

Suitability

Pass Perfect

Making Suitable Recommendations

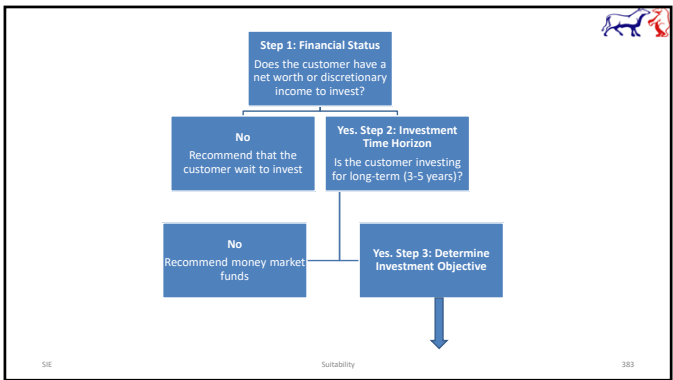
- FINRA rules require reasonable grounds for believing that the recommendation is suitable for that customer
- NYSE Know Your Customer Rule requires knowing all the essential facts about a customer before making a recommendation
- Some of the facts a rep should determine include:
 - Investment Objectives
 - Investment Experience
 - Product Knowledge
 - Other investments
 - Age &/or Time Horizon
 - Risk tolerance
 - Financial and non-financial considerations

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Suitability example

- Client: Mr. Jones, age 40 and has preservation of capital as his investment objective
- Can the rep recommend shares of a blue-chip common stock?**
 - Blue chip stock – large company that usually pays dividends – **but** it's still a stock and may lose value. The Board of Directors can cut dividends anytime!!!
 - So...NO this isn't suitable!
- Alternative scenario – Mr. Jones calls the rep to buy a blue-chip stock, what should the rep do?
 - JUST DO IT – follow the customer's instructions
 - Mark the order ticket = UNSOLICITED!

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<p>CONSERVATION OF CAPITAL / SAFETY</p> <p>Recommend:</p> <p>For Safety, Treasury Securities Funds, GMMB Funds</p> <p>For Safety w/ Tax-Exempt Income, Muni Bond Funds</p> <p>For Safety w/ Liquidity, Money Market Funds</p>	<p>LIFETIME INCOME</p> <p>Recommend:</p> <p>For Fixed Income, Fixed Annuity</p> <p>For Income w/ Inflation Protection, Variable Annuity</p>	<p>CURRENT INCOME</p> <p>Recommend:</p> <p>For Income w/ Safety, Treasury Securities Funds, GMMB Funds</p> <p>For Higher Income w/ Higher Risk, High-Yield Corp Bond Funds, International Bond Funds</p> <p>For Tax-Exempt Income, Muni Bond Funds</p> <p>For Income w/ Growth and Low/Moderate Risk, Growth & Income Funds, Blue Chip Stock Funds, Balanced Funds, Conservative Securities Funds, Equity Income Funds, Asset Allocation Funds</p>
<p>CAPITAL APPRECIATION</p> <p>Recommend:</p> <p>For Capital Appreciation w/ Low Risk, Balanced Funds, Asset Allocation Funds</p> <p>For Capital Appreciation w/ Moderate Risk, Growth Funds, Large Cap Funds, Value Funds, S&P 500 Index Funds</p> <p>For Capital Appreciation w/ Higher Risk, International Growth Funds, Mid-Cap Growth Funds</p>	<p>AGGRESSIVE GROWTH</p> <p>Recommend:</p> <p>For Higher Capital Appreciation w/ Higher Risk, Micro-Cap Growth Funds, Small-Cap Growth Funds, Sector Funds, Emerging Markets Fund</p>	

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SUITABILITY FACTORS

- obviously before a rep makes an appropriate investment recommendation to a customer, the rep should obtain the customer's:
 - INVESTMENT OBJECTIVES;
 - FINANCIAL AND TAX STATUS; AND
 - RISK TOLERANCE

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1) CLIENT INVESTMENT OBJECTIVES

– generally, the client has one or more of these three main investment objectives:

- **Preservation Of Capital**
- **Capital Appreciation**
- **Current Income**

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1) CLIENT INVESTMENT OBJECTIVES (cont.)

– **Preservation of Capital**

- keeping principal safe and avoiding investment loss
- these investors are conservative and will generally pursue defensive investment strategies of low risk

– **Capital Appreciation**

- accepting some risk to achieve growth

• **Aggressive Growth**

- for investors willing to take on even greater risks for the potential of greater returns

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1) CLIENT INVESTMENT OBJECTIVES (cont.)

– **Current Income**

- for investors who are more interested in receiving income from their investments

• **Tax-Exempt Income**

- for investors in high tax brackets who desire income free from income tax (like by investing in municipal bonds)
 - » the return on the municipal investments should be higher than the after-tax return on taxable investments
 - » note that "private purpose" municipal bonds are taxable
 - like for a sports stadium
 - » "public purpose" municipal bonds are not taxable
 - like for a school

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2) CLIENT FINANCIAL/TAX STATUS

–to analyze a client's financial status, the rep should look at the client's:

- **Balance Sheet**; and
- **Income Statement**

ASSETS + LIABILITIES
↓
REVENUES + EXPENSES

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2) CLIENT FINANCIAL/TAX STATUS (cont.)

– **Balance Sheet**

- gives the customer's financial situation

• **Assets = Liabilities + Net Worth**

- **Assets** are what the client owns
 - » *Current Assets* are ones that can be transferred into cash quickly (like securities)
 - » *Fixed Assets* are ones that cannot readily be turned into cash (like real estate)
- **Liabilities** are what the client owes
 - » *Current Liabilities* are bills that must be repaid within 1 year (like a credit card bill)
 - » *Long-Term/Fixed Liabilities* are bills payable in more than 1 year (like a mortgage)
- **Net Worth** is what is left from the Assets after paying the Liabilities

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2) CLIENT FINANCIAL/TAX STATUS (cont.)

– **Income Statement**

- shows the client's income and expenses over the entire year

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3) RISK TOLERANCE AND TIME HORIZON

- **Risk Tolerance**
 - probably the most important of all suitability considerations
 - risk takers are **aggressive investors** seeking higher returns
 - for those that want current income, a high-yield bond fund might be suitable
 - **for those not as aggressive**, but risk tolerant might invest in growth funds, value funds, international funds, and similar common stock funds
 - **more conservative investors** who tolerate only a moderate level of risk might find a growth and income fund or a blue-chip stock fund more suitable
 - **for risk averse investors** seeking preservation of capital, a government securities fund might be suitable
 - regarding **senior citizens** it should be noted that while many retired individuals are risk averse, some might still tolerate a more aggressive investment, like one in a common stock fund

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3) RISK TOLERANCE AND TIME HORIZON (cont.)

- **Investment Time Horizon**
 - the length of time a customer expects to hold an investment
 - customers should have liquid assets to meet short-term needs, including emergency needs
 - stocks should normally be purchased for one who has a time horizon of at least 3-5 years
 - a customer who needs money within a short time should invest in a money market fund

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3) RISK TOLERANCE AND TIME HORIZON (cont.)

