Series 65 Exam Preparation Textbook

Comprehensive Course Text, Worked Examples, and Practice Questions

2026 Course Edition

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This text is accompanied by a corresponding video lecture series and an online practice question bank, both referenced in the Introduction. These companion materials are provided as independent study aids and are subject to their own separate terms of use.

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Introduction

I created this book during a sabbatical from my position as a finance professor. I have taught at the university level for more than twenty years, and in recent years a growing number of my students have asked me where they can find reliable materials to prepare for the Series 65 exam. I have also spoken with employers who require new hires to pass the Series 65 exam before they can begin working as investment adviser representatives. I decided to use my sabbatical to close that gap.

Much of what I have taught in my courses over the past two decades overlaps directly with the material on the Series 65 exam: economics, financial statement analysis, portfolio theory, taxation, retirement planning, and the ethical and regulatory duties advisers owe their clients. I wrote this text to organize that material specifically around the exam and the content outline provided by the NASAA for the Series 65 exam, so you are not left guessing which parts of a general finance education matter for licensing.

The exam, and this book, share a single purpose: preparing you to work competently and ethically as an Investment Adviser Representative. Every lesson in this book ties back to that goal, whether it covers economic indicators, portfolio construction, retirement accounts, or the regulatory duties owed to clients.

This text is one part of a complete study system. I have also recorded a full set of video lectures that follow this book lesson by lesson, so you can watch me walk through the same material you are reading here. Alongside the book and videos, I have built an online question bank where you can practice exam-style questions on every topic covered in this text. I designed the practice quizzes to help you identify your weak areas, so you know exactly where to focus your remaining study time instead of reviewing material you have already mastered. Those materials can be found at https://www.vandalsemfinancelab.com.

I hope this book, together with the video lectures and the question bank, gives you an efficient and reliable path to passing the Series 65 exam and starting your career as an Investment Adviser Representative.

Shane A. Van Dalsem, PhD

Part I. Economic Factors and Business Information

Lesson 1: Business Cycles

Learning Objectives

- Define a **business cycle** and distinguish the major phases of **expansion**, **peak**, **contraction**, **trough**, and recovery.
- Explain how business cycles are measured and dated using economic indicators rather than a single rule.
- Differentiate **leading**, **coincident**, and **lagging indicators** and connect them to investment analysis.
- Describe how cash, bonds, stocks, sectors, commodities, real estate, and alternative assets tend to behave across the cycle.
- Apply business-cycle concepts to Series 65-style investment recommendation questions while recognizing the limits of forecasting.

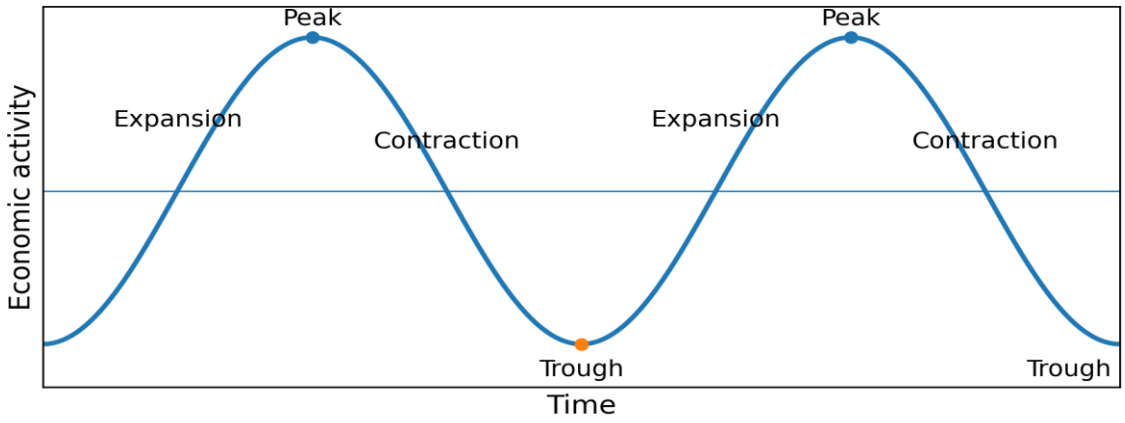


Figure 1.1: A business cycle. Actual cycles vary in length, depth, and shape; financial markets often begin repricing before official economic data confirm a turning point.

1.1 What Is a Business Cycle?

A business cycle is the recurring rise and fall in overall economic activity. It is not the same thing as a calendar year, a presidential term, or a stock market cycle. It describes broad movements in production, employment, income, spending, credit conditions, and business confidence.

Business cycles matter to investors because corporate profits, interest rates, credit quality, inflation, and investor risk appetite tend to change as the economy moves through different phases. A client with a long time horizon should not normally change an entire portfolio based on a forecast, but advisers should understand how the cycle can affect risk, expected return, and suitability.

A key exam point is that business cycles are uneven. Expansions can last many years, contractions can be brief or severe, and the economy can move through rolling sector slowdowns without entering a broad recession. The labels are useful, but the real world is messy.

1.2 The Main Phases of the Cycle

Expansion. Economic activity is increasing. Employment, income, production, retail sales, and business investment generally improve. Credit conditions are usually easier than they were during the prior downturn. Corporate earnings often rise, although inflationary pressure may eventually build.

Peak. A peak is the high point before a broad slowdown. Labor markets may look strong, capacity utilization may be high, inflation pressure may be rising, and central banks may be tightening monetary policy. Importantly, a peak is usually identified after the fact.

Contraction or recession. Economic activity declines across much of the economy. Sales weaken, corporate profits fall, unemployment rises, credit spreads widen, and households and businesses may reduce spending. Not every slowdown is a recession; a recession requires breadth, depth, and duration.

Trough. A trough is the low point before economic activity begins to recover. It is often difficult to recognize in real time because the news still feels bad. Financial markets may begin improving before employment and earnings data fully recover.

Recovery or early expansion. Growth resumes from a depressed level. Monetary policy may remain accommodative, credit conditions gradually improve, and risk assets may recover as investors begin discounting better future earnings.

Business Cycle Phase Summary

Phase	Economic conditions	Inflation / rates	Corporate profits	Common investment implications
Early recovery	Growth turns positive from a low base; unemployment remains elevated but improves.	Rates may be low; policy may remain supportive.	Profits rebound from depressed levels.	Equities, cyclical sectors, small-cap stocks, high-yield bonds, and credit-sensitive assets may recover early, but volatility remains high.

Phase	Economic conditions	Inflation / rates	Corporate profits	Common investment implications
Mid expansion	Growth broadens; employment and consumer spending improve.	Inflation often contained; rates may normalize.	Profits generally increase.	Broad equities, investment-grade credit, real estate, and balanced portfolios often perform well.
Late expansion	Economy runs closer to capacity; wage and input pressures may rise.	Inflation pressure and central-bank tightening become more important.	Margins may peak or compress.	Quality stocks, value/income strategies, shorter-duration bonds, TIPS, commodities, energy, and defensive positioning may become more attractive.
Contraction	GDP, employment, income, production, and sales weaken broadly.	Rates may eventually fall, but credit conditions tighten.	Profits decline; defaults may rise.	Cash, Treasury securities, high-quality bonds, defensive sectors, and lower-volatility strategies often hold up better. Cyclical firms, high yield bonds, and small caps may struggle.

Phase	Economic conditions	Inflation / rates	Corporate profits	Common investment implications
Trough / new recovery	Data still weak, but the rate of deterioration slows.	Policy may be accommodative; yield curve may steepen.	Forward-looking profit expectations begin improving.	Risk assets can begin recovering before the economy feels healthy. Rebalancing discipline matters.

1.3 How Business Cycles Are Measured and Determined

There is no single statistic that perfectly measures the business cycle. Analysts look for broad, persistent changes in economic activity. In the United States, the National Bureau of Economic Research Business (NBER) Cycle Dating Committee is widely treated as the official historical judge of recession peaks and troughs. Its approach focuses on whether there is a significant, economy-wide decline in activity that lasts more than a few months.

A common shortcut says that a recession means two consecutive quarters of negative real GDP growth. This rule of thumb is useful for quick conversation, but it is not the official approach. GDP can be revised, and some downturns may show broad weakness even before two quarterly GDP readings are available.

Economic indicators are pieces of evidence. A good analyst asks whether the evidence is broad, persistent, and consistent across production, income, employment, and spending.

Major Indicators Used to Read the Cycle

Indicator	What it measures	Typical interpretation
Real GDP	Inflation-adjusted value of final goods and services produced.	Broadest common measure of economic output; reported quarterly and revised as more data arrive.
Employment and unemployment	Labor-market strength, payrolls, unemployment rate, job openings, and claims.	Employment is usually coincident to lagging; layoffs and unemployment rise in contractions.

Indicator	What it measures	Typical interpretation
Real personal income	Household income adjusted for inflation, often excluding transfer payments for cycle analysis.	Rising real income supports consumption; falling real income can signal stress.
Industrial production	Output from manufacturing, mining, and utilities.	Sensitive to business demand and inventory cycles; often weakens before or during downturns.
Retail and wholesale sales	Final and intermediate spending activity.	Broad sales declines show weakening demand.
CPI / inflation	Change in consumer prices.	Inflation can rise late in expansions and fall in recessions, but supply shocks can complicate the pattern.
Yield curve / term spread	Difference between longer-term and shorter-term interest rates.	An inverted curve has historically warned that monetary policy is tight and recession risk is elevated.
Credit spreads	Extra yield investors demand for riskier bonds over Treasuries.	Widening spreads indicate rising default and liquidity concerns; narrowing spreads indicate improving risk appetite.
Trade deficit	Imports minus exports, often discussed in GDP and global context.	Can affect GDP accounting and currency analysis; not a standalone recession signal.

1.4 Leading, Coincident, and Lagging Indicators

Economic indicators are often grouped by timing. **Leading indicators** tend to move before the overall economy, **coincident indicators** move roughly with the economy, and **lagging indicators** move after the economy has already changed direction.

This timing distinction is important for investments. Financial markets are forward looking. Stocks and credit spreads often move before the data series that later confirm the cycle phase. A recession may not be officially dated until after it has already begun, and a recovery in stocks may occur while unemployment is still rising.

Type	Examples	How to use it
Leading	Yield curve, new orders, building permits, stock prices, credit conditions, initial unemployment claims.	Helpful for assessing future risk, but not precise enough to rely on alone.
Coincident	Payroll employment, real income, industrial production, real sales.	Useful for confirming the current state of the economy.
Lagging	Unemployment rate, corporate defaults, inflation measures in some settings, loan delinquencies.	Useful for confirming stress after the turn has begun; often poor timing tools.

1.5 Investment Performance Across the Business Cycle

The relationship between the business cycle and investment performance is probabilistic, not guaranteed. Asset prices reflect expectations about the future, so markets may move before the economy officially changes phase. Still, the cycle provides a useful framework for thinking about risk, return, diversification, and portfolio suitability.

A disciplined adviser should avoid making extreme all-or-nothing allocation changes based on a forecast. Instead, business-cycle awareness can inform modest tilts, risk controls, rebalancing decisions, income planning, and conversations with clients about volatility.

Asset / strategy	Early recovery	Mid expansion	Late expansion	Contraction / recession
Cash / money markets	Low return but valuable liquidity.	Return improves if rates normalize.	Attractive if short rates are high.	Capital preservation and spending liquidity.
Treasury securities	May lag if risk appetite improves and yields rise.	Diversifier; performance depends on rate path.	Shorter duration may reduce rate risk.	Often strong if yields fall and investors seek safety.

Asset / strategy	Early recovery	Mid expansion	Late expansion	Contraction / recession
Investment-grade corporate bonds	Credit spreads may narrow; total returns can improve.	Income plus moderate credit exposure.	Sensitive to rate increases and spread widening.	Higher quality usually preferred; spreads can widen.
High-yield bonds	Often strong as default fears recede.	Can perform well when growth is steady.	Risk increases if leverage and spreads look stretched.	Vulnerable to defaults, downgrades, and liquidity stress.
Broad equities	Often rebound early as future earnings are repriced.	Earnings growth can support returns.	Volatility rises if rates and inflation pressure valuations.	Often decline before or during recessions, though recovery may start before data improve.
Small-cap / cyclical stocks	Can lead when growth accelerates.	Participate if credit and demand remain supportive.	Higher sensitivity to slowing growth and higher financing costs.	Typically more vulnerable than defensive large caps.
Defensive sectors	May lag aggressive risk-on markets.	Provide stability but may underperform cyclicals.	Often become more attractive as investors seek quality.	Utilities, consumer staples, and health care may hold up better.
Commodities / energy	Industrial commodities can recover with demand.	May perform well as growth broadens.	Often benefit from inflation or supply constraints.	Demand-sensitive commodities may weaken unless supply shocks dominate.

Asset / strategy	Early recovery	Mid expansion	Late expansion	Contraction / recession
TIPS	Useful if inflation expectations rise.	Inflation hedge with real-rate sensitivity.	Attractive when inflation risk is prominent.	Can help preserve purchasing power, but may be hurt by rising real rates.
REITs / real estate	May recover as credit conditions improve.	Income and growth if rates are stable.	Vulnerable to higher rates and tighter credit.	Can struggle if financing costs rise and occupancy weakens.

1.6 Sector Rotation and Portfolio Strategy

Sector rotation is a tactical strategy that changes sector exposure based on the expected stage of the business cycle. It is related to, but different from, strategic asset allocation. Strategic asset allocation sets long-term portfolio weights based on a client's objectives, time horizon, risk tolerance, and constraints. Tactical allocation makes shorter-term tilts around those long-term weights.

Typical early-cycle leadership may include consumer discretionary, financials, industrials, materials, small-cap stocks, and credit-sensitive assets. Mid-cycle leadership may broaden. Late-cycle leadership often shifts toward energy, commodities, quality companies, dividend payers, and inflation-sensitive assets. Recession leadership often shifts toward defensive sectors, high-quality bonds, and cash.

In practice, the safest answer is usually not "put everything in the asset that worked last cycle." The better response is to preserve diversification, match the recommendation to the client profile, and understand that cycle-based positioning is a risk-management tool rather than a promise of outperformance.

1.7 Practical Examples

Example 1: Retiree in a late-cycle environment

A retired client depends on portfolio withdrawals and has low risk tolerance. Inflation and short-term rates are elevated, and credit spreads are beginning to widen. A suitable response may include maintaining cash reserves for near-term spending, emphasizing high-quality bonds with controlled duration, avoiding excessive high-yield exposure, and keeping equity exposure diversified rather than aggressively chasing cyclical sectors.

Example 2: Younger accumulator during a recession

A 35-year-old client with stable employment, a long time horizon, and high risk tolerance is investing monthly. A recession has caused equity prices to fall. The adviser may explain dollar-cost averaging, rebalancing into target equity exposure, and the risk that markets can decline further. The client's time horizon makes panic selling less suitable, but the recommendation must still account for emergency savings and risk tolerance.

Example 3: Business owner near a cyclical peak

A business owner whose personal income is tied to a cyclical industry may already have high economic exposure to the business cycle. Even if the client is optimistic, the adviser should consider diversification away from concentrated cyclical risk, adequate liquidity, and avoiding leverage that could become problematic in a downturn.

1.8 Series 65 Exam Tips

- Do not confuse a business cycle with a stock market cycle. Stocks often turn before the economy turns.
- A recession is not officially defined solely by two quarters of negative GDP growth. That is a common shortcut, not the full dating process.
- Leading indicators are useful but imperfect. A yield-curve inversion raises recession risk; it does not guarantee the exact timing of a recession.
- Client suitability still dominates. A cycle forecast does not override risk tolerance, liquidity needs, tax situation, time horizon, or investment objectives.
- Defensive investments may reduce downside risk in contractions, but they may lag during expansions. Risk management involves trade-offs.
- Inflation, interest rates, yield curves, and credit spreads are not separate from the business cycle; they are part of the economic environment that affects asset prices.

Key Terms

Term	Definition
Business cycle	Recurring expansion and contraction in broad economic activity.
Expansion	A period when economic activity is increasing.
Peak	The high point of activity before a downturn begins.
Contraction	A period when economic activity declines; a recession is a broad, significant contraction lasting more than a few months.

Term	Definition
Trough	The low point before recovery begins.
Leading indicator	A data series that tends to move before the overall economy.
Coincident indicator	A data series that tends to move with the overall economy.
Lagging indicator	A data series that tends to move after the economy has already changed direction.
Yield curve	A graph of interest rates by maturity for bonds of similar credit quality, often Treasury securities.
Credit spread	The additional yield above a benchmark Treasury that investors require for **credit risk**.

References and Further Reading

- North American Securities Administrators Association (NASAA). Series 65 Test Specifications, effective June 12, 2023. Uploaded outline used to identify business cycles as the first topic under Basic Economic Concepts.
- National Bureau of Economic Research. Business Cycle Dating and Business Cycle Dating Procedure: Frequently Asked Questions. Used for the definition and official U.S. recession dating framework.
- U.S. Bureau of Economic Analysis. Gross Domestic Product learning resources and GDP data descriptions. Used for GDP measurement and revision explanation.
- Federal Reserve Bank of New York. The Yield Curve as a Leading Indicator. Used for the term spread / yield curve discussion.
- The Conference Board. U.S. Leading Economic Indicators. Used for the leading, coincident, and lagging indicator framework.

Practice Questions

1. Which statement best describes a business cycle?

A. The daily fluctuation in stock prices
B. The pattern of dividend payments across industries
C. The annual federal budget process
D. The recurring expansion and contraction of broad economic activity

2. Why is the "two consecutive quarters of negative GDP growth" rule incomplete?

A. Recessions can only be measured by the unemployment rate
B. It ignores interest rates
C. Official cycle dating considers broader evidence across the economy
D. GDP is not an economic indicator

3. Which indicator is typically considered leading?

A. Final revised GDP from several years ago
B. Initial unemployment claims
C. Corporate defaults after a credit crisis
D. The unemployment rate after layoffs have already occurred

4. Which asset class often benefits when investors seek safety during a recession?

A. Distressed high-yield bonds
B. Treasury securities
C. Highly leveraged cyclical stocks
D. Speculative small-cap stocks

5. A long-term investor continues monthly purchases during a recession. Which concept best supports this strategy?

A. A guaranteed return
B. Margin trading
C. Dollar-cost averaging
D. Selling away

6. Which statement about cycle-based investing is most accurate?

A. It is a probabilistic risk-management framework
B. It applies only to municipal bonds
C. It guarantees outperformance if the phase is identified correctly
D. It should replace suitability analysis

Answer Key and Explanations

1. D — The recurring expansion and contraction of broad economic activity

2. C — Official cycle dating considers broader evidence across the economy

3. B — Initial unemployment claims

4. B — Treasury securities

5. C — Dollar-cost averaging

6. A — It is a probabilistic risk-management framework

Lesson 2: Fiscal and Monetary Policy

Learning Objectives

- Distinguish **fiscal policy** from **monetary policy** and identify the institutions responsible for each.
- Explain **expansionary** and **contractionary** policy tools in plain language.
- Describe how policy changes transmit through interest rates, aggregate demand, inflation, employment, and investor expectations.
- Evaluate how stocks, bonds, cash, real assets, and international investments may respond to different policy environments.

2.1 Why Policy Matters to Investors

Fiscal and **monetary policy** are two of the most important macroeconomic forces investors monitor. They influence growth, inflation, interest rates, credit conditions, corporate profits, valuation multiples, and investor risk appetite. A Series 65 candidate does not need to forecast policy perfectly, but should understand the direction of policy and how that direction tends to affect different investments.

Policy should be interpreted in context. A tax cut, spending bill, interest-rate cut, or bond-purchase program may be bullish or bearish depending on why it is being used. Stimulus during a recession may support recovery; stimulus when the economy is already overheating may raise inflation concerns. Tightening during high inflation may restore price stability over time; tightening during a weak economy may increase recession risk.

Exam point
Fiscal policy is primarily associated with elected government officials. Monetary policy is primarily associated with the Federal Reserve. Series 65 questions often test who does what and whether a policy is expansionary or contractionary.

2.2 Fiscal Policy

Fiscal policy uses government spending, taxation, transfer payments, and borrowing to influence the economy. It affects aggregate demand directly when the government buys goods and services and indirectly when taxes or transfers change household and business income.

Main Fiscal Policy Tools

Fiscal policy tool	How it affects the economy
Government spending	Infrastructure projects, defense spending, grants, public-sector salaries, and purchases from private firms can directly increase demand.

Fiscal policy tool	How it affects the economy
Taxes	Lower taxes generally leave households or businesses with more after-tax income. Higher taxes generally reduce after-tax income and can slow demand.
Transfer payments	Payments such as unemployment benefits, **Social Security**, or other benefits can support household income and consumption.
Deficits and surpluses	A deficit occurs when government spending exceeds revenues. A surplus occurs when revenues exceed spending. Deficits are financed by borrowing.
Debt management	The maturity, amount, and perceived sustainability of government borrowing can affect interest rates, inflation expectations, and private investment.

Expansionary Fiscal Policy

Expansionary fiscal policy is designed to increase economic activity. It usually involves higher government spending, lower taxes, larger transfer payments, or some combination of the three. The goal is to increase aggregate demand, support employment, and reduce the severity of a slowdown.

- **Typical tools:** Increase government spending, cut taxes, increase transfer payments, or run larger deficits.
- **Likely short-run effect:** Higher demand, higher employment, stronger corporate revenues, and potentially higher inflation if the economy has limited spare capacity.
- **Investment relevance:** Cyclical equities and companies tied to government spending may benefit, but bond investors may worry about higher issuance, higher inflation, or higher long-term rates.

Contractionary Fiscal Policy

Contractionary fiscal policy is designed to slow economic activity or reduce inflationary pressure. It usually involves lower government spending, higher taxes, reduced transfer payments, or smaller deficits. This policy can reduce demand, but it can also weigh on employment and corporate earnings in the short run.

- **Typical tools:** Reduce spending, raise taxes, reduce transfer payments, or decrease deficits.

- **Likely short-run effect:** Lower demand, slower growth, lower inflation pressure, and potentially lower government borrowing needs.
- **Investment relevance:** Defensive equities and high-quality bonds may be relatively more attractive if growth slows and inflation expectations decline.

Automatic Stabilizers vs. Discretionary Fiscal Policy

Some fiscal policy responds automatically to the business cycle. For example, tax receipts tend to fall during recessions because incomes and profits fall, while certain benefit payments tend to rise. These automatic stabilizers support demand without a new law. Discretionary fiscal policy, by contrast, requires an active decision, such as passing a stimulus package or changing tax law.

Feature	Automatic stabilizers	Discretionary fiscal policy
Requires new legislation?	No, not for the automatic response.	Usually yes.
Speed	Can begin quickly because formulas already exist.	May be delayed by debate, design, and implementation.
Examples	Income taxes, unemployment insurance, means-tested benefits.	New stimulus checks, special infrastructure bill, temporary tax cut.
Main risk	May be too small or not targeted enough.	May arrive late or be poorly targeted.

Fiscal Policy Limitations

- **Recognition lag:** Policymakers may not know immediately whether a slowdown, recovery, or inflation problem is temporary or persistent.
- **Implementation lag:** Fiscal policy often requires political negotiation, legislation, and administrative rollout.
- **Impact lag:** Even after a policy is enacted, it may take months or years to fully affect employment, inflation, and output.
- **Crowding out:** Government borrowing can compete with private borrowing, potentially pushing interest rates higher and reducing private investment.
- **Debt sustainability:** Persistent deficits can raise concerns about future taxes, inflation, or the government's ability to manage debt costs.
- **Targeting problem:** Stimulus is most effective when it reaches households or businesses likely to spend; poorly targeted policy can be less effective or inflationary.

2.3 Monetary Policy

Monetary policy is conducted by the Federal Reserve in the United States. It affects the economy mainly by influencing short-term interest rates, liquidity, credit conditions, financial conditions, and expectations. Because financial markets update quickly, monetary policy often affects bond yields, stock prices, mortgage rates, and the value of the dollar before its full effect appears in employment or inflation data.

Difference between Monetary and Fiscal Policies
Fiscal policy changes government budgets. Monetary policy changes the price and availability of money and credit.

The Federal Reserve and the FOMC

The Federal Reserve System includes the Board of Governors, 12 regional Federal Reserve Banks, and the Federal Open Market Committee. The FOMC is especially important because it sets the target range for the federal funds rate and directs open market operations. In exam terms, the Fed is the central bank; the FOMC is the key monetary-policy decision-making body.

Main Monetary Policy Tools

Monetary policy tool	Purpose and effect
Federal funds target range	The FOMC sets a target range for the overnight federal funds rate. Changes in this target influence many other short-term rates.
Open market operations	Purchases or sales of securities help implement the target rate and manage reserves and liquidity.
Interest on reserve balances	The Fed can pay interest on reserve balances, which helps establish a floor under short-term rates in the banking system.
Discount rate	The rate charged to banks that borrow from the Federal Reserve discount window.
Reserve requirements	Rules governing required reserves have historically been a monetary-policy tool, though they are less central in the modern ample-reserves framework.

Monetary policy tool	Purpose and effect
Forward guidance	Fed communications about likely future policy can influence expectations, yields, and asset prices.
Balance sheet policy	Large-scale asset purchases or reductions can influence longer-term yields and financial conditions.

Expansionary Monetary Policy

Expansionary monetary policy is intended to stimulate economic activity. The Fed generally makes policy more accommodative by lowering short-term interest rates, increasing liquidity, or communicating that rates may stay lower for longer. Lower rates reduce borrowing costs and can increase the present value of future cash flows, which is especially relevant for growth stocks and long-duration assets.

- **Typical tools:** Lower the federal funds target range, buy securities, provide liquidity, or use accommodative forward guidance.
- **Likely effect:** Lower borrowing costs, easier credit conditions, stronger demand, higher asset prices, and potentially higher inflation if demand exceeds supply.
- **Investment relevance:** Bond prices often rise when market rates fall. Growth stocks, real estate, and credit-sensitive assets may benefit, though results depend on whether easing is responding to a mild slowdown or a severe crisis.

Contractionary Monetary Policy

Contractionary monetary policy is intended to slow demand and reduce inflationary pressure. The Fed generally tightens policy by raising short-term interest rates, reducing liquidity, or communicating a restrictive stance. Higher rates increase borrowing costs, make cash and short-term instruments more competitive, and can reduce the present value of future cash flows.

- **Typical tools:** Raise the federal funds target range, sell securities or allow securities to mature without reinvestment, reduce liquidity, or use restrictive forward guidance.
- **Likely effect:** Higher borrowing costs, tighter credit conditions, slower demand, lower inflation pressure over time, and higher risk of recession if policy becomes very restrictive.
- **Investment relevance:** Long-duration bonds and long-duration equities can be pressured by rising rates. Cash, Treasury bills, floating-rate securities, and defensive equities may look relatively more attractive.

