Series 63

Uniform Securities Agent State Law Examination

Study Manual – 42nd Edition

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About the Series 63 Examination

The Series 63 Uniform Securities Agent State Law Examination consists of 60 multiple-choice questions. The examination will test your knowledge of the following topic areas:

Topic Area	No. of Questions	Percentage of Exam
Regulation of Investment Advisers	3	5%
Regulation of Investment Adviser Representatives	3	5%
Regulation of Broker-Dealers	9	15%
Regulation of Agents of Broker-Dealers	9	15%
Regulation of Securities and Issuers	3	5%
Remedies and Administrative	6	10%
Communications with Customers and Prospects	12	20%
Ethical Practices and Fiduciary Obligations	15	25%
	60	**100%**

Note: Each examination will include five additional, unidentified pretest questions that are randomly distributed throughout the examination and do **not** contribute toward your score (65 questions total).

Students are allotted 1 hour and 15 minutes to complete the exam and a score of 72% or greater is passing.

About the Training Program

Securities Training Corporation (STC) is the leading provider of registration preparation materials within the financial services industry. The Series 63 Training Program is designed to provide you with the information needed to pass your examination, regardless of prior experience or educational level. The program consists of the following materials:

- A seven-chapter Study Manual
- Final examinations with detailed explanations

Since exam content is subject to change, we recommend that you visit our website at www.stcusa.com to see if there have been changes or supplemental materials created for this training program.

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Study Manual

The Study Manual represents the first phase of exam preparation and is divided into seven chapters. Each chapter is clearly and concisely written to guide you through all of the significant aspects of the Series 63 Examination material.

Included at the end of each of the chapters, you will find *Test Your Understanding* quizzes that should be completed once the reading of the chapter has been completed. The Test Your Understanding quizzes are designed to reinforce key concepts that are described in the chapters.

This Study Manual provides the foundation for the most important step in preparing for the test—completing the final examinations.

Final Examinations

The final examinations cover content from all seven chapters of the Study Manual. The questions in these exams are generally more challenging than the Test Your Understanding questions. The intricacy of the final exams is meant to simulate the level of difficulty and the application-type questions that you may encounter on the Series 63 Examination. To access the final examinations, you must log in to www.my.stcusa.com and enter your user name and password.

Students can choose to have explanations appear after each question is answered or to review explanations after an entire exam is completed. For the first attempt, we recommend selecting to have the explanations appear after each question. Studying each explanation is crucial to the understanding of the material since many of the explanations not only provide the reason why one answer is correct, but also why the other choices are wrong. By concentrating on only the correct response and disregarding the explanation, students run the risk of memorizing answers without fully understanding the underlying concepts.

As time permits, students are encouraged to repeat the final examinations. For the second attempt, students may choose not to have explanations appear after each question to simulate the actual testing environment. By repeating the exams, students ensure that they have learned the material rather than simply memorized the questions.

Creating Custom Exams

To focus on specific topic areas, the "Create a Custom Exam" feature permits the student to work through the STC exam bank and choose questions that pertain to any of the seven chapters in the study manual. After completing a chapter, some students may choose to review a series of questions that pertain to that chapter. To do this, a student must log in to www.*my.stcusa.com*. From her Dashboard, selects *Final Exams*, then must scroll down and select *Create a Custom Exam*. Now, she selects the appropriate chapter number and, at the bottom of the screen, enters the desired number in the *Number of Questions* box, and then selects *Build Exam*. Once again, students can choose whether or not to have the explanation appear after each question is answered.

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Instructor Support Hotline

As a convenience to students who are preparing for their registration exams, STC offers an instructor hotline. Anyone with additional questions may speak with an instructor by calling 800-STC-EXAM (800-782-3926) during normal business hours.

Series 63 Lectures, Presentations, and Products

Series 63 On-Demand™

The Series 63 On-Demand™ is a prerecorded presentation that's delivered online. The program is supported with slides, mini-quizzes, and the STC Instructor Hotline. This product covers the key concepts and applications of the Series 63 Examination. Similar to a DVD, you can pause, go back, and view the presentation numerous times. Although it's intended for students to view this lecture before attempting the final exams, many students have indicated that it was beneficial to view the On-Demand Lecture again after having completed the finals.

Traditional and Virtual Classes

You should also consider the benefits of attending an STC Series 63 class.

- We offer Instructor-led Virtual Classes that you can attend from any location in which Internet access is available. These classes are conducted over a four-hour session.

Flashcards

STC's Flashcards are an ideal additional study option for students who are interested in going beyond the practice exams. The Flashcards can be used whenever and wherever Internet access is available. The Flashcards can be organized by course, chapter, or NASAA exam section. The Series 63 Flashcards are available for 90 days from the date of first use. (Extra time is available for an additional fee.) Although no purchase of STC study material is required, we strongly recommend that a study program be used along with the Flashcard series.

Standardized Test-Taking Tips

As with any standardized exam, you will be able to increase your score by employing good test-taking techniques. Following is a series of suggestions that will help you perform more efficiently on your multiple-choice exam.

- **Be careful when reading the question.** The most common mistakes occur when you skim the question and responses. You should read the question once, then read the question again, and put the question into your own words.

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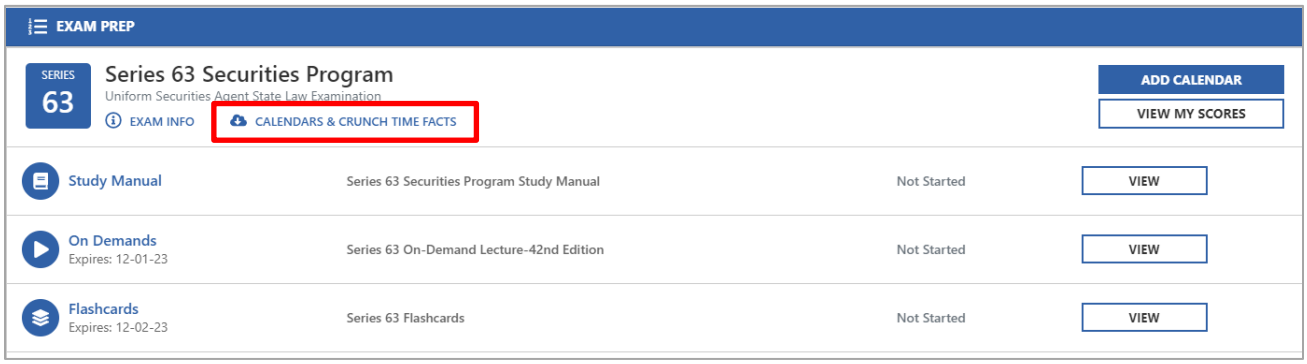
- **Use logic or common sense when analyzing the question.** Don't just simply guess Choice C and move on out of frustration. Look for clues within the question and responses. If you get stuck, you should ask yourself whether the response is true or false and attempt to eliminate the incorrect answers in that manner.
- **Pay attention to key words and phrases including** "All," "None," "Exempt," "Excluded," "Except," "Unless," "True," "False," "Always," and "Never."
- **Don't be afraid to guess.** If all else fails, you should eliminate the statements that are wrong and make your best guess. There's no penalty for guessing. Don't allow the exam to expire without answering all the questions.
- **Practice answering multiple-choice questions.** STC provides you with final examinations that simulate the actual exam. They should be reviewed prior to scheduling your regulatory exam.

Study Calendars

STC provides sample study calendars which are designed to help students in organizing their time and allowing for a manageable amount of daily study. Remember, these calendars are simply suggestions for how you may plan your studies. Feel free to make any modifications that you deem appropriate.

The calendars are available for download on your student dashboard on www.my.stcusa.com.

- Click on the link to "Calendars and Crunch Time Facts" that appears below the Series 63 Securities Program course title
- Choose the calendar that best fits your needs



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Chapter 1

Overview

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To prepare for the Series 63 Regulatory Examination, you must have a thorough grasp of key terms and concepts. The examination will focus on the laws, rules, and regulations as they apply to various persons and securities. The objective of this chapter is to provide you with a preview of the key terms and concepts that are tested on your exam. Although it's important to have a working knowledge of the individual components, the more critical point is to understand how the pieces fit together.

Key Terms

The Series 63 Examination will test a person's knowledge of the registration requirements of two major categories—securities and persons. When discussing registration requirements, a clear understanding of the terms *exempt* and *non-exempt* is essential.

For example, if a security is exempt, then it's not required to be registered with a regulator. On the other hand, a non-exempt security may need to be registered. It's essential that you are able to distinguish between who or what's required to be registered and who or what is not.

The exam may get creative with language and may reference a security as being unregistered, exempt. It may seem that because the security is unregistered, its sale would be prohibited. However, the reason the security is unregistered is because it's exempt. Although securities professionals are permitted to sell unregistered, exempt securities, it's a violation to solicit the sale of unregistered, non-exempt securities.

Once it has been established that registration is required, a determination must be made as to the appropriate level—federal or state. If the security is required to be registered at the state level, then following the rules, regulations, and guidelines of the Uniform Securities Act (USA) is necessary. Federal registration will require that documents be filed with the Securities and Exchange Commission (SEC). As always, there are additional rules and regulations that may exempt or exclude registration at one or both levels.

But, before going too far, let's slow down and take a look at the definitions of some key terms.

State

When defining the term *state*, the Uniform Securities Act includes a state, commonwealth, territory, or possession of the United States, including the District of Columbia and the Commonwealth of Puerto Rico.

Security

A *security* includes common stock, bonds, option contracts, and variable annuities.

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Again, if securities are non-exempt, they must be registered in order to be offered or sold in a state. In addition to recognizing the securities that are exempt or non-exempt, it may be necessary to determine the basis for an exemption. To be sure this concept is understood, a later chapter has been devoted to the registration of securities.

Person

A *person* is defined as any legal entity that's not deceased, is not a minor, and is not mentally incompetent. Under the Uniform Securities Act, the term *person* may include individuals, corporations, partnerships, sole proprietorships, issuers, and state Administrators (both the office and the individual). So, keep in mind, the definition of a person is very broad—including individuals as well as organizations.

The following information provides an introduction to specific persons and their characteristics that are tested on the Series 63 Examination. The persons primarily tested on the exam will be defined now, but described in greater detail in the chapters that follow.

Issuer An *issuer* is any person who issues or proposes to issue any security. The term issuer includes the U.S., state, local, or foreign governments, corporations, and partnerships.

Broker-Dealer A *broker-dealer* (BD) is a person in the business of effecting securities transactions for the accounts of others or for its own account.

A firm is acting in the capacity of a broker when it effects securities transactions on behalf of its clients. In other words, a broker will locate the other side of the trade—finding the buyer when representing the seller, or finding the seller when representing the buyer. A broker charges its customers a commission for providing this service.

A firm is acting in the capacity of a dealer when it effects securities transactions for its own account. A dealer stands ready to take the other side of any transaction—buying for its own inventory with a markdown or selling from its own inventory and charging a markup. A dealer providing liquidity by publishing quotes in the Nasdaq marketplace is also referred to as a *market maker*.

Agent The USA identifies two different types of agents—one who represents a broker-dealer and one who represents an issuer of securities. Let's consider the individual representing a broker-dealer first.

Agent of a Broker-Dealer An agent of a broker-dealer is defined as a non-clerical individual who represents a broker-dealer in effecting securities transactions. Without exception, salespersons of broker-dealers who effect securities transactions are considered agents and must be registered. However, not every employee of a broker-dealer is considered an agent and subject to registration. An individual who simply performs clerical tasks, such as filing paperwork or answering the phone, is not considered an agent. Consider the following example to determine whether an individual is defined as an agent of a broker-dealer.

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Lenny and Janice are employed by High Bridge Securities. Lenny works with a team of individuals who are responsible for forwarding client calls and mailing campaign literature on behalf of the agents with whom he works. He also coordinates seminars and helps with mailing invitations.

Janice is responsible for executing equity transactions for customers who open accounts after attending the seminars coordinated by Lenny. Are Lenny and Janice required to register as agents?

Since Lenny's role is clerical and doesn't involve securities transactions, he's not defined as an agent and is not subject to registration. However, in this example, because Janice is clearly representing a broker-dealer in effecting securities transactions, she's required to register as an agent.

Registered Representatives and Agents …

While your firm may have a different title for you, such as registered representative or financial adviser, the Series 63 Examination refers to individuals representing a broker-dealer in effecting securities transactions as agents.

Agent of an Issuer An agent of an issuer is a non-clerical individual who represents an issuer in effecting securities transactions with the public involving the issuer's securities. Let's analyze the following examples to determine whether the individuals described are considered agents of the issuer.

Lucy and Jim work for a newly formed company that's in the process of conducting an initial public offering (IPO) of stock. Jim is a director and is currently soliciting commitments from public investors for which he will earn compensation based on the number of investors who agree to purchase the securities.

Once the shares are publicly traded, Lucy, the Director of Human Resources, as part of her regular duties, will administer a plan that permits company employees to purchase registered common shares of the company. Who's required to register as an agent of the issuer?

Although Lucy and Jim are both directors, their responsibilities are different. Jim is considered an agent of the issuer since his activities involve effecting transactions with the public in the issuer's securities. Furthermore, Jim will be compensated based on the number of investors who purchase shares. Therefore, he must register as an agent.

Lucy is not considered an agent since her responsibility (handling the distribution of shares to employees) is one of her regular functions in the Human Resources Department. Since she's not compensated for sales, Lucy is not required to register as an agent.

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The next two persons that must be defined are investment advisers and investment adviser representatives. It's important to understand fully the difference between the two, as this tends to be trickier than differentiating between broker-dealers and agents.

Investment Adviser An *investment adviser* (IA) is any person (usually a firm, rather than an individual) that, for compensation, engages in the business of providing others with securities-related advice, reports, or analysis. To meet the definition of an investment adviser, a person must satisfy all three parts of the A-B-C test by:

1. Providing **A**dvice about securities
2. Providing these services as a **B**usiness
3. Receiving **C**ompensation for these services

Investment Adviser Representative An *investment adviser representative* (IAR) is any partner, officer, director, or other individual who is associated with an investment adviser that:

- Makes recommendations or gives advice regarding securities
- Manages accounts or portfolios of clients
- Determines which recommendations or what advice should be given
- Solicits, offers, or negotiates the sale of investment advisory services
- Supervises employees who perform any of these functions

As a reinforcement of these terms, consider the following example:

> *Harrison Investment Advisory Services employs several individuals who sell the firm's portfolio management services to institutional and non-institutional clients. Last month, Marti led the team in sales. Based on Marti's activities, is she considered an investment adviser? What role does Harrison play in this scenario?*
>
> As with certain employees of a broker-dealer, an employee of an investment adviser whose job is solely clerical or ministerial (administrative) is not included in the definition of an investment adviser representative. Since Marti is involved in soliciting the investment advisory services that Harrison offers, she's considered an investment adviser representative. Harrison (the firm) is considered an investment adviser.

Good to know …

Investment advisers and investment adviser representatives are also referred to as registered investment advisers (RIAs) and registered investment adviser representatives (RIARs).

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State versus Federal Regulations

The Series 63 Examination includes several questions on registration requirements. Certain securities and/or persons are required to register at either the state or federal level based on various factors (discussed later). For now, let's examine the laws governing state and federal registration and the person responsible for enforcing these requirements. The state requirements will be covered first.

State Securities Laws and Regulations

The Uniform Securities Act State securities rules and regulations are based on the Uniform Securities Act (blue-sky laws). The USA is a model law, which means that it's not the actual law of any one state, but rather a blueprint or template that each state may customize to suit its own needs. While the securities laws of most states are based on the Uniform Securities Act issued in 1956, the Series 63 Examination doesn't test the specific modifications made by a particular state.

> **Keep in mind …**
>
> It may be necessary for certain persons and securities to be registered at the state or federal level. Although the Series 63 Examination expects you to understand the requirements for both, you will find a focus on the registration requirements of the Uniform Securities Act.

Administrator The state securities regulator, more commonly referred to as the state Administrator, is the person responsible for not only administering and enforcing the securities laws in a state, but for educating investors as well. The fundamental mission of a state securities regulator is to protect the consumers who purchase securities or pay for investment advice within the state.

In some states, a special official, such as the Securities Commissioner, may carry out the Administrator's duties, while in other states these functions may fall under a more comprehensive office such as the Secretary of State. The powers of the Administrator will be discussed in more detail later in this Study Manual.

North American Securities Administrators Association (NASAA) NASAA is responsible for updating the Uniform Securities Act as well as maintaining the content of the Series 63 Examination. Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's current membership is comprised of 67 state, provincial, and territorial securities Administrators. These Administrators come from the 50 U.S. states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico.

Additionally, NASAA has released a number of Model Rules and Statements of Policy that serve to clarify various provisions of the USA. The Series 63 Examination will test your knowledge of certain NASAA rules covering the activities of broker-dealers, agents, investment advisers, and investment adviser representatives. As with the USA, these Model Rules and Statements of Policy are not the actual law of any one state, although many states have chosen to adopt at least some of them.

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Federal Securities Laws and Regulations

To easily identify the questions that are referencing federal laws or regulations, remember that they have a number in their title (e.g., the Securities Act of 1933 and SEC Release IA 1092). However, since the Uniform Securities Act has no number reference in its title, it's state law. In addition, some questions may not reference a specific federal law, but will instead refer to the Securities and Exchange Commission (SEC) as the regulator. When the SEC is referenced, the question is referring to federal law, not state law.

Although the Series 63 Examination focuses primarily on state law issues, the test may also touch on the following federal securities acts:

- The Securities Act of 1933 (regulation of new issues)
- The Securities Exchange Act of 1934 (regulation of secondary markets, also known as trading markets)
- The Investment Advisers Act of 1940 (federal regulation of investment advisers)
- The Investment Company Act of 1940 (regulation of mutual funds and other investment companies)
- Uniform Prudent Investor Act (UPIA)
- The National Securities Markets Improvement Act of 1996
- The Dodd-Frank Act (also called The Wall Street Reform and Consumer Protection Act)

Securities Act of 1933 ('33 Act) The Securities Act of 1933 was passed in reaction to the stock Market Crash of 1929. Before then, state law primarily regulated the issuance, offer, and sale of securities. This federal law requires that certain securities be registered with the SEC in order to be offered or sold to the public.

The purpose of the act is to prevent fraud in the sale of new issues of securities (primary distributions) by requiring that investors be provided with enough relevant information about the offering to make an informed decision. This information is contained in the registration statement, which is a public document that an issuer files with the SEC. The registration statement is designed to provide full and fair disclosure of all material information about the issuer and the offering.

Issuers are also required to prepare a prospectus for distribution to potential purchasers. The prospectus is essentially an abbreviated version of the registration statement.

The Securities Exchange Act of 1934 ('34 Act) The Securities Exchange Act of 1934 established the Securities and Exchange Commission (SEC). The SEC is the federal regulatory agency charged with enforcing the federal rules and regulations, including the registration of broker-dealers. Additionally, the Act of 1934 governs the trading (secondary) markets.

The Investment Advisers Act of 1940 (IA '40 Act) This federal law governs investment advisers that must register with the SEC. Many of its concepts have been incorporated in the USA and in the model rules that NASAA has adopted regarding investment advisers. While the provisions of the Uniform Securities Act will be a significant exam focus, the Series 63 Examination will also test a candidate's knowledge of the Investment Advisers Act of 1940. Paying close attention to this concept is important since the exam may require a person to be able to recognize state versus federal laws as they apply to investment advisers.

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The National Securities Markets Improvement Act of 1996 (NSMIA) Initially, there were no regulations in place that prohibited states from demanding the registration of persons and securities that were in the process of being registered or were already registered at the federal level. Eventually, in 1996, Congress officially enacted the *National Securities Markets Improvement Act (NSMIA)* to eliminate the duplication of state and federal regulation of securities and advisers. Let's examine some of the major changes resulting from NSMIA.

NSMIA created a specific category of securities that are exempt from formal state registration. These securities are classified as *federal covered securities* and include:

- Securities listed on the U.S. exchanges (NYSE, Nasdaq, etc.)
- Certain Regulation D offerings (private placements)
- Municipal securities issued outside the state
- Securities issued by registered investment companies (e.g., mutual funds)

These federal covered securities are no longer regulated by the states or required to register at the state level. Keep in mind, if the state doesn't require registration, it may neither deny nor revoke that registration. However, Administrators will want to know what's being offered or sold in their state. Therefore, states may require the issuers of federal covered securities to file copies of the documents that have been submitted to the SEC and may also require the issuer to pay a fee to the state. This process is referred to as *notice filing*.

In order to prevent the duplication of regulation of advisers, NSMIA further created a specific category of investment advisers called *federal covered advisers*. The federal covered adviser determination is often based on either the adviser's assets under management (AUM) or the types of clients it services. Consequently, advisers are only subject to regulation at one level—either state or federal. Further details regarding the registration requirements of investment advisers will be described in subsequent chapters.

Regarding broker-dealers, NSMIA prohibits states from enforcing requirements that are more restrictive than existing federal requirements. Some of these requirements relate to minimum net capital, bonding, and the maintenance of books and records.

Remember …

Although federal covered securities are not required to be registered at the state level, some issuers may be required to notice file and pay a filing fee. Among the most common securities that fall into this category are mutual funds.

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Chapter 1 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Understand key terms, including:
  - *State*
  - *Security*
  - *Person*
  - *Issuer*
  - *Broker-dealer*
  - *Agent*
  - *Investment adviser*
  - *Investment adviser representative (IAR)*
- Recognize the difference between state and federal laws
  - State = Uniform Securities Act (USA)
  - Federal = Securities Act of 1933, Securities Exchange Act of 1934, and Investment Advisers Act of 1940
- Identify state and federal regulators
  - State = State Securities Administrator and the North American Securities Administrators Association (NASAA)
  - Federal = Securities and Exchange Commission (SEC)

Create a Chapter 1 Custom Exam

Now, log in to *my.stcusa.com*. From your Dashboard, select *Final Exams*, then scroll down and select *Create a Custom Exam*. Then, select *Chapter 1* and, at the bottom of the screen, enter 10 questions in the *Number of Questions* box, and select *Build Exam*.

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Chapter 2

State Registration of Securities

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This chapter concentrates on the Uniform Securities Act's regulations and registration requirements for securities. We will begin by identifying both the investments that do and those that don't meet the definition of a security. You will be required to compare and contrast the various methods of securities registration as well as determine whether a security is exempt from registration.

Securities

To identify whether an investment is defined as a *security*, state and federal authorities often use a four-part test described in the U.S. Supreme Court decision of *SEC versus W.J. Howey Co.* The four required elements are:

1. An investment of money
2. In a common enterprise
3. With the expectation of profits
4. Solely from the efforts of others

This general definition applies to many different types of investments. The following list represents investments that are considered securities:

- Stocks (including treasury stocks), rights, warrants, transferable shares, or certificates of deposit for a security (e.g., American Depositary Receipts)
- Notes, bonds, debentures, collateral trust certificates, or other evidence of indebtedness
- Interest in any profit-sharing agreement
- Variable annuities and variable life insurance contracts
- Voting trust certificates, certificates of interest in an oil, gas, or mining title or lease, preorganization certificates or subscriptions
- Investment contracts, including interests in oil and gas drilling programs, real estate condominiums and cooperatives, farm lands or animals, whiskey warehouse receipts, multilevel distributorship arrangements, and merchandising marketing schemes
- Stock options or options on commodity futures contracts

Since the following list is much shorter, it's often easier to remember what doesn't meet the definition of a security. The investment instruments that are NOT defined as securities include:

- Insurance, endowment policies, or annuity contracts under which an insurance company promises to pay a fixed sum of money either as a lump sum or periodically for life or other specified period (i.e., term, universal, or whole life insurance policies, and fixed annuities)
- Individual retirement accounts (IRAs) or Keogh plans
- Commodity futures contracts
- Currencies
- Collectibles
- Condominiums (as primary residences)

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Identifying a Security

It's quite common for the Series 63 Examination to test a candidate's knowledge of securities by comparing similar types of investment instruments. The following chart summarizes which instruments are securities and which are not:

According to the Uniform Securities Act	
Securities	**NOT Securities**
Stocks (*equities*)	Art
ADRs	Antiques
Bonds (*debentures, certificates of indebtedness*)	Other Collectibles
Rights	
Warrants	
Options on Stocks	
Options on Currencies	Currencies
Options on Commodities	Commodities
Options on Futures	Futures
Variable Life Insurance	Term Life Policies
Variable Universal Life Insurance	Whole Life Policies
(Any insurance product that includes the word variable)	Universal Life Policies
Viatical Settlements (*see description on next page*)	Endowments
	(Any insurance product that doesn't include the word variable)
Variable Annuities	Fixed Annuities (*guaranteed contracts*)
Investment Companies (Face-Amount Certificates, Unit Investment Trusts, and Management Companies)	
Packaged Real Estate Investments, such as Interests in a Condominium Pool, Real Estate Investment Trusts (REITs), or Real Estate Limited Partnerships (RELPs)	Individual Real Estate Properties and Mortgages
Participation in a Profit-Sharing Agreement (e.g., Keogh Participation)	Keogh Plans
	IRAs, 401(k) Plans, and other Retirement Plans
Investment Contracts	
Limited Partnerships	
Whiskey Warehouse Receipts	
Multilevel Distribution Arrangements	
Merchandise Marketing Schemes	
Voting or Collateral Trust Certificates	
Preorganization Certificates	
Interests in Farmland or Livestock	

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As a form of derivative, an option contract is considered a security. Options derive their value from the movement of an underlying instrument (e.g., a stock, index, currency, etc.). There are two types of options—*calls* and *puts*—and these contracts provide the owner with the ability to buy (if it's a call) or sell (if it's a put) the underlying instrument at a preset price. However, the owner of an option doesn't have the ability to vote. An important concept with options is determining whether an option is in-the-money (i.e., has intrinsic value). The option's type will influence how the intrinsic value is determined:

- Call options have intrinsic value if the value of the underlying instrument is UP above the option's strike price.
- Put options have intrinsic value if the value of the underlying instrument is DOWN below the option's strike price.

Clearly, the preceding list of investments that are considered securities contains some strange entries. For example, what's a whiskey warehouse receipt? Before answering that question, it may help to know that many of these instruments were added to the definition of a security in response to specific instances of investment fraud encountered by states. Including them as securities allowed Administrators to regulate them and potentially stop investment scams that were not originally envisioned by state law.

By the way, whiskey warehouse receipts represent a share in a quantity of whiskey being aged for future sale—perhaps 10 or 12 years before bottling. If investors did not want to wait for the product to be sold before cashing out, they might sell their warehouse receipts to other investors. Under state law, the transfer of a whiskey warehouse receipt is equivalent to the delivery of the property it represents and, therefore, it constitutes a security.

Another seemingly unusual instrument is a real estate condominium. This instrument was added to the list of securities to cover investment opportunities in which the purchaser of a condominium allows his property to be included in a rental pool that's managed by a third party. For example, the condominium may be part of a complex near a ski lodge and the buyer purchases the property for investment purposes, rather than for occupancy. In this situation, offering this type of condominium investment could be viewed as the offer of a security.

Multilevel distributorships and merchandising marketing programs are structures used to market products to the public. In the past, these types of programs have occasionally been used to create *Ponzi schemes.* A Ponzi scheme is a pyramid scam where returns received by earlier investors are derived from the capital contributed by subsequent investors. As with a chain letter, the fraud typically causes a collapse and results in investors losing money. Due to the negative history of these types of programs, they're defined as securities and are regulated under the USA.

Viatical Investments Viatical investments, also referred to as life settlements, represent the purchase of the rights to the death benefits from individual life insurance policies. Typically, a policyholder who is ill or in need of cash will sells the right to the death benefit from his life insurance policy to a viatical company. The company then resells these interests to investors. An investor may purchase a whole interest in an individual death benefit or a fractional interest. Investors may also purchase interests in pools of viatical settlements that have been put together by the company.

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For exam purposes, an important consideration is whether viatical investments are considered securities? The answer is yes, according to NASAA, viatical investments are securities under state laws and must be registered in the states in which they're sold. The agents and broker-dealers who sell them must also be registered in these states.

Under the NASAA Guidelines Regarding Viatical Investments, viaticals are not suitable investments for the average retail investor. Since death is unpredictable, the rate of return that the investor will receive cannot be calculated until the policyholder dies. The investor will not have access to her capital in the meantime and also there's no secondary market for viaticals.

If the policy owner lives longer than expected, investors may need to contribute additional money to pay the policy's premiums. Investors may not receive anything if either the viatical company or the life insurance company that issued the policy goes out of business.