- **Volatility**
 - the fluctuation of the value of invested capital as market prices change
 - aggressive growth funds are likely to have greater changes in value than other funds (like a balanced fund) during periods of stock market volatility
 - interest rate changes affect long term bond funds more than short-term bond funds
 - high-volatility investments are suitable to more risk-tolerant customers

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3) RISK TOLERANCE AND TIME HORIZON (cont.)

- the rep should review a customer's suitability factors periodically to make sure of any changes in the customer's investment objectives/situations

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FINRA RULES REGARDING RECOMMENDATIONS

- before making a recommendation, reps must make a reasonable effort to obtain the customer's (suitability):
 - financial and tax status;
 - investment objectives; and
 - any other info considered reasonable when making a recommendation
- if the customer refuses to provide sufficient personal information, the rep cannot make recommendations, but can still open the account and accept unsolicited orders from the customer

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Chapter 9

Regulation

Securities Act of 1933

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SECURITIES ACT OF 1933

The wording of the Securities Act of 1933 states that if:
 an interstate offer;
 of a non-exempt security;
 is made in a non-exempt transaction; then
 the issue must be registered with the SEC

Registration is time-consuming and expensive, and the way to avoid it comes out of the wording above.

If an offer is made **INTRASTATE**, it is exempt.

If the securities are **EXEMPT**, then there is no registration.

The act specifies the exempt securities.

If the securities are offered in an **EXEMPT TRANSACTION**, there is no registration

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EXEMPT SECURITIES

U.S. Gov'ts, Agencies, Munis, & Sovereign Gov't Debt – because we trust our governments, so we don't put the burden of SEC registration on them!

Money Market Instruments - Banker's Acceptances and Commercial Paper as long as the maturity is 270 days or less – because it is mainly an institutional market and they can protect themselves!

Issuers already regulated under other laws – so they are already being tortured by another regulator!

- Bank issues
- Insurance company offerings (EXCEPT variable annuities)
- Common Carrier Issues (i.e., railroads, trucking companies,...)
- Public Utility issues

Miscellaneous – Non-for-profit issues like church bonds, and SBICs – Small Business Investment Companies - which fund minority businesses

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All of the following are exempt securities under the Securities Act of 1933 EXCEPT:

- A. Charitable organization issues
- B. Commercial Paper maturing under 270 days
- C. Foreign Government obligations
- D. Industrial machinery issues

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Which of the following are exempt securities under the Securities Act of 1933?

- I US Gov't bonds
- II General Obligation bonds
- III Mortgage bonds
- IV Convertible debentures

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

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Commercial paper is an exempt security as long as its maturity does not exceed:

- A. 30 days
- B. 60 days
- C. 90 days
- D. 270 days

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Banker's Acceptances are:

- A. money market instruments subject to the Securities Act of 1933
- B. capital market instruments subject to the Securities Act of 1933
- C. money market instruments exempt from the Securities Act of 1933
- D. capital market instruments exempt from the Securities Act of 1933

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Which of the following is an exempt issue?

- A. Fixed annuity contract
- B. Variable annuity contract
- C. Government bond mutual fund
- D. Municipal bond unit investment trust

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EXEMPT TRANSACTIONS

RULE 147 – INTRASTATE EXEMPTION

Federal government typically has jurisdiction across state lines
 If transaction stays within 1 state, then only that state's laws apply
 80% of issuer's sales or assets or proceeds in that state
 All purchasers must be state resident
 Issuer must be state resident

Resale is "locked-up" within state for 1st 6 months after offering is completed

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All of the following statements are true about Rule 147 EXCEPT:

- A. Both the issuer and all purchasers must be state residents
- B. Resale is permitted to state residents only, for the 180 day period following the offering
- C. The rule exempts intrastate issues from State registration
- D. The rule exempts intrastate issues from Federal registration

New Issues & Regulations

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A customer who has his primary residence in Colorado, has a vacation home in Montana. An intrastate offering is being made in the state of Montana. Which statement is TRUE regarding the customer purchasing this securities offering?

- A. The customer is permitted to buy these securities
- B. The customer is prohibited from buying these securities
- C. The customer can buy the securities if he spends at least 2 weeks per year in the state of Montana
- D. The customer can buy the securities if he files an affidavit of domicile in the state of Montana

New Issues & Regulations

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EXEMPT TRANSACTIONS

REGULATION D – PRIVATE PLACEMENTS

An offering of any dollar amount made in any state to a maximum of 35 non-accredited investors and an unlimited number of accredited investors
 Accredited investors are wealthy:

Annual Income \$200,000 year (\$300,000 couple); or
 Net Worth: \$1,000,000 (not including the investor's primary residence);
 Institution with \$5,000,000 for investment; or
 Officer or Director of issuer

Purchasers get "restricted" private placement stock – cannot be traded

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Under Regulation D, ~~regarding private~~ placements, how many accredited investors are allowed to invest in the offering?

A. 0
 B. no more than 35
 C. exactly 35
 D. an unlimited amount

RTFQ

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Who is an accredited investor under Regulation D?

A. Officer or director of the issuer
 B. Individual with a \$200,000 Net Worth
 C. Trust with \$2,000,000 of Assets
 D. Employee Benefits Fund with \$1,000,000 of assets

EXEMPT TRANSACTIONS

RULE 144 – PUBLIC RESALE OF RESTRICTED STOCK

Assume you go to work for a start-up venture capital financed company. They give you a "so-so" salary, but they also give you stock – and this is restricted stock because the company is not public.

If the company goes public, you can either sell your restricted stock by registering it with the SEC and selling with a prospectus (time consuming and expensive) or you can use Rule 144

In a Rule 144 sale, the transfer agent is authorized to remove the restriction legend from the shares and issue clean registered stock to the buyer, so Rule 144 is the easier way to sell

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EXEMPT TRANSACTIONS

- To do a Rule 144 sale, hurdles must be cleared:
- The company must have gone public and it must be current in its SEC filings
- The seller must have held the stock fully-paid, at risk, for 6 months
- The seller must file a Form 144 notice of sale with the SEC at or prior to sale. The Form 144 can be filed every 3 months
- On the Form 144, the maximum permitted sale is calculated. It is the GREATER of:
 - 1% of the outstanding shares; or
 - Weekly average of the prior 4 weeks' trading volumes

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EXEMPT FROM THE ACT OF 1933 (cont.)

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can sell: 1% of the outstanding shares

OR

4

the average of the last 4 weeks trading volume

4

can be done 4 times a year (every 90 days)

whichever is greater

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EXEMPT TRANSACTIONS

RULE 144 (cont.)