Monetary Policy Transmission

Monetary policy works through several channels. The **interest-rate channel** affects borrowing and saving decisions. The **credit channel** affects the willingness and ability of lenders to make loans. The **wealth channel** affects household and business confidence through asset prices. The expectations channel affects how investors, consumers, and businesses plan for future inflation, rates, and growth.

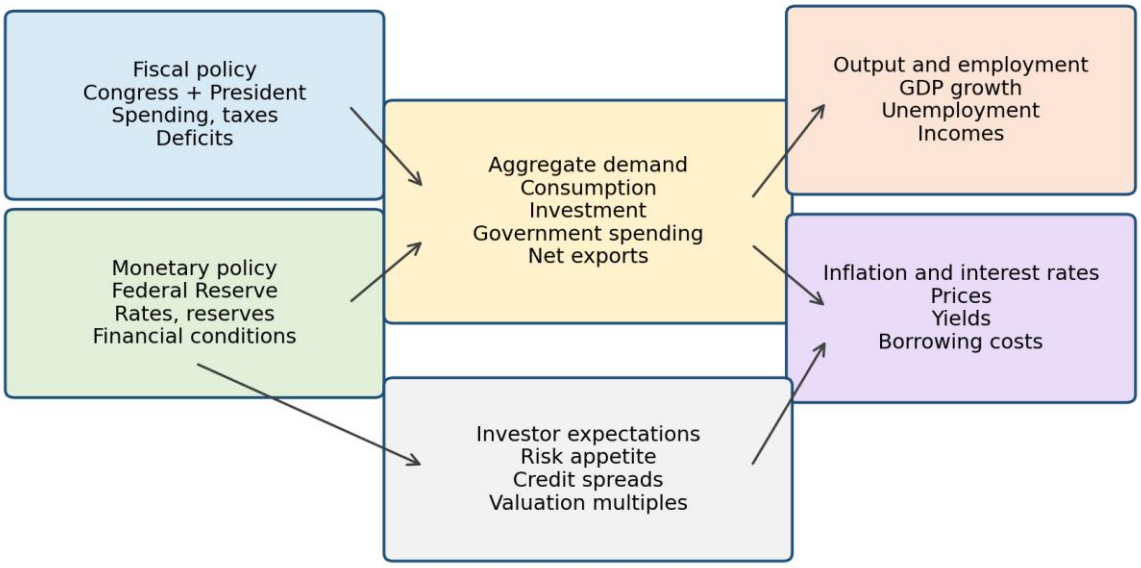


Figure 2.1: Fiscal and Monetary Policy Transmission

2.4 Expansionary vs. Contractionary Policy Summary

Policy type	Who uses it?	Expansionary examples	Contractionary examples	Primary goal
Fiscal	Congress and President	Increase spending; cut taxes; increase transfers; run larger deficits	Cut spending; raise taxes; reduce transfers; shrink deficits	Influence aggregate demand through the government budget
Monetary	Federal Reserve / FOMC	Lower policy rates; buy securities; increase liquidity; accommodative guidance	Raise policy rates; reduce liquidity; restrictive guidance; balance sheet runoff	Influence rates, credit, liquidity, expectations, and financial conditions

2.5 Policy Mix: When Fiscal and Monetary Policy Interact

Fiscal and monetary policy often operate at the same time. Their effects can reinforce each other, offset each other, or create tension. The policy mix matters because investors are pricing the combined effect on growth, inflation, interest rates, and corporate earnings.

Policy mix	Economic interpretation	Possible investment implications
Loose fiscal + loose monetary	Strongest demand support. Can be powerful during recession, but may raise inflation risk if the economy is near capacity.	Cyclicals, credit, and risk assets may benefit; inflation-sensitive assets may also attract attention.
Loose fiscal + tight monetary	Fiscal policy supports demand while monetary policy tries to restrain inflation.	Long-term rates may rise; equity leadership may be uneven; cash yields may be attractive.
Tight fiscal + loose monetary	Government demand weakens while the Fed tries to support credit and private-sector activity.	High-quality bonds may benefit if inflation expectations decline; rate-sensitive assets may improve.
Tight fiscal + tight monetary	Demand is restrained from both directions.	Defensive assets may outperform; recession risk rises; cash and short-term high-quality fixed income may be attractive.

2.6 Policy and the Business Cycle

Policy decisions are closely tied to the business cycle. During recession or early recovery, policymakers may prefer expansionary tools to support demand and employment. During late-cycle overheating or high inflation, policymakers may prefer contractionary tools to slow demand and restore price stability. The difficult case is stagflation, when growth is weak but inflation is high. In that environment, the goals of supporting employment and reducing inflation can conflict.

Economic environment	Fiscal policy tendency	Monetary policy tendency	Investor focus
Recession / contraction	Stimulus, automatic stabilizers, deficits may widen	Rate cuts, liquidity support, easier guidance	Credit quality, duration, defensive cash flows, recovery candidates
Early expansion	Stimulus may remain in place, then gradually fade	Policy may remain accommodative	Cyclicals, credit spreads, small/mid-cap sensitivity, earnings recovery
Mid-cycle expansion	Policy may normalize	Neutral or gradually less accommodative	Earnings growth, valuation discipline, sector rotation
Late-cycle / overheating	Less stimulus or fiscal restraint may be discussed	Rate hikes or restrictive policy	Inflation hedges, cash yields, defensive sectors, duration risk
Stagflation risk	May face pressure to support households while inflation remains high	May tighten despite weak growth	Real assets, pricing power, quality balance sheets, shorter duration

2.7 Investment Performance Implications

Policy changes do not mechanically determine investment returns, but they change the environment in which securities are priced. Investors should connect policy to discount rates, expected cash flows, inflation expectations, credit risk, and risk appetite.

Bonds and Interest-Rate Risk

Bond prices and market interest rates move in opposite directions. When policy easing causes market yields to fall, existing fixed-rate bonds generally rise in price. When policy tightening pushes market yields higher, existing fixed-rate bonds generally fall in price. Duration measures a bond's sensitivity to interest-rate changes, so long-duration bonds are generally more affected by policy-rate expectations than short-duration bonds.

- **Short-term bonds and cash:** Respond quickly to changes in policy rates. They may become more attractive during tightening because yields rise.

- **Long-term bonds:** More sensitive to changes in expected inflation, real rates, and future Fed policy.
- **Credit bonds:** Affected by both Treasury yields and credit spreads. Easing may help spreads, while recession risk may widen spreads.
- **TIPS:** May help when inflation expectations rise, but they are still affected by real interest rates and duration.

Stocks and Valuation

Stocks are affected through expected earnings and discount rates. Expansionary policy can support earnings by boosting demand, and lower rates can increase the present value of future cash flows. Contractionary policy can reduce valuation multiples if discount rates rise and can pressure earnings if demand slows.

- **Growth stocks:** Often more sensitive to interest rates because more of their expected value is tied to future cash flows.
- **Value stocks:** May be less rate-sensitive than high-growth stocks, but still depend on economic conditions and sector exposures.
- **Cyclical stocks:** Tend to benefit when policy supports recovery and demand accelerates.
- **Defensive stocks:** May hold up better when policy tightening raises recession risk.
- **Financial stocks:** Can benefit from higher rates if net interest margins improve, but can suffer if credit losses rise or the yield curve inverts.

Real Assets, Commodities, and Real Estate

Real assets are often discussed when fiscal stimulus or easy monetary policy raises inflation concerns. Commodities may benefit from stronger demand or supply constraints. Real estate can benefit from lower financing costs, but it can be hurt when rates rise and capitalization rates adjust upward. Infrastructure spending can affect construction, materials, industrials, utilities, and transportation-related firms.

International Investments and Currency Effects

Policy differences across countries can affect exchange rates and international returns. Higher domestic interest rates may support a currency, all else equal, while lower rates may reduce currency support. Fiscal deficits, inflation expectations, and relative growth prospects also matter. For U.S. investors, currency movement can either add to or subtract from local-market investment returns.

Practical Asset Allocation Guidance

Policy environment	Assets that may benefit	Assets that may face pressure	Why
Easier monetary policy	Intermediate/long bonds, growth stocks, REITs, credit-sensitive assets	Cash yields may fall; weak-economy sectors may still struggle	Lower rates reduce discount rates and borrowing costs.
Tighter monetary policy	Cash, Treasury bills, floating-rate securities, defensive stocks	Long-duration bonds, expensive growth stocks, highly leveraged firms	Higher rates increase discount rates and financing costs.
Expansionary fiscal policy	Cyclicals, industrials, materials, infrastructure beneficiaries, small/mid-cap firms	Long bonds if inflation or issuance concerns rise	Higher government demand can support revenues but may lift rates.
Contractionary fiscal policy	High-quality bonds and defensive equities may be relatively attractive	Cyclicals and firms dependent on public spending	Lower demand can slow growth and reduce inflation pressure.
High inflation + tightening	Short duration, TIPS, commodities, quality firms with pricing power	Long-duration assets, low-margin firms, highly indebted borrowers	Investors focus on real returns and financing pressure.

Adviser perspective
Policy analysis should support suitability, diversification, and risk management. It should not become a promise that a particular asset class will perform a certain way. The Series 65 exam often expects directional reasoning, not market timing certainty.

2.8 Common Exam Traps

- **Mixing up policy authorities:** Congress and the President control fiscal policy; the Federal Reserve controls monetary policy.
- **Confusing expansionary and contractionary actions:** Tax cuts and spending increases are expansionary fiscal policy. Rate cuts and bond purchases are expansionary monetary policy.

- **Ignoring inflation:** Expansionary policy can support growth, but if the economy has little slack it can also increase inflation pressure.
- **Assuming bond yields and prices move together:** They move inversely. Higher yields reduce prices of existing fixed-rate bonds.
- **Assuming the Fed directly sets all interest rates:** The Fed targets short-term rates and influences broader rates through policy expectations and financial conditions.
- **Forgetting time lags:** Fiscal policy can be slow to enact; monetary policy can move financial markets quickly, but the real-economy effects still take time.

2.9 Lesson Summary

- Fiscal policy uses government spending, taxes, transfers, deficits, and borrowing to influence aggregate demand.
- Monetary policy uses central bank tools to influence short-term rates, liquidity, credit conditions, expectations, and financial conditions.
- Expansionary policies are generally used to stimulate growth; contractionary policies are generally used to reduce inflation or cool overheating.
- Policy affects investments through discount rates, earnings expectations, inflation expectations, credit spreads, currency values, and investor risk appetite.
- The investment implications of policy depend on the business-cycle stage, inflation conditions, valuation, and whether policy is expected or surprising.
- For Series 65 purposes, know the policy authority, the direction of the policy action, and the likely directional effect on rates, bond prices, inflation, and economic growth.

Key Terms

Term	Definition
Fiscal policy	Government decisions about taxation, spending, transfer payments, deficits, and borrowing.
Monetary policy	Central bank actions and communications that influence short-term interest rates, credit conditions, money, and overall financial conditions.
Expansionary policy	Policy intended to stimulate economic activity, usually by increasing demand, lowering borrowing costs, or both.
Contractionary policy	Policy intended to slow economic activity or reduce inflationary pressure.

Term	Definition
Automatic stabilizers	Tax and spending mechanisms that change with the business cycle without a new vote, such as progressive income taxes or unemployment benefits.
Discretionary policy	Policy that requires active legislative, executive, or central bank action.
Federal funds rate	The overnight rate at which depository institutions lend reserve balances to one another; it is the Fed's primary short-term policy rate target.
Open market operations	Purchases or sales of securities by the Federal Reserve to support its policy rate target and liquidity conditions.
Yield curve	The relationship between yields and maturities for debt securities, often used as a signal about policy expectations and economic conditions.
Policy lag	The delay between recognizing an economic problem, implementing a policy response, and seeing the economic effect.

References and Further Reading

- Federal Reserve Board. Monetary Policy.
- Federal Reserve Board. Monetary Policy: What Are Its Goals? How Does It Work?
- Federal Reserve Board. Federal Open Market Committee.
- Federal Reserve Board. Open Market Operations.
- Federal Reserve Board. Interest on Reserve Balances.
- International Monetary Fund. Fiscal Policy: Taking and Giving Away.
- Center on Budget and Policy Priorities. Fiscal Stimulus.

Practice Questions

1. Which of the following is an example of expansionary fiscal policy?

A. The Federal Reserve sells Treasury securities
B. The Federal Reserve raises the federal funds target range
C. A bank increases its loan underwriting standards
D. Congress passes a temporary tax cut

2. Which institution is primarily responsible for U.S. monetary policy?

A. The Federal Reserve
B. The Department of Labor
C. The Securities and Exchange Commission
D. The Internal Revenue Service

3. If market interest rates rise, the price of an existing fixed-rate bond generally:

A. Rises
B. Falls
C. Remains unchanged
D. Becomes equal to par value

4. A government increases infrastructure spending during a recession. This is best described as:

A. Contractionary fiscal policy
B. Expansionary monetary policy
C. Expansionary fiscal policy
D. Contractionary monetary policy

5. The Federal Reserve lowers its target range for the federal funds rate. This action is generally intended to:

A. Increase borrowing costs
B. Reduce bond prices by increasing yields
C. Stimulate borrowing and economic activity
D. Tighten credit and reduce inflation immediately

6. Which policy combination is most likely to create tension between growth support and inflation control?

A. Tight fiscal policy and loose monetary policy
B. Neutral fiscal policy and neutral monetary policy
C. Tight fiscal policy and tight monetary policy
D. Loose fiscal policy and tight monetary policy

7. Automatic stabilizers differ from discretionary fiscal policy because automatic stabilizers:

A. Are controlled by the Federal Reserve
B. Respond to economic conditions without new legislation each time
C. Always require a vote by Congress
D. Affect only corporate bond yields

8. A contractionary monetary policy stance would most likely involve:

A. Raising short-term interest rates
B. Increasing transfer payments
C. Lowering short-term interest rates
D. Cutting taxes

9. Which asset is generally most exposed to interest-rate increases, all else equal?

A. A checking account
B. A 3-month Treasury bill
C. A money market fund
D. A 30-year zero-coupon bond

10. During a period of high inflation and monetary tightening, which portfolio adjustment would most directly reduce duration risk?

A. Increase exposure to high-P/E growth stocks
B. Move from long-term bonds to short-term bonds
C. Move from short-term bonds to long-term bonds
D. Increase leverage

11. Which statement best describes fiscal deficits?

A. They occur when government spending exceeds revenues
B. They eliminate the need for government borrowing
C. They occur when government revenues exceed spending
D. They are set directly by the FOMC

12. Open market operations are associated with:

A. Federal Reserve monetary policy implementation
B. State securities registration only
C. Municipal zoning policy
D. Corporate dividend policy

13. Which of the following is the best description of crowding out?

A. Investors moving from one **mutual fund** share class to another
B. Lower rates causing investors to crowd into equities
C. Inflation reducing purchasing power
D. Government borrowing competing with private borrowing and potentially raising rates

14. If the Fed cuts rates because the economy is entering a severe recession, the immediate effect on stock prices may be uncertain because:

A. Bond prices and stock prices must always move together
B. Stock prices only respond to fiscal policy
C. Lower rates are positive, but the weak earnings outlook may be negative
D. Monetary policy never affects stocks

15. Which sector would be most directly affected by a large federal infrastructure program?

A. Money market funds only
B. Precious metals only
C. Foreign currency only
D. Industrials and materials

16. Which statement is most accurate?
A. The Fed influences financial conditions, but markets determine many rates
B. Fiscal policy is implemented by the FOMC
C. Monetary policy is implemented by Congress through tax law
D. The Fed directly controls all long-term interest rates

17. An inverted yield curve is often interpreted as a signal that investors expect:
A. Tax rates to fall immediately
B. Future rate cuts or slower economic growth
C. Higher long-term growth with no recession risk
D. Short-term rates to remain below long-term rates forever

18. Which policy is most likely to be used to reduce demand-pull inflation?
A. Larger transfer payments and bond purchases
B. Higher government spending and lower rates
C. Higher rates or reduced fiscal stimulus
D. Lower taxes and lower rates

19. Why might growth stocks be especially sensitive to monetary tightening?
A. They are always issued by banks
B. They never have earnings
C. Their value often depends heavily on cash flows expected far in the future
D. They are unaffected by discount rates

Answer Key and Explanations

1. D — Fiscal policy involves government spending and taxation. A tax cut is generally expansionary because it increases after-tax income.

2. A — The Federal Reserve is the central bank responsible for monetary policy.

3. B — Bond prices and market yields move inversely.

4. C — Infrastructure spending is government spending, and increasing it to support demand is expansionary fiscal policy.

5. C — Lower short-term rates generally reduce borrowing costs and support demand.

6. D — Loose fiscal policy supports demand while tight monetary policy attempts to restrain demand and inflation.

7. B — Automatic stabilizers are built into existing tax and spending rules.

8. A — Raising short-term rates is a common contractionary monetary policy action.

9. D — Long-duration bonds, especially zero-coupon bonds, are highly sensitive to interest-rate changes.

10. B — Shorter-duration bonds are less sensitive to rising rates.

11. A — A fiscal deficit occurs when spending is greater than revenue and is typically financed by borrowing.

12. A — Open market operations are a Federal Reserve tool used in monetary policy implementation.

13. D — Crowding out describes the possibility that government borrowing increases interest rates and reduces private investment.

14. C — Lower discount rates can support valuations, but recessionary earnings risk may offset that benefit.

15. D — Infrastructure spending can directly affect construction, materials, equipment, transportation, and industrial firms.

16. A — The Fed strongly influences short-term rates and expectations, but many rates are market-determined.

17. B — An inverted curve can signal expectations of slower growth and eventual policy easing, though it is not a guarantee.

18. C — Demand-pull inflation can be addressed by policies that restrain aggregate demand.

19. C — Higher discount rates reduce the present value of future cash flows, which can be especially important for growth stocks.

Lesson 3: Global and Geopolitical Factors

Learning Objectives

- Explain why **global factors** can affect both domestic and international investments.
- Describe what it means for a currency to appreciate or depreciate, and how a strong or **weak U.S. dollar** affects investors.
- Calculate the basic effect of exchange-rate movements on foreign investment returns.
- Distinguish **currency risk**, country risk, political risk, and **sovereign debt** risk.
- Evaluate how global shocks can affect stocks, bonds, cash, commodities, and international funds.

3.1 Why Global Factors Matter to Investors

Investors do not need to buy foreign securities to be affected by global events. A U.S. company may sell products overseas, rely on foreign suppliers, borrow in global credit markets, or compete with foreign firms. A purely domestic client portfolio can still be affected by exchange rates, energy prices, supply chain disruptions, sovereign debt stress, and geopolitical shocks.

An investment adviser representative should understand the risk and return consequences of global factors and can apply them to client suitability. The IAR should recognize that international exposure can improve diversification, but it can also introduce currency, political, liquidity, and sovereign credit risks.

Exam point
The three core subtopics for this Lesson are: (1) currency valuation, (2) effects of exchange rates on investment returns, and (3) sovereign debt. Geopolitical events matter because they often move currencies, interest rates, credit spreads, commodity prices, and investor risk appetite.

3.2 Currency Valuation

Currency valuation refers to the relative value of one currency compared with another. For a U.S.-based investor, the key comparison is often the U.S. dollar versus foreign currencies such as the euro, yen, pound, peso, or yuan. A currency can appreciate, meaning it becomes more valuable relative to another currency, or depreciate, meaning it becomes less valuable relative to another currency.

Exchange rates are quoted in different ways, but the concept is straightforward: if the U.S. dollar strengthens, each dollar buys more foreign currency. If the U.S. dollar weakens, each dollar buys less foreign currency. The direction of the exchange-rate movement determines whether foreign-currency assets are helped or hurt when translated back into U.S. dollars.

What Can Cause a Currency to Strengthen or Weaken?

- Interest-rate differentials: Higher interest rates may attract foreign capital, supporting the currency, all else equal.

- Inflation differentials: Higher inflation tends to reduce a currency's purchasing power over time.
- Economic growth and productivity: Strong growth can attract investment, but overheating can also create inflation risk.
- Trade flows: A country that imports much more than it exports may face downward pressure on its currency over time, although capital flows can offset this effect.
- Capital flows: Foreign demand for a country's stocks, bonds, real estate, or businesses can support its currency.
- Central bank policy: Rate cuts, rate hikes, quantitative easing, and foreign-exchange intervention can affect currency values.
- Political and legal stability: Investors generally prefer currencies backed by stable institutions, predictable law, and credible monetary policy.

Strong Dollar vs. Weak Dollar

Dollar movement	Import effect	Export effect	Foreign investment effect
U.S. dollar strengthens	Foreign goods become cheaper for U.S. buyers; imports may rise.	U.S. exports may become less competitive because foreign buyers need more local currency to buy dollar-priced goods.	Unhedged foreign investments may be hurt when foreign-currency returns are translated back into dollars.
U.S. dollar weakens	Foreign goods become more expensive for U.S. buyers; import prices may add to inflation.	U.S. exports may become more competitive because foreign buyers need less local currency to buy dollar-priced goods.	Unhedged foreign investments may be helped when foreign-currency returns are translated back into dollars.

A strong dollar is not automatically good or bad. It can help U.S. consumers and importers by making foreign goods less expensive, but it can hurt exporters and U.S. multinationals because foreign revenues translate into fewer dollars. A weak dollar has the opposite effect: it can help exporters and unhedged foreign holdings, but it may raise the cost of imports and contribute to inflation.

Currency Valuation and Companies

Company or sector exposure	Likely currency sensitivity
U.S. importer	Often benefits when the dollar strengthens because imported goods or inputs become cheaper.
U.S. exporter	Often benefits when the dollar weakens because foreign customers can buy U.S. goods more cheaply.
U.S. multinational	May report lower dollar earnings when foreign profits are translated back during a strong-dollar period.
Foreign company selling into the U.S.	May benefit from a strong dollar if U.S. customers have more purchasing power relative to the company's home currency.
Commodity producer	May be affected because many commodities are priced in dollars; dollar moves can influence global demand and commodity prices.

3.3 Effects of Exchange Rates on Investment Returns

The return a U.S. investor receives from a foreign investment is not only the return of the asset in its local market. The investor must also translate that return back into U.S. dollars. This is the core of currency risk.

The exact home-currency return can be written as:

Home-currency return = (1 + local-currency return) × (1 + currency return) − 1

A simpler approximation is: home-currency return is roughly equal to the local-currency return plus the currency return. The exact formula is better when movements are large.

Scenario	Exact calculation	Dollar return	Interpretation
Foreign stock rises 8%; foreign currency rises 4% vs. dollar	(1.08 × 1.04) − 1	12.32%	Local gain plus favorable currency movement.

Scenario	Exact calculation	Dollar return	Interpretation
Foreign stock rises 8%; foreign currency falls 5% vs. dollar	(1.08 × 0.95) − 1	2.60%	Local gain is mostly offset by adverse currency movement.
Foreign stock falls 3%; foreign currency rises 4% vs. dollar	(0.97 × 1.04) − 1	0.88%	Currency gain more than offsets the local-market loss.
Foreign bond earns 3%; foreign currency falls 7% vs. dollar	(1.03 × 0.93) − 1	-4.21%	Currency loss overwhelms the bond income.

Foreign currency movements and domestic investor returns
A foreign investment can earn a positive local-currency return but still produce a low or negative U.S.-dollar return if the foreign currency depreciates against the dollar. The reverse is also possible: a weak local-market return can be improved by favorable currency movement.

Unhedged vs. Hedged International Funds

International mutual funds and ETFs may be hedged or unhedged. An unhedged fund gives the U.S. investor exposure to both the foreign securities and the foreign currencies. A hedged fund attempts to reduce the effect of currency movements, usually through forward contracts or other currency instruments.

Investment type	Main exposure	Investor implication
Unhedged foreign equity fund	Exposed to local stock returns and currency movements.	Can benefit from a weaker dollar; can be hurt by a stronger dollar.
Currency-hedged foreign equity fund	Attempts to reduce currency impact.	More closely reflects local stock performance, but hedging has costs and may not be perfect.
Unhedged foreign bond fund	Exposed to foreign interest rates, credit risk, and currency movements.	Currency volatility can dominate the bond's coupon income.

Investment type	Main exposure	Investor implication
Currency-hedged foreign bond fund	Attempts to isolate foreign bond exposure from currency movement.	Still exposed to interest-rate risk, credit risk, **liquidity risk**, and **sovereign risk**.

Currency Effects on ADRs and Foreign Stocks

American Depositary Receipts, or ADRs, trade in the United States but represent shares of a foreign company. Trading in dollars does not eliminate economic exposure to the foreign company, its home market, or the currency in which its revenues and expenses are generated. A U.S. investor may still be affected by currency translation, foreign market conditions, and geopolitical risk.

Currency Effects on Bonds

Foreign bonds can be especially sensitive to currency movements because bond returns are often modest compared with equity returns. A bond paying a 4% yield can still lose value for a U.S. investor if the foreign currency declines by more than the bond income and price return. For this reason, foreign bond funds are often analyzed by separating interest-rate risk, credit risk, sovereign risk, and currency risk.

3.4 Sovereign Debt

Sovereign debt is debt issued by a national government. U.S. Treasury securities are sovereign debt of the United States. German bunds, Japanese government bonds, U.K. gilts, Brazilian government bonds, and Mexican government bonds are also examples of sovereign debt issued by their respective governments.

Investors often treat sovereign debt as a fixed-income investment, but not all sovereign debt has the same risk. A government's creditworthiness depends on its economic strength, tax capacity, debt burden, currency regime, inflation record, political stability, and willingness to pay. Sovereign risk becomes more important when a country borrows heavily, faces weak growth, has fragile institutions, or owes debt in a foreign currency.

Ability to Pay vs. Willingness to Pay

Sovereign debt analysis focuses on both ability to pay and willingness to pay. Ability to pay refers to the government's economic and financial capacity to service debt. Willingness to pay refers to the political decision to honor debt obligations rather than default, restructure, inflate, impose controls, or seek relief from creditors.

- **Ability to pay** is affected by GDP growth, tax revenue, debt-to-GDP, fiscal deficits, foreign-exchange reserves, and access to capital markets.
- **Willingness to pay** is affected by political stability, public pressure, election cycles, legal institutions, and the government's relationship with creditors.

- A country can be financially stressed but still pay, or financially capable but politically unwilling to pay under certain circumstances.

