LIQUIDATION**

---

#### **Secured Creditors**

- Senior secured debt
- Junior secured debt

#### **Unsecured Creditors**

- Administrative expenses
  - Unpaid wages, salaries, and commissions
  - Unpaid contributions to employee benefits
  - Customer deposits
  - Taxes
  - General debentures
  - Convertible debentures
  - Preferred stock
  - Common stock
- 

## **Issuance of Preferred Stock**

Companies generally issue preferred stock when the sale of bonds or common stock is not feasible. For example, a company seeking to acquire the assets of another company in a merger may issue preferred stock to use in exchange for the other company's assets so as not to dilute its own voting control. A company with unstable earnings may issue preferred stock, because it is discouraged by the high interest payments it faces in the bond market. Or a company may wish to maintain liquidity on its balance sheet by avoiding the legal obligation of paying periodic interest on a bond. Alternatively, a company may issue preferred stock because of market demand.

Preferred stock returns can be particularly attractive to corporations, which receive a 70% "dividend received" tax deduction on preferred dividends.



## *Innovative Resources for Securities Exam Preparation*

### **Value at Issuance**

---

Unlike common stock, preferred stock certificates have a face value, or par value, that actually means what it says. The par value of a share of preferred stock is usually either \$25 or \$100, but for the exam, you are more likely to see questions referring to preferred stock as \$100. Par value represents the claim of the preferred stockholder against the value of the firm. Put another way, it is the amount of money received from the initial sale of the stock. Unlike a bond, however, preferred stocks generally do not have a maturity date but last in perpetuity, that is, throughout the life of the corporation.

### **Transfer of Preferred Stock**

---

Preferred stocks trade freely in the secondary market, but price fluctuations are caused by changing interest rates, not company earnings. As with bonds, a preferred stock appreciates in value with falling interest rates and depreciates with rising interest rates. Since they behave more like bonds, preferred stocks tend not to fluctuate as dramatically in price as common stocks.

Preferred shares are mostly held by corporations, which can deduct 70% of a dividend from their taxable income. Individual investors must pay taxes on the full dividend received, though usually at the 15% qualified dividend rate. However, dividends are taxed as ordinary income when individuals have not owned the stock beyond a given “holding period” or when they hold the stock of their employer.

### **Classes of Preferred Stock**

Corporations that offer preferred stock often have different issues outstanding at any one time, each with different qualities and degrees of preference. One of the issues, for example, is usually designated to have the highest priority to receive dividends. **Prior preferred stock** has first call on dividends in case a company has insufficient funds to meet the dividend payment of all preferred classes. **Preference preferred stock** receives preference over all other classes of the company’s preferred except for prior preferred. If a company offers more than one issue of preference preferred, then the various issues are ranked by their relative seniority. Because its dividend payments are relatively more secure, prior preferred stock usually has a lower yield than the other classes of preferred stock.

Besides degree of preference, different issues of preferred shares vary in the quality of their rights to dividends. **Cumulative preferred stock** allows dividends to accumulate when a payment is not made. If a corporation misses a dividend payment, it will have to pay the accrued dividend the next time it offers one, before it pays common stockholders. **Non-cumulative preferred stock** does not accrue unpaid dividends. Few companies issue such shares since they are unattractive to investors, but terms may sometimes be added to improve their value, such as fixing the number of allowable missed payments or automatically granting voting rights when a payment is missed.

**Participating preferred stock** allows investors to receive extra dividends when the company exceeds



## *Innovative Resources for Securities Exam Preparation*

some predetermined financial goals. Investors will always receive their regular dividend but may also participate in a company's accelerated growth. Participating preferred also often receives a greater claim during liquidation than non-participating preferred. For example, participating preferred may receive 120% of its invested value rather than 100% of its invested value. Participating preferred stock is extremely rare. Most preferred stock is non-participating.

**Convertible preferred stock** also allows shareholders to participate in the growth of a company. These investors have a one-time opportunity to convert their preferred shares to common stock at a set **conversion ratio**. This exchange may occur any time at the investor's sole discretion. If a \$25 certificate may be traded for five shares of common stock (or for \$5 per share) and the common stock rises to \$10, the price for the preferred stock in the secondary market will rise to around \$50 (\$10 x 5 shares). The preferred shareholder has the option to sell the certificate or convert the issue and receive five shares of stock.

### EXAMPLE QUESTION 1

**Ruby Red Jewelry has issued both common stock and cumulative preferred stock. The cumulative preferred stock pays an 8% annual dividend on stock with a \$100 par value. Ruby Red Jewelry has not paid a common or preferred dividend for two quarters. It has committed to pay a \$2 per share dividend to its common stockholders. How much will it be required to pay its preferred shareholders per share?**

- A. \$0
- B. \$2
- C. \$5
- D. \$6

**Answer:** D. Before Ruby Red Jewelry can pay its common stockholders a dividend, it must pay its cumulative preferred shareholders their dividend and all missed dividends. Ruby Red must pay \$2 per share for each quarterly dividend ( $8\% / 4 \text{ quarters} \times \$100 = \$2$ ). It must pay two missed dividends and the current dividend, for a total of \$6.

### EXAMPLE QUESTION 2

**A \$100 convertible certificate is issued in March 2011. The stock pays 4% in dividends and is convertible at \$20. The price of the company's common stock at issue was \$10.27 per share. On the conversion date of March 15, 2015, the common stock is at \$13.10 per share. What is the conversion parity price for the preferred share if the shareholder converts on the conversion date?**

- A. \$51.35
- B. \$20.00
- C. \$65.50
- D. \$100.00



## Innovative Resources for Securities Exam Preparation

**Answer:** C. The convertible price tells the shareholder how many shares of common stock she will get for one share of preferred stock. To find the number of shares, divide the convertible price into the face value of the preferred stock. In this example, it is  $\$100 / \$20 = 5$ . Thus, the conversion ratio is 5; the shareholder will receive 5 shares of common stock upon conversion. The conversion parity price is the current market value of the preferred share if converted. It is calculated by multiplying the current market price by the number of shares,  $\$13.10 \times 5 = \$65.50$ . This means that the \$100 convertible certificate, if converted on March 15, would become worth \$65.50, constituting a loss of value of \$34.50.

### Maturity

---

Most preferred stocks have no maturity date, and dividends are meant to be paid as long as the company is in business (**perpetual preferred stock**). Preferred stock with **delayed perpetuity** will defer the first dividend payment to some future year after issuance but continue payments into perpetuity.

Sometimes, a company will issue **term preferred stock**, in which it will repay the par value of the stock in cash or in common shares at a set maturity date of, say, ten years. Term preferred stock may include a sinking fund provision, requiring the corporation to set aside funds for the orderly or eventual redemption of its outstanding securities. A sinking fund provision often requires that a fixed number of securities be retired each year. Default in providing the sinking fund may result in penalties, but it is not as serious as defaulting on a loan. Typical penalties might prevent a company from using cash to pay common stock dividends or to repurchase its stock.

Many preferred stocks are also redeemable. **Callable preferred stock** gives the issuing company the right to call in its shares after some prescribed date at a prescribed price. An issuer will usually choose to call in the stock if interest rates drop and the issuer can issue new preferred stock at a lower rate. Callable preferred shares are usually redeemed at a premium to par. For example, if the shares have a par value of \$100, the investor may receive \$110 to redeem the shares. Callable preferred stock tends to pay higher dividends than non-callable stock to compensate for the fact that the stock may be called.

Less common is **putable preferred stock**, which allows investors the right to force the company to buy back their shares under conditions initially set by the company.

### Protective Provisions

**Protective provisions** are a relatively standard feature of preferred stocks, often written into a company's certificate of incorporation. Protective provisions permit preferred shareholders to veto certain actions by the company, such as the sale or merger of the company and the raising of capital. They are designed to protect the preferred stockholders, the minority shareholders, from the unfair dilution of their investment by the common shareholding majority. These veto rights extend to:

- Any sale or dissolution of the company



## Innovative Resources for Securities Exam Preparation

- The issue of new shares of stock
- The issue of new debt beyond some stated amount
- A change to the certificate of incorporation or bylaws
- Changes to any rights of other shares that give better rights than their preferred shares

Protective provisions also protect one class of preferred shareholders against another. Series A preferred shareholders, for example, might object to the issuance of a Series B preferred that would have rights senior to their own. Preferred stockholders can veto a corporate action with a 50% or greater majority vote.

### COMPARISON OF COMMON AND PREFERRED STOCK

	Common	Preferred
<b>Market price</b>	Market price fluctuates with issuer's profits and losses	Market price fluctuates with interest rates and issuer's creditworthiness
<b>Risk</b>	More risky, but more growth potential	Less risky, but less growth potential
<b>Voting rights</b>	One per share	None
<b>Income production (dividends)</b>	May receive a share in company's profits in the form of dividends Dividends may or may not be paid regularly Participate in the company's growth through appreciation in stock price	When dividends are paid, they are paid as a fixed percentage of par (5% of par) Dividend payments go to preferred stockholders before common stockholders
<b>Priority during liquidation</b>	Common stockholders are last in line	Higher claim on assets than common

## RIGHTS AND WARRANTS

### Warrants

A **warrant** is a financial instrument that gives the holder the right to purchase securities from the issuing company at a specific price within a specified time frame. The time specified for a warrant usually extends from two to ten years. By allowing the purchase of shares from the issuing company, warrants tend to increase the number of shares outstanding in the market and dilute the holdings of existing shareholders.

Warrants are usually offered in conjunction with a new issuance of equity or debt as a sweetener to entice investors. For example, a bond issue may include a warrant for the company's stock, allowing the company to



## *Innovative Resources for Securities Exam Preparation*

pay a lower yield on the bond issue. A new stock issue may prove more attractive to investors if a warrant is offered as part of the package.

Buyers of a warrant pay a **premium** for the right to buy a set amount of stock at a stipulated price called a **strike price**. This right to buy may be exercised at any time up to a stated **termination date**, after which the warrant will expire. At the time of issuance, the strike price normally is quite a bit higher than the price of the security, since the investor assumes that the company will prosper over time. If the market price at some point exceeds the strike price, the buyer may present the warrant to the issuer, buy the agreed-upon number of shares at the strike price, and resell the securities in the market at a profit.

The attractiveness of a warrant to a buyer is that one never risks more than the premium. Suppose as part of your purchase of a new issue at \$20/share, you buy a warrant for \$2/share at a \$25 strike price. If the company goes out of business, you lose the \$2 premium for the warrant and \$20 for the stock. On the other hand, if the stock doubles in value to \$40, you stand to receive a profit of \$13 on the warrant ( $\$40 - \$25 - \$2$ ). For the stock you bought outright, your profit per share is \$20. You gain the bulk of the upside profit for a fraction of the downside risk. This is called **leveraging** your risk.

 **Example:** Suppose when you buy 10 bonds of Hot Box Lunches Corporation, you receive 10 warrants for Hot Box Lunches stock. The stock is currently trading at \$20 per share, and your warrants have \$50 strike prices. Ten years later, Hot Box Lunches stock has risen to \$200 per share. You exercise your warrants and purchase 10 shares of Hot Box Lunches at \$50 per share. If you sell the stock at that price, you will have made \$1,500 ( $\$2,000 - \$500$ ).

In addition, warrants are transferable. They may be bought and sold on the market. The premium rises and falls in value as a function of the warrant's intrinsic value and its time value. **Intrinsic value** is the difference between the market value of the stock and the warrant's strike price. If the current market price of the stock remains below the strike price, its intrinsic value is zero. The **time value** of the warrant trends toward zero as its expiration date approaches. The less time before expiration, the less time a stock has to move in your favor.

## **Subscription Rights**

A subscription right is similar to a warrant but has a shorter life, usually lasting two to four weeks. Essentially, subscription rights originate when a company decides to raise additional money by offering additional shares of an existing stock to the public. This is called a **follow-on offering**.

When a follow-on offering occurs, current stockholders have a preemptive right to maintain their proportionate ownership share in a stock. The company will usually fulfill this right through a rights offering. During a rights offering, each shareholder is given one right for each share owned. The company will state a number of rights that can buy a share at a reduced price called a subscription price.

Shareholders who want to receive subscription rights must own the stock by a designated record date. Because stocks take two business days to settle, the stock has to be purchased at least two business days



## *Innovative Resources for Securities Exam Preparation*

prior to the record date to receive the rights. Those who purchase the stock after this day purchase the stock ex-rights, that is, without rights.

Rights unused by the expiration date lose all value and cease to exist. Like warrants, rights are tradable in the marketplace.

Shareholders are not required to exercise their right to buy the discounted stock. If not all shareholders exercise their subscription rights, the issuer may enter into an agreement with a standby underwriter, which agrees to purchase any shares that were not bought in the rights offering in a firm commitment. This is called a **standby underwriting**.

### **Stock Appreciation Rights**

A **stock appreciation right** is an option given to a company employee to receive a bonus equal to the appreciation in a set number of shares of the company's common stock. Stock appreciation rights are granted at a set exercise price, usually the fair market value of the common stock on the date they were granted. Stock appreciation rights have a vesting period during which the option cannot be exercised, usually one to three years, and they have an expiration date, usually ten years. Once vested, an employee can exercise the option at any time prior to the date of expiration. When the employee exercises the right, the employee receives the difference between the exercise price and the current market price of the stock. Payment may be made to the employee in cash or stock or both.

☒ **Example:** When you start your new job, the company grants you 1,000 stock appreciation rights at the current market price of its stock (\$15). After your three-year vesting period, the stock has risen in price to \$30. You decide to exercise your option. You will receive your choice of \$15,000 cash ( $1,000 \times \$15$ ) or 500 shares of the company stock ( $1,000 \times \$15 / \$30$ ).

Similar to stock appreciation rights are **employee stock option plans (ESOPs)**. These, too, are an option on the common stock of a company, but they are granted to employees as part of their compensation package. They are used as an incentive to get employees to stay and to improve a company's share price and performance. Employee stock options operate exactly like stock appreciation rights, except that the employee must pay the exercise price to receive the shares. With stock appreciation rights, the employee receives the difference between the grant price and the market price without having to shell out any money.

☒ **Example:** When he was hired, a member of the management of Hot Box Lunches, Inc., was awarded 1,000 stock options with an exercise price of \$30 per share. Five years later, the stock is now at \$100/share. He decides to exercise his stock options. He purchases 1,000 shares at \$30 and immediately sells them at the market price of \$100, for a profit of \$70,000 ( $\$100,000 - \$30,000$ ).

Neither stock appreciation rights nor employee stock options can be traded on the open market, since they are employment-related benefits.



## **AMERICAN DEPOSITORY RECEIPTS AND INTERNATIONAL SECURITIES**

---

Equity securities can be bought on international stock markets and may be a useful way to diversify one's equity holdings. Investors can access international stocks in a variety of ways. Some foreign stocks trade directly on U.S. exchanges. Foreign markets may also be accessed through a mutual fund or exchange-traded fund. Additionally, investors may make direct foreign investments or obtain American Depositary Receipts to make international investments more convenient.

### **Direct Foreign Investment**

Individuals who wish to invest in a specific international security on a foreign exchange may do so through their broker, who will contact a market maker in the host country to make a trade. Alternatively, they may set up their own account in that country with a local brokerage firm.

Investment in foreign securities comes with some unfamiliar risks. Disclosure information about a security is not always timely or accurate in some countries. Different accounting procedures can also make stock analysis difficult. In addition, unfamiliar regulations and taxes may increase investment costs, as will higher transactions fees and brokerage commissions in some markets. The transfer of funds from a foreign account to a domestic account may often be restricted or subject to taxation. Economic and political instability in a foreign country may undo the best analysis.

Exchange rate fluctuations are a risk that can operate for or against an investor. When one receives a dividend or sells a security, the cash received must be converted into U.S. dollars. If the dollar has been strong, the foreign earnings will translate into fewer dollars. If the dollar has been weak, earnings will increase. International securities can provide a lucrative market, but they do not come without a comparable risk.

### **American Depositary Receipts**

**American Depositary Receipts (ADRs)** offer an easier approach to international investment. An ADR is a certificate issued by a U.S. bank for the purpose of trading equity shares of a foreign-based corporation in the U.S. stock market. Created in 1927 by J.P. Morgan, ADRs are a convenient way to avoid many of the costs and inconveniences associated with currency exchange rates, foreign regulations, commissions, and other transaction costs. They permit American investors to buy and sell foreign securities within the safety of the U.S. stock markets.

Here's how they work. A bank in the U.S. purchases the issuing company's shares in the issuer's home country. This U.S. bank is called the depository bank. The depository bank deposits the purchased shares in a bank located in the issuer's country, called the custodian bank. The custodian bank is usually a branch of the U.S. depository bank. The depository bank then issues ADRs, which represent the shares held in the custodian bank, and sells them in U.S. markets.

An ADR certificate may represent more or less than a single share of the underlying stock. If the stock





## *Innovative Resources for Securities Exam Preparation*

is expensive, the depository bank may wish to make the price of its ADR comparable to similar stocks on American exchanges. In this case, one ADR may represent a fraction of a share of the stock. Likewise, if the stock is cheap, one ADR might represent several shares of the issuer's stock. ADR shares held in the custodian bank are called **American Depository Shares (ADSs)**.

The price of ADRs in the secondary market fluctuates like other stocks with supply and demand, but the **depository bank** will not let it deviate much from the price of the underlying stock. If the ADR is trading higher than shares in the domestic market, the depository bank will buy the cheaper foreign shares to hold in the custodian bank and issue more ADRs in the U.S. If the ADR is trading lower, the bank will buy back ADRs and sell shares held by the custodian bank until prices once again are in parity. Thus, the price of ADRs in the U.S. market closely follows the price of their underlying securities in the foreign market.

ADRs may be sponsored or unsponsored. An **unsponsored ADR** is one that is created as just described, by an investment bank. It is called unsponsored because the issuer has no role in the creation of the ADR. A **sponsored ADR**, then, is an ADR initiated by the foreign issuing company, which wishes to make its shares available in the U.S.

With a sponsored ADR, the issuer registers with the SEC and chooses a single depository bank to service and maintain the program. Sponsored ADRs have two advantages for the foreign issuer. First, certain stock exchanges, such as the NYSE, allow only sponsored ADRs to be listed. Second, only one U.S. depository generally sponsors an ADR program, whereas unsponsored programs may be duplicated without the issuer's consent. As to holders of sponsored ADRs, they have voting rights, as specified in the **Deposit Agreement** signed by the issuer and the depository bank.

Sponsored ADRs are the most common, and they come in three categories. A **Level I sponsored ADR** does not register with the SEC and can only be traded over-the-counter. These ADRs carry the most risk and disclose the least amount of information for investors. A **Level II sponsored ADR** must register with the SEC and comply with many U.S. reporting and accounting standards. **Level III sponsored ADRs** represent new shares that are being issued in an initial public offering, and they must comply with all U.S. rules and regulations. Both Level II and Level III are listed on U.S. stock exchanges.