According to NASAA, the following investors are suitable candidates for viatical investments:

1. Investors with a minimum net worth of $150,000 and an annual income of more than $100,000, *or* a minimum net worth of $250,000. The net worth calculations may not include the value of the investor's home. No more than 10% of each person's net worth should be invested in viatical investments.
2. Accredited investors, according to Regulation D of the Securities Act of 1933. Generally, accredited investors are financial institutions and individuals with an annual income of at least $200,000, or a minimum net worth of $1 million (again, the net worth excludes the value of their residence). More detail regarding accredited investors and Regulation D will be provided later in this chapter.

General Registration Process

An issuer that wants to sell its securities to the public must register the offering at both the federal and the state level unless it can qualify for an exemption. At the federal level, this means that the issuer must file a registration statement with the SEC. At the state level, the issuer must register the securities with each state in which it intends to offer them.

The Series 63 Examination will test a person's knowledge of state registration requirements. Under the USA, it's unlawful for any person to offer or sell a security in a state unless the security is either registered or exempt from registration.

State Administrators require registrants to provide general information about the securities being offered, such as:

- The amount of securities to be offered in the state
- Any adverse ruling entered in connection with the offering by a state regulatory authority, a court, or the SEC
- Other states in which a registration statement has been or will be filed

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Watch out …

While the Administrator will want to know the other states in which a security will be offered, disclosure of the number of shares being offered in each and every state is not required.

Often the issuer must also provide the Administrator with financial information and its articles of incorporation, charter, or the equivalent organizational documents. Any document that was filed with the Administrator during the last five years may be incorporated in its state registration materials by reference.

The XYZ Corporation files financial statements with the state at the end of the quarter and then files a registration statement a few weeks later. Does it need to include these financial statements with the registration documents?

No. The XYZ Corporation may simply mention that its financial statements were previously filed with the state. Any person reading the registration statement may obtain these documents from the state if she wishes.

Filing Fees

Issuers are required to pay *filing fees* at both the time of initial registration and at annual renewal. If either of these fees is not paid, the Administrator may issue a stop order, which suspends the sale of the security. The fee will vary from state to state, so there's no specific dollar amount that will be tested on your exam.

Effective Date of Registration

The *effective date* is the date on which the appropriate regulator releases the security for public distribution. If any securities of the same class are outstanding, a registration statement may not be withdrawn for one year after its effective date, unless the Administrator determines otherwise.

An Administrator may also require the filing of quarterly reports by the same person who filed the initial registration statement. The Administrator's goal is to keep registration information as current as possible and to monitor the progress of the securities offering.

Amendments

The issuer may amend its registration statement after the effective date to increase the number of shares being sold. If the issuer does amend the statement, it's not required to file a new registration statement as long as the issuer's public offering price, underwriters' discount (spread), and commission schedule are not being changed.

If information in the registration statement becomes outdated or turns out to be inaccurate or incomplete, a *correcting amendment* must be filed with the Administrator. The effective date of the registration will then depend on the date of the amendment, not the date of the original filing.

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Expiration Dates

A security's registration *expires* one year after its effective date. In order to continue to offer or sell the security, it must be reregistered (which is unlikely) or sold through an exemption (which is what usually happens). Later in this chapter, a number of the exemptions from registration that are available under the USA will be examined.

> *HCI Company's public offering of securities became effective on January 14, 20XX. When will the registration expire?*
>
> The registration of a security expires one year after its effective date—NOT on December 31.

Types of Securities Registration

In addition to meeting the general registration requirements previously described, each state securities registration must be completed using one of the following three methods:

1. Notification (Filing)
2. Coordination
3. Qualification

All registration statements are effective for at least one year from their effective date.

Registration by Notification (Filing)

Registration by *notification*, also called *filing*, is used by well-established corporations that meet stringent financial requirements. This method of registration was always reserved for larger issuers with securities that trade on a national exchange and have previously registered with the SEC.

Not all states permit the use of registration by filing. However, in those states where it's use is allowed, the following conditions must be met:

1. A registration statement must have been filed under the Securities Act of 1933.
2. The issuer is organized under the laws of the U.S. or a state, or if not, the issuer has appointed a duly authorized agent in the U.S. for Service of Process.
3. The issuer has registered with the SEC a class of equity securities that are held by 500 or more persons.
4. The issuer has:
   - A total net worth of at least $4,000,000 or a total net worth of $2,000,000 and net pre-tax income for at least two of the previous three years
   - Not less than 400,000 units of the class of securities registered under Section 12 of the '34 Act are held by the public, excluding securities held by officers and directors of the issuer, underwriters, and persons beneficially owning 10% or more of that class of securities, and
   - Outstanding warrants and options held by the underwriters and executive officers and directors of the issuer in an amount not exceeding 10% of the total number of shares to be outstanding after completion of the offering of the securities being registered

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5. The issuer has been in business for at least 36 calendar months preceding registration.
6. For the issuer's securities registered pursuant to the '34 Act, there must have been at least four market makers for a period of at least 30 days during the three months preceding filing.
7. The aggregate commissions or discounts received by underwriters may not exceed 10% of the aggregate offering price.
8. The issuer or any subsidiary may not have failed to pay a dividend on preferred stock or have defaulted on any bond or long-term lease since the end of the last fiscal year before it filed the registration statement.
9. In the case of an equity security, the *offering price must be $5 per share or more*.

The application for registration by filing must contain the following information:

- A statement of eligibility
- The issuer's name, address, and form of organization
- A statement describing the offering
- A copy of the prospectus that has been filed with the SEC

If all or part of the offering is for the benefit of someone other than the issuer (a non-issuer distribution), the statement must also contain the name, address, and amount of securities held by that person, and the reasons for making the offering.

Registration by filing becomes effective at the same time as the federal registration, provided no stop order has been entered by the SEC or the Administrator. In addition, the required information and documents must have been on file for at least five days and the registration fee must have been paid. If the federal registration became effective at an earlier time, the state registration becomes effective when all required conditions are met.

This method of registration is rarely used anymore since NSMIA was enacted in 1996. As we will see later in this chapter, the securities of large issuers that trade on the major stock exchanges are usually *federal covered securities* that are considered exempt from state registration. However, there could be questions about registration by notification (filing) on the Series 63 Examination, which is the reason that this registration method is described in this course.

Be careful …

Some test-takers confuse registration by notification (filing) with notice filing. Although both use the word *filing*, notice filing is not a registration method. Notice filing will be examined shortly.

Registration by Coordination

A security may be registered by *coordination* if the same offering is being registered under the Securities Act of 1933. While the state registration statement is coordinated with the federal registration, the two statements don't need to be filed at the same time.

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Under coordination, a registration statement must be filed with the Administrator along with three copies of the latest prospectus that were filed with the SEC. The Administrator may also request a copy of the articles of incorporation, any underwriting agreement or indenture related to the security, or other information or documents the Administrator deems appropriate. Any amendments to the federal prospectus must also be forwarded to the Administrator promptly.

Registration by coordination becomes effective at the same time as the federal registration, provided no stop order has been entered by the SEC or the Administrator. The registration statement must be on file with the Administrator for at least 10 days. Furthermore, a statement of the minimum and maximum offering prices, maximum underwriting discounts, and commissions must have been on file with the Administrator for at least two business days.

If the federal registration becomes effective prior to the satisfaction of all the requirements of previous paragraph, the state registration will become effective once the requirements have been met, unless otherwise waived by the Administrator.

Registration by Qualification

Registration by *qualification* is used when either a security's federal registration has already become effective or when no federal registration will be filed—as is the case for offerings made in one state only (intrastate offerings). Intrastate offerings are exempt from federal registration.

The process of registering a security by qualification is much more involved than both the filing and coordination methods. The following disclosures are required under registration by qualification:

1. Information about the issuer and any significant subsidiary including its name, address, form of organization, the state or foreign jurisdiction in which it operates, and the general competitive conditions in the industry or business in which it is or will be engaged
2. Information on all officers or directors of the issuer including their names, addresses, principal occupations for the last five years, and the amounts of securities they're holding within 30 days of the filing of the registration statement
3. Information on any person who owns 10% or more of any class of the issuer's outstanding shares
4. For any non-issuer distributions, the name and address of the person on whose behalf the offering is to be made, the amount of securities owned, and a statement of the reason for making the offering
5. A description of the issuer's capitalization and long-term debt
6. The type and amount of securities to be offered, the price of the securities, estimated selling fees, and underwriting agreements
7. The estimated cash proceeds to be received and the purposes for which the proceeds will be used
8. A copy of every prospectus, letter, advertisement, or other literature to be used in connection with the offering, and a legal opinion if it's a debt offering
9. A recent balance sheet and a profit-and-loss statement for each of the last three years
10. Any additional information required by the Administrator

One of the unique characteristics of registration by qualification is that the registration becomes effective *only when determined by the Administrator*.

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Remember …

Although the effective date for securities registered by notification (filing) and coordination is based on the effective date of the issuer's federal registration, this is not the case for registration by qualification.

Interaction with Federal Law

Rule 147 and Rule 147A Rule 147 was created as a safe harbor under the statutory intrastate offering exemption which is provided by the Securities Act of 1933. The rule (also referred to as the intrastate exemption) allows companies to raise capital from their in-state investors. Typically, companies that are selling new securities are required to register their securities with the SEC; however, under Rule 147, if a company is conducting an offering and only selling its securities to its state residents, the offering is exempt from registration. Today, the strict issuer eligibility requirements and developments in both company business practices and communications technology have made Rule 147 outdated.

Amendments to the existing Rule 147 and the implementation of a new rule—Rule 147A—are designed to update and modernize the existing intrastate offering framework and permit a company to raise money from investors who reside within its state without being required to register the offers and sales at the federal level.

Although it's similar to Rule 147, the new Rule 147A will allow for multi-state offers (not sales), which means that:

- Issuers are permitted to use general solicitation and publicly available websites to locate potential in-state investors. Although *offers* are able to be made outside of the state, all *sales* must still be limited to in-state residents.
- Companies are able to be incorporated or organized outside of the state in which they conduct the offering as long as they have their *principal place of business* in that state. Principal place of business is defined as the location from which the principal officers, manager, or partners primarily direct, control, and coordinate the activities of the issuer.
  - For example, ABC is incorporated in Delaware, but its principal business is conducted in New Jersey. Under Rule 147A, ABC will be allowed to sell securities to residents of New Jersey. Both the amended Rule 147 and the new Rule 147A include the following provisions:
- For an issuer to sell securities in a state, it must have its principal office (under Rule 147) or principal place of business (under Rule 147A) in that state and satisfy one of four "doing business" requirements. By satisfying one of the four new requirements, the issuer can avoid having to comply with all three of the 80% tests for assets, revenue, and proceeds of the offering.
  - If a Rule 147 or 147A issuer subsequently changes its principal place of business after issuing securities, it will not be able to conduct another intrastate offering under these rules in another state for a period of six months from the date of last the sale in the previous state.
  - An issuer is considered to be "doing business" in a state as long as it meets just one of the following four new requirements:

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1. At least 80% of its consolidated gross revenues are derived from the operation of a business or of real property that's located in the state or territory or from the rendering of services within the state or territory;
2. At least 80% of its consolidated assets are located within the state or territory at the end of its most recent semiannual fiscal period prior to the first offer under the exemption;
3. At least 80% of the net proceeds from the offering are intended to be used by the issuer, and are in fact used in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within the state or territory; or
4. A majority of the issuer's employees are based in the state or territory (this fourth requirement was not included in the original Rule 147)

- An issuer must utilize a reasonable belief standard when determining the residency of the purchaser at the time of the sale of securities. This standard is supported by the requirement that the issuer obtain a written representation from all purchasers as to their residency.
- Resales to persons who reside outside of the state in which the offering is conducted are restricted for a period of six months from the date of the sale by the issuer to the purchaser (formerly nine months).
  - A legend requirement applies to notify offerees and purchasers about the resale restriction.

Regulation A Under Regulation A, if an issuer offers a new issue of securities valued at $75 million or less sold over a 12-month period, the offering is exempt under the Act. However, it's not a complete exemption since the issuer must file an offering statement with the SEC and provide an *offering circular* to prospective purchasers. Advantages of conducting a Regulation A offering rather than a full registration include lower legal and filing fees and a shorter time needed to prepare documents.

The JOBS Act expanded Regulation A (which was originally $5 million) into the following two tiers:

- Tier 1 – Sales of up to $20 million are permitted within a 12-month period. Of that amount, no more than $6 million may be sold on behalf of selling shareholders.
  - The offerings are subject to both SEC and blue sky review
  - Continuing disclosure information must be filed
- Tier 2 – Sales of up to $75 million are permitted within a 12-month period. Of that amount, no more than $22.5 million may be sold on behalf of selling shareholders.
  - The offerings are subject to SEC review, but not Blue-Sky review
  - Has stricter continuing disclosure information and filing requirements

Additional Information Regarding Regulation A

- Current SEC reporting companies may not use Regulation A
- Both U.S. and Canadian companies are eligible
- The offerings may be for either equity or debt securities

Be careful …

Under Rule 147, the SEC exempts intrastate offerings from federal registration. However, the offering may still need to be registered with the state in which it's being sold.

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Denial, Suspension, and Revocation of Registration

Administrators have the authority to issue a stop order to deny, suspend, or revoke a registration. These actions may be taken if they find it to be in the public interest and if any of the following conditions apply:

- A registration statement is incomplete, false, or misleading in any material respect.
- A provision of the Uniform Securities Act or any rule or order imposed by an Administrator has been willfully violated in connection with the offering by the issuer, any partner, officer, director, or control person, or underwriter.
- Any officer of the issuer or underwriter has been convicted of a crime involving securities.
- The security is already subject to a stop order or an injunction by a federal or state court.
- The issuer's enterprise or method of business includes activities that are illegal.
- The offering is fraudulent, or is made on terms that are unfair, unjust, or inequitable.
- The seller's compensation is unreasonably large.
- The registrant fails to pay the proper filing fee. (The Administrator may enter a denial order that will be vacated when the deficiency is corrected.)

Administrators may not deny, suspend, or revoke a registration based solely on an issuer's weak financial condition. In addition, Administrators may not institute a stop order proceeding against a registration based on facts of which they were aware when the registration became effective, unless the proceedings are instituted within 30 days.

An Administrator may summarily postpone or suspend a registration pending a final determination of any proceedings being conducted under this section. If administrative action is taken, the registrant must be provided with prior written notification and be allowed to submit a written request for a hearing, which must be held within 15 days of the request.

Registration Exemptions

When a security is not required to be registered, it's classified as an *exempt security*. Issuers often prefer to offer securities under an exemption because it's more timely and cost-effective than going through the formal registration process. Under the USA, provisions exist for exempt securities and exempt transactions that are based on the method by which the security is offered or sold. When an exemption for a security or a transaction is claimed, the burden of proof rests with the person requesting it.

Both exempt securities and exempt transactions are exempt from registration requirements. However, there's no exemption from the antifraud provisions of the Uniform Securities Act. A security may be exempt from registration under federal law, but not state law, and vice versa. When the rules overlap, the most restrictive rule applies. Once again, an exemption from registration doesn't exempt a security from federal and state antifraud provisions. All securities and persons are subject to the antifraud provisions.

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Exempt Securities

Securities that qualify as exempt retain their exemption both when initially issued as well as in subsequent trading. Exempt securities include:

1. Securities issued by the U.S. government and municipalities—including debt issued by government agencies as well as states, counties, or school districts
2. Securities issued by the Canadian government and municipalities—including debt issued by provinces or cities
3. Securities issued by other foreign governments—provided the U.S. maintains diplomatic relations with the foreign country and the securities being issued are recognized as a valid obligation of the issuer
4. Securities issued by banks, savings institutions, or trust companies
5. Securities issued by federal credit unions or industrial loan associations
6. Securities issued by insurance companies (This exemption doesn't apply to issuing variable annuities.)
7. Securities issued by common carriers (railroads) and public utility holding companies. Regulation of common carriers is performed by the Interstate Commerce Commission (ICC), while utility companies are regulated under the Public Utility Holding Company Act of 1935.
8. Securities issued by not-for-profit organizations. This includes religious, educational, fraternal, charitable, social, athletic, trade, and professional associations.
9. Any promissory notes, drafts, bills of exchange, or bankers' acceptances maturing in no more than nine months, issued in denominations of $50,000 or more, and rated in one of the three highest rating categories by a Nationally Recognized Statistical Rating Organization (NRSRO), such as S&P or Moody's. In other words, this exception covers commercial paper.
10. Any investment contracts issued in connection with an employee's stock purchase, savings, pension, and profit-sharing or similar benefit plan if the Administrator is notified in writing at least 30 days before the inception of the plan
11. Federal covered securities

Federal Covered Securities These securities are not required to be registered at the state level. NSMIA eliminated a state's ability to regulate the public offerings, proxy solicitations, periodic disclosures and advertising filing requirements of the issuers of federal covered securities. Although no federal covered security is required to be registered with a state Administrator, certain securities that fall in this category are required to notice file. For now, it's important to know the characteristics of the various types of federal covered securities.

Exchange-Listed Securities These are securities that are currently listed on an exchange, or will be listed on an exchange once the offering is completed. These include securities that trade on the New York Stock Exchange, Nasdaq, and the Chicago Stock Exchange. The exemption extends to securities that are equal to or higher in seniority to the listed security, as well as to rights and warrants to purchase the subject security. These securities were previously exempt under a provision referred to as the *blue-chip exemption*.

Securities Sold to Qualified Purchasers Qualified purchasers, as defined under the Investment Company Act of 1940, are persons who own at least $5 million in investments. These sophisticated investors are deemed to be capable of evaluating investments and protecting themselves in a manner that renders regulation by state authorities unnecessary.

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Investment Companies Investment company securities (e.g., mutual fund shares) are registered under the Investment Company Act of 1940 and are also required to be registered with the SEC under the Act of 1933.

Securities Issued Pursuant to Regulation D—Rule 506 Private offerings of securities that are not sold to the public are exempt from federal registration. Issuers using the Rule 506 private offering exemption are able to raise an unlimited amount of money; however, restrictions are imposed on the types of investors that may purchase the securities.

Generally, the securities may be sold to an unlimited number of accredited investors, but no more than 35 non-accredited investors. If the issuer publicly advertises the securities or solicits investors without prequalifying them, then only accredited investors may actually purchase the securities.

Under Regulation D, an accredited investor is defined as:

- A financial institution (such as a bank), a large tax-exempt plan, or a private business development company
- Any director, executive officer, or general partner of the issuer
- An individual who meets either *one* of the following criteria:
  - A net worth of at least $1 million (excluding his primary residence), or
  - A gross income of at least $200,000 ($300,000 for a married couple) for each of the past two years, with the anticipation that this income level will continue

Notice Filing *Notice filing* refers to a state's demand that certain issuers of federal covered securities satisfy state requirements, such as signing a Consent to Service of Process, paying a filing fee, and possibly filing with an Administrator any copies of material that has been filed with the SEC as a part of the issuer's federal registration. Notice filing is required for issuers of investment company securities as well as issuers that distribute their securities pursuant to a Rule 506 private placement.

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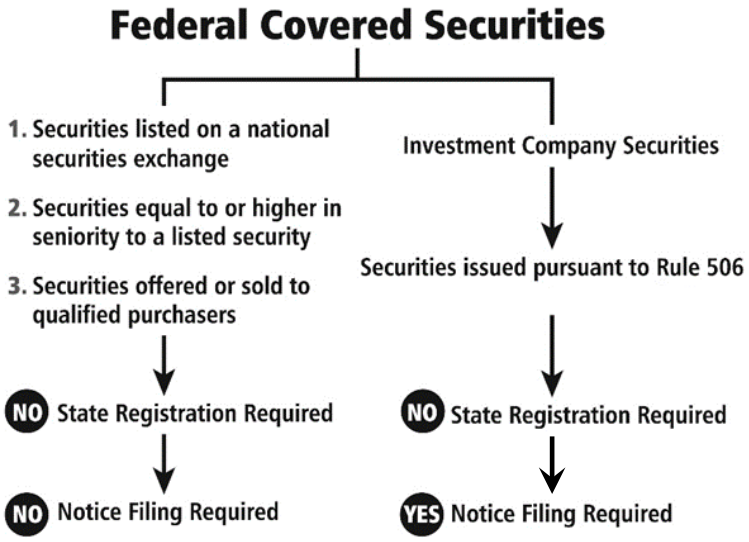
The following chart provides a summary of the registration and notice filing requirements for federal covered securities:



Remember, unless securities are exempt, they must be registered at the state level by means of notification (filing), coordination, or qualification.

Exempt Transactions

Another way for securities to avoid state registration is through one of the various *exempt transactions*. Under the USA, an exempt transaction is a method through which an exemption is provided based on how the security is offered or sold. For transactions, the exemption must be established on a trade-by-trade basis.

Since the following list is extensive, no student is expected to memorize all of the exemptions. Instead, the best approach is to focus on key terms or themes within the list.

The transactions that are exempt from the registration requirements of the USA include:

1. Any *isolated (infrequent) non-issuer* transaction, regardless of whether it's effected through a broker-dealer. (This covers any secondary market transaction between parties that are not affiliated with the financial industry.)
2. Any *non-issuer* transaction by a registered agent of a broker-dealer provided the issuer is actually engaged in business. This means that the issuer may not be in the organizational stage, in bankruptcy, or in receivership. Also, it may not be a blank-check, a blind-pool, or a shell company whose primary purpose is to engage in mergers or acquisitions.
    a. The securities must be senior to the issuer's common stock.
    b. The securities must have been outstanding for at least three years and the issuer may not have defaulted on any of its obligations during this time.

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OR

a. The securities have been in the hands of the public for at least 90 days AND
b. The price is reasonably related to the securities' current market price AND
c. The securities are not part of the underwriter's original allotment that it failed to sell AND
d. Information about the issuer is publicly available either through documents filed with the SEC or through a nationally recognized securities manual designated by the Administrator AND
e. The issuer's stock is traded on one of the exchanges, or the issuer is a unit investment trust registered under the Investment Company Act of 1940, or the issuer has been in business continuously for at least three years, or the issuer's total assets equal at least $2 million.

3. A *non-issuer* transaction in outstanding securities by a registered agent of a registered broker-dealer, provided that:
   a. The issuer is a reporting issuer in Canada together with its provinces and territories, or designated by rule or order of the Administrator, and has been subject to continuous reporting requirements in such foreign country for not less than 180 days before the transaction.
   b. The security is listed on the Toronto Stock Exchange, the TSX Venture Exchange, or designated by rule or order of the Administrator, or is a security of the same issuer, which is substantially equal to or senior in rank to such listed securities, or is a warrant or right to purchase or subscribe to any of the previously mentioned securities.
4. Any *non-issuer* transaction in a security of a company:
   a. That's subject to the registration and reporting requirements of the Securities Exchange Act of 1934, or
   b. Is registered under the Investment Company Act of 1940, or
   c. Has filed information with the Administrator that's substantially the same as that which is required for registered issuers by the Securities Exchange Act of 1934 for a period of at least 180 days prior to the transaction
5. Any *non-issuer* transaction effected through a registered broker-dealer on an *unsolicited* basis. The Administrator may require that the client acknowledge on a specified form that the order was unsolicited and that the broker-dealer maintains the form for a prescribed period.

Remember …

The language of the USA can be tricky. Soliciting the sale of unregistered, exempt securities is permitted because the securities are exempt. However, soliciting the sale of unregistered, non-exempt securities is prohibited.

6. Any transaction *between an issuer and an underwriter*
7. Any transaction in a bond secured by a real estate mortgage or deed of trust, provided that the entire mortgage or deed of trust, together with the bonds, are offered and sold as a unit
8. Any transaction by a *fiduciary* such as an executor, administrator, sheriff, marshal, trustee in bankruptcy, guardian, or conservator
9. Any transaction by a bona fide pledgee if the sale is not for the purpose of evading the Uniform Securities Act

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10. Any sale or offer to an *institutional investor* such as a bank, savings institution, trust company, insurance company, investment company, pension or profit-sharing trust, or to a broker-dealer
11. A *private placement* transaction, provided it's directed to *no more than 10 retail (non-institutional) investors* and the following conditions are met:
    a. The seller believes that all of the non-institutional buyers are purchasing for investment purposes only.
    b. No commissions or other remuneration is paid for soliciting any non-institutional buyer.
    c. Form D is filed with the SEC and the state Administrator.
12. Any sale of a preorganization certificate, provided that:
    a. No commission is paid for soliciting any buyer
    b. The number of subscribers doesn't exceed 10, and
    c. No payment is made by any subscriber
13. Any transaction involving existing security holders of the issuer, including persons holding convertible securities and warrants, if no commission or other remuneration is paid for soliciting buyers, or the issuer files a notice specifying the terms of the offer, and the Administrator doesn't disallow the exemption within five days
14. Any offer (but not a sale) of a security for which a registration statement has been filed under the Uniform Securities Act and the Securities Act of 1933, provided that no stop order is in effect. Sales may take place only after the registration is effective.

Again, try to focus on key words or phrases when attempting to identify whether an exemption applies. For exam purposes, remember the terms *non-issuer*, *fiduciary*, *isolated*, *private*, and *unsolicited*. Also, pay attention to phrases such as *trades between issuer and underwriter*, *trades with institutional investors*, *directed to no more than 10 retail clients*, or *not involving the public*.

The reason that most non-issuer transactions are exempt is because they represent secondary market trades that will be regulated at the federal level. On the other hand, when the issuing entity is in a position to receive the proceeds of the distribution (e.g., an IPO), it's considered an *issuer transaction*. Issuer transactions may be subject to state registration.

The Administrator may deny or revoke any exemption upon prior written notice to all interested parties. If action is taken, the Administrator must offer the opportunity for a hearing and must provide written findings of fact and law. Pending a final determination of any proceedings, the Administrator may deny or revoke the exemptions.

> *Acme Inc. is planning to expand its business and is in need of additional capital. Acme's financial advisers recommend that it offer shares of the company to the public. Are the securities being offered by Acme required to be registered? And, what role will Acme play in the offering?*
>
> > Since there's no indication of an exemption, Acme is required to register the securities prior to offering them to public investors. Generally, when public investors are involved, registration is required. In this example, Acme is the issuer of the securities.

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Consider another example of securities registration:

A corporation is offering its stock only in California. If the company's stock will be listed on Nasdaq, what method of state registration will the corporation use?

Since the corporation is offering its stock only in California, it may seem as though the intrastate method of registration (qualification) would be used. However, since the corporation will be listed on Nasdaq, it's not required to register at the state level as the securities are considered federal covered.

Summary of Exemptions from State Registration	
Exempt Securities	**Exempt Transactions**
Securities issued by the U.S. government, agency of the U.S. or any municipality (i.e., state, county, school district, etc.)	Any isolated (infrequent) non-issuer transactions
Securities issued by the Canadian government including any state, province, or local Canadian municipality	Any non-issuer transaction by a registered agent of a broker-dealer, provided that the issuer is actually engaged in business
Securities issued by any other foreign government with which the U.S. maintains diplomatic relations	Any non-issuer transaction in a security of a company that's subject to the registration and reporting requirements of the Securities Exchange Act of 1934 for at least 180 days
Securities issued by banks, savings institutions, or trust companies	Any non-issuer transaction effected through a registered broker-dealer on an *unsolicited* basis
Securities issued by federal savings and loan associations, federal credit unions, or any security of a similar association	Any transaction between an issuer and an underwriter
Securities issued by insurance companies	Any transaction in a bond secured by a real estate mortgage or deed of trust
Securities issued by railroads, common carriers, or public utility holding companies that are subject to specified regulations	Any transaction by a fiduciary (e.g., executor, administrator, or sheriff).
Securities issued by not-for-profit organizations such as religious, educational, fraternal, charitable, social, athletic, or trade and professional associations	Any transaction by a bona fide pledgee if the sale is not for the purpose of evading the Uniform Securities Act
Any promissory note, draft, bill of exchange, or banker's acceptance meeting certain requirements	Any offer or sale to various financial or institutional buyers
Any investment contract issued in connection with an employee stock purchase, savings, pension, profit-sharing, or similar benefit plan meeting certain requirements	Any transaction directed to no more than 10 retail (non-institutional) investors (private placement) ▪ No commissions may be paid
Federal Covered Securities: ▪ Securities listed on a National Exchange (blue-chip) ▪ Securities sold to qualified purchasers under the Investment Company Act of 1940 ▪ Investment company securities ▪ Securities issued pursuant to Rule 506	Any sale of a preorganization certificate
	Any transaction involving existing security holders of the issuer, including persons holding convertible securities and warrants
	Any offer (but not a sale) of a security for which a registration statement has been filed under the Uniform Securities Act and the Securities Act of 1933 (preorganization certificate)

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Chapter 2 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Use the four-part Howey Test to define a security:
  1. An investment of money
  2. In a common enterprise
  3. With the expectation of profit
  4. Solely from the efforts of others
- Describe a viatical investment as well as recognize and understand their risks
- Understand who pays filing fees and when they're required
- Understand what the effective date means for an issuer and who declares the effective date
- Identify when the state registration of a security expires
- Recognize the differences in the three types of securities registration under the USA:
  1. Notification (Filing)
  2. Coordination
  3. Qualification
- Understand the reasons that an Administrator may deny, suspend, or revoke the registration of a security
- Recognize the securities that are exempt under the USA
  - Identify the federal covered securities and which of these are required to notice file
  - Understand the characteristics of notice filing
- Recognize the transactions that are exempt under the USA

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Chapter 3

State Regulations Governing Broker-Dealers and Agents

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Although this chapter is titled State Regulations Governing Broker-Dealers and Agents, it's important to note that there are general registration requirements that apply to all firms and financial professionals. We begin the chapter by reviewing the general registration procedures for all persons that are tested on the Series 63 Examination, including broker-dealers, agents, investment advisers, and investment adviser representatives. We also carefully highlight differences that exist. Once we have covered the general registration process, we turn our focus to the specific regulations that apply to broker-dealers and agents, and review some of the types of accounts that they may open for their customers.