Local-Currency vs. Hard-Currency Sovereign Debt

A key distinction is whether the debt is issued in the government's own currency or in a major external currency. **Local-currency debt** may be easier for a government to service if it can tax and issue currency in that same money. However, too much reliance on money creation may lead to inflation and currency depreciation. **Hard-currency debt** can be riskier for emerging-market borrowers because the government must obtain dollars, euros, or another external currency to make payments.

Debt type	Meaning	Primary risks
Local-currency sovereign debt	Debt issued in the country's own currency.	Inflation, currency depreciation, central bank credibility, local interest rates.
Hard-currency sovereign debt	Debt issued in a foreign currency, often U.S. dollars or euros.	Foreign-exchange reserves, access to external funding, currency mismatch, default risk.
Developed-market sovereign debt	Debt issued by countries with deep markets and generally stronger institutions.	Interest-rate risk, inflation risk, fiscal sustainability, but often lower default risk.
Emerging-market sovereign debt	Debt issued by countries with less mature markets or higher perceived country risk.	Default/restructuring risk, currency risk, liquidity risk, political risk.

What Happens in a Sovereign Debt Crisis?

A sovereign debt crisis can affect investors through multiple channels. Bond prices may fall, yields and credit spreads may rise, the country's currency may depreciate, local banks may experience stress, equity markets may decline, and investors may demand higher risk premiums. The crisis can also spread to other countries if investors become less willing to hold similar debt.

- **Default:** The government misses a scheduled interest or principal payment.
- **Restructuring:** Creditors receive revised terms, potentially including a longer maturity, lower coupon, or reduced principal value.
- **Capital controls**: The government restricts money movement to prevent capital flight.

- **Currency devaluation:** The local currency falls sharply, reducing foreign investors' home-currency returns.
- Contagion: Investors sell assets in similar countries or regions because perceived risk has increased.

Foreign sovereign debt is not necessarily risk free
Sovereign debt is not risk-free simply because it is issued by a government. U.S. Treasury securities are generally treated as having very low default risk, but foreign sovereign debt may involve default risk, currency risk, political risk, liquidity risk, and inflation risk.

3.5 Global and Geopolitical Shocks

Global and geopolitical events are often difficult to forecast, but advisers must understand how they may affect client portfolios. Examples include wars, sanctions, terrorist attacks, elections, coups, trade restrictions, nationalization, debt crises, pandemics, cyberattacks, and disruptions to commodity supply. These events matter because they can change expected cash flows, discount rates, inflation expectations, and investor risk appetite.

Global event	Potential market effect
War or regional conflict	Higher risk premiums, supply disruption, safe-haven flows, commodity price swings.
Sanctions or trade restrictions	Reduced market access, supply-chain disruption, sector winners and losers.
Political instability	Lower investor confidence, weaker currency, higher country risk premium.
Capital controls	Reduced liquidity and difficulty repatriating money.
Commodity supply shock	Potential inflation pressure; sector impact may differ for producers and consumers.
Sovereign downgrade	Higher yields, lower bond prices, weaker currency, spillover to banks and equities.

3.6 Global Factor Transmission

Global factors usually affect client portfolios through transmission channels. A geopolitical event may not directly lower the price of every security, but it can influence exchange rates, credit spreads, inflation expectations, commodity prices, and valuation multiples.

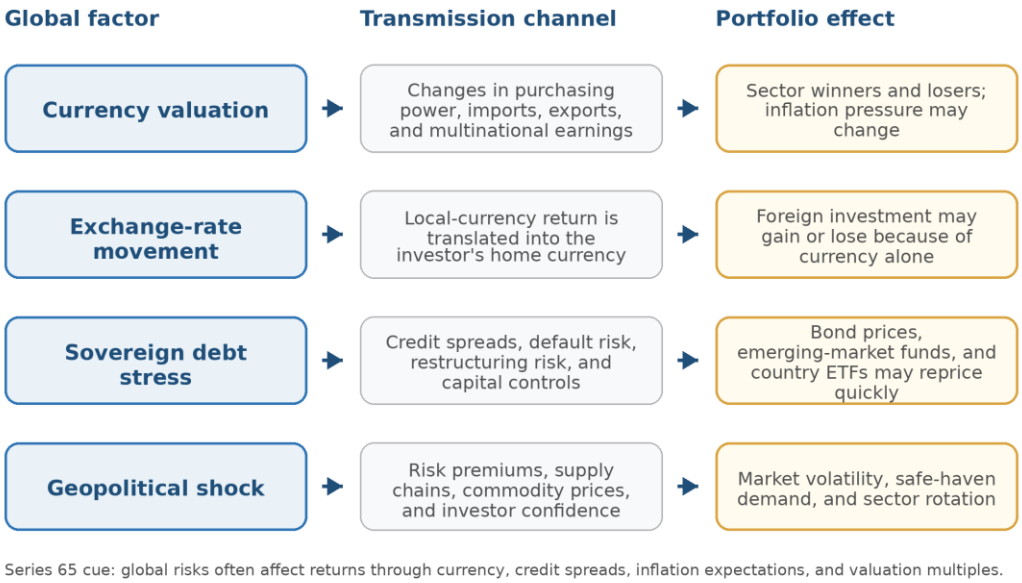


Figure 3.1: How global factors flow into investment returns

3.7 Portfolio and Asset-Class Implications

Global factors rarely affect all investments in the same way. The correct answer often depends on the client's time horizon, liquidity needs, risk tolerance, tax situation, and whether the investment is hedged or unhedged. The table below summarizes common directional effects, not guarantees.

Asset class	Global factor sensitivity
U.S. large-cap multinationals	Affected by foreign sales, supply chains, and currency translation of overseas earnings.
U.S. small-cap domestic companies	May have less direct foreign revenue exposure, but still affected by rates, inflation, imports, and supply chains.
International developed-market equities	Affected by local market returns and currency translation; generally lower country risk than emerging markets.

Asset class	Global factor sensitivity
Emerging-market equities	Higher sensitivity to currency swings, capital flows, political risk, commodity prices, and sovereign debt stress.
Foreign bonds	Affected by foreign interest rates, credit risk, sovereign risk, and currency risk.
U.S. Treasuries	May benefit from safe-haven demand during global stress, but still exposed to interest-rate and inflation risk.
Commodities	Can be affected by global supply shocks, dollar movements, and inflation expectations.
Cash and money markets	May be useful for liquidity during uncertainty but may lose purchasing power if inflation rises.

Diversification Benefit and Limitation

International exposure can improve diversification because foreign markets do not always move exactly with the U.S. market. However, diversification does not eliminate risk. In a severe global crisis, correlations may rise as investors sell risky assets broadly. The adviser should not claim that international diversification guarantees protection from loss.

Suitability Considerations

For a conservative client with a short time horizon and high **liquidity need**, a large allocation to unhedged emerging-market debt would usually be difficult to justify. For a long-term growth client with high risk tolerance, some international equity exposure may be appropriate. The key is to match the global exposure to the client profile and to disclose material risks in plain language.

3.8 Common Series 65 Exam Traps

Trap	Correct exam framing
Assuming foreign trading in dollars removes all foreign risk	ADRs and U.S.-listed foreign funds may still have foreign business, currency, and political exposure.

Trap	Correct exam framing
Confusing strong dollar effects	A stronger dollar helps U.S. consumers/importers but can hurt exporters and unhedged foreign investments.
Ignoring currency in return calculations	Dollar return depends on both local asset performance and currency movement.
Assuming all government debt is risk-free	Foreign sovereign debt may have default, restructuring, currency, liquidity, and political risk.
Treating hedging as free protection	Currency hedging may reduce currency risk, but it has costs and does not eliminate market, credit, or interest-rate risk.
Forgetting suitability	The exam often turns on matching global risk to client time horizon, risk tolerance, and objectives.

3.9 Lesson Summary

- Global factors matter because investment returns are affected by currencies, capital flows, trade conditions, political risk, sovereign credit risk, and investor confidence.
- A strong dollar usually makes imports cheaper for U.S. buyers, can hurt U.S. exporters, and can reduce U.S.-dollar returns on unhedged foreign investments.
- A weak dollar usually makes imports more expensive, can help U.S. exporters, and can increase U.S.-dollar returns on unhedged foreign investments.
- Foreign investment return equals local-market return translated through currency movement. Currency can amplify, reduce, or reverse the local return.
- Sovereign debt risk depends on a government's ability and willingness to pay. Foreign sovereign bonds are not automatically risk-free.
- Currency hedging can reduce exchange-rate exposure but does not eliminate market, credit, interest-rate, liquidity, or political risk.
- For Series 65 suitability questions, evaluate the client profile before recommending concentrated foreign, emerging-market, or sovereign debt exposure.

Key Terms

Term	Plain-language meaning
Global factors	Economic, financial, political, and currency forces outside a single domestic market that can affect investment returns.
Geopolitical risk	Risk that political instability, war, sanctions, elections, policy changes, or international conflict will affect markets.
Exchange rate	The price of one currency expressed in terms of another currency.
Currency valuation	Whether a currency is strengthening, weakening, overvalued, or undervalued relative to another currency or a basket of currencies.
Appreciation	A rise in the value of a currency relative to another currency.
Depreciation	A decline in the value of a currency relative to another currency.
Strong U.S. dollar	A dollar that buys more foreign currency or foreign goods than before.
Weak U.S. dollar	A dollar that buys less foreign currency or foreign goods than before.
Currency risk	The risk that exchange-rate changes will reduce the investor's return after converting back into the investor's home currency.
Local-currency return	The return earned in the currency of the country where the investment is denominated.

Term	Plain-language meaning
Home-currency return	The return experienced by the investor after translating the local-currency return into the investor's own currency.
Hedged foreign investment	An international investment that uses currency hedges to reduce or offset currency exposure.
Unhedged foreign investment	An international investment where the investor remains exposed to currency movements.
Sovereign debt	Debt issued by a national government.
Sovereign default	A failure by a national government to make promised payments on its debt.
Debt restructuring	A renegotiation of debt terms, often involving maturity extensions, reduced interest payments, or reduced principal.
Hard-currency debt	Debt issued in a major external currency, such as the U.S. dollar or euro, rather than the **issuer**'s local currency.
Capital controls	Government restrictions on the movement of money into or out of a country.

Practice Questions

1. A U.S. investor owns an unhedged international equity fund. The foreign stock market rises in local currency, but the foreign currency depreciates sharply against the U.S. dollar. Which statement is most accurate?

A. The investor is unaffected because the fund is owned by a U.S. resident.
B. The investor's U.S.-dollar return may be lower than the local-market return.
C. Currency depreciation always increases the U.S.-dollar return.
D. The investor is guaranteed to earn the local-market return.

2. Which company is most likely to benefit directly from a stronger U.S. dollar?

A. A U.S. multinational translating foreign earnings into dollars.
B. A U.S. exporter that sells only to foreign customers.
C. A U.S. importer that buys inventory from foreign suppliers.
D. An unhedged U.S. investor holding foreign-currency assets.

3. A foreign bond earns 5% in local currency, while the foreign currency falls 6% against the U.S. dollar. What is the approximate U.S.-dollar return?

A. About +5%
B. About +11%
C. About -6%
D. About -1%

4. Sovereign debt is best described as:

A. Debt that has no default risk because it is issued by a government.
B. Debt issued by a national government.
C. Debt issued only by corporations with foreign operations.
D. Debt issued by a domestic municipality.

5. Which risk is most specific to hard-currency sovereign debt issued by an emerging-market country?

A. The bond cannot experience price volatility.
B. Currency depreciation always helps the issuer repay.
C. The government may need to obtain foreign currency to service the debt.
D. The bond is exempt from all interest-rate risk.

6. A U.S. dollar decline would most likely have which effect, all else equal?

A. It may improve the dollar return on unhedged foreign investments.
B. It eliminates currency risk from foreign securities.
C. It reduces the competitiveness of U.S. exports.
D. It makes foreign goods cheaper for U.S. consumers.

7. Currency hedging in a foreign bond fund is primarily intended to reduce:

A. Default risk.
B. Interest-rate risk.
C. Liquidity risk.
D. Exchange-rate risk.

8. An adviser is evaluating an unhedged emerging-market debt fund for a retired client who needs stable income and principal preservation over the next two years. What is the main concern?

A. The investment may involve currency, sovereign, liquidity, and political risks that conflict with the client's objective.
B. Emerging-market debt cannot be affected by geopolitical events.
C. The fund has no currency risk if purchased through a U.S. brokerage account.
D. The fund is automatically suitable because bonds are always conservative.

9. Which event would most likely increase country risk premiums?

A. A credible central bank that reduces inflation uncertainty.
B. A perfectly predictable legal system.
C. A stable fiscal position with low debt levels.
D. Political instability that reduces investor confidence.

10. Which statement about ADRs is correct?

A. They may still expose U.S. investors to foreign business and currency risks.
B. They eliminate all risks associated with the foreign issuer.
C. They are not affected by the foreign company's operating results.
D. They are always issued by the U.S. Treasury.

11. If a foreign stock loses 2% in local currency and the foreign currency appreciates 5% against the U.S. dollar, the exact U.S.-dollar return is closest to:

A. -7.00%
B. +2.90%
C. +3.00%
D. +7.00%

12. A sovereign debt restructuring most commonly means:

A. Foreign investors are guaranteed full and immediate repayment.
B. The debt becomes risk-free after the restructuring.
C. The government and creditors renegotiate payment terms.
D. The government converts all debt into common stock.

Answer Key and Explanations

1. B — Unhedged foreign investments are affected by both local-market performance and currency translation.

2. C — A stronger dollar allows U.S. buyers to purchase foreign goods or inputs with fewer dollars.

3. D — The quick approximation is local return plus currency return: 5% + (-6%) = about -1%.

4. B — Sovereign debt is debt issued by a national government. It may still have risk, especially for foreign issuers.

5. C — Hard-currency debt can become more burdensome when the issuer's local currency weakens against the currency of repayment.

6. A — A weaker dollar means foreign-currency assets translate into more dollars, helping unhedged foreign investments.

7. D — Currency hedging targets currency exposure. It does not eliminate credit, duration, or liquidity risk.

8. A — The suitability analysis must consider the client's short horizon, risk tolerance, income need, and the fund's global risks.

9. D — Political instability can raise required returns, weaken currencies, and reduce asset valuations.

10. A — ADRs trade in the United States but represent foreign companies, so foreign and currency exposure may remain.

11. B — Exact return = (0.98 × 1.05) − 1 = 2.9%.

12. C — A restructuring usually changes maturity, coupon, principal, or other payment terms.

Lesson 4: Inflation and Deflation

Learning Objectives

- Define **inflation**, **disinflation**, and **deflation** in plain language and in exam-ready terms.
- Explain how inflation is measured and why **real returns** matter more than **nominal returns** for long-term planning.
- Identify the common causes of inflation and deflation, including **demand**, **supply**, **money**, **credit**, and **expectations**.
- Describe how inflation and deflation affect **interest rates**, **bonds**, **equities**, **cash**, **commodities**, **TIPS**, and **purchasing power**.
- Apply inflation/deflation concepts to **client suitability**, **risk tolerance**, **time horizon**, and **portfolio construction** questions.

4.1 The Big Picture: Price Level and Purchasing Power

Inflation and **deflation** describe changes in the overall price level of an economy. Inflation means prices are rising on average. Deflation means prices are falling on average. These concepts matter because investment advice is ultimately about future purchasing power. A client does not retire on nominal account values alone; the client retires on the goods and services those account values can buy.

The key distinction is the difference between nominal values and real values. Nominal values are stated in current dollars. Real values adjust for inflation. A portfolio that earns 6% when inflation is 4% has grown in nominal terms, but its real purchasing-power gain is much smaller. This is why investment advisers must consider inflation risk when recommending cash, bonds, annuities, retirement income strategies, and long-term asset allocations.

Inflation is not automatically good or bad in every circumstance. Moderate inflation is common in a growing economy. Rapid inflation is harmful because it makes planning difficult and erodes purchasing power. Deflation may sound attractive because prices fall, but broad deflation can be dangerous because consumers delay purchases, companies lose pricing power, debt burdens rise in real terms, and unemployment may increase.

Inflation and deflation
Inflation hurts purchasing power. Deflation may help the dollar buy more, but it often hurts the economy, corporate profits, and borrowers.

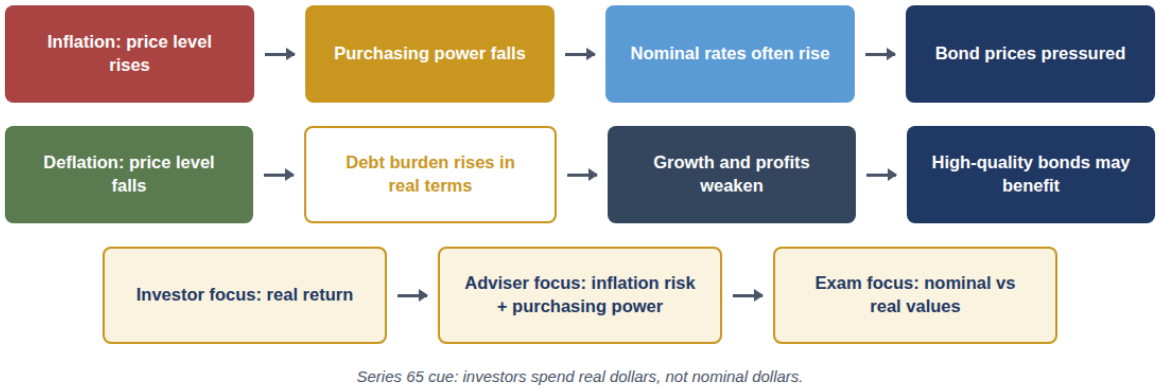


Figure 4.1: Inflation and deflation transmission to investments.

4.2 How Inflation Is Measured

Inflation is measured by tracking changes in price indexes. A price index attempts to summarize the price of a basket of goods and services over time. If the index rises from one period to the next, the economy is experiencing inflation. If the index falls persistently, the economy is experiencing deflation.

The Series 65 outline separately lists the **Consumer Price Index (CPI)** under economic indicators, but CPI is closely connected to inflation/deflation. CPI tracks the prices paid by urban consumers for a basket of consumer goods and services. Candidates should also recognize that other inflation measures exist, including the Personal Consumption Expenditures (PCE) price index, the Producer Price Index (PPI), and the GDP deflator. The exam is more likely to test the concept than the exact construction of each index.

Measure	What It Tracks	Exam-Relevant Point
Consumer Price Index (CPI)	Consumer goods and services purchased by households.	Most familiar inflation measure; often linked to cost-of-living adjustments and TIPS adjustments.
Core inflation	Inflation excluding food and energy.	Used because food and energy prices can be volatile.
Producer Price Index (PPI)	Prices received by producers.	Can provide clues about input-cost pressure before it reaches consumers.

Measure	What It Tracks	Exam-Relevant Point
PCE price index	Prices embedded in consumer expenditures.	Often watched by policymakers; conceptually similar for exam purposes.
GDP deflator	Prices of goods and services included in GDP.	Broad economy-wide price measure.

Calculation cue
Approximate real return = nominal return - inflation. Exact real return = $\frac{(1+nominal\ return)}{(1+inflation)} - 1$

Example: If a portfolio earns 7% and inflation is 3%, the approximate real return is 4%. The exact real return is about 3.88%:$\frac{1.07}{1.03} - 1$.

4.3 What Causes Inflation?

Inflation can arise from several sources. The exam may describe a scenario rather than name the type of inflation. Candidates should focus on the underlying economic force: too much demand, higher costs, excessive money or credit growth, supply shocks, or changing expectations.

Type	Definition	Possible Exam Scenario
Demand-pull inflation	Aggregate demand grows faster than the economy's ability to supply goods and services.	Strong consumer spending, fiscal stimulus, low unemployment, or rapid credit growth.
Cost-push inflation	Production costs rise and firms pass those costs to consumers.	Higher wages, energy costs, raw materials, tariffs, or transportation costs.
Monetary inflation	Money and credit grow faster than output over time.	Too much money chasing too few goods.
Supply-shock inflation	A disruption reduces supply or raises input costs.	Oil shock, war, natural disaster, pandemic disruption, or trade restriction.

Type	Definition	Possible Exam Scenario
Expectations-driven inflation	Households and firms expect higher future inflation and change behavior now.	Workers demand higher wages; firms raise prices preemptively.

4.4 What Causes Deflation?

Deflation occurs when the general price level falls. It can result from weak demand, a contraction in credit, excess productive capacity, falling asset prices, or a severe recession. Deflation is especially dangerous when it interacts with debt. If prices and incomes fall but loan payments remain fixed in nominal dollars, borrowers face a higher real debt burden.

Not every price decline is harmful deflation. A narrow decline in the price of one product, or a decline caused by productivity improvement, is different from a broad economy-wide decline in the general price level. The exam is most concerned with broad deflation and its effect on borrowers, lenders, businesses, and investments.

Deflation Driver	How It Works	Why It Matters
Weak demand	Consumers and businesses reduce spending.	Businesses cut prices to attract buyers; profits may fall.
Credit contraction	Banks and lenders reduce lending; borrowers repay or default.	Money and credit shrink, reducing spending power.
Debt deflation	Falling prices increase the real burden of fixed nominal debt.	Borrowers struggle, defaults rise, and lenders tighten standards.
Excess capacity	Firms can produce more than customers want to buy.	Competition forces prices lower.
Productivity-driven price declines	Technology or efficiency lowers production costs.	May be less harmful if incomes and demand remain healthy.

4.5 Policy Responses to Inflation and Deflation

Inflation and deflation connect directly to monetary and fiscal policy. Policymakers generally use restrictive policy to cool inflation and expansionary policy to fight deflation or recession. You should know the direction of policy, the expected effect on interest rates and demand, and the investment implications.

Economic Problem	Common Policy Response	Investment Connection
High or rising inflation	Restrictive monetary policy: raise short-term rates, reduce money/credit growth, or tighten financial conditions.	Higher rates generally pressure bond prices and can reduce equity valuations.
High or rising inflation	Restrictive fiscal policy: reduce spending, raise taxes, or reduce deficits.	May reduce demand but can slow economic growth.
Deflation or recession risk	Expansionary monetary policy: lower short-term rates, increase liquidity, or encourage lending.	May support bond prices and risk assets, depending on confidence and credit conditions.
Deflation or recession risk	Expansionary fiscal policy: increase government spending, lower taxes, or run larger deficits.	May support demand but can raise future inflation or debt concerns.

Exam point
Do not assume that all falling prices are good. Broad deflation is usually associated with weak demand, falling profits, rising real debt burdens, and economic stress.

4.6 Investment Implications

Inflation and deflation influence investments through purchasing power, interest rates, discount rates, corporate revenues, profit margins, and investor expectations. The Series 65 exam may ask which asset is most exposed to inflation risk, which investment may provide inflation protection, or how a change in inflation expectations affects bonds and equities.

Investment	Inflation Impact	Deflation Impact / Caveat
Cash / money market instruments	Nominal value is stable, but purchasing power erodes if inflation exceeds the yield.	May become more attractive if yields rise, but broad deflation can coincide with low rates.
Short-term bonds	Less price sensitivity to rising rates than long-term bonds; reinvestment can occur at higher yields.	May provide stability, but real return can still be negative.
Long-term fixed-rate bonds	Usually hurt by unexpected inflation because rates rise and fixed coupons lose purchasing power.	May benefit when deflation pushes rates lower and investors seek safety.
TIPS	Principal adjusts with CPI, helping protect real purchasing power.	Can still decline in market value if real interest rates rise.
Common stocks	Companies with pricing power may pass through inflation; high inflation can compress valuation multiples.	Weak deflation can hurt revenues, profits, and risk appetite.
Commodities / real assets	Often benefit from unexpected inflation or supply shocks.	Can suffer when demand weakens in deflationary environments.
Real estate / REITs	May benefit from rent growth and replacement-cost increases; rate sensitivity matters.	Deflation can hurt rents, occupancy, and property values.
Fixed annuities / fixed pensions	Payments lose purchasing power unless inflation-adjusted.	Payments may become more valuable in real terms during deflation, but issuer credit risk still matters.

4.7 Inflation, Interest Rates, and Bonds

Bonds are central to inflation/deflation questions because many bonds pay fixed nominal coupons. When inflation rises unexpectedly, investors usually demand higher nominal yields to compensate for lost purchasing power. Because bond prices move inversely to yields, rising inflation expectations often pressure existing bond prices, especially long-duration bonds.

The relationship can be summarized as: nominal interest rate approximately equals real interest rate plus expected inflation. This is not a precise pricing model for every bond, but it is an exam-useful way to think about why inflation expectations affect interest rates.

Deflation can have the opposite mechanical effect: falling inflation expectations may reduce nominal yields, which can raise the prices of high-quality bonds. However, deflation can also increase credit risk if borrowers are under pressure. That is why Treasury bonds and high-quality bonds may behave differently from lower-quality corporate bonds during deflationary stress.

Scenario	Rate Effect	Bond Price / Risk Effect
Inflation rises unexpectedly	Nominal yields tend to rise.	Existing bond prices tend to fall, with longer duration hit harder.
Inflation falls / disinflation	Nominal yields may fall.	Existing bond prices may rise if credit risk does not dominate.
Deflationary recession	Safe-haven yields may fall, but credit spreads may widen.	Treasuries may benefit; lower-quality bonds may suffer.
TIPS principal adjustment	Principal adjusts upward with CPI inflation.	Provides inflation linkage but not immunity from market price volatility.

4.8 Client and Suitability Considerations

Investment adviser representatives must connect inflation/deflation concepts to client facts. Inflation risk is especially important for clients with long time horizons, retirees relying on fixed income, education funding goals, and conservative investors holding large cash positions. Deflation risk is most important when economic weakness, default risk, or liquidity needs dominate the client scenario.

Client or Position	Inflation/Deflation Issue	Adviser Application
Retiree with fixed pension income	Inflation erodes real income and living standards.	Consider inflation-adjusted income sources, TIPS, equities with dividend growth potential, and realistic withdrawal assumptions.
Young investor saving for retirement	Long horizon magnifies inflation risk.	Growth assets may be appropriate if consistent with risk tolerance.
Conservative investor holding only cash	Safety of principal does not equal safety of purchasing power.	Discuss inflation risk and real return.
Borrower with fixed-rate debt	Unexpected inflation can reduce the real burden of fixed payments.	Inflation can benefit borrowers relative to lenders, all else equal.
Lender or fixed-rate bondholder	Unexpected inflation reduces real value of received payments.	Long-term fixed-rate debt is exposed to inflation risk.