---

### **CATEGORIES OF SPONSORED ADRs**

---

#### **Level I sponsored ADR:**

- Does not register with the SEC
  - Only traded over-the-counter
  - Highest risk
  - Least disclosure
-



*Innovative Resources for Securities Exam Preparation*

---

**CATEGORIES OF SPONSORED ADRs**

---

**Level II sponsored ADR:**

- Must register with the SEC
- Must comply with many U.S. reporting and accounting standards
- Listed on U.S. stock exchanges

---

**Level III sponsored ADR:**

- Must comply with all U.S. rules and regulations
  - Listed on U.S. stock exchanges
  - Most disclosure
- 

ADRs are subject to currency risk (also called exchange rate risk). Currency risk affects foreign investments and is the risk that as the U.S. dollar strengthens against the foreign currency, the value of the foreign investment will decline for the U.S. investor. ADRs are subject to currency risk because when the price of the U.S. dollar goes up, the price of the ADR will fall in U.S. dollars. But ADRs can also provide protection against a decline in the U.S. dollar—when the U.S. dollar falls, the price of the ADR increases in response.

As with common stocks, holders of ADRs are entitled to dividend payments if the issuer of the underlying stock declares a dividend. ADR dividends contribute to their exchange rate risk. The foreign company pays dividends in its own currency, and the depository bank distributes these dividends in U.S. dollars minus exchange costs and foreign taxes. If the value of the dollar rises, the value of the dividend will decrease, and vice versa.

Depository receipts are like ADRs, but they are created and sold in countries other than the United States. Global Depository Receipts (GDRs) are sold in countries throughout the world to broaden the issuer's markets or raise new capital. They act exactly like ADRs and are often denominated in U.S. dollars. Shares of GDRs are called Global Depository Shares (GDSs).

---

**REAL ESTATE INVESTMENT TRUSTS**

---

Real Estate Investment Trusts (REITs) differ from other real estate companies in that they are required to operate the properties they develop after they have built them, rather than selling them off. Most REITs specialize in a single type of real estate.

Investing in real estate can provide diversity to a portfolio and a nice rate of return if values appreciate over time. On the other hand, real estate can be an expensive investment. Liquidity can be limited due to unpredictable market conditions and lack of interested investors, especially for commercial or industrial real estate.

A **Real Estate Investment Trust** is a type of company that is modeled on a mutual fund. A REIT buys, develops, manages, and sells a portfolio of income-producing properties. Because a REIT is a trust, it



*Innovative Resources for Securities Exam Preparation*

sells shares of **beneficial interest**. The holder of these shares receives benefits from the assets held by the trust—in this case, real estate—but does not own the actual assets. By owning a REIT, investors can take part in real estate’s potential benefits, including price appreciation and income, without the added burden of owning and managing property.

REIT shareholders receive dividends from investment income (primarily rent). They also receive capital gains distributions when properties are sold. REITs do not pass through losses to shareholders, unlike a real estate limited partnership (RELP) or a real estate direct participation program (DPP). Another difference between REITs and real estate DPPs is that REITs acquire and develop properties mostly to keep in their portfolios, rather than to resell after development.

To qualify with the IRS, a REIT must uphold the following requirements:

- Annually, at least 75% of the REIT’s gross income must be real estate-related income (for example, rents). Additionally, 95% of its gross income must be from real estate sources *and* from dividends or interest from any source.
- At least 75% of its total assets must be invested in real estate.
- It must be managed by a board of directors or trustees.
- It must have a minimum of 100 shareholders (the “100 Shareholder Test”).
- It must distribute at least 90% of its income to its shareholders.

By meeting these requirements, a REIT is exempt from taxation for all income distributed as dividends. Any retained income is taxed at the corporate rate.

Many REITs are registered with the SEC, and their units are publicly traded on a stock exchange. These are **publicly traded REITs**. **Non-traded REITs**, or **non-exchange traded REITs**, also register with the SEC, but unit shares can only be bought through a broker that has been engaged to participate in the non-traded REITs offering.

The REITs described above are the most common and are called **equity REITs**. Two other categories of REITs are called mortgage REITs and hybrid REITs. Rather than owning and operating new real estate developments, **mortgage REITs** generally lend money to owners and operators of existing real estate by offering mortgages or purchasing preexisting mortgages. Mortgage REITs tend to rely more on borrowed money than equity securities for raising capital and are a riskier investment. **Hybrid REITs**, as you might guess, are companies that both own development property like equity REITs and offer real estate loans like mortgage REITs.

**Suitability**

As with ETFs, broker-dealers must analyze the suitability of REITs prior to offering them as part of their portfolio of products. They must also determine their suitability for the investment objectives, risk tolerance,



## *Innovative Resources for Securities Exam Preparation*

and trading sophistication of individual customers. Non-traded REITs have been under particular scrutiny in recent years because of issues related to transparency and limited liquidity.

### **HEDGE FUNDS**

---

A **hedge fund** is a fund that tries to achieve a positive return for its investors, even when market returns are negative. Hedge funds are similar to a mutual fund in that they pool investors' money and invest it in securities, but they usually try to avoid classification as a mutual fund so that they are not required to register under the Investment Company Act. Hedge funds avoid being called mutual funds by meeting one of two exemptions:

1. Limit the number of investors to less than 100 investors (up to 35 may be non-accredited, but the rest need to be accredited investors). An **accredited investor** is someone the SEC regards as wealthy or sophisticated enough to be able to make good financial decisions and absorb substantial losses.
2. Sell to qualified purchasers only. **Qualified purchasers** are individuals with more than \$5 million and institutions with more than \$25 million.

Hedge funds also differ from mutual funds in that they usually rely on broader investment strategies, such as investing in derivatives to hedge risk and increase leverage. Hedge funds may also invest in less liquid investments than mutual funds. For all these reasons, hedge funds tend to be riskier than other investment vehicles and, thus, may yield large gains or large losses. Because of their increased risk and illiquid nature, hedge funds are usually available to accredited investors only.

Unlike mutual fund shares, which can be redeemed at any time, hedge funds often have limited periods when shares can be redeemed (monthly, quarterly, or annually). Additionally, hedge funds are usually subject to lock-up periods when investors cannot redeem their shares in the first one or more years of investment, and hedge fund shares cannot be traded on an exchange. For these reasons, hedge funds are suitable only for customers who are willing and able to lock up their money for a long period.

Hedge funds set high minimum investment amounts for investors. High risk coupled with high-minimum investments make hedge funds a tool for wealthy individuals and institutions seeking high returns. Typical investors tend to be insurance companies and pension funds.

Investors in a hedge fund generally pay a management fee of 2% of their invested assets annually, plus 20% of the profit. Sometimes these fees are in excess of a certain benchmark threshold—say, 5%. Because of high fees and risk, a representative must make sure this type of investment is suitable for the customer. The investor must be known to be risk tolerant and be advised of the investment risks.



*Innovative Resources for Securities Exam Preparation*

**SAMPLE QUESTION**

**A particular hedge fund receives, annually, 2% of invested assets and 20% of any profits. In a year, an investor makes \$1 million in returns on a \$10 million investment. How much money will the hedge fund receive from the investor this year?**

- A. \$220,000
- B. \$300,000
- C. \$350,000
- D. \$400,000

**Answer: D.** The management fee will be \$200,000 (\$10 million x 0.02). The hedge fund would share in 20% of the profits. So 20% of \$1 million is \$200,000. In total, the hedge fund will receive \$400,000.

Hedge funds are subject to the same anti-fraud rules as other types of investments in the securities industry, and fund managers owe a fiduciary duty to the fund, meaning they must put the fund's interests before their own. After the financial crisis of 2008, the **Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010** required funds with over \$150 million in assets to register with the SEC.

Dodd-Frank also created a **Financial Stability Oversight Council** to track hedge funds by the size of their investments. Funds that the council considers "too big to fail" (that is, they must not be allowed to fail to avoid harming the economy) may be subject to regulatory oversight by the Federal Reserve. Finally, investment banks can now use hedge funds only on behalf of their customers and not to generate their own corporate profits.



---

## CHARACTERISTICS OF HEDGE FUNDS

---

- Differ from mutual funds in that they usually rely on broader investment strategies, such as short-selling and investing in derivatives to hedge risk, speculate, and increase leverage
  - Often invest in long-term, illiquid investments
  - Riskier than other investment vehicles, such as mutual funds, and may face high returns and high losses
  - Because of their higher risk and illiquid nature, hedge funds are for institutions and wealthy individuals
  - Often have limited periods when they can be redeemed (monthly, quarterly, or annually), unlike mutual funds, which can be redeemed at any time
  - Often organized as limited partnerships
  - Provide information to investors in private offering memorandum or private placement memorandum
  - Usually subject to lock-up periods: investors usually cannot redeem shares in the first one or more years of investment
  - Though exempt from registration, subject to antifraud provisions of securities laws
- 

# SUMMARY

## CORPORATE DEBT SECURITIES

Borrowing is the other way for a company to raise money. Unlike you and me, however, corporations don't have to stand in line at the bank, papers in hand, and apply for a loan. Instead, companies can issue debt securities called bonds. Debt securities have the advantage of allowing business owners to raise capital without diluting their ownership and operating control of their business. On the other hand, missing an interest payment on a loan is less forgiving than missing a dividend payment. As with someone who doesn't pay on their credit cards, not paying creditors can ruin a company's credit rating. Businesses generally seek a balance between equity and debt financing, based on the size of their operation, their profitability, their cash flow needs, and the nature of their assets.

## GENERAL FEATURES OF BONDS

---

Corporations and other organizations borrow capital by issuing **bonds**. A bond is a *promise-to-pay* issued



## *Innovative Resources for Securities Exam Preparation*

by the borrowing company for the amount of money lent by the bondholder. The company that issues the bond promises to return a specific amount of money to the lender by a certain date and to deliver a periodic interest payment on the borrowed funds. Bonds have a **maturity date** ranging from 1 to 20 years or more. This is the date the bond must be **redeemed**, that is, when the amount of money originally borrowed, the **principal**, must be repaid.

The **interest rate**, also called the **coupon rate** or the **nominal yield**, is the percentage of the principal written on the bond certificate that must be paid annually as payment for the loan. For example, a coupon rate of 5% on a \$1,000 bond requires the issuing company to pay the bondholder \$50 interest annually. Interest is usually paid in two semiannual installments, and it must be paid religiously as long as the borrowing company is solvent. The coupon rate is a function of many factors, including the company's credit standing at time of issue, the term of the bond, prevailing interest rates, and any peculiar features the bond may have. Normally, longer term bonds carry higher coupon rates than shorter term bonds, and companies with lower credit ratings issue bonds with higher coupon rates than companies with higher credit ratings. This makes sense, because longer term bonds and lower credit ratings both mean higher risk for the investor, and as stated earlier, the interest rate that an investor requires hinges on perceived risk.

Sometimes a company will issue a bond that can be paid off or redeemed prior to its maturity date. A 20-year bond, for example, may be redeemable after the 10th year. This is known as a **callable bond**. An issuer may wish to redeem a callable bond when current interest rates drop lower than the bond's coupon rate. The company will pay off the bond and issue a new one at a lower interest rate. The investor, on the other hand, would prefer to keep the bond and keep receiving those higher payments. Because a callable bond presents higher risks to the investor, callable bonds generally command a higher coupon rate than a similar bond without that provision.

### **Maturity Structure**

New issues of bonds may be structured to mature in one of two ways. First, term bonds are those in which the entire issue is scheduled to reach maturity on the same date and offers a single interest rate. A corporation that issues \$20 million of term bonds with a maturity of 10 years must repay the entire \$20 million principal when the bond comes due.

Second, a serial bond is a bond issue whose maturities are staggered in equal installments over a specific time period. That same \$20 million might come due in \$2 million installments during each of the years of the bond's 10-year life. A serial bond with a balloon maturity has one maturity, most often the last one, which contains a disproportionately large amount of the principal.

Serial bonds have the advantage to the issuer of requiring lower interest expense over the life of the bond. As the principal is paid off with its scheduled redemptions, the reduced principal provides a corresponding reduction of interest payments.



## Bond Certificates

Bonds are normally issued in \$1,000 denominations, and they may take several forms. **Bearer bonds**, also called **coupon bonds**, are bond certificates that have no name printed on them and have coupons attached. Anyone who possesses these highly negotiable instruments may present a coupon to receive an interest payment or present the bond itself for payment at maturity. In addition, the owner can receive interest payments anonymously without having to declare them at tax time. As a result, the **Tax Equity and Fiscal Responsibility Act of 1982** prohibited their further issuance, although many 50-year bonds still remain active. Today anyone depositing coupons must present identification, which is instantly passed to the IRS.

**Registered bonds** are certificates issued to the bondholder with the owner's name printed on them, and they have no coupons attached. Instead, the issuer's transfer agent sends the interest to the bondholder when payments are due and the principal at maturity. Registered bonds can be transferred to another individual only with the signed endorsement of the owner, who must present the endorsed certificate to the transfer agent. The transfer agent will then cancel the certificate and issue a new one to the new owner.

Registered bonds, too, have largely been supplanted today by **book-entry bonds**. Owners of a book-entry bond do not receive a physical certificate. Instead, each bond issue has only one master certificate, which is kept at a securities depository. Ownership of book-entry bonds is recorded by computer at a central depository. Generally, brokers or dealers are listed as owners in place of their clients, who are the beneficial owners. The broker or dealer maintains its own records of beneficial ownership. The issuer's transfer agent forwards all interest and principal payments to the depository, which delivers them to the brokerage account.

### TYPES OF BOND CERTIFICATES

Bearer Bonds (Coupon Bonds)	Registered Bonds	Book-Entry Bonds
<ul style="list-style-type: none"> <li>• No name printed on them</li> <li>• Coupons are attached</li> <li>• Anyone who has possession of the bearer bond can receive interest payment</li> <li>• Interest payments are received anonymously</li> <li>• No longer issued, though some are still active</li> </ul>	<ul style="list-style-type: none"> <li>• Owner's name printed on them</li> <li>• No coupons attached</li> <li>• Interest is sent directly to the bondholder</li> </ul>	<ul style="list-style-type: none"> <li>• No physical certificate</li> <li>• Ownership recorded by computer</li> <li>• Interest is sent to a broker</li> <li>• Most common form of bond today</li> </ul>

SUMMARY





## EXERCISE

---

### ANSWER TRUE OR FALSE

1. **True or false. A bond's coupon rate depends on the creditworthiness of the issuer.**
2. **True or false. The Tax Equity and Fiscal Responsibility Act of 1982 prohibited the further issuance of registered bonds.**
3. **True or false. When book-entry bonds are held in street name, the beneficial owner is the broker-dealer.**
4. **True or false. All else equal, an investor would rather own a callable bond than a bond with a put feature, because the coupon rate is higher.**

### ANSWERS

1. **True.** The coupon rate depends on the creditworthiness of the bond, which depends on the creditworthiness of the issuer. An issuer with a strong credit rating will be able to borrow at a lower rate than an issuer with a poor credit rating. Risk is reflected in the coupon rate.
  2. **False.** The Act prohibited further issuance of bearer bonds, also known as coupon bonds, so investors would be identified for tax purposes.
  3. **False.** When book-entry bonds are held in street name, the investor is the beneficial owner.
  4. **False.** A callable bond will probably have a higher coupon rate than a bond with a put feature, but an investor may or may not prefer to choose a bond with higher risk (callable risk) in exchange for a higher coupon rate.
- 

## Corporate Notes

A **corporate note** is a debt security very much like a short-term bond, except for two factors. Bonds are underwritten by investment banks, meaning that the banks assume financial responsibility for getting the bond issue sold to investors. Notes are sold through broker-dealers, who provide no such guarantee. If the note issue goes partially unsold, the company will not get its money. Second, bond issues come in very large offerings and each new issue must be registered with the SEC. Corporate notes are sold on a regular basis in relatively small amounts and must be registered only once. They are typically registered through a shelf registration. Notes are a convenient way of providing certain companies with a steady cash flow. They may have a maturity of as little as 270 days or as long as five years.



## Terms of Payment

The nominal yield on a bond, also known as the interest rate or coupon rate, is the percentage of par value received annually as payment for the loan. Because coupon payments usually are made semiannually, the annual coupon payment generally comes in two installments.

**Example:** What are the interest payments on an 8% bond? Recall that corporate bonds have a par value of \$1,000. For an 8% bond, the annual interest payment is  $0.08 \times \$1,000 = \$80$ . Because coupon payments are typically made twice a year, the investor will receive \$40 every six months.

Market interest rates are constantly changing and may change dramatically during the life of a bond, but the nominal yield (NY) of a bond will always reflect the interest rate stated on the bond certificate. Suppose you want to sell your 6% bond in the market, and similar bonds are being issued today at 8%. No one is likely to pay \$1,000 to receive 6% (\$60 per year) when they can lend the same amount at 8% and receive \$80. Your bond will not attract potential investors unless you offer to sell the bond at a discount, that is, below its par value. A bond that sells below its par value is called a discount bond.

Investors who purchase a discount bond will receive periodic payments at that bond's coupon rate, which is lower than the nominal yield for a similar bond issued in today's market. The benefit of such a bond, however, is that investors receive the face value of the bond when it matures, which is greater than the price they paid for it.

In contrast to a discount bond, a premium bond is a bond sold above its par value. Suppose interest rates have fallen to 4% and you hold a 6% bond. You're not likely to be interested in selling such a bond and giving up its higher interest rate without receiving some sort of incentive, such as a premium above the stated value of the bond.

Current yield is a snapshot approximation that represents the return an investor might expect to receive if she purchased a bond today and held it for a year. It is calculated by this formula:

$$\text{current yield} = \frac{\text{annual coupon payment}}{\text{current market price of bond}}$$

**Current yield** is an approximate valuation, because the market price of the bond is constantly fluctuating due to changing market conditions. If an investor waits until tomorrow to buy the bond, it might have a different purchase price and, therefore, a different current yield.

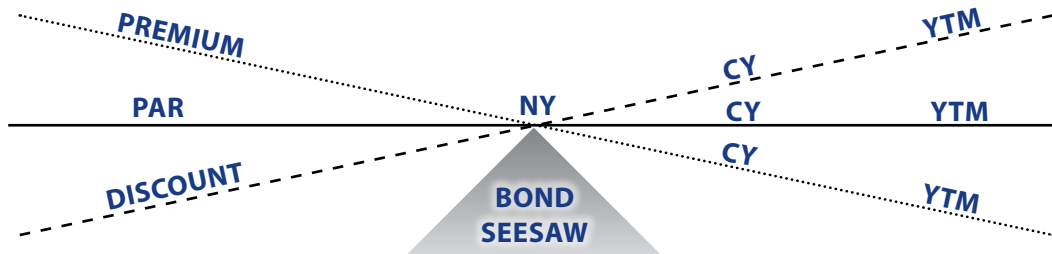
**Example:** What is the current yield of a 6% bond purchased at discount for \$960? The annual coupon payment is 6% times its par value ( $0.06 \times \$1,000 = \$60$ ). The annual coupon payment, \$60, divided by the purchase price of \$960 is 0.0625. Thus, the current yield is 6.25%.