- Rule 144 limits are also placed on control persons (key officers, directors) that wish to sell their registered shares. They are not subject to the 6-month hold (since these shares are registered) but must file the Form 144 and sell within the volume restrictions

HOW TO AVOID RULE 144 (ONLY IF PUBLIC COMPANY)

- Die! – The estate can sell the shares without restriction
- Sell Small Amount! – A maximum of 5,000 shares worth a maximum of \$50,000 can be sold every 3 months
- Leave Company! – An officer that leaves the company can sell all shares without restriction once 6-month hold is met and officer is out of company for 3 months

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Under Rule 144, control stock that is purchased in the open market can be sold:

- A. immediately
- B. after a 6 month holding period has elapsed
- C. after a 2 year holding period has elapsed
- D. after a 3 year holding period has elapsed

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SEC Rule 144 applies to all of the following EXCEPT:

- A. sales of registered securities by an officer of the company
- B. sales of registered securities by a minority shareholder of the company
- C. sales of unregistered securities by an officer of the company
- D. sales of unregistered securities by a minority shareholder of the company

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All of the following restricted securities are subject to the 6 month holding period rule under Rule 144 EXCEPT securities:

- A. received as a gift through a donor
- B. acquired through a private placement
- C. held by an estate for a person since deceased
- D. held in a trust for a beneficiary

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Securities Exchange Act of 1934

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SECURITIES EXCHANGE ACT OF 1934

- Manipulation – very bad to “manipulate” the market price (pump and dump)
- Insiders – defined as officers/director of the company or anyone that owns 10%
- SEC created
- Short Sale Rules – what is a short sale = selling stock that you don't own (1st borrow the stock)
- Proxy Rules – shareholders must be sent an absentee ballot (vote)
- Exchanges must register with the SEC
- Reports annual and quarterly financial reports
- Margin control over credit on securities given to Federal Reserve
- Stabilization – only legal form of manipulation

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The Securities Act of 1934 regulates all of the following markets EXCEPT:

- A. Primary
- B. Secondary
- C. Third
- D. Fourth

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The Securities Exchange Act of 1934 regulates trading of which of the following?

- I Corporate Stock
- II Options
- III Fixed Annuities
- IV Commodities Futures

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

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EXCHANGE ACT OF 1934

MANIPULATION

Manipulating markets is fraudulent (duh!)

Rule 10b-5 is most famous – the catch-all fraud rule – whatever you dream up can be fraud under Rule 10b-5, even if the Act does not explicitly prohibit it!

Manipulation rules apply to ALL securities – exempt and non-exempt

All the other '34 Act rules only apply to non-exempt issues

INSIDER RULES

The Act defines an insider as an officer, director or 10% shareholder. Insiders must report their:

- insider status to the SEC;
- trades in the company's stock in 2 business days



EXCHANGE ACT OF 1934

INSIDER RULES (cont.)

Insiders cannot:

- Sell their own company's stock short;
- Retain short-swing profits trading own company's stock (profit achieved within 6 months); and
- Trade based on material non-public information

INSIDER TRADING ACT AMENDMENTS OF 1988

Put in the "Tipper-Tippee" Doctrine – the tipper is liable as well as the tippee who traded – brokerage firms can be held as tippees if their employees inside trade unless they put in Chinese Walls

Penalties for violations – treble damages, \$ fines (paid to Treasury), jail, and liability to shareholders of company

Informant bounty of 10-30% of the take if you rat on an insider and they wind up paying big fines!



INSIDER RULES (cont.)

• CHINESE WALLS

- to stop information flow between certain departments of the same firm, there are barriers that must be maintained between:




The president of a company is out playing golf with a registered representative and tells her, in confidence, that this will be the best quarter ever. Based on this information, the registered representative buys this stock. Who, if anyone, has violated the insider trading rules?

- A. the registered representative only
- B. the president only
- C. both the registered representative and the president
- D. neither the registered representative nor the president

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A Chinese Wall must be maintained by a broker-dealer between investment banking and all of the following departments EXCEPT:

- A. Research
- B. Trading
- C. Retail Sales
- D. Mergers and Acquisitions

464

If a person is convicted of insider trading:

- I. the amount of any profit achieved or loss avoided must be paid
 - II. three times the amount of any profit achieved or loss avoided must be paid
 - III. payments are made to the Department of Treasury
 - IV. payments are made to the Securities and Exchange Commission
- A. I and III
 - B. I and IV
 - C. II and III
 - D. II and IV

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EXCHANGE ACT OF 1934

SHORT SALE RULES

Regulation SHO was written to regulate the impact of short sales on the market

SEC CREATED

The Act created the SEC and gave it enforcement power over the Securities markets. All exchanges and SROs register with the SEC and have their rules approved by the SEC (there are only 13 exchanges, plus FINRA and the MSRB are SROs).

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EXCHANGE ACT OF 1934

PROXY RULES

These are rules that make sure shareholders are not denied their right to vote

The only part of the rules that must be known is Rule 13D – anyone who accumulates a 5% or greater holding in a company with the intention of exercising control (like asking for a vote to get a seat on the Board) must file a Form 13D with the SEC (public document) within 10 business days of crossing the 5% threshold

EXCHANGE REGISTRATION

Exchanges register with the SEC and become SROs – Self Regulatory Organizations - under SEC oversight. FINRA and MSRB are non-exchange SROs. Member firms (BDs) register; their officers register; and their salespersons and traders (you!) register – hence the term registered representative

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EXCHANGE ACT OF 1934

REPORTS FROM ISSUERS

Issuers must prepare and file audited annual financial reports (10Ks) and quarterly unaudited financial reports (10Qs)

If a significant event occurs at a company (merger, divestiture, bankruptcy, change in Board of Directors), an 8K filing is required with the SEC within 4 business days of the event

MARGIN ON SECURITIES

The Federal Reserve was given the power to set margin on securities – but only non-exempts!

- Reg. T: Credit on securities from broker to customer
- Reg. U: Credit on securities from bank to broker

STABILIZATION

To prevent an IPO from starting to trade at a significant discount to the POP, the managing underwriter can place a one-sided Bid at or just below the POP

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An 8K Report would be required for all of the following EXCEPT:

- A. declaration of a merger
- B. declaration of a divestiture
- C. declaration of a dividend
- D. declaration of bankruptcy

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All of the following publicly held issuers must report to the SEC under the Securities Exchange Act of 1934 EXCEPT:

- A. Municipalities
- B. Unit investment trusts
- C. Mutual funds
- D. Corporations

470

The provisions of the Securities and Exchange Act of 1934 apply to all of the following activities EXCEPT:

- A. trading of municipal bonds
- B. issuance of municipal bonds
- C. issuance of corporate financial statements
- D. trading of corporate bonds

471

All of the following are covered under the Securities and Exchange Act of 1934 EXCEPT:

- A. registration of broker/dealers
- B. registration of exchanges
- C. registration of new issues *ACT OF '33*
- D. stabilization of new issues

472

The general provisions of the Securities and Exchange Act of 1934 apply to all of the following EXCEPT:

- A. Individuals ~~trading non-exempt securities~~
- B. Individuals ~~trading exempt securities~~
- C. Broker/dealer firms ~~trading non-exempt securities~~
- D. Broker/dealer firms ~~issuing non-exempt securities~~

ACT OF '33

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Other Federal Acts

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OTHER FEDERAL ACTS

TRUST INDENTURE ACT OF 1939
Requires non-exempt debt issues (corporates) over \$50,000,000 to have a Trust Indenture.
Trustee must be commercial bank or trust company – not a trust attorney, not a broker-dealer

INVESTMENT ADVISERS ACT OF 1940
Requires all advisers to investment companies and other big advisers with over \$110 mil of assets under management to register with the SEC as an RIA – Registered Investment Adviser
Smaller advisers (under \$100 mil assets) are only required to register with the State – not the SEC
Excluded from registration are banks, broker-dealers, and professionals who give incidental advice

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OTHER FEDERAL ACTS

SECURITIES INVESTOR PROTECTION ACT OF 1970
Created SIPC, which protects customer accounts from BD failure – going out of business!!