4.9 How the Series 65 May Test This Topic

- Recognize whether a scenario describes inflation, deflation, or disinflation.
- Distinguish nominal returns from real returns.
- Know that unexpected inflation generally hurts long-term fixed-rate bonds.
- Understand that TIPS are designed to protect against inflation, but they are not risk-free in market value terms.
- Identify the effect of inflation on purchasing power, retirement income, and fixed payments.
- Know that deflation can increase real debt burdens and may signal economic weakness.
- Avoid confusing deflation with disinflation: disinflation means prices are still rising, just more slowly.

Lesson Summary

Concept	Must-Know Point
Inflation	General price level rises; purchasing power falls.
Deflation	General price level falls; may signal weak demand and rising real debt burdens.
Disinflation	Inflation rate falls but remains positive.
Real return	Nominal return adjusted for inflation.
Most inflation-sensitive common exam item	Long-term fixed-rate bonds and fixed payments.
Common inflation hedge	TIPS; real assets and commodities may help, but each carries its own risk.
Key advisory concept	Clients need purchasing power, not just nominal dollars.

Key Terms

Term	Definition	Series 65 Cue
Inflation	A sustained increase in the general price level of goods and services.	A dollar buys less over time; purchasing power falls.
Deflation	A sustained decrease in the general price level.	A dollar buys more, but deflation often signals weak demand, falling profits, and credit stress.
Disinflation	A decrease in the rate of inflation.	Prices are still rising, but at a slower rate.
Purchasing power	The amount of goods and services money can buy.	Inflation reduces purchasing power; deflation increases it in narrow price terms.

Term	Definition	Series 65 Cue
Nominal return	The stated investment return before adjusting for inflation.	The return on paper.
Real return	The return after adjusting for inflation.	The return that reflects actual change in purchasing power.
Inflation risk	The risk that inflation will erode an investment's purchasing power.	Especially important for cash, fixed-rate bonds, and fixed annuities.
TIPS	Treasury Inflation-Protected Securities; principal adjusts with CPI.	Designed to help protect against inflation, but market prices can still fluctuate.

References and Further Reading

- North American Securities Administrators Association (NASAA). Series 65 Test Specifications, effective June 12, 2023. Used to identify inflation and deflation as a topic under Basic Economic Concepts.
- U.S. Bureau of Labor Statistics. Consumer Price Index and inflation measurement resources.
- Federal Reserve Board. Monetary policy and inflation/deflation risk materials.

Practice Questions

1. Which statement best describes inflation?

A. A decline in the rate of inflation
B. A decrease in the general price level
C. A sustained increase in the general price level
D. An increase in the real value of money

2. A portfolio earns 6% during a year when inflation is 4%. What is the approximate real return?

A. 6%
B. 4%
C. 2%
D. 10%

3. Which investment is generally most vulnerable to unexpected inflation?

A. A Treasury bill maturing in 30 days
B. A long-term fixed-rate bond
C. A TIPS issue held to maturity
D. A floating-rate note

4. Disinflation means:

A. The rate of inflation is declining
B. Inflation is rising faster than expected
C. The money supply has stopped growing
D. Prices are falling overall

5. Which client is most exposed to inflation risk?

A. A holder of CPI-adjusted Treasury securities
B. A company with strong pricing power
C. A borrower with a long-term fixed-rate mortgage
D. A retiree receiving fixed monthly income with no cost-of-living adjustment

6. Deflation is often harmful because it can:

A. Guarantee higher stock valuations
B. Eliminate credit risk
C. Increase the real burden of fixed nominal debt
D. Reduce the real burden of debt

7. If inflation expectations rise, what is the most likely effect on nominal interest rates?

A. They are unaffected because rates are real variables only
B. They generally rise
C. They generally fall to zero
D. They become negative by definition

8. Which statement about TIPS is most accurate?

A. TIPS eliminate all investment risk
B. TIPS principal adjusts with CPI
C. TIPS pay a variable coupon rate tied to the prime rate
D. TIPS always outperform common stocks during inflation

9. Cost-push inflation is most likely caused by:

A. Lower government spending
B. Falling credit growth
C. A broad decline in consumer demand
D. Rising input costs such as energy, wages, or raw materials

10. An adviser tells a client that keeping all long-term savings in cash is risk-free. What is the best criticism of this statement?

A. Cash may lose purchasing power to inflation
B. Cash always has default risk equal to common stock
C. Cash is highly exposed to market-price volatility
D. Cash has no nominal value

11. Broad deflation is most commonly associated with:

A. Higher nominal wages across the economy
B. Lower real interest rates by definition
C. Guaranteed corporate profit growth
D. Rising real debt burdens and weak demand

12. Which statement best explains why real return is important?

A. It measures the change in purchasing power after inflation
B. It is always equal to nominal return
C. It applies only to bonds and not stocks
D. It ignores inflation because inflation is only relevant to consumers

Answer Key and Explanations

1. C — Inflation is a sustained increase in the general price level. It reduces purchasing power.

2. C — Approximate real return equals nominal return minus inflation: 6% - 4% = 2%.

3. B — Long-term fixed-rate bonds are exposed because coupon payments are fixed and their prices are sensitive to rising rates.

4. A — Disinflation means inflation is still present, but the inflation rate is lower than before.

5. D — Fixed income with no inflation adjustment loses purchasing power as prices rise.

6. C — With deflation, prices and incomes may fall while debt payments remain fixed, increasing the real burden on borrowers.

7. B — Nominal rates generally include compensation for expected inflation, so higher expected inflation usually pushes nominal rates higher.

8. B — TIPS are Treasury Inflation-Protected Securities; their principal adjusts with CPI. Their market prices can still fluctuate.

9. D — Cost-push inflation occurs when production costs increase and firms pass those costs on through higher prices.

10. A — Cash may be stable in nominal terms, but inflation can erode its purchasing power over time.

11. D — Deflation can raise the real burden of fixed nominal debt and is often connected to weak demand.

12. A — Real return adjusts nominal return for inflation and therefore measures the investor's change in purchasing power.

Lesson 5: Interest Rates, Yield Curve, and Credit Spreads

Learning Objectives

- Define **nominal interest rates**, **real interest rates**, **risk-free rates**, and **market rates**.
- Explain the inverse relationship between interest rates and bond prices.
- Interpret **normal**, **flat**, **inverted**, and **humped yield curves**.
- Explain what **credit spreads** measure and why they widen or narrow.
- Connect **interest-rate**, **yield-curve**, and **credit-spread** changes to investment performance and client suitability.

5.1 Interest Rates: The Price of Money Over Time

An **interest rate** is the price paid to borrow money or the compensation received for lending money. Investors often think of interest rates as the required return for deferring consumption, accepting inflation risk, and accepting the risk that the borrower may not repay as promised.

- **Borrowers pay interest** because they receive purchasing power today and repay later.
- **Lenders earn interest** because they give up current use of funds and accept uncertainty.
- **Investors compare rates** across maturity, credit quality, tax treatment, liquidity, and inflation expectations.

Nominal Rates, Real Rates, and Inflation Expectations

A **nominal rate** is the stated rate. A **real rate** adjusts for inflation. In simple terms, the approximate real return equals the nominal return minus the inflation rate.

Nominal return	Inflation rate	Approximate real return	Interpretation
6%	2%	4%	Positive purchasing-power gain
5%	5%	0%	Purchasing power roughly preserved
4%	6%	-2%	Nominal gain but real loss

Inflation expectations are built into interest rates. If investors expect higher inflation, they usually demand higher nominal yields to protect purchasing power. If expected inflation falls, nominal yields may fall as well, all else equal.

5.2 Interest Rates and Bond Prices

Bond prices and market interest rates move in opposite directions. A bond promises fixed cash flows. When market rates rise, those fixed cash flows are less attractive, so the bond price must fall to offer a competitive yield. When market rates fall, the existing fixed cash flows become more attractive, so the bond price rises.

Core rule
Rates up → bond prices down. Rates down → bond prices up. The longer the maturity and the higher the duration, the more sensitive the bond price generally is to rate changes.

Duration and Maturity

Duration measures a bond's sensitivity to interest-rate changes. For exam purposes, remember that longer-maturity, lower-coupon bonds usually have higher duration and greater price volatility than shorter-maturity, higher-coupon bonds.

- Short-term bonds usually have lower price sensitivity to rate changes.
- Long-term bonds usually have higher price sensitivity to rate changes.
- Zero-coupon bonds are especially rate-sensitive because all cash flow is received at maturity.
- Floating-rate securities generally have less price sensitivity because coupon payments can adjust with market rates.

Reinvestment Risk

Falling rates are not always good for every fixed-income investor. When rates fall, existing bond prices may rise, but coupons and maturities may have to be reinvested at lower yields. This is reinvestment risk. It matters most for investors relying on income from maturing bonds, certificates of deposit, money market funds, or short-term bond ladders.

5.3 Yield Curves

A **yield curve** plots yields on bonds of similar credit quality across different maturities. The U.S. Treasury yield curve is the most commonly referenced curve because Treasury securities are often used as risk-free benchmarks. The shape of the curve reflects expectations about future interest rates, inflation, monetary policy, economic growth, and investor preferences for liquidity and maturity.

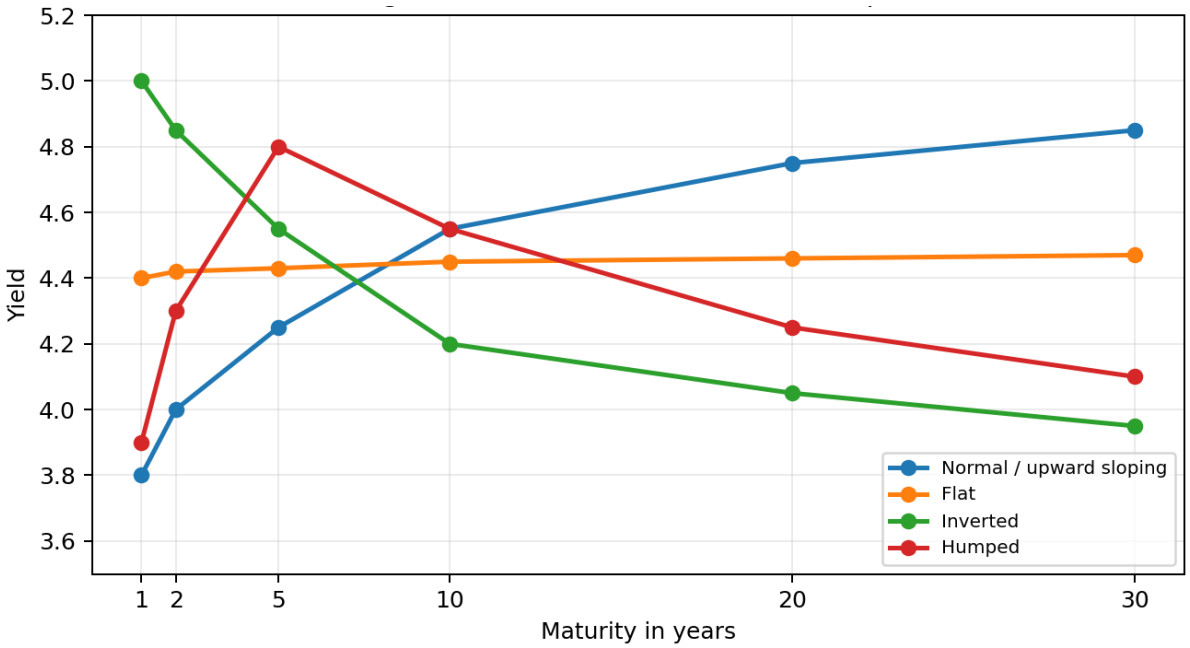


Figure 5.1: Common yield curve shapes. The exact yield levels are illustrative; the exam focuses on the shape and the interpretation.

Common Yield Curve Shapes

Curve shape	What it shows	Common interpretation
Normal / upward sloping	Long-term yields are higher than short-term yields.	Often associated with expansion, positive term premium, and expectations of future growth/inflation.
Flat	Short-term and long-term yields are similar.	May suggest uncertainty or a transition between economic stages.
Inverted	Short-term yields are higher than long-term yields.	Often interpreted as a warning sign of tighter monetary policy and possible economic slowdown.
Humped	Intermediate maturities have the highest yields.	May reflect unusual expectations about future policy, inflation, or supply/demand at specific maturities.

Flattening and Steepening

Yield curves can change shape even when all rates do not move in the same direction. A flattening curve means the difference between long-term and short-term rates is shrinking. A steepening curve means the difference is growing. The **bear** vs. **bull** designation indicates whether the change in the shape of the yield is expected to decrease (bear) or increase (bull) the outcomes for, especially long-duration, fixed income investments.

- **Bear flattening**: short-term rates rise faster than long-term rates; often connected to central-bank tightening.
- **Bull flattening**: long-term rates fall faster than short-term rates; often connected to lower growth or inflation expectations.
- **Bear steepening**: long-term rates rise faster than short-term rates; often connected to higher inflation or term-premium concerns.
- **Bull steepening**: short-term rates fall faster than long-term rates; often connected to expected rate cuts or easier policy.

5.4 Credit Spreads

A **credit spread** is the extra yield an investor receives for buying a bond with credit risk instead of a comparable U.S. Treasury security. If a 10-year corporate bond yields 6% and a 10-year Treasury yields 4%, the credit spread is 2%, or 200 basis points.

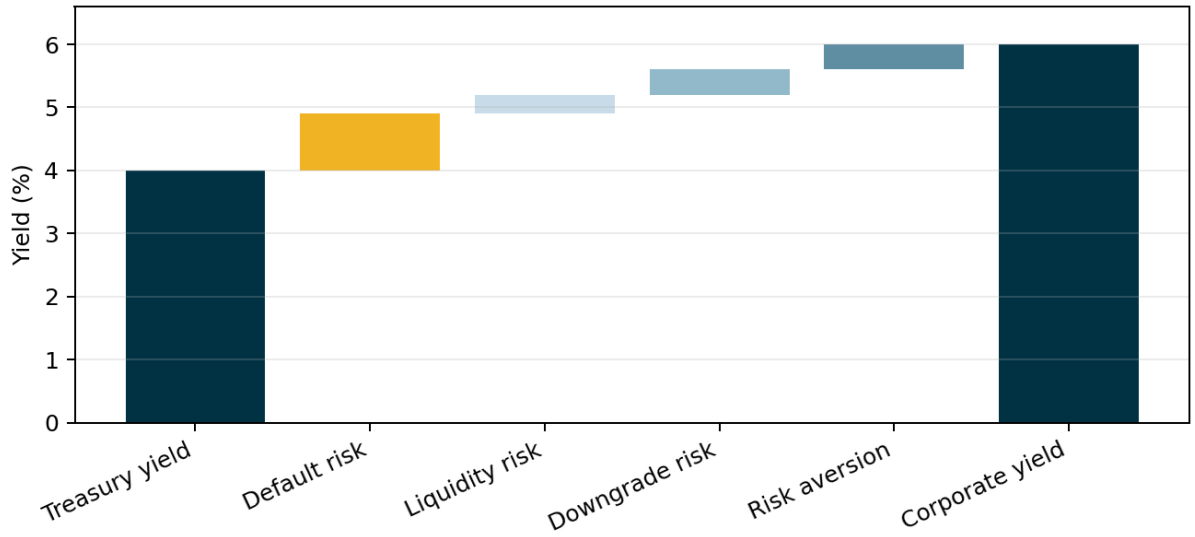


Figure 5.2: A simplified view of how a corporate bond yield can be understood as Treasury yield plus compensation for credit and liquidity risks.

What Credit Spreads Measure

- **Default risk:** the possibility the issuer will fail to make promised payments.
- **Downgrade risk:** the possibility the issuer's credit rating will be reduced.
- **Liquidity risk:** the possibility the bond will be difficult or costly to sell before maturity.
- **Risk appetite:** the market's willingness to own riskier bonds rather than safer bonds.

Widening and Tightening Spreads

Spread movement	Meaning	Typical market environment
Spreads widen	Riskier bonds yield more relative to Treasuries.	Economic stress, rising default concern, falling liquidity, or risk-off behavior.
Spreads tighten	Riskier bonds yield less relative to Treasuries.	Improving growth, stronger credit conditions, higher risk appetite, or search for yield.

Yield curve vs. credit spread
Do not confuse the yield curve with the credit spread. The yield curve compares maturities. The credit spread compares credit quality at a similar maturity.

5.5 Investment Implications

Investment	Rates rise	Rates fall	Spread widening
Short-term bonds	Smaller price decline; income can reset sooner.	Smaller price gain; reinvestment at lower rates.	Less sensitive than low-quality long bonds, but credit risk still matters.
Long-term bonds	Larger price decline due to duration.	Larger price gain due to duration.	Can be hit by both rate and credit spread risk.
Money market / CDs	New rates may become more attractive.	New rates may become less attractive.	High-quality instruments may benefit from flight to safety.
Growth stocks	Valuations often pressured by higher discount rates.	Valuations may benefit from lower discount rates.	Risk-off markets can pressure speculative growth.
Dividend stocks / REITs	Income competition from bonds can pressure prices.	May become more attractive when bond yields fall.	Credit stress and financing costs can matter.

Investment	Rates rise	Rates fall	Spread widening
High-yield bonds	Higher rates can hurt; credit quality matters.	Lower rates can help, unless recession risk dominates.	Often pressured when spreads widen.

Client Suitability Considerations

- **Time horizon**: long-term bonds may be unsuitable for a client who needs principal stability in the near term.
- **Income needs**: rising rates can improve future income opportunities but can hurt the market value of existing bonds.
- **Risk tolerance**: widening credit spreads usually indicate that riskier bonds are becoming more volatile.
- **Liquidity needs**: lower-quality bonds can become harder to sell in stressed markets.
- **Tax status**: taxable, municipal, and tax-exempt yields must be compared on an after-tax or tax-equivalent basis when appropriate.

Common Series 65 Exam Traps

Trap	Correct exam framing
Thinking higher rates help all bond investors	Higher rates may improve future income, but existing bond prices fall.
Confusing yield curve slope with credit spread	Yield curve slope compares maturities; credit spread compares credit quality.
Assuming an inverted curve guarantees recession	It is a warning signal, not a certainty.
Ignoring duration	Longer-duration bonds are more price-sensitive to interest-rate changes.
Treating yield as the same as total return	Total return includes income, price change, and reinvestment effects.
Forgetting call risk	When rates fall, callable bonds are more likely to be called, limiting upside for investors.

Key Takeaways

- Interest rates are the price of money and the discount rate applied to future cash flows.
- Bond prices and interest rates move inversely.
- Longer-duration bonds are more sensitive to interest-rate changes.
- Yield curves compare yields across maturities; credit spreads compare yields across credit quality.
- Widening credit spreads usually signal greater concern about default, liquidity, or risk appetite.
- Suitability depends on time horizon, income needs, risk tolerance, liquidity needs, and tax status.

Key Terms

Term	Meaning
Interest rate	The cost of borrowing money or the return earned for lending money.
Nominal rate	The stated interest rate before adjusting for inflation.
Real rate	The inflation-adjusted rate; approximately nominal rate minus inflation rate.
Risk-free rate	A benchmark rate often represented by U.S. Treasury securities of a comparable maturity.
Yield curve	A graph showing yields on bonds of similar credit quality across different maturities.
Normal yield curve	An upward-sloping curve where longer maturities generally have higher yields than shorter maturities.
Flat yield curve	A curve where short-term and long-term yields are similar.
Inverted yield curve	A downward-sloping curve where short-term yields are higher than long-term yields.
Credit spread	The additional yield a bond offers above a comparable Treasury security.

Term	Meaning
Basis point	One one-hundredth of one percentage point; 100 basis points equals 1.00%.

References and Further Reading

- NASAA. Series 65 Test Specifications, effective June 12, 2023. Topic I.A.5: interest rates, yield curves, credit spreads.
- Federal Reserve. Monetary Policy and interest-rate transmission materials.
- U.S. Department of the Treasury. Daily Treasury rates and yield curve information.
- FINRA. Bond facts, duration, interest-rate risk, and credit risk investor education resources.

Practice Questions

1. If market interest rates rise sharply, what will most likely happen to the price of an existing fixed-rate bond?

A. It will rise only if the issuer is downgraded.
B. It will fall because its fixed payments are less attractive.
C. It will remain unchanged because the coupon is fixed.
D. It will rise because the bond is safer.

2. Which bond is generally most sensitive to changes in interest rates?

A. A 30-year zero-coupon bond
B. A 3-month Treasury bill
C. A short-term floating-rate note
D. A 1-year certificate of deposit

3. A normal yield curve generally means:

A. Short-term yields are higher than long-term yields.
B. All maturities have the same yield.
C. Long-term yields are higher than short-term yields.
D. Credit spreads have disappeared.

4. An inverted yield curve occurs when:

A. Treasury yields exceed corporate yields.
B. Long-term yields exceed short-term yields.
C. Credit spreads tighten to zero.
D. Short-term yields exceed long-term yields.

5. A credit spread is best described as:

A. The difference between a bond's coupon rate and dividend yield.
B. The difference between yields on similar maturity bonds with different credit quality.
C. The difference between the bid and ask price of a stock.
D. The difference between the federal funds rate and inflation.

6. If the yield on a 10-year corporate bond is 7% and the yield on a 10-year Treasury is 4%, the credit spread is:

A. 30 basis points
B. 700 basis points
C. 3 basis points
D. 300 basis points

7. Credit spreads would most likely widen when:

A. Investors become more confident about corporate earnings.
B. Treasury yields rise but corporate yields do not change.
C. Default risk concerns increase.
D. Inflation expectations fall to zero.

8. Which statement about falling interest rates is most accurate?

A. Existing fixed-rate bond prices generally fall.
B. Callable bonds become less likely to be called.
C. Existing fixed-rate bond prices generally rise.
D. Duration risk disappears.

9. The yield curve primarily compares:

A. Dividend yields across equity sectors.
B. Different maturities of similar credit quality.
C. Nominal returns and real returns.
D. Different credit qualities with the same maturity.

10. A retired client needing stable principal over the next year would generally be most concerned about:

A. Long-duration bond price volatility.
B. Voting rights on preferred stock.
C. Whether common stock dividends are qualified.
D. Whether the yield curve is humped or normal.

Answer Key and Explanations

1. B — Existing fixed cash flows become less attractive when new bonds offer higher yields, so the bond price falls.

2. A — A long maturity and no interim coupon payments usually create high duration and high rate sensitivity.

3. C — A normal yield curve is upward sloping, with longer maturities carrying higher yields.

4. D — An inverted curve slopes downward because short-term yields are higher than long-term yields.

5. B — Credit spread measures the extra yield investors demand for lower credit quality relative to a safer benchmark.

6. D — 7% minus 4% equals 3%, or 300 basis points.

7. C — When investors are more concerned about defaults, they demand more compensation for credit risk.

8. C — Falling market yields make existing fixed-rate bonds more attractive, raising prices.

9. B — The yield curve shows yields across maturities, usually for bonds of similar credit quality.

10. A — A client with short-term liquidity needs may be poorly matched with long-duration bonds that can fluctuate sharply when rates change.

Lesson 6: Economic Indicators: GDP, Employment, Trade Deficit, and CPI

Learning Objectives

- Explain what **GDP** measures and why **real GDP** growth matters to investors.
- Identify the major employment indicators used to evaluate labor market conditions.
- Explain what a **trade deficit** means and how it may affect currencies, interest rates, and growth expectations.
- Explain what the **Consumer Price Index** measures and how CPI relates to inflation and purchasing power.
- Apply economic indicators to investment performance, policy expectations, and client suitability questions.

6.1 Why Economic Indicators Matter

Economic indicators do not tell investors exactly what to buy or sell. Instead, they help investors form expectations about growth, inflation, corporate earnings, interest rates, and central bank policy. On the Series 65 exam, indicators are usually tested conceptually rather than as current data points.

- **Growth indicators** help assess whether economic activity is expanding or slowing.
- **Labor market indicators** help assess household income, consumer spending capacity, and wage pressure.
- **Inflation indicators** help assess purchasing power, real returns, and monetary policy pressure.
- **External trade indicators** help assess imports, exports, currency pressure, and international competitiveness.

> **Exam point**
> The exam is unlikely to require the current GDP growth rate, unemployment rate, trade deficit, or CPI value. It is more likely to ask what the indicator measures and what a change in the indicator generally signals.

6.2 Gross Domestic Product

Gross Domestic Product, or GDP, is the broadest measure of a country's economic output. It measures the market value of final goods and services produced within the country during a specific period. GDP is commonly reported quarterly and annually.

The expenditure approach

A common way to remember GDP is: GDP = C + I + G + NX. In this formula, C is consumer spending, I is business investment, G is government spending, and NX is net exports, or exports minus imports.

Component	Plain-language meaning	Investment relevance
Consumer spending (C)	Household purchases of goods and services.	Important for retailers, restaurants, autos, travel, and consumer discretionary stocks.
Investment (I)	Business spending on equipment, buildings, inventories, and residential construction.	Sensitive to interest rates and business confidence.
Government spending (G)	Federal, state, and local government purchases.	Can support activity during slowdowns but may increase deficits.
Net exports (NX)	Exports minus imports.	Affected by exchange rates, foreign demand, and trade policy.

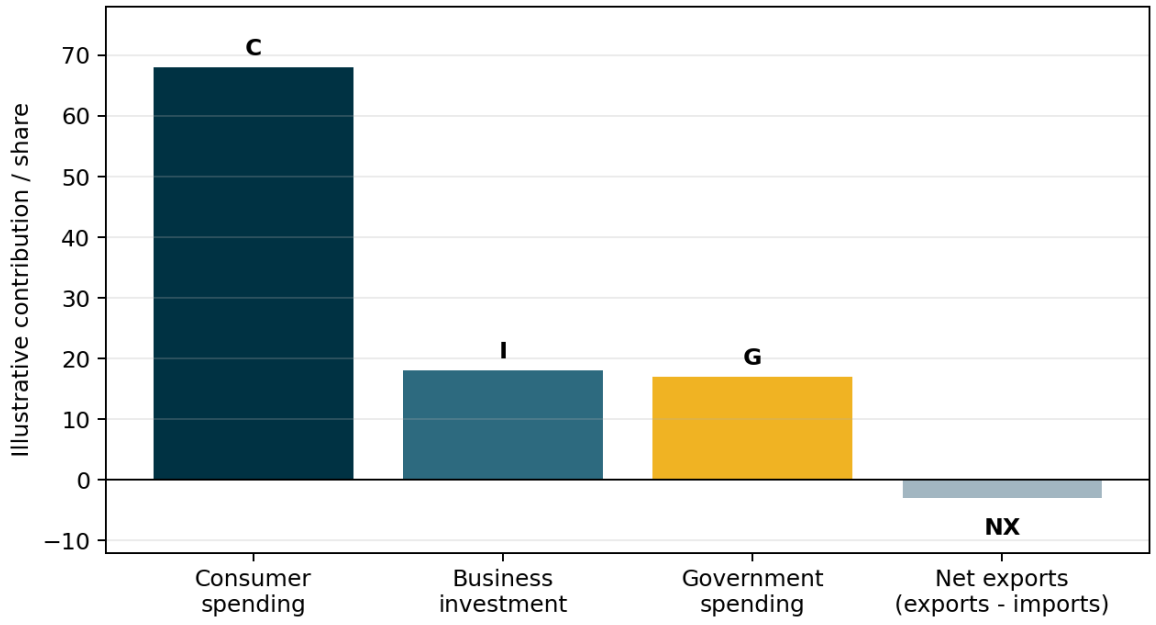


Figure 6.1: Summary of GDP components using the expenditure approach. The percentages are illustrative and are included for teaching purposes rather than as current data.