**Yield to maturity (YTM)** is the anticipated yield of a bond that is bought and held to maturity. It is essentially the rate of return over the life of the bond based on its current value in the market. It differs from current yield in that its calculation includes the coupon rate, the price, and the maturity.



## Innovative Resources for Securities Exam Preparation

There is an inverse relationship between the price of bonds and yield to maturity. When a bond's yield to maturity goes up, the price of the bond goes down. When a bond's yield to maturity goes down, the price of the bond goes up, as shown in the figure below.



The yield for a callable bond, since it is likely to be redeemed at a call date before maturity, is called **yield to call (YTC)**. Yield to call is always higher than yield to maturity for a discount bond and usually lower for a premium bond, depending on the call price.

Another term that may be on the exam is **yield to worst (YTW)**. The yield to worst calculation is important to investors who want to know the minimum yield they could possibly receive from their bond investments. Yield to worst is the lowest yield of the yield to maturity, yield to every possible call date, and yield to every possible put date.

## SUMMARY

### YIELD SUMMARY

Type of Bonds	Yield Comparison
<b>Discount bonds</b>	nominal yield < current yield < YTM
<b>Par bonds</b>	nominal yield = current yield = YTM
<b>Premium bonds</b>	nominal yield > current yield > YTM

## Interest Rates and Bond Prices

As interest rates rise, the prices of bonds decline in the secondary market, because investors can invest their money in higher paying new issues. This is considered **market risk** for bond investors. Market risk is greater for long-term bonds than short-term bonds because there is more opportunity for interest rates to rise over the



## *Innovative Resources for Securities Exam Preparation*

bond's life. To reduce market risk, investors could invest in short-term bonds over long-term bonds, because when interest rates rise, the prices of long-term bonds fall faster than the prices of short-term bonds.

**Sensitivity to interest rates.** Because there is more time for interest rates to move in an undesirable way, the prices of long-term bonds are more sensitive to changes in interest rates than the prices of short-term bonds. Another way to say this is that long-term bonds have a higher duration than short-term bonds. **Duration** is a measure of a bond's sensitivity to changes in interest rates. Short-term bonds also tend to be more liquid than long-term bonds because investors don't have to tie their money up for as long a time period.

When interest rates fall, bond prices appreciate (increase). The price of discount bonds will appreciate faster than the price of premium bonds, because the increase in a discount bond will increase proportionally more than a similar premium bond. In other words, the change in the price is a greater percentage of the cost of a discount bond than a premium bond. For the same reasons discussed above, when interest rates rise, the prices of discount bonds depreciate faster than the prices of premium bonds.

### **Bond Points and Basis Points**

---

Bonds are quoted in the market in terms of their price and their yield to maturity. A bond "quote" just means the price at which a bond is trading, that is, its market price. The market price for bonds is quoted as a percentage of the bond's par value. Percentages are expressed in terms of bond points. A bond point represents one hundredth, or 1%, of par. Thus, ten bond points is 10% of par, and five bond points is 5% of par. Because corporate bonds typically have a par value of \$1,000, one bond point is equal to \$10.

Corporate bonds are typically quoted in increments of one-eighth (see first two examples, following). They may also be quoted in decimals of bond points (see third example, following).

1. A discount bond quoted at  $97 \frac{1}{8}$  will have a market price of 97.125% of par, or \$971.25 ( $\$1,000 \times 0.97125$ ). Another way of calculating this is first thinking that 97 bond points equals \$970. An eighth of a bond point is equal to an eighth of \$10, or \$1.25. So  $\$970 + \$1.25 = \$971.25$ .
2. A premium bond quoted at  $101 \frac{3}{8}$  will have a market price of 101.375% of par, or \$1,013.75 ( $\$1,000 \times 1.01375$ ).
3. A discount bond quoted at 97.5 will have a market price of 97.5% of par, or \$975 ( $\$1,000 \times 0.975$ ).

A bond's yield to maturity is expressed in terms of basis points. A basis point equals one hundredth of a percentage point, and it represents the smallest increment of change in a bond's yield.

One hundred basis points is 1%; 25 basis points is 0.25%. So when a bond's yield to maturity increases from 4.25% to 4.79%, the bond yield is said to have increased by 54 basis points.



## Yield Spread

Yield spread is the difference between a bond's yield and some benchmark yield. The most common spread compares the yield of a bond against the yield of a U.S. Treasury security of a similar maturity. Treasury securities are perceived to be virtually risk-free, so they serve as a useful benchmark to compare a bond's yield to. For example, you may want to compare the yield of a 10-year corporate bond with a 10-year Treasury note. If the 10-year Treasury note currently yields 1% and the 10-year corporate bond yields 5%, the yield spread is 4%. This means investors currently demand a risk premium of 4%, or 400 basis points, for the corporate bond because of its higher perceived risk. If the yield on the corporate bond declines to 3%, the yield spread or risk premium declines to 2%. A narrowing in the yield spread means bond investors are more confident the corporate issuer will not default. In contrast, when a yield spread widens, it means that investors are less confident that the issuer will continue to make its interest payments.

## Bid-Ask Spreads

The difference between the price at which investors are willing to buy bonds and the price at which investors are willing to sell them is called the **bid-ask spread**. The **bid price** is the maximum price a buyer is willing to pay, and the **ask price** is the minimum price a seller is willing to offer. A dealer who quotes a price of  $99 \frac{1}{8} - 99 \frac{7}{8}$  is indicating a willingness to buy at \$991.25 and sell at \$998.75. The spread represents the dealer's profit. The bid-ask spread is a key indicator of the liquidity of a security. A bond that trades at a smaller spread is generally one that trades more frequently (more liquid) than one that has a larger spread (less liquid).

### EXAMPLE QUESTION

**If the bid-ask spread of a corporate bond is  $98 \frac{3}{8}$  to  $99 \frac{7}{8}$ , what is the amount of the spread in dollars?**

**Answer: \$15.00.** Recall that the face value of a corporate bond is \$1,000. The bid price in dollars on a corporate bond is therefore \$983.75 ( $98 \frac{3}{8} = 0.98375 \times \$1,000$ ). The ask price is \$998.75 ( $99 \frac{7}{8} = 0.99875 \times \$1,000$ ). The spread is the difference between bid and ask ( $\$998.75 - \$983.75$ ), or \$15.00.

## Bond Ratings

Before a bond is issued, it is rated according to its creditworthiness. Private ratings services such as Standard & Poor's, Moody's Investors Services, and Fitch Ratings are hired by the issuing company to assess the financial strength of the company. Their evaluation of the company's ability to pay a bond's principal and interest in a timely fashion will determine the bond's coupon rate. The higher the ratings service's grade, the lower the coupon rate.

Bond ratings are expressed as letters ranging from AAA to D. A triple-A rating is the most desirable,



## Innovative Resources for Securities Exam Preparation

representing an investment grade bond with a minimal credit risk. To be considered **investment grade** a corporate bond must be rated a BBB- or better. BB+ or below are considered **non-investment grade**. Each of the services uses the same basic grading system, with some variations in style. The difference of a letter is called a “grade” (AA vs. A), whereas a number of the Moody’s or a plus or minus for S&P and Fitch are called a “notch” (AA+ vs. AA). Here is a sampler:

MOODY’S	S&P	FITCH	INVESTMENT GRADE / ABILITY TO MEET OBLIGATIONS
<b>Investment Grade</b>			
Aaa	AAA	AAA	Highest quality, minimum credit risk
Aa1	AA+	AA+	
Aa2	AA	AA	High quality, low credit risk
Aa3	AA-	AA-	
A1	A+	A+	
A2	A	A	Upper medium
A3	A-	A-	
Baa1	BBB+	BBB+	
Baa2	BBB	BBB	Medium quality, medium credit risk
Baa3	BBB-	BBB-	
<b>Non-Investment Grade</b>			
Ba1	BB+	BB+	
Ba2	BB	BB	Low quality, high credit risk
Ba3	BB-	BB-	
Caa1	CCC+	CCC+	
Caa2	CCC	CCC	Poor standing, high credit risk
Caa3	CCC-	CCC-	
Ca	CC	CC	Highly vulnerable
-	C	C	Extremely speculative
C	D	D	In default

The ratings agencies consider several factors in determining a company’s credit rating, including:

- Company’s history and corporate philosophy
- Surrounding economic, political, and regulatory environment



## *Innovative Resources for Securities Exam Preparation*

- Company's management structure and governance
- Company's financial position, debt structure, and sources of liquidity

In addition to grading the bonds at issuance, the agencies periodically review their ratings to determine whether these factors have changed significantly enough over time to have caused an increase or decrease of the bond's creditworthiness and to merit a change of its credit rating. You may see something in the financial news about a bond issue rating falling a notch or two. For example, "S&P has downgraded Hot Box Lunches 5% bonds two notches, from AA+ to AA-."

### **THE BOND INDENTURE**

---

To issue a corporate bond, an issuer must prepare a formal written document called a **bond indenture**, or **deed of trust**, and file it with the SEC. The bond indenture is the legal document that specifies the scope and features of the bond and holds the issuer to its terms. Specifically, the indenture must identify:

- Purpose of the bond issue and its features
- Conditions under which the bonds may be redeemed before maturity
- **Covenants** or promises that the issuing company makes with respect to its behavioral obligations over the life of the bond
- Procedures and remedies should the issuer default
- Rights and duties of the trustee

The issuer must appoint an independent trustee to protect the bondholders' rights as stated in the indenture. This third-party trustee, usually a bank or trust company, is responsible for authenticating the bonds and assuring that the issuer complies with all of the covenants specified in the indenture. The trustee also has the right to seize the bond issuer's assets if the issuer becomes insolvent in order to protect the bondholders' rights to their investment. The bond indenture must be signed by both the issuer and the trustee.

By the **Trust Indenture Act of 1939**, bond indentures are required to be qualified by the SEC for all corporate bond issues valued at over \$5 million. Prior to 1939, the indenture trustee was frequently aligned with the issuer of the debt instrument and was exempted from liability for non-enforcement.

The Trust Indenture Act requires a bond issue to be registered and "qualified" by the SEC before becoming effective. Qualification requires the issuance of an indenture and SEC acceptance of the eligibility of the designated trustee. Among its other requirements, the act prohibits provisions that relieve the trustee from liability for negligence; additionally, trustees who later become a creditor of the issuer must establish certain accounts for the benefit of the bondholders should the issuer default on the loan.



## Protective Covenants

Because the value of a bond depends on the financial strength of the issuing company, indentures usually include **covenants** to place limits on the issuer's management of its company. A default or violation of any covenant can serve to alert investors of a potentially deteriorating situation. In that sense, covenants are a risk management tool for bondholders. Protective covenants require that the issuer take certain actions in case of default, while negative or **restrictive covenants** impose limitations on the issuer. Both serve to increase the market value of the bond and reduce its chance of default. Restrictive covenants also have value to the issuer because they allow bonds to be offered at a lower yield. A safer bond will have a lower yield.

Every bond indenture is different, but restrictive covenants may feature these general characteristics:

- **Restriction on indebtedness.** New borrowing by the issuer is limited past a given level and any new senior debt may be prohibited.
- **Restriction on payments.** A company's cash outflows, dividend payments, acquisitions, and investments may be restricted to a certain percentage of its net income.
- **Restriction on liens.** A company's ability to secure future debt with its assets may be restricted. Alternatively, unsecured bonds may automatically become secured when new secured debt is issued. This will become clearer momentarily.
- **Restriction on asset sales.** Assets may not be sold unless the proceeds are used to reinvest in the business or pay back bondholders at par.
- **Restrictions on mergers.** Mergers may be prohibited unless (1) the issuing company is the survivor, (2) the net worth of the new company is at least 95% of its net worth prior to the merger, and (3) the new company can issue at least \$1 of new debt. Bondholders may be allowed early redemption in the event of a merger.

Examples of **protective covenants** requiring the issuer to take action are as follows:

- **Change of ownership control.** If the controlling ownership when the bonds were issued subsequently loses its controlling interest, the issuer may be required to buy back the bonds at 101% of par, if the bondholder so desires.
- **Acceleration in case of default.** If a default occurs, the issuer may be required to accelerate the maturity of some or all of the debentures, which will become due and payable.
- **Release of mortgaged property.** For a mortgage bond, if mortgaged property is sold or released





## *Innovative Resources for Securities Exam Preparation*

from the mortgage, other property must be substituted and made subject to the lien, or bonds must be retired in sufficient amounts to maintain the adequacy of the collateral.

A bond covenant, once established, is extremely difficult to change. To request a change, the issuer must generally write an amendment to the bond indenture. If the trustee agrees to the change, the bondholders will be permitted to vote on the change, with a supermajority often required for the change to take effect.

Because every bond has a unique set of covenants, potential buyers must take them into account when analyzing the bond's attractiveness as an investment. A bond with weak covenants may be extremely risky relative to its stated yield and the issuer's financial standing. Strong covenants can attract investors even while offering them a lower yield.



## EXERCISE

### ANSWER TRUE OR FALSE.

1. **True or false. Nominal yield is different from coupon rate.**
2. **True or false. For a corporate bond, a coupon rate of 4.5% means an annual coupon payment of \$45.**
3. **True or false. Bonds rated below BBB- are considered non-investment grade.**

### ANSWER THE FOLLOWING QUESTIONS.

4. **The indenture includes all the following except:**
  - A. The purpose of the bond issue and its features
  - B. The conditions under which the bonds may be redeemed before maturity
  - C. The procedures and remedies should the issuer default
  - D. Provisions that relieve the trustee from liability for negligence
5. **What piece(s) of information do you need to determine if a bond is a discount bond or a premium bond?**
  - A. Par value
  - B. Market price
  - C. Nominal yield
  - D. Yield to maturity
  - E. Current interest rate
  - F. Investment grade



*Innovative Resources for Securities Exam Preparation*

6. **For par bonds, what is the relationship between nominal yield and current yield?**
7. **If the bid-ask spread of a corporate bond is  $97 \frac{1}{8}$  to  $99 \frac{5}{8}$ , what is the spread in dollars?**
8. **If a premium bond is quoted at  $102 \frac{1}{8}$ , what is its market price?**
9. **If a discount bond is quoted at 96.75, what is its market price?**

**ANSWERS**

1. **False.** Nominal yield is the same as coupon rate and interest rate.
2. **True.**  $4.5\% \times \$1,000 = 0.045 \times \$1,000 = \$45$ .
3. **True.** Bonds rated below BBB- are considered non-investment grade.
4. **D.** There are no such provisions that relieve the trustee from liability for negligence; such provisions are prohibited by the Trust Indenture Act.
5. **A and B.** A bond that sells below its par value is a discount bond and a bond that sells above its par value is a premium bond. You may be able to assume a bond is a discount or premium bond from its nominal yield and current interest rate, but the relationship of sales price to par value is the defining factor.
6. **For par bonds, nominal yield and current yield are equal.**
7. **\$25.** If the bid-ask spread of a corporate bond is  $97 \frac{1}{8}$  to  $99 \frac{5}{8}$ , the bid price is  $97 \frac{1}{8}\%$  of \$1,000, or  $0.97125 \times \$1,000 = \$971.25$ . The ask price is  $99 \frac{5}{8}\%$  of \$1,000, or  $0.99625 \times \$1,000 = \$996.25$ . The difference is  $\$996.25 - \$971.25 = \$25$ .
8. **\$1,021.25.** A premium bond quoted at  $102 \frac{1}{8}$  has a market price of  $102 \frac{1}{8}\%$  of \$1,000, or  $1.02125 \times \$1,000 = \$1,021.25$ .
9. **\$967.50.** A discount bond quoted at 96.75 has a market price of 96.75% of \$1,000, or  $0.9675 \times \$1,000 = \$967.50$ .

---

**SECURED BONDS**

---

Secured bonds are bonds backed by a property or some other real asset, such as physical equipment that acts as collateral for the loan. In the event of default, the property can be foreclosed and sold off to repay the bond. Secured bonds are considered high grade, safe investments, because they are paid off first, ahead of all other bondholders. Because they are a safer investment, they generally pay a lower yield.



## **Mortgage Bonds**

Mortgage bonds provide bondholders with a first lien on corporate property. Bondholders are given the right to sell the property if the corporation defaults on its payments. Trustees rarely have to seize property, however, since the company has strong incentives to find other means of paying its bondholders than selling off its hard assets.

## **Equipment Trust Bonds**

**Equipment trust certificates (ETCs)** are commonly issued by transportation companies. When an airline buys a fleet of new planes, it may decide to use an ETC to finance the purchase. ETCs are bonds in which a trustee sells the issue to investors and delivers the proceeds to the borrower, in this case the airline. The trustee holds legal title to the mortgaged equipment (the fleet of new airplanes), which it leases to the airline until the bond is paid off. The trustee collects rent from the airline, which it uses to send interest payments to the bondholders. Equipment trust certificates are considered the safest of corporate bonds, because the mortgaged equipment has a ready market and is easily transferable. If the company defaults, the trustee can lease the equipment to another company. Defaults on ETCs are more common in recessionary times.

## **Collateral Trust Bonds**

Collateral trusts are secured by financial assets, such as stocks and bonds. They are issued by companies that have few hard assets but significant amounts of securities. The indenture usually requires that the market value of the collateral securities always be greater than the face value of the bonds by a specified margin. Should it fall below this minimum, the issuer must provide more collateral to the trust.

## **Guaranteed Bonds**

Guaranteed bonds are backed by a firm other than the original issuer. Railroad companies are a common issuer of these bonds, and the guarantor is usually a parent company. While guaranteed bonds are technically a debenture since they are not secured by any hard assets, their credit quality is similar to a secured bond since both companies must make good on the bond.

## **UNSECURED BONDS**

---

### **Debenture Bonds**

Debentures are bonds not secured by a physical asset or collateral but rather by the “full faith and credit”



## *Innovative Resources for Securities Exam Preparation*

of the issuer. Generally issued by well-established companies with a high credit rating, debentures are purchased in the belief that the issuer is unlikely to default on the repayment. Less creditworthy companies may add protective covenants to provide assurance for the potential bondholder. Investors in debentures have a general claim on all assets not pledged to secure other debt. They also have a claim on pledged assets, to the extent that they yield greater value than is needed to satisfy secured creditors.