Coverage limit is \$500,000 of equity per customer, of which no more than \$250,000 can be in cash claims

Assume investor will take cash claims first

Uncovered claims – General creditor of failed BD
Does NOT cover commodities or futures accounts ("Non-Securities Credit Account")

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A customer has an account with \$350,000 in securities and \$350,000 of cash. What is the coverage amount in a SIPC liquidation?

- A. \$500,000
- B. \$450,000
- C. \$350,000
- D. \$150,000

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In a SIPC liquidation, if a customer still has claims above the covered amount, the customer becomes a:

- A. secured creditor
- B. general creditor
- C. limited partner
- D. general partner

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Mike Jones has two accounts at a failed brokerage firm; a cash account with ~~\$350,000~~ of cash and a margin account with \$600,000 in securities. Which of the following statements is true regarding SIPC coverage limits?

Handwritten notes: 250K CASH, 250K SECURITIES

- A. The customer is covered for the total amount of \$950,000
- B. The customer is covered for \$250,000 for the cash account and \$500,000 of the securities
- C. The customer is covered for a total of \$500,000 in securities only
- D. The customer becomes a general creditor for \$100,000 of cash and \$350,000 in securities

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A customer has an account with a brokerage firm that is in receivership. The account holds \$220,000 of securities and has a \$90,000 debit. Which statement is true regarding SIPC coverage?

- A. The customer must deposit \$90,000 to receive the \$130,000 of securities
- B. The account is covered for \$100,000
- C. The account is covered for \$130,000
- D. The account is covered for \$220,000

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OTHER FEDERAL ACTS

FEDERAL TELEPHONE CONSUMER PROTECTION ACT

Original Act requires companies (BDs) to maintain Do Not Call lists
 Unsolicited cold calls cannot be made before 8 AM nor after 9 PM in the time zone of the recipient
 If recipient says "Don't Call Me" = put him or her on the Firm Do Not Call List

Later on, the Federal Do Not Call List was created – so now there are 2 lists to deal with!
 The rules boil down to this:

If the person is on the Firm Do Not Call list, you can't call him – period
 If the person is on the Federal List, but NOT the Firm List, you can't call him

UNLESS:

He or she is a family member or friend;
 He or she invites you to call; or
 There is an Established Business Relationship – meaning that he did a trade with your firm in the last 18 months or has an account

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Which of the following callers is EXEMPT from the provisions of the Federal Telephone Consumer Protection Act of 1991?

- A. Telemarketing firm
- B. Real estate company
- C. Non-profit organization
- D. Securities firm

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Primary responsibility for enforcement of the Federal Telephone Consumer Protection Act rests with the:

- A. SEC
- B. FTC
- C. FCC
- D. FINRA

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A newly registered representative is making solicitation calls to potential clients. The representative is told by his father that his brother, the representative's uncle, might be interested in getting investment advice. When the representative enters the telephone number of his uncle, it comes up as blocked since this person is on the National "Do Not Call" list. Which statement is true?

- A. Because the referral was made by an immediate family member, the uncle can be solicited by the representative
- B. Because a personal relationship exists between the uncle and the representative, the solicitation may be made
- C. Because the representative is newly registered and has not "seasoned" for 18 months, the solicitation cannot be made
- D. Because the uncle is on the National "Do Not Call" list, no solicitation by the representative is permitted

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A satisfied customer gives his representative a client referral. Which statement is true?

- A. The representative should check the Do Not Call list before acting on the referral
- B. The representative is not required to check the Do Not Call List prior to acting because the client was referred
- C. The referred client may only be contacted between the hours of 8:00 AM and 9:00 PM
- D. The representative is not permitted to contact the referred client unless the referred client initiates the contact

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SRO Rules

Licensing Test

- Test is confidential – cannot disclose content. If flunk test, wait 30 days; if flunk 3X, wait 180 days

Full Time Employment Obligation

- If you want to engage in any outside business activity (including not-for-profit work like going on your Coop's Board of Directors), you must notify the firm in writing and follow firm's instructions

Continuing Education Obligation

- Firm Element: Annual training by firm
Regulatory Element: On 2nd anniversary of registration and every 3 years thereafter, FINRA training. If don't show up, suspended without pay.

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SRO – RR RULES

Borrowing From / Lending To Clients

RR cannot borrow money from, or lend money to, a client. RR can borrow from immediate family, or a "significant other" who is a client if written notice given to firm and firm's instructions are followed

Gift Limit

\$100 give or get, related to your work, per person per year. Does not apply to business entertainment (meaning you are there with the client)– then follow firm policies

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SRO – RR RULES

Political Contribution Limit:

MSRB limits MFPs (Municipal Finance Professionals) to a \$250 contribution to an elected official's campaign in which the MFP is entitled to vote.

If the MFP gives more than \$250; or

The MFP gives ANY \$ amount to a campaign where the MFP can't vote, then;

The firm is banned for 2 years doing municipal securities business (negotiated underwritings) with that issuer

If a check is written on a joint checking account to an elected official's campaign where one party to the account is an MFP, the MSRB counts the contribution as ½ only if BOTH SIGN the check

MFP: a registered person who performs financial advisory work or underwriting for municipalities; i.e. a reg. rep. who deals with retail clients is NOT an MFP; i.e. a reg. rep. who negotiates underwriting terms with a municipality is defined as an MFP subject to the rule

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A Municipal Finance Professional (MFP) gave \$550 to the election campaign of her next door neighbor, who is running for the office of mayor of her town. Which statement is **TRUE**?

- A. There is no impact on the municipal securities firm because of the political contribution
- B. The political contribution will result in a ban on the municipal securities firm performing negotiated underwritings for that issuer for 1 year
- ✓ C. The political contribution will result in a ban on the municipal securities firm performing negotiated underwritings for that issuer for 2 years
- D. The political contribution will result in a ban on the municipal securities firm performing negotiated underwritings for that issuer for 3 years

SRO – RR RULES

Intra-Industry Disputes:

When you signed the U-4 Form to become registered, you also signed an arbitration agreement, mandating arbitration to settle disputes with member firms or other RRs. Note that you can still sue for sexual harassment, whistleblowing, and discrimination claims, however!

Correspondence With Clients:

Defined as any communication sent to 25 or fewer existing or prospective clients, including e-mails and IMs. All correspondence must be approved in advance before going out UNLESS the firm implements correspondence compliance procedures that include training of RRs and audit of communications. If so, then correspondence is subject to "post-use review and approval."