Real GDP vs. Nominal GDP

Nominal GDP is measured in current dollars. **Real GDP** adjusts for inflation and is therefore better for comparing economic growth across time. If nominal GDP rises only because prices rose, the economy may not have produced more real output.

> **Exam point**
> Do not confuse nominal GDP growth with real economic growth. Real GDP removes inflation and is the better measure of changes in actual output.

Investment implications of GDP

- **Strong GDP growth** may support corporate revenues and cyclical equities, but if growth is too strong it may raise inflation and rate-hike concerns.
- **Weak GDP growth** may hurt earnings expectations and cyclical sectors, but may support high-quality bonds if investors expect lower rates.
- Negative real GDP growth may signal recession risk, especially if it persists and appears alongside rising unemployment and falling confidence.

6.3 Employment Indicators

Employment indicators measure the condition of the labor market. A strong labor market tends to support household income and consumer spending. However, a labor market that is too tight can increase wage inflation and pressure the central bank to raise rates.

Indicator	What it measures	Series 65 cue
Unemployment rate	Share of the labor force without a job but actively looking for work.	Lower usually signals labor strength, but extremely low unemployment can create wage pressure.
Nonfarm payrolls	Monthly net jobs added or lost in the economy, excluding farm and certain other workers.	A major growth and policy signal.
Initial jobless claims	New claims for unemployment benefits.	Rising claims can be an early warning of labor-market weakness.
Labor force participation	Share of the working-age population employed or looking for work.	A falling unemployment rate is less impressive if participation is also falling.

Indicator	What it measures	Series 65 cue
Average hourly earnings	Wage growth.	Higher wages support consumers but can add inflation pressure.

Exam point A low unemployment rate generally indicates a strong labor market. Rising jobless claims or falling payrolls usually signal weakness. Wage growth can be positive for consumers but may contribute to inflation.

Employment and investment performance

- **Equities** may benefit from strong employment because consumers have income to spend.
- **Bonds** may weaken if employment strength leads to inflation and higher interest rates.
- **Consumer discretionary stocks** are often sensitive to job security and wage growth.
- **Defensive sectors** may hold up better when employment weakens and recession risk rises.

6.4 Trade Deficit

A **trade deficit** occurs when a country imports more goods and services than it exports. In GDP accounting, net exports equal exports minus imports. When imports exceed exports, net exports are negative and subtract from GDP.

- **Imports** are goods and services purchased from abroad.
- **Exports** are goods and services sold to buyers in other countries.
- **Trade deficit** means imports are greater than exports.
- **Trade surplus** means exports are greater than imports.

Why trade deficits are not automatically good or bad

A trade deficit can reflect strong domestic demand because consumers and businesses are buying many imported goods. It can also reflect weak export competitiveness, a strong domestic currency, or dependence on foreign production. The investment implication depends on the cause and the broader economic context.

Possible cause	Likely interpretation	Investment link
Strong domestic demand	Consumers and businesses are buying more imported goods.	May support retailers and logistics but subtracts from GDP through net exports.

Possible cause	Likely interpretation	Investment link
Strong domestic currency	Foreign goods become cheaper for domestic buyers; exports become more expensive abroad.	May hurt exporters and help importers.
Weak foreign demand	Other countries buy fewer domestic exports.	May hurt multinational or export-oriented firms.
Supply chain dependence	Domestic production relies heavily on imports.	Can expose companies to currency and geopolitical risk.

Exam point
A trade deficit subtracts from GDP through net exports, but the deficit itself is not automatically proof that the economy is weak. The cause matters.

6.5 Consumer Price Index

The Consumer Price Index, or CPI, measures changes in the price of a basket of consumer goods and services. It is one of the most widely watched inflation indicators because it directly relates to household purchasing power.

- **Headline CPI** includes food and energy prices.
- **Core CPI** excludes food and energy prices because they can be volatile.
- **CPI inflation** reduces purchasing power when wages or investment income do not keep pace.
- **High CPI readings** may increase the likelihood of tighter monetary policy.
- **Falling CPI or deflation** may indicate weak demand, lower pricing power, and recession risk.

CPI and real returns

Investors care about real returns, not just nominal returns. If a client earns 5% while inflation is 3%, the approximate real return is 2%. If a client earns 4% while inflation is 6%, the client has a positive nominal return but a negative real return.

Nominal return	CPI inflation	Approx. real return	Meaning
7%	3%	4%	Purchasing power increases

Nominal return	CPI inflation	Approx. real return	Meaning
5%	5%	0%	Purchasing power roughly preserved
4%	6%	-2%	Purchasing power declines

6.6 Putting the Indicators Together

The most useful economic analysis looks at indicators together rather than in isolation. A single report may be noisy, revised, or affected by temporary conditions. Exam questions often present a bundle of facts and ask what the indicators imply for the economy or a client portfolio.

Scenario	GDP	Employment	CPI / rates implication
Healthy expansion	Real GDP rising	Payrolls rising, unemployment low	Inflation stable; equities may benefit.
Overheating	GDP strong	Labor market very tight, wages rising	CPI may rise; rates may increase; long bonds vulnerable.
Slowdown	GDP slowing or falling	Payrolls weak, claims rising	Rates may fall; defensive assets may become more attractive.
Stagflation risk	GDP weak	Employment weakening	CPI high; difficult environment for both stocks and bonds.

Series 65 Exam Traps

- **GDP measures production within a country**, not the income of citizens wherever they live.
- Real GDP adjusts for inflation; nominal GDP does not.
- **The unemployment rate excludes discouraged workers** who have stopped actively looking for work.
- A trade deficit means imports exceed exports; it is not automatically proof that the economy is weak.

- Core CPI excludes food and energy; headline CPI includes them.
- *A positive nominal return can still be a negative real return if* inflation is higher than the investment return.

Quick Reference Table

Indicator	Measures	Rising value often suggests	Potential portfolio effect
Real GDP	Inflation-adjusted output	Stronger growth	Cyclicals may benefit; rates may rise if growth is too strong.
Payrolls	Jobs added or lost	Labor-market strength	Supports spending; may increase rate-hike risk.
Jobless claims	New unemployment claims	Labor-market weakness when claims rise	Defensive assets may become more attractive.
Trade deficit	Imports minus exports when imports are larger	Strong import demand or weak exports	Currency and sector effects depend on cause.
CPI	Consumer price inflation	Lower purchasing power and possible tighter policy	TIPS and inflation hedges may help; long bonds can struggle.

Key Takeaways

- GDP is the broadest measure of economic output; real GDP is adjusted for inflation.
- Employment data helps assess income, spending capacity, wage pressure, and recession risk.
- A trade deficit means imports exceed exports and subtracts from GDP through net exports.
- CPI measures consumer price inflation and is central to real-return and monetary-policy analysis.
- For Series 65 questions, focus on what each indicator measures and the general investment implication.

Key Terms

Term	Meaning
Gross Domestic Product (GDP)	The market value of final goods and services produced within a country during a period.
Real GDP	GDP adjusted for inflation; used to evaluate actual output growth.
Nominal GDP	GDP measured in current dollars without removing inflation.
Unemployment rate	The percentage of the labor force that is unemployed and actively seeking work.
Labor force participation rate	The percentage of the working-age population that is employed or actively seeking work.
Nonfarm payrolls	A monthly measure of jobs added or lost, excluding farm workers and selected other categories.
Trade deficit	A situation in which a country imports more goods and services than it exports.
Consumer Price Index (CPI)	A price index measuring changes in the cost of a basket of consumer goods and services.
Headline CPI	CPI including food and energy prices.
Core CPI	CPI excluding food and energy prices, often used to assess underlying inflation trends.

Practice Questions

1. Which indicator is the broadest measure of goods and services produced within a country?

A. GDP
B. Initial jobless claims
C. Trade deficit
D. CPI

2. Which GDP measure is adjusted for inflation?

A. Nominal GDP
B. Core GDP
C. Headline GDP
D. Real GDP

3. If imports exceed exports, the country has a:

A. Trade surplus
B. Trade deficit
C. Positive real return
D. Budget surplus

4. Core CPI excludes which categories?

A. Taxes and imports
B. Housing and medical care
C. Food and energy
D. Wages and salaries

5. A rising unemployment rate and falling payrolls usually suggest:

A. Labor-market weakness
B. Higher real GDP by definition
C. A trade surplus
D. Stronger wage pressure only

6. If an investor earns 5% and CPI inflation is 7%, the approximate real return is:

A. -2%
B. 12%
C. 5%
D. 2%

7. Which employment indicator can be an early warning signal of labor-market weakening?

A. Higher net exports
B. Rising nominal GDP only
C. Rising initial jobless claims
D. Falling CPI

8. Which part of GDP is represented by exports minus imports?

A. Government spending
B. Consumer spending
C. Business investment
D. Net exports

9. Why might strong employment data hurt bond prices?

A. It guarantees deflation
B. It reduces consumer spending
C. It eliminates credit risk
D. It may increase inflation and rate-hike expectations

10. Which statement is most accurate about a trade deficit?

A. It is the same as a federal budget deficit.
B. It means imports exceed exports.
C. It always means the economy is in recession.
D. It means exports exceed imports.

Answer Key and Explanations

1. A — GDP measures the market value of final goods and services produced within a country.

2. D — Real GDP removes the effect of inflation.

3. B — A trade deficit occurs when imports are greater than exports.

4. C — Core CPI excludes food and energy because those prices can be volatile.

5. A — Rising unemployment and falling payrolls usually point to weakening labor conditions.

6. A — Approximate real return equals nominal return minus inflation, or 5% - 7% = -2%.

7. C — Initial jobless claims measure new unemployment claims and can rise before broader employment data deteriorates.

8. D — Net exports equal exports minus imports.

9. D — Very strong labor data can increase expectations for inflation and tighter monetary policy.

10. B — A trade deficit means imports exceed exports; its interpretation depends on the cause.

Lesson 7: Financial Reports

Learning Objectives

- Identify the purpose of the **income statement**, balance sheet, and **statement of cash flows**.
- Distinguish **profitability**, **solvency**, **liquidity**, and **cash-flow** information in **financial reports**.
- Recognize auditor disclosures, especially **unqualified** versus **qualified audit opinions**.
- Connect corporate **SEC filings** and **annual reports** to the information investors use for analysis.
- Avoid common Series 65 traps involving point-in-time versus period-of-time reporting.

7.1 Why Financial Reports Matter

Financial reports give investors a structured way to evaluate a company. They help answer three basic questions: Is the company profitable? Is the company financially stable? Is the company generating cash?

For the Series 65, the emphasis is usually recognition and interpretation rather than deep accounting mechanics. You should be able to identify which report contains which information and how a basic financial fact affects an investment decision.

The exam may phrase financial reporting questions as client scenarios. For example, a question may ask which statement an investor would review to evaluate liquidity, profitability, or cash generated from core operations.

7.2 The Income Statement

The **income statement** measures performance over a period of time, such as a quarter or fiscal year. It starts with revenue and subtracts expenses to arrive at net income.

Common income statement line items include revenue, cost of goods sold, gross profit, operating expenses, operating income, interest expense, taxes, and net income. Earnings per share also comes from income statement information combined with share count.

A profitable company can still experience cash-flow problems. This is why the income statement should be read with the statement of cash flows and the balance sheet.

7.3 The Balance Sheet

The **balance sheet** reports the financial position at a specific point in time. It follows the accounting equation: assets equal liabilities plus owners' equity.

Assets are resources controlled by the company. Liabilities are obligations owed to creditors or other parties. Equity represents the residual ownership interest after liabilities are subtracted from assets.

Balance sheets are especially useful for evaluating liquidity, leverage, working capital, and capital structure. They also provide the base information for ratios such as current ratio, debt-to-equity ratio, and book value per share.

7.4 The Statement of Cash Flows

The **statement of cash flows** explains why cash increased or decreased during the period. It classifies cash flows into operating, investing, and financing activities.

Operating cash flow comes from the company's core business activities. Investing cash flow usually includes capital expenditures, asset purchases, and asset sales. Financing cash flow includes debt issuance or repayment, share issuance or repurchases, and dividends.

For investment analysis, cash flow can be more difficult to manipulate than earnings, but it still requires context. A single year of high cash flow may reflect asset sales rather than strong operating performance.

7.5 Auditor Disclosures: Qualified vs. Unqualified

An **independent audit** provides assurance that financial statements are fairly presented according to the applicable accounting framework. It does not guarantee future performance and does not eliminate investment risk.

An **unqualified audit** opinion is commonly called a clean opinion. It indicates that the auditor believes the statements fairly present the company's financial position and results in accordance with the relevant standards.

A **qualified opinion** signals a specific exception, limitation, or departure. On the Series 65, the exam may test the difference between a clean opinion and an opinion with a reservation. A qualified opinion is not the same as an unqualified opinion.

7.6 Corporate SEC Filings

Public companies file reports with the SEC. These filings give investors standardized access to financial statements, risk disclosures, management discussion, and important current events.

Form 10-K is the annual filing and typically includes **audited financial statements**. **Form 10-Q** is the quarterly filing and typically includes unaudited interim financial statements. **Form 8-K** reports important current events, such as major acquisitions, leadership changes, bankruptcy events, or material agreements.

Investors and advisers should not rely only on promotional summaries. SEC filings and annual reports provide more complete information and should be part of fundamental analysis.

7.7 Annual Reports

An annual report is a company's yearly communication to shareholders. It commonly includes a business overview, management discussion and analysis, audited financial statements, notes to the financial statements, and the auditor's report.

Annual reports can be useful, but they also have narrative sections written by management. Investors should separate management's explanation from the audited financial statements and footnote disclosures.

For exam purposes, remember that annual reports are broader communications, while Form 10-K is the required annual SEC filing for reporting companies.

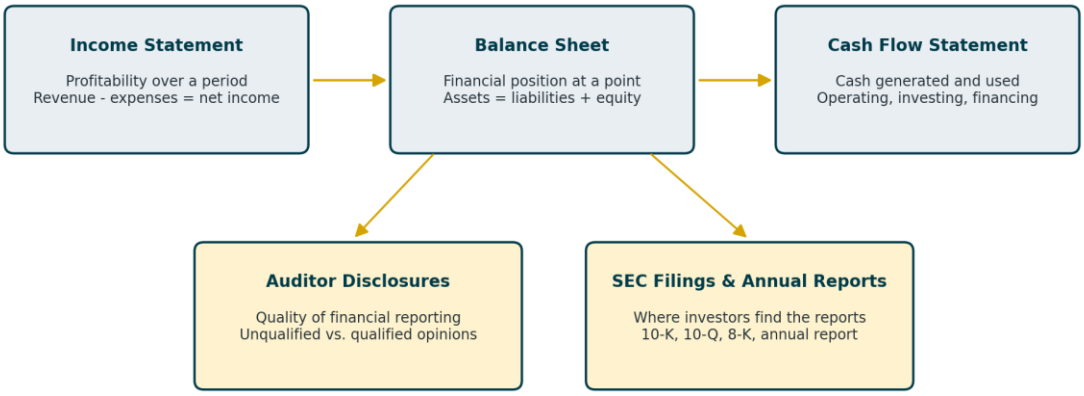


Figure 7.1: How the Major Financial Reports Fit Together

The main financial statements are complementary. The income statement shows profitability, the balance sheet shows financial position, and the cash-flow statement reconciles cash generated and used during the period.

What Each Report Answers

Report	Question It Helps Answer	Common Contents
Income statement	How profitable was the company during the period?	Revenue, expenses, net income, earnings per share
Balance sheet	What did the company own and owe at a specific date?	Assets, liabilities, shareholders' equity, working capital
Statement of cash flows	Where did cash come from and where did it go?	Operating, investing, and financing cash flows
Auditor report	How much assurance did an independent auditor provide?	Unqualified, qualified, adverse, or disclaimer opinion

Report	Question It Helps Answer	Common Contents
Annual report / 10-K	Where can investors find a full annual picture?	Business description, risks, MD&A, audited statements, notes

Simple Case Application

Assume a company reports rising revenue and net income, but operating cash flow is negative and accounts receivable is rising sharply. The income statement suggests profitability, but the cash-flow statement and balance sheet raise a collection-quality concern. A Series 65 question may ask which statement reveals the cash-flow problem or which additional report should be reviewed before recommending the stock.

Common Exam Traps

- Confusing the balance sheet with the income statement. The balance sheet is a point-in-time snapshot; the income statement covers a period.
- Assuming net income equals cash flow. Accrual accounting can produce earnings before cash is received or paid.
- Treating an audit opinion as a guarantee. Audits provide reasonable assurance about reporting, not a guarantee of investment success.
- Mistaking qualified and unqualified opinions. Unqualified means clean; qualified means there is a specific exception or limitation.
- Thinking an annual report is only marketing. It usually includes audited financial statements, footnotes, and management discussion.

Key Terms

Term	Definition
Financial reports	Company documents that summarize financial performance, financial position, cash flows, and disclosures.
Income statement	A period-of-time report showing revenues, expenses, gains, losses, and net income.
Balance sheet	A point-in-time report showing assets, liabilities, and shareholders' equity.
Statement of cash flows	A period-of-time report explaining cash from operating, investing, and financing activities.

Term	Definition
Unqualified opinion	A clean audit opinion indicating the financial statements are fairly presented in accordance with the applicable accounting framework.
Qualified opinion	An audit opinion with an exception or limitation; the auditor has a specific reservation.
Form 10-K	The annual report filed with the SEC by public companies.
Form 10-Q	The quarterly report filed with the SEC by public companies.
Form 8-K	A current report filed with the SEC to disclose important events.

References and Further Reading

- NASAA Series 65 Test Specifications, Economic Factors and Business Information: Financial Reporting.
- SEC EDGAR company filings: Forms 10-K, 10-Q, and 8-K.
- Public company annual reports and audited financial statements.

Practice Questions

1. Which financial statement shows a company's assets, liabilities, and shareholders' equity at a specific point in time?

A. Statement of cash flows
B. Income statement
C. Auditor's report
D. Balance sheet

2. A company is profitable on an accrual basis but has negative operating cash flow. Which statement would most directly show the cash-flow concern?

A. Income statement
B. Statement of cash flows
C. Proxy statement
D. Balance sheet

3. Which statement is most accurate about an unqualified audit opinion?

A. It is a clean opinion indicating the statements are fairly presented.
B. It means the investment is low risk.
C. It means the company will remain profitable.
D. It indicates the auditor found a specific exception.

4. A qualified audit opinion most likely means:

A. the company is exempt from SEC filing requirements
B. the auditor has no reservations
C. the auditor identified a specific exception or limitation
D. the company has issued qualified stock options

5. Which SEC filing is the annual report filed by a public company?

A. Form 10-Q
B. Form S-1
C. Form 8-K
D. Form 10-K

6. Which SEC filing is most likely used to report a significant current event?

A. Form 8-K
B. Form 10-Q
C. Form 10-K
D. Annual report to shareholders only

7. The income statement is best used to evaluate:

A. revenues, expenses, and net income during a period
B. cash from investing activities only
C. assets and liabilities at one date
D. auditor independence only

8. Which cash-flow category usually includes capital expenditures?

A. Operating activities
B. Audit activities
C. Investing activities
D. Financing activities

9. A company's debt-to-equity ratio would primarily use information from which statement?

A. Statement of cash flows
B. Auditor's engagement letter
C. Balance sheet
D. Income statement

10. Which is the best definition of annual reports?

A. They are irrelevant if a company has a website.
B. They are broader shareholder communications that commonly include financial statements and disclosures.
C. They replace the need for SEC filings in all cases.
D. They are never audited.

Answer Key and Explanations

1. D — The balance sheet is a point-in-time statement of financial position.
2. B — The statement of cash flows shows cash generated or used by operating activities.
3. A — Unqualified means clean; it does not guarantee safety or future performance.
4. C — A qualified opinion includes a specific reservation or scope limitation.
5. D — Form 10-K is the annual filing, generally including audited financial statements.
6. A — Form 8-K is used for important current events.
7. A — The income statement measures operating results and profitability over a period.
8. C — Purchases and sales of long-term assets are generally investing cash flows.
9. C — Debt and equity are balance-sheet items.
10. B — Annual reports typically include narrative information, audited financial statements, notes, and disclosures.

Lesson 8: Accounting Fundamentals: Cash vs. Accrual; Audited vs. Unaudited

Learning Objectives

- Understand the differences between **cash accounting** and **accrual accounting.**
- Recognize the importance of **audited** financial statements compared to **unaudited** financial statements and the increased risk of relying on unaudited financial statements.

Business Scenario

Assume ABC Consulting performs consulting work for a client in December and sends the client an invoice for $5,000 on December 20. The client does not pay until January 15 of the next year. ABC Consulting also receives a utility bill for $600 for December electricity usage. The bill is received in December but paid in January.

Transaction	Date Service Occurs	Date Cash Changes Hands	Amount
Consulting services provided	December	January	$5,000 revenue
December utility expense incurred	December	January	$600 expense

Under Cash Accounting

Cash accounting records revenue when cash is received and expenses when cash is paid. The timing of economic activity matters less than the timing of cash collection and cash payment.

December: Cash Basis

December Cash-Basis Income Statement	Amount
Revenue	$0
Expenses	$0
Net income	$0

Explanation: ABC did the work and used electricity in December, but no cash was collected or paid in December. Therefore, the cash-basis income statement shows no revenue, no expense, and no net income for these transactions in December.

January: Cash Basis

January Cash-Basis Income Statement	Amount
Revenue	$5,000
Expenses	$600
Net income	$4,400

Explanation: The client pays the $5,000 invoice in January, and ABC pays the $600 utility bill in January. Under cash accounting, both the revenue and expense are recorded in January because that is when cash changes hands.

Under Accrual Accounting

Accrual accounting records revenue when it is earned and expenses when they are incurred, regardless of when cash is received or paid. This approach attempts to match revenues with the expenses used to generate those revenues.

December: Accrual Basis

December Accrual-Basis Income Statement	Amount
Revenue earned	$5,000
Utility expense incurred	$600
Net income	$4,400

December Balance Sheet Item	Amount
Accounts receivable	$5,000
Accounts payable	$600

Explanation: ABC earned the $5,000 revenue in December because it completed the consulting work in December. ABC also incurred the $600 utility expense in December because the electricity was used in December. Since the client has not paid yet, ABC records accounts receivable. Since ABC has not paid the utility bill yet, it records accounts payable.

January: Accrual Basis

January Accrual Accounting Effect	Amount
Cash received from client	+$5,000
Accounts receivable reduced	-$5,000
Cash paid for utility bill	-$600
Accounts payable reduced	-$600
New revenue recognized	$0
New expense recognized	$0

Explanation: When cash is collected and the utility bill is paid in January, ABC does not record new revenue or new expense. The revenue and expense were already recognized in December. January's entries simply convert accounts receivable into cash and reduce accounts payable when the bill is paid.

Side-by-Side Comparison

Question	Cash Accounting	Accrual Accounting
When is revenue recorded?	When cash is received.	When revenue is earned.
When are expenses recorded?	When cash is paid.	When expenses are incurred.
What does December show in this example?	$0 net income.	$4,400 net income.
What does January show in this example?	$4,400 net income.	$0 new revenue or expense from these transactions.
Best reflects…	Cash-flow timing.	Economic performance timing.

Key Lesson

Cash accounting focuses on cash flow timing. It answers the question, "When did the money come in or go out?"

Accrual accounting focuses on economic activity timing. It answers the question, "When was the revenue earned, and when was the expense incurred?"

For investment analysis and financial reporting, accrual accounting is generally more informative because it better matches revenues with related expenses. In this example, accrual accounting gives a clearer picture of December's performance because ABC completed the work and used the electricity in December, even though the cash moved in January.

Series 65 Exam Tip

For exam purposes, remember the distinction this way: cash accounting follows the cash; accrual accounting follows the business activity.

Audited vs. Unaudited Financial Statements

Audited financial statements have been examined by an independent auditor. The auditor performs procedures designed to obtain reasonable assurance that the statements are free of material misstatement and then expresses an opinion. An audit does not guarantee that the company is financially strong, that no fraud exists, or that every number is perfectly accurate.

Unaudited financial statements have not been subjected to a full independent audit. They may still be prepared using generally accepted accounting principles and may be useful for analysis, but the investor does not have the additional assurance provided by an independent audit opinion.

For public companies, annual financial statements in Form 10-K are generally audited, while interim quarterly financial statements in Form 10-Q are generally unaudited, although they are subject to review procedures. The key exam distinction is the level of independent assurance, not whether the statements contain useful information.

When comparing otherwise similar information, audited statements generally provide a higher level of confidence in the presentation of the financial statements. However, an audit opinion is not an investment recommendation and does not eliminate business, market, credit, or fraud risk.

Type	Explanation
Audited	Independent audit performed; auditor issues an opinion; reasonable assurance, not a guarantee.
Unaudited	No full independent audit opinion; information can still be useful but has less independent assurance.