### **Subordinated Debentures**

These are debentures that will be repaid only after other corporate debts, including unsubordinated debentures, have been satisfied. These are generally issued by companies that have already borrowed a lot of money and need to borrow more. They have a high credit risk and must pay out higher yields.

### **Junior Subordinated Debentures**

As you might expect, junior subordinated debentures constitute a second issue of subordinated debentures and receive their claims after the holders of senior subordinated debentures have been paid. They have an even lower credit standing and must pay even higher yields.

### **High-Yield or Junk Bonds**

Non-investment grade bonds (BB+ credit rating or lower) are also known as junk bonds. Junk bonds are a type of unsecured or partially secured corporate bond that typically offers significantly higher yields as a risk premium to compensate for their lower credit rating. For this reason, junk bonds are also known as high-yield bonds. Non-investment grade ratings are usually given to companies that do not have a long track record or who have a questionable ability to meet their debt obligations.

For most of the twentieth century, all new publicly issued bonds were investment grade. The only junk bonds in the market were bonds that had once been investment grade but were downgraded by the issuing company's financial deterioration. Companies deemed to be speculative grade could borrow money only from commercial banks and finance companies. Not until 1977, an era of high inflation and curtailed bank lending, did the market for junk bonds materialize. They quickly caught on and by 1989 junk bonds had grown to a \$189 billion market.

Like other bonds, junk bonds generate a steady stream of income from a stated coupon rate. But where the price of investment grade bonds rises or falls based on the fall or rise of interest rates, junk bonds are generally shorter term and, partly for this reason, are less sensitive to interest price movements. In fact, junk bonds tend to act more like stocks in their market behavior than other bonds. This is because their low credit standing makes them particularly sensitive to market conditions and to the issuer's financial performance.

During a recession interest rates generally fall, as does a company's corporate earnings. Where falling



## *Innovative Resources for Securities Exam Preparation*

interest rates will increase the market price of bonds in general, the drop in corporate earnings dampens that impact on junk bonds and tends to drive their prices down. After recessionary periods, junk bonds have the potential for strong price appreciation as the economy begins to expand and corporate earnings improve, possibly leading rating agencies to upgrade their bond ratings. The price of investment grade bonds will drop, on the other hand, as the improving economy drives interest rates upward.

### **Convertible Bonds**

**Convertible bonds** are bonds that can be converted into shares of common stock (and sometimes preferred stock) at a fixed conversion ratio, which is stipulated in the bond indenture.

The **conversion price** is usually set at a premium to the market price of the common stock at the time that the bonds are issued. For example, if the common stock is trading at \$20 per share, the convertible bonds may be issued at a conversion price of 25% above the market price. This would be  $\$20 \times 1.25 = \$25$  per share. To get the **conversion ratio**, which is the number of shares of stock an investor receives for one bond, the bondholder can divide the conversion price into the par value of the bond. In this case,  $\$25$  into the \$1,000 par value = 40 shares per bond.

$$\text{conversion ratio} = \frac{\text{par value of the convertible bond}}{\text{conversion price}}$$

Suppose the convertible bond has a conversion ratio of 40 and the issuer's stock is currently selling at \$30. The conversion value of the bond is  $40 \times \$30 = \$1,200$ . If the bond happens to be selling at \$1,200, it is said to be at **conversion parity**. A price of a convertible bond will never vary far from its conversion parity because if it did, many investors would try to profit from the difference between a bond's conversion value and its selling price. This investing strategy of profiting from differences in prices across markets is called **arbitrage**. To illustrate, suppose a convertible bond has a conversion value of \$1,200 but is selling at \$1,160. An arbitrageur (a fancy word for an investor who wants to take advantage of this difference) purchases the bond and immediately converts it, making a risk-free \$40 profit. Because there are always arbitrageurs who will make a profit by doing this in quantity, bond prices never vary far from parity.

This convertibility feature means that the price of a convertible bond is usually tied to the price of the issuing company's common stock, allowing the bondholder to participate in the company's growth. While convertible bonds offer upside potential, they also offer downside protection because if the stock does poorly, the bondholder doesn't have to convert, and will simply receive the face value of the security at maturity.

Convertible bonds do have some credit risk in that if the company goes out of business, convertible bonds are lower on the liquidation priority list than non-convertible bonds. Because convertible bonds can be converted to stock, the price of convertible bonds is more related to the price of a company's stock than to changes in interest rates.



## *Innovative Resources for Securities Exam Preparation*

Issuers of convertible bonds are able to get away with offering lower coupon rates for non-convertible bonds because of the benefits of their convertible feature. So a disadvantage of convertible bonds to investors is their lower coupon rates. An additional disadvantage is that convertibles are relatively illiquid investments.

Convertible bonds come with another important downside: they are callable. If the stock price is below the conversion price at the call date, the issuer may choose to call the bond if interest rates have dropped and the issuer decides that it can issue a new set of bonds at a lower rate. In this situation, the bondholder will choose to receive the call price rather than convert the bond because converting the bonds would be less profitable.

If the stock price is at or above the conversion price and the issuer decides to call the bonds, the bondholder will choose to forego the call price, and convert the bond to stock because this option is more profitable. Thus, the issuer is essentially forcing the bondholder to convert the bonds into a predetermined number of shares of the company's common stock. This is often referred to as a **forced conversion**.

The potential of a forced conversion puts a cap on the appreciation of convertible bonds. An issuer of convertible bonds will typically not allow the stock's market value to rise too high before calling the bond and before forcing its bondholders to convert. For example, on a bond with a conversion price of \$25, the issuer may force conversion when the stock price rises to \$32. Once bondholders have converted their bonds, they no longer receive interest payments or the principal at maturity. Instead, they become stockholders in the company.

**Example:** On January 2, Reba purchases 5 convertible bonds issued by Choral Diagnostics, a pharmaceutical company that is working on several drugs to combat dementia. The bonds have a conversion price of \$25 and a conversion ratio of 40. They also have a coupon rate of 3.5%, and a call feature and a call price of 105 bond points (\$1,050). On April 1, Choral's latest drug is approved by the FDA and its share price rises to \$30. At the same time, the market value of Choral's convertible bonds rise to 115 bond points (\$1,150), and Choral decides to call the bond. Because Reba would receive the highest amount of money by converting ( $\$30 \times 40 \text{ shares} = \$1,200$ ), she decides to convert her bond to shares of stock. As a result, Reba loses the right to receive the regular interest payments that came with her bond and its principal. Instead, she now holds 200 shares of Choral's common stock (40 conversion ratio  $\times$  5 bonds = 200 shares of stock).

Companies issue convertible bonds for a few reasons. First, the convertible nature of the bonds allows the issuer to pay a lower interest rate. Additionally, each time the bonds are converted to shares of the company's common stock, part of the company's debt disappears. When this occurs, the company no longer needs to make interest payments and it is no longer obligated to return the former bondholder's principal at maturity. Finally, convertible bonds offer a way for an issuer to raise revenue while deferring dilution of its common stock. While investors in convertible bonds have the right to convert their shares, that is typically not done until the common stock's market price rises to a certain price, typically sometime in the future.



## Innovative Resources for Securities Exam Preparation

Thus, any dilution of common stock is delayed while the company still has access to the bond investors' principal payments.

Issuing convertible bonds means that as investors convert their bonds to stock, the number of outstanding shares of common stock increases, reducing the stock's earnings per share. Additionally, the number of voting shareholders increases, diluting each shareholder's stake in the company.

### ADVANTAGES AND DISADVANTAGES OF CONVERTIBLE BONDS

Entity	Advantages	Disadvantages
Investor	<ul style="list-style-type: none"> <li>Limited downside risk (will receive par value at maturity)</li> <li>Potential to profit from rise in stock price</li> <li>Benefits of both bonds and stocks</li> </ul>	<ul style="list-style-type: none"> <li>Lower yields than most bonds</li> <li>Illiquid</li> <li>Call feature caps gains</li> </ul>
Issuer	<ul style="list-style-type: none"> <li>Lower interest payment</li> <li>When converted to stock, debt vanishes</li> <li>Can raise money and defer dilution of stock</li> </ul>	<ul style="list-style-type: none"> <li>Potential for dilution of common stock at some point in the future</li> <li>Potential for decreased voting control of existing shareholders</li> </ul>

#### SAMPLE QUESTION 1

**A customer purchases a 6% XYZ convertible debenture at par for \$1,000. The bond is convertible at \$25. If the stock is selling at \$30 per share and the bond is sold at parity, what will it be sold at?**

**Answer: \$1,200.** First, find the conversion ratio by dividing the conversion price into the par value:  $\$1,000 / \$25 = 40$  shares of common for 1 bond. Then multiply 40 shares times \$30 to find the parity value ( $40 \times \$30 = \$1,200$ ).

Another way of doing it is to find the conversion value:  $\$1,000 / \$25 = 40$  shares per bond. Then subtract the current share price from the convertible share price to get the difference:  $\$30 - \$25 = \$5$  per share. Then multiply \$5 times the number of shares per bond, or  $\$5 \times 40 = \$200$ . Finally, add that \$200 to the bond's par value of \$1,000 to get the answer: \$1,200.

#### SAMPLE QUESTION 2

**A customer purchased a 6% XYZ convertible debenture at par for \$1,000. The bond has a conversion ratio of 50. The price of the stock has risen to \$25 per share. The bonds are trading 10% above parity. What can the customer sell his bond for in bond points?**



*Innovative Resources for Securities Exam Preparation*

**Answer: 137.5 bond points.** First, find the conversion parity value by multiplying the conversion ratio by the stock price: 50 shares x \$25 = \$1,250. Then multiply the parity value by 110% (\$1,250 x 1.1 = \$1,375). So the customer could sell his bond for 137.5 bond points.

**HYBRID BONDS**

**Income Bonds**

**Income bonds** are a long-term debt security in which the principal is usually secured by a mortgage, like a mortgage bond, but the coupon payments are strictly contingent on a company’s ability to pay, like preferred stock. They are not guaranteed. Income bonds are most often issued by financially strapped companies in an effort to avoid bankruptcy. Generally, companies offer income bonds to existing creditors prior to going into default in exchange for the company’s outstanding debentures, in an effort to make its capitalization more flexible and reduce its fixed charges. In such an instance, they are known as **adjustable bonds**. Income bonds are seldom accepted by investors out of choice. Faced with an insolvent company, a junior bondholder has no better option than to accept an income bond or lose her entire investment.

Income bonds may allow for the accrual of missed interest payments like preferred stock dividends, but as with preferred stock, there is no remedy to be had if payments are never made. Sometimes they offer creditors some of the voting rights of common shareholders. They also may be callable by the company at par.

**Zero Coupon Bonds**

A zero coupon bond (or “zero”) is one that makes no periodic interest payments. Instead, zero coupon bonds are issued at a deep discount to their face value, with the face (or par) value being delivered at maturity; a zero, thus, is a type of discount bond.

For example, a 20-year bond that has a par value of \$5,000 may have a \$1,000 issue price. A lower price means a greater return.

Zeros are attractive to the issuer (borrower) because they do not cost anything in terms of interest payments until the bond matures. They are attractive to the lender (investor) because they offer greater leverage. Instead of loaning \$5,000 for \$5,000 worth of bonds, in our example above, the investor needs to offer up only \$1,000, freeing the balance for other investments. However, even though zeros do not make interest payments, the IRS treats the discount as interest, and the bondholder will need to pay taxes on this “phantom interest” at his ordinary income rate. In our example above, the taxpayer would have to calculate the discount and divide by the number of years to find the annual interest payment (((\$5,000 – \$1,000) / 20 years = \$200 per year).

Another advantage for the bondholder is that zero coupon bonds lock in the current interest rate for





## *Innovative Resources for Securities Exam Preparation*

the life of the bond, eliminating reinvestment risk. If the investor had bought an interest-paying bond, the periodic coupon payments would need to be reinvested, possibly at lower interest rates than the coupon rate. With zeros, the coupon is effectively paid at maturity, meaning that it is always earning the prevailing interest rate at the time the bond was issued.

Deferred coupon payments also mean that zero coupon bonds offer the disadvantage of having a higher credit risk, since the entire investment is at risk until maturity. Credit risk is further enhanced by the fact that corporate zero coupon bonds tend to be offered in the high-yield (junk) bond market by companies that have the highest risk of default. As if that weren't discouraging enough, investors are required to pay federal income tax on accrued interest, as if interest payments had actually been made, leaving them with a negative cash flow.

With no periodic cash flows, zero coupon bond prices swing much more wildly in the secondary market from changes in market interest rates than other bonds. In other words, they have a high duration. Price fluctuations can be up to three times those of an interest-paying bond, and the longer the maturity, the greater the volatility. The reason is simple. With an interest-paying bond, the amount of coupon payments subject to interest rate swings gradually declines as semiannual payments are paid out. With zeros, every dollar remains at risk until maturity.

### **Eurobonds**

**Eurobonds** are a type of international bond and are unique primarily in the way they are issued. A Eurobond is denominated in a currency other than that of the country where it is issued (sold) or where the company is headquartered.

Typically issued by multinational corporations and national governments, Eurobonds are underwritten by an international syndicate and sold to a market dominated by institutional investors. The bonds may be issued and sold in Britain by a Kuwaiti company, for example, and denominated in yen. Whatever currency the Eurobond is denominated in will be the currency the principal and interest are paid in. Eurobonds may be denominated in any international currency.

Issuers of Eurobonds can choose to issue the bond in a country with the fewest regulatory constraints and in a currency most acceptable to the international market. Eurobonds are bearer bonds and thus provide anonymity to the owners and allow them to avoid paying taxes on the interest they receive. Issuers can therefore offer these bearer bonds at an even lower yield. **Eurodollar bonds** are Eurobonds denominated in U.S. dollars, meaning that the interest and principal will be paid in U.S. dollars, but the bonds will be sold outside the U.S. Since Eurodollar bonds are not offered to U.S. investors or issued on its shores, *they do not have to meet SEC registration requirements*, and the bondholders are not subject to U.S. taxes.



**SUMMARY OF BOND TYPES**

<b>Secured</b>	<b>Unsecured</b>	<b>Other</b>
Mortgage bonds	Debentures	Income bonds
Equipment trust certificates	Subordinated debentures	Zero coupon bonds
Collateral trust bonds	High-yield (junk) bonds	Eurobonds and Eurodollar bonds
	Convertible debentures	



**DEBT RETIREMENT**

The retirement of bonds does not always happen at maturity. Retirement may come early or late, it may be optional or mandatory, and it may be initiated by either the issuer or the investor. We have talked about bonds that are callable by the issuer, and we are about to talk about them some more. But bonds also may have put features, which allow the investor to force early redemption. Provisions for redeeming bonds are codified in the indenture. Let's take a look.

**Callable Bonds**

When interest rates go up, a company can retire its debt by buying its bonds in the open market at a lower price than principal. If trading volume is insufficient, the company might publish a **tender offer**, which is an offer to buy at a slight premium above the current market price to motivate bondholders to sell. Callable bonds come into play when interest rates go down. They come in several forms.

**Optional calls** allow the issuer to call the bond in whole or in part at its discretion for any reason. Generally a call option is exercised when the issuer can reissue the debt at a lower interest rate. What works for the issuer, of course, works against the creditor, who is forced to reinvest in the same lower yield environment.

But an issuer may exercise an optional call for other reasons in an interest rate environment that may not result in a loss for the investor. The company may wish to change the terms of the indenture, which might inconvenience the investor but not necessarily cause financial harm. Or the issuer may simply wish to reduce the amount of its debt.

Securities with optional redemption features come with higher yields than non-callable securities to compensate investors for their inconvenience and mitigate possible losses. Optional calls may also demand a **call premium** to mitigate the risk of a call. When a **call price** is set at a higher value than the face value of the bond, the difference is the call premium. A \$1,000 bond with a call price of \$1,100 has a \$100 call premium payable to the investor if the bond is called. Another safeguard is **call protection**, which prohibits



## *Innovative Resources for Securities Exam Preparation*

redemption during the first few years of the bond's life. The earliest date on which a bond is callable is called the **first call date**.

A second type of call provision is the **extraordinary call**, in which a company may redeem its bond if certain events occur that are specified in the indenture, such as an earthquake or fire. These calls may be optional or mandatory and are generally written to protect a company from an event that destroys a plant, or a project that disrupts the company's flow of income, particularly if the bond had been issued to build or complete it. Rather than continue making coupon payments, the company may find it prudent to redeem the bond and pay the bondholder with its insurance payment.

A third type of callable bond is the **mandatory call** or **sinking fund redemption**. Here, the issuer must put a portion of its earnings into a sinking fund to enable the redemption within a certain time frame. A mandatory call may provide for a partial redemption or the whole amount, and it may be scheduled at a specific point in time or whenever the sinking fund reaches a specified amount. How much money must be paid into the sinking fund, and over what time frame, is specified in the indenture.

When an issuer initiates a partial call, it must send out a notification letter at least thirty days in advance. The call may be accomplished in one of two ways. It may be made randomly, in which an impartial party, such as the Depository Trust Corporation, conducts a lottery to select which bondholders must redeem their bonds. Alternatively, the call may be executed on a pro rata basis, where all bondholders must give up a certain percentage of their holdings.

Bond issues with sinking fund provisions require the issuer to set aside periodic payments aimed at **amortizing** or reducing their debt. Monies are put in escrow at intervals stated in the indenture to provide for the retirement of all or some of its long-term debt prior to maturity. It is a binding obligation. The trustee may have the option to deposit the money in an interest-bearing bank account, invest the money in another company's bonds, or invest it in the company's own bonds by buying the issue in the secondary market.

Unlike other types of calls, a sinking fund redemption offers some protection to the investor. First, the existence of a sinking fund lowers the risk of default. Reducing credit risk is particularly critical in the extractive industries, whose coal, gas, and oil fields are at risk of going dry. Second, a sinking fund redemption is partial and fixed in time. Only a certain amount of the issue can be retired in any given year, and it will happen irrespective of market interest rates. Since the relative advantage is to the investor, however, bonds are redeemed at par value. Bondholders do not receive a call premium, as with other types of calls.



## TYPES OF CALLABLE BONDS

Optional Calls	Extraordinary Calls	Mandatory Calls (Sinking Fund Redemption)
<ul style="list-style-type: none"> <li>• Issuer can call bond for any reason</li> <li>• Often used to reissue bond at lower interest rate</li> </ul>	<ul style="list-style-type: none"> <li>• Issuer can call bond if certain events occur, e.g., flooding or act of God</li> <li>• Often used when an event disrupts company's flow of income</li> </ul>	<ul style="list-style-type: none"> <li>• Issuer must set aside earnings to redeem bond within a certain time frame</li> <li>• Often used in extractive industries at risk of going dry</li> </ul>

## Refunding of Bonds

The process of retiring outstanding bonds and issuing new ones is called **refunding**. Bond refunding may or may not involve an early redemption. A company may issue new bonds, called **refunding bonds**, whose proceeds have the sole purpose of being used to retire an existing issue, the refunded bonds. When an issuer uses the proceeds from the refunding bonds to retire the old debt immediately, subject to the bond's call provisions, it is called a **current refunding**.