All correspondence must be retained for 3 years and

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SRO – RR RULES

Leave Business:

If an RR leaves the business, then all licenses lapse after being out for 2 years. If you re-enter after 2 years out, must take all tests again! Parking or hanging your license with a "friendly BD" while you are out of the business to avoid this is explicitly prohibited

Military Duty:

If you are called up for military duty, registration goes into "special inactive" status, which stops the clock on the above. You don't lose licenses because you are out for 2 years or more! When you return, the clock starts counting again from where you left off. Can be paid and can share commissions with another RR in firm who services your accounts while you are away

 Pass Perfect

SRO – RR RULES

Reportable Events:

If bad things are happening to you, FINRA wants to know about it. Any registered person must report to FINRA promptly, but no later than 30 days after the event, if the RR is:

- suspended or expelled by another regulator;
- sued under the Securities Acts;
- enjoined by a court of law from being in the securities business;
- the subject of a really, really serious customer complaint (essentially a complaint alleging a felony, like theft or embezzlement)
- the subject of a customer complaint settled for more than \$15,000
- the subject of withheld commissions or fines by firm of more than \$2,500
- arrested or indicted (except for misdemeanor traffic violations and misdemeanor DUIs – ALL felonies MUST be reported)

 Pass Perfect

SRO – CUSTOMER RULES

BD Financials:

The BD must send its balance sheet and computed net capital (liquid net worth) to customers 2X a year, annual audited and mid-year unaudited. No requirement to send an income statement


FINRA Manual:

The FINRA manual must be in each branch office, available for customer inspection. Giving the customer access to the FINRA web site satisfies this requirement

Charges to Customers:

BD cannot separately charge for recommendations – included in commission or mark-up (if your firm unbundles and charges separately for recommendations, it becomes an Investment Adviser and is subject to all the IA rules)

Can charge for clerical services such as safekeeping, appraisals of securities, collection of dividends – but cannot charge for distribution of proxies because this is paid by the issuer

 Pass Perfect

SRO – CUSTOMER RULES

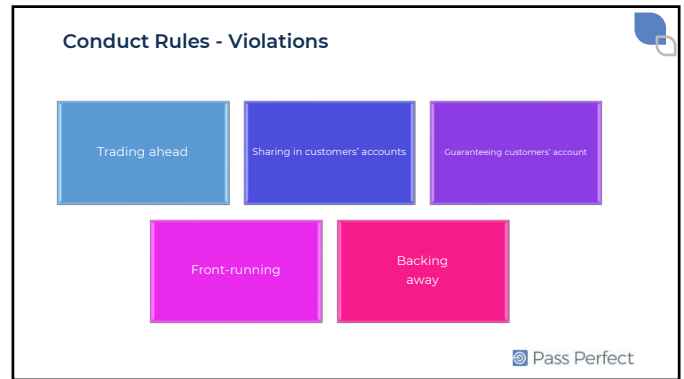
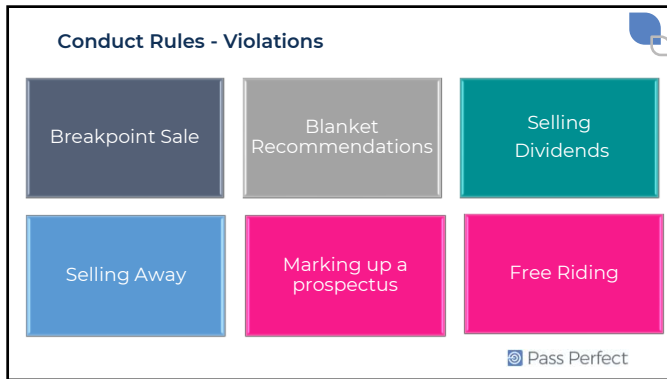
Customer Disputes:

Handled by arbitration only if the customer signed a "pre-dispute" arbitration agreement. If not, the customer can choose to arbitration, can use the FINRA Code of Procedure for settling disputes or can sue

Private Placement Offerings:

Private placements (Reg. D) are not registered with the SEC, there is no explicit due diligence obligation, and there is no prospectus. As private placement offerings have become more popular, FINRA fixes this by requiring either the member firm or RR offering a private placement offering, to perform due diligence on the offering

 Pass Perfect



A mutual fund has the following breakpoint schedule:

Purchase Amount	Sales Charge
\$0 - \$10,000	6%
\$10,001-\$25,000	5%
\$25,001-over	4%

Which of the following single purchase amount would be considered a "breakpoint sale"?

A. \$1,000
 B. \$11,000
 ✓ C. \$24,000
 D. \$26,000

New Issues & Regulations 497

A registered representative would like to increase her production by working from home at nights and on weekends. As part of this effort, the representative wants to use her home e-mail account to send her customers information and recommendations. This action is:

A. permitted as long as the rep uses her personal e-mail account
 B. permitted with the prior permission of the branch manager
 ✓ C. not permitted because the member firm has no way of auditing the rep's personal e-mail account
 D. not permitted because the rep has not registered her personal e-mail account with the SEC

498

A customer buys securities without making payment and then sells the same securities without showing the intent to settle the transaction. This is:

✓ A. Free Riding
 B. Front Running
 C. Interpositioning
 D. Backing Away

Series #7 New Issues & Regulations 499

All of the following must be sent to customers of broker-dealers semi-annually EXCEPT:

✓ A. Broker-dealer securities inventory amounts
 B. Broker-dealer balance sheet
 C. Broker-dealer subordinated loan amounts
 D. Broker-dealer net capital computation

500



All of the following are violations of FINRA's Conduct Rules EXCEPT:

- A. guaranteeing a customer account against loss
- B. selling a customer an exempt security with a written agreement to buy back that security at a fixed price
- C. making blanket recommendations of low price speculative stocks to customers
- D. selling dividends to customers by inducing customers to buy stocks just prior to the ex date

501



A registered representative says the following to her customer: "If we do not generate an investment return of 10% within 1 year, we will happily refund your money." This statement is:

- A. permitted since the customer benefits from the guarantee
- B. prohibited because it is not known if the broker-dealer will be in business 1 year later
- C. prohibited since this is a guarantee of performance
- D. permitted if the broker-dealer maintains adequate Net Capital to fund any customer refund claims made

518

Suitability

502



A registered representative can promise a customer that he will resell a security at a price equal to that paid by the customer:

- A. only if agreed to in writing
- B. only if approved by a manager
- C. only if the customer is sophisticated
- D. under no circumstances

518

Suitability

503



All of the following practices are prohibited under FINRA rules EXCEPT:

- A. Trading mutual fund shares
- B. Selling dividends
- C. Making blanket recommendations of low price speculative stocks
- D. Charging 7% on a mutual fund transaction

504



A registered representative receives a large buy order from an institution and buys that stock for his own account before placing the order. This is known as:

- A. Interpositioning
- B. Free Riding
- C. Backing Away
- D. Front Running

505



A customer calls a registered representative to sell 500 shares of an over-the-counter stock and tells the representative that he wants the trade done privately - not in the public market. This is:

- A. allowed without restriction
- B. allowed with the oral approval of the principal
- C. allowed if the trade is performed as "agent"
- D. not allowed

Failure to honor a stated quote is a violation known as:

- A. backing away
- B. selling away
- C. quoting away
- D. trading away

Securities purchased by a customer in a cash account are NOT paid for by the payment date. If the securities are sold by the customer, this is an example of:

- A. Churning
- B. Day trading
- C. Free-riding
- D. Marking to market

508

COMMUNICATIONS RULES

Defined Communications With The Public

Advertising: Intended for the general public – includes TV, radio, magazines, billboards, non-password protected websites and internet bulletin boards. In advertising, NO recommendations

Sales Literature: Intended for a specific audience – includes research reports, market letters, speeches about investing to an audience, password-protected websites, form letters or communications to **more than 25** existing or prospective clients (if less, it is correspondence). Recommendations CAN be made in sales literature