General Registration of Financial Professionals

The Application Process

Broker-dealers, agents, investment advisers, and investment adviser representatives each begin their registration process by filing an *application* with the appropriate regulatory authority. The initial application includes the following information:

- Applicant's name and aliases
- Address (business or residence) for the last five years
- Applicant's financial condition and history
- Employment history for the last 10 years
- Type of business to be conducted
- Other business activities
- Any charge, no contest plea, injunction, administrative order, felony conviction, or securities-related misdemeanor conviction issued by a domestic, foreign, or military court
- Details regarding unsatisfied judgments or liens against the registrant
- Settlements of $15,000 or more related to customer complaints, arbitration, or civil litigation
- Whether a bonding company has ever denied, paid out on, or revoked a bond for the registrant
- Qualifications and business history of any partner, officer, director, and other persons in a controlling position

If material information that was provided to the Administrator becomes inaccurate or outdated, an amendment must be filed promptly (generally within 30 days).

For purposes of announcing a person's interest in obtaining registration, the Administrator may require the registrant to publish an announcement of the application in one or more newspapers published in the state in which registration is being sought.

Consent to Service of Process A *Consent to Service of Process* is a document that irrevocably appoints the Administrator as a registered person's attorney for the service of legal papers. A registrant is required to file this document only as a part of the initial registration package.

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The consent then becomes a permanent document in the registrant's file and is not required to be resubmitted at the time of registration renewal. Filing the Consent to Service of Process is a convenience for customers who have complaints that they wish to pursue in court. Customers may serve notice directly on the Administrator, rather than the registrant personally.

How does the document actually work?

> *A client believes that her agent has taken funds from her securities account without authorization and, therefore, files a lawsuit in state court to recover her losses. However, when she files the lawsuit, her agent is no longer associated with his now former employer and cannot be located in order to serve him with legal papers. Does the client have recourse?*
>
> Since the Consent to Service of Process was filed at the time the agent was originally registered, the client may serve the papers on the state Administrator instead of the agent. Serving the Administrator is equivalent to serving the legal papers on the agent directly.

Substituted Consent to Service of Process The benefit of a Substituted Consent to Service of Process arises when a seller in one state directs an offer into a second state either in violation of the laws of the second state or fraudulently. Under a Substituted Consent, the purchaser may sue the seller in the purchaser's state and then bring an action on the judgment in the seller's state.

Filing Fee A *filing fee* must be paid at the time of initial registration and annually at renewal. If an application is denied or withdrawn, the Administrator may retain all, or part, of the fee.

Over the course of a year, if two or more firms combine to become one firm, the new firm (successor firm) is permitted to fill the unexpired portion of the registration term. Rather than paying a new filing fee, only the successor firm is required to file a new application. The following example reinforces this concept:

> *Heritage Securities, a California broker-dealer, purchased GST Investments, a small New York-based broker-dealer. Heritage completed the purchase of GST in March and will now operate as Heritage Investments. The new firm will have offices in California and New York. What are the requirements for Heritage Investments to operate as the successor firm for the remainder of the year?*
>
> Heritage Investments will be required to file a new application with the Administrator in California and New York. However, since Heritage Securities and GST Investments were properly registered, including having paid their filing fees, the successor firm (Heritage Investments) will not be required to pay another fee until its registration is required to be renewed.

The successor firm doesn't actually need to be in existence at the time that the application is filed. Instead, it may still be in the process of being formed or incorporated.

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Examinations The Administrator reserves the right to require applicants to take an *examination*—which may be written, oral, or both. However, the Administrator may excuse certain categories of persons from taking an exam.

Keep in mind that simply passing an examination is not sufficient for registration. Applicants must meet all requirements for registration and are not allowed to do business in a state until their registration is deemed effective by the Administrator.

Surety Bond A *surety bond* is insurance which is issued by a bonding company that agrees to pay the sum of money awarded by a court up to a certain amount. The need for a surety bond may arise as a result of a registrant's violations of the USA. The bond must be maintained for as long as the registrant is in business and *for three years thereafter*.

The requirement to post a bond may also apply to registered broker-dealers, agents, and investment advisers if any of these securities professionals maintain custody of their clients' funds or securities, or have discretionary authority over their assets. (Discretionary authority means that the firm or one of its employees is authorized to place orders for an account without first obtaining the client's approval.) Although not always the case for investment advisers, broker-dealers generally have custody of their clients' funds and securities and must post a bond.

If a broker-dealer's *net capital* or an investment adviser's *minimum financial requirement* meets specified minimum amounts, the posting of a bond will not be required. In lieu of posting a bond, Administrators allow registrants to deposit cash or securities, but not personal property. However, if depositing securities, the Administrator has the authority to determine the appropriate type and amount.

Effective Date and Expiration

A person's registration becomes *effective at noon on the 30th day after the filing of the application* (or on the 30th day after the filing of an amendment). If Administrators consider it appropriate, they have the authority to grant registration earlier. Issues that impact a person's registration include denial orders or pending proceedings regarding denial, revocation, suspension, cancellation, or withdrawal.

For financial professionals, all registrations *expire on December 31*. The annual renewal process is as simple as updating the application and paying a new fee. However, Administrators retain the right to suspend or revoke a registration whenever they feel it's necessary and in the public's best interest.

> *LJ Securities has completed all of its requirements for registration as a broker-dealer and filed its application with the Administrator on May 1. Provided the Administrator doesn't deny LJ's application, when will it become effective?*
>
> LJ Securities' registration becomes effective at noon on May 31 and will remain effective until December 31. However, since the 30-day wait delays LJ's ability to initiate business, the Administrator may grant registration earlier. Therefore, if the Administrator notified LJ on May 8 that its registration is effective, LJ may begin acting as a broker-dealer without waiting the full 30 days.

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Similar application …

Although the previous example involved a broker-dealer, the same scenario and effective date applies to the registration of an agent, investment adviser, or investment adviser representative. Remember, Administrators may choose to grant registration earlier.

Please review the following table to identify the appropriate form and system used for the registration of different securities professionals:

Person	Form	System
Broker-Dealer	Form BD	Central Registration Depository (CRD)
Agent	Form U4	CRD
Investment Adviser	Form ADV (Parts 1 and 2)	Investment Adviser Registration Depository (IARD)
Investment Adviser Representative	Form U4	IARD through the CRD

The Central Registration Depository (CRD) system is a computerized database that contains information about broker-dealers and their agents. Information includes the states in which a person is registered, any reported disciplinary problems with regulators, and serious complaints from investors.

The Investment Adviser Registration Depository (IARD) is also an electronic filing system that facilitates investment adviser registration, regulatory review, and the public disclosure of information. Although FINRA has no regulatory control over advisers, it developed and operates the IARD. More detailed information on Form ADV and the IARD will be found in the next chapter.

Now that the general registration requirements for persons have been covered, let's take a closer look at the specific requirements for broker-dealers and agents.

State Registration of Broker-Dealers

Net Capital

The Administrator may require broker-dealers to maintain a specified minimum amount of *net capital* (essentially a broker-dealer's liquid net worth). However, the state Administrator may not set a level that exceeds the requirement established by federal (SEC) rules.

Advertising and Sales Literature

All *advertising*, *sales literature*, and other written materials (prospectuses, pamphlets, circulars, form letters, etc.) intended for distribution to current or potential clients must be filed with the Administrator. For materials relating to exempt securities, exempt transactions, or federal covered securities, filing with the Administrator is not required.

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Any communication or correspondence must be fair and balanced. Materials prepared for retail investors must be approved by an appropriate qualified principal in writing prior to being distributed to the public.

Sales Seminars A principal must approve all written seminar materials and guest speakers beforehand (including advertising or notices for the seminar itself). If an agent regularly conducts sales seminars, then a supervisor should attend occasionally in order to fulfill the firm's supervisory responsibilities.

Correspondence Correspondence includes e-mail, instant messages and texts, as well as letters. The broker-dealer must be able to effectively monitor all incoming and outgoing correspondence (electronic and paper-based). This process must include a way of detecting potential client complaints.

Maintenance Requirements

There are specific maintenance requirements for the different records created by broker-dealers. Depending on the type of record, the periods for record keeping include the lifetime of the firm, six years, and three years. Unless otherwise indicated by the Administrator, advertising, correspondence, confirmations, and trade tickets are examples of records that must be preserved for *three years.* However, *for the first two years*, each of these records must be kept in *an easily accessible location*.

Order Memorandums

Both broker-dealers and investment advisers need records regarding transactions in their customers' accounts. These are known as order memorandums or order tickets and must include:

- Account number, date of entry, date of execution
- Instruction, modification, or cancelation
- Terms and Conditions (e.g., limit price, time restrictions)
- The person who recommended the order or that it was unsolicited
- If the order was executed on a discretionary basis
- The broker-dealer or bank that executed the order

Financial Reports

Certain *financial reports* must be filed with the Administrator. The filing requirement for these reports could be quarterly, annually, or as frequent as determined by rule or order.

Special Examination

All required records of a broker-dealer, whether located within or outside the state, are subject to periodic or *special examination* as determined by the Administrator. The Administrator will cooperate with the Administrators of other states and the SEC, as well as national securities exchanges and associations, to avoid the duplicate inspection of records.

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Exclusions

A broker-dealer must be registered with the SEC as well as any state in which it's defined as a broker-dealer. Under the USA, if a person is defined as a broker-dealer in a state, it must register in that state. However, if a person is excluded from the broker-dealer definition, it's not required to register with the state Administrator.

What's the process for determining whether a firm or individual is defined as a broker-dealer? First, look at the activity in which the firm is involved. Next, look at where the firm is doing business. And finally, identify the types of clients with whom the firm is doing business.

In Chapter 1, the term *broker-dealer* was defined as any person in the business of effecting securities transactions for the accounts of others or for its own account.

The USA excludes the following persons from the broker-dealer definition:

- Agents (the employees involved in securities transactions)
- Issuers
- Banks, savings and loan companies, savings institutions, and trust companies (Bank holding companies and broker-dealer subsidiaries of banks are not excluded from the definition.)

> **Helpful hint …**
>
> There are patterns in the USA. For example, banks are provided an exclusion from the broker-dealer and investment adviser definitions. Another consistent exclusion is a situation where firms limit their business to institutional clients.

The next two exclusions from the broker-dealer definition require more explanation:

- A person that has no place of business in the state AND only transacts business with issuers, other broker-dealers, banks, savings institutions, trust companies, insurance companies or other financial institutions, or institutional clients

  While the USA provides the framework for states to create their own specific state securities laws, it's also concerned with protecting individual or retail investors. Institutional investors are often treated differently since they're more sophisticated and often have the expertise and ability to make independent investment decisions. Typically, institutions are able to assume greater risks and have a better understanding of those risks than individual (non-institutional) investors. For this reason, a firm that doesn't have an office in a state is allowed to deal exclusively with institutions without meeting the broker-dealer definition.

- A person that has no place of business in the state AND is registered where the person maintains its place of business and only conducts business with existing retail clients who are not residents of the state (e.g., clients on vacation, attending school, or working in another state)

  The bottom line is that if a broker-dealer has an office in a state, it must register in the state. However, if the broker-dealer doesn't have an office in a state and its non-institutional clients don't live in the state, then it's not required to register there.

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The following scenarios should be helpful in understanding the concept of registration:

Rocksolid is a broker-dealer with its only office located in Wyoming, but it consistently engages in securities transactions with mutual fund managers in Colorado. If Rocksolid has not opened an office in Colorado and its only clients there are institutional investors, is it required to register as a broker-dealer in Colorado?

No. Under the Uniform Securities Act, Rocksolid is not considered a broker-dealer in Colorado because it has *no place of business there* and its *clients are limited to institutional investors* in Colorado.

Rocksolid decides to expand and open a branch office in Colorado. It has yet to open accounts with non-institutional clients. Therefore, its only clients are institutional. Since Rocksolid has no retail clients in Colorado, is it required to register as a broker-dealer in Colorado?

Yes. Although Rock Solid has no retail clients in Colorado, it now has a place of business in Colorado and is required to register there.

Younge Securities, a Michigan broker-dealer, has both institutional and retail clients. Grace, an existing retail client of the firm, is spending three weeks in Florida house-sitting for her best friend who's traveling out of the country. If Younge Securities is not registered in Florida, will it be able to do business with Grace while she's in Florida? Will the agent that assists Grace be required to register in Florida?

Since Grace is only in Florida temporarily, Younge Securities will not be required to register in Florida. In addition, Grace's agent will not be required to register in Florida since Grace is not a resident of Florida.

If asked to identify whether a firm is considered a broker-dealer in a state:

(1) Identify the activity in which the firm is involved
(2) Determine whether the firm has an office in the state
   - If YES, the firm must register
   - If NO, identify the type of client
     - If all clients are institutional clients, the firm is NOT required to register.
     - If one or more clients are retail clients who are residents of the state, then the firm must register.

State Registration of Agents

In Chapter 1, the two types of agents were introduced—agents of broker-dealers and agents of issuers. Although questions may be asked about both types, the Series 63 Examination places more of an emphasis on agents of broker-dealers.

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At this point, let's get into greater detail about both types of agents.

Agents of Issuers

Occasionally, issuers use individuals to effect or to attempt to effect transactions for their own securities. These individuals are considered *agents of issuers*.

> *Henry is the president of a newly formed company. In an effort to help his company raise capital, Henry has been publicly offering his company's shares to friends and other potential investors. Is Henry an agent?*
>
> Yes. Since Henry is representing the issuer in the public offering of its stock, he's considered an agent of the issuer (the company).

An exclusion from the definition of an issuer agent exists when the individual effects:

- Transactions in securities that are exempt, such as:
  - U.S. government and municipal securities
  - Canadian government or other specific foreign national government securities
  - Bank, trust company, and savings institution securities
  - Commercial paper that has an initial maturity of nine months or less, is issued in denominations of at least $50,000, and receives a rating in one of the three highest rating categories from a nationally recognized statistical rating organization (NRSRO)
  - Investment contracts for employees, such as savings plans, profit-sharing and pension plans, and stock purchase plans
  - Federal covered securities
- Transactions that are exempt (those that don't involve the public), such as:
  - Private placements
  - Sales to qualified purchasers
  - Transactions between an issuer and an underwriter
  - Transactions with a trust company or savings institution
  - An individual selling stock of his company to employees of the company in which no compensation is received in connection to the transactions (e.g., a clerk handling employee stock purchase plans)

> *The treasurer's office of the city of Metropolis frequently issues municipal notes directly to large institutional investors. Mona, a Metropolis government employee, arranges these transactions. Is Mona considered an agent and required to register?*
>
> No. Although Mona is representing the issuer (Metropolis) in effecting transactions in securities, she's not considered an agent because of the nature of the securities she's selling (municipal notes).
>
> What if Metropolis sold its municipal notes to investors through Greg, an agent of Rocksolid Brokerage? Greg would not qualify for an exception since he's an agent of a broker-dealer, not the issuer.

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Be careful …

When an individual represents a broker-dealer in effecting securities transactions for compensation, that person must be registered as an agent, even if the security is exempt from registration.

Agents of Broker-Dealers

If an individual represents a broker-dealer in effecting securities transactions, without exception, he's an *agent of the broker-dealer.* For a person to solicit business in a state as an agent, he must be registered under the Uniform Securities Act by filing Form U4 (the Uniform Application for Securities Industry Registration or Transfer) through the CRD.

A broker-dealer may not employ an agent who is not properly registered. The registration of an agent is only in effect while she's associated with a registered broker-dealer. If an agent's employment is terminated or she chooses to leave her job, that broker-dealer is responsible for filing Form U5 (the Uniform Termination Notice) with its self-regulatory organization and the Administrator to disclose the termination of the relationship. The agent must also receive a copy of this form. If the agent doesn't join another firm within two years, her registration will lapse. If this happens, she's required to requalify by examination to reenter the industry.

Good to know …

Form U4 is the form that both agents and IARs use to register. As was just mentioned, broker-dealers must file Form U5 when an agent leaves the firm. The regulators use Form U6 to report disciplinary actions against broker-dealers and agents.

Agents Who are Affiliated with More than One Firm The dual registration of an agent (i.e., being affiliated with two broker-dealers simultaneously) is allowed, but only if the Administrator's direct authorization is received. Also, if an agent intends to *split or divide commissions with another person,* the other person must be a registered agent in the same state and be employed by the same broker-dealer or a firm that's under common control. A firm under common control includes an affiliate, subsidiary, or parent company.

Unregistered Personnel Keep in mind that not every employee of a broker-dealer who deals with clients is effecting securities transactions. Broker-dealers may employ unregistered individuals to perform the following functions:

- Extending invitations to firm-sponsored events at which presentations and account or order solicitation will be conducted by registered personnel
- Inquiring whether a prospective customer wishes to discuss investments with a registered person
- Determining whether a prospective customer wishes to receive investment literature from the firm

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The firms that employ unregistered persons to perform these functions must ensure that these employees don't solicit new accounts or orders, discuss general or specific investment products or services offered by the firm, or prequalify customers as to their financial status, investment history, or objectives.

Remember that any persons who are employed by a broker-dealer must be registered if they're authorized to receive either solicited or unsolicited orders, open customer accounts, or service accounts.

Agent Exemptions from State Registration

In most circumstances, agents must be registered in a particular state before engaging in securities transactions in that state. However, there are two situations in which agents may conduct business with an *existing client* without being registered in the state.

In the first situation, if an agent's application for registration is pending in a state, the agent may engage in transactions for up to 60 days with an existing client who has moved to that state. This provision is contingent on the Administrator not denying the agent's application during this period and the following conditions being met:

1. The agent must be eligible to register in the state.
2. The agent's broker-dealer must be registered in the state.
3. The agent must be registered with a national securities association (e.g., FINRA).
4. The agent must be registered in at least one other state.

The second situation allows an agent to engage in securities transactions with an existing client who is temporarily visiting a state in which the agent (and the broker-dealer) is not registered.

> *Norm and his broker-dealer are registered in New York. One of Norm's New York clients is on a business trip and calls him from the airport in Kansas to place an order. Is Norm required to register in Kansas to be able to accept the order?*
>
> No. Since the client is only in Kansas temporarily, neither Norm nor his broker-dealer is required to be registered in Kansas.

Managers as Agents

All original partners, officers, and directors of a broker-dealer who are involved in effecting securities transactions are automatically registered as agents when the broker-dealer initially registers with the state.

> *Al, Bob, and Charlene are the founders of a brokerage firm and were named senior officers when the company was formed. Al is responsible for handling the finances, but doesn't participate in securities transactions in any way. Bob and Charlene are responsible for managing the brokerage business. Two years after the firm was founded, Elsie replaced Bob as a senior officer. In this situation, how do the rules regarding the registration of agents apply?*

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When the firm's registration as a broker-dealer became effective, Bob and Charlene were automatically registered as agents. Al's responsibilities didn't involve effecting securities transactions, so he was not required to register as an agent. Since Elsie was not a partner, officer, or director at the time of the firm's initial registration, she didn't receive the benefit of automatic registration. Elsie was required to register and follow the same procedure as any other agent.

Supervision of Broker-Dealer Agents

Every broker-dealer must have written supervisory procedures (WSPs) and must ensure that they're updated periodically and enforced. WSPs are a vital element in a broker-dealer's supervisory system—they explain what the firm's employees must do in order to comply with the securities regulations.

Branch Office Audits A firm must conduct internal audits of its offices to make sure that its supervisory procedures and systems are being enforced. The firm must inspect all offices of supervisory jurisdiction and all branch offices that supervise other offices at least once a year. All other branch offices must be inspected at least once every three years, and non-branch offices on a regular basis.

According to NASAA, an effective branch audit program should include unannounced visits, a method of conveying feedback, and procedures for following up so that any deficiencies discovered by the auditors are corrected.

Post-registration Requirements for Agents

As described earlier, Form U4 requires registrants to provide information about themselves and their employment history. Additionally, if a registrant is currently engaged in any other businesses, he must answer a series of questions about whether he's ever:

- Violated the federal or state securities laws or SRO rules
- Been the subject of a regulatory proceeding or investigation
- Been involved in any legal proceedings (civil or criminal)
- Been the subject of a customer complaint
- Been terminated by a previous employer
- Declared bankruptcy, had a lien placed on your property or any unsatisfied judgments

By signing Form U4, a person agrees to amend this form promptly—generally within 30 days—if the information that's been submitted on this form changes. This includes both minor changes (e.g., change of address) and more important matters. Failure to report changes promptly may result in the person being fined, censured, or even barred from the industry, if the regulators determine that the oversight was deliberate. Insurance license suspensions, unsatisfied judgments and liens, and outside business activities are some of the items that must be disclosed on the Form U4.

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Rules for Canadian Broker-Dealers and Agents

The Uniform Securities Act contains a provision allowing for the limited registration of *Canadian broker-dealers and their agents.* If broker-dealers and agents are properly registered in Canada and have no place of business in a U.S. state, they will be exempt from certain provisions of the Uniform Securities Act. However, the antifraud provisions of the USA will always apply regardless of a person's registration status.

Canadian broker-dealers and agents may effect transactions with a person from Canada who's temporarily in a U.S. state provided there was an existing broker-dealer/client relationship before the person entered the United States. The firms are also permitted to effect transactions with or for an existing client who's located in a state if the trades are effected in a Canadian, self-directed, tax-advantaged retirement account for which the person is the holder or contributor. However, they may not solicit new clients in a state, Canadian or otherwise.

Jim is an agent with a broker-dealer in Canada. Sally, one of Jim's long-term clients, spends every winter in Florida. Both Jim and his broker-dealer are registered in a limited capacity in Florida since they have many senior clients who spend every winter there. Is Jim able to contact Sally about some new investment opportunities while she's in Florida?

Yes. Jim may contact Sally in Florida since she's an existing client who is in the U.S. temporarily.

Sally is very excited about a new investment opportunity that Jim has just proposed and mentions it to her broker Kevin, who retired to Florida many years ago. If Kevin is interested, is Jim able to contact him?

No. Jim may not contact Kevin since is not an existing client.

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Broker-Dealer Summary Chart

Broker-Dealer Definition	A person (usually a firm, rather than an individual) that's in the business of effecting transactions in securities for the accounts of others or for its own account		
Compensation	▪ Commissions ▪ Markups and Markdowns		
Exclusions from Definition	▪ Agents ▪ Issuers ▪ Banks, savings and loan companies, savings institutions, and trust companies ▪ Broker-dealers with no office within the state that conduct business only with: – Institutional investors – Existing clients who are not residents of the state		
Registration Process	▪ Registration usually required at state and federal levels ▪ File Form BD through CRD ▪ File Consent to Service of Process ▪ Pay filing fee ▪ Meet federal net capital requirement ▪ Post a surety bond *Note: A surety bond is not required if the broker-dealer's net capital meets the state's minimum requirement.*		
Segregation	Customer securities are required to be segregated from the broker-dealer's securities. (Cash may be commingled.)		
Recordkeeping	**Three Years** – Advertising – Order Tickets – Confirmations	**Six Years** – Blotters – General Ledgers – Customer Statements	**Lifetime** – Articles of Incorporation – Partnership Agreements – Stock Certificates Books – Minutes from Board Meetings

Client Accounts and Orders

Once a broker-dealer and its agents are properly registered in a state, they may begin opening accounts and taking orders for clients. The following are some types of customer accounts that students may encounter on the Series 63 Examination.

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New Customer Accounts

A firm must collect information from each individual who opens a new account and must create a record of this information. These records should include the following:

- Name
- Address (other than a P.O. Box) and telephone number
- Tax identification number
- Date of birth (for individuals)
- Occupation
- Whether the customer is an associated person of another broker-dealer
- Financial/Suitability information (net worth, annual income, tax status, investment objectives and experience, risk tolerance, liquidity needs, and other investments)

Agents must always obtain at least the customer's name, address, tax identification number (Social Security or Employer Identification Number), and date of birth to open an account. Additionally, they must make a good-faith effort to obtain the rest of the information that's cited in the last three bullet points. If the client refuses to provide all the information, agents should explain in the account record why this data was not collected.

The account record should also indicate the name of the agent who opened the account and the principal (supervisor) who approved it. Brokerage firms must keep all these records for six years after the account information is updated or replaced, or the account is closed.

Name and Address Changes If there's a change in the account name or the customer's address, a letter must be sent to the client notifying her of the change at both her former and current addresses. This is to prevent unscrupulous individuals from changing the client's address so that they can intercept her confirmations and account statements and then raid the account before the client knows what's happening.

Individual Accounts

An individual account is opened by and for one person. That one person acts purely on her own behalf and not for any other person or entity. She's also the only person who's able to initiate activity in the account unless she has provided another person with written third-party authorization. For example, if a married person opens an individual account, that person's spouse may not trade in the account unless the owner has formally granted the spouse with written third-party trading authorization.

Accounts for Minors Minors are not permitted to open accounts in their own names. This prohibition is due to the fact that they're not legally responsible and could refuse to accept transactions once they reach the age of majority. Although most states consider the age of 18 as the age of majority, each state is able to set its own standard. There are two approaches to opening accounts for minors—UGMA and UTMA accounts.

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According to the Uniform Transfers to Minors Act (UTMA), the securities in a UTMA account are the property of the minor. The custodian, who is typically a family member, makes the investment decisions; however, the assets are owned by the minor.

Joint Accounts

Joint accounts are established when two or more persons have ownership rights to an account. Since any recommendations an agent makes in a joint account must be suitable for all joint owners, he's required to obtain information from each owner of the account. In addition, all parties involved in the account must sign the account documents. Once the joint account is opened, any owner may buy or sell assets without the consent of the co-owners. However, checks and securities must be issued in the same manner as the account is titled. Any tax events will be recorded under one tax ID number.

There are two basic types of joint accounts—*Joint Tenants with Right of Survivorship* (*JTWROS*) and *Joint Tenants in Common (JTIC)*. In an account established as JTWROS, the owners are typically a married couple. In this type of account, if one owner dies, the survivor will individually own all of the assets in the account.

With JITC accounts, if one owner dies, that person's portion of the account reverts to her estate. If a person wants to leave her share of an account to someone other than the co-owner, this account structure should be used. Although the assets in a JTIC account are usually evenly split, the account assets may be divided in any way specified by the tenants. The individual investments in the account are not designated to a specific tenant since each tenant is assumed to have an ownership interest in the entire portfolio.

Transfer on Death (TOD) Accounts

Both individual and joint accounts may have a Transfer-on-Death (TOD) or Pay-on-Death (POD) provision. If the account owner dies, the account passes to the designated beneficiary. Generally, the only document that's required to transfer the assets into the beneficiary's name after the account owner dies is a copy of the death certificate.

A TOD or POD account may have more than one beneficiary, with each receiving a specified percentage of the account or certain securities. Only the account owner may change the beneficiaries. If the account owner becomes incapacitated prior to death and the courts appoint a guardian, that person may not change the beneficiary.

Margin Accounts

Cash accounts require clients to pay for all of their securities trades in full. In contrast, a margin account allows a client to pay only a portion of the purchase price of the securities he purchases. The customer borrows the balance from the brokerage firm and the firm charges the client interest for the loan. The portion of a margin trade that a customer has paid for is referred to as his equity and represents the customer's ownership interest in the position.