However, refunding does not necessarily mean that the old debt must immediately be paid off by the new debt. A refunding in which the old issue remains outstanding for a period longer than 90 days after the issuance of the refunding bonds is called an **advance refunding**. The refunded bonds may remain outstanding until maturity or some future call date.

As long as assets sufficient to pay off the old debt are kept in escrow, the escrow account and the refunded bonds cancel each other out for legal and accounting purposes. The refunded bonds are said to be **defeased**, meaning that they are removed from the balance sheet as an outstanding loan, and the rights and liens of the bondholders on the assets of the issuer are terminated. The new refunding bonds have replaced them on the books.

**Defeasance** may serve any of several purposes. The refunded bond, which may have been secured by a mortgage, will now be secured exclusively by the escrow account, freeing up the previously mortgaged property for some other purpose. An advance refunding can also change the timing of the repayment of principal by replacing the old bond with another bond having a longer maturity. The refunded bond may also gain an increased credit rating because of the quality of the investments required in the escrow account. In fact, refunded bonds almost always increase to a AAA rating.

## Put Features

**Put bonds** allow the investor the discretion to redeem the bonds at par before the maturity date. A put makes the bonds more attractive to investors when rising interest rates force the price of bonds down. Investors can redeem the bond at par and reinvest the principal at the higher interest rates. They also offer



## *Innovative Resources for Securities Exam Preparation*

protection should the credit rating of the company deteriorate, reducing bond prices and raising the specter of default. Put bonds carry slightly lower yields than **straight bonds** and save the issuer interest expenses, but they require the issuer to set funds aside for early redemption. Because of their lower reinvestment risk, put bonds limit a bond's potential price depreciation: as interest rates rise, the price of a put bond will not go below its put price. Many put bonds are guaranteed by a third party, in case the issuer is unable to pay the bondholders.

### **Extension of Maturity**

---

Occasionally, a bond will be written that allows either the issuer or the investor the right to extend the maturity date. Such a bond might have a 10-year maturity, allowing for its extension to 15 or 20 years. Investors purchase them to take advantage of falling interest rates without assuming the risks of buying a longer term bond. If interest rates rise, they let the bond retire. If interest rates fall, they extend. Similarly, when the issuer has this right, he may choose to extend if interest rates soar.



## **EXERCISE**

---

### **ANSWER THE FOLLOWING QUESTIONS.**

**1. A bond is selling at a discount when its:**

- A. Coupon rate is higher than its yield to maturity
- B. Current yield is lower than its coupon rate
- C. Yield to maturity is higher than its coupon rate
- D. Yield to maturity is lower than its current yield

**2. Which two of the following statements are true about bonds?**

- I. The prices of short-term bonds fluctuate more than the prices of long-term bonds due to changes in interest rates.
  - II. The prices of long-term bonds fluctuate more than the prices of short-term bonds due to changes in interest rates.
  - III. Long-term bonds tend to be more liquid than short-term bonds.
  - IV. Short-term bonds tend to be more liquid than long-term bonds.
- A. I and III
  - B. II and IV
  - C. I and IV



## *Innovative Resources for Securities Exam Preparation*

D. II and III

**3. A bond will be more likely to be called when:**

- A. Interest rates rise
- B. Interest rates fall
- C. Interest rates are flat
- D. There is no relation between interest rates and when a bond is called

**4. What two types of risk are callable bonds most susceptible to?**

- I. Call risk
  - II. Default risk
  - III. Reinvestment risk
  - IV. Market risk
- A. I and IV
  - B. II and III
  - C. III and IV
  - D. I and III

**5. When is advance refunding most likely to occur?**

- A. When interest rates are low and the bond issue has not reached its call date
- B. When interest rates are low and the bond is past its call date
- C. When interest rates are high and the bond issue has not reached its call date
- D. When interest rates are high and the bond issued has passed its call date

### **ANSWERS**

1. **C.** The yield to maturity is higher than the coupon rate and the current yield when a bond is selling at a discount. A discounted bond also has a current yield that is higher than its coupon rate.
2. **B.** Because there is more time for interest rates to move in an undesirable way, the prices of long-term bonds are more sensitive to changes in interest rates than the prices of short-term bonds. Another way to say this is that long-term bonds have a higher duration than short-term bonds. Duration is a measure of a bond's sensitivity to changes in interest rates. Short-term bonds also tend to be more liquid than long-term bonds, because investors don't have to tie their money up for as long a time period.
3. **B.** An issuer will be more likely to call an issue of bonds when interest rates fall, because it can reissue new bonds at a lower rate.
4. **D.** While callable bonds are susceptible to all these types of risk, they are especially susceptible to call risk and reinvestment risk. Call risk is the risk that the bonds may be called before maturity, and reinvestment risk is the risk that the bondholder will get back his money early and have to reinvest it at a lower rate.



*Innovative Resources for Securities Exam Preparation*

5. **A.** Advance refunding is most likely to occur when interest rates are low and the issuer would like to lock in the low rates, but the bond issue has not reached its call date yet. The issuer cannot call the bonds, but it can issue new bonds at the low rate in anticipation of the call date.

**PORTFOLIO ANALYSIS**

**INVESTMENT GOALS**

Though many different factors should be considered when determining what investments to recommend to a customer, there are some basics to follow when defining investors and investments. First of all, how you invest your money is driven primarily by what you need the money for. Do you need it to buy groceries tomorrow? Do you need it for a down-payment on a house in the next five years? Or do you want to save it for retirement or for a trust for your future grandchildren? Knowing this can help you assess risk tolerance, and risk tolerance, in the world of securities and investing, is all about volatility and time horizon. How big are the swings you are willing to tolerate? If you need the money for groceries tomorrow, you can't afford any swings in the value of your portfolio, and you should have your money in cash. But if you're saving to buy a house in five years or saving 30 years for retirement ... you get the idea. So when talking to customers, a fundamental question is, when do you want to access the money you have invested?

Different customers have different investment goals, and recommendations should change depending on their goals. Four common goals are the following: capital preservation, capital appreciation, income, and speculation. **Capital preservation** means you don't want to lose your money. Safety first. **Capital appreciation** means growth, the dream of all investors. You want your investments to increase in value over time. If you are an **current income** investor, you want regular returns in cash (interest, dividends, and other distributions). If you are a **speculator**, you are willing to risk losing it all for the opportunity to win big. Speculators may have a short- or long-term time horizon, but the defining feature of a speculative investor is that she is willing to take great risk for the possibility of great gain. Viva Las Vegas!

**Preservation of Capital**

When customers are averse to any decline in the value of their investment, in the language of money, they want to "preserve their capital." Only the most conservative investments will satisfy this goal. FDIC-insured bank CDs, U.S. Treasury securities, and money market mutual funds would all be acceptable recommendations. Any type of investment that puts the principal at risk is not acceptable to this type of investor. But with the safety of these investments comes lower returns, and customers should be made aware that their



## *Innovative Resources for Securities Exam Preparation*

portfolio now faces purchasing power risk. In other words, the returns from their investments may not be able to keep up with inflation. This is a longer term risk, however, and their main goal is to avoid short-term dangers to their principal. Often, someone who seeks preservation of capital may need the money for a near-term expense, such as college tuition or a down-payment on a house.

### **Current Income**

---

Investors whose top priority could best be described as “current income,” or simply “income,” are looking for regular cash returns from their investments. Whether monthly, quarterly, semiannually, or annually, these investors seek investments that offer a predictable cash payout and are relatively stable. Current income investors are often retirees or individuals who need the income to meet their living expenses. Portfolios that need to generate regular and stable cash returns may invest in a combination of fixed-income securities, such as U.S. Treasuries, agency bonds, municipal bonds, and corporate bonds, as well as equities that emphasize income over growth, such as preferred stocks, REITs, and dividend-paying stocks. Stocks that pay no or a low dividend are unacceptable, as is any other investment that does not offer a regular cash return to the investor. Current income investors may also be concerned about minimizing taxes on investment income so that the maximum amount of money stays in their pockets. If a customer is in a high tax bracket and values current income, municipal bonds are an excellent choice because the interest earned is tax-free. More about the tax status of federal, municipal, and corporate bonds is covered later in this chapter.

REITs must pay at least 90% of their profits in dividends, and REITs also offer the possibility for capital appreciation. So they can be a good recommendation for those who want appreciation plus income. But remember, REIT dividends are taxed at the investor’s ordinary income rate, so they can add to an investor’s tax bill.

Current income investors face several risks that are associated with fixed-income securities. When interest rates rise, current income investors are exposed to interest rate risk because the value of existing fixed-income securities and dividend-paying equities drops. Interest rate risk can be somewhat mitigated by diversifying among several types of fixed-income securities and by “laddering”—investing in fixed-income securities with multiple maturity dates. Investing in a mutual fund or funds can also accomplish diversification and, thereby, reduce interest rate risk.

With default risk, also referred to as credit risk, current income investors face the possibility that the issuer of the income-paying security may not be able to make the payments or, even worse, cease to exist. This can occur, for example, when a REIT or dividend-paying company does poorly and has to reduce or eliminate its dividend or when a municipality goes bankrupt and can’t pay its bondholders. Current income investors also face purchasing power risk, because the returns they receive may not keep up with inflation. Current income investors are also subject to reinvestment risk because if they don’t spend all the income their investments are generating, they must reinvest it. If interest rates decline, mortgage-backed agency bonds, such as Fannie Mae and Freddie Mac, can be especially susceptible to reinvestment risk. When





## *Innovative Resources for Securities Exam Preparation*

interest rates drop, homeowners refinance at the new lower rates, which means Fannie Mae or Freddie Mac bondholders receive their principal back early and must reinvest their money at the new lower rates.

Typical current income customers are retired or soon-to-be-retired individuals who are no longer saving for retirement and who are ready to reduce the amount of risk they've been taking (less equities). Because these customers must use the income from their portfolio to live on, they prefer not to be subject to the gyrations of the stock market. By investing in fixed-income securities, such as bonds and dividend-paying stocks, which generate a regular stream of cash, their portfolio is less volatile. Current income customers may also include disabled individuals, parents of a disabled child, or guardians or trustees of a disabled individual.

### **Capital Growth**

An investor who seeks capital growth wants to increase the value of his investment over time. To do this, the investor must be willing to take risk and accept volatility in the value of his investments. Stocks are considered the best recommendation for an investor who wants to grow his principal. Over time, stocks produce higher returns than other investments. An equity investor is essentially participating in the business, albeit passively. By taking the risk and uncertainty that comes with being an owner of a business—some businesses do well, some do so-so, and some fail—equity investors are able to reap the long-term financial rewards that come with business ownership. Again, this is only appropriate for those who are able to live with the ups and downs of the market. This investment approach is highly relevant for anyone with a long time horizon, such as those saving for retirement, especially younger retirement savers who have the time to ride out the short- and medium-term ups and downs of the market, focused instead on maximizing appreciation over time.

So-called “growth stocks”—that is, the shares of smaller, faster-growing companies—provide the possibility for the greatest capital appreciation, but, and it is a big but, these stocks require a high risk tolerance and a long time horizon. Some small companies grow into big companies, some stay small, and some die, unable to survive the competitive economic jungle. Also, growth/small-company stocks are less likely to pay a dividend, which means, presumably, that the company is reinvesting any earnings into the business, and it is hoped doing this will build the business even more. For the investor, investing in small and/or growth stocks means accepting that growth will be in the form of appreciation, not dividends. Mutual funds and ETFs can be a good option for growth investors because they provide a diversified portfolio of stocks. For investors who do not have a long time horizon because they are older or need the money sooner, stocks from larger, established companies can be appropriate. Large-cap equity funds or ETFs may be appropriate for these investors.

### **Speculation**

Some investors may want to allocate a portion of their portfolio to speculation. These brave souls hope to make a profit from the rapid change in the value of an investment. With the potential for big or rapid gains



## Innovative Resources for Securities Exam Preparation

must come the acceptance of lots and lots of risk. Still, speculation in the markets probably has better odds than Las Vegas. So if your customer has the desire and the ability to play with fire, investments that have the potential to turn a small investment into a much bigger one in a short amount of time include penny stocks, derivative-like options, commodity futures, and any asset that may be unloved or out of favor at the moment. Speculation, however, is something that should only be done by those who can afford to lose and know how risky the activity is. These kinds of investments often come with disclosure documents to make sure that an investor knows what they are investing in. Speculative investors may be interested in opening a margin account to take advantage of the magnifying power of leverage.

On the exam, expect situational questions that require you to understand the risks associated with an investment and an investment goal. You must also be able to use that understanding to determine whether an investment is appropriate to recommend to a customer given his investment goals.

### INVESTMENT GOALS AND ASSOCIATED RISKS

Goal	Types of Investment Recommendations	Biggest Risks
<b>Preservation of capital</b>	<ul style="list-style-type: none"> <li>• Insured bank CDs</li> <li>• U.S. Treasuries</li> <li>• Money market funds</li> </ul>	<ul style="list-style-type: none"> <li>• Inflation risk</li> </ul>
<b>Current income</b>	<ul style="list-style-type: none"> <li>• U.S. Treasuries</li> <li>• Agency bonds (MBSs and CMOs)</li> <li>• Preferred stock</li> <li>• Bond funds</li> <li>• Corporate bonds</li> <li>• Municipal bonds</li> <li>• REITs</li> </ul>	<ul style="list-style-type: none"> <li>• Interest rate risk</li> <li>• Default/credit risk</li> <li>• Inflation risk</li> <li>• Reinvestment risk</li> <li>• Prepayment risk (for agency bonds)</li> </ul>
<b>Capital growth</b>	<ul style="list-style-type: none"> <li>• For aggressive investors, small-cap stocks or growth funds</li> <li>• For less aggressive investors, large-cap stocks or large-cap funds</li> </ul>	<ul style="list-style-type: none"> <li>• Market risk</li> <li>• Business risk</li> <li>• Potential loss of investment</li> </ul>
<b>Speculation</b>	<ul style="list-style-type: none"> <li>• High-yield bonds</li> <li>• Penny stocks</li> <li>• Derivatives, including options</li> </ul>	<ul style="list-style-type: none"> <li>• Potential loss of investment</li> <li>• Potential loss beyond investment</li> </ul>

SUMMARY



## **PORTFOLIO MANAGEMENT STRATEGIES**

---

### **Capital Appreciation vs. Income Management**

Capital appreciation investing usually means a portfolio filled with non-dividend-paying common stocks that have large growth potential. An important advantage of this type of investing is that capital gains will not be taxed until the stocks are sold, lowering a customer's annual tax bill. In addition, as long as the customer has a well-diversified portfolio and a long time horizon, the returns on growth stocks usually beat inflation and most other investments. A customer who desires capital appreciation typically has a long time horizon (younger or middle-aged), can tolerate risk, and does not require regular income. The biggest risk facing a capital appreciation investor is market risk. If there is a large drop in the overall market, this kind of portfolio will take a large hit. A way to minimize this type of risk is to buy puts on a broad market index. A put is an option that grants the holder the right to sell shares of the index at a specified price.

Income investing usually involves fixed-income securities that offer periodic interest payments. Fixed-income investors face several risks. Perhaps the greatest is purchasing power risk. If their total returns cannot keep up with inflation, they may be losing money over time. Default and credit risk are also a worry. If a company is downgraded, a bondholder may have difficulty selling his bonds in the market. Interest rate risk can also be a problem. If interest rates rise, the bondholder will have difficulty selling the bond unless he sells it at a discount. Finally, a fixed-income investor may face liquidity risk if he is unable to find a buyer for his securities. To minimize these risks, an income investor may prefer to fill his portfolio with other income-producing investments, as well as bonds, such as preferred stock, REITs, and dividend-paying stocks.

A third type of investor may want to blend the goals of income and capital appreciation. In this type of account, higher-dividend common and preferred stocks are purchased in the hopes that this income will contribute to the overall portfolio's return. Dividend-paying common stocks are typically ones that have higher dividend yields and lower price/earnings ratios. For example, if a target rate of return for a portfolio is 8%, ensuring that all the stocks in the portfolio pay at least 2% in annual dividends lowers the amount of capital appreciation needed out of the stocks to just 6%. One such famous income strategy worth noting is the "Dogs of the Dow" strategy. An investor using the Dogs of the Dow strategy buys the ten highest yielding stocks out of the thirty in the Dow Jones Industrial Average and holds them for a period such as one year.

Dividend-paying stocks can also provide some insulation from downturns in the markets. Filling a portfolio with income-bearing stocks can offset a market drop of up to the amount of income earned in the portfolio. Additionally, investors are often reluctant to sell their dividend-paying stocks in a down market, meaning that a portfolio full of these types of stocks may fare well, as other investors are slow to sell these positions.



## Diversification

There is perhaps no more well-known portfolio management technique than the basic concept of diversification. As the name implies, **diversification** is the process of making a portfolio that is over-concentrated in just a few positions more diverse with the goal of minimizing the portfolio's nonsystematic risk. In doing so, the customer seeks to reduce the possibility that poor performance in one position will destroy an entire portfolio's return. One strategy for achieving diversification is the buying of **uncorrelated** or **negatively correlated** assets, or assets that do not have a history of moving the same direction at the same time. Uncorrelated assets are those whose performances are unrelated to one another. When one asset is up, the other asset may be either up or down. Negatively correlated assets are those whose performances are directly opposite to one another. When one asset is performing well, the other is performing poorly and vice versa.

As we will see below diversification can reduce the overall risk within a portfolio by reducing the risk of any one investment, but it will not reduce the risk of the entire market crashing. Diversification among asset classes, however, can help with this. If the stock market crashes, but you have a portfolio of stocks, bonds, cash, and real estate, you will be at least partially protected.

Unfortunately, some well-meaning investors intending to diversify accidentally over-concentrate their portfolios by buying too many securities from the same sectors or in the same markets. For example, buying ten different stocks in the healthcare sector does not provide as much diversification as buying ten different stocks from ten truly unrelated industries. Investors need to make sure that their investments have as few common threads as possible that could lead to their entire portfolio unraveling at the same time.

Another common diversification mistake is not paying attention to what a customer owns in her company's retirement plan, if one is offered. Especially in plans where a portion of the customer's money is invested in her company's stock, advisers need to make sure other investments (especially mutual funds) do not hold the same or similar companies.