Every piece of advertising and sales literature must be approved by a principal prior to use and be retained for 3 years

 Pass Perfect

A registered representative presents a seminar to a group of prospective investors about investing in mutual funds. At the seminar, he makes recommendations of various funds, based on their objectives and performance. The seminar is defined by FINRA as:

- A. correspondence
- B. an internal memorandum
- C. advertising
- D. sales literature

510

An electronic communication of an "individual" nature sent by a representative to a customer is defined as:

- A. Advertising
- B. Sales Literature
- C. Correspondence
- D. Educational Material

511

A registered representative wishes to give a speech about investments in growth stocks versus value stocks to a group of 50 retail attendees. All of the following statements are true regarding the speech EXCEPT:

- A. The speech must be approved in writing by a compliance officer or principal
- B. The speech should be informational, not promotional in nature
- C. The speech can contain comparisons of past performance of recommended investments to that of recognized market indices
- D. A written copy of the speech must be retained by the member firm for 6 years

512

COMMUNICATIONS RULES


FILING OF RETAIL COMMUNICATIONS

For a member firm's first year of operations, generally, all retail communications must be filed 10 business days in advance of use (exceptions are forthcoming)
 Thereafter, no filing is required, but the firm is subject to spot checks

Retail Communications always filed 10 Business Days IN ADVANCE
 Options retail communications; and Mutual fund retail communications with member-prepared performance rankings

Retail Communications always filed 10 Business Days AFTER First Use
 All other mutual fund retail communications;
 CMO retail communications; and
 DPP retail communications

FINRA name can be used on websites, stating that the firm is a "member." The FINRA name must be smaller than the firm name and hyperlinked to FINRA web site. (Also note, RR cannot say he or she is a FINRA member – only the firm is!)




COMMUNICATIONS RULES

CMO ADVERTISING

Required Disclosures:
 Coupon; anticipated yield and average life; specific tranche ID - # and class; final maturity date; and underlying collateral

The statement:
 "The yield and average life shown above consider prepayment assumptions that may or may not be met. Changes in payments may significantly affect yield and average life."

Optional Disclosures:
 Minimum denomination; rating; agency/Gov't backing; income payment structure; generic tranche description (i.e. PAC, TAC, Companion Class); and YTM of CMOs offered at Par




COMMUNICATIONS RULES

When a recommendation is made (which is only permitted in Sales Literature and Correspondence – NOT in advertising):

The price of the security at the time must be disclosed;
 There must be a basis in fact for making the recommendation;
 Every conflict of interest known to man must be disclosed, such as if the:

- Firm or its officers own the recommended stock;
- Firm is a MM in the stock;
- Firm has been an underwriter for that company in the past 12 months;
- Firm intends to seek underwriting business from that company in the upcoming 3 months, etc.



COMMUNICATIONS RULES

Research Analyst / Research Report Rules

The Analyst that wrote the recommendation must certify that this is his or her honest, pure unconflicted, pure-as-the-driven snow, opinion (Regulation AC – Analyst Certification)

If a registered representative:
 Gives a presentation to **15** or more persons; and
 The information presented allows the attendees to form a buy or sell opinion on a security; then

The RR is subject to the Research Analyst Disclosure Rules and Trading Prohibitions!



COMMUNICATIONS RULES

Research Analyst / Research Report Rules

If an issuer is doing an underwriting for a company, it cannot issue a research report on that company once registration is effective, since a favorable report could manipulate the price up

IPO – No research reports by underwriter for **10 days** following effective date
 Add-On (Secondary) – No research reports by underwriter for **3 days** following effective date

Public Appearance / Public Forum

An unscripted, spontaneous appearance, such as participation in a seminar, forum (including electronic venues, such as internet chat rooms), radio, TV, or other public appearance


This doesn't require prior principal approval, but the firm must still establish policies to supervise them for compliance




A representative wishes to invite 10 of her best customers to an intimate dinner, to be followed by a presentation that the rep. will make on investing. If the rep. includes analyses of specific stocks in the speech; and the attendees use this information to determine whether to invest in those securities, then the:

- I presentation is considered to be a research report
- II presentation is not considered to be a research report
- III rep. is required to make all of the disclosures required of research analysts
- IV rep. is not required to make all of the disclosures required of research analysts

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

SIE  **518**



A representative wishes to invite 30 of her best customers to a buffet dinner, to be followed by a presentation that the rep. will make on investing. If the rep. includes analyses of specific stocks in the speech; and the attendees use this information to determine whether to invest in those securities, then the:

- I presentation is considered to be a research report
- II presentation is not considered to be a research report
- III rep. is required to make all of the disclosures required of research analysts
- IV rep. is not required to make all of the disclosures required of research analysts

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

SIE 519

MISCELLANEOUS ITEMS

MSRB (Municipal Securities Rulemaking Board)
Rules Apply

- o The MSRB writes rules for municipal market participants that deal in municipal securities including:
 - Municipal brokers;
 - Municipal dealers; and
 - Bank municipal bond departments
- o The MSRB has no authority over municipal issuers, that is, the municipalities
- o The MSRB just writes rules – they don't enforce them – FINRA enforces MSRB rules. When FINRA audits BDs, it audits for MSRB compliance.

Pass Perfect

MISCELLANEOUS ITEMS

MSRB Annual Notice To Customers
 Annually each customer must be sent:
 A statement that the broker-dealer is registered with the SEC and MSRB;
 The website for the MSRB; and
 A statement as to the availability of an MSRB "Investor Brochure" – which details the procedures to be followed for filing a complaint with FINRA (as the MSRB does not enforce its own rules)

Complaint

- One in writing – a written record of any complaint must be kept on file for **6 years** (FINRA rule is 4 years)

Pass Perfect

MISCELLANEOUS ITEMS

EMMA
 Electronic Municipal Market Access - created by the MSRB for retail customer use - it gives investors access to municipal new issue disclosure documents (Official Statements) and municipal trade reports

EMMA includes:

- Official Statements for new municipal issues
- Pre-refunded bond information
- 529 plans, auction rate securities, and variable rate demand note information
- Municipal bond trade reports via RTRS (Real Time Reporting System)
- Municipal short-term note trade reports via SHORT (SHORT-term Obligation Rate Transparency System)

Pass Perfect

Chapter 10

Analysis

Pass Perfect

Fundamental Analysis

FUNDAMENTAL FACTORS
 ANALYST EXAMINES:

Outlook for industry (1) — Management of company (2)
 Product lines of company (3) — Anticipated introduction of new products (4)
 Market share of the company (5)

Pass Perfect

3 Financial Statements

ANALYST EXAMINES:

- 1 Balance Sheet
- 2 Income Statement
- 3 Statement of Changes to Retained Earnings (i.e. the Cash Flow Statement)

ASSETS VS LIABILITIES
REVENUES + EXPENSES

Pass Perfect

Balance Sheet

"Snapshot" of company's assets and liabilities
 NET WORTH = Assets - Liabilities
 ASSETS = Liabilities + Net Worth

ASSETS
 arranged in order of liquidity
 those assets that are quickly convertible to cash are listed first

LIABILITIES
 arranged in order of liquidity
 those liabilities that must be paid promptly are listed first