Margin accounts are governed by the Federal Reserve Board's (FRB's) Regulation T requirements and FINRA rules. Under Regulation T, customers who buy securities on margin must deposit 50% of the initial purchase price; however, brokerage firms may have more stringent internal (house) rules.

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Since Regulation T is 50%, a customer's gains or losses will be doubled. The easiest way to determine this is by remembering that a margin investor is able to buy securities worth two-times his invested amount. If the securities rise in value, he experiences two-times the gain; however, if the securities fall in value, he experiences two-times the loss.

To open a margin account, a client must sign a margin agreement which attests to the fact that he agrees to follow the regulations of the FRB, FINRA, and the brokerage firm. The margin agreement usually contains three separate agreements—the credit agreement, the hypothecation agreement, and the loan consent agreement. These three agreements are summarized below:

- **Credit Agreement** By signing the credit agreement, a customer acknowledges that she's borrowing funds from the firm and is responsible for payment of interest and repayment of the loan amount. The agreement discloses the terms under which the client is borrowing the money. This is a required document that a customer must sign to open a margin account.
- **Hypothecation Agreement** The hypothecation agreement states that the customer hypothecates (pledges) the securities to the brokerage firm and gives the firm the right to rehypothecate (repledge) the securities to secure a loan at a bank. This is a required document that a customer must sign to open a margin account.
- **Loan Consent Agreement** The loan consent agreement gives the firm the right to lend the customer's securities. Broker-dealers typically lend these securities to clients who are seeking to borrow stock for short selling purposes. This is an optional document; a customer is not required to sign it to open a margin account.

According to a NASAA Statement of Policy, the margin account documents that require a signature must be signed by a customer promptly *after* the first transaction.

Option Accounts

Option trading involves a high degree of risk and is not suitable for all clients. A customer's account must be approved by an ROP for option trading before the firm can accept an order from a customer to buy or sell options.

All broker-dealers must have written supervisory procedures for overseeing and approving option accounts. A Registered Options Principal (ROP) (normally an officer or general partner) is responsible for implementing these procedures.

Options Agreement An agent must gather financial and background information to see whether the customer has the ability to understand the nature of options trading and to assume the risk. Generally, the registered representative obtains this information by completing the Options Account Agreement on the client's behalf. If the client is not present when the representative fills out the Options Account Agreement, the broker-dealer must send the Agreement to the client for her to verify the information and sign it. If the customer refuses to provide information, a note to this effect must be made on the agreement.

The customer must sign and return the agreement to the brokerage firm within 15 days of the time the ROP approves the account. By signing this document, the customer verifies that the financial information provided is correct and agrees to abide by the rules of the Options Clearing Corporation, the option exchanges, and the broker-dealer. The customer also agrees not to violate any exercise or position limits.

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If a signed form is not returned within the 15-day period, the customer may not open new option positions. Instead, only liquidating (closing) transactions would be permitted.

The client must be given a disclosure document (the Options Disclosure Document, or ODD) by no later than the time the account is approved for options trading.

Customer Orders

Firms must prepare an order ticket (order memorandum) for every order it accepts from their clients before the order is executed. Today, this is typically done electronically. All order tickets must contain the following information:

- The terms and conditions of the order (e.g., limit order, market order, etc.)
- Whether the order is solicited (and who recommended it) or unsolicited
- The account name or designation (number) for which the order is entered
- The identity of the registered representative (if any) responsible for the account
- The identity of anyone else who accepted or entered the order for the client
- Whether the order involved the exercise of discretionary authority
- The identity of the broker-dealer or bank that received the order and the time of receipt
- The time the order was entered
- The time and price at which the order was executed, modified, or cancelled (to the extent possible)

A supervisor does NOT need to approve every order ticket before it's entered. However, a supervisor must approve every new account before the first order for that account may be entered. A supervisor must also review all client orders after they're executed.

Confirmations Broker-dealers must send confirmations to customers for each transaction that they execute on the client's behalf. These documents (which may be delivered electronically) must be sent by no later than the date on which the transaction settles. Among other things, the confirmation must disclose whether the broker-dealer acted as a broker (agent) or as a dealer (principal), as well as the commission or markup charged. The confirmation for a bond transaction does NOT need to include the bond's rating.

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Chapter 3 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Recognize when each application form must be filed with the CRD or IARD
  - Form BD for broker-dealers
  - Form U4 for agents and investment adviser representatives (IARs)
  - Form ADV for investment advisers
- Understand the exclusions from the definition of a broker-dealer
- Understand the difference between an agent of a broker-dealer and an agent of an issuer, as well as the exclusions from those definitions
- Recognize that partners, officers, and directors of a broker-dealer are automatically registered as agents, but only when the firm is initially being registered in a state
- Understand the purpose for a consent to service of process, when it's filed, and when it's renewed
- Understand the purpose for posting a surety bond and when it's not required
- Recognize when a person's registration becomes effective and when it expires
- Understand the minimum net capital requirements for broker-dealers under the USA
- Understand which advertisements and other written materials are filed with the Administrator and those that are not filed
- Understand the recordkeeping requirements for broker-dealers
- Understand the limited registration of Canadian broker-dealers and their agents as well as the clients they're permitted to solicit
- Understand the features of different brokerage accounts
- Recognize what a broker-dealer must include on an order ticket

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Chapter 4

State and Federal Regulations Governing Investment Advisers and IA Representatives

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This chapter focuses on the registration requirements and rules that govern investment advisers and their representatives. We begin by discussing the general registration requirements that apply to all advisers, and then cover the specific requirements for state- and federal-registered advisers.

Larger advisers and those that advise mutual funds register with the SEC as federal covered advisers. Smaller advisers must register with at least one state. It's critical that you understand the differences between these two types of advisers. Also, be sure to pay attention to the differences in the regulations between broker-dealers and investment advisers, and between agents and investment adviser representatives.

General Registration of Investment Advisers

Any person that meets the investment adviser definition is required to register with either the SEC or one or more states. For advisers, this is accomplished by filing a two-part application—Form ADV—with the appropriate regulator.

An adviser files Form ADV electronically through the Investment Adviser Registration Depository (IARD) system. Remember, the IARD system is similar to FINRA's Central Registration Depository (CRD) system and was created to make the filing of documents faster and more convenient.

If there are technical difficulties with the IARD system that prevent electronic filing or if the system will not accept the form, an adviser may file Form ADV manually. When filing electronically, the typed name of the adviser's authorized officer is considered irrefutable evidence that the appropriate person has signed the application.

Let's begin with an overview of each part of Form ADV. As the chapter continues, the additional forms and schedules that an adviser may be required to file will be examined.

Form ADV Part 1

Form ADV Part 1 includes information about an adviser's business, ownership, clients, employees, business practices, affiliations, and any disciplinary events of the adviser or its employees.

In addition, specific information of interest to regulators includes:

- The investment adviser's name, number of employees, and form of organization
- The name, address, disciplinary history, and business affiliations for the past 10 years of each partner, officer, director, or any person performing an advisory activity
- The education and business background of certain employees of the investment adviser (The IA Act of 1940 sets no minimum qualifications that must be met for registration. However, some advisory firms will set their own standards regarding the education and background of any employee who advises clients.)

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- How the investment adviser will maintain custody of client assets
- Whether the investment adviser or any person associated with the firm is subject to any disqualification that would be a basis for denial, suspension, or revocation of registration as an investment adviser
- The number and size of discretionary and non-discretionary accounts
- A statement as to whether the adviser's principal business will consist of *investment supervisory services.* Investment supervisory service is defined as the giving of continuous advice regarding the investment of funds on the basis of the specific needs of each client.

Although the information found in Part 1 of Form ADV is generally not required to be disclosed to the public, the SEC makes the information available through the Investment Adviser Public Disclosure (IAPD) website.

Form ADV Part 2

As with Part 1, Form ADV Part 2 must be filed with either the state(s) or the SEC through the IARD system. Part 2 consists of a series of items that contain disclosure requirements for an investment adviser's brochure as well as other required supplements. Responses to these items must be in a specific order and written in a narrative, plain English format that takes into consideration the client's level of sophistication. Plain English is generally understood to mean language that facilitates effective communication in a narrative form that avoids legal and highly technical terms as well as the use of multiple negatives.

Form ADV Part 2A—The Brochure Rule

All registered investment advisers are required to provide clients with a disclosure document (*brochure*) to describe their overall business as well as actual or potential conflicts of interest. Since Part 2 already requires advisers to satisfy a list of disclosures as a part of the registration process, firms may use either Form ADV Part 2A or produce a brochure with substantially equivalent information.

The firm brochure must include the following information.

- The adviser's name, address, website, and the date of the brochure
- A statement that registration doesn't imply a certain level of skill or expertise
- A description of the advisory firm, the length of time the firm has been in business, its principal owners, types of services offered, amount of assets under management (both discretionary and nondiscretionary), and the method used to compute the amount of these assets
- Fees and compensation, types of clients, methods of analysis used and investment strategies employed, and the fact that capital is at risk
- Disciplinary information, such as criminal or civil actions in a domestic, foreign, or military court, involving the firm or its management personnel that resulted in a conviction, or plea of guilty or *nolo contendere* (no contest), or any proceeding involving the SEC, state, SRO, or foreign financial regulatory authority
- The adviser's code of ethics
- Soft-dollar arrangements

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- Whether the firm has been subject to bankruptcy during the last 10 years
- Financial information
  - An adviser must disclose all financial conditions that may reasonably impair its ability to meet its contractual commitments to clients.

You should know …

Advisers with different types of clients may create and file different brochures that are tailored to each specific client.

Delivering the Brochure A *state-registered investment adviser* that's entering into a contract with a client must deliver its brochure:

- Not less than 48 hours prior to entering into any advisory contract with the client,

  OR

- At the time of entering into the contract, if the client has a right to terminate the contract without penalty within five business days after entering into the contract

A *federal covered adviser* that's entering into a contract with a client must deliver its brochure:

- Either before or at the time it enters into an investment advisory contract with a client

Federal covered advisers are NOT required to provide a brochure to registered investment companies.

Additionally, investment advisers (both state and federal) do NOT need to provide a brochure to clients whose contracts are only for *impersonal advisory services* for which they pay less than $500 per year. Impersonal advisory service refers to providing financial advice that's not tailored to a client's specific objectives or doesn't consist of statistical information with opinions as to the investment merits of specific securities.

On an annual basis, an adviser must give all of its existing clients either an updated version of its brochure or a summary of any material changes that have been made to its old brochure. The delivery must take place within 120 days after the end of the adviser's fiscal year.

Although a brochure may not be required, the fiduciary relationship between an adviser and its advisory client may still require the adviser to provide the client with any disclosures it considers necessary.

Form ADV Part 2B—Brochure Supplement

The same clients who receive the firm's brochure must also be provided with a brochure supplement. The supplement is similar to a resumé that describes the education, qualifications, and disciplinary history of all supervised persons who directly interact with clients or who have discretionary authority over client accounts. The brochure supplement must also disclose whether any of these people have other business activities or receive fees or compensation for selling financial products.

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Advisers must deliver the brochure supplement to their clients either prior to or at the time the person described in the supplement begins advising the clients. If an adviser experiences a material change, such as a disciplinary event involving one of its employees who manages accounts, the adviser must send the client an updated brochure supplement.

If the material normally contained in the supplement is already covered in the firm's brochure, there's no need to provide a separate document. The firm is also not required to provide a brochure supplement to qualified clients (officers or directors of the adviser, or other non-clerical affiliated employees).

Advisers that are registering in one or more states must file a copy of the brochure supplement through the IARD system for each supervised person doing business in the state. However, advisers that are registering with the SEC are not required to file their brochure supplements. Instead, they must retain copies for their own records. If requested by a regulator, an adviser must be able to produce the brochure supplement.

Something to consider …

Investment adviser representatives should never verbally diminish the importance of the brochure or alter its content. Any such action is considered a misleading business practice and is prohibited.

Balance Sheet An audited *balance sheet* (financial information) is required if an adviser:

- Has full discretionary authority over a client's account
- Solicits prepayment of advisory fees
  - For federal-registered advisers: more than $1,200 in fees per client, six months or more in advance
  - For state-registered advisers: more than $500 in fees per client, six months or more in advance

The following table summarizes the important details regarding a firm's Form ADV.

ADV Part 1 is divided into the following parts:	
Part 1A	Must be completed by all advisers that are registering with the SEC or any state securities authorities ▪ Details about the adviser, its business practices, the firm's ownership or control, and the persons who provide the investment advice
Part 1B	Must only be completed by all advisers registering with a *state securities authority*, not advisers that are applying for SEC registration or that are already SEC-registered ▪ Additional details required by state securities authorities and contains additional disclosure reporting pages (DRPs), including those related to criminal, regulatory, or civil judicial issues
ADV Part 2 is divided into the following parts:	
Part 2A	Must be completed by all advisers registering with the SEC or any state securities authority ▪ Requires advisers to create a narrative *brochure* to provide disclosure to clients regarding the advisory firm (This replaces the previous *check-the-box* format.)
Part 2B	Must be completed by all advisers that are registering with the SEC or any state securities authority (must accompany the adviser's brochure) ▪ Requires advisers to create *brochure supplements* containing resumé-like information about supervised persons who provide investment advice

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Updates and Amendments

Every registered investment adviser must renew its registration with either the SEC or the state Administrator(s). Advisers that are registered with the SEC must renew their registration within 90 days of their *fiscal year-end*. However, advisers that are registered under the Uniform Securities Act must renew their registration within 90 days of the *calendar year-end* (i.e., December 31). In addition, advisers must update their brochure at least once per year by filing an *annual updating amendment*. This amendment must be filed with at the time of the investment adviser's registration renewal. The main items that are required to be updated are the investment adviser's assets under management, the number of accounts, investment adviser representatives, other employees, and clients.

If material information in an adviser's brochure becomes inaccurate, the adviser must update its brochure promptly (i.e., within 30 days), rather than waiting until the end of its fiscal year. A change in the adviser's name or location, changes to custody disclosures, changes due to successions and ownership arrangements, and the occurrence of reportable disciplinary or financial issues are all considered of material importance.

In lieu of filing a new application, a successor adviser may simply file an amendment to Form ADV, provided the changes are limited to:

- The form of organization
- The state of incorporation or partnership

State Registration of Investment Advisers

Up to this point, many of the requirements that have been covered were established by both the state and federal regulators. However, the Series 63 Examination requires an understanding of the differences between state-registered investment advisers and federal-registered investment advisers.

As previously defined, an investment adviser (IA) is any person (usually a firm, rather than an individual) that, for compensation, engages in the business of advising others as to the value of securities or the advisability of purchasing or selling securities. The advice may be given directly or through publications or correspondence. To meet the definition of an investment adviser, a person must satisfy all three parts of the A-B-C test by:

1. Providing **A**dvice about securities
2. Offering this service as a regular part of doing **B**usiness
3. Receiving **C**ompensation for these services

An adviser that's ineligible for federal registration must be registered at the state level. This includes advisers that have less than $100 million in assets under management (AUM). Unless an adviser is exempt from registration or excluded from the investment adviser definition, it may not conduct business in a state unless it's registered under the Uniform Securities Act.

The following requirements related to discretion, custody, and financial requirements apply to state advisers that are regulated under the Uniform Securities Act.

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Discretionary Authority

An investment adviser may retain the discretionary authority to manage an account, but avoid being considered to have custody of a client's funds or securities by having the assets held by a broker-dealer. However, according to the NASAA Model Rule on Custody Requirements for Investment Advisers, an adviser that has been granted full discretion is considered to have custody of the client's assets.

- **Limited discretion**: Allows an adviser to enter orders to buy or sell securities, but not to remove money or securities from the account.
- **Full discretion**: Gives an adviser all of the abilities acquired through limited discretion, with the addition of check-writing privileges and authority to remove other assets from the account.

Oral Discretion Typically, discretion may be exercised only after receiving written authorization from the client. However, a client's *oral discretion* is enough to allow an investment adviser to buy or sell securities on the client's behalf without written authorization. This oral discretion provision is only available to investment advisers and only effective for a period of 10 business days after the discretion is granted. By the end of the 10-day period, the adviser must obtain the client's written authorization to continue operating in a discretionary capacity.

Fletcher is in the airport and about to leave on an extended vacation with his family, but cannot stop thinking about the current state of the market and his investments. Before boarding, Fletcher calls Julie, his investment adviser representative, and tells her that she has his permission to take care of things in his account while he's gone. Although Fletcher has not signed a power of attorney, may Julie execute trades for Fletcher?

Yes. This example illustrates the oral discretion provision that's permitted for investment advisers and their representatives. Julie has discretionary authority over Fletcher's account for 10 business days. In order to retain discretionary control after the 10 days, Fletcher must provide a signed power of attorney.

Be careful …

The oral discretion provision doesn't apply to broker-dealers and their agents. To exercise discretion, broker-dealers and their agents must obtain a client's written authorization.

Custody

Custody is defined as having legal responsibility for, or control over, another person's assets. The USA states that an adviser is considered to have custody when it's in possession of client funds or securities. An adviser will also be considered to have custody when it has:

- Legal ownership or access to its client's funds or securities within a partnership, corporation, or investment pool
- Full discretionary authority over a client's account
- Inadvertently received a client's funds or securities and has not returned them to the client within three business days
- Accepted a third-party check from a client and has not forwarded it to the third party within three business days

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NASAA's Custody of Client Funds or Securities by Investment Advisers Model Rule establishes additional guidelines that advisers must follow when they're considered to have custody of client funds or securities. The model rule requires investment advisers to notify the Administrator whether they have or will have possession of client funds or securities. Ultimately, the Administrator has the power to allow or disallow any adviser from maintaining custody.

Questions concerning the relationship between IAs and customers should be analyzed carefully since the USA has created requirements for IAs that maintain custody. If an adviser has custody, it must:

1. Provide immediate written notification to the Administrator using Form ADV
2. Use a qualified custodian to hold the funds and securities in a separate account (Qualified custodians include an FDIC-insured bank or savings association or a registered broker-dealer that holds client assets in customer accounts.)
3. Provide written notification to all clients of the custodian's name, address, and the manner in which the funds will be maintained
4. Send quarterly account statements to clients that indicate the amount of funds, a list of each security held in custody, a record of all transactions, and any fees deducted by the adviser:
   - If the account statements are sent by a qualified custodian rather than the adviser, the adviser must have a reasonable basis for believing that the statements have been provided.
   - If the account statements are sent by an investment adviser:
     - The IA must have an independent CPA verify and audit the accounts each year.
     - The auditor's findings are reported through the IARD on Form ADV-E within 120 days of completion of the audit.
     - If the auditor discovers material discrepancies, the Administrator must be notified within one business day.

Most IAs avoid being considered to have custody of their clients' funds and securities by having the assets held by a brokerage firm. However, if an adviser does maintain custody, the firm will be subject to additional scrutiny.

Minimum Financial Requirements (Net Worth)

According to NASAA's Minimum Financial Requirements for Investment Advisers Model Rule, an adviser's minimum financial requirement (net worth) is based on its level of control.

If the adviser has/requires	Minimum Financial Requirement
Custody of client assets	$35,000 at all times
Limited discretionary authority over client accounts (but not custody)	$10,000
Prepaid fees of more than $500, six months or more in advance	Positive net worth at all times

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In order to identify whether an investment adviser is operating within the rules, it must furnish financial reports as required by the Administrator. If an investment adviser's net worth drops below the minimum level established by the Administrator, the adviser must notify the Administrator about the deficiency by the end of the next business day. After transmitting the notice, the adviser must file a report of its financial condition by the end of the following business day. (Note that net worth equals the adviser's assets minus its liabilities.)

NASAA's Model Rule is not binding. Therefore, each state is free to set its own minimum financial requirements for advisers. However, an adviser is required to satisfy only the minimum financial requirement of the state in which its principal office is located.

An investment adviser is headquartered in Oklahoma, which has a minimum financial requirement of $35,000. The adviser is in the process of opening a new office in Texas, which has a minimum financial requirement of $50,000. To open the Texas office, will the adviser be required to satisfy the $50,000 Texas requirement?

No. Since the adviser is headquartered in Oklahoma, it's required to satisfy only the $35,000 minimum financial requirement for Oklahoma. The adviser is not required to satisfy the $50,000 requirement that's set by the state of Texas.

Remember …

If advisers are in compliance with the minimum financial requirement ($35,000 for advisers with custody and $10,000 for advisers with discretion), the Administrator may waive the obligation to post a surety bond.

Client Disclosures and Recordkeeping

Certain information about an advisory firm is required to be disclosed to clients and disclosure is accomplished by providing clients with specific documentation. The Administrator may require investment advisers to provide all information that would be in the public's best interest or useful for the protection of advisory clients. As previously described, advisers must provide clients with a copy of Form ADV Part 2 or a separate document used as the firm's brochure.

Financial and Disciplinary Disclosures

Advisers must disclose to their clients all material, legal, or disciplinary actions that have occurred within the preceding 10 years. Remember, any legal or disciplinary event that reflects negatively on an adviser's integrity must be disclosed.

If an investment adviser experiences a financial condition that may reasonably impair its ability to meet client commitments, it must be disclosed to clients. This disclosure is specifically required when the adviser:

- Has discretionary authority over client accounts
- Has custody of client funds or securities
- Requires prepayment of more than $500 in fees, six months or more in advance

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Failure to make the required disclosures is considered fraudulent. However, disclosure of SRO proceedings is required only if the fine levied against the adviser exceeds $2,500.

State Recordkeeping Requirements

State-registered investment advisers must produce and keep records as required by the Administrator. These include account records, order tickets, original copies of correspondence, and signed copies of client contracts (particularly those concerning discretionary accounts). They must also keep copies of all advertising that's sent to two or more persons.

Unless otherwise directed by the Administrator, all required records must be preserved for a period of five years in an easily accessible location. However, for the first two years (of the five), the records must be kept in the principal office of the investment adviser.

All required records of a registered investment adviser, whether located within or outside the state, are subject to periodic or special examination by the Administrator. The Administrator may cooperate with the Administrators of other states and the SEC in order to avoid duplicate records inspections.

Exclusions and Exemptions from State Registration

Not every person that provides securities-related *advice* as a *business* for some form of *compensation* is included in the IA definition. The USA specifically states that certain persons are *excluded* from the definition or are *exempt* from the registration requirements of the Act.

Exclusions from the Definition of a State Investment Adviser

According to the Uniform Securities Act, the following persons are excluded from the investment adviser definition:

- Investment adviser representatives (IARs)
- Banks, savings institutions, and trust companies
- Professionals whose investment *advice is incidental* to the practice of their professions (*Remember the four letters L,A,T,E.*)
  - **L**awyers
  - **A**ccountants
  - **T**eachers
  - **E**ngineers
- All other persons designated by the Administrator

> *Jim is an accountant who charges clients $125 per year to complete and file their tax returns. Occasionally, Jim suggests to his clients that they make use of their employer-sponsored retirement plans and recommends certain mutual fund families. Does Jim meet the IA definition?*

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No. Since Jim's advice is incidental to his accounting profession and he doesn't receive specific compensation for giving that advice, he's excluded from the definition of an investment adviser.

Remember, an investment adviser is defined as a person that gives securities-related advice as a regular part of its business and receives compensation for this service. The individuals who work for the adviser are considered investment adviser representatives. In the previous example, if Jim established a sole proprietorship investment advisory business, he'd be required to register it as an investment adviser and would also be required to register separately as an investment adviser representative.

The following three additional exclusions from the investment adviser definition are available:

- Broker-dealers and their agents
- Publishers
- Federal covered advisers

Due to the uniqueness of these three exclusions, an additional explanation for each will be provided.

Broker-Dealers and their Agents An exclusion is available to a broker-dealer and its agents (registered representatives) as long as the investment advice being provided is within the scope of the broker-dealer's business and there's no special compensation for the advice. Brokerage commissions don't constitute special compensation unless a clearly definable portion is for investment advice.

A broker-dealer and its agents regularly recommend securities through their research reports that are distributed to clients. If and when a client's trade is executed, the firm collects a commission for the service provided. Is the broker-dealer considered an investment adviser?

No. The broker-dealer is not considered an investment adviser since it's not receiving a fee for providing advice. Distributing research reports to customers is an incidental practice for a broker-dealer. The commission received is for executing transactions, not for advice.

Agents are also entitled to the exclusion if they provide advice under the knowledge and control of their broker-dealer. The one exception is when broker-dealers sponsor wrap accounts. A wrap account typically charges clients a single fee for investment advice, execution of transactions, asset allocation, and administrative services. Brokerage firms that offer wrap accounts must register as investment advisers and must treat these clients as advisory clients. In practice, most of the broker-dealers that offer wrap accounts do so through affiliates or subsidiaries that are registered investment advisers.

Publishers An exemption is available for *publishers* of bona fide newspapers, news magazines, or other financial publications provided they have general and regular circulation. To be considered general, the publication may not contain promotional material and the advice given must be impersonal. Impersonal advice is neither tailored to the specific investment needs of a particular client nor timed to specific events affecting the securities industry.

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Although some newsletters offer impersonal investment advice, if the publications are not of general circulation, the newsletter publishers may be required to register as investment advisers.

Federal Covered Advisers As has already been mentioned, federal covered advisers are advisers that are required to register with the SEC and are regulated under the Investment Advisers Act of 1940. Although federal covered advisers will be covered in greater detail shortly, for now it's important to understand the relationship between the state Administrator and federal covered advisers.

State Requirements for Federal Covered Advisers While federal covered advisers (FCAs) are required only to register with the SEC, states *may* require them to complete the process of *notice filing.* There are two situations in which an adviser is required to perform notice filing: (1) when a federal covered adviser has a place of business in a state, and (2) when an adviser has no place of business in the state, but has six or more non-institutional clients who reside in a state.

The notice filing requirement for federal covered advisers is similar to the process that issuers of federal covered securities must follow. Notice filing is not a method of registration; instead, it represents an Administrator's ability to require the FCA to pay a fee and to file the same documents that have been filed with the SEC.

Since the state Administrator doesn't have the power to grant registered status to federal covered advisers, the Administrator is not permitted to revoke the federal covered adviser's registration. However, the Administrator may issue a stop order preventing a federal covered adviser from conducting business in the state due to the adviser's violations of state securities laws.

Exemptions from State Registration

Under the USA, there are two situations in which a person that meets the definition of an investment adviser is considered exempt from registration. The first exemption is a situation in which:

- The adviser has no place of business in the state and the adviser's only clients are institutional investors.

> **Remember …**
>
> Institutional investors include investment companies, other investment advisers, broker-dealers, banks, trust companies, savings and loan associations, insurance companies, employee benefits plans with at least $1,000,000 of assets, or government entities.

An investment adviser is registered in North Dakota and provides advice to numerous institutional clients in Montana, but doesn't have a place of business in that state. Is the firm exempt from registering as an investment adviser in Montana?

Yes. As long as the advisory firm has no place of business in Montana, it may continue advising its institutional clients. However, if the firm opens an office in Montana to serve its clients better, it's no longer exempt from registering as an investment adviser in Montana—even if it continues to serve only institutional clients.

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The second exemption from registration is based on the following situation:

- The adviser has no place of business in the state, and the adviser doesn't direct communications to more than five non-institutional clients in the state within 12 consecutive months. (This is referred to as the *de minimis* exemption for investment advisers.)

A firm is registered as an investment adviser in North Dakota and has no office in Montana. Most of the adviser's clients are in North Dakota. However, due to job relocations, four non-institutional clients now live in Montana. Is the firm required to register as an investment adviser in Montana?

No. Under the USA, since the adviser has no place of business in Montana and directs communications to no more than five non-institutional clients, it's exempt from registration in Montana.

Always remember …

There's no de minimis exemption for broker-dealers. If a broker-dealer has no office in a state, but intends to do business with non-institutional (retail) clients in that state, it must be registered there regardless of the number of clients.

Registration of Investment Adviser Representatives

Now that all of the details regarding the registration of investment advisory firms have been covered, let's examine the registration requirements of IA representatives.

As defined in Chapter 1, an *investment adviser representative* is a non-clerical employee of an investment adviser who manages accounts, provides advice to clients, solicits advisory services, or supervises the employees who perform these functions. IARs work for IAs; they're not the firm. Investment adviser representatives are not regulated by the SEC at the federal level; instead, they're regulated by state Administrators at the state level.