## Strategic Asset Allocation

Under a strategic asset allocation model, a portfolio manager and customer work together to design an ideal mix (on a percentage basis) of major asset classes and subclasses. The model seeks to find the optimal level of portfolio performance given a customer's investment goals (growth, income, capital preservation, and tax benefits).

When using strategic asset allocation, a key question is what method to use to divide the assets in a portfolio. Two primary methodologies are allocating by style and allocating by asset class.

An allocation by **style** divides the assets into investment goals such growth and value. An allocation by **asset class** divides into general asset categories, such as stocks, bonds, and cash, and then further subdivides these categories (common stock, preferred stocks, international stocks, corporate bonds, government bonds, etc.)

Portfolios are often strategically allocated into smaller subcategories that are a mix of both style and



## *Innovative Resources for Securities Exam Preparation*

asset class, such as value stocks, growth stocks, investment grade corporate bonds, corporate junk bonds, and so forth.

Here's a simple example of strategic asset allocation: a customer decides that she wants to invest a \$100,000 portfolio into:

- 60% stocks (40% domestic common, 10% international common, 10% preferred)
- 30% bonds (20 government bonds, 10% corporate bonds)
- 10% cash

Initially, it is easy to invest according to the percentages. But six months later, after the prices of stocks and bonds have changed, and dividends and interest have been reinvested, the portfolio may no longer be aligned with the original strategic asset allocation goal. For example, the portfolio may now be:

- 63% stocks
- 25% bonds
- 12% cash

Under the strategic asset allocation model, adjustments would have to be made to bring the stock allocation back to 60%, the bond allocation back to 30%, and the cash allocation back to 10%. This process of adjusting the portfolio back toward the original model is called **rebalancing**. The easiest way to rebalance is often to use excess cash in the account to buy more of the assets that are underrepresented. It may also be necessary to sell some assets to bring an asset class back down to its intended allocation level. One approach to the problem of shifts in allocation is to rebalance on a regular schedule. Regular rebalancing causes the investor to sell assets from classes that are doing well and buy assets that are underperforming. This helps the investor to buy investments at lower prices and sell investments at higher prices.

The strategic asset allocation model is compatible with a **buy and hold** strategy because most assets are held and only sold when a rebalancing takes place. The strategic asset allocation strategy minimizes capital gains tax consequences because fewer transactions take place and remove the need to "time the market."

Strategic asset allocation offers investors a way to maintain a disciplined investment portfolio that offers higher investment returns and lower volatility through diversification. Additionally, the exam may want you to know that a balanced portfolio of bonds, preferred stock, common stock, and convertible securities can provide a good hedge against inflation.

## **Laddering**

**Laddering** is a strategy whereby a fixed-income investor buys multiple bonds or CDs at different maturities in order to avoid being locked into a single interest rate and a single maturity. Laddering is a way to reduce interest rate risk and spread out reinvestment risk. If the exam asks how can a fixed-income investor save for a target date and reduce interest rate risk, laddering may be the answer. Through laddering, bonds or CDs can be purchased to mature when cash is needed by the investor. See the figure that follows. The short-term



*Innovative Resources for Securities Exam Preparation*

bonds offer liquidity, while the longer term bonds offer higher coupon rates. This is an especially effective strategy for retirees who need continuous cash flow or customers who need money in the future to pay for college tuition. Laddering reduces both interest rate risk and reinvestment risk because an investor is not stuck at one interest rate for long. Because he has bonds maturing at different times, he will have cash flow to get back into higher paying securities if he desires and if interest rates rise.

Ladders can be filled with a variety of different kinds of bonds to diversify default risk. Corporate bonds, municipals, government bonds, Treasuries, and CDs are all possibilities. The number of rungs and distance between the rungs can also vary. The more rungs, the more diversified your portfolio will be. The distance between rungs is equal to the difference between the maturities in the bonds. The greater the distance between the rungs, the greater the average return in the portfolio because more money will be distributed to the later rungs, which have higher returns. But the greater average return will be offset by greater reinvestment risk and decreased liquidity. It is also important to note that callable bonds should not be included in a ladder, or the intended goals may not be reached.

Ladders do not have to be filled with all one kind of bonds. To increase diversification, bond ladders can consist of multiple types of bonds. For example, you may have a bond ladder with Treasuries, municipals, and corporates.

**\$100,000 OF TREASURY NOTES ARE PURCHASED  
IN 2016 TO HELP PAY FOR COLLEGE TUITION**

\$25,000	2%	Treasury notes to mature in 2020
\$25,000	2.15%	Treasury notes to mature in 2021
\$25,000	2.30%	Treasury notes to mature in 2022
\$25,000	2.45%	Treasury notes to mature in 2023

**TYPES OF INVESTMENT RISK**

Risk is a critical factor when assessing the performance of a security and the construction of a portfolio. In the context of investing, risk is defined as the volatility in the returns of a security or a portfolio. When volatility is high, returns can vary from high to low, so investors expose themselves to the possibility of bigger losses and bigger gains.

**Systematic and Nonsystematic Risk**

A portfolio of securities is comprised of both **systematic** and **nonsystematic risk** (also called **unsystematic risk**). Systematic risk is the risk that the whole system (i.e., market) will drop, causing a drop in the performance of the portfolio. Systematic risk is also referred to as **market risk**. If the performance of a



## *Innovative Resources for Securities Exam Preparation*

portfolio drops due to systematic risk, it has dropped because the whole market has dropped, not because of the performance of the specific stocks within the portfolio.

Nonsystematic risk is the risk that the value of the specific securities within the portfolio will decline due to factors specific to the companies issuing the security (e.g., a decline in the company's Standard & Poor's rating). The amount of nonsystematic risk in a portfolio depends on the number of securities in the portfolio and the correlations among the securities in the portfolio. The more securities in a portfolio, the less nonsystematic risk because the volatility in the returns within the portfolio is reduced. When one security is down, another is likely to be up, reducing the nonsystematic risk of each specific security. But the more correlated the performance of securities in a portfolio, the less nonsystematic risk will be reduced, because when a specific security performs poorly, the other correlated securities in the portfolio probably also performed poorly. For this reason, a truly diversified portfolio consists of securities whose returns are either uncorrelated or negatively correlated. If a portfolio is sufficiently diversified, it is possible to reduce nonsystematic risk to almost zero. It is important to remember, however, that diversification does not reduce the systematic risk of a portfolio.

While diversification protects an investor from nonsystematic risk, hedging can protect an investor from systematic risk. For example, an investor could protect himself from drops in the market by buying puts on a broad-based index, such as the S&P 500 or the Russell 2000. If the market drops, the investor exercises the puts and profits from the drop, mitigating her losses from her long positions. An investor could also hedge by shorting broad-based exchange-traded funds. If the market drops, the investor will profit from the decline, again mitigating losses from long positions.

### **Credit Risk**

**Credit risk**, also known as **default risk**, is critical to bondholders. The definition of credit risk has two related parts. First, it is the risk that an issuer's perceived or actual creditworthiness will drop, causing the bond's price to drop. Second, it is the risk that the issuer will default on the bond issue and therefore not pay the bondholder the interest or principal that is due to her. U.S. Treasury bonds have no credit risk, but municipal and corporate bonds usually have some credit risk. A bond's credit risk is graded by the credit rating agencies: Standard & Poor's, Fitch, and Moody's. Investment grade bonds are bonds with a Standard & Poor's and Fitch rating of BBB- or above, or a Moody's rating of Baa3 or above. Bonds below this level are considered speculative bonds (also known as high-yield or junk bonds).

When a rating agency downgrades a bond, the price falls because fewer people want the bond. Credit risk is like most other principles in the financial world: greater risk means greater reward. Bonds with high credit risk also pay high yields, while bonds with low credit risk pay low yields. Credit risk can often be helped by diversification. An investor with a broad portfolio of bonds from different issuers is protected from credit risk because when one issuer drops in credit rating, another is likely to improve. In addition, a recommended strategy for many portfolios is to combine levels of risk: the riskier bonds offer higher yields, while the less



## Innovative Resources for Securities Exam Preparation

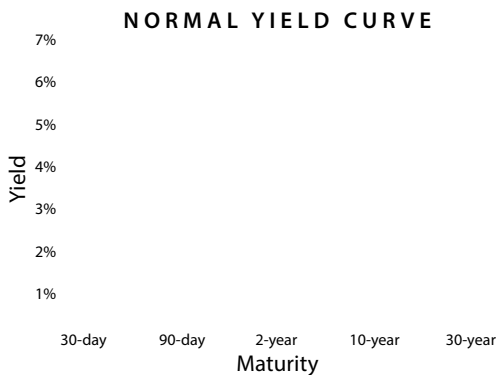
risky bonds offer safety. It is important to note, however, that a portfolio that invests in speculative bonds must be able to hold the securities over market fluctuations and may require more active management.

### Interest Rate Risk

Fixed-income securities, which include both bonds and preferred stock, are subject to interest rate risk. **Interest rate risk** is the risk that when interest rates rise, the price of the bond or preferred stock will decline. As discussed earlier, when interest rates rise, prices of fixed-income securities decline, because investors want to purchase bonds with the new higher rates, and previously issued bonds that offer the lower rates are undesirable and therefore decline in value. Bonds with longer maturities are more vulnerable to interest rate risk than bonds with shorter maturities, because there is a greater chance that interest rates will rise over the bond's life. Again, greater risk means greater reward. Bonds with longer maturities tend to pay higher yields than bonds with shorter maturities. This is represented by a typical yield curve. Assuming that an investor can tolerate some loss of principal and does not need to remove her money in the near future, an optimal strategy is a mix of maturities. Long-term bonds provide higher yields, and short-term bonds provide lower interest rate risk while making some funds available sooner if needed.

### Purchasing Power Risk

**Purchasing power risk** is the risk that the return on an investment cannot keep up with the rise in the cost of goods and services. When inflation is rising faster than the return an investor is earning, one could argue that the investor is not really earning any "real" return at all. Fixed-income investments tend to have more purchasing power risk than stocks. This is because they tend to yield lower returns on average than equities, and they pay the same payments regardless of inflation. On average, stocks tend to outpace inflation and



perform well during the expansionary phase of a business cycle when the price of goods and services is increasing. In contrast, during a contraction, when the prices of goods and services decline, stocks tend to decline as well. Bonds, however, tend to do better during a contraction because the economic conditions put downward pressure on interest rates. For this reason, a mix of common stocks, preferred stocks, and bonds can protect a portfolio against inflation during an expansionary period and protect against deflation during a contractionary period.

### Call Risk

**Callable bonds** are subject to call risk. Call risk is the risk that a bond will be called when interest rates are declining. When interest rates decline, an issuer of a bond usually does not want to continue to pay interest





## *Innovative Resources for Securities Exam Preparation*

payments at the higher rate, so the company borrows money at the lower rate and uses it to pay the bondholders their principal early. Note that the bondholder will receive the callable price at maturity if it is different from the par value. For example, if an investor purchases a corporate bond with a call price of 104, she will receive \$1,040 if the bond is called. If the bond is not called, the bondholder will receive the par value of the bond (\$1,000) at maturity. Why is this a risk to the bondholder? The bondholder will no longer receive the coupon payments that were at that nice higher rate, and she will receive the principal early and have to reinvest it at the now lower rate.

Callable bonds may not be appropriate for certain investment goals. For instance, an investor who needs a particular income each month may not be able to afford a lower rate if the bonds are called. In addition, if an investor expects to receive the principal at a certain point in time for a specific goal such as college tuition, the investor may not appreciate receiving the bonds earlier. An investor can protect herself against call risk by buying non-callable bonds, but these typically offer a lower return.

### **Liquidity Risk**

---

**Liquidity risk** is the risk that an investor will not be able to sell his investment quickly at a fair price. In other words, liquidity risk is a measure of how liquid or marketable the investment is. Stocks and bonds with a dynamic secondary market are usually not subject to liquidity risk. In contrast, thinly traded stocks and bonds, direct participation programs (DPPs), municipal securities, and hedge funds are subject to liquidity risk because they are difficult to sell at a fair price quickly. Private placements usually are subject to liquidity risk. Investors who may need their money for emergencies should not invest in products with great liquidity risk.

### **Economic, Social, and Political Risk**

---

Economic, social, and political risks are concepts listed on the FINRA exam outline. **Economic risks** generally refer to any macroeconomic risk to an investment or security, such as the business cycle, inflation/deflation, innovation, supply disruption, and labor costs. **Political risks** are often associated with investments in foreign securities where the political process may be unstable. If a government is unpredictable or changes quickly, policies that affect investments could be negatively (or positively) impacted. War is the ultimate political risk, and while it is possible to make money in war, it is not something most investors want to deal with. Political risks can be domestic as well and could include changes in fiscal policy that would affect the allocation of government funding, currency risk associated with the federal deficit, political gridlock, and adverse legislation/regulation. **Social risks** could include changes in behavior or social norms that affect investments, such as a decrease in the smoking rate, increased urbanization, or smaller family sizes. FINRA wants registered reps to be cognizant of economic, social, and political risks when constructing and maintaining investment portfolios.



## Currency Risk

**Currency risk** is the risk that an investment in a foreign security may lose its value due to a strengthening of the U.S. dollar against the foreign country's currency. For example, imagine that you invest in a Japanese security that is trading on a Japanese exchange. If the dollar strengthens against the Japanese yen, you will get fewer American dollars when you sell your Japanese security. An investor can buy puts against the Japanese yen to protect herself against currency risk.

TYPE OF INVESTMENT RISK	INVESTMENTS MOST AFFECTED
<b>Market Risk</b>	Stocks
<b>Credit Risk</b>	Municipal bonds Corporate bonds Not U.S. Treasury bonds
<b>Interest Rate Risk</b>	Fixed-income securities, such as bonds and preferred stock
<b>Purchasing Power Risk</b>	Fixed-income securities, such as bonds
<b>Call Risk</b>	Callable bonds
<b>Liquidity Risk</b>	Thinly traded stocks and bonds DPPs Municipal securities Hedge funds Private placements
<b>Political Risk</b>	Emerging markets
<b>Currency Risk</b>	Investments in foreign securities

SUMMARY

## TAX CONSEQUENCES OF SECURITIES TRANSACTIONS

A customer's tax rate can be critical in evaluating a customer's portfolio and making suitable recommendations. In this section, we will summarize pertinent tax rules and good practices.

When a customer sells securities, there are tax consequences. The consequences that arise depend primarily on the kinds of securities that were purchased and the length of time that they were held. When a customer sells a corporate security, the customer can realize either a **gain** if the security appreciated in value or a **loss** if the security depreciated in value.

If the customer held the security for one year or less, the IRS will consider the gain/loss to be **short-term**,



## *Innovative Resources for Securities Exam Preparation*

and if the customer held the security for over one year, the IRS will consider the gain/loss to be **long-term**. Short-term gains are taxed at the taxpayer's ordinary rate, while long-term gains are taxed at a lower rate (0% to 20%). According to the IRS, the holding period clock begins the day after the investment is purchased and ends on the day the investment is sold. The date of purchase and sale are the trade dates rather than the settlement dates. If an investor bought a security on January 5, 2017, and sold it on January 5, 2018, it would be considered a short-term gain/loss. On the other hand, if the investor bought the security on January 5, 2017, and sold it on January 6, 2018, it would be considered a long-term gain/loss.

### **Calculating Capital Gains and Losses**

Gains and losses are calculated by subtracting what was paid for the security at purchase, plus any commissions (the cost basis) from what was received for the security at sale (proceeds). The proceeds are the money that is received from the sale minus the commission paid. The **cost basis** is the money paid for the security plus any commission or fees.

$$\text{gains and losses} = \text{proceeds} - \text{cost basis}$$

For example, if an investor paid \$20 per share for 100 shares of XYZ and a \$40 commission, the cost basis per share will be \$20.40. The \$40 commission on a per share basis is \$0.40, so  $\$2,040 / 100 \text{ shares} = \$20.40$  per share. If the investor now sold all 100 shares at \$25 for \$2,500 with a \$40 commission, the proceeds would be  $\$2,500 - \$40 \text{ commission} = \$2,460$  net. Divided by 100 shares, the net proceeds per share would be \$24.60. Therefore, the capital gain per share would be  $\$24.60 - \$20.40 = \$4.20$  per share, or \$420 total for the 100 shares.

Appreciation in value on a security is not taxed until the security is actually sold. Before the security is sold, any appreciation is referred to as an **unrealized capital gain**, which is not subject to taxation. When the security is sold, it is referred to as a **realized capital gain**, and all realized capital gains are taxed. For the exam, remember that the taxes on unrealized gains will be \$0.

Many people buy shares of the same company at different times and at different prices. How does an investor choose which share price to use as the cost basis? There are several acceptable methods to determine the cost basis in securities transactions, but the exam is most likely to ask about two: specific identification and FIFO. In the **specific identification** method, the investor can identify the shares that are being sold by using the CUSIP number located on the shares. The investor must provide a copy of the trade confirmation as evidence that these were the shares that were indeed sold. An investor who wants to use the specific identification method must inform his broker by the settlement date which specific shares he wishes to sell.

The second method the exam may ask about is called **first in, first out (FIFO)**. Because share prices typically rise over time, this method usually results in the greatest gain, and hence the most revenue for the IRS. Broker-dealers report the proceeds of transactions to the IRS, and they are required to report the



## *Innovative Resources for Securities Exam Preparation*

adjusted cost basis on any securities purchased after January 1, 2011. If the investor does not identify the specific shares to be sold, the IRS will use the cost of the first shares purchased.

### **Using Losses to Offset Gains**

Losses can be used to offset gains on a tax return. The taxpayer must first offset short-term gains with short-term losses and long-term gains with long-term losses. If there are any long-term or short-term gains remaining, these can be offset with any remaining losses. If there are any losses remaining after all gains have been offset, up to \$3,000 of the losses can be deducted from a person's taxable income each year. If there are still losses remaining after that, they can be carried over to the following year.

**Example:** Jon has \$5,000 in short-term gains and \$15,000 in long-term gains. He has \$3,000 in short-term losses and \$30,000 in long-term losses. First, he must align the short-term gains and the short-term losses. He can use his \$3,000 short-term loss to offset his \$5,000 short-term gain. He can also use his \$30,000 long-term loss to offset all of his \$15,000 long-term gain. He now has \$15,000 in long-term losses remaining. He may use \$2,000 of this to offset his remaining \$2,000 short-term gain. He then can use an additional \$3,000 to deduct from his taxable income. He now has \$10,000 of remaining long-term losses that he can carry over to the following year or beyond.

### **Taxing Cash Dividends**

As we said earlier, long-term capital gains are generally taxed at 15% (0% for low income brackets and 20% for the high income bracket), whereas short-term capital gains are taxed at a taxpayer's ordinary tax rate. Dividends can be either qualified or non-qualified. Qualified dividends are taxed at the investor's capital gains rate. Non-qualified dividends are taxed at the taxpayer's ordinary rate. All cash dividends that are automatically reinvested are still subject to taxation.