Practice Questions

1. Under cash-basis accounting, revenue is generally recognized when:

A. The fiscal year ends
B. An invoice is sent
C. Cash is received
D. It is earned

2. Under accrual accounting, an expense is generally recognized when:

A. It is paid in cash
B. It is incurred
C. The company borrows money
D. The related asset is sold

3. A firm performs services in December but collects the receivable in January. Under accrual accounting, the revenue is generally recorded in:

A. January only
B. December
C. The month cash is deposited
D. Neither month

4. Which statement best describes audited financial statements?

A. They are always free from estimates
B. They are prepared only for private companies
C. They guarantee that no fraud exists
D. They have been examined by an independent auditor who expresses an opinion

5. Which statement best describes unaudited financial statements?

A. They have not been subjected to a full independent audit
B. They are automatically fraudulent
C. They cannot be useful to investors
D. They must be prepared on a cash basis

6. Which statement is most accurate about an audit?

A. It provides reasonable assurance, not an absolute guarantee
B. It removes all management judgment from the statements
C. It converts accrual accounting to cash accounting
D. It guarantees future profitability

7. Why is accrual accounting often more useful for investment analysis than cash accounting?

A. It eliminates estimates
B. It records only transactions involving cash
C. It matches economic activity more closely to the period in which it occurs
D. It ignores liabilities

8. Which comparison is correct?

A. Audited means guaranteed while unaudited means inaccurate
B. Cash accounting follows economic activity while accrual accounting follows cash
C. Unaudited statements cannot use GAAP
D. Cash accounting follows cash flows; accrual accounting follows when revenues are earned and expenses incurred

Answer Key and Explanations

1. C — Cash-basis accounting generally recognizes revenue when cash is received.

2. B — Accrual accounting recognizes expenses when they are incurred, not simply when cash is paid.

3. B — The revenue was earned in December, so accrual accounting generally records it in December.

4. D — Audited statements are examined by an independent auditor, who expresses an opinion and provides reasonable rather than absolute assurance.

5. A — Unaudited statements have not undergone a full independent audit, although they may still provide useful financial information.

6. A — An audit provides reasonable assurance regarding fair presentation; it is not a guarantee of accuracy or future results.

7. C — Accrual accounting better matches revenues and related expenses to the periods in which economic activity occurs.

8. D — Cash accounting focuses on cash receipts and payments, while accrual accounting focuses on when revenues are earned and expenses are incurred.

Lesson 9: Time Value of Money Concepts

Learning Objectives

- Explain why a dollar today is worth more than a dollar received in the future.
- Identify the variables used in time value of money calculations: PV, FV, rate, periods, and payments.
- Calculate and interpret **future value**, **present value**, and **annuity** concepts at a conceptual level.
- Distinguish **compounding** from **discounting** and **ordinary annuities** from **annuities due**.
- Apply time value of money concepts to bonds, retirement planning, loans, and investment suitability.
- Explain the concepts of **NPV** and **IRR** and calculate the approximate time to double the value of an investment using the **Rule of 72.**

9.1 The Core Idea: Money Has a Time Value

Time value of money means that money available today is usually worth more than the same dollar amount received in the future. A dollar today can be invested, can earn a return, and provides immediate flexibility. A dollar received later has opportunity cost, inflation risk, and uncertainty about when and whether it will be received.

For the Series 65, time value of money is less about memorizing advanced formulas and more about recognizing the direction of the relationship. More time and a higher positive return increase future value. More time and a higher discount rate reduce present value. These concepts support bond valuation, retirement planning, loan analysis, and discounted cash-flow reasoning.

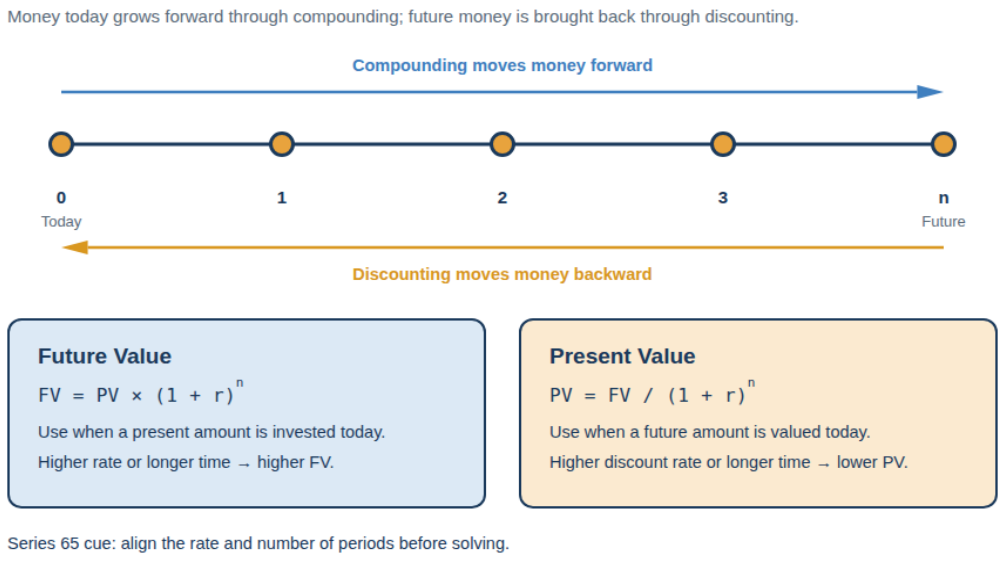


Figure 9.1: Time value of money timeline. Compounding moves values forward; discounting moves values backward.

9.2 The Five Main Variables

Most time value of money problems use the same basic variables.

Variable	Meaning	Typical Question	Exam Cue
PV	Present value	What is it worth today?	Discount back to time 0.
FV	Future value	What will it grow to?	Compound forward.
r or i	Interest rate or required return	What return is earned or required?	Match the rate to the period.
n	Number of periods	How many periods does money grow or discount?	Monthly periods require monthly rates.
PMT	Recurring payment	What is the periodic cash flow?	Used for annuities and loans.

9.3 Future Value: Compounding Forward

Future value asks what an amount today will be worth at a future date if it earns a stated return. The basic lump-sum formula is: $FV = PV \times (1 + r)^n$. The interest rate and number of periods must use the same period length. If interest compounds annually, use annual rates and annual periods. If interest compounds monthly, use monthly rates and monthly periods.

Compounding becomes powerful because returns can earn returns. The longer the time horizon, the more important the growth rate becomes. This is why early retirement contributions can have a large effect on retirement wealth, even if the annual contribution is modest.

9.4 Present Value: Discounting Backward

Present value asks what a future cash flow is worth today. The basic lump-sum formula is: $PV = FV / (1 + r)^n$. The rate used to discount a future cash flow is often called the discount rate, required return, or opportunity cost of capital. A higher discount rate lowers present value because investors require more compensation for waiting and bearing risk.

Present value is central to investment valuation. A bond, stock, annuity, real estate project, or business can be analyzed by estimating future cash flows and discounting those cash flows back to today. The Series 65 often tests the direction of the relationship rather than requiring complex arithmetic.

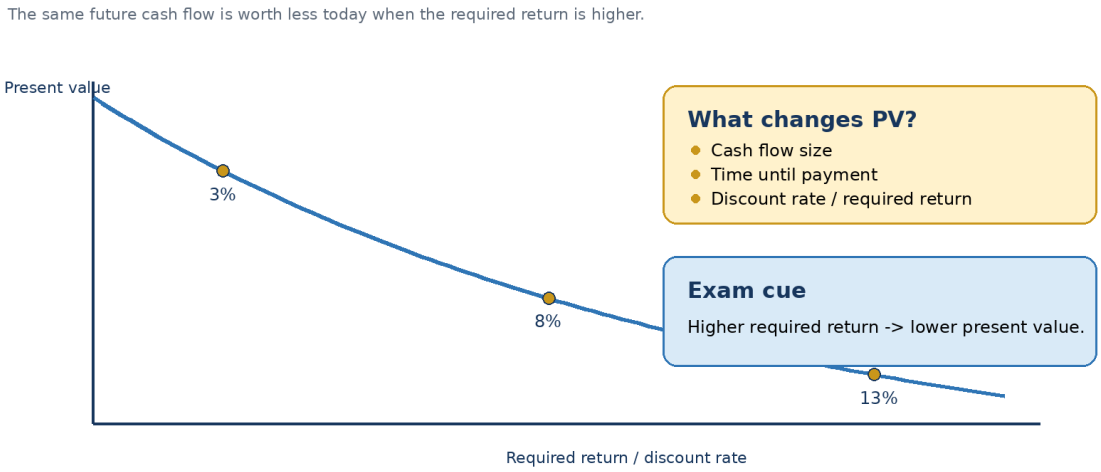


Figure 9.2: Present value decreases as the required return or discount rate increases.

9.5 Annuities and Recurring Payments

An **annuity** is a series of equal payments made at regular intervals. Retirement contributions, mortgage payments, lease payments, and many insurance-related payouts can be analyzed as annuities. The present value of an annuity asks what the series of payments is worth today. The future value of an annuity asks what the series of payments will accumulate to over time.

An **ordinary annuity** assumes payments occur at the end of each period. An **annuity due** assumes payments occur at the beginning of each period. Because each payment in an annuity due is invested or discounted for one additional period, an annuity due has a higher value than an otherwise identical ordinary annuity.

Cash Flow Pattern	Payment Timing	Key Interpretation
Lump sum	One cash flow	Used for one deposit, one bond principal payment, or one future target.
Ordinary annuity	End of each period	Common assumption for loans and many investment payment problems.
Annuity due	Beginning of each period	Worth more than an ordinary annuity because cash flows occur sooner.

Cash Flow Pattern	Payment Timing	Key Interpretation
Perpetuity	Equal payments forever	Conceptual valuation tool; value rises when payment rises or discount rate falls.

9.6 Compounding Frequency and Rate Alignment

The interest rate must match the number of periods. If a problem gives a 12% annual rate compounded monthly, the monthly periodic rate is 1% and there are 12 periods per year. If a problem uses quarterly compounding, there are four compounding periods per year. Many exam mistakes come from using an annual rate with monthly periods or monthly rate with annual periods.

More frequent compounding increases the effective annual return when the stated nominal rate is positive. The more often interest is credited, the sooner it can begin earning additional interest. The effect may be small over short periods but becomes more important over longer horizons or at higher rates.

9.7 Investment Applications

Application	How TVM Is Used	Exam Cue
Bonds	Bond value equals the present value of coupon payments and principal.	Higher market rates generally lower existing bond prices.
Retirement planning	Contributions compound over long horizons.	Starting earlier can matter as much as saving more later.
Loans and mortgages	Payments reflect present value, rate, term, and payment timing.	Longer terms lower payments but increase total interest.
Stocks and businesses	Expected future cash flows can be discounted to estimate value.	Higher required return lowers valuation.
Inflation	Future dollars may buy less than current dollars.	Real return adjusts nominal return for inflation.

9.8 Series 65 Exam Traps

- Confusing present value with future value. Future value compounds forward; present value discounts backward.
- Using an annual rate with monthly periods. Always align the rate and number of periods.
- Assuming higher discount rates increase present value. They do the opposite.
- Forgetting that annuity-due payments occur at the beginning of the period and are therefore more valuable.
- Treating nominal returns and real returns as the same. Inflation reduces purchasing power.
- Assuming a long time horizon always helps. It helps future value, but it lowers the present value of a distant cash flow.

Quick Reference Table

Concept	Question It Answers	Direction	Common Mistake
Future value	What will it become?	Forward in time	Forgetting compound interest
Present value	What is it worth today?	Backward in time	Thinking higher discount rate raises PV
Compounding	How does money grow?	Interest earns interest	Using wrong compounding period
Annuity	What is a stream of payments worth?	Multiple cash flows	Confusing ordinary annuity and annuity due
Real return	What is return after inflation?	Purchasing power	Ignoring inflation in long-term planning

Important Applications: NPV, IRR, and the Rule of 72

9.9 Time Value of Money Recap

The time value of money is the idea that a dollar today is worth more than a dollar received in the future. A dollar today can be invested, can earn a return, and can be used immediately. A dollar received later is worth less today because the investor gives up the opportunity to earn a return during the waiting period.

NPV, IRR, and the Rule of 72 all apply this same basic principle. NPV converts future cash flows into today's dollars. IRR finds the return implied by a set of cash flows. The Rule of 72 provides a quick mental estimate of compounding.

9.10 Net Present Value (NPV)

Net present value is the present value of expected future cash inflows minus the present value of expected cash outflows. In most investment examples, the initial cost occurs today, so it is already stated in present-value terms.

NPV = sum of present values of future cash inflows - initial investment. A positive NPV means the investment is expected to add value at the required rate of return.

The discount rate represents the required return, hurdle rate, or opportunity cost of capital. A higher discount rate reduces the present value of future cash flows.

Decision rule:

- If NPV is positive, the project earns more than the required return and may be acceptable.
- If NPV is zero, the project earns exactly the required return.
- If NPV is negative, the project earns less than the required return and should generally be rejected.

Worked Example: NPV

Assume a business can invest $10,000 today in equipment that is expected to generate cash inflows of $3,500 in Year 1, $4,200 in Year 2, and $5,000 in Year 3. The required return is 8%.

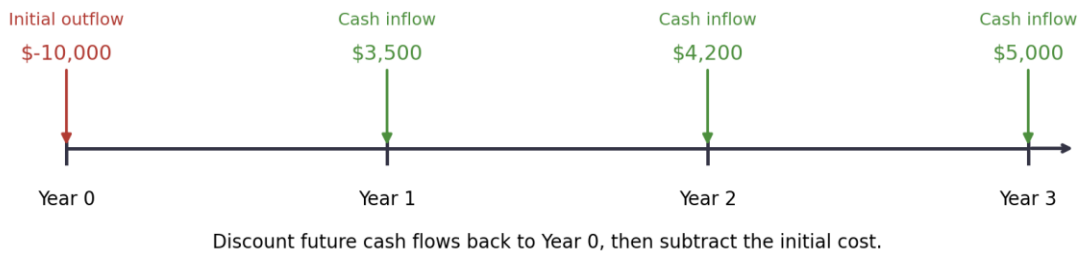


Figure 9.3: Cash-flow timeline for the NPV and IRR example.

Year	Cash flow type	Cash flow	Discount factor	Present value
0	Initial investment	($10,000)	1.0000	($10,000.00)
1	Cash inflow	$3,500	1 / 1.08 = 0.9259	$3,240.74
2	Cash inflow	$4,200	1 / 1.08^2 = 0.8573	$3,600.82

Year	Cash flow type	Cash flow	Discount factor	Present value
3	Cash inflow	$5,000	1 / 1.08^3 = 0.7938	$3,969.16
			NPV	$810.72

At an 8% required return, the project has an NPV of approximately $810.72. Since the NPV is positive, the project is expected to earn more than the required return.

9.11 Internal Rate of Return (IRR)

Internal rate of return is the discount rate that makes the NPV of a set of cash flows equal zero. It is the project's implied annualized return, assuming the cash-flow estimates occur as expected.

IRR is the rate r that solves: NPV = 0. In practice, IRR is usually found with a financial calculator, spreadsheet, or trial-and-error process.

Using the same cash flows, the IRR is approximately 12.18%. This means the project breaks even in present-value terms when the discount rate is about 12.18%. If the required return is below that rate, NPV is positive; if the required return is above that rate, NPV is negative.

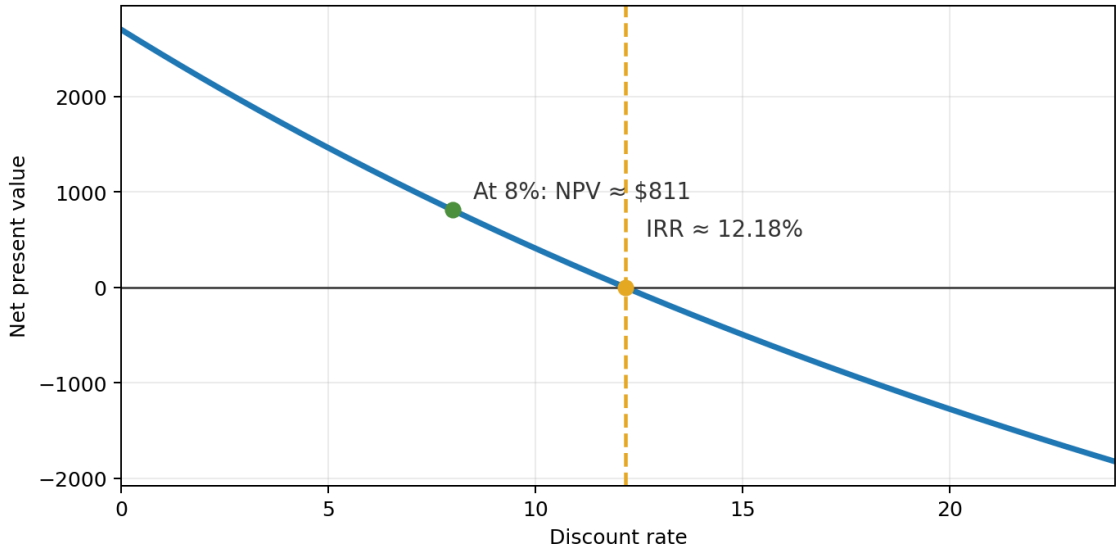


Figure 9.4: NPV profile showing the relationship between the discount rate and NPV.

9.12 NPV vs. IRR

NPV and IRR are related, but they answer different questions. NPV answers: "How many dollars of value are added after accounting for the required return?" IRR answers: "What rate of return is implied by these cash flows?"

Issue	NPV	IRR
What it measures	Dollar value added	Percentage return implied by the cash flows
Decision rule	Accept if NPV > 0	Accept if IRR > required return
Best use	Ranking value creation, especially for mutually exclusive projects	Communicating return in percentage terms
Potential weakness	Requires choosing an appropriate discount rate	Can mislead when cash flows are unconventional or projects differ in scale
Exam emphasis	Best direct measure of value added	Rate that makes NPV equal zero

NPV vs. IRR
When NPV and IRR conflict for mutually exclusive projects, NPV is generally preferred because it measures dollar value added.

9.13 The Rule of 72

The **Rule of 72** is a quick approximation for estimating how long it takes an investment to double with compound growth. It is not exact, but it is useful for mental math and for explaining the power of compounding to clients.

Approximate years to double = 72 / annual percentage return. Approximate annual return needed = 72 / years to double.

Annual compound return	Approximate doubling time
4%	72 / 4 = 18 years
6%	72 / 6 = 12 years
8%	72 / 8 = 9 years
12%	72 / 12 = 6 years

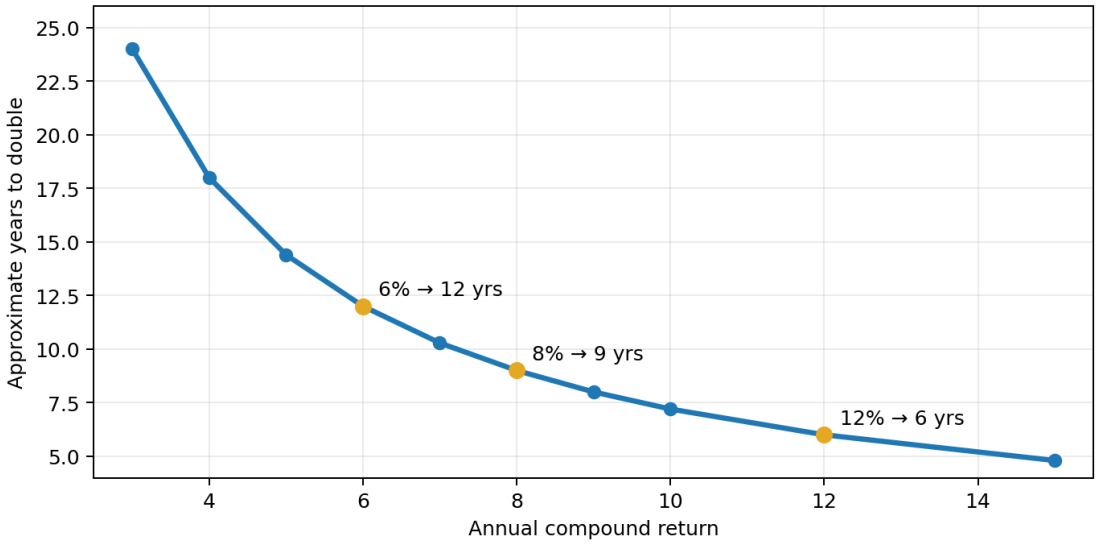


Figure 9.5: Rule of 72 examples for approximate doubling time.

Limitations: the Rule of 72 assumes compound growth, is an approximation, and becomes less precise at very low or very high rates. It also does not account for taxes, fees, inflation, or investment risk.

9.14 Series 65 Exam Tips

- NPV is stated in dollars; IRR is stated as a percentage rate.
- A positive NPV means the project exceeds the required return.
- IRR is the rate that makes NPV equal zero, not the rate used to calculate every NPV problem.
- A higher discount rate lowers the present value of future cash flows.
- The Rule of 72 is a shortcut for doubling time under compound growth.
- Suitability still matters: calculations support advice, but they do not replace client objectives, risk tolerance, liquidity needs, taxes, or time horizon.

Key Terms

Term	Definition
Present value (PV)	The value today of a future cash flow or series of cash flows.
Future value (FV)	The amount an investment may grow to at a future date.
Interest rate / required return (r)	The rate used to compound money forward or discount future cash flows back to today.

Term	Definition
Number of periods (n)	The number of compounding or discounting periods.
Payment (PMT)	A recurring cash flow, such as a mortgage payment, bond coupon, or retirement contribution.
Compounding	Earning returns on both the original principal and previously earned returns.
Discounting	Finding what a future cash flow is worth today.
Annuity	A series of equal payments made at regular intervals.
Annuity due	An annuity with payments made at the beginning of each period.

References and Further Reading

- North American Securities Administrators Association (NASAA). Series 65 Test Specifications, effective June 12, 2023. Used to align this supplement with the analytical methods topic of time value of money concepts.
- Standard investment analysis and corporate finance treatment of present value, net present value, internal rate of return, and compound growth.

Practice Questions

1. Which statement best captures the time value of money?

A. A dollar today can be invested and is generally worth more than a dollar received later.
B. Time has no effect on investment value.
C. A dollar received in the future is always worth more than a dollar today.
D. Present value and future value are identical concepts.

2. Future value is best described as:

A. the amount a present investment may grow to over time.
B. the current value of a future cash flow.
C. the amount of tax owed on an investment.
D. the value of an investment after removing all risk.

3. Present value is best described as:

A. the amount of annual interest paid on a bond.
B. the original cost of an asset only.
C. the market price of every security.
D. what a future cash flow is worth today.

4. All else equal, what happens to the present value of a future cash flow when the discount rate increases?

A. It increases.
B. It decreases.
C. It becomes equal to future value.
D. It is unaffected.

5. Which variable represents the number of compounding or discounting periods?

A. n
B. FV
C. PV
D. PMT

6. Which is most likely to have the higher value, assuming all other terms are identical?

A. A cash flow with no payments.
B. An annuity due.
C. A deferred annuity with later payments only.
D. An ordinary annuity.

7. Which application relies heavily on present value concepts?

A. Recording a stock split.
B. Listing the names of company directors.
C. Calculating only historical accounting depreciation.
D. Estimating the value of a bond's future coupon and principal payments.

8. If the time horizon increases, all else equal, future value will generally:

A. remain unchanged.
B. become negative.
C. decrease.
D. increase.

9. Real return differs from nominal return because real return adjusts for:

A. trading volume.
B. the number of shareholders.
C. inflation.
D. par value.

10. What does net present value measure?

A. The amount of cash currently in a client account
B. The accounting profit reported this year
C. The coupon rate on a bond
D. The dollar value added after discounting expected cash flows at the required return

11. If a project has a positive NPV at an 8% required return, what does that generally mean?

A. The project is risk-free
B. The project is expected to earn more than 8%
C. The project will double in 8 years
D. The project has no opportunity cost

12. Internal rate of return is best described as:

A. The rate that makes NPV equal zero
B. The inflation rate used by the Federal Reserve
C. The highest available CD rate
D. The dividend yield on a stock

13. Which statement about discount rates is correct?

A. The discount rate has no effect on NPV
B. The discount rate only applies to cash flows received today
C. A higher discount rate lowers the present value of future cash flows
D. A higher discount rate increases the present value of future cash flows

14. Using the Rule of 72, approximately how long does it take money to double at 6%?

A. 6 years
B. 8 years
C. 12 years
D. 18 years

15. When NPV and IRR conflict for mutually exclusive projects, which measure is generally preferred?

A. NPV, because it measures dollar value added
B. **Current yield**, because it includes all future cash flows
C. The Rule of 72, because it is more precise
D. IRR, because it is always higher

16. The Rule of 72 is most useful for estimating:

A. The probability of a recession
B. The exact yield to maturity of a bond
C. The number of years required for money to double at a compound return
D. The taxable portion of a bond payment

17. A project requires a $50,000 investment today and is expected to produce future cash inflows. In an NPV calculation, the $50,000 investment is usually:

A. Divided by the IRR
B. Treated as a current cash outflow
C. Ignored because it occurs today
D. Treated as a future cash inflow

Answer Key and Explanations

1. A — A dollar today has immediate use and can earn a return, so it is generally worth more than the same dollar received in the future.

2. A — Future value compounds a present amount forward at a stated rate over a stated number of periods.

3. D — Present value discounts a future cash flow back to the present using a required return or discount rate.

4. B — A higher discount rate reduces the value today of money received in the future.

5. A — The variable n represents the number of periods.

6. B — An annuity due is more valuable because payments occur at the beginning of each period and therefore occur sooner.

7. D — Bond valuation discounts future coupon and principal payments back to present value.

8. D — With a positive return, more time allows compounding to increase future value.

9. C — Real return adjusts nominal return for the loss of purchasing power caused by inflation.

10. D — NPV measures value in today's dollars after applying the required return.

11. B — Positive NPV means the expected cash flows exceed the required return.

12. A — IRR is the discount rate at which NPV equals zero.

13. C — Future cash flows are worth less when discounted at a higher required return.

14. C — 72 divided by 6 equals 12 years.

15. A — NPV is generally preferred for mutually exclusive projects because it measures value added in dollars.

16. C — The Rule of 72 estimates doubling time under compounding.

17. B — The initial investment is a current cash outflow and is already in present-value terms.

Lesson 10: Descriptive Statistics for Investment Analysis

Learning Objectives

- Calculate and interpret **mean**, **median**, **mode**, **range**, and **standard deviation** from a small dataset.
- Explain why investors use standard deviation as a measure of volatility.
- Interpret **alpha**, **beta**, and the **Sharpe ratio** as portfolio performance and risk measures.
- Explain how **correlation** affects diversification and portfolio construction.
- Apply descriptive statistics to Series 65-style suitability and portfolio analysis questions.

10.1 Why Descriptive Statistics Matter

Descriptive statistics summarize a set of data**.** In investment analysis, the data may be annual returns, monthly returns, portfolio values, expense ratios, risk measures, or benchmark-relative performance. A statistic does not make an investment suitable by itself, but it helps an adviser describe risk and return more precisely.

For the Series 65, the most important skill is interpretation. You should know what each statistic tells you, what it does not tell you, and how it connects to client suitability. For example, a high average return may be less attractive if it comes with very high volatility, and a low correlation investment may improve diversification even if its expected return is modest.