The Series 63 Examination expects candidates to be able to distinguish the investment adviser (the firm) from the investment adviser representative (the employee). The relationship is parallel to that of a broker-dealer (the firm) and an agent (the employee) who represents the firm in effecting securities transactions.

Sally is a non-producing branch manager who has no clients, but is responsible for supervising a group of salespeople who actively solicit clients for the financial services firm. Does Sally meet the IAR definition?

Yes. Although Sally doesn't have clients, she supervises employees who are performing the functions of IA representatives. Therefore, she must also become registered as an IA representative.

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Representatives of State-Registered Investment Advisers

An investment adviser may not employ an investment adviser representative unless the representative is properly registered. A representative's registration is effective only during the time the individual is employed by a registered investment adviser. When the representative's association with an investment adviser begins or ends, the Administrator must be notified by the investment adviser.

In order to register with a state, an investment adviser representative must:

- File an application
- File a Consent to Service of Process
- Pay a filing fee

An IAR will be required to complete Form U4, which is filed by the investment adviser through the CRD system (which links to IARD). At the time of separation or termination of an IA representative's employment, the advisory firm will file Form U5 to notify the state Administrator of the end of the association.

IAR applicants may also be required to pass an oral or written examination. However, simply passing an examination is not sufficient for registration. Applicants may not transact business in a state until all required items are filed and registration is granted by the Administrator. If the Administrator considers it appropriate, the examination may be waived for certain categories of persons.

Investment adviser representatives of state-registered investment advisers are exempt from registration in any state in which they:

- Have no place of business, and
- Don't direct solicitations to more than five non-institutional clients who are residents of the state within 12 consecutive months

This exemption applies regardless of whether the IAR or any person to whom the solicitation is directed is present in the state.

A repeated exemption …

The previous exemption is referred to as the de minimis exemption.
Both IAs and IARs are afforded the same exemption.

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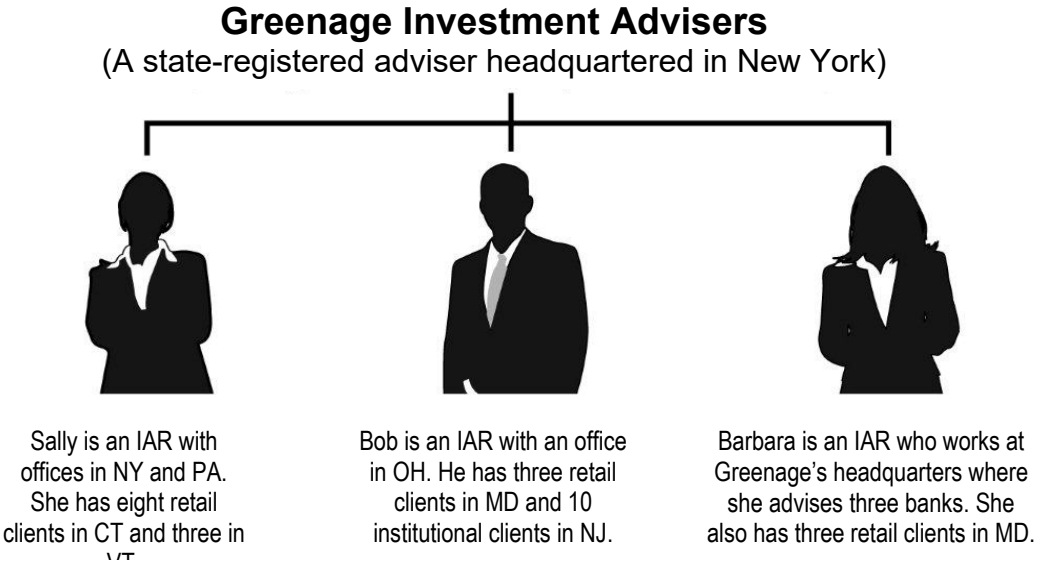
Let's analyze a situation in which a state-registered investment adviser and its IA representatives are conducting business with multiple clients in different states.



As a first step, consider the states in which each IAR has a place of business.

- *Sally* has a place of business in both New York and Pennsylvania.
- *Bob* has a place of business in Ohio.
- *Barbara* has a place of business in New York.
  - Based on this information, Sally must register in New York and Pennsylvania.
  - Bob must register in Ohio.
  - Barbara must register in New York.

Next, it's necessary to examine the number of *retail clients* and where they reside.

- *Sally* has eight retail clients in Connecticut and three in Vermont.
- *Bob* has three retail clients in Maryland and 10 institutional clients in New Jersey.
- *Barbara* services three banks in New York and has three retail clients that reside in Maryland.
  - Sally's eight retail clients in Connecticut exceed the de minimis exemption, so she must register in Connecticut. Bob and Barbara each have three retail clients in Maryland, so neither is required to register in that state.

To summarize:

- *Sally* must register as an IAR in New York, Pennsylvania, and Connecticut.
- *Bob* must register as an IAR in Ohio.
- *Barbara* must register as an IAR in New York.

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Solicitors and Promoters

A solicitor or promoter is a person who receives either cash (e.g., a fee) or non-cash (e.g., reduction in advisory fees) compensation for referring clients to an investment adviser, but is not directly affiliated with the adviser. For example, CPAs and attorneys may refer potential customers to specific advisers. Investment advisers can also hire marketing firms and social media influencers to act as promoters. According to the Investment Adviser Act, solicitors are generally not required to register as investment advisers. Solicitors and promoters must disclose to investors if they're paid more than $1,000 in a 12-month period as well as any material conflicts of interest. They typically do so through the use of a specific disclosure document or the adviser's brochure. According to the Uniform Securities Act, most states require solicitors to register as either investment advisers or investment adviser representatives. Under state law, advisers also need to document that their customers have received the appropriate disclosure documents and brochure from the promoter or solicitor.

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STATE-REGISTERED INVESTMENT ADVISER SUMMARY		
Definition	A person (usually a firm, rather than an individual) that, for compensation, engages in the business of advising others as to the value of securities or the advisability of purchasing or selling securities (required to register with the state Administrator)	
Compensation	▪ Percentage of assets under management ▪ Fulcrum fee ▪ Commissions	▪ Performance-based fee ▪ Hourly fee ▪ Hard or Soft Dollars
Exclusions from Definition	▪ Investment adviser representatives ▪ Banks, savings institutions, and trust companies (not bank holding companies) ▪ Professionals whose investment advice is *incidental* to the practice of their profession (LATE): Lawyers, Accountants, Teachers, and Engineers ▪ Broker-dealers and their agents ▪ Publishers of newspapers that don't give timed or tailored advice ▪ Federal covered advisers ▪ Any other person designated by the Administrator	
Exemptions from Registration	▪ Institutional exemption: – Adviser has no place of business in the state and only advises institutional clients ▪ De minimis exemption: – Adviser has no place of business in the state and doesn't direct communications to more than five non-institutional clients in the state within 12 consecutive months	
Registration Process	▪ File Form ADV through the IARD ▪ File Consent to Service of Process ▪ Pay registration fee ▪ Meet Administrator's financial requirement (net worth) and/or post a surety bond (home state's requirement supersede the requirement of any other state)	
Segregation	Customer *cash* and *securities* are required to be segregated from firm assets	
Custody	Evidenced by an investment adviser that: ▪ Possesses or has the ability to appropriate customer cash and/or securities ▪ Inadvertently receives customer cash and/or securities and holds for more than three business days ▪ Accepts third-party checks and holds them for more than three business days ▪ Has full discretionary authority over clients' accounts *Note: Advisers may use a qualified custodian to hold cash and securities*	
Discretionary Authority	Advisers may exercise oral discretion for 10 business days	
Recordkeeping	▪ Five years in an easily accessible location with the first two years in an appropriate office	

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Investment Advisers Act of 1940

One convenient aspect of the Advisers Act is that its investment adviser definition includes the same three elements that are identified in state law (the A-B-C Test).

An Investment Adviser:
1. Provides **A**dvice about securities
2. As a regular part of its **B**usiness
3. Receives **C**ompensation for these services

Federal Covered Advisers (FCAs)

As previously described, any person that meets the investment adviser definition is generally required to register with either the SEC or one or more states. However, federal covered advisers are required to register only with the SEC at the federal level. FCAs include the following:

- Investment advisers with $110 million or more in assets under management (IAs with assets under management between $100 million and $110 million may choose to register with either the SEC or one or more states.)
- Advisers to registered investment companies (e.g., mutual funds)
- Advisers that do business in 15 or more states
- Advisers that are not regulated or required to be regulated as investment advisers in the state in which they have their principal office and place of business (With the exception of Wyoming, all states, the District of Columbia, and Puerto Rico require the registration of state investment advisers. Wyoming has no IA registration provisions. Therefore, advisers with offices in Wyoming are regulated by the SEC.)
- Pension consultants that provide advice to employee benefit plans with assets of at least $200 million
- Affiliates of federal-registered IAs, if their principal office and place of business is the same as that of the SEC-registered adviser
- Newly formed advisers that reasonably believe that they will become eligible for federal registration within 120 days of formation

Generally, if an adviser doesn't qualify as a federal covered adviser, it must be registered at the state level. If an adviser withdraws its registration, it has the right to initiate the registration process again. Any persons defined as investment advisers, even if they qualify for an exemption from registration, are subject to the antifraud provisions of the Investment Advisers Act.

The following table should help to identify the appropriate regulator for an investment adviser based on its assets under management.

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An adviser with assets under management of:	Must register with:
$110 million or more	SEC only
$100 million up to $110 million	Either SEC or state
Less than $100 million	State only

If a federal covered adviser's assets under management fall below $90 million, it's required to initiate state registration.

Remember …

Advisers to investment companies (mutual funds) must register with the SEC regardless of the amount of assets that they have under management (i.e., they're federal covered advisers).

Registration Requirements for IARs of Federal Covered Advisers

While investment advisers may be required to register at either the state or federal level, investment adviser representatives are required only to be registered at the state level. Therefore, all IARs, whether they work for state-regulated or federal-covered investment advisers, must be registered in at least one state. An IAR of a federal covered adviser is required to register in any state in which she maintains an office. The number of clients that an IAR has in a state is not the determinant of whether registration is required there. Instead, registration is based on the state in which her office(s) is located. Remember, federal covered advisers (the firms) are not registered in a state; instead, they're required to register only with the SEC. When an IAR's association with a federal covered adviser begins or ends, the Administrator must be notified by the IAR.

Much like the example that was provided earlier in this chapter for state-registered investment advisers, the following example analyzes the registration requirements for federal covered advisers and their investment adviser representatives.

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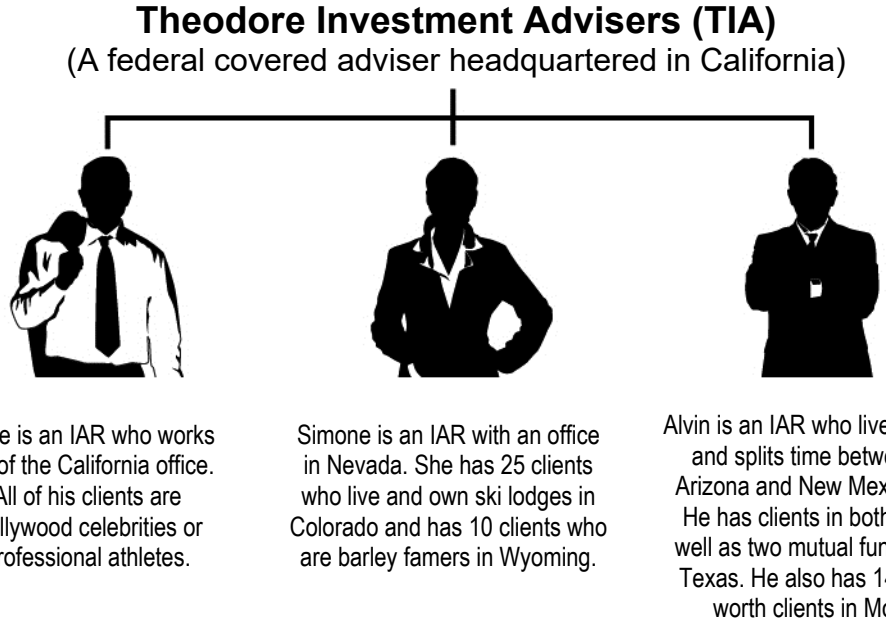

Dave—Since Dave is an IAR and works out of the California office, he's required to register in California.

Simone—Since Simone is an IAR and works out of the Nevada office, she's required to register in Nevada. The fact that Simone also has 25 clients who are business owners in Colorado and 10 clients who are farmers in Wyoming doesn't create a registration issue. As long as Simone doesn't have a place of business in either state, she's not required to register in Colorado or Wyoming.

Alvin—Since Alvin is an IAR who works out of the Arizona and New Mexico offices (has a place of business in both states), he's required to register in both states. Although Alvin also has two institutional clients in Texas and 14 high-net-worth clients in Montana, he's not required to register in either state since he has no office in Texas or Montana.

Theodore Investment Advisers—TIA is a federal covered adviser and is, therefore, not required to register at the state level. However, notice filing is required in any state in which TIA and its investment adviser representatives have an office or in any state in which they have no office, but have six or more non-institutional clients.

Statutory Disqualifications from Registration

An investment adviser's registration remains in effect unless it has been withdrawn, cancelled, or revoked by the SEC. The SEC also has the authority to suspend an investment adviser's registration for up to 12 months. These actions may be taken if the investment adviser or any person associated with the adviser has:

- Willfully made or caused any required report or application filed with the Commission to be false or misleading with regard to any material fact, or has omitted any material fact
- Been convicted within the previous 10 years of a misdemeanor involving securities, misappropriation of funds, or a felony

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- Been permanently or temporarily prohibited by court order from acting as an investment adviser, underwriter, broker, dealer, or as an affiliated person of an investment company, bank, or insurance company
- Willfully violated or is unable to comply with any provision of federal securities law
- Willfully aided another person's violation of federal securities law or has failed to reasonably supervise a person who commits a violation
- Been subject to an order of the Commission barring or suspending the person from being associated with an investment adviser

The Antifraud Rule

Although the Brochure Rule of the Investment Advisers Act of 1940 dictates the type of written disclosures that must be provided to clients, it generally doesn't require that specific verbal disclosures be made when discussing an adviser's services with a potential client. However, untrue or misleading verbal statements are prohibited.

The antifraud section of the Act is somewhat vague since the SEC cannot define every action that constitutes a fraudulent practice. Although the SEC has created rules that specify certain practices as prohibited, it has taken action against advisers for practices that were not specifically prohibited but were considered to be fraudulent. Therefore, advisers must always consider whether the verbal representations they make to clients may be construed as fraudulent, deceptive, or manipulative.

Investment Advisory Contracts

The relationship between a customer and an investment adviser typically is formalized through a contract. State law requires that contracts between clients and state-registered advisers be in writing. Although federal law doesn't require investment advisory contracts to be in written form, most federal registered advisers put contracts in writing as a matter of good business practice.

In addition, SEC rules place the following conditions on *all* investment advisory contracts:

- Advisers may not include provisions in contracts that claim to waive compliance with the Advisers Act or any of its rules. Therefore, contract language may not lead clients to believe they have waived any available right to take legal action against the adviser (i.e., through exculpatory contract provisions). This also means that advisory contracts may not contain hedge clauses that absolve the adviser from liability or mandatory arbitration provisions. (A client may be asked to *voluntarily* sign a predispute arbitration agreement at the time of account opening.)
- An adviser may not *assign* its clients' contracts without their consent.
- Performance-based fees generally are not permitted; however, exceptions may be made for certain types of clients.

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Assignment *Assignment* is considered the direct or indirect transfer of an advisory contract by the adviser, or the transfer of a controlling block of the investment adviser's outstanding voting securities by a security holder of the advisory firm.

Involuntary Assignment of Contract An investment adviser must obtain its clients' consent in order for their contracts to be assigned to another adviser. If an adviser is a corporation, the acquisition of a *controlling block* of the adviser's shares by another entity is considered a change of control that requires client consent.

Also, if an adviser is organized as a partnership, the death or resignation of a *majority* of the partners is considered a change of control that requires client consent. Although the death or resignation of a *minority* of the partners doesn't constitute a change of control, the adviser is required to notify clients within a reasonable period.

Performance-Based Fees *Performance-based fees* are those that are based on a share of the capital gains or capital appreciation in a client's account.

Fulcrum Fee One type of performance-based fee is referred to as a *fulcrum fee*. This is a fee that has two parts—a base fee plus a performance-based fee that increases or decreases relative to the performance of the client's portfolio as compared to a specific benchmark over a specific period (e.g., compared to the S&P 500 Index for the calendar quarter). The benchmark index must be comprised of securities with similar risks and objectives as those in the client's portfolio.

Exceptions to the Prohibition of Performance Fees Congress placed a general prohibition on performance fees in the Advisers Act to prevent unsophisticated advisory customers from being subject to arrangements in which the adviser has everything to gain if successful and little, if anything, to lose if unsuccessful. However, several exceptions have been established for sophisticated investors that understand that the investment adviser may be compensated on unrealized gains and may have an incentive to make speculative investments.

The types of clients that may be charged a performance-based fee include:

- Registered investment companies (e.g., mutual funds)
- *Qualified clients* that have at least $1.1 million under management with the adviser or have more than $2.2 million in net worth (A person's primary residence is excluded.)
- Clients who are not U.S. residents
- Knowledgeable individuals associated with the investment adviser, such as an executive officer, director, trustee, general partner, or non-clerical employee who has participated in the investment activities of the adviser for at least 12 months

Performance Fees for State-Registered Advisers The state and federal laws concerning performance-fees are the same. While the USA prohibits performance fees, NASAA's Model Rule (Performance-Based Compensation Exemption for Investment Advisers) allows these fees for qualified clients.

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Custody of Client Funds and Securities

The federal requirements regarding advisers that maintain custody are very similar to the state requirements that were covered earlier in this chapter. Again, an investment adviser has custody of client funds and securities when it possesses the assets or has the ability to appropriate them.

The Advisers Act requires investment advisers with custody to:

1. Deposit the funds of each client in a separate account with a qualified custodian. The accounts must be maintained either in the client's name or in the name of the adviser as agent or trustee. Records must be kept for each account showing where it's maintained, all deposits and withdrawals, and the amount of each client's ownership in the account.
2. Provide each client with written notification of the place and manner in which the funds and securities will be maintained. Clients must also be notified of subsequent changes.
3. Send to each client, at least quarterly, an itemized statement of all the funds, securities, and transactions effected in the account, and any free credit balances.
4. Arrange an unannounced annual examination by an independent public accountant to verify the amount of funds and securities. The accountant must file Form ADV-E with the SEC promptly following the examination (within 120 days). If required, the accountant must also file this form with the state regulators.

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FEDERAL COVERED ADVISER SUMMARY	
Definition	A person (usually a firm, rather than an individual) that, for compensation, engages in the business of advising others as to the value of securities or the advisability of purchasing or selling securities. The firm is required to register with the SEC.
Forms of Compensation	▪ Hourly fee ▪ Fee plus commissions ▪ Percentage of assets under management ▪ Performance-based fees (e.g., fulcrum fees) ▪ Hard or soft dollars
Registration Process	▪ File Form ADV Part 1 and Part 2 through the IARD ▪ File a Consent to Service of Process ▪ Pay a registration fee ▪ Meet SEC minimum financial requirement
Segregation	Customer *cash* and *securities* are required to be segregated.
Custody	Established when the adviser: ▪ Accepts customer securities and/or cash ▪ Inadvertently receives customer securities and holds them for more than three business days ▪ Accepts third-party checks and holds them for more than three business days ▪ Has full discretion *Note: Advisers may avoid having custody by using a broker-dealer to hold their clients' cash and securities.*
Discretionary Authority	Oral discretion may be given to an adviser for up to 10 business days.

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Chapter 4 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Understand the definition of an *investment adviser* and application of the A-B-C Test
- Recognize that investment advisers must register with either the SEC or state Administrator(s) by filing Form ADV
  - ADV Part 1 = General disclosures about adviser's business, clients, and disciplinary events
  - ADV Part 2 = Disclosures about services offered by the adviser and related fees
- Understand that information in Form ADV Part 2 is a required disclosure to new clients
  - Investment advisers can use Form ADV Part 2 to make the disclosures or use a disclosure document (i.e., brochure) with the same information
- Understand when an investment adviser must deliver a brochure to a client
- Recognize when an audited balance sheet must be provided by an investment adviser
  1. Investment adviser has custody of client funds or securities
  2. Investment adviser has full discretionary authority over a client's account
  3. Investment adviser requires prepayment of advisory fees in excess of $1,200, six months or more in advance of service (*for federal covered advisers*)
  4. Investment adviser requires prepayment of fees in excess of $500, six months or more in advance of service (*for state-registered advisers*)
- Understand the difference between limited discretion and full discretion
- Recognize that power of attorney is required to maintain discretion and when it must be received
- Understand when an investment adviser has custody as well as the required disclosures to the Administrator and customers
- Understand the minimum financial requirements for investment advisers
- Identify the recordkeeping requirements for investment advisers under the USA
- Recognize the exclusions from state registration as an investment adviser
- Identify the two exemptions from state registration as an investment adviser:
  1. The IA has *no place of business* in the state and has only institutional investors
  2. The IA has *no place of business* in the state and has no more than five non-institutional clients in the state (*de minimis*)
- Understand the registration requirements for an investment adviser representative of a state-registered investment adviser
- Define the term *solicitors* and understand the registration and disclosure requirements for solicitors
- Understand the definition of a *federal covered adviser*
  - Assets under management (AUM)
  - Advisers to certain clients, including pension and private funds
  - Advisers to clients in 15 or more states
- Identify what's permitted and/or prohibited in an advisory contract
  - Prohibition and exceptions to performance-based fees in an advisory contract

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Chapter 5

Investment Advisory Practices

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A significant focus of the Series 63 Examination will be the relationship between advisory firms and their clients. This chapter reviews the fiduciary responsibilities of the IA and IAR and examines how the information obtained from clients may be used to determine the suitability of investment products and strategies.

Fiduciary Duty

IAs and IARs are considered fiduciaries when advising their clients. A *fiduciary* is a person who acts for, and on behalf of, another person. This role creates a relationship of trust and confidence.

Other types of fiduciaries …

Along with IAs and IARs, other examples of fiduciaries include the executor or administrator of an estate, a trustee, and a pension plan administrator.

Fiduciaries are held to a higher standard than other financial professionals. When fiduciaries make decisions in their official capacities, their primary concern must be for the interests of the persons they represent. IAs and IARs are prohibited from engaging in fraudulent, deceptive, or manipulative conduct in their roles as fiduciaries. Rather than pursue their own personal gain, fiduciaries have an affirmative duty to act in good faith and solely in the best interest of their clients. Any conflicts of interest that arise for an IA or IAR must be disclosed fully to clients at, or prior to, the time the transaction occurs. This means that an adviser and its representatives may be responsible for both what *is* said and what is *not* said when discussing potential investment strategies or products with clients.

Regarding the fiduciary duty of an investment adviser, let's examine state law to understand how the general fiduciary obligations were initially established. There are essentially two approaches to consider in the evolution of the fiduciary relationship—the Prudent Man Rule and the Uniform Prudent Investor Act (UPIA).

The Traditional View

Court cases from the early 1800s developed the basis for the initial view of a fiduciary's responsibility as it applied to investments. The courts recognized that all investments, even government securities, have some degree of risk. The decisions in these cases articulated a new guideline—the *Prudent Man Rule*. The rule stated that trustees should *"observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital to be invested."* In other words, fiduciaries are obligated to do what's best for the clients they represent based on their clients' objectives.

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The Uniform Prudent Investor Act

A major shift in fiduciary investing occurred in the second half of the 20th Century with the creation of the *Uniform Prudent Investor Act (UPIA).* The impetus for its formation was the development of a new theory of investing that was based partially on Modern Portfolio Theory (MPT). A key feature of Modern Portfolio Theory is its emphasis on the trade-off between risk and reward. The higher the investment risk, the greater the potential return, and conversely, the lower the risk, the lower the expected return.

In 1994, the National Conference of Commissioners on Uniform State Laws recommended that all states adopt the Uniform Prudent Investor Act to better guide fiduciaries in carrying out their investment responsibilities. A majority of the states have since adopted this model law, which gives several criteria for prudent investing, such as:

- The standard of prudence applies to the entire portfolio, not on an investment-by-investment basis.
- A central consideration for a fiduciary is the trade-off between risk and reward.
- Categorical restrictions on specific types of investments have been removed. Therefore, any investment may be appropriate as part of a portfolio designed to achieve specific goals.
- The recognition of the explicit need for diversification in a portfolio

Under the UPIA, a fiduciary, such as an IA, custodian, or trustee, may make individual investments that are risky as long as the overall risk/reward profile of the account remains suitable. For some portfolios, attempting to earn only the risk-free rate of return may be inappropriate. The UPIA also permits fiduciaries to delegate investment responsibilities to competent third parties (e.g., accountants and attorneys).

All fiduciaries should:

- Pay close attention to their clients' goals
- Determine their clients' risk tolerance
- Develop an appropriate investment policy/strategy
- Focus on the management of risk, not the complete avoidance of risk
- Diversify appropriately

Some trusts have multiple beneficiaries, who may have different needs. A trustee who's in charge of a trust with more than one beneficiary must act impartially when investing and managing the trust's assets. The trustee must take into account the different interests of all the beneficiaries when selecting investments.

Many assume that the investment portfolios of pension funds and endowments are among the more conservative since their fund managers' objective is to select investments that meet the future needs of the participants. However, advisers for these portfolios often recommend that a portion of the portfolio be invested in hedge funds.

Since hedge funds are usually illiquid and potentially volatile, does this advice seem appropriate? Based on the UPIA, this advice is suitable. Endowments and pension funds have long time horizons and are generally not concerned with having immediate access to all of the funds.

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Investing a small percentage of a portfolio's assets in hedge funds could actually increase the portfolio's return without dramatically increasing its risk. This is one of the lessons of Modern Portfolio Theory for the investment adviser—the inclusion of an investment that's risky could be beneficial for an entire portfolio since it may result in a higher return.

Watch out …

Although constructing a portfolio that includes hedge funds is suitable, constructing a portfolio of *only* hedge funds is excessively risky.

SEC Views of Fiduciary Duty

The SEC has indicated that there are numerous specific obligations that an adviser assumes when it begins a fiduciary relationship, including:

- Being loyal to clients
- Having a reasonable and objective basis for the investment advice being provided
- Ensuring that investment advice is suitable based on the client's objectives, needs, and circumstances
- Obtaining the best execution for its clients' securities transactions when in a position to direct brokerage transactions

Best execution doesn't always mean obtaining the lowest possible price for client transactions. When an investment adviser directs trades to a broker-dealer, it may take other factors into consideration, such as the speed and quality of the services that a brokerage firm provides. The services provided by broker-dealers will vary and may enhance the performance of a portfolio. An adviser should choose a broker-dealer based on its overall contribution to the adviser's ability to better manage its clients' accounts.

Soft-Dollar Arrangements

Soft dollars are broadly defined as commission rebates that money managers (IAs) receive for channeling some or all of their trades through certain brokerage firms. When an adviser uses soft dollars to obtain products or services, its clients are paying for more than simple execution and, accordingly, obtaining soft dollars may result in clients paying a higher commission on their trades.

Section 28(e) of the Securities Exchange Act of 1934 recognizes soft-dollar arrangements as an acceptable means of conducting business (safe harbor). However, to rely on the safe harbor, the following three conditions must be satisfied:

1. The adviser must be exercising investment discretion over the accounts of others.
2. The broker-dealer must provide the adviser with services that assist the adviser in making investment decisions for client accounts.
3. The adviser must determine that the value of these services is reasonable in relation to the commissions being charged by the brokerage firm.

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The key is that the service(s) the adviser receives as part of a soft-dollar arrangement *must benefit its clients* and be reasonable in relation to commissions paid. Provided the investment adviser is using soft dollars to purchase items (e.g., research reports) that assist it in the investment process and clients receive full disclosure, the SEC permits the arrangement.

The following chart provides details regarding the acceptable and unacceptable uses of soft-dollar arrangements.

Soft-Dollar Arrangements	
May be used to acquire	**May NOT be used to acquire**
– Traditional research reports and related publications – Discussions with research analysts – Software for analyzing portfolios – Certain types of trading software – Market and economic data services – Coverage of attendance fees for a conference/seminar where company executives discuss their company's performance	– Payments for advertising and marketing – Travel expense reimbursement (including meals and entertainment) – Overhead and administrative expenses – Employee salaries – Accounting and professional licensing fees – Computer terminals – Correction of trading errors – Subscriptions to publications for general circulation, such as *The Wall Street Journal*

Keep in mind …

Acceptable uses of soft dollars include obtaining certain types of software. However, it's unacceptable for the adviser to use soft-dollar rebates to buy the computer on which to run the software.