**Note:** The exam may give you fictional tax rates to test your conceptual knowledge.

### **Taxing Stock Dividends and Stock Rights**

When a company gives a distribution of its own stock it is often referred to as a **stock dividend**. When a company gives out rights to acquire its own stock, this is called **stock rights** or **stock options**. Typically, neither stock dividends nor stock rights are taxable at the time of the distribution. This means that the transaction does not result in a capital gain or loss at the time of the distribution and therefore does not need to be reported on a tax return.

Stock dividends and stock rights are taxable if the shareholder was given the choice to receive cash or some other property instead of the stock or stock option. They are also taxable if the distribution was in preferred stock or some shareholders were given preferred stock.



## **Exchange of Securities**

When a company merges with another company, it may give its shareholders stock in a new company in exchange for the stock they currently hold. This is usually not a taxable event, meaning the shareholder does not have to pay taxes on the new shares at the time of the exchange. Moreover, if the company gives shares of common or preferred stock to shareholders because of a corporate restructuring or bankruptcy, this is also not a taxable event.

Additionally, the conversion of convertible preferred stock (or bonds) to common stock is not a taxable event.

## **Inherited and Gifted Securities**

When someone inherits securities, the heir's cost basis will be the fair market value (FMV) on the date of death. When the heir decides to sell the securities, any capital gain will be treated as a long-term capital gain, regardless of how long the security was held.

In contrast, when someone gives securities as a gift to another individual, the recipient's cost basis is the lower of (1) the giver's cost basis or (2) the fair market value at the time of the gift. The giver's holding period will correspond to the cost basis. For example, if the giver has held the security for two years with a cost basis of \$20, and the security is now worth \$30, the recipient's cost basis would also be \$20 with a holding period of 2 years.

## **Charitable Donations of Securities**

When an individual decides to donate securities to a qualified charity, the donor can deduct the fair market value of the securities (as of the date of donation) from his taxable income for that year, as long as the securities have been held for over a year. If the securities have been held for less than a year, the individual can deduct the cost of the securities rather than the fair market value.

## **Wash Sales**

While losses can almost always be used to offset gains, there is a limitation. When an investor sells securities at a loss and then buys back the same or substantially identical securities within 30 days, the investor cannot use the loss to offset gains. This is considered a **wash sale**, according to IRS rules. Moreover, the investor could not have purchased replacement securities 30 days before the sale either—this would also be considered a wash sale because the investor is replacing the shares that she is selling at a loss. Thus, the wash sale period is 30 days before the trade and 30 days after the trade, plus the day of the trade.

Keep in mind that a wash sale is not illegal; rather, it is using the loss from a wash sale to offset gains that is a violation of IRS rules. In fact, the investor can capture the loss later by adding it to the cost basis



## *Innovative Resources for Securities Exam Preparation*

of the new securities. If an investor does implement a wash sale, then the holding period of the new shares must include the holding period of the old shares; this rule is to prevent converting a long-term loss (on the old security) to a short-term loss (the new security).

The wash sale rule applies to taxable and IRA accounts. This means that if you want to deduct a loss, you can't sell a security in a taxable account and then buy it back in a IRA account during the 61-day wash sale period (i.e., 30 days before the day of the sale, the day of the sale, and 30 days after the date of the sale). Also, wash sale rules apply to spousal accounts and to any corporate account that a taxpayer controls. This applies to stocks, bonds, mutual funds, ETFs, warrants, short sales, and options in any of your accounts, including an IRA or retirement account. Also, the wash sale rule applies if the same or substantially identical securities are purchased by the spouse or a corporation controlled by the individual making the wash sale.

**Example:** Jon sells 300 shares of XYZ. He has realized a loss of \$1,200 on the shares. Two weeks later, he has a change of heart and buys 300 shares of XYZ back at \$20 per share. He may not use the loss on this year's annual tax return, but he may apply the \$1,200 to the cost basis of the new shares. That is  $\$1,200 / 300 = \$4$  per share. So his cost basis for the new shares \$20 per share plus \$4 or \$24 per share.

## Taxation of Corporate Bonds

### Interest Payments

---

Most corporate bonds pay interest annually. This interest is taxed at the bondholder's ordinary tax rate.

### Premium Bonds

---

A corporate bond can be bought at either a premium or discount to its par value, and each has different tax consequences for the bondholder. If the bond is purchased at a premium, the bondholder can choose one of two alternatives at tax time. If the bond is sold for less than what it was bought for, the bondholder can take a loss on her taxes in the year of the sale. The loss is the difference between the purchase price and the sale price. A loss can also be taken if the bondholder holds the bond to maturity. In this case, the loss is the difference between what the bondholder paid for the bond and the face value of the bond—also called the premium.

An alternative method of dealing with the tax consequences is to amortize the premium over the life of the bond. In this case, a portion of the premium is subtracted from the bond's annual interest, resulting in reduced reported interest. The amortized amount is determined by dividing the premium by the number of years to maturity. This amount is also subtracted from the cost basis of the bond each year (called the **adjusted cost basis**), so that at maturity, the cost basis of the bond will be equal to the par value of the bond. Note that when a bond is a municipal bond, taxes are not paid on the interest.



## Innovative Resources for Securities Exam Preparation

### EXAMPLE QUESTION

**A customer purchases a 6% corporate bond at 105, maturing in 10 years. After six years, she sells the bond at 102. Assuming the premium has been amortized, what is her capital gain or loss at sale?**

**Answer: \$0.** First, figure the amount of the premium, which is \$50 because it was purchased at \$50 above par at \$1,050. The value of the bond reduces year by year by a set amount until it reaches face value at maturity. This is called amortization. So to figure the amount amortized, take \$50 and divide it by 10 years to get \$5 per year. Thus, the value of the bond reduces by \$5 each year. For example after year one, it will be worth \$1,045. This adjusted value is called the adjusted cost basis. After six years, the adjusted cost basis will be figured by the following equation:

$$\text{adjusted cost basis} = \text{purchase price} - ((\text{time that bond was held}) \times (\text{annual amortized amount}))$$

$$\text{adjusted cost basis} = \$1,050 - (6 \times \$5) = \$1,020$$

To find the gain or loss, take the proceeds that were made in the sale minus the adjusted cost basis.

$$\text{gain or loss} = \text{proceeds} - \text{adjusted cost basis}$$

$$\text{gain or loss} = \$1,020 - \$1,020 = \$0$$

So the customer did not experience a gain or loss.

### Discount Bonds

When a bond is bought at a discount, the bondholder has the same two alternatives at tax time. The bondholder can report a capital gain if the bond was sold for more than it was bought for and pay the tax on this gain in the year of the sale. If the bondholder holds the bond to maturity, he will report a gain in the year that the bond matures.

The alternative method is to accrete the amount of the discount over the life of the bond. In this case, the accreted amount is added to the annual interest reported on the tax return. In addition, the accreted amount is added each year to the cost basis of the bond, resulting in an adjusted cost basis that is greater each year. At maturity, the adjusted cost basis of the bond will be equal to the par value of the bond.

### Zero Coupon Bonds

Treasury bills, Separate Trading of Registered Interest and Principal of Securities (STRIPS), and corporate zeros are all considered zero coupon bonds because they do not pay annual interest over the life of the bond. Instead, they are bought at a deep discount and mature at the bond's par value. Even though the bond does not pay interest payments, the IRS considers the discount that the bond was bought at to be taxable interest. The taxpayer must divide the discount by the bond's maturity to come up with the bond's annual



## Innovative Resources for Securities Exam Preparation

“phantom” interest. The bondholder will then pay taxes on this phantom interest at her ordinary tax rate. She will also adjust the cost basis of the bond by adding the annual phantom amount each year. This process is called accretion, and the adjusted cost basis of the bond will accrete (increase) until it is equal to the par value at maturity.

**Example:** Sally buys a \$1,000 zero for \$750. It will mature in five years. The amount of the discount is \$250. Annual phantom income is \$50 ( $\$250 / 5 = \$50$ ). The adjusted cost basis will change according to the following schedule:

TIMING	ADJUSTED COST BASIS
At Purchase	\$750
Year 1	\$800
Year 2	\$850
Year 3	\$900
Year 4	\$950
Year 5	\$1,000

## Taxation of U.S. Treasuries and Municipal Securities

One reason why an investor may choose to purchase Treasury or municipal bonds is that his interest is taxed at a lower rate than corporate bonds. For Treasury bond interest, an investor pays federal taxes but no state taxes on earnings. For municipal bonds, the tax benefits can be even greater. Investors pay no federal taxes on earnings from municipal bonds and also pay no state or municipal taxes if they live in the state or municipality that issued the bond. For this reason, sometimes municipal bonds are called “triple tax-free bonds.”

Because interest on corporate bonds is taxed at an investor’s ordinary income rate, investors often want to be able to compare after-tax yields of government or municipal bonds to corporate bonds. There are two ways to do this.

The most straightforward way is to multiply the yield of each kind of bond by one minus the tax rate for the bond. For example, imagine an investor who has a federal tax rate of 27% and a state tax rate of 3%. The investor would like to compare a corporate bond with a 10% yield and a municipal bond issued by the state in which he lives which has a yield of 7.5%. We can calculate the corporate bond’s after-tax yield by multiplying  $10\% \times (1 - 0.30)$ , which equals 7%. We can compare this after-tax yield directly to the yield of the municipal bond because the investor will not pay federal or state taxes on this municipal bond. In this case, we see that the municipal bond, with a tax-free 7.5% yield, beats the corporate bond’s after-tax yield of 7%.

$$\text{after-tax yield on a corporate bond} = \text{coupon rate} \times (1 - \text{tax rate})$$





## Innovative Resources for Securities Exam Preparation

Another approach to this question is to calculate the tax-equivalent yield (TEY) of the municipal bond. This is also called the corporate equivalent yield (CEY). This concept measures the yield that a corporate bond will have to pay to be equivalent to a municipal or Treasury bond, factoring in the investor's tax rate.

$$\text{TEY} = \frac{\text{coupon rate}}{1 - \text{tax rate}}$$

Again, consider the investor with a 27% federal tax rate and a 3% state tax rate. If the investor is considering a municipal bond issued by the investor's own state, the investor will not pay federal or state taxes on this bond. We can calculate the corporate equivalent rate by dividing the municipal bond yield by one minus the investor's tax rate. In this case,  $7.5\% / (1 - 0.30) = 10.7\%$ . Thus, the investor would have to invest in a corporate bond with a yield of at least 10.7% to match the municipal bond's yield.

- ☒ **Example:** Susan, a resident of Mississippi, has purchased a Georgia municipal bond with a rate of 5.12%. If Susan's federal tax bracket is 30% and the state income tax rate is 4%, what would she need to earn on a corporate bond to have a comparable rate?

Corporate bonds are taxed at the federal and state level. Municipal bonds are not taxed at the federal level, but in this case it will be taxed at the state level because Susan is not a resident of Georgia. Thus, to get the comparable corporate rate, we need to divide by one minus Susan's federal rate.

$$\frac{5.12\%}{1 - 0.30} = \frac{5.12\%}{0.70} = 7.31\%$$

- ☒ **Example:** Catie, a resident of Georgia, has purchased a Georgia municipal bond with a rate of 5.12%. If Catie's federal tax bracket is 30% and the state income tax rate is 4%, what would she need to earn on a corporate bond to have a comparable rate?

This municipal bond will not be taxed at either the federal or state level because Catie is a Georgia resident. To get the comparable corporate rate, we need to divide by one minus the federal plus the state tax rate.

$$\frac{5.12\%}{1 - 0.34} = \frac{5.12\%}{0.66} = 7.76\%$$



## FINRA RULES

### FINANCIAL EXPLOITATION OF VULNERABLE ADULTS

Suppose you have an elderly or disabled customer who begins making decisions that don't appear to be in his best interest. Maybe you have a hard time getting ahold of the customer when you try to call him up to talk about unusual trading activity. Maybe you suspect someone is taking advantage of the customer. If the trades appear to be legally authorized by the customer, is there anything you can do about your suspicions?

Yes. FINRA allows a member firm to put a temporary hold on the disbursement of funds or securities from an account if it suspects that an elderly or disabled customer is being exploited. FINRA calls this category of customers, **specified adults**. This type of temporary hold can be placed on an account if:

- One of the individuals authorized to transact business on the account is a specified adult, defined as one of the following:
  - ▶ At least 65 years of age
  - ▶ At least 18 years of age and has a mental or physical condition that keeps him from protecting his own interests
- The member firm has a reasonable belief that the customer may be the victim of financial exploitation

**Financial exploitation** is defined broadly for these purposes. Such exploitation can consist of “taking, withholding, appropriation, or use” of assets in the customer’s account, whether cash or securities. The reasonable belief can be in regard to past, present, or future exploitation. It can involve unusual actions that the customer supposedly took, or it can involve actions taken by someone else “through the use of a power of attorney, guardianship, or any other authority.” It can involve suspicion of intimidation, trickery, a combination of the two, or any other form of “undue influence” over the vulnerable person.

When this kind of temporary hold is placed on an account, the firm must follow up in several ways. The firm has two business days to notify (orally, in writing, or electronically):

- Any party authorized to transact business on the account
- The trusted contact person, if any, listed in the customer’s personal information

Note that if the firm has a reasonable belief that an individual is involved in the exploitation, that individual is excluded from the notification requirement, even if it is the trusted contact person.

The notification must disclose the temporary hold and the reason for it. Assuming the trusted contact person is not excluded from notification, the firm might be allowed to share more information with the trusted contact person. The firm can share the customer’s information with the trusted contact person if doing so would do any of the following:

- Help the member firm address the suspected exploitation



## *Innovative Resources for Securities Exam Preparation*

- Confirm for the member firm the customer's:
  - ▶ Contact information
  - ▶ Health status
  - ▶ Legal guardian, executor, trustee, or holder of the customer's power of attorney

Another way the firm must follow up is with an internal review of what the reasonable belief of exploitation was based on. This review must be opened as soon as the hold is placed. It is important that the review happen promptly because it may affect the length of the hold.

Initially, the temporary hold may be placed for up to 15 business days. The firm is allowed to grant an extension of up to 10 more business days, but only if the internal review is completed and finds that the belief was in fact reasonable. (On the other hand, if the internal review finds that the belief was not reasonable, the hold would likely be ended immediately.)

Each member firm must have written procedures specifying who within the firm is authorized to place, remove, or extend this kind of hold. Only an associated person whose job function is supervisory, legal, or compliance-related can be authorized to place this kind of hold. All records related to such a hold must be retained.

Note that while FINRA does not require the member firm to take action if it suspects financial exploitation, the member firm may have other obligations in such situations. For example, many states have laws regarding what action must be taken if there is suspected abuse of an elderly or disabled individual.

FINRA Rules 2165 and 4512

## **CHARGES FOR SERVICES PERFORMED**

---

Charges for services performed, including the collection of money due for principal, dividends, or interest, the transfer of securities, appraisals, the safekeeping, and custody of securities, and other services must be reasonable and not unfairly discriminatory among customers.

FINRA Rule 2122

## **ANTI-INTIMIDATION AND COORDINATION RULE**

---

No broker-dealer or affiliated person may coordinate its prices, quotations, trades, or trade reports with any other persons or request anyone else to alter a price or quotation. Nor may they engage in any conduct that threatens, harasses, coerces, or otherwise attempts to improperly influence any other person. This includes attempts to influence others to adjust or maintain a price or quotation, whether displayed on any facility operated by FINRA or otherwise. It includes refusals to trade or any conduct that retaliates against or discourages the competitive activities of another market maker or market participant.

FINRA Rule 5240



## **RESTRICTIONS ON THE PURCHASE AND SALE OF AN IPO—NEW ISSUE RULE**

---

Initial public offerings must be offered to all public investors fairly and must not give an advantage to industry insiders. No broker or dealer may sell shares of an IPO to an account in which a “restricted person” has a beneficial interest, subject to certain limited exceptions. **Restricted persons** are defined as:

- Broker-dealers and their personnel (including both associates and other employees)
- Owners of a broker-dealer
- Finders or individuals acting in a fiduciary capacity to the lead underwriter (including lawyers, accountants, or consultants)
- Portfolio managers (any person who has authority to buy or sell securities for a bank, savings and loan institution, insurance company, investment company, investment adviser, or collective investment account)
- Individuals with a beneficial interest in the broker-dealer

Employees of limited broker-dealers are excluded from this rule. A limited business broker-dealer is a “broker-dealer whose authorization to engage in the securities is limited solely to the purchase and sale of investment company/variable contracts securities and direct participation program securities.”

Accounts fall under the rule if a restricted person has beneficial interests in at least 10% of the account.

This rule extends to the immediate family members of restricted persons. Immediate family members include children, spouses, parents, siblings, in-laws (of siblings, children, or parents), and anyone else for whom the restricted person provides material support. “Material support” means directly or indirectly providing more than 25% of a person’s income in the prior calendar year or living in the same household.

Underwriters and members of the selling group (and their agents) generally may not retain shares of the IPO for their own accounts to sell at a later time. However, underwriters may purchase unsold shares of an IPO under a **standby agreement**, if the following conditions are met:

- The prospectus discloses it
- The agreement is written
- A statement from the lead underwriter attests that it couldn’t find any buyers
- The shares will not be sold within three months

Underwriters may place a portion of the issue in their accounts if it was stated in the underwriting agreement and the underwriters were unable to sell the shares to the public.

**Issuer-directed exemptions.** The prohibition on sales to restricted persons does not apply to shares that are specifically directed by the issuer, as long as the restricted person is not (1) a broker-dealer or (2) a beneficial owner who is not also a family member or an officer or employee of the company or its affiliates. Nor



## *Innovative Resources for Securities Exam Preparation*

does it apply to issuer-directed shares for an offering where no broker-dealer has any participation in the issue, either as underwriter, seller, or by any other means. Finally, the prohibition does not apply to shares that are part of an issuer-sponsored program, as long as the program is offered broadly (at least to 10,000 participants) and equitably.

**Anti-dilution provisions.** The prohibition on sales of new issues to restricted persons is not intended to cause the dilution of their beneficial interest. Therefore, such persons are not restricted from purchases and sales of new issues, as long as they meet these conditions:

- They have held an equity ownership interest in the issuer for at least one year prior to the offering.
- Their percentage ownership will not increase above the level as of three months prior to the filing of the registration statement.
- The purchase is not resold, transferred, or assigned for three months following the effective date of the offering.