10.2 Core Measures of Central Tendency

Central tendency describes the center or typical value in a dataset. The three basic measures are mean, median, and mode.

Measure	Definition	Exam interpretation
Mean	The arithmetic average.	Useful for average return, average expense ratio, or average income. Sensitive to outliers.
Median	The middle value after sorting the data.	Useful when data include extreme values. Half the observations are above and half are below.
Mode	The most frequently occurring value.	Useful for repeated categories or repeated observations; often less useful for continuous return data.

Worked Example 1: Mean, Median, Mode, and Range

Assume a fund had the following annual returns over five years:

Year 1	Year 2	Year 3	Year 4	Year 5
12%	8%	-4%	16%	6%

- Mean = (12% + 8% - 4% + 16% + 6%) / 5 = 38% / 5 = 7.6%.
- Median = 8%, because the ordered returns are -4%, 6%, 8%, 12%, and 16%.
- Mode = none, because no return appears more than once.
- Range = 16% - (-4%) = 20 percentage points.

Exam point
The mean uses every observation but can be pulled by an extreme value. The median is less sensitive to outliers. The range is easy to understand but only uses the highest and lowest values.

10.3 Dispersion: Range and Standard Deviation

Dispersion describes how spread out the observations are. In investments, dispersion is usually connected to risk because returns that vary widely are less predictable than returns clustered near the average.

Measure	What it measures	Investment use
Range	Highest observation minus lowest observation.	Quick estimate of spread, but ignores the observations in the middle.
Standard deviation	Typical distance of observations from the mean.	Common measure of volatility. Higher standard deviation generally means more variability in returns.

Standard deviation and volatility. A portfolio with a standard deviation of 6% has historically had less variability than a portfolio with a standard deviation of 18%, assuming both were measured over the same period and with the same return frequency. Standard deviation does not distinguish between upside volatility and downside volatility; it treats deviations above and below the mean as variability.

Worked Example 2: Interpreting Standard Deviation

Investment	Average annual return	Standard deviation	Interpretation
Fund A	7%	5%	Lower volatility; returns have tended to cluster more tightly around the average.
Fund B	7%	18%	Same average return but much higher volatility; less suitable for a low-risk client.

If two investments have the same mean return, the one with the lower standard deviation usually has the better risk profile. However, risk preference and **investment objective** still matter. A long-term growth client may accept more volatility than a retiree relying on portfolio withdrawals.

10.4 Alpha and Beta

Alpha and beta are benchmark-related measures. They are often discussed in relation to the Capital Asset Pricing Model, but the Series 65 emphasis is usually practical interpretation.

Beta	Meaning	Interpretation
Beta = 1.00	Moves about like the market benchmark.	If the market rises or falls 10%, the portfolio may tend to move roughly 10%, before considering manager skill or other factors.
Beta > 1.00	More sensitive than the market.	A beta of 1.20 suggests higher market sensitivity and potentially more volatility.
Beta < 1.00	Less sensitive than the market.	A beta of 0.70 suggests the portfolio has historically moved less than the market.

Beta	Meaning	Interpretation
Negative beta	Moves opposite the market in the historical period.	Uncommon for traditional long-only funds; may occur with certain hedging or inverse strategies.

Alpha measures return above or below what would be expected based on the investment's risk exposure to a benchmark. Positive alpha means the investment outperformed the benchmark-adjusted expectation; negative alpha means it underperformed.

Worked Example 3: Alpha Using CAPM Logic

Assume the following: risk-free rate = 3%, market return = 8%, portfolio beta = 1.20, and actual portfolio return = 10%.

- Expected return = risk-free rate + beta x (market return - risk-free rate).
- Expected return = 3% + 1.20 x (8% - 3%) = 3% + 6% = 9%.
- Alpha = actual return - expected return = 10% - 9% = +1%.

Interpretation
The portfolio earned 1 percentage point more than expected after adjusting for its market sensitivity. That is positive alpha in this simplified example.

10.5 Sharpe Ratio

The Sharpe ratio measures excess return per unit of total risk. It is calculated as:

Sharpe ratio = (Portfolio return - Risk-free rate) / Standard deviation

A higher Sharpe ratio generally indicates better risk-adjusted performance, assuming the investments are being compared over the same time period and using the same return frequency.

Portfolio	Return	Risk-free rate	Std. dev.	Sharpe ratio
Portfolio X	10%	3%	12%	(10% - 3%) / 12% = 0.58
Portfolio Y	8%	3%	6%	(8% - 3%) / 6% = 0.83

Portfolio Y has the lower return, but it has the higher Sharpe ratio because it generated more excess return per unit of volatility.

10.6 Correlation and Diversification

Correlation measures how two investments move in relation to one another. It ranges from -1.00 to +1.00.

Correlation	Meaning	Investment interpretation
+1.00	Perfect positive correlation	The investments move together perfectly. Diversification benefit is minimal.
0.00	No linear relationship	Movements are not systematically related. Diversification benefit may be meaningful.
-1.00	Perfect negative correlation	The investments move exactly opposite each other. Strong diversification potential, but rare in practice.

Diversification depends on correlation. Combining assets with lower correlations can reduce portfolio volatility because not all investments rise and fall at the same time. This does not eliminate risk, but it can reduce **unsystematic risk** and improve the portfolio's risk-return profile.

10.7 Pulling the Measures Together

Analysis goal	Useful statistic	Question it helps answer
Return level	Mean, median	What has the investment typically earned?
Risk level	Range, standard deviation, beta	How much has the investment varied, and how sensitive is it to the market?
Risk-adjusted performance	Alpha, Sharpe ratio	Did the investment compensate the client for the risk taken?

Analysis goal	Useful statistic	Question it helps answer
Diversification	Correlation	Does the investment move differently from the rest of the portfolio?

10.8 Series 65 Exam Tips

- **Mean** is the arithmetic average; median is the middle value; mode is the most frequent value.
- **Range** is the highest value minus the lowest value.
- **Standard deviation** is a common measure of total volatility; higher standard deviation generally means higher variability.
- **Beta** measures market sensitivity, not manager skill.
- Alpha measures performance relative to a risk-adjusted benchmark expectation.
- **Sharpe ratio** measures excess return per unit of total risk.
- Correlation drives diversification benefits; lower or negative correlation can reduce portfolio volatility.
- No statistic overrides suitability. Client objective, time horizon, liquidity need, risk tolerance, and tax situation still control the recommendation.

Key Terms and Formulas

Concept	Plain-language meaning	Investment use
Mean	Average return or value	Add the observations and divide by the number of observations.
Median	Middle observation	Order the values and find the center value. Less affected by outliers than the mean.
Mode	Most frequent observation	Useful when a value repeats often; a dataset may have no mode or more than one mode.
Range	Simple spread	Highest value minus lowest value. Easy to calculate, but uses only two observations.

Concept	Plain-language meaning	Investment use
Standard deviation	Volatility or dispersion	Measures how widely observations vary around the mean. Higher standard deviation means more variability.
Alpha	Risk-adjusted excess return	Actual return minus the return predicted by a benchmark model such as CAPM.
Beta	Market sensitivity	Measures how much a security or portfolio tends to move relative to the market.
Sharpe ratio	Return per unit of total risk	(Portfolio return - risk-free rate) / standard deviation. Higher is generally better, all else equal.
Correlation	Co-movement between two investments	Ranges from -1.00 to +1.00. Lower correlation can improve diversification.

References and Further Reading

North American Securities Administrators Association (NASAA). Series 65 Test Specifications, effective June 12, 2023. Uploaded outline used to identify descriptive statistics as the next topic under Analytical Methods.

Standard investment analysis terminology: mean, median, mode, range, standard deviation, alpha, beta, Sharpe ratio, and correlation as commonly used in portfolio management and performance evaluation.

Practice Questions

1. Which measure is most affected by an extreme outlier?

A. Correlation
B. Mean
C. Median
D. Mode

2. A dataset has returns of 4%, 7%, 7%, 9%, and 13%. What is the mode?

A. 8%
B. 4%
C. 13%
D. 7%

3. If a fund has a beta of 1.30, what does that generally indicate?

A. It is more sensitive to market movements than the benchmark
B. It has guaranteed positive alpha
C. It is less sensitive to the market than the benchmark
D. It has no market risk

4. Which statistic is calculated as excess return divided by standard deviation?

A. Range
B. Sharpe ratio
C. Alpha
D. Beta

5. Two assets with a correlation close to -1.00 would be expected to:

A. Move in opposite directions
B. Move exactly together
C. Have the same expected return
D. Move mostly independently

6. Which statement best describes standard deviation?

A. It measures the middle observation
B. It measures only downside risk
C. It measures the variability of observations around the mean
D. It measures the most common observation

7. A portfolio return is 11%. Its expected return based on beta and the market is 9%. What is its alpha?

A. -2%
B. +20%
C. 0%
D. +2%

8. Which statistic is most directly used to evaluate diversification benefit between two assets?

A. Mode
B. Range
C. Correlation
D. Alpha

Answer Key and Explanations

1. B — The mean uses every observation and can be pulled by an extreme value.

2. D — Seven percent appears more often than any other value.

3. A — A beta above 1.00 means greater market sensitivity than the benchmark.
4. B — The Sharpe ratio equals excess return divided by standard deviation.
5. A — A correlation near -1.00 means the assets tend to move in opposite directions.
6. C — Standard deviation measures dispersion around the mean.
7. D — Alpha equals actual return minus expected return, or 11% - 9% = +2%.
8. C — Correlation measures how two assets move together and is central to diversification.

Lesson 11: Financial Ratio Interpretation and Calculation

Learning Objectives

- Calculate and interpret the **current ratio**, **quick ratio**, and **debt-to-equity** ratio.
- Distinguish **liquidity ratios** from **leverage/solvency ratios**.
- Recognize why a ratio must be interpreted in context rather than treated as automatically good or bad.
- Apply financial ratios to Series 65-style comparisons of companies and client investments.

11.1 Why Financial Ratios Matter

Financial ratios convert raw accounting figures into relationships that are easier to compare across time or across companies. A ratio is most useful when it is compared with the company's own history, similar firms, or an appropriate industry benchmark.

Exam distinction
Liquidity ratios ask whether near-term obligations can be met. Leverage ratios ask how heavily the firm relies on debt financing. A strong liquidity ratio does not, by itself, prove that a company is profitable or a good investment.

11.2 Current Ratio

The **current ratio** measures short-term liquidity by comparing current assets with current liabilities. Current assets commonly include cash, marketable securities, accounts receivable, inventory, and other assets expected to become cash within the next twelve months.

Current ratio: Current Assets ÷ Current Liabilities
Calculated example: Current assets of $500,000 ÷ current liabilities of $250,000 = 2.00. The company has $2.00 of current assets for each $1.00 of current liabilities.

- **Higher ratio:** Generally indicates a larger short-term liquidity cushion, but an extremely high ratio can also reflect inefficient use of assets.
- **Lower ratio:** May indicate tighter liquidity, but acceptable levels vary by industry and business model.
- **Exam cue:** If both current assets and current liabilities are supplied, use all current assets unless the question specifically asks for the quick ratio.

11.3 Quick Ratio (Acid-Test Ratio)

The quick ratio is a stricter liquidity measure because it excludes inventory and other less-liquid current assets. A common formulation uses cash, marketable securities, and accounts receivable in the numerator.

Quick ratio: (Cash + Marketable Securities + Accounts Receivable) ÷ Current Liabilities
Calculated example: Cash $60,000 + marketable securities $40,000 + receivables $100,000 = $200,000. $200,000 ÷ $160,000 = 1.25.

Why inventory is excluded
Inventory may require time to sell and may not be converted to cash at its stated balance-sheet value. The quick ratio therefore asks whether the firm can meet short-term obligations using its most liquid current assets.

11.4 Debt-to-Equity Ratio

The debt-to-equity ratio measures financial leverage: how much debt financing is used relative to owners' equity. The exact numerator can vary across textbooks and analytical systems. On an exam question, follow the definition and figures supplied. A common formulation is total debt divided by total shareholders' equity.

Debt-to-equity ratio: Total Debt ÷ Total Shareholders' Equity
Calculated example: $600,000 of debt ÷ $400,000 of equity = 1.50. The firm has $1.50 of debt for each $1.00 of equity.

- **More leverage:** Can magnify returns to shareholders when operations are strong, but also magnifies **financial risk** and fixed interest obligations.
- **Less leverage:** Usually means a larger equity cushion, though it may also mean the firm is using less debt than peers that can employ it efficiently.
- **Exam cue:** A higher debt-to-equity ratio generally indicates greater financial risk, all else equal.

11.5 Putting the Ratios Together

Ratio	Primary Question	Higher Usually Suggests	Key Limitation
Current ratio	Can current obligations be covered by current assets?	More near-term liquidity	Includes inventory and other current assets that may not be very liquid

Ratio	Primary Question	Higher Usually Suggests	Key Limitation
Quick ratio	Can current obligations be covered by the most liquid current assets?	Stronger immediate liquidity	Receivables may still be slow or uncollectible
Debt-to-equity	How much debt is used relative to owners' capital?	More financial leverage	Industry norms differ; numerator definitions can differ

Interpretation Example

Company A has a current ratio of 2.0, a quick ratio of 0.8, and a debt-to-equity ratio of 2.2. Company B has a current ratio of 1.5, a quick ratio of 1.3, and a debt-to-equity ratio of 0.7. Company A appears liquid if inventory is included, but its quick ratio shows greater dependence on inventory or other less-liquid current assets. It also uses substantially more leverage. Company B has a smaller current ratio but stronger immediate liquidity and less financial leverage.

Series 65 Exam Cues

- Current ratio includes inventory; quick ratio normally excludes it.
- Debt-to-equity is a leverage ratio, not a liquidity ratio.
- Do not assume the highest ratio is always the best ratio. Context and industry comparisons matter.
- When a problem provides unnecessary information, identify which balance-sheet items actually belong in the formula.

References and Further Reading

- NASAA, Series 65 Test Specifications (effective June 12, 2023), Analytical Methods: financial ratio interpretation and calculation.
- Financial-ratio conventions can vary by source; follow the formula or components stated in an exam question.

Practice Questions

1. A company has current assets of $900,000 and current liabilities of $450,000. What is its current ratio?

A. 2.00
B. 0.50
C. 3.00
D. 1.50

2. Which item is normally excluded from the numerator of the quick ratio?

A. Cash
B. Inventory
C. Accounts receivable
D. Marketable securities

3. A company has $300,000 of total debt and $200,000 of shareholders' equity. Its debt-to-equity ratio is:

A. 0.50
B. 2.00
C. 1.50
D. 0.67

4. Which ratio is designed to provide the stricter test of short-term liquidity?

A. Debt-to-equity ratio
B. Dividend payout ratio
C. Price-to-book ratio
D. Quick ratio

5. A firm's current ratio is high but its quick ratio is low. Which is the best interpretation?

A. A significant portion of current assets may be inventory or other less-liquid items.
B. The firm must have negative equity.
C. The firm has no current liabilities.
D. The firm necessarily has high profitability.

6. All else equal, a substantial increase in the debt-to-equity ratio most directly indicates:

A. Stronger immediate liquidity
B. Lower fixed obligations
C. Greater financial leverage
D. A lower proportion of debt financing

7. Which comparison generally gives the most useful context for a financial ratio?

A. Only the ratio from one quarter
B. The par value of the company's bonds
C. Only the company's stock price
D. The company's history and comparable industry firms

8. Cash is $40,000, marketable securities are $20,000, accounts receivable are $60,000, inventory is $80,000, and current liabilities are $100,000. The quick ratio is:

A. 0.80
B. 1.20
C. 1.00
D. 2.00

Answer Key and Explanations

1. A — 2.00. Current ratio = $900,000 ÷ $450,000 = 2.00.

2. B — Inventory. Inventory is normally excluded from the quick-ratio numerator.

3. C — 1.50. Debt-to-equity = $300,000 ÷ $200,000 = 1.50.

4. D — Quick ratio. The quick ratio excludes inventory and is a more stringent short-term liquidity measure.

5. A — A significant portion of current assets may be inventory or other less-liquid items. A gap between the current and quick ratios often reflects inventory or similar current assets.

6. C — Greater financial leverage. More debt relative to equity means more leverage and generally more financial risk.

7. D — The company's history and comparable industry firms. Ratios are most informative when compared with relevant benchmarks and trends.

8. B — 1.20. Quick assets = $40,000 + $20,000 + $60,000 = $120,000; $120,000 ÷ $100,000 = 1.20.

Lesson 12: Valuation Factors: Price-to-Earnings and Price-to-Book

Learning Objectives

- Define **valuation multiples** and explain why investors use them in security analysis.
- Calculate and interpret the **price-to-earnings** ratio using market price and earnings per share.
- Calculate and interpret the **price-to-book** ratio using market price and book value per share.
- Recognize the limits of **P/E** and **P/B** ratios when earnings, accounting values, industry norms, or growth expectations differ.
- Apply valuation ratios to Series 65-style interpretation questions without confusing valuation with suitability.

12.1 Why Valuation Ratios Matter

A **valuation ratio** compares the market price of a security with a financial statement measure. Instead of asking whether a stock price is simply "high" or "low" in dollars, valuation ratios ask what investors are paying for the company's earnings, assets, cash flows, or book value. A $100 stock may be cheaper than a $20 stock if the $100 company earns much more per share or owns substantially more net assets per share.

For the Series 65 exam, price-to-earnings and price-to-book are usually tested in two ways. First, you may be asked to calculate the ratio from given numbers. Second, you may be asked to interpret what a higher or lower ratio suggests. Interpretation is always contextual: a low ratio may suggest undervaluation, but it may also reflect weak growth prospects, business risk, accounting issues, or financial distress.

Exam point
Valuation ratios are comparison tools. They should be compared with industry peers, the company's own history, expected growth, risk, and the client's investment objective and risk tolerance.

12.2 Price-to-Earnings Ratio

The **price-to-earnings ratio**, often abbreviated P/E, compares the market price per share of common stock with the company's earnings per share. It shows how much investors are paying for each dollar of earnings.

P/E Ratio = Market Price per Share / Earnings per Share (EPS)
Example meaning: a P/E of 15 means investors are paying $15 for each $1 of annual earnings per share.

Earnings per share generally represents the amount of net income attributable to each common share. In simplified exam problems, EPS is usually provided directly. If EPS must be calculated, a basic version is:

EPS = Net Income Available to Common Shareholders / Weighted Average Common Shares Outstanding

12.3 P/E Ratio Worked Example

Assume Lakeside Products has a current market price of $60 per share and earnings per share of $4.00.

Input	Amount
Market price per share	$60.00
Earnings per share	$4.00
P/E ratio	$60.00 / $4.00 = 15.0

Lakeside Products trades at 15 times earnings. This does not automatically make the stock attractive or unattractive. The analyst would compare the 15x P/E with the company's peer group, historical valuation range, expected earnings growth, balance sheet quality, and business risk.

12.4 Interpreting the P/E Ratio

P/E result	Possible interpretation	Important caution
Higher P/E	Investors may expect stronger future growth, higher profitability, or lower risk.	A high P/E may also signal overvaluation if expectations are too optimistic.
Lower P/E	The stock may be inexpensive relative to current earnings.	A low P/E may reflect weak growth, declining earnings, cyclical risk, or financial stress.
Negative or not meaningful P/E	If EPS is negative, the basic P/E ratio loses usefulness.	Use other metrics or wait for normalized earnings; do not treat a negative P/E as automatically cheap.

When is P/E most useful?
P/E is most useful when earnings are positive, reasonably stable, and comparable across firms. It is less useful for early-stage companies, highly cyclical companies near peak earnings, or firms with large one-time gains or losses.

12.5 Trailing P/E vs. Forward P/E

A trailing P/E uses earnings from the most recent reported period, often the last twelve months. A forward P/E uses projected future earnings. The trailing ratio is based on actual reported earnings but may be backward-looking. The forward ratio may better reflect expectations but depends on analyst forecasts that can be wrong.

Version	Numerator	Denominator	Strength	Weakness
Trailing P/E	Current market price	Past EPS	Uses actual reported earnings	May not reflect changing conditions
Forward P/E	Current market price	Expected future EPS	Connects price to expected growth	Depends on uncertain forecasts

12.6 Price-to-Book Ratio

The **price-to-book ratio**, often abbreviated P/B, compares the market price per share of common stock with the company's book value per share. Book value is an accounting measure of net assets: assets minus liabilities. For common shareholders, book value is usually based on common shareholders' equity.

P/B Ratio = Market Price per Share / Book Value per Share

Book Value per Share = Common Shareholders' Equity / Common Shares Outstanding

A **P/B ratio** of 1.0 means the stock trades at its book value per share. A P/B above 1.0 means the market values the company above its accounting book value. A P/B below 1.0 means the market values the company below book value, which may suggest undervaluation or concern about asset quality, profitability, or future prospects.

12.7 P/B Ratio Worked Example

Assume Prairie Bank has common shareholders' equity of $2.4 billion, 50 million common shares outstanding, and a market price of $72 per share.

Step	Calculation	Result
Book value per share	$2.4 billion / 50 million shares	$48.00
Price-to-book ratio	$72.00 / $48.00	1.50

Prairie Bank trades at 1.5 times book value. The market is valuing the stock above its accounting net asset value. Whether that is attractive depends on the bank's profitability, credit quality, growth prospects, interest rate exposure, capital position, and peer valuation multiples.

12.8 Interpreting the P/B Ratio

P/B result	Possible interpretation	Important caution
P/B above 1.0	The market values the firm above accounting book value.	May be justified by strong profitability, intangible value, brand strength, or growth.
P/B near 1.0	The market value is close to accounting net asset value.	Common in some asset-heavy or financial firms, but context matters.
P/B below 1.0	The market values the firm below book value.	Could suggest undervaluation, but could also signal poor asset quality or weak profitability.

Exam point
A stock trading below book value is not automatically a good investment. Book value may overstate the economic value of assets, especially if assets are impaired, obsolete, or difficult to sell.

12.9 P/E Compared With P/B

P/E and P/B answer different questions. P/E focuses on the price paid for earnings. P/B focuses on the price paid for accounting net assets. A company may look cheap on one measure and expensive on another because earnings quality, asset intensity, intangible assets, and growth expectations differ.

Ratio	Primary question	Often useful for	Less useful when
P/E	How much are investors paying for each dollar of earnings?	Profitable firms with reasonably stable earnings	Earnings are negative, distorted, cyclical, or unusually high/low
P/B	How much are investors paying for each dollar of book value?	Banks, insurers, financial firms, and asset-heavy businesses	Book value omits valuable intangibles or overstates asset values

12.10 Mini Case: Same Price, Different Valuation

Two companies both trade at $50 per share. The share price alone does not tell the analyst which stock is cheaper. The ratios provide a more meaningful comparison.

Company	Price	EPS	Book value/share	P/E	P/B
Alpha Software	$50	$2.00	$10	25.0	5.0
Beacon Manufacturing	$50	$5.00	$40	10.0	1.25

Alpha Software has the higher P/E and P/B. That may reflect stronger growth expectations, valuable intangible assets, or optimism about future profitability. Beacon Manufacturing has the lower P/E and P/B. That may reflect a mature business, lower expected growth, or investor pessimism.

The correct conclusion is not that one stock must be better. The analyst needs additional evidence about earnings quality, asset quality, growth, risk, industry norms, and client suitability.

12.11 From Ratio Result to Recommendation

- Start with the calculation: use the correct numerator and denominator.
- Compare the result with peers, the company's own history, and industry norms.
- Ask whether the denominator is reliable: Are earnings stable? Is book value meaningful?
- Connect valuation to risk: low valuation can signal opportunity or distress.

- Apply suitability: even a seemingly attractive stock may be unsuitable for a conservative client with short-term liquidity needs.

Series 65 takeaway
The exam will often reward the answer that recognizes context and suitability. A ratio can support analysis, but it does not replace a client-specific recommendation process.

Key Terms

Term	Plain-language meaning
Valuation multiple	A ratio that compares market price with a financial measure such as earnings or book value.
P/E ratio	Market price per share divided by earnings per share.
Earnings per share (EPS)	The portion of company earnings attributable to each common share.
Book value	Accounting value of assets minus liabilities.
Book value per share	Common shareholders' equity divided by common shares outstanding.
P/B ratio	Market price per share divided by book value per share.

References and Further Reading

NASAA Series 65 Test Specifications, effective June 12, 2023. Used to identify the topic area: valuation factors, interpretation, and calculation, including price-to-earnings and price-to-book ratios.

Standard financial statement and investment analysis concepts are presented for educational use in Series 65 preparation.

Practice Questions

1. Which formula correctly calculates the price-to-earnings ratio?

A. Earnings per share / book value per share
B. Market price per share / earnings per share
C. Total assets / total liabilities
D. Dividends / market price per share

2. A stock trades at $45 per share and has EPS of $3.00. What is its P/E ratio?

A. 6.7
B. 30.0
C. 15.0
D. 48.0

3. Which statement best describes a high P/E ratio?

A. It may reflect high growth expectations, but context is needed.
B. It always means the stock is overvalued.
C. It always means the stock is undervalued.
D. It means the company has no debt.

4. If a company has negative earnings, what is the most accurate statement about the basic P/E ratio?

A. It is generally not meaningful.
B. It equals the price-to-book ratio.
C. It becomes more reliable.
D. It automatically proves the stock is cheap.

5. Which formula correctly calculates the price-to-book ratio?

A. Net income / sales
B. Current assets / current liabilities
C. Book value per share / earnings per share
D. Market price per share / book value per share

6. A company has common shareholders' equity of $900 million and 30 million common shares outstanding. The stock price is $45. What is the price-to-book ratio?

A. 1.00
B. 1.50
C. 0.67
D. 2.00

7. For which type of company is P/B often especially relevant?

A. A start-up with no financial statements
B. A company with no assets
C. A company with negative book value only
D. A bank or other asset-intensive financial institution

8. Which statement is most correct?

A. P/E and P/B are unrelated to investment analysis.
B. A low P/E always requires a buy recommendation.
C. Valuation ratios should be interpreted with industry, risk, growth, and client suitability in mind.
D. A low P/B always proves that the company is undervalued.

Answer Key and Explanations

1. B — Market price per share / earnings per share

2. C — 15.0

3. A — It may reflect high growth expectations, but context is needed.

4. A — It is generally not meaningful.

5. D — Market price per share / book value per share

6. B — 1.50

7. D — A bank or other asset-intensive financial institution

8. C — Valuation ratios should be interpreted with industry, risk, growth, and client suitability in mind.

Lesson 13: Types of Risk: Systematic and Unsystematic

Learning Objectives

- Distinguish **systematic risk** from **unsystematic risk**.
- Explain why **diversification** can reduce unsystematic risk but cannot eliminate systematic risk.
- Identify common examples of systematic risk, including **interest rate risk**, **sector risk**, and **geopolitical risk.**
- Identify common examples of unsystematic risk, including credit risk, **legal/regulatory risk**, financial risk, and **issuer-specific risk**.