A trader solicits an advisory firm to send its securities trades to his broker-dealer. In exchange for the business, the trader agrees to pay bonuses to IA employees using a portion of the commissions. Is this practice acceptable?

No. The practice of using earned commissions to pay bonuses to the IA's employees is an unacceptable form of soft-dollar rebating. These actions don't directly benefit the advisory client. Instead, they benefit the IA and its employees.

Suitability Obligations

For investment advisors and their representatives, the suitability obligation has two components—*Know Your Customer* and *Know Your Products*. To satisfy the *Know Your Customer* component, an adviser must:

1. Make a reasonable inquiry into the customer's background
2. Provide suitable recommendations only

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Duty to Inquire

Before providing advice, an investment adviser and its representatives should make a reasonable inquiry into the client's financial situation, investment experience, and investment objectives. The extent of the inquiry depends on the advisory products and services being offered. For example, an IAR who's going to create a comprehensive financial plan for a client may need more detailed background information than an IAR who's recommending a mutual fund asset allocation program to a client.

What if an investment adviser representative lacks all of the requested information because the client refuses to provide complete details? IARs may not make assumptions about the client. When no other information is available, IARs must treat the client as if he has no assets or sources of income other than that which they know.

An investment adviser representative who fails to obtain complete background information about a customer is in a different position than an agent of a broker-dealer. An agent also must know the customer and must know the products that she sells in order to satisfy her suitability obligations. Although an agent who lacks information about a customer is limited in the recommendations she could make, she's still able to execute unsolicited orders for her clients. However, it will be difficult for an IAR to provide suitable advice without obtaining detailed information about a customer.

Duty to Give Only Suitable Advice

Once an investment adviser has collected the appropriate client information, the investment advice provided to the client must be suitable. What factors should be considered when determining the suitability of investment advice?

There are three basic asset classes—stocks (equity securities), bonds (fixed-income investments), and money-market instruments (cash equivalents, such as CDs, etc.). Broadly speaking, the percentage of each of these three asset classes that investors should have in their portfolios depends on two things—their time horizons (i.e., the length of time they have to achieve their financial goals) and their risk tolerances.

As the chart below illustrates, investors with long-term goals should allocate a greater proportion of their portfolios to stocks compared to investors who have short-term goals. Historically, stocks have produced the greatest long-term returns, but they have also fluctuated the most in value. An investor in her 20s or 30s who's saving for retirement is able to tolerate the ups and downs of the stock markets much easier than an investor in her 50s or 60s.

At the same time, more conservative investors with low risk tolerances (unable to handle marked changes in the value of their portfolios) should put a greater percentage of their assets in bonds and money-market instruments. Still, being too conservative may backfire on long-term investors since a portfolio that's too heavily weighted in bonds and cash equivalents may actually lose value over time due to inflation.

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Security Summary				
Most Conservative → Most Aggressive				
Security Type	Money Market	Bonds	Preferred Stock	Common Stock
Investment Objective	Preservation of Capital	Income	Income	Growth
Investor Age/Profile	Any/Short-Term Objectives	Older/Medium-Term Objectives	Older/Medium-Term Objectives	Younger/Long-Term Objectives

Once an investment adviser representative has a clear picture of the customer's financial profile, the IAR must recommend a product or strategy that fits the client's needs. This is the *know-your-product* phase of the suitability process.

Let's consider some examples to illustrate these principles.

A young couple enters an investment adviser's office with the objective to invest $30,000. The money is to be used as a down payment on a new home in two months. The couple tells the investment adviser representative to try to generate as much money as possible in the next 60 days. What should the IAR recommend?

IARs must pay close attention to their clients' goals and risk tolerance. This couple will need to liquidate the $30,000 in 60 days and cannot risk losing their down payment. Although the couple indicated the desire for high returns, they also have a liquidity need. The most appropriate recommendation is money-market instruments (high-quality, short-term debt) due to their stable prices and low risk of default. Examples include T-bills, money-market funds, and bank-issued CDs.

A young woman in her mid-20s is seeking advice about how to invest an inheritance she recently received. She plans to use the money to return to school to get her MBA in three years. In the meantime, she has a well-paid position at a consulting firm in a major city and is paying a considerable amount in state and federal income taxes. She says that she heard a variable annuity is a great way to invest in the stock market while avoiding taxes. What should the IAR recommend?

The IAR should tell her not to purchase a variable annuity. Variable annuities are long-term investments—they're not suitable for investors who want liquidity or plan to withdraw their money in a few years. Investors, such as this one, who withdraw money in less than 5-7 years, will usually incur significant withdrawal penalties. Since she's under the age of 59 1/2, she may need to pay a tax penalty as well. The IAR should recommend alternatives, such as a bond fund, or perhaps a municipal bond fund since taxes are a concern.

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It's important to remember that the fundamental benefit of purchasing municipal securities is the receipt of interest income which is tax-exempt. Municipal securities are neither risk-free investments, nor do they pay dividends. Although the value of municipal securities may increase over time and allow the holder to sell and realize a capital gain, this is secondary to receiving tax-free income.

A couple in their early 50s need help deciding what to do with the large payout that the husband received from his retirement plan when he changed jobs last year. The husband rolled the payout into an IRA where it's currently invested in a money-market fund. They're both healthy and don't plan to retire for another 15 years. They also indicate that they're willing to take some risk.

This couple still has many years to go until retirement. They also need to consider that their money may have to last for another 20 to 30 years once they retire. One or both of them may live into their 80s or 90s. The IAR should advise them to move their money out of the money-market fund and into stock and bond funds instead.

One rule of thumb that's used by many professionals for retirement planning is to subtract a client's age from 100 to determine the approximate percentage of that client's portfolio that should be invested in stocks. Ultimately, the older the client, the less his risk tolerance and the less money he should invest in equity securities. In this couple's case, that formula will result in a portfolio that's divided 50/50 between stocks and bonds. However, since they're willing to take some risk, the IAR may recommend a portfolio consisting of 60% stocks and 40% bonds.

An older, wealthy couple consults an adviser about the best way to invest the money in the 529 College Savings Plans they've set up for their grandchildren's educations. The children are one, three, and five years old. Since this couple is retired, most of their portfolio is invested in fixed-income securities, such as Treasuries and corporate and municipal bonds. They ask the adviser if they should invest their grandchildren's 529 plan accounts the same way. What should the IAR say?

The IAR should explain to them that their investment needs are different from those of their grandchildren. Since their grandchildren will not be starting college for 13 to 17 years, a portion of these accounts should be invested in stocks. An allocation of 75% stocks and 25% bonds would be appropriate. As the children approach college age, the funds should be shifted away from stocks into fixed-income investments and money-market instruments.

Also, these accounts should not be invested in municipal securities. The main reason to invest in municipal securities is to generate tax-advantaged income for investors in high-income tax brackets. The earnings in 529 Saving Plan accounts are already free of most taxes as long as the money is used for college expenses. Therefore, there's no reason to duplicate these benefits.

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Chapter 5 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Define the term *fiduciary* and understand how it applies to investment advisers and investment adviser representatives
- Understand the Uniform Prudent Investor Act (UPIA) and its impact on fiduciaries and advisers
- Understand the SEC's view of fiduciary duty and the obligations that an adviser assumes
- Define the term *soft dollar arrangements*
  - Understand the benefits to each party
  - Identify permitted and prohibited uses of soft-dollars
  - Understand the disclosure requirements
- Identify the suitability obligations and duties of investment advisers and investment adviser representatives

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Chapter 6

Prohibited and Ethical Business Practices Under the USA

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The underlying purpose of the Uniform Securities Act is to prevent fraud and to prohibit certain business practices from occurring in the securities industry. The information presented in this chapter is rudimentary and, in most cases, common sense will be your guide as to whether a practice is prohibited. Your examination may contain questions that require you to determine if an action constitutes fraud or whether it's an unethical practice (both of which are considered violations of the USA). In this chapter, we also focus on the differences in the activities of broker-dealers and investment advisers.

Fraudulent and Other Prohibited Activities

Fraud is often defined as intentional deception carried out for personal gain or to damage another person. However, under state law, fraud is not as clearly defined. Some states have held that it's necessary to prove willful intent for a person to be found guilty of fraud. The difficult part is that states don't consider willful intent to be the same as having an ulterior motive. For potential violations, willful intent is present if a person intended to perform the acts of which he's accused. It doesn't require a specific state of mind. In other words, if a person is charged with fraud for having sold unregistered, non-exempt securities, all that a state prosecutor must prove is that the person engaged in the act of selling the securities—not that the person knew the securities were unregistered and non-exempt.

So, while some fraudulent activity is obvious and easily recognizable, other cases at the state level have abandoned the self-centered motive of the defendant and, instead, focused on a lack of reasonable care (i.e., negligence).

The Uniform Securities Act states that it's *unlawful for any person,* in conjunction with the direct or indirect offer, sale, or purchase of any security, to directly or indirectly:

1. Employ any device, scheme, or artifice to defraud
2. Make an untrue statement of material fact or omit any material fact that's needed to make a statement not misleading
3. Engage in any act, practice, or course of business that operates, or would operate, as a fraud or deceit upon any person

This language is broad enough to cover a number of practices, but the USA doesn't define which particular practices are permitted and which are not. Over the years, enforcement actions by Administrators, as well as court cases, have pointed out many specific actions that are violations of the Act. In addition, the NASAA Statement of Policy on Dishonest or Unethical Business Practices provides guidance regarding acceptable (legal) and unacceptable (illegal) activities.

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Fraudulent and Misleading Activities of Broker-Dealers and Agents

The following section will identify the practices that financial professionals should avoid for fear of violating the USA. Broker-dealers and agents must be careful not to engage in any of these actions since they may lead to a suspension or revocation of their registrations or worse.

False and Misleading Statements

No person may make false or misleading statements in connection with the purchase or sale of a security. Although these provisions apply to all securities professionals, many of the court cases and administrative actions that illustrate the unacceptable practices involve agents of broker-dealers. The following list is straightforward and generally requires little explanation.

It's prohibited for any person to:

- Tell clients that the registration of broker-dealers or agents implies that their business practices, knowledge, or capabilities have been certified or approved by the SEC, the Administrator, or FINRA
- Promise to perform certain services without intending to do so
- Promise free services and then charge hidden fees
- Falsely state anticipated or current earnings
- Falsely state the amount of a commission or markup
- Overstate or misrepresent the status of a client's account

Let's expand on the next group of misleading statements and/or activities to ensure a more clear understanding of the violations.

Claiming that a security has been approved by a regulator

The violation

An agent of a broker-dealer calls a client and solicits the sale of an IPO. During his sales presentation, the agent states that the securities are a great investment opportunity, are legal, and have been approved by both the SEC and the state securities Administrator.

The rule

The Administrator and the SEC don't provide approval for securities. They simply require that the securities be registered. When the agent stated that the securities are legitimate or safe because they have been approved, he made a misleading and untrue statement.

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Stating that a security is about to be listed without justification

The violation

An agent calls a client to announce that a company's stock is about to be listed on Nasdaq. The agent stresses that the client should place a buy order before the announcement is made. The agent's belief is that the stock's market price will rise due to the fact that index fund managers will begin buying large quantities of the stock for their portfolios.

The rule

Unless the broker-dealer or agent has firm grounds (such as a press release) for believing that the security is about to be listed on the exchange, his statements are considered misleading. In this situation, the agent's statements are a violation since he stated that the order should be placed prior to the announcement.

Using inflated language

The violation

An agent of a broker-dealer has been analyzing the technology sector for several months, and although the market has been down, she feels that market conditions are improving. When speaking with a client about Xcel stock, she says, "As soon as the market corrects, Xcel is definitely going to rise to $40."

The rule

Since using promissory language is a violation, agents must carefully consider their words when making recommendations to clients. Using definitive words such as *always*, *only*, *never, will,* and *guarantee* may be problematic when making statements to clients. In this situation, when the agent used the word *definitely*, she violated the USA by using inflated language.

Providing inaccurate market quotations

The violation

A customer called a broker-dealer to inquire about the price of XYZ stock in her account. Knowing that the client will be upset by the fact that the stock's price dropped, the agent provided the previous day's price, which was significantly higher.

The rule

Although it's never easy to give clients bad news, agents should never tell clients that everything is okay with their accounts when, in fact, a stock position has fallen in value. An agent who misrepresents the true market price of the stock by quoting the previous day's price has committed an unethical act.

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Providing false information

The violation

An agent tells one of his clients that a specific fund is a no-load fund and that a sales charge will not be deducted from the purchase price. However, the agent fails to mention that the fund has a deferred (back-end) sales charge that's assessed at redemption.

The rule

As will be covered in more detail later, a fund may be described as a no-load fund only if it has no front-end sales charge, no back-end (deferred) sales charge, and no 12b-1 fee that exceeds *.25% of the fund's average net assets each year.* In an effort to execute a trade, the agent has given false information by suggesting that the fund (which has a deferred charge) is a no-load fund. Once again, this practice is unethical.

> **Consider this …**
>
> False information potentially could be presented to a client in many different ways. On the exam, look out for situations that range from trade confirmations to advertising.

It's also considered an unethical business practice for a broker-dealer and its agents to publish or circulate an advertisement, report, notice, or other form of communication that reports a transaction without the reasonable belief that the transaction is a bona fide purchase or sale. If an agent provides an execution report to a customer without verifying the price, this is also an unethical business practice.

Spreading rumors in order to effect transactions

The violation

A broker-dealer has a bullish outlook for the common stock of The Green Company. Jenny, an agent of the broker-dealer, goes to a chat room on a financial market Web site and poses as an employee of The Green Company. Jenny begins discussing The Green Company's favorable sales outlook and new client acquisitions in an effort to make the company appear more successful.

The rule

This type of activity is prohibited for all persons, not just agents. State and federal authorities have charged a number of individuals with fraud for circulating rumors on the Internet to pump up the price of a stock. Jenny's actions could lead to her registration being suspended or revoked. She could also be subject to more severe penalties if prosecuted.

Selling dividends

The violation

ABC Corporation has just announced a $1.00 dividend per share that's payable to shareholders of record on Thursday, May 12. Ted, an agent of a broker-dealer, calls Jane and encourages her to buy the stock by Monday, May 9, to lock in the $1.00 dividend. Otherwise, she will miss receiving the dividend and lose the profit. Should Jane succumb to this high-pressure sales tactic?

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The rule

No. An investor who buys the stock in order to receive the dividend will be paying a price that includes the dividend. Jane would effectively be receiving her money back in the form of a taxable dividend. If Jane waits to buy the stock on or after the ex-dividend date, she will be able to buy it at a reduced price. Ted acted unethically when he attempted to induce the sale of stock based on its impending dividend.

Omitting material facts

The violation

An agent of a broker-dealer has been selling a large quantity of stock that's on his firm's recommended list. The agent is on the phone with a client who places an order to buy the shares when he receives news that the issuing company's earnings will need to be restated. Fearing the news will cause the client to withdraw the trade, he decides not to disclose it to his client. What actions has the agent taken?

The rule

The agent's actions are fraudulent and deceitful since he withheld material facts from a client. Registered persons don't need to tell an outright lie to violate the USA's antifraud rule. While it's virtually impossible to disclose all known facts, a reasonable person can determine if the information is a *material fact*—one that's important in order to decide whether to engage in a particular transaction. The agent withheld material facts when involved in a securities transaction. In this example, the agent would be required to disclose the material information regarding the company's earnings to his client prior to entering the order.

Other Prohibited Practices

Although any financial professional may be accused of the following violations, these activities are more likely to involve broker-dealers and their agents.

Use of Insider Information

Insider information is any material information that has not yet been disseminated to the public. An agent who has access to material, non-public information may not make recommendations based on it and, with the exception of a supervisor, may not discuss it with anyone.

> *Brian, an agent of a broker-dealer, learns from a client who sits on the board of directors of a Fortune 100 company that the company is going to be subject to an expensive lawsuit. The client asks that Brian keep the information confidential. If another client calls and expresses interest in buying that company's stock, does Brian have an obligation to provide this news to his client?*
>
> No. This is insider information and Brian is prohibited from sharing it publicly.

An insider trading violation occurs if a person *uses* material, non-public information either to make a profit or avoid a loss. Remember, it's using the information (i.e., trading on the information) that creates the problem.

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Situations may arise in which one person provides the information to another person who ultimately executes trades. If this is the case, the person providing the information (the tipper) and the person who receives and trades on the information (the tippee) are both considered to have engaged in insider trading.

Sales of Company Stock by Corporate Executives Many high-ranking corporate executives acquire large amounts of their companies' securities. Since these executives usually have material, non-public information about their companies, they must be careful when they buy or sell their companies' securities.

> *Donald is the CEO of a publicly traded corporation. He wants to sell some of his company's stock to purchase his own private Caribbean Island, but his company is about to announce their quarterly earnings. What should Donald do?*
>
> Donald should wait until after his company releases its quarterly earnings to sell his shares.

Penalties for Insider Trading The consequences of violating the insider trading laws are severe. The SEC may impose civil penalties of up to three times the profits earned or losses avoided (i.e., treble damages). They violators will also be required to forfeit their profits (disgorgement). Investors who believe that they were harmed also may sue to recover their damages.

The government may even prosecute the offenders criminally—fines of up to $5 million and jail sentences ranging up to 20 years are possible. Corporations may face criminal penalties of up to $25 million.

Making Unsuitable Recommendations

Agents should always have reasonable grounds for recommending a particular security and must ensure that the recommendation is suitable. When determining suitability, agents depend on the information obtained from clients, such as financial status, needs, objectives, and risk tolerance.

When making recommendations to a client, an agent MAY NOT:

- Recommend transactions that are excessive in size in relation to the client's financial resources
- Omit details relating to the risks of a transaction
- Engage in churning of the client's account

Churning involves an agent engaging in excessive trading in a client's account, usually for the purpose of generating commissions.

> **Broker-Dealers versus IAs …**
>
> Excessive trading (churning) is unlikely to be a concern in a fee-based advisory account since the client pays a single flat fee that covers all transaction costs. However, in a brokerage account, this may be of greater concern since agents are compensated by commissions. This is particularly true if the account is discretionary.

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Commingling Client and Firm Securities

Commingling is the practice of intermixing securities belonging to customers with those belonging to the broker-dealer.

Client securities that are retained by the broker-dealer must be segregated (separated) from the securities that are owned by the broker-dealer. The purpose of segregation is to prevent the misuse of customer securities and to eliminate the potential risk of commingling.

In order to avoid possible commingling, securities may be registered in a client's name and sent directly to the client. Another possibility is the securities may be held in safekeeping by the broker-dealer, with the firm charging the client a reasonable fee for the service.

> *A broker-dealer has 70,000 shares of XYZ Company in its inventory and its clients own 15,000 shares of the same stock. In an effort to reduce bookkeeping expenses, the broker-dealer keeps all 85,000 shares together in one secure vault. Is this permitted?*
>
> Yes. A broker-dealer may keep customer stock and its own stock in the same vault. However, the securities must be maintained in such a way that it's clear which certificates belong to the broker-dealer and which certificates belong to customers. When securities are separated appropriately, they're considered segregated. Separate client ledgers and journals of securities transactions are created to record where each security is located.

Conversion of Client Cash and Securities *Conversion* occurs when an agent illegally takes possession of a client's assets for her own personal use.

> *An agent receives a check from a client who wants to open a brokerage account. Since it's late in the day on Friday, the agent decides to deposit the client's check in her business account and write a check to the broker-dealer next week when she returns to the office. Is this practice acceptable?*
>
> No. Regardless of the agent's good intentions, this is considered conversion. The agent may not deposit cash or securities that belong to a customer into her personal or business account.

Remember, if an agent of a broker-dealer inadvertently receives a client's cash or securities, the assets must be deposited promptly with a qualified custodian or returned to the customer. Agents who inadvertently hold funds or securities that belong to clients for longer than three business days are considered to have custody of clients' assets.

Borrowing and Lending

As to be expected, borrowing money or securities from, and lending money to, a client is generally considered a conflict of interest. However, there are some limited exceptions which allow the practice. There are more exceptions available for broker-dealer agents than for investment adviser representatives.

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Broker-Dealer Agents For an agent to borrow money or securities from, or lend money to, a client, the agent's broker-dealer must have written procedures allowing the arrangement and:

- The customer must be a member of the agent's immediate family (i.e., parent, grandparent, husband or wife, brother or sister, child, mother or father-in-law, brother or sister-in-law, son or daughter-in-law, grandchild, cousin, aunt or uncle, niece or nephew, or any other person whom the agent supports, directly or indirectly, to a material extent);
- The customer must be a financial institution that's regularly engaged in the business of providing credit, financing, or loans (the loan must be made on the same commercial terms that are available to the general public);
- The customer and the agent must both be registered persons of the same broker-dealer; and
- The customer and the agent must have either a personal or business relationship that exists outside of the brokerage relationship

Unless the borrowing or lending arrangement is with an immediate family member or with a customer that's a financial institution in the business of extending credit, agents are required to provide notification to their member firms and obtain written approval prior to entering into such arrangements.

IAs and Investment Adviser Representatives Since advisory relationships provide IAs and IARs with access to confidential information about their clients' income and assets, it's considered a breach of their fiduciary duty and generally prohibited to borrow money or securities from, or lend money to, their clients.

Under NASAA's Unethical Business Practices Module Rule, IAs and IARs are prohibited from borrowing money or securities from a client or lending money to a client *unless the client is*:

- A broker-dealer
- An affiliate of the investment adviser, or
- A financial institution that's engaged in the business of loaning funds

It's important to note that IAs and IARs are not permitted to borrow money from, or lend money to, an immediate family member who happens to be a client of the firm.

Sharing in the Profits or Losses in a Client's Account

Another practice that generally is prohibited is sharing in a client's account. However, an agent may share in the profits and losses in a client's account if:

- The sharing arrangement is approved in writing by the customer and the agent's broker-dealer
- The sharing is proportionate based on the amount invested by each party

Guaranteeing Clients a Profit

As mentioned earlier, agents must be careful not to use a definitive term, such as *guarantee.* Under the Uniform Securities Act, the only reference to a guarantee is in connection with a security whose payment of dividends, interest, and principal is guaranteed by an entity other than the issuer (a guaranteed security). In such cases, the guarantee is only as good as the guarantor.

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Agents are prohibited from guaranteeing their clients a minimum rate of return or a specific profit on an investment. Also, if clients lose money on their investments, agents are prohibited from reimbursing them for any portion of those losses.

Outside Securities Accounts

For supervisory reasons, member firms are required to monitor the personal accounts that their employees (both clerical and registered persons) open or establish with a firm other than the one at which they're employed. For example, if a registered person of ABC Brokerage approaches another financial institution in an attempt to open an outside (away) account to trade securities, both the employee and the firm must observe special rules prior to the account being opened. For purposes of this rule, the term *financial institution* refers to a broker-dealer, investment advisor, bank, insurance company, trust company, or investment company.

Employee Requirements Employees who intend to open outside accounts in which securities transactions may be executed are required to obtain the prior written consent of their firm. In addition, before an outside account is opened, the employees are required to provide written notification to the executing firm of their association with another member firm.

Related and Other Persons This rule also applies to any account in which securities transactions can be executed and in which the employee has beneficial interest, including any account that's held by:

- The employee's spouse
- The employee's children (provided they reside in the same household as, or are financially dependent on, the employee)
- Any related person over whose account the employee has control, and
- Any other individual over whose account the employee has control and to whose financial support the employee materially contributes

Previously Opened Account If an employee had opened an account prior to the time that he became associated with a broker-dealer, the employee is required to obtain the written consent of his employer within 30 days of the beginning of his employment in order to maintain the account. Also, the employee is required to provide written notification to the executing firm of his employment with another broker-dealer.

Once an account has been opened for a member firm employee, the executing firm is not required to obtain the employing firm's approval prior to the entry of each order. However, the employee's activities are subject to any rules or restrictions that have been established by his employing firm.

Executing Broker-Dealer Requirements Upon written request, the executing firm is required to send duplicate copies of confirmations, statements, or any other transactional information to the employee's broker-dealer.

Exemptions The requirements of this rule don't apply to accounts that are limited to transactions involving redeemable investment company securities (mutual fund shares), unit investment trusts, variable contracts, or 529 plans.

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Failing to Notify a Supervisor of a Written Client Complaint

Broker-dealers are required to respond to all written customer complaints and must maintain a file with a copy of the complaints. Complaints may be delivered in either a traditional medium (written letter) or an electronic medium (e-mail or text message). If a complaint is directed to an agent, the appropriate action is for the agent to forward it to his immediate supervisor. Ignoring or failing to respond to a complaint is a violation of the USA. However, there's no need to notify the Administrator about a client complaint.

Market Manipulation

Under securities laws, market manipulation is strictly prohibited and includes buying or selling a security to unfairly influence its market price. One of the most important federal rules is 10b-5 which, in connection with the purchase or sale of any security, makes it unlawful to:

- Employ any device, scheme, or artifice to defraud
- Make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made not misleading
- Engage in any act, practice, or course of business that operates or would operate as a fraud or deceit on any person

If a senior executive of a publicly traded company reports inflated earning by using false financial statements that action would be an example of market manipulation. Since the price of a company's stock is impacted based on its earnings, if earnings are inflated, it can affect the market price of the stock.

Front-Running *Front-running* occurs when a brokerage firm executes orders on a security for its own account to take advantage of advance knowledge of pending orders from its customers. This illegal practice may involve either a broker-dealer buying for its own account before filling customer buy orders that subsequently drive up the price, or selling from its own account before filling customer sell orders that subsequently drive down the price.

Another manipulative practice is referred to as *shadowing*. This involves a broker-dealer executing a trade for its own account immediately after it executes a substantial client trade, but before the client's trade is reported. By waiting for the client trade to be executed, the firm may be hoping to avoid making it appear as though it's front-running.

Painting the Tape *Painting the Tape* involves financial professionals buying and/or selling securities among themselves in order to create false trading volume. When the trades are reported, the appearance of increased trading activity is intended to attract investors.

> *Mort and Mickey are friends who work on the trading desks of rival brokerage firms. The two traders decide to trade a certain low-priced stock with each other at agreed-upon prices in an attempt to create a new single-day trading volume record for that stock. The next day, news of the trading circulates in the press and other investors start to bid up the stock's price. Mort and Mickey subsequently sell their shares at a nice profit and stop trading the stock. What form of market manipulation is being committed?*

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Since Mort and Mickey prearranged their trading activity to create false volume in the security, they're guilty of Painting the Tape.

Trading Ahead *Trading ahead* occurs when a broker-dealer accepts an equity security order from a client and, rather than immediately executing the order, the firm trades that security on the same side of the market for its own account at a price that would satisfy the client's order. For example, a broker-dealer is holding an order from a client who wants to buy ABC stock at $21. Later, rather than filling the client's order, the broker-dealer buys ABC stock for its own account at $21 or better.

Selling Away

Selling away occurs when an agent executes securities transactions without the knowledge of her broker-dealer. Often, these rogue sales wind up harming clients' investment portfolios.

If an agent wishes to sell securities outside the normal course of her employment, she must first obtain her firm's written permission. If the firm approves of the arrangement, the agent's activities must then be recorded on the books and records of the firm. Ultimately, firms are responsible for supervising their agents' transactions. Also remember, an agent's compensation for effecting securities transactions may only be paid by her employing broker-dealer.

In addition to selling away, any outside business activity in which the agent may receive compensation requires the agent to notify her employing broker-dealer.

Knowingly Failing to Follow Client Instructions

Securities professionals are required to follow all lawful client requests when servicing their accounts. If a client indicates a desire to purchase, sell, transfer, or close an account, the agent has an obligation to execute the client's instructions properly in a timely manner.

A client contacts his agent and enters a market order to sell a 1,000-share position in RST Corp. Rather than route the order for immediate execution, the agent holds the client's order because he feels as though RST stock is going to rally later in the day. Ultimately, the agent was right and the stock was later sold near the closing price which was the high for the day. Was the agent justified in holding the client's order?

No. Although delaying the execution of the market order resulted in a benefit to the client, knowingly failing to follow client instructions is an unethical business practice. This rule applies even if the broker-dealer or agent has discretion over the account.