Pass Perfect

Financial Statements

Net Worth = Total Assets - Total Liabilities
 289 = 770 - 481

ASSETS		LIABILITIES	
Current assets		Current liabilities	
Cash	2,100	Notes payable	\$ 5,000
petty cash	100	Accounts payable	35,000
Treasury investments	10,000	Wages payable	2,500
Accounts receivable	30,000	Interest payable	2,000
Inventory	3,000	Taxes payable	6,100
Supplies	3,000	Warranty liability	1,100
Prepaid insurance	1,800	Unearned revenues	1,500
Total current assets	83,000	Total current liabilities	63,000
Investments	36,000	Long-term liabilities	
Property, plant & equipment	36,000	Notes payable	20,000
Land	5,500	Bonds payable	400,000
Land improvements	6,500	Total long-term liabilities	420,000
Buildings	180,000	Total liabilities	481,000
Equipment	201,000	STOCKHOLDERS' EQUITY	
Less: accum. depreciation	(305,000)	1. Common stock	110,000
Prop. plant & equip - net	357,000	2. Retained earnings	220,000
Intangible assets		3. Accum. other comprehensive income	6,000
Goodwill	100,000	Total Stockholders' Equity	386,000
Trade names	200,000	Total stockholders' equity	386,000
Total intangible assets	300,000	Total liabilities & stockholders' equity	770,000
Other assets	3,000		
Total assets	\$ 770,000		

Pass Perfect

Liquidity Measures

Net Working Capital =
 Current Assets - Current Liabilities

A "current" asset turns into cash in 1 year; a Current liability is a bill to be paid within 1 year.

Pass Perfect

Liquidity Measures (cont.)

Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

- Shows whether a company has enough current assets to pay its current bills coming due
- The ratio should be more than "1"

Pass Perfect

Liquidity Measures (cont.)

Quick Ratio / Acid Test = $\frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$

- Quick assets are current assets that are "quickly" turned into cash - these are cash on hand and accounts receivable; inventory is excluded
- The Quick Ratio shows whether the company has enough assets that are turning into cash "quickly" to pay its current bills coming due
- This ratio should also be more than "1"

Pass Perfect

Statement of Changes in Retained Earnings

EARNINGS PER COMMON SHARE = $\frac{\text{Earnings Available for Common}}{\text{Common Shares Outstanding}}$

DIVIDEND PAYOUT RATIO = $\frac{\text{Common Dividends Paid}}{\text{Earnings Available for Common}}$

- low ratio = growth co.
- high ratio = mature co., utility

Pass Perfect

All assets minus all liabilities equals:

- A. net worth
- B. net working capital
- C. book value
- D. net tangible assets

532

Current assets minus current liabilities equals:

- A. net worth
- B. net working capital
- C. book value
- D. net tangible assets

533

The Current Ratio measures:

- A. debt service coverage
- B. liquidity
- C. leverage
- D. profitability

534

Income Statement

ABC Corporation Income Statement for the year ending 12-31-XX (\$000)	
Gross Sales	12,500
Returns	500
Net Sales	12,000
Cost of Goods Sold	8,000
Gross Margin	4,000
Operating Expenses	2,200
Operating Margin	1,800
Non-operating Income	200
Total Operating and Non-operating Income	2,000
Interest Expense	200
Net Income before Tax	1,800
Taxes	800
Net Income after Tax	1,000

Pass Perfect

ABC Corporation Income Statement For the year ending 12-31-XX (\$000)

Gross Sales	4,000
Expenses	2,000
Operating Income	2,000
Bond Interest	200
Net Income Before Tax	1,800
Taxes	800
Net Income After Tax	1,000
Preferred Dividend	100
Earnings for Common	900
Common Dividend	500
Retained Earnings	400

RESTATE FINANCING FOR EARNINGS FOR COMMON

BUTTER

THE

PAPERMAN

"GONNER"
"EBTPC" = Every Body Trades Puts and Calls

536

All of the following items are found on a company's income statement EXCEPT:

- A. Depreciation Expense
- B. Current Liabilities
- C. Cost of Goods Sold
- D. Bond Interest Expense

537

A company has reported earnings per share of \$5.00. If the company paid a common dividend of \$1.00, what is the dividend payout ratio?

- A. 10%
- B. 20%
- C. 50%
- D. 60%

$$\frac{\text{Div. Paid}}{\text{Earnings Available for Common}} = \frac{1}{5}$$

538

A company has reported earnings per share of \$5.00. If the company paid a preferred dividend of \$2.00 and a common dividend of \$1.00, what is the dividend payout ratio?

- A. 10%
- B. 20%
- C. 33%
- D. 40%

$$\frac{\text{Div. Paid}}{\text{Earnings Available for Common}} = \frac{1}{5}$$

To get Earnings, you BTP

539

Economic Analysis

Pass Perfect

ECONOMIC ANALYSIS

GROSS NATIONAL PRODUCT (GNP)

- Sum of all goods and services produced within a country
- Consists of consumer spending plus Gov't spending plus business investment
- Proper term is Gross Domestic Product (GDP), but GNP is usu. used in FINRA exams!
- Real GNP
 - Any effects of inflation on prices are eliminated to achieve a valid measure (Real GNP = Nominal GNP - Inflation)

Pass Perfect

If a country is importing more, then the country's:

- A. GDP is increasing
- B. GDP is decreasing
- C. Inflation rate is increasing
- D. Inflation rate is decreasing

Pass Perfect

Business Cycle (cont.)

Expansion
Beginning at a low point, activity expands and Real GNP output increases

Recovery
Business decline bottoms out before starting next expansion phase

Prosperity
As expansion ages, it tends to reach a peak

Recession
Business contraction
When GNP drops 2 consecutive quarters (if GNP drops for 6 quarters, it's a depression)

Pass Perfect
A Great Company

543

Which of the following occurs between a recession and a recovery?

- A. expansion
- B. depression
- C. trough
- D. prosperity

Series #7 Analysis 544

The usual order of the economic cycle is:

- A. expansion, recession, recovery, peak
- B. recession, recovery, peak, expansion
- C. expansion, peak, recession, recovery
- D. peak, recession, expansion, recovery

545

During which phase of the economic cycle would one most likely find monetary "inflation" starting to occur?

- A. Expansion
- B. Prosperity
- C. Recession
- D. Recovery

546

A six month mild decline in economic activity is a(n):

- A. recession
- B. depression
- C. correction
- D. expansion

547

ECONOMIC THEORIES TO EXPLAIN BUSINESS CYCLE

- 1** **Keynesian Theory**
To stimulate consumption, Keynes advocated increased Gov't spending and transfer payments to individuals. To get the money to spend, the Gov't borrows
- 2** **Monetarist Theory**
Actions of Fed. Reserve are driving force behind economic cycles
- 3** **Supply Side Theory**
• i.e. Reaganomics
• Tax cuts and reduced government spending stimulate "supply" and cause the economy to grow

Pass Perfect
A Great Company



Keynesian Theory states that the economy is stimulated by:

- A. the actions of the Federal Reserve
- B. increased Government spending
- C. decreased Government spending
- D. lowered tax rates

Analysis

549



Monetarist Theory states that:

- A. increased government spending will stimulate the economy
- B. tax rate reductions and lower government spending will stimulate the economy
- C. the actions of the Federal Reserve control the level of economic output
- D. tax rate increases and increased transfer payments will stimulate the economy

Analysis

550



Supply Side Theory states that:

- A. increased government spending will stimulate the economy
- B. tax rate reductions and lower government spending will stimulate the economy
- C. the actions of the Federal Reserve are the driving force behind the economy
- D. tax rate increases will stimulate the economy

Analysis

551



GROWTH IS AFFECTED BY:

Fiscal Policy

- Gov't actions (set by Congress) that influence economic activity
- Can be used to increase or decrease take home pay of American public by:
 - Changing tax rates
 - Changing transfer payments (such as Social Security)
 - Changing Gov't spending on goods and services

Pass Perfect



Fiscal Policy is set by:

- A. Supreme Court decisions
- B. Congressional action
- C. Presidential edict
- D. Federal Reserve action

553



To stimulate the economy using Fiscal Policy which of the following actions could be taken?