FINRA Rule 5130

### EXAMPLE QUESTION

**Jenny is an employee of a broker-dealer. She is a receptionist at the firm and is not a registered representative. She would like to purchase shares in an IPO that she has recently heard about at her office. Which of the following best describes her participation?**

- A. Jenny may purchase shares of the IPO on the same basis as other customers.
- B. Jenny is prohibited from purchasing shares of the IPO, but her spouse may purchase shares on the same basis as other customers.
- C. Jenny may purchase shares of the IPO as long as the purchase quantity doesn't exceed 200 shares.
- D. Jenny is prohibited from purchasing shares of the IPO.

**Answer:** D. FINRA Rule 5130 prohibits a member from selling shares of an IPO to an account in which a restricted person has a beneficial interest, subject to certain limited exceptions. All employees of a broker-dealer are considered restricted persons under the rule.

## MEMBER PRIVATE OFFERINGS

A **member private offering (MPO)** is a private placement of unregistered securities issued by a FINRA member or a control entity. A control entity is any entity that controls or is controlled by the member firm. In this case, control means a beneficial interest of 50% of the outstanding voting securities. FINRA states that no member may participate in an MPO unless the following conditions have been met:




## *Innovative Resources for Securities Exam Preparation*

- If an offering has a PPM or term sheet, it must be provided to each prospective investor and must contain disclosures addressing the intended use of the offering proceeds, the offering expenses, and the amount of selling compensation that will be paid to the syndicate members.
- If an offering does not have a PPM or term sheet, then the member must prepare an offering document that contains these required disclosures and must provide it to each prospective investor.
- A member must file the PPM or term sheet with FINRA prior to the time the document is first provided to any prospective investor. Any amendments or exhibits to the private placement memorandum or term sheet also must be filed within 10 days of being provided to any prospective investor.
- With any MPO, at least 85% of the offering proceeds must be used for business purposes, which do not include offering costs, discounts, commissions, or any other cash or non-cash sales incentives, and their use must be consistent with the private placement memorandum.

Offerings sold solely to institutional accounts, qualified purchasers, qualified institutional buyers, investment companies, and banks are exempt from the requirements of this rule. Nor does the rule apply to exempted securities, or offshore Regulation S offerings.

FINRA Rule 5122

 **Example:** XYZ Broker-Dealer is owned by ABC Bank. ABC Bank decides to raise \$5 million in a private placement. The private placement has a PPM. Because ABC owns a broker-dealer, its offering is considered a member private offering. All broker-dealers must provide the PPM to their customers with a description of the offering proceeds, the offering expenses, and the amount of selling compensation they will receive. They must file the PPM with FINRA.

## **CONTACTING FORMER CUSTOMERS AFTER MOVING TO A NEW FIRM**

---

When a registered rep moves to a new firm, he may want to persuade his former customers to move over to his new firm. Upon contacting these former customers, the rep must give them an educational document that describes the costs and complications of transferring assets to a new firm.

The first time the representative (or anyone else at the representative's new firm) has individualized contact with a former customer regarding transferring assets to the new firm, the new firm must provide the former customer with the educational communication. This "educational communication" is created by FINRA and designed to clearly explain the issues that could come up if the customer moves to the new firm, such as non-transferable products and account termination fees. The educational communication may be viewed at <http://www.finra.org/industry/broker-recruitment-notice>. It must be provided to the customer exactly as it appears on FINRA's website.

Individualized contact includes written, electronic, or oral communication, but excludes communication



## *Innovative Resources for Securities Exam Preparation*

aimed at the general public, such as a print ad or social media post. If the individualized contact is in writing, a physical copy of the educational communication must be included. If the contact is electronic, the educational communication must be provided as an attached file or by prominently including the above link. If the contact is oral, it must include oral notice that the educational communication will be provided (which must be done within three business days). Even a mention that the representative has moved to the new firm is considered enough of a lead-in to the topic of transferring assets that it triggers the requirement.

If a former customer wishes to transfer her assets without ever having received individualized contact (perhaps after having heard about the representative's new position through other means, such as word of mouth), then the new firm must provide the educational communication when it provides the account transfer form.

The requirement to distribute the educational communication applies for three months from the representative's first day of employment at the new firm.

If the customer explicitly states he isn't interested in transferring his assets, the educational communication will not need to be sent. However, if the customer later changes his mind within the three-month window, the educational communication will need to be sent to the customer.

Note that this rule specifically applies to cases where the broker has already joined the new firm and is contacting customers from the new firm.

The educational communication states:

*You're receiving this notice because your broker has changed firms. If you're thinking about whether to follow your broker or stay with your current firm, it's a good idea to examine key issues that will help you make an informed decision.*

It encourages customers to ask the following questions:

- Could financial incentives create a conflict of interest for your broker?
- Can you transfer all of your holdings to the new firm? What are the implications and costs if you can't?
- What costs will you pay—both in the short-term and ongoing—if you change firms?
- How do the products at the new firm compare with your current firm?
- What level of service will you have?

FINRA Rule 2273

### **SAMPLE QUESTION**

**Which of these would require immediately providing a former customer with FINRA's educational communication when a representative moves to a new firm?**

- A. A post on the representative's social media account announcing the move to a new firm



## *Innovative Resources for Securities Exam Preparation*

- B. An oral discussion about the representative's new job with a former customer who the representative runs into at a social gathering
- C. A "thank you" note mailed to the representative's former customers, which only mentions that the representative has left her job at the old firm
- D. An email sent to the representative's former customers asking them to consider transferring their accounts to the new firm

**Answer: D.** The requirement to provide the educational communication only applies to individualized contacts, which the social media post is not. It only applies to contacts that raise the topic of transferring assets to the new firm (defined broadly enough to include any mention of the representative's new firm). The "thank you" note doesn't raise this topic. The oral discussion does trigger the requirement to provide the educational communication, but gives the representative three business days to do so.

The email communication is an individualized contact to former customers on the topic of transferring their assets to the representative's new firm, which triggers the requirement. Because it is in electronic form, the educational communication must immediately be provided electronically by incorporating it into the email, either as an attachment or by prominently displaying a link to its location on FINRA's website.

## TELEMARKETING

Consistent with federal law, FINRA and the MSRB require that telephone soliciting generally be made between the hours of 8:00 A.M. and 9:00 P.M. in the prospective customer's time zone. Callers must identify themselves and the firm, provide an address or phone number where they may be contacted, and state the purpose of the solicitation. The telephone number must not be a 900 number, which requires the customer to pay for the call.

FINRA prohibits the cold-calling of anyone on the Federal Trade Commission's (FTC) National Do Not Call Registry, unless the member firm has an established business or personal relationship with the person or has that person's prior written consent. An **established business relationship** is one in which the member firm has made a transaction or had account activity with a customer within the last 18 months or in which the customer has called the firm to ask about a product or service within the last 3 months.

If prospective customers ask the member firm not to be called again, they must be put on a firm-specific do-not-call list when the request is made, and that request must be honored indefinitely.

FINRA requires the member firm to establish written procedures that comply with the federal do-not-call regulations, including procedures to ensure the proper training of its personnel, to record and keep all do-not-call requests, and to maintain a firm-specific do-not-call file. A member firm will not be liable for a violation if it can demonstrate that all of the following are true:

- It happened because of an error





## *Innovative Resources for Securities Exam Preparation*

- Written procedures are in place and implemented
- The firm has accessed the National Do Not Call Registry

A member firm may engage another entity to perform telemarketing services on its behalf, but the firm remains responsible for compliance with FINRA's rules.

FINRA Rule 3230 and MSRB Rule G-39

## **REPORTS AND RECORDKEEPING**

### **LIFETIME AND SIX-, FIVE-, FOUR-, AND THREE-YEAR RECORDS**

Section 17a of the Securities Exchange Act outlines rules for what records to keep and for how long. The general tier of recordkeeping is three years, six years, and lifetime. Additionally, the firm must keep most records easily accessible for the first two years.

All records may be kept either as hard copy or electronic files, as long as they are in an un-rewritable and un-erasable format. Additionally, a firm may use an outside service bureau, depository, or bank to maintain the records. If so, the outside entity must file a notice with the SEC indicating for whom it is holding the records, along with a statement allowing any SEC designee permission to look at the records during business hours.

The exam will not expect you to know every record that must be kept and for how long it must be kept. However, the ones that are important follow.

### **LIFETIME RECORDS**

Records associated with the foundation of a firm must be kept for the firm's lifetime. These types of records are partnership articles if it is a partnership, articles of incorporation if a corporation, minutes of partners' or directors' meetings, and stock certificate books.

### **SIX-YEAR RECORDS**

If FINRA or Exchange Act rules do not specify a time period for a specific book or record, it should be kept at least six years.

FINRA Rule 4511

Records associated with blotters, ledgers, securities, and customer accounts must be retained for six years. These items may be defined as follows.



## *Innovative Resources for Securities Exam Preparation*

**Blotters.** These are daily records containing itemized reports of all purchases and sales of securities and receipts, deliveries of certificates and receipts, disbursements of cash, and all other debits and credits.

**General ledger.** This ledger includes records of all assets and liabilities, income and expenses, and capital accounts.

**Customer ledgers.** These ledgers separately itemize each cash and margin account of every customer. It must include a detailed record of all credits and debits made on each account.

**Securities record.** This record gives information on the owner and physical location of every stock held by the firm. It also includes the position (long or short) that each customer and the firm holds in a security. This is also called a stock record.

**Customer account information.** Records of customer account information must be retained for up to at least six years after the information was last updated. Members also need to preserve a record of the last update to any customer account, or the original account information if there were no updates, for at least six years after the account is closed.

### **FIVE-YEAR RECORDS**

---

The Bank Secrecy Act mandates that all reports and documentation related to Monetary Instrument Log (MILs), Currency Transaction Report (CTRs), and Suspicious Activity Report (SARs) be kept on file for five years from the date of the filing.

### **FOUR-YEAR RECORDS**

---

Customer complaint records shall be kept at the Office of Supervisory Jurisdiction under whose jurisdiction the complaint was filed and maintained for at least four years.

### **THREE-YEAR RECORDS**

---

Most other records must be retained for three years. They include:

- Communications with the public, including retail and institutional communications and correspondence.



## *Innovative Resources for Securities Exam Preparation*

- A memorandum of each brokerage order given or received for the purchase or sale of securities for customer and firm accounts. This memorandum must include the following:
  - ▶ Terms and conditions of the order
  - ▶ Account for which it was entered
  - ▶ Time the order was received
  - ▶ Time of entry
  - ▶ Price at which executed
  - ▶ Identity of each associated person, if any, responsible for the account
  - ▶ Identity of any other person who entered or accepted the order on behalf of the customer
  - ▶ Time of execution or cancellation
- A memorandum of each purchase and sale for the firm's account. This must show the same information as above.
- Copies of customer confirmations and copies of notices of all other debits and credits for customer accounts.
- Authorization records to draw funds from a customer's accounts using a check or another negotiable instrument if the authorization is separate from the check. These must be kept for three years from the check's expiration.
- Copies of office inspections.
- Identification data on beneficial owners of all accounts. This must include the beneficial owner's name and address.
- The application for employment and/or any questionnaire for employment for any associated person. This must be kept for up to three years after employment is terminated.
- Fingerprint records for everyone associated with the firm, including each of its partners, directors, officers, and employees. Like employment applications, these fingerprint records must be kept until three years after employment is terminated.



## *Innovative Resources for Securities Exam Preparation*

### HOW LONG A RECORD IS KEPT

LENGTH OF TIME	TYPE OF RECORD
<b>Three years</b>	<ul style="list-style-type: none"> <li>• Communications with the public</li> <li>• Memo of each brokerage order given or received</li> <li>• Memo of each purchase and sale for the firm's account</li> <li>• Copies of customer confirmations and notices</li> <li>• Authorization records to draw funds from a customer's account</li> <li>• Copies of office inspections</li> <li>• Identification data on beneficial owners of all accounts</li> <li>• Applications for employment/questionnaires for employment</li> <li>• Fingerprint records for everyone associated with the firm</li> </ul>
<b>Four years</b>	<ul style="list-style-type: none"> <li>• Customer complaint records</li> </ul>
<b>Five years</b>	<ul style="list-style-type: none"> <li>• All reports and documentation related to MILs, CTRs, and SARs</li> </ul>
<b>Six years</b>	<ul style="list-style-type: none"> <li>• Any book or record for which FINRA rules do not specify a time period</li> <li>• Blotters</li> <li>• General ledger</li> <li>• Customer ledgers</li> <li>• Securities (stock) record</li> <li>• Customer account information</li> </ul>
<b>Lifetime</b>	<ul style="list-style-type: none"> <li>• Records associated with the foundation of a firm</li> </ul>

# SUMMARY



## Chapter 3 Practice Questions

---

- 1. In examining the suitability of a particular investment recommendation for a customer, you are expected to consider all of the following except:**
  - A. Information about the customer that is commonly known but that the customer refuses to disclose
  - B. The customer's financial status and past investment experience
  - C. The customer's tax status
  - D. The customer's investment objectives and expectations
- 2. The risk that a bond might be redeemed by its issuer prior to the maturity date is known as:**
  - A. Interest rate risk
  - B. Default risk
  - C. Credit risk
  - D. Call risk
- 3. The risk that an investment will lose its value due to an overall decline in the market is called:**
  - A. Systematic risk
  - B. Interest rate risk
  - C. Inflation risk
  - D. Specific risk
- 4. The riskiest investment-grade bond, according to Moody's, is rated:**
  - A. B3
  - B. Ba3
  - C. Baa3
  - D. Baa1
- 5. The risk of fluctuation in the market value of fixed-income investment products, due to interest rate movements, is considered:**
  - A. Credit risk
  - B. Call risk
  - C. Market risk
  - D. Interest rate risk
- 6. To qualify for long-term capital gains tax treatment, an asset must be held for:**



## *Innovative Resources for Securities Exam Preparation*

- A. A month or more
- B. More than a month
- C. A year or more
- D. More than a year

**7. All of the following are true of diversification except:**

- A. It involves investing in uncorrelated assets.
- B. It can lower systematic risk.
- C. It can be used to reduce risk within an asset class or across asset classes.
- D. It supports the old adage, "Don't put all your eggs in one basket."

**8. Which of the following would you not expect from someone with an income strategy?**

- A. Investment in a rental building
- B. Investment in growth stocks
- C. Investment in corporate bonds
- D. Investment in preferred stock

**9. Which of the following would be most subject to purchasing power risk?**

- A. Common blue chip stock
- B. Preferred stock
- C. ADRs
- D. REITs

**10. Which of the following is true about call risk?**

- A. Call risk is the risk that a bond will be called when interest rates are increasing.
- B. If the bond is not called, the bondholder will receive the call value of the bond at maturity.
- C. Non-callable bonds are typically offered at a lower rate than callable bonds.
- D. Call risk is a risk to the issuer rather than the investor.

**11. Which of the following risks would be most likely to apply to equity securities?**

- A. Purchasing power risk
- B. Legislative risk
- C. Credit risk
- D. Interest rate risk

**12. Which of the following investment strategies involves rebalancing a portfolio after a certain period of time?**

- A. Strategic asset allocation
- B. Tactical asset allocation



*Innovative Resources for Securities Exam Preparation*

- C. Dollar cost averaging
- D. Sector rotating

**13. Bart is a registered representative who is running advertisements in the paper. For recordkeeping purposes, what is required for the advertisement?**

- A. The ad must be maintained in a file for seven years.
- B. The ad must be maintained in a file for three years.
- C. Bart may not run the ad for more than six months without refiling it with FINRA.
- D. Since the ad will need to be filed with FINRA, it is not necessary to keep a record of it.



## Chapter 3 Practice Question Answers

---

1. **Answer: A.** You are expected to know the customer's financial status, tax status, and investment objectives. You are not expected to know information the customer refuses to disclose.
2. **Answer: D.** Often, bond issuers will choose to redeem their higher paying bonds in a declining interest rate environment. This tendency of higher paying bonds to get called before their maturity date is referred to as "call risk."
3. **Answer: A.** Systematic risk refers to the tendency of a downward trend in the overall investment market to depress individual securities.
4. **Answer: C.** Using Moody's combination of letters and numbers to rate bonds, Baa3 is the lowest quality investment-grade bond available. S&P would rate the same bond BBB-.
5. **Answer: D.** Interest rate risk refers to the risk of fluctuation in the market value of fixed-income investment products due to interest rate movements. Typically, interest rate risk is higher for fixed-income investment products with longer maturities and higher durations.
6. **Answer: D.** To qualify for long-term capital gains tax treatment, an asset needs to be held for more than a year.
7. **Answer: B.** Diversification is grounded in the idea that it is unwise to put all your eggs in one basket. Specifically, diversification is the process of choosing a variety of assets to spread out the risk from any one asset. One strategy for achieving diversification is the buying of uncorrelated assets, or assets that do not have a history of moving the same direction at the same time. Diversification lowers nonsystematic risk, but it does not lower systematic (market-wide) risk. Diversification can be used to lower risk in a portfolio within asset classes or across asset classes.
8. **Answer: B.** Someone who needs income might invest in a rental building so that she can collect the rental payments. She may also invest in corporate bonds to collect the interest payments. She may also invest in preferred stock to collect the dividends. She would not invest in growth stocks, because these stocks usually do not pay out dividends. An investor who invests in growth stock is an investor who seeks capital appreciation over income.
9. **Answer: C.** Call risk is the risk that a bond will be called when interest rates are declining. If the bond is called, the bondholder will receive the call value of the bond at maturity. If the bond is not called, the bondholder will receive the par value of the bond at maturity. Non-callable bonds are typically offered at a lower rate than callable bonds. Call risk is a risk to the investor rather than the issuer.
10. **Answer: B.** Fixed-income securities are usually more subject to purchasing power risk than equity securities. Blue chip stocks, ADRs, and REITs are all equity securities that are likely to out-perform inflation. While preferred stock usually pays higher dividends, its value hardly appreciates resulting in typically lower overall returns than common stock. These lower returns make it more subject to purchasing power risk.
11. **Answer: B.** Debt securities are associated with purchasing power risk, credit risk, call risk interest rate risk, and





## *Innovative Resources for Securities Exam Preparation*

often liquidity risk. Legislative risk is the risk that a piece of legislation will be introduced that will have an adverse effect on the company. For example, the health care industry is sensitive to changes in legislation relating to insurance coverage. These changes affect healthcare equity securities more than healthcare debt securities.

12. **Answer: A.** Under a strategic asset allocation model, a representative and customer work together to design an optimal mix (on a percentage basis) of major asset classes and subclasses. It will rebalance the portfolio on a regular basis as the portfolio grows, recognizing that some portions will grow faster or slower than others. Unlike a strategic asset allocation model, which relies on keeping an optimum portfolio mix to maximize return, the tactical asset allocation model attempts to time the market, moving in and out of asset classes and sectors based on certain indicators of the direction of the market.
13. **Answer: B.** The ad must be maintained in a file for three years. FINRA members must maintain all retail communications in a separate file for three years from the date of last use.