Soliciting Orders for Unregistered, Non-Exempt Securities

When an agent solicits a buy order from a customer, the agent and the broker-dealer have an obligation to make sure that the security they're recommending is both suitable and compliant with the provisions of the Uniform Securities Act. This includes making sure the security is either registered or exempt from registration. Agents may not solicit the sale of an unregistered, non-exempt security.

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If a client places an *unsolicited* order for unregistered, non-exempt securities, the transaction may be completed. However, the Administrator may require a signed acknowledgement from the client confirming that the order was unsolicited.

Withholding Sales of IPO Shares

When involved in an initial public offering (IPO), a broker-dealer must always make a genuine (bona fide) public offering of all securities to which it was allocated as an underwriter or member of a selling group. When presented with a customer order, it's considered an unethical sales practice to withhold the sale of these securities.

Failing to Deliver a Final Prospectus

Broker-dealers are responsible for ensuring that every customer who purchases a new issue receives a copy of the final prospectus by the date the transaction is confirmed. This requirement may also be fulfilled by providing the client with a written or electronic copy of the preliminary prospectus together with an additional document so that the two documents together contain all the information in the final prospectus.

A firm that sells a new issue in the aftermarket shortly after it begins trading may also be required to provide prospectuses to its customers. This obligation to provide prospectuses continues for 25 days after the effective date for securities that will be listed on a national exchange, such as Nasdaq and the New York Stock Exchange. For secondary offerings of securities that will trade over-the-counter (i.e., securities that are not eligible to be listed on Nasdaq), this obligation lasts for 40 days. If the offering is an initial public offering (IPO), the obligation lasts for 90 days.

Security	Time Frame
For a non-listed IPO	90 days
For a non-listed follow-on offering	40 days
For an IPO of a security to be listed on the NYSE or Nasdaq	25 days
For an NYSE or Nasdaq-listed follow-on offering	No requirement

Be careful …

An agent should never underline or highlight any portion of the final prospectus or preliminary prospectus for a client, even if she's only trying to be helpful. Pointing out specific information implies that certain portions of the prospectus are more important than others and suggests that the customer doesn't need to review the entire document.

Failing to Disclose Control Relationships

If a broker-dealer is affiliated with or controlled by an issuer of a security, it must disclose this relationship to all of its clients before allowing them to buy or sell the security. The firm may initially disclose this relationship orally, provided a follow-up disclosure is made in written form no later than the date on which the transaction is completed.

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Keith is a producing branch manager of a brokerage firm, but also sits on an advisory board for his local municipality. When the municipality needs to issue bonds, the deals usually are directed to and completed by Keith's firm. As Keith's firm sells these bonds to clients, what disclosure must be provided?

Clients must receive a specific disclosure of the relationship that Keith and his firm have with the issuer. The disclosure must be made at least orally before the trade, followed by a written disclosure at or prior to the settlement of the trade.

Unnecessarily Delaying Payments or Deliveries of Securities

Broker-dealers generally require customers to pay for their securities purchases by the settlement date of the trade (typically by the second business day following the trade date, or T + 2). Customers may also demand the same level of prompt treatment by their broker-dealer.

Therefore, firms are not allowed to delay the delivery of securities that were purchased by a client, delay the payment to a client for securities sold from their account, or delay the payment of funds that a client has available in his account (*free credit balance*). A customer free credit balance represents available funds in a client's account due to sales or the crediting of a dividend or interest payment.

Executing Orders at Unfair Prices

When quoting prices in the marketplace, broker-dealers have an obligation to honor their quotes. Transactions must be executed at contemporaneous prices or, in other words, at prices that are reasonably related to the current market price. Quoting prices that are better than the market and then adding an unreasonable commission or markup is considered a violation. Remember, if a firm states that a security is being offered at its current market price, it must have reasonable grounds for making this statement.

Charging Excessive Fees

A broker-dealer may charge a client reasonable fees for miscellaneous services, such as appraising, transferring, exchanging, or maintaining custody of assets, and collecting dividends or interest payments that are due. However, charging unusually high or excessive fees is not allowed.

The firm should always inform a customer if a transaction will involve unusually high commissions or extra fees, even if these charges (e.g., taxes) are being imposed by an outside entity.

Exercising Discretion without Written Authority

Broker-dealers and agents may not exercise any discretionary authority when placing an order for the purchase or sale of securities for a client without first obtaining written discretionary authority from the client. However, remember, discretionary authorization is different for investment advisers. IAs and IARs may buy and sell securities on a client's behalf if the client grants them oral permission for 10 days. In other words, they must obtain the client's written authorization *within 10 business days after* the date on which the first discretionary transaction is placed.

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Written discretionary authority is not required when the customer instructs an agent to buy or sell a specific amount of a security and leaves only the exact price and time to the agent. An order in which a client determines the action, asset, and amount, but leaves the decision as to the price and/or time of execution to an agent, is referred to as a *Not-Held* order. Not-Held orders may be accepted and executed without obtaining written authorization, but may be executed only during the day on which the order was entered.

An agent of a broker-dealer recently opened an account for a client. The agent's initial recommendation of Atlas Industries has appreciated in value by more than 20% in a short period. The agent thinks the time is right to take the profits and sell, but is unable to get in contact with the client. The agent sells the stock and decides to explain everything to the client later. Were the agent's actions justifiable since the result was a profit?

No. The profitability of the transaction doesn't make the agent's actions acceptable. The agent was not granted discretionary authorization; therefore, she's not permitted to effect transactions without the client's prior knowledge. Without proper trading authorization, every order that's placed in the client's account requires her specific approval prior to placement. If a broker-dealer doesn't have discretionary authorization over a client's account, but the client specifically states whether to buy or sell, the specific security, and the specific quantity, the client's agent may exercise judgment only as to the price and/or time of execution.

Grace has a non-discretionary account with a brokerage firm. Grace contacts her agent and says, "At some point today, buy 100 shares of ABC whenever you think it's best." Is her agent allowed to execute this order without written discretionary authority (power of attorney)?

Yes. Grace indicates that she wants to buy 100 shares of ABC. Since she specified the three important details—the action (buy), the amount (100 shares), and the asset (ABC)—the agent may use his judgment regarding the best price and/or time of execution without written authorization.

Durable Power of Attorney Standard brokerage power of attorney becomes invalid if a client dies or becomes incapacitated. If a client wants to name authorize a person to manage his financial affairs in the event that he becomes incapacitated due to physical injury, disease, or mental illness, he must execute a *durable* power of attorney. Keep in mind, all forms of power of attorney become null and void at the time of the customer's death.

Telephone Solicitations

The Federal Telephone Consumer Protection Act of 1991 was enacted to help protect consumers from abusive cold-calling practices. FINRA has incorporated its main provisions into its rules.

- Telephone solicitations may be placed only between 8:00 a.m. and 9:00 p.m. local time of the person being called, unless that person has given prior consent.

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- When calling prospective customers, an agent must give her name, the name of her employer and a telephone number or address where her employer may be contacted. This information must be provided promptly and in a clear and conspicuous manner.
- Each broker-dealer is responsible for creating a *Do Not Call List*. If an individual is solicited by telephone and asks not to be called again, the broker-dealer must place his number on a Do Not Call List which must be maintained indefinitely. In addition, the firm must train its agents regarding the proper use of the list and create a written policy that describes how the list will be maintained.
- Agents may not make calls that are harassing or abusive.

FINRA recognizes that when an agent has an existing relationship with a customer, the agent may need to contact the client outside the 8:00 a.m. to 9:00 p.m. window. Therefore, the time-of-day and disclosure requirements don't apply to existing customers if the purpose of the call is to service the client's account. The agent may also delegate the task to another person, such as a qualified sales assistant.

NASAA's Statement of Policy on Dishonest or Unethical Business Practices in Connection with Investment Company Shares

NASAA has issued a policy statement that describes different dishonest and unethical practices that are associated with selling shares of investment companies (mutual funds). This statement alerts agents to what they must do (and what they may not do) when they're selling mutual fund shares.

Communications Regarding Sales Charges (Loads)

An agent who is soliciting sales of investment company shares *must disclose ALL costs* including sales charges, management fees, 12b-1 fees, and contingent deferred sales charges. The agent must also inform clients about any of the methods that are available for reducing their sales charges, such as *breakpoints* or *letters of intent*.

Breakpoint A *breakpoint* is the minimum amount of money that clients need to invest in order to receive a discounted sales charge. Basically, the more money invested, the lower the sales charge.

Letter of Intent A *letter of intent* allows clients to qualify for a breakpoint without immediately depositing the required funds. Once the letter is signed, investors are given 13 months to meet their investment target.

No-Load Funds

No-load mutual funds may not assess front-end sales charges (loads) or contingent deferred sales charges (back-end loads). However, they may assess a 12b-1 fee provided it doesn't total more than .25% of the fund's average annual net assets. An agent should never refer to a mutual fund as a no-load fund if it doesn't meet this definition.

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Share Classes

Many funds have multiple share classes (e.g., A, B, C, etc.) that indicate the specific method by which sales charges are collected. An agent should always recommend that the client purchase the share class that's most suitable based on the client's investment objectives, financial situation, and other securities holdings.

Recommendations

An agent should not advise a client to purchase shares in different mutual funds with similar investment objectives unless the agent has reason to believe this is a suitable strategy based on the client's individual needs. If a client invests in similar funds that are sponsored by different fund families, she may not receive the benefit of breakpoints and will often pay higher sales charges as a result.

Also, an agent should not advise a client to redeem shares of one investment company in order to purchase shares in a different investment company with similar investment objectives unless there's a valid reason for believing the change is in the client's best interest. The client will usually be required to pay a new sales charge on the purchase and may also be required to pay capital gains taxes on any increase in the value of the fund that was sold.

Disclosure When soliciting sales of mutual funds, agents may not state or imply:

- A fund's current yield or income without disclosing the fund's most recent average annual return calculated for 1-, 5-, and 10-year periods
- That a fund's investment performance is comparable to that of a savings account, CD, or other bank account without disclosing that the shares are not insured or otherwise guaranteed by the FDIC or other government agency
- The existence of insurance, credit quality, guarantees, or similar features regarding the fund's portfolio without disclosing the relevant investment risks such as interest-rate, political, liquidity, or currency exchange risk
- That purchasing shares shortly before the ex-dividend date is advantageous to clients unless there are specific, clearly described tax advantages

Summary Prospectus As was explained earlier, an agent should never alter a prospectus. However, when dealing with mutual funds, clients may receive a copy of a summary prospectus rather than the entire prospectus, assuming the regular prospectus is available on the fund's website.

Securities Transactions on Bank Premises

The NASAA model rules for selling securities at a bank apply to broker-dealers that conduct business with retail clients on the premises of another financial institution (a bank, savings and loan, or credit union). There are five primary elements to these rules—setting, networking arrangements, customer disclosure and written acknowledgement, communications with the public, and notification of termination.

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Setting

Whenever possible, the brokerage firm's activities should be in an area that's physically separated from the area where the bank accepts retail deposits. If this is not possible, then the broker-dealer has a heightened responsibility to distinguish its services from those of the bank. In all cases, the brokerage firm's name must be prominently displayed in the area in which it conducts business and the broker-dealer's services must be clearly distinguished from the services offered by the bank.

Networking Arrangements

A networking arrangement is an understanding between a broker-dealer and a bank under which the broker-dealer conducts business on the premises of a retail bank. These arrangements must be governed by written agreements.

This agreement must define the responsibilities of all the parties involved and the manner in which they will be compensated. The agreement must further stipulate that the brokerage firm's supervisory personnel and representatives of the state securities authorities will be given access to the bank's premises to inspect the records maintained by the brokerage firm of its operations at that locale.

Customer Disclosures and Written Acknowledgement

The brokerage firm must make the following disclosures, both orally and in writing, anytime it opens an investment account for a client on the premises of a bank:

- These products are *not* insured by the Federal Deposit Insurance Corporation (FDIC).
- They are *not* bank deposits or obligations and they are not guaranteed by the bank.
- They are subject to investment risk, which includes possible loss of the principal.

The firm must make a reasonable effort to obtain acknowledgement from each client that he has received these disclosures during the account-opening process.

Communications with the Public

All confirmations and account statements must indicate clearly that the broker-dealer is the one providing investment services, not the bank. Advertising and sales literature that announce the location of a bank where the broker-dealer is doing business or that are distributed at the bank must include the same disclosures that were just described.

A shorter logo format version of these disclosures may be used in any advertisement that's designed for radio or television broadcasts, or ATM screens, posters, and brochures, provided it's displayed in a conspicuous manner. The condensed version must include the following details:

- Not FDIC-insured
- No bank guarantee
- May lose value

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Notification of Termination

The broker-dealer must promptly inform the bank if it has cause to terminate an agent who's also employed by the bank.

Investment Advisory Activities

Many of the concepts that have been described in this chapter apply to all financial professionals. However, up to this point, the concentration has been on activities that are fraudulent and prohibited in connection with the purchase or sale of securities.

Keep in mind, broker-dealers and agents are in the business of effecting securities transactions. Therefore, when answering questions regarding the previous violations, remember to look for scenarios that involve agents and/or broker-dealers. However, it's necessary to understand that the Uniform Securities Act's antifraud provisions also apply to investment advisers. Let's consider some of the advisory practices that are regulated under state law.

Identifying Conflicts of Interest

Since investment advisers have a fiduciary relationship with their clients, one of the most important issues facing fiduciaries in general, and investment advisers in particular, is the potential for conflicts of interest. The general rule regarding the handling of conflicts of interest may be referred to as the *Disclose or Abstain Principle*. At some point, advisers may be faced with choosing between what's in their best interests and what's in their clients' best interests. The ethical and legal choice in these types of situations is clear—advisers must always consider their clients' best interests.

When an action involves a conflict of interest, an investment adviser should disclose the conflict to the client before providing any service. While disclosure of a conflict of interest will often satisfy a fiduciary's duty to a client, there are cases where disclosure is not enough. If a situation arises that result in an adviser putting its interests ahead of its clients, the adviser is required to abstain (refrain) from the activity.

The following chart identifies the conflicts that IAs and IARs must disclose to clients as well as the actions from which they must abstain.

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CONFLICTS OF INTEREST FOR IAs AND IARs	
Disclose the Action	**Abstain from the Action**
Acting as a broker-dealer or agent for advisory clients	Acting as an issuer or affiliate of an issuer of securities
Advisers intending to use the services/ products of a broker-dealer with whom they're associated	Recommending unregistered, non-exempt securities or the use of unregistered broker-dealers
The IAR's personal transactions are inconsistent with the advice given the clients	Engaging in any activity that seeks to defraud or deceive clients
Effecting agency cross or principal transactions for its advisory clients	Charging unreasonable fees
Using third-party research	Failing to disclose to all customers the availability of fee discounts
Receiving hidden fees in the form of undisclosed service charges, wrap fees, or expenses reimbursed by other parties	Using contracts that seek to limit or avoid an adviser's liability under the law (exculpatory provisions)
Receiving any form of compensation for soliciting or referring clients to another adviser or a broker-dealer	Limiting a client's options with regard to the pursuit of a civil case or arbitration
Receiving transaction-based compensation, including 12b-1 or other marketing fees, related to securities recommended to clients	Borrowing money from or lending money to clients

Principal and Cross Trades

An investment adviser that buys or sells securities for its own inventory (proprietary account) is executing principal trades. Cross trades are executed when an investment adviser acts as a broker for both a client and another person when effecting a securities transaction. An adviser may engage in both types of trades, provided the firm:

- Discloses the capacity in which it's acting prior to the transaction, AND
- Obtains each client's written consent

Be aware …

For a firm to effect a cross trade, one side of the trade must be unsolicited.

These requirements don't apply to broker-dealers that are NOT acting as investment advisers since principal and cross trades are a standard part of business for a broker-dealer. All client confirmations must indicate the capacity in which the broker-dealer executed the trade.

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TipTop Financial is registered as both a broker-dealer and an investment adviser. Jim, an advisory client of TipTop, has just placed an order to sell 500 shares of XYZ. TipTop knows another advisory client for whom XYZ would be an appropriate purchase. TipTop would charge a small brokerage fee for arranging the trade. Is this permissible?

Yes. By *crossing the trade*, TipTop may be able to provide each client with a better price than what might be obtained in the open market. Before the trade, TipTop must obtain each client's written consent and must disclose the firm's capacity (as a *dual agent*) to each customer. Representing both sides of the trade is generally a conflict of interest; however, the conflict may be resolved through disclosure.

Confidentiality of Client Information

An investment advisory firm must keep all information concerning its clients confidential. However, firms may release the information if required to do so by law or with the client's approval. The Administrator, the SEC, FINRA, and the IRS are regulatory organizations that have the authority to demand access to the information without the client's approval.

Communications with Clients

When investment advisers distribute information to the public, a communication that's sent to more than one person is considered advertising. All advertising by investment advisers must meet the standards contained in the Uniform Securities Act. Among other things, adviser advertising *may not*:

- State that a report, analysis, or other service will be furnished free, unless these items have no cost or obligation
- Contain untrue statements of material fact, be false, or misleading

It's also a violation to represent rumors, opinions, or other unfounded statements as being factual either in advertisements or in other client communications. If hypothetical returns are used in an illustration, the assumptions used must be disclosed.

An IAR should contact her compliance and/or legal department if she suspects that false or misleading information has been disseminated about a security or that material facts have been omitted.

Lists of Past Recommendations Investment advisers may include a list of their previous investment recommendations in advertising and sales materials as long as the list includes *all* of the advisers' recommendations during the relevant period (which must be at least one year). The list must also state the name of each security, the date on which the recommendation was made, the type of recommendation (e.g., buy, sell, or hold), and the current market price of the security. Basically, the list needs to be an accurate reflection of the advisers' recommendations during that period. Advisers are prohibited from including only recommendations that produced favorable results (i.e., no *cherry-picking).*

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Third-Party Research An adviser that provides its clients with research reports or recommendations that are produced by third parties must disclose that the adviser is not the author of these materials. However, this disclosure requirement doesn't apply when advisers use various outside sources to formulate their own independent conclusions.

Use of the Term *Financial Planner* Some people who claim to be financial planners may not actually be trained or educated in the discipline of financial planning. Under the USA, the use of the term *financial planner* by a person whose business is limited to selling products may be a deceptive practice, since financial planning goes beyond simply selling products.

Qualifications of Personnel An adviser may not misrepresent or inflate the qualifications of itself or its employees. The adviser is also prohibited from misrepresenting the nature of the services that it provides or the fees that it charges.

Use of the Terms Investment Counsel, RIA, and IAR An *investment counsel* is a firm or individual that's registered as an IA, whose principal business consists of acting as an investment adviser, with a substantial part of its business consisting of providing investment supervisory services. *Remember, investment supervisory services represent the continuous advice related to the investment of a client's funds on the basis of the individual needs of the client.* If an investment adviser's business meets these requirements, it may use the terms *investment counsel* or *registered investment adviser* when describing its activities. These terms may also be used in the firm's correspondence and on its business cards. However, the initials RIA (Registered Investment Adviser) and IAR (Investment Adviser Representative) cannot be used in any client communications since they're not professional designations that have been earned (unlike the Certified Financial Planner [CFP®] designation).

Social Media

Several years ago, keeping clients informed meant communicating with them by phone, letter, or in person. Today, there are an extraordinary number of choices, including Twitter, Facebook, and LinkedIn postings, Tumblr discussions, chat-room talk, and texting.

To compete in an increasingly electronic and fast-moving environment, agents and IARs are increasingly turning to social media. More prospective and existing clients can be reached, more targeted information delivered, and more investment advice dispensed through these technologies than were ever imagined a few years ago. It's a new world for financial professionals, but also one that's filled with potential rule violations.

Some broker-dealers ban the use of all social media. Firms that do so clearly reduce the risk that their personnel may inadvertently violate regulatory requirements. However, a blanket ban may significantly hamper the ability of agents to prospect for new clients and retain their existing ones. Other firms allow their agents to make limited use of social media. This approach requires firms to develop well-structured policies and procedures that must include a way of supervising and retaining these communications.

If a firm allows the use of social media for business purposes, a principal is required to review the sites prior to use. The decision to approve the use of a particular site should include an analysis of whether it's designed in such a way to allow personnel to comply with regulatory requirements.

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Social Media and Investment Advisers

All of the same rules that apply to other types of communications with the public also cover social media. The SEC and the state securities regulators are concerned that if advisers permit the use of social media, they may forget to include it in their compliance programs. For this reason, firms should include the following provisions in their compliance programs:

- **Usage Guidelines** Compliance procedures should address appropriate usage and restrictions on use of social media, based on potential risks.
- **Content Standards** Content may violate a firm's fiduciary duty or other regulatory issues; therefore, procedures must address it.
- **Monitoring** Advisers should consider how to monitor the use of social media by employees, representatives, and solicitors, taking into consideration the lack of ability to monitor third-party sites.
- **Approval of Content** Advisers should consider requiring the preapproval of communications, rather than after-the-fact reviews.
- **Training** Advisers should consider implementing a training program that's related to social media, with a view toward promoting compliance
- **Personal/Professional Sites** Advisers should consider whether to adopt policies to address the business being conducted on personal or third-party media sites.
- **Information Security** Advisers should consider whether permitting representatives to have access to social media sites poses information security risks, as well as how to protect the information.

Testimonials A specific concern of the SEC and the states is the use of testimonials on social media sites. The term testimonial means any statement by a current or former client that endorses the adviser or gives a favorable impression of that customer's experience with the adviser. Today, the Investment Advisers Act of 1940 permits investment advisers to use testimonials as long as the testimonials are not misleading and the following conditions are met:

- **Disclosure** – An investment adviser must disclose:
  - Whether the person who's making the testimonial (i.e., the promoter) is a current client
  - Whether the promoter is receiving cash or non-cash compensation and, if the promoter is being compensated, a description of the compensation
  - Disclosure of conflicts of interest (e.g., whether the person promoting the IA is also an employee of the IA)
- **Oversight** – An investment adviser must supervise the publication of testimonials. In addition, a written contract between the IA and promoter must be created if compensation is being paid to the promoter.
- **Disqualification** – Certain "bad actors" are not permitted to make testimonials.

An exception to the requirement to have a written contract with a person making a testimonial is available if the investment adviser is paying a person $1,000 or less during the preceding 12-month period (i.e., "de minimis compensation.").

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Entanglement and Adoption In some cases, an adviser is permitted to share or distribute content that's created by a blogger or social media influencer. If third-party content is created and posted without being requested by an investment adviser and the advisory firm then uses the content in its marketing campaign, the SEC considers the material to have been "adopted" by the adviser.

According to the SEC, an investment adviser is considered to have adopted content when it implicitly or explicitly approves of information. An obvious example is when an adviser shares, retweets, or posts an article about its services. If the adviser commented in its reposting of the material, "what a great article!," the SEC would consider the adviser to have adopted the content. However, if the article is simply shared without comment, it will not be considered adopted.

Additionally, advisory customers can also comment about an article that's shared on their adviser's social media page and the adviser will still not be considered to have adopted the content. However, if an adviser comments about a customer's comment, then the article is considered to have been adopted by the adviser. The SEC has also provided guidance on profane or offensive comments. Advisory firms are permitted to delete offensive comments on their social media pages, while also avoiding the implication of the content being edited. When adopting content, advisers are not specifically requesting the content or influencing its creation; instead, the interaction occurs after it's created.

If an adviser pays for a social media post, it's a testimonial. However, since it was not created by the adviser directly, but was instead written by a third party and originally posted on a third-party site, the SEC considers the adviser to be "entangled" in the content. In other words, an adviser that's directly involved in the creation of third-party content or has influence over what's created is entangled in the third-party content. As another example, an adviser that pays a blogger to create a list of the most successful investment advisers is entangled in the article.

The rules for both adopted and entangled material are very similar to advertisements that are created directly by an investment adviser. Both adopted and entangled content are permitted as long as they don't mislead the public. In addition, although adopted and entangled content has not been directly created by the investment adviser, the adviser is still responsible for the content's accuracy. The SEC wants advisers to investigate and verify third-party content before adopting and distributing it.

Performance-Based Advertising Investment advisers are only permitted to use performance-based advertising in certain circumstances. The following conditions must be met:

- **Fees**: If an adviser intends to put the gross rate of return in a social media post, the firm must also disclose performance net of advisory fees. For example, an investment adviser cannot simply advertise that it generated a 7% return for its managed accounts last year. Instead, it must also disclose that its clients' net return was actually 6% after the firm's 1% management fee was deducted.
- **Time Frames**: In order to include past returns, an adviser must include performance over one-, five-, and 10-year periods. If the adviser or the portfolio for which it's providing returns has not existed for five or 10 years, then the performance over the life of the account must be provided. The SEC wants to ensure that advisers don't cherry pick their best years and exclude any poor performance. An adviser also needs to be certain that it's comparing similar investment portfolios. For example, an adviser cannot compare the return of an equity portfolio with the return of a debt portfolio.

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- **No Approval**: If an adviser still wants to include performance data, it cannot imply that the SEC has approved or reviewed its performance numbers. An adviser also needs to be careful with disclosures that are made regarding the personnel who generated the performance. For example, let's assume that an investment adviser representative of an advisory firm was managing a portfolio and earned 17% for her advisory clients. If that portfolio manager left her position, the firm is still permitted to use the 17% performance in marketing material; however, the firm must disclose the fact that the portfolio manager is no longer managing the portfolio. Also, the adviser must provide details regarding the manager's investment objectives to ensure that they match up with the objectives of the accounts being marketed.
- **Hypothetical Returns:** Investment advisers are permitted to use hypothetical returns, but only if certain disclosures are made. These disclosures are very similar to other parts of Rule 204(6)-1. Hypothetical returns must be relevant to the account being marketed, and the estimated returns cannot be misleading in any way. Advisers are also required to make sufficient disclosures about both projected performance and assumptions to ensure that investors are able to evaluate the advertising. Since this part of the rule doesn't mention a timeline, advisers are permitted to project performance indefinitely; assuming it's not misleading according to the SEC.

Cyber Security and Data Protection

To establish the proper information security procedures, an investment advisory firm must first identify which threats and vulnerabilities pose the most risk to the firm. Once the firm has evaluated the greatest risk, it's important for the firm to establish an information security policy which includes employee training as part of its broader policies and procedures.

For example, given the frequency of email communication with clients, many RIA firms are at risk of being deceived by hackers who impersonate a client and make a fraudulent disbursement request via email. It's important that agents follow their broker-dealer's procedures to verify that these types of requests have actually come from the customer, especially if the request seems unusual or is going to a third party.

More and more larger firms are beginning to engage outside experts in order to help them develop the proper policies, monitoring, and safeguards. To properly protect sensitive client information, it's crucial for a firm to perform proper due diligence and establish confidentiality agreements with all third-party vendors that may have access to this information.

Every RIA firm must install the proper anti-virus software on all firm computers. In addition, firms should consider implementing additional encryption and authentication capabilities to help protect against the theft of client information or client impersonation attempts.

Some of the issues that need to be considered regarding a firm's cybersecurity risks include:

- Whether the firm has written policies, procedures, or training programs in place in order to safeguard client information
- Whether the firm maintains insurance coverage for cybersecurity

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- Whether the firm has experienced a cybersecurity incident where theft, loss, unauthorized exposure, use, or access to customer information occurred
- Whether the firm uses safeguards such as encryption, antivirus, and anti-malware programs

NASAA Model Act to Protect Vulnerable Adults from Financial Exploitation

In many states, financial exploitation is the fastest growing category of elder abuse in many states. The NASAA Model Act applies to broker-dealers and investment advisers, including certain qualified individuals (e.g., broker-dealer agents, investment adviser representatives, and persons who serving in a supervisory, compliance, or legal capacity for a broker-dealer or investment adviser). Although the Financial Industry Regulator Authority (FINRA) has adopted a financial exploitation rule, the protections afforded by the FINRA rule are substantively different from those afforded by the NASAA Model Rule. For example, NASAA requires broker-dealers to report suspected financial exploitation of *eligible adults* to state regulators and Adult Protective Services (APS) agencies.

Eligible Adults According to NASAA's Model Act, the term *eligible adult* is defined as:

- Any person who is age 65 or older
- Any person who is age 18 or older and who the firm reasonably believes has a mental or physical impairment that renders the person unable to protect his own interests. This determination should be based on the facts and circumstances that are observed in the firm's business relationship with the person.