- I Tax rates could be reduced
- II Tax rates could be increased
- III Government spending could be reduced
- IV Government spending could be increased

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

554

GROWTH IS AFFECTED BY:**Monetary Policy**

- Action taken by Fed. Reserve to influence growth of money supply
- By expanding money supply, credit is loosened, and interest rates lowered (this stimulates economy)
- By contracting money supply, credit is tightened, and interest rates raised (this dampens economy)
- 4 tools of Fed - "**DORM**"
 - Discount Rate
 - Open Market Operations
 - Reserve Requirements
 - Margin on Securities

 Pass Perfect
ROLE OF THE FEDERAL RESERVE

Fed. Reserve controls money supply growth

TOOLS OF FED. RESERVE:

- **D**iscount Rate
- **O**pen Market Operations
- **R**eserve Requirements
- **M**argin (Reg. T)

 Pass Perfect
ROLE OF THE FEDERAL RESERVE (cont.)**Setting **D**iscount Rate**

- Discount rate is rate that Federal Reserve charges member banks to borrow reserves
 - To tighten credit, FRB increases discount rate
 - To loosen credit, FRB lowers discount rate

 Pass Perfect
ROLE OF THE FEDERAL RESERVE (cont.)**Conducts **O**pen Market Operations**

- FRB trading desk in NY, directed by FOMC, adjusts credit availability daily through repurchase and reverse-repurchase agreements with Gov't dealers
 - Under a "repo," FRB **BUYS** Gov't securities from a bank-dealer, giving the dealer funds in return for temporary pledge of Gov't securities – this loosens credit because bank has more money to lend
 - Under a "reverse-repo," FRB **SELLS** Gov't securities to a bank-dealer, giving dealer a temporary pledge of Gov't securities in return for cash, tightening credit

 Pass Perfect

If the Federal Reserve Open Market Committee authorizes its trading desk to enter into system wide repurchase agreements, the effect will be to:

- I Increase yields
- II Decrease yields
- III Raise debt prices
- IV Lower debt prices

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

559

The Federal Reserve will implement an "easy money" policy when which of the following increases?

- A. Unemployment
- B. Index of industrial production
- C. Money supply levels
- D. Housing starts

ROLE OF THE FEDERAL RESERVE (cont.)

Setting Reserve Requirements

- FRB sets level of reserves that member banks must maintain
- If reserve requirement is set at 10%, then bank can lend 90%
 - Increasing reserve requirement would tighten credit
 - Reducing reserve requirement would loosen credit

ROLE OF THE FEDERAL RESERVE (cont.)

Setting Margins on Non-Exempt Securities

- FRB sets initial margin rates for non-exempt securities under Reg. T
 - To tighten credit, FRB can increase margins
 - To loosen credit, FRB can lower margins

If the Federal Reserve Board lowers the discount rate, which of the following is true?

- I the Fed is loosening credit
- II the Fed is tightening credit
- III lending levels at financial institutions should fall
- IV lending levels at financial institutions should rise

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

563

The Federal Reserve Board is charged with the responsibility for establishing:

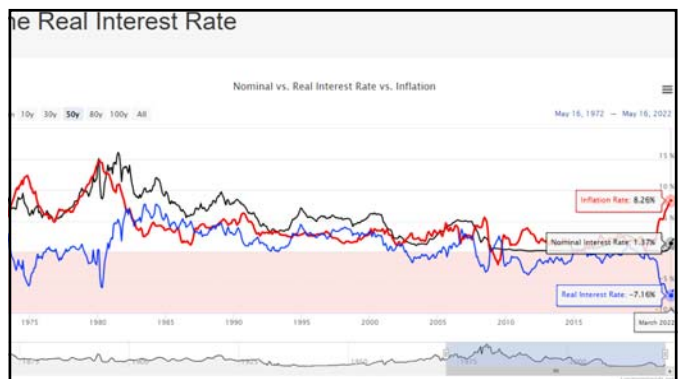
- A. Fiscal policy
- B. Monetary policy
- C. Foreign policy
- D. Tax policy

564

REAL INTEREST RATE


	1990s	2020s
Yld On 30-Yr T-Bond	10%	3%
Inflation Rate	7%	0%
Real Interest Rate	3%	3%

- Note That The Real Interest Rate Is Unchanged Over The Past 30 Years
- The Real Interest Rate = Nominal Rate - Inflation Rate
- "Nominal rates move with inflation; real rates are unaffected by inflation"



The prime rate is current 4%. What would be deducted to find the real interest rate?

- A. The discount rate
- B. The fed funds rate
- C. The broker loan rate
- D. The inflation rate




ECONOMIC INDICATORS

To determine what monetary action to take, the FRB looks at the "Leading Economic Indicators" such as:


- Housing Starts
- Durable Goods Orders
- S & P 500 Index
- Money Supply Levels
- Consumer Goods Orders
- Initial Unemployment Claims

To deal with test questions, there is only 1 "Coincident" Economic Indicator used – Index of Industrial Production - and 2 "Lagging" Indicators used – Reported Corporate Profits and Consumer Debt Levels. If it isn't one of these 3, it is a LEADING indicator!

Money Supply Levels measured by M1, M2, M3 and L (M1 is narrowest measure; L is broadest measure)




<u>EVENT</u>	<u>EFFECT ON U.S. DOLLAR</u>
Inflation Increases	↓
Inflation Decreases	↑
Trade Deficit Widens	↓
Trade Deficit Narrows	↑
Fed. Raises Interest Rates	↑
Fed. Lowers Interest Rates	↓




Analysis 569

<u>EVENT</u>	<u>EFFECT ON U.S. DOLLAR</u>
More Foreigners Buy U.S. Securities	↑
More U.S. Citizens Buy Foreign Securities	↓
More U.S. Citizens Visit Foreign Countries	↓
More Foreigners Visit U.S.	↑



Analysis 570

<u>EVENT</u>	<u>EFFECT ON U.S. STOCK PRICES</u>
Economic Output Rises	↑
Economic Output Falls	↓
Interest Rates Fall	↑
Interest Rates Rise	↓
Inflation Falls	↑
Inflation Rises	↓




571


Which of the following economic events would have a positive long term impact on common stock prices?

- I Rising interest rates
- II Rising capital gains tax rates
- III Rising employment rates
- IV Falling inflation rates

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




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Questions

 Pass Perfect