Financial Exploitation According to NASAA's Model Act, *financial exploitation* includes:

- Wrongful or unauthorized taking, withholding, appropriation, or use of a specified adult's funds or securities; or
- Any act or omission taken by a person, including through the use of a power of attorney, guardianship, or any other authority, regarding a specified adult, to:
  - Obtain control, through deception, intimidation, or undue influence, over the specified adult's money, assets, or property; or
  - Convert the specified adult's money, assets, or property

Third-Party Disclosures To the greatest possible extent, seniors and other vulnerable adults should make decisions regarding whom a financial services professional should contact in the event of suspected financial exploitation (this person may be referred to as a *trusted contact person*). If a qualified individual reasonably believes that financial exploitation of an eligible adult may have occurred, may have been attempted, or is being attempted, he may notify any third party who was previously designated by the eligible adult. However, disclosure should not be made to any designated third party who's suspected of financial exploitation or other abuse of the eligible adult.

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Delaying Disbursements The act permits a broker-dealer or investment adviser to *delay a requested disbursement* from an eligible adult's account if:

- After initiating an internal review of the requested disbursement, the broker-dealer or investment adviser reasonably believes that it may result in financial exploitation, and
- Immediately, but by no later than *two business days* after the requested disbursement, the broker-dealer or investment adviser provides written notification of the delay to all parties who are authorized to transact business in the account, unless the firm reasonably believes that any such party has engaged or attempted to engage in the financial exploitation of the eligible adult;
- Immediately, but by no later than two business days after the requested disbursement, the broker-dealer or investment adviser notifies the state Administrator and APS agency; and
- The firm continues its internal review of the suspected or attempted financial exploitation of the eligible adult and reports its findings to the state Administrator and APS agency within seven business days after the requested disbursement.

Expiration of the Disbursement Delay A disbursement delay will expire upon the sooner of:

1. A determination by the broker-dealer or investment adviser that the disbursement will not result in financial exploitation of the eligible adult, or
2. *15 business days* after the date that the broker-dealer or investment adviser first delayed disbursement of the fund, unless either the state Administrator or APS agency requests that the delay be extended, in which case, the delay will expire no more than 25 business days after the first disbursement delay was initiated.

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Chapter 6 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Understand the difference between fraudulent and unethical business practices and provide examples of each
- Identify statements which are considered misleading under the USA
- Recognize and provide examples of prohibited activities, including:
  - Insider trading
  - Making unsuitable recommendations
  - Mishandling of customer funds, including borrowing from and lending to customers
  - Providing guarantees against losses
  - Failing to provide disclosure of conflicts of interest as an adviser
  - Market manipulation in both the primary and secondary markets
  - Executing trades in a client's account without discretionary authorization
- Understand the standards and prohibitions that apply to communications with clients and cold calling rules
- Understand unethical business practices in connection with investment company shares
- Understand NASAA's model rules for broker-dealers conducting business on a bank's premises
- Compare and contrast principal and agency cross trades and recognize the required disclosures for investment advisers to engage in these trades
- Understand the requirements for cyber preparedness and how to comply with applicable rules
- Understand industry guidelines on the use of social media, including standards and approvals
- Understand the prohibition on using testimonials that applies to investment advisers and investment adviser representatives (IARs)
- Understand the NASAA Model Act to Protect Vulnerable Adults from Financial Exploitation

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Chapter 7

Administration of the USA

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Remember, the USA was created to provide a template for states to use when formulating their specific securities laws. It's the responsibility of the state Administrator to oversee all securities-related activity in a state.

This chapter identifies the specific powers that have been granted to the Administrator to enforce the Uniform Securities Act. After reading this chapter, you should have a better understanding of the actions that may be taken by an Administrator, the reasons an Administrator would take action, and when an Administrator must involve the courts.

Administrative Authority and Enforcement

Again, Administrators regulate securities-related activities that occur within their states. Administrators may require the registration of persons involved in effecting securities transactions, persons giving advice regarding securities, and/or securities being offered or sold in their state. If a regulation is violated, the four basic tools that may be used to enforce the Uniform Securities Act are:

1. Orders issued by the Administrator
2. Actions against registration
3. Civil actions
4. Criminal actions

Before describing violations, it's important to become familiar with the specific activities that are regulated by the Administrator.

Offers and Sales

To understand a significant part of an Administrator's role, it's helpful to have a clear understanding of the two parts to a transaction—an *offer (offer to sell)* and a *sale*. An offer includes every attempt to dispose of, and every solicitation to buy, a security for value. The term *sale* is considered any contract or agreement to dispose of a security for value. Think of it this way, a sale is the result of a successful offer.

Jurisdiction Over Offers

The term *jurisdiction* is defined as (1) the power to interpret and apply the law, or (2) the territorial range of authority or control. Some of the exam questions may focus on a student's ability to identify which Administrator has jurisdiction over the different types of offers that are made.

An Administrator has jurisdiction over any offers to buy or sell a security that are *made* or *accepted* in her state. An offer is considered to have been made in a state if the offer *originated in,* or was *directed to* and *received in,* the Administrator's state.

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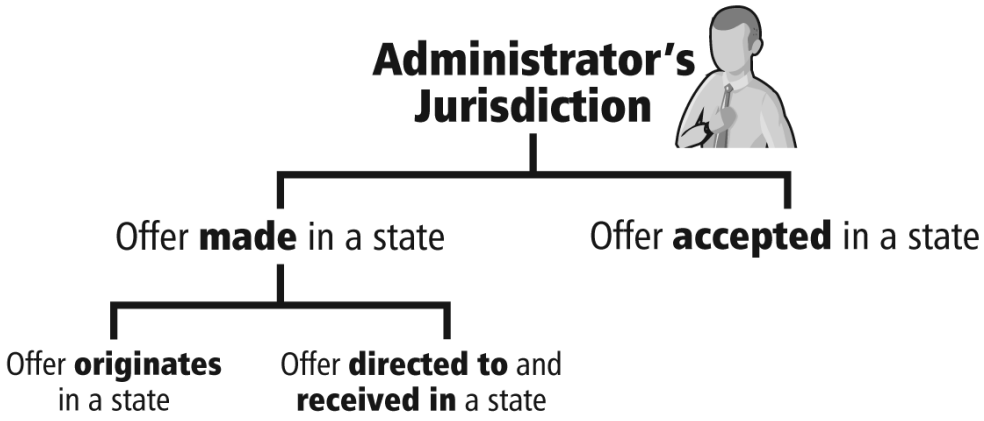
Keep in mind …

There are some situations in which state registration is not required. However, a state Administrator will still have jurisdiction over all securities-related activity.



Let's review the following example to determine when an offer and sale take place:

On Monday, Phillip, an agent of a broker-dealer, calls Jean, an existing client, and recommends that she purchase 10,000 shares of stock. Jean calls Phillip on Wednesday night and agrees to purchase the stock. The transaction is executed early on Thursday morning. When did the offer and/or sale take place?

Although Jean didn't agree to purchase the stock immediately, the offer occurred on Monday when Phillip first made the recommendation.

The sale occurred on Thursday—the day the trade was executed. The execution signals the existence of a contract in which a buyer and seller agree to exchange a security for value. Under the USA, this example describes both an offer and a sale.

Consider a few more examples to reinforce the concept of jurisdiction. To make the determination of jurisdiction, it's important to consider how an offer is being made. Offers may be made over the phone, through the mail, in a newspaper, or through radio and television broadcasts.

Mark, an agent of a broker-dealer, is located in his firm's Connecticut branch office. Mark calls and speaks with his client who lives in New Hampshire. While speaking with his client, if Mark solicits the sale of EBH, Inc. common stock, which state Administrator will have jurisdiction?

Since the offer originated in Connecticut and was directed to and received in New Hampshire, the offer is considered to have been made in Connecticut and New Hampshire. Ultimately, since the offer was made in both Connecticut and New Hampshire, the Administrators of both states have jurisdiction over the offer to sell.

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An agent of a broker-dealer, who works out of his firm's Virginia branch office, calls a client who lives in Maryland to solicit the sale of a security. The client agrees to buy the security and arranges to meet the agent at a restaurant in West Virginia to take possession of the securities and provide a check as payment. Which state Administrator has jurisdiction in this example?

The offer was made in Virginia where it originated, but also in Maryland, where it was directed, received, and accepted. Therefore, both the Virginia and Maryland state Administrators have jurisdiction. What about the Administrator of West Virginia? The USA doesn't recognize the jurisdiction of states where securities are simply delivered or where the payment is made. Therefore, the state Administrator of West Virginia doesn't have jurisdiction. Remember, the determination of which Administrator has jurisdiction is based on the details of the offer, not the details of the payment or delivery of the securities.

Herman is an agent of a broker-dealer that's located in California. To solicit the sale of a security, he sends a letter to Ms. Rose, his client who resides in Arizona. Unbeknownst to Herman, Ms. Rose is visiting her brother in Wyoming for a few weeks and is having her mail forwarded to Wyoming. Will the state Administrator from all three states have jurisdiction?

The Administrator of California will have jurisdiction since the offer originated there. Although Ms. Rose never received the offer while in Arizona, an offer was considered to be made because it was directed to and received in Arizona. The USA jurisdiction rule doesn't recognize an offer being made in any state to which mail is forwarded. Therefore, the offer is made in California and Arizona and the state Administrator of these two states will have jurisdiction over the offer.

The previous examples covered the jurisdiction rules that apply when an offer is made over the phone or through the mail. However, some offers are also made through a bona fide newspaper or through a radio or television broadcast.

In the case of an offer made through a newspaper, the Administrator of the state in which the newspaper is published has jurisdiction over the offer, but there's one exception to this rule. If the newspaper is published in a state and more than two-thirds of its circulation is outside the publishing state, then no offer is considered to have been made in the state. If that's the case, then no state Administrator will have jurisdiction.

Jill, an agent licensed in Ohio, publishes an offer to sell bonds in a local newspaper. If the newspaper has some of its circulation in Pennsylvania, is the offer considered to have been made in Pennsylvania?

No. An offer in a newspaper may only be made in the state in which the paper is published. In this example, the newspaper is published in Ohio and, since there's no indication that more than two-thirds of the circulation is outside of the publishing state, the offer is made in Ohio. Therefore, the Ohio Administrator has jurisdiction.

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If an offer is made by means of a radio or television program, the only possible state in which the offer is considered to have been made is the state from which the broadcast originates.

Jim lives in Texas and is watching a ballgame being broadcast by a station in Chicago, IL. At a break in the action, a reporter is shown interviewing an agent in Chicago. The agent is promoting a stock and provides his firm's number for interested investors. Is this considered an offer to residents of Texas?

No. Since the reporter's interview is being broadcast from Illinois, the offer is only be considered to have been made there, because the agent has no control over where the broadcast is received.

Determination of Jurisdiction Over Offers	
If Made Using U.S. Mail or Telephone	**In two states at most** – The state from which it originated and the state to which it's directed to and received in (For mail, not the state to which it may be forwarded)
If Made Using Television or Radio	**One state only** – The state in which the camera or microphone is located
If Made Using Newspaper or Magazine	**One state or no state** – The state in which the newspaper or magazine is published, unless more than two-thirds of the circulation is outside the state

Gifts of Securities

If one person gives a gift of securities to another person, is the state Administrator required to regulate it? The answer depends on the nature of the gift. Ordinarily, a gift doesn't involve a sale. Remember, the term *sale* is considered any contract or agreement to dispose of a security for value. If a security is given as a gift, the assumption is that the recipient receives it without an exchange in value (i.e., no payment is required). However, a gift of *assessable securities* involves both an offer and a sale, and is subject to the USA's requirement to disclose all material facts.

Assessable stock is a class of stock in which the issuing company is allowed to demand additional funds from existing stockholders. Testing on the concept of assessable stock is somewhat dated, considering that stock has not been issued in assessable form since the early 1900s. In order to promote awareness of the unethical sales practices that were employed in the past, the Uniform Securities Act and the Series 63 Examination may address the concept of assessable stock in questions concerning offers and sales. As a comparison, non-assessable stock is the typical stock that trades actively in the secondary market today.

Prior to the USA, individuals were able to give gifts of assessable stock without disclosing that additional capital (an assessment) was required in order to maintain ownership. Today, the Uniform Securities Act requires disclosure to be made to the recipient of the gift of assessable stock.

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Other unusual situations that involve offers and/or sales include the following:

- Any security given or delivered with, or as a bonus for, the purchase of a security, is considered both an offer and a sale. For example, if an investor buys a bond with a warrant attached, the warrant is a part of the sale, even though an investor didn't purchase it separately.
- The sale of a warrant or right enabling the holder to subscribe to purchase another security is considered an offer to sell the other security. Stated plainly, since rights and warrants are securities, a sale takes place when the warrant or right is purchased. However, warrants and rights also represent an offer to sell another security.

The following actions do NOT involve an offer or a sale:

- A bona fide pledge or loan of stock
- An exchange of securities due to a merger, reorganization, or bankruptcy
- A stock dividend, if the stockholders don't provide anything of value in return

The following situations will be used to examine whether the transactions described represent a gift, an offer, or a sale:

Al gives his nephew Eric 1,000 shares of stock that trade on the NYSE. Al tells Eric that the stock will help to cover the costs of his future college education. However, within one year, the company is bankrupt and the stock is worthless. Will the Administrator in Eric's state consider this situation to be a sale?

No. Al freely gave his nephew the stock without requiring payment or other exchange in value. While it was unfortunate that the company became insolvent, since the stock was a gift and Eric had nothing to lose, it's not considered an offer or sale. The stock Eric received was considered *non-assessable*.

Earl owns 1,000 shares of assessable Hawaiian Railroad (HRR) stock. The board of directors of HRR announces a $3.00 per share assessment to investors which must be paid over a period of two years. Earl doesn't want to put more money into the investment and decides to use the stock to entice a customer to buy products from his general store. Earl tells the customer that if he spends a certain amount of money at his store, he will give him a free gift of shares of the Hawaiian Railroad Company. How does the state Administrator view this situation?

In the 1880s, many would have considered this an *unethical* act. However, today this practice is *illegal*. Under the USA, Earl is required to disclose to the customer the ramifications of accepting a gift of assessable securities. If the customer takes possession of the assessable shares, Earl will be relieved of any obligation to pay the assessment to Hawaiian Railroad—an obligation that the customer (unknowingly) will assume. For this reason, a gift of assessable stock is considered to involve both an offer and a sale.

Good to know …

The exam may refer to a sale or an offer as a stock offering.

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Administrative Actions Associated with Registration

Although exemptions and exclusions may be available, Administrators generally require the registration of financial professionals (e.g., broker-dealers and investment advisers), the individuals who work for them (e.g., agents and investment adviser representatives), and the securities that are sold in their state. The broker-dealers, IAs, agents, IARs, and securities issuers are defined as registrants under the USA.

With this in mind, Administrators have the authority to grant registration, limit the activities of a registrant, or institute proceedings to deny a registration. The Administrator must always consider the public's best interest when rendering decisions. If a registration is already granted and the Administrator finds it in the best interest of the public, he may also:

- Suspend a registration
- Revoke a registration
- Bar a registrant from association with a registered broker-dealer or investment adviser

Possible causes for these administrative actions include the following:

1. The registrant filed an application for registration that was incomplete or contained false or misleading information pertaining to a material fact.
2. The registrant willfully violated, or willfully failed to comply with, the provisions of the Uniform Securities Act.
3. The registrant was convicted of a felony or misdemeanor involving securities within the past 10 years.
4. The registrant has been found to have violated federal or state securities or commodities laws within the past 10 years.
5. The registrant is temporarily or permanently prohibited by court order from engaging in the securities business.
6. The registrant is subject to an order of a state Administrator denying, suspending, or revoking registration.
7. The registrant is engaged in dishonest or unethical practices.
8. The registrant is determined by the Administrator to be insolvent, either because its liabilities exceed its assets or because the applicant cannot meet its current obligations as they mature.
9. The registrant is not qualified due to lack of training, experience, *and* knowledge of the securities business. (Lack of experience alone is not grounds for denial.)
10. The registrant has failed to reasonably supervise its employees to ensure compliance with the Uniform Securities Act.
11. The registrant has failed to pay the proper filing fee. However, a denial under this clause is lifted (vacated) when the fee is paid.

If action is being taken, the Administrator may postpone or suspend a registration pending a final determination of the matter. The applicant and the employing broker-dealer or investment adviser must be notified of the action, the reasons for the action, and the fact that a hearing will be scheduled within 15 days of the filing of a written request.

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Although foreign governments have no jurisdiction under the provisions of the USA, the Administrator may deny, suspend, revoke, cancel, or withdraw the registration of any registrant that has been the subject of a foreign securities regulator's disciplinary action within the past five years.

Additionally, the Administrator may deny or revoke the registration of a particular partner, officer, or director without disturbing the status of the firm. For example, the personal bankruptcy of a minority owner will not affect the status of a broker-dealer that's organized as a corporation. However, what if a broker-dealer files for bankruptcy? For broker-dealer bankruptcy, the Administrator must first request a court hearing to obtain an order to be appointed to act as the firm's receiver. As the receiver, the Administrator will conduct an orderly liquidation of the firm's assets and attempt to satisfy creditor claims. Fortunately, customer brokerage accounts are insured up to a certain level by the Securities Investor Protection Corporation (SIPC).

The disqualification of an agent of a broker-dealer or of any employee of an investment adviser may not be used against the firm unless the employee's disqualification is based on a lack of supervision. However, if the Administrator feels that it's in the public interest, the disqualification of a director, officer, or partner (as distinct from an ordinary agent), may be the basis for a proceeding against the firm's registration.

> *Jim, an agent of a broker-dealer, has been accused of unauthorized trading by a customer. After a hearing, the state Administrator revokes Jim's registration as an agent. May this disqualification be used against the broker-dealer's registration?*
>
> Yes. The Administrator may take action against Jim's broker-dealer if it's determined that the firm failed to reasonably supervise Jim's activities.

Proceedings by the Administrator must be accomplished with appropriate notice to the registrant, the opportunity for a hearing, written findings of fact, and conclusions of law. When the Administrator makes a determination after a hearing, the decision must be in writing, along with the legal basis of the decision, and the facts that support the case. If a registrant disagrees with either the legal reasoning or the truth of the facts given, this may be used as the basis for an appeal.

Although the registrant may appeal these actions, activities within the state will be suspended until a decision is rendered by a court of competent jurisdiction. An appeal must be filed with a state court within 60 days. However, the appeal doesn't stay (suspend) the Administrator's order.

Powers of the State Administrator

The power to alter a state's blue-sky laws lies with the state legislature. However, if Administrators believe it's in the public interest, they have the power to amend or repeal any rule, form, or order related to registration, reports, definitions, terms, interpretations of laws, and other activities that are necessary to carry out the provisions of the USA.

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Investigations and Subpoenas

The Administrator has the power to initiate *investigations* to determine whether any provisions of the Act have been or are about to be violated. In pursuing investigations, the Administrator may require written statements under oath detailing the facts and circumstances concerning the suspected violation. The investigations may take place in the Administrator's home state or in another state, and may be either public or private. The overall power and ability of Administrators to investigate real and potential violations of the USA is referred to as their *inspectorial power.*

The Administrator may also *subpoena* witnesses and require that they produce materials relevant to the inquiry. Subpoenas may be issued both in and outside the state. At the request of a securities agency or the Administrator of another state, an Administrator may issue subpoenas in her own state as long as the allegations under investigation constitute a potential violation in the Administrator's home state.

No person is excused from responding to a subpoena. If the subpoena is ignored, the Administrator may request enforcement by the court. Any failure to obey the court's orders is punishable as contempt of court.

Keep in mind …

No person may be prosecuted or retaliated against for testifying or providing information pursuant to a subpoena.

Cease and Desist Orders

A *cease and desist* order is a demand to halt an activity immediately or risk facing legal action. Such orders are effective as of the date of issuance. The Administrator may issue a cease and desist order against a person who's engaging in, is about to engage in, or has engaged in any act or practice that constitutes a violation of the USA. However, the Administrator doesn't have jurisdiction over violations that occur in other states.

Cease and desist orders may be issued without a hearing and must include a statement as to whether the Administrator will seek a civil penalty or intends to recover the costs of the investigation. The statement must also include the reasons for issuing the order and a notice that a hearing will be held within 15 days after a written request is made.

Injunctions

Since Administrators are not officers of the court, they cannot compel compliance with a cease and desist order. However, if an offender fails to comply with the order, the Administrator may bring action in a competent court (one with jurisdiction) to request a permanent or temporary *injunction* or restraining order. The Administrator may also seek an injunction without first issuing a cease and desist order.

Remember …

Administrators may seek, but may not issue injunctions. Only a court has the authority to issue injunctions.

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After investigating one of the brokerage firms in her state, the Administrator of Iowa has determined that the firm is selling unregistered, non-exempt securities in Iowa. Although a cease and desist order has been issued against the firm, it becomes apparent that the firm is ignoring the order. What step may the Administrator take?

The Administrator may ask the state court to issue an injunction prohibiting the firm from selling securities in Iowa. The court has the authority to fine the firm and its principals, in addition to having the owners of the firm imprisoned. Remember, ignoring a court-ordered injunction is considered contempt of court.

Cancellations and Withdrawals

An existing registration may be *cancelled* without a hearing if the Administrator determines that a registered person is no longer living, has ceased business, has been found to be mentally incompetent, or cannot be located after a reasonable search. In other words, the cancellation of a registration is not the result of a violation of the USA.

Individuals may choose to *withdraw* their registration in a state simply because they no longer intend to conduct business in that state. Withdrawals from registration become effective 30 days after the filing of a withdrawal application. If there are revocation or suspension proceedings pending at the time the withdrawal is filed, the withdrawal becomes effective at a time that's determined by the Administrator.

The Administrator has the ability to institute proceedings for up to one year following the effective date of a withdrawal. Therefore, a registrant is not able to quickly withdraw his registration in hopes of avoiding punishment for violations that have not yet become known.

A firm may also decide to withdraw its registration. If the firm's withdrawal application has been filed and determined effective, the firm must subsequently reregister in order to once again conduct business. If a broker-dealer withdraws its registration, the registrations of its agents are no longer valid. Remember, an agent's registration is only effective when he's employed by a properly registered broker-dealer.

Know the difference …

An Administrator may deny, suspend, or revoke a registration for punitive reasons. However, the cancellation or withdrawal of registration is done for non-punitive reasons.

To summarize, the role of an Administrator is to enforce state securities laws and does so through laws, rules, and orders in the following manner:

- Laws—These apply to all persons, regardless of whether they're defined as a financial services professional. For example, fraud is always a violation of state securities laws and is considered a criminal act.

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- Rules—These apply to persons who come under one of the definitions of a financial securities professional that have been described in this Study Manual. For example, if a person meets the definition of a broker-dealer or investment adviser, that person must satisfy the rules regarding registration.
- Orders—These apply to a specific person. For example, a cease and desist order may be issued to prevent an investment advisory firm from operating in a state.

Civil and Criminal Proceedings

Customers seeking remedies for monetary damages that were the result of alleged violations of the securities acts may sue in civil court. State Administrators may also bring civil cases in court to seek injunctions (court orders) in an attempt to prevent persons from violating the USA. Based on an Administrator's request, courts may order defendants to disgorge profits or remunerations that were unlawfully earned.

Only a government official may bring criminal proceedings against a person for violations of a securities act. Although Administrators have the authority to investigate securities violations and issue cease and desist orders, they must request that the attorney general or local district attorney begin criminal proceedings. Penalties for criminal violations of securities acts may include a prison sentence, a fine, or both.

Civil Liability for Securities Sold in Violation of the Act

Under certain conditions, a person who has purchased securities that were sold in violation of the Uniform Securities Act may sue the seller of the securities. A purchaser has this *right of action* when:

- The securities were sold in violation of the registration provisions of the Uniform Securities Act.
- The offer or sale was made by a person who should have been registered as a broker-dealer or agent under the Act, but was not.
- The securities sold were misrepresented (e.g., stating they were recommended or approved by the Administrator).
- The state's requirements regarding sales literature were violated in connection with the sale.
- The seller violated any requirements for the offering mandated by the Administrator (e.g., the Administrator required the delivery of a prospectus for offerings registered by qualification.)
- As part of an offer or sale, the seller made an untrue statement or omitted a material fact.

The burden of proof is on the purchaser. He must present sufficient evidence that the seller violated the USA for the case to proceed.

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If the purchaser proves that the seller committed a violation, the amount that that the purchaser may recover is determined by the following formula:

	The full purchase price of the securities
+	Interest (at a rate determined by the state)
+	Court costs and reasonable attorney fees
–	Income received from the security
	Purchaser's recovery amount

Imelda purchased 1,000 shares of stock at $18 per share. Her shares were part of an IPO that was underwritten by Bedrock Brokerage. A few months after the offering, the stock paid its first dividend of $0.25 per share. However, one week after the dividend payout, a negative report was released by the issuer and the market price of the stock plummeted. Imelda believes the issuer and Bedrock knew of the bad news at the time she purchased the stock. What recourse does Imelda have? What could she recover?

Imelda may file a lawsuit in state court against the issuer and Bedrock for omitting material facts in connection with the offering. If she wins her lawsuit against Bedrock, she may recover the original purchase price of $18,000 (1,000 shares x $18), plus interest that accrues from the day that she bought the securities until she receives her settlement, plus court costs and reasonable attorney fees, minus the $250 dividend.

Letter of Rescission A *letter of rescission* is used when a firm realizes that it has effected an illegal sale. This letter represents an offer to buy back the security, plus interest, minus any income received on the security. If the client doesn't act within 30 days of receipt of the letter, the client is generally not permitted to bring action in court.

Younge Securities has discovered that one of its agents sold a security to Ramona and it was not registered in the state in which the transaction occurred. Younge's compliance department cannot find an exemption for the transaction and, rather than waiting to be sued, sends a letter to Ramona offering to buy back the stock, plus interest, minus any dividends she may have received from the stock. Is Ramona required to accept the firm's offer?

No. Ramona may choose to ignore the firm's offer. If the stock has appreciated in value since Ramona purchased it, she may not want to rescind the trade.

If Ramona doesn't respond within 30 days of receiving the letter, she will not be able to sue Younge Securities.

Civil Liability for Fraudulent Investment Advice

Since the determination has been made regarding the level of liability that a seller has to the purchaser if certain violations of the USA occur, let's examine how a person who dispenses investment advice for a fee may be liable to an advisory client for acting in a fraudulent manner.

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The amount that an advisory client may sue to recover is determined using the following formula:

The cost of the advice
+ Any loss due to the advice
+ Interest (at a rate determined by the state)
+ Court costs and reasonable attorney fees
– Income received

Advisory client's recovery amount

Clyde has a managed account with an investment adviser. After a few months, Clyde notices that his portfolio contains a large amount of the stock of a small local company. He discovers that the company's majority owner is the husband of one of the advisory firm's senior officers. Clyde believes that the purchase of this stock for his portfolio represents a conflict of interest. Since the conflict was not disclosed, what action may Clyde take against the advisory firm?

Clyde may hire an attorney to file a lawsuit against the adviser. In the lawsuit, he may seek to recover the advisory fees paid, any loss on the stock, interest, costs, and attorney fees. However, any settlement (if Clyde wins) will be reduced by any income earned from this security while it was in his account. The liability also extends to supervisors who may be deemed guilty for failing to supervise their employees properly.

Time Limits for Civil Liabilities Under the civil liabilities section of the USA, no person may sue more than three years after the occurrence of the violation or the rendering of the investment advice, or after two years from discovering the violation—whichever occurs first.

Criminal Penalties

A criminal liability exists if a person *willfully* violates an order or provision of the Uniform Securities Act. A client doesn't need to be involved in the activity for criminal charges to be filed. The maximum penalty for each violation under the USA is a fine of $5,000, imprisonment for three years, or both. However, no prison sentence will be imposed if the person is able to prove that she had no prior knowledge of the rule or order violated.

Good to know …

Violations of the Securities Act of 1933, which is a federal law, can result in a maximum fine of $10,000 and/or up to five years imprisonment.

A state securities Administrator doesn't have the authority to impose criminal or civil penalties. Instead, these actions must be taken by the courts in each state.

Time Limits for Criminal Penalties Under the Uniform Securities Act, the statute of limitations for criminal penalties is five years after the alleged violation. This provision is used if the state doesn't have a general criminal statute of limitations.

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Chapter 7 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Define the terms *offer* and *sale*
- Recognize the offers and sales over which an Administrator has jurisdiction
- Understand when a gift is considered both an offer and sale
- List the administrative actions that an Administrator may take against a registered person and the reason for such actions
- Understand the *inspectorial powers* of the Administrator
- Understand civil proceedings, including parties involved, liabilities, and the statute of limitations
- Understand a letter of recission and when it's issued
- Understand criminal proceedings, including parties involved, penalties, and the statute of limitations

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