13.1 Why Risk Classification Matters

Risk is the possibility that actual investment results will differ from expected results. In investment analysis, risk does not only mean the chance of losing money. It also includes uncertainty about returns, income, liquidity, purchasing power, and whether a recommendation remains suitable for a client.

A key distinction is whether a risk is broad and market-wide or specific to a company, issuer, bond, sector exposure, or legal situation. This distinction matters because some risks can be reduced through diversification while others remain even in a well-diversified portfolio.

> **Core exam idea**
> Diversification is powerful, but it is not magic. It can reduce company-specific and issuer-specific risks. It cannot eliminate broad economic, market, interest rate, inflation, or geopolitical risks that affect many investments at the same time.

13.2 Systematic Risk

Systematic risk is risk that affects the overall market or a broad segment of the market. It is sometimes called market risk or nondiversifiable risk because it cannot be eliminated simply by owning more securities. A diversified stock portfolio still has exposure to recessions, interest rate changes, inflation shocks, broad investor risk aversion, and global events.

A client can manage systematic risk but cannot diversify it away completely. Common tools include asset allocation, duration management, cash reserves, hedging strategies, reducing leverage, and aligning the portfolio with the client's time horizon and risk tolerance.

Systematic Risk Examples

Type of systematic risk	Definition	Investment impact
Interest rate risk	Risk that changing rates affect security prices and borrowing costs.	Bond prices generally fall when market rates rise. Long-duration bonds are usually more sensitive. Higher rates can also pressure stock valuations.
Sector risk	Risk that a broad sector faces unfavorable conditions.	Energy stocks may be affected by oil prices; technology may be affected by rates and growth expectations; banks may be affected by credit and yield curve conditions.
Geopolitical risk	Risk from war, sanctions, political instability, trade restrictions, or diplomatic conflict.	Can increase volatility, disrupt supply chains, affect currencies and commodities, and reduce investor risk appetite.
Inflation and purchasing power risk	Risk that inflation reduces real returns.	Fixed income streams lose purchasing power when inflation rises; stocks may also be pressured if costs rise faster than revenues.
Market risk	Risk that broad market prices decline.	A diversified equity fund can still lose value during a bear market.

Interest Rate Risk

Interest rate risk is especially important for fixed income securities. Bond prices and market interest rates generally move in opposite directions. If a bond pays a fixed coupon and newly issued bonds offer higher yields, the older bond becomes less attractive and its price tends to fall.

Duration is a key measure of interest rate sensitivity. Longer-duration bonds usually experience larger price changes when rates move. A long-term bond fund can therefore be riskier than a short-term bond fund when rates rise, even if both funds hold high-quality bonds.

Series 65 tip
Do not assume "bond" automatically means "safe." High-quality bonds may have low default risk but still carry interest rate risk, especially when duration is long.

Sector Risk

Sector risk is risk that affects a group of companies with similar economic exposure. An investor who owns several companies in the same industry may appear diversified by number of holdings but still be concentrated economically. For example, several bank stocks may all be exposed to credit conditions and interest-rate spreads. Several oil producers may all be exposed to energy prices.

Sector risk is sometimes systematic within that segment of the market but can be reduced by diversifying across sectors. It is not the same as issuer-specific risk because the problem is tied to a broad industry or sector environment rather than one company alone.

Geopolitical Risk

Geopolitical risk arises from political and international events. Examples include military conflict, sanctions, nationalization, trade disputes, capital controls, terrorism, and political instability. These events can affect commodities, currencies, foreign investments, multinational companies, supply chains, and investor sentiment.

Geopolitical risk often interacts with other risks. For example, a war that disrupts energy supply may also increase inflation, raise interest rates, reduce consumer confidence, and widen credit spreads.

13.3 Unsystematic Risk

Unsystematic risk is risk that is specific to an issuer, company, security, industry position, management team, legal issue, or financial condition. It is often called specific risk, diversifiable risk, or idiosyncratic risk. Unlike systematic risk, unsystematic risk can usually be reduced by holding a diversified portfolio rather than concentrating in one issuer or narrow group of issuers.

A client who owns one company's stock is exposed to the entire company-specific outcome. A client who owns a diversified equity fund still faces market risk, but the failure of one company has a much smaller effect on the total portfolio.

Unsystematic Risk Examples

Type of unsystematic risk	Definition	Investment impact
Credit risk	Risk that a borrower or bond issuer will not make promised payments.	Bond prices can fall if default risk rises. Lower-quality bonds usually require higher yields to compensate investors.
Legal/regulatory risk	Risk from lawsuits, enforcement actions, rule changes, or compliance failures.	A company may face fines, restrictions, litigation costs, or damage to reputation.
Financial risk	Risk from leverage, weak liquidity, poor cash flow, or inability to meet obligations.	Highly leveraged companies may perform well in good times but struggle during downturns or rate increases.
Issuer-specific risk	Risk tied to one company or issuer, such as poor management, fraud, product failure, or loss of a major customer.	The security may decline even if the overall market is rising.
Business risk	Risk that the company's operations or strategy underperform.	Margins, sales, earnings, and market share may decline.

Credit Risk

Credit risk is the possibility that a borrower will fail to pay interest or principal as promised. It is central to bond analysis, but it can also matter for preferred stock, structured products, loans, and other income-oriented investments.

Credit ratings are one tool for evaluating credit risk, but ratings are not guarantees. An issuer's credit quality can deteriorate because of declining revenue, excessive debt, poor management, recession exposure, or industry disruption. When credit risk rises, bond prices typically fall and credit spreads widen.

Legal and Regulatory Risk

Legal and regulatory risk includes the possibility that lawsuits, enforcement actions, regulatory changes, or compliance failures will harm an issuer. This risk may be company-specific, as with a lawsuit against one company, or sector-related, as with regulation affecting an entire industry.

For example, a pharmaceutical company may face litigation over a product, a bank may face enforcement action, or a technology company may face privacy or antitrust scrutiny. The risk is not limited to whether the company loses in court; uncertainty itself can affect valuation and investor confidence.

Financial Risk

Financial risk refers to the risk created by a company's financing decisions and financial condition. Companies with high leverage have more fixed obligations. Debt can magnify returns when business conditions are favorable, but it can also magnify losses when revenue declines or borrowing costs increase.

Financial risk is different from business risk. Business risk is the uncertainty of operating results. Financial risk is the added pressure that comes from debt, interest obligations, refinancing needs, and liquidity constraints.

Issuer-Specific Risk

Issuer-specific risk is the risk that something happens to one particular issuer. Examples include accounting fraud, loss of a key executive, a failed product launch, a factory accident, cyberattack, bankruptcy, or the loss of a major customer. These events may cause one security to decline even while the broader market is stable or rising.

Issuer-specific risk is one of the main reasons advisers discourage clients from concentrating too much wealth in a single stock, employer stock, or one corporate bond issuer.

13.4 Diversification and Risk

Diversification means spreading investments across different issuers, industries, asset classes, maturities, geographies, and strategies. Proper diversification can reduce unsystematic risk because poor performance by one issuer may be offset by better performance elsewhere.

However, diversification does not eliminate systematic risk. A portfolio of hundreds of stocks can still decline when the overall equity market falls. A diversified bond portfolio can still lose value when interest rates rise. The goal is not to eliminate all risk, but to build a portfolio whose risks are appropriate for the client.

Question	Systematic risk	Unsystematic risk
Can diversification eliminate it?	No. It can be managed but not diversified away completely.	Usually yes, or at least substantially reduced.

Question	Systematic risk	Unsystematic risk
Main source	Broad market, economy, rates, inflation, geopolitical events.	Specific issuer, company, security, or narrow exposure.
Examples	Interest rate risk, market risk, inflation risk, geopolitical risk.	Credit risk, legal/regulatory risk, financial risk, issuer-specific risk.
Portfolio implication	Requires asset allocation, risk tolerance fit, time horizon alignment, and risk controls.	Requires diversification across issuers, sectors, securities, and credit exposures.

13.5 Applying Risk Concepts to Client Recommendations

Risk classification should always connect back to suitability. A client with a short time horizon and low risk tolerance should not be exposed to excessive systematic market risk. A client with concentrated wealth in employer stock should understand issuer-specific and financial risk. A retiree relying on bond income should understand both credit risk and interest rate risk.

The Series 65 exam often tests whether an investment adviser representative can identify the type of risk and recommend a response that matches the client profile. The best answer is usually the one that controls the relevant risk without ignoring the client's objectives, liquidity needs, tax situation, time horizon, and risk tolerance.

Practical Examples

Scenario	Primary risk	Possible adviser response
Client owns 70% of portfolio in employer stock.	Issuer-specific and financial risk.	Discuss concentration risk, diversification, tax consequences, and a staged plan to reduce exposure if suitable.
Retiree owns a long-term bond fund before rates rise.	Interest rate risk.	Explain duration, consider shorter-duration or laddered high-quality bonds, and align fixed income with cash flow needs.

Scenario	Primary risk	Possible adviser response
Client owns several oil stocks and believes the portfolio is diversified.	Sector risk.	Explain that multiple companies in one sector can share the same economic exposure; consider broader sector diversification.
High-yield bond issuer shows declining cash flow and rising leverage.	Credit and financial risk.	Review credit quality, default risk, spread compensation, and suitability for the client's risk tolerance.
Foreign holdings decline after sanctions and currency stress.	Geopolitical and currency-related market risk.	Review country and currency exposure, diversification, and whether the client's international allocation remains appropriate.

13.6 Series 65 Exam Tips

- **Systematic risk** affects the market or a broad segment of the market and cannot be eliminated by diversification.
- **Unsystematic risk** is specific to an issuer, company, security, or narrow exposure and can usually be reduced through diversification.
- **Interest rate risk** is especially important for fixed income securities; long-duration bonds are more sensitive to rate changes.
- **Credit risk** is the risk that an issuer or borrower will fail to make promised payments.
- Sector concentration is not the same thing as a diversified portfolio, even when the client owns many securities.
- Risk classification does not replace suitability analysis. Client objectives, time horizon, liquidity needs, tax situation, and risk tolerance still control the recommendation.

Key Terms

Term	Definition
Systematic risk	Market-wide or broad economic risk that cannot be eliminated through diversification.

Term	Definition
Unsystematic risk	Issuer-specific or security-specific risk that can usually be reduced through diversification.
Interest rate risk	Risk that changes in market interest rates will affect security prices, especially bonds.
Sector risk	Risk from concentration in a particular industry or sector.
Geopolitical risk	Risk from political, military, trade, or international events.
Credit risk	Risk that a borrower or issuer fails to meet promised payment obligations.
Legal/regulatory risk	Risk from lawsuits, enforcement actions, or regulatory changes.
Financial risk	Risk arising from leverage, liquidity pressure, or financial weakness.
Issuer-specific risk	Risk tied to one particular company, bond issuer, or security.
Diversification	The practice of spreading investments to reduce exposure to any single issuer, sector, or risk factor.

References and Further Reading

- North American Securities Administrators Association (NASAA). Series 65 Test Specifications, effective June 12, 2023. Used to identify the risk topics covered in this Lesson.
- Standard investment risk taxonomy used in investment adviser education and portfolio management: market/systematic risk, issuer-specific risk, credit risk, interest rate risk, sector risk, and diversification.

Practice Questions

1. Which statement best describes systematic risk?

A. Risk specific to one issuer only
B. Risk eliminated by holding a single mutual fund sector portfolio
C. Market-wide risk that cannot be eliminated through diversification
D. Risk that applies only to municipal bonds

2. A client owns one company's stock and the company announces accounting fraud. What risk is most directly involved?

A. Geopolitical risk
B. Issuer-specific risk
C. Interest rate risk
D. Purchasing power risk

3. Which risk is most directly associated with a long-term bond declining when market yields rise?

A. Interest rate risk
B. Legal risk
C. Issuer-specific risk
D. Reinvestment risk only

4. A portfolio owns many stocks, but all are in the energy sector. Which risk remains elevated?

A. Currency risk only
B. Custody risk
C. Sector risk
D. Call risk

5. Which risk can generally be reduced most effectively by diversifying across issuers?

A. Geopolitical risk
B. Market risk
C. Inflation risk
D. Unsystematic risk

6. A corporate bond issuer has rising leverage and falling cash flow. Which risks are most relevant?

A. Systematic risk only
B. Credit risk and financial risk
C. No risk if the coupon is fixed
D. Sector risk only

Answer Key and Explanations

1. C — Systematic risk affects the market broadly and cannot be diversified away completely.

2. B — Accounting fraud at one company is issuer-specific risk.

3. A — Bond prices generally move inversely to market interest rates.

4. C — Owning many securities in one sector still leaves concentrated sector exposure.
5. D — Unsystematic risk is the diversifiable category of risk.
6. B — Rising leverage and weak cash flow increase both credit risk and financial risk.

Lesson 14: Opportunity Cost

Learning Objectives

- Define **opportunity cost** as the value of the best alternative given up when a choice is made.
- Explain why opportunity cost is an investment risk even when no dollar loss appears on an account statement.
- Apply opportunity cost **to asset allocation, liquidity decisions**, **retirement planning**, and **client suitability**.
- Recognize Series 65 exam language involving trade-offs among return, safety, liquidity, time horizon, and taxes.

14.1 What Opportunity Cost Means

Opportunity cost is the benefit an investor gives up by choosing one alternative instead of the next-best available alternative. It is not always a visible accounting cost. Instead, it is an economic cost: the return, flexibility, protection, or other benefit that could have been received from the alternative that was not selected.

Opportunity cost is best understood as a trade-off. Every investment decision uses scarce resources: money, time, liquidity, risk capacity, tax benefits, and attention. Choosing one path means not choosing another.

14.2 Basic Formula and Interpretation

A simple way to express opportunity cost is:

Opportunity cost = Benefit of the best forgone alternative - Benefit of the chosen alternative

If the chosen investment has a lower expected return than the alternative, the opportunity cost may be the difference in expected return. If the chosen investment has lower liquidity, the opportunity cost may be reduced flexibility. If the chosen investment has lower risk, the investor may be giving up upside potential in exchange for safety.

14.3 Investment Examples

Decision	Chosen Alternative	Best Forgone Alternative	Opportunity Cost
Emergency fund	Cash reserve earning 4%	Stock fund with higher expected return	Potential long-term return forgone in exchange for liquidity and principal stability

Decision	Chosen Alternative	Best Forgone Alternative	Opportunity Cost
Retirement investing	Short-term Treasury bills	Diversified stock/bond portfolio	Possible failure to keep pace with long-term goals and inflation
Debt repayment	Pay off 8% credit card debt	Invest in market portfolio	Possible market upside forgone, but debt repayment provides a certain benefit
College savings	Taxable brokerage account	**529 plan**	Possible state tax benefits or tax-free education growth forgone

14.4 Numeric Example: Cash Versus Growth Portfolio

Assume a client keeps $100,000 in cash for one year. The cash account earns 4%. A diversified growth portfolio has an expected return of 8%, but with substantially higher risk. Ignoring taxes and risk, the expected-return opportunity cost of choosing cash is:

$100,000 x (8% - 4%) = $4,000

This does not automatically mean cash is unsuitable. If the client needs the money soon, has low risk tolerance, or needs emergency liquidity, the lower-return cash position may be appropriate. The opportunity cost is the price paid for safety and liquidity.

14.5 Opportunity Cost and Suitability

Opportunity cost should never be evaluated in isolation. A high expected-return investment may carry market risk, liquidity risk, tax costs, or volatility that makes it unsuitable for a particular client. Similarly, a very conservative portfolio may be safe in nominal terms but expose a long-term client to inflation risk and the opportunity cost of insufficient growth.

Client Situation	Likely Trade-Off
Young investor saving for retirement	Holding too much cash may create high opportunity cost because the time horizon supports growth-oriented assets.

Client Situation	Likely Trade-Off
Retiree needing withdrawals in the next year	Holding some cash may be suitable even though it creates opportunity cost. Liquidity and stability matter.
Client with concentrated employer stock	Keeping the stock may preserve upside but gives up diversification. Selling may reduce company-specific risk but gives up possible future gains.
Client choosing municipal bonds	Tax benefits and income stability may be gained, but the client may give up higher taxable yields or capital appreciation potential.

14.6 Common Series 65 Exam Traps

- Do not treat opportunity cost as the same thing as a realized loss. The investor may not lose money, but may still give up a better alternative.
- Do not assume the highest expected return is always the best recommendation. Suitability factors still control.
- Do not ignore liquidity. Cash may have a high opportunity cost, but it can be suitable for emergency reserves and short-term goals.
- Do not ignore inflation. A conservative investment may preserve principal but lose purchasing power over time.

Practice Questions

1. Which statement best defines opportunity cost?

A. The commission charged on a trade
B. The interest rate paid by a bond issuer
C. The value of the best alternative given up when a choice is made
D. The tax paid when a security is sold

2. A client keeps all retirement savings in cash for 25 years. Which risk is most directly illustrated?

A. Opportunity cost and inflation risk
B. Custody risk
C. Selling away risk
D. Insider trading risk

3. Which choice most clearly creates opportunity cost?

A. Reading a prospectus
B. Receiving a dividend
C. Choosing one investment strategy instead of another
D. Updating a client address

4. A retiree keeps one year of withdrawals in cash. The cash has a lower expected return than stocks. What is the best interpretation?

A. The cash position is always unsuitable
B. The cash position eliminates all investment risk
C. The cash position has no opportunity cost
D. The cash position may be suitable despite opportunity cost

5. For suitability analysis, opportunity cost should be weighed against:

A. The number of trades in the account
B. Client objectives, risk tolerance, liquidity needs, taxes, and time horizon
C. The adviser's preferred product only
D. The highest recent-performing sector

Answer Key and Explanations

1. C — Opportunity cost is the benefit of the next-best forgone alternative.

2. A — The client may give up long-term growth and lose purchasing power.

3. C — Opportunity cost arises from mutually exclusive choices.

4. D — Liquidity needs may justify lower expected return.

5. B — Opportunity cost is part of a broader suitability analysis.

References and Further Reading

- North American Securities Administrators Association (NASAA). Series 65 Test Specifications, effective June 12, 2023. Used to identify opportunity cost as a testable analytical-methods concept.
- Standard investment analysis and financial planning treatment of opportunity cost, trade-offs, and suitability.

Lesson 15: Capital Structure and Liquidation Priority

Learning Objectives

- Define **capital structure** and identify the major sources of corporate financing.
- Explain the difference between **debt**, **preferred stock**, and common stock.
- Rank claims in **liquidation priority** from highest to lowest.
- Connect **priority of claims** to **investment risk**, **expected return**, **income stability**, and **voting rights**.
- Apply liquidation priority to numerical examples similar to Series 65 exam questions.

15.1 What Capital Structure Means

Capital structure describes how a company finances its assets and operations. A company may use debt, preferred stock, common stock, or some combination of these sources. Each layer of the capital structure has different legal rights, risks, and expected returns.

The capital structure matters because it determines who has the strongest legal claim on company assets and cash flows. Investors lower in the capital structure usually accept more risk in exchange for higher potential return.

15.2 Definitions of the Major Capital Sources

For the Series 65 exam, it is important to know both the definition of each capital source and where that source fits in the priority structure.

Capital Source	Definition	Investor Claim and Typical Rights
Debt	Money borrowed by the company from lenders or bondholders. Debt creates a contractual obligation to pay interest and repay principal.	Creditors generally have the highest priority claim. Secured debt is backed by collateral; unsecured debt is not backed by specific collateral. Debt holders usually do not have ownership voting rights.

Capital Source	Definition	Investor Claim and Typical Rights
Preferred Stock	An equity security with preference over common stock, usually through a stated dividend and a liquidation preference.	Preferred shareholders are paid after debt holders but before common shareholders. Preferred stock may be cumulative or noncumulative and often has limited or no voting rights.
Common Stock	Residual ownership in the corporation. Common shareholders own the remaining claim after creditors and preferred shareholders are satisfied.	Common shareholders are last in liquidation but have the greatest upside if the company grows. Common stock usually carries voting rights and may receive dividends if declared.

15.3 The Basic Priority Order

Liquidation priority is the order in which claimants are paid if a company is liquidated. In general, legal claims are paid before ownership claims. Within debt, secured creditors are usually paid before unsecured creditors because they have a claim on specific collateral.

Priority Rank	Claimant	Series 65 Interpretation
1	Secured debt	Highest priority; backed by specific collateral.
2	Senior unsecured debt	Paid after secured debt; still senior to subordinated debt and equity.
3	Subordinated debt	Debt claim, but contractually junior to senior debt.
4	Preferred stock	Equity claim with priority over common stock.
5	Common stock	Residual claim; last in line.

15.4 Comparing Debt, Preferred Stock, and Common Stock

Feature	Debt	Preferred Stock	Common Stock
Income	Interest; contractual if the issuer remains solvent.	Stated dividend if declared; may be cumulative depending on terms.	Dividend only if declared by the board.
Priority	Highest of the three; creditors are paid before equity holders.	After debt but before common stock.	Last; residual claim.
Upside Potential	Usually limited to interest and repayment of principal.	Usually limited, although some preferred shares may be convertible.	Highest; benefits most from business growth.
Ownership	Creditor relationship, not ownership.	Equity ownership with preference features.	Residual equity ownership.
Voting Rights	Usually none as an owner; creditor protections may exist in bond covenants.	Often limited or none, depending on terms.	Usually voting rights.

15.5 Liquidation Example

Assume a company is liquidated and has $10 million available after administrative costs. Its capital structure includes $4 million of secured debt, $3 million of unsecured debt, $2 million of preferred stock liquidation preference, and common stock.

Claimant	Amount Paid	Reason
Secured debt	$4 million	Paid first.
Unsecured debt	$3 million	Paid after secured debt.
Preferred stock	$2 million	Paid after debt but before common stock.

Claimant	Amount Paid	Reason
Common stock	$1 million	Receives the residual after higher-priority claims are paid.

If only $7 million were available, secured debt and unsecured debt would be paid, while preferred and common shareholders would receive nothing. This illustrates why common stock has the highest liquidation risk.

15.6 Why Priority Affects Investment Risk

Higher-priority claims generally have lower risk because they are paid before lower-priority claims. However, they also have limited upside. A bondholder may receive interest and principal but does not normally participate in the unlimited growth of the business. Common shareholders have the greatest upside but also bear the most residual risk.

Preferred stock sits between debt and common stock in the priority structure. It is not debt, and its dividends are not the same as bond interest. However, preferred shareholders typically receive dividends before common shareholders and have a higher claim than common shareholders in liquidation.

15.7 Common Series 65 Exam Traps

- Debt is generally senior to preferred stock and common stock.
- Secured debt is generally senior to unsecured debt because it has collateral backing.
- Preferred stock is still equity even though it has priority over common stock.
- Common stock has the residual claim and is last in liquidation priority.
- Higher priority usually means lower risk and lower upside; lower priority usually means higher risk and higher potential return.
- Do not confuse dividend preference with a guaranteed dividend. Preferred dividends are generally not the same as bond interest.

Practice Questions

1. In a corporate liquidation, which group is generally paid before preferred shareholders?

A. Bondholders and other creditors
B. Common shareholders
C. Employees who hold stock options only
D. Market makers

2. Which security is usually last in liquidation priority?

A. Common stock
B. Secured debt
C. Senior debt
D. Preferred stock

3. Preferred stock is best described as:

A. Debt with guaranteed interest
B. Equity with priority over common stock
C. A money market instrument
D. A risk-free security

4. A company has $6 million in secured debt, $3 million in unsecured debt, and $2 million in preferred stock. If $9 million is available in liquidation, who is not fully paid?

A. All claimants are fully paid
B. Unsecured debt only
C. Preferred stock and common stock
D. Secured debt only

5. Why do common shareholders generally require higher expected returns than bondholders?

A. They have no exposure to market risk
B. They are paid first in liquidation
C. Their returns are guaranteed by the issuer
D. They bear residual risk and are last in liquidation priority

Answer Key and Explanations

1. A — Debt claims generally precede equity claims.

2. A — Common stock is the residual ownership claim.

3. B — Preferred stock is equity but has dividend and liquidation preference over common stock.

4. C — The $9 million fully pays the $6 million of secured debt and the $3 million of unsecured debt; preferred and common receive nothing.

5. D — Common shareholders have the lowest priority but greatest upside.

Part II. Investment Vehicle Characteristics

Lesson 16: Cash and Cash Equivalents

Learning Objectives

- Identify **cash** and **cash equivalent investments.**
- Distinguish **insured deposits** from **money market instruments**.
- Explain how FDIC and NCUA insurance limits apply to single-owner and joint-owner accounts.
- Compare **demand deposits**, **certificates of deposit**, **commercial paper**, and **Treasury bills**.
- Evaluate **liquidity**, **credit risk**, **interest rate risk**, **reinvestment risk**, and suitability considerations.

16.1 Why Cash and Cash Equivalents Matter

Cash and **cash equivalents** are the most liquid portion of a client portfolio. They are used for emergency reserves, near-term spending needs, transaction balances, and temporary parking of funds before a longer-term investment decision is made. In Series 65 questions, cash and cash equivalents are usually associated with liquidity and principal stability rather than long-term growth.

The trade-off is that safety and liquidity often come with lower expected return. A client who holds too much cash may face inflation risk and opportunity cost. A client who holds too little cash may be forced to sell volatile investments at an unfavorable time.

Client need	Why cash or cash equivalents may be suitable	Potential trade-off
Emergency reserve	Highly liquid and stable value	May lag inflation over long periods
Upcoming tuition or home purchase	Short time horizon makes principal preservation important	Lower growth potential than equities
Retiree spending reserve	Reduces need to sell securities during market declines	Cash drag if held excessively
Temporary holding account	Useful while awaiting investment decision or distribution	Reinvestment risk when rates fall

16.2 The Basic Categories

The NASAA outline separates this topic into insured deposits and money market instruments. That distinction is essential. An **insured deposit** is a bank or credit union account covered by federal insurance if the institution fails. A **money market instrument** is a short-term debt security. Some money market instruments are very high quality, but they are not the same as federally insured deposits.

Category	Examples	Key Series 65 point
Insured deposits	Demand deposits; certificates of deposit	May be covered by FDIC or NCUA insurance, subject to limits and ownership categories
Money market instruments	Commercial paper; Treasury bills	Short-term debt instruments; generally liquid, but not FDIC/NCUA insured

16.3 Insured Deposits

Insured deposits are deposit accounts held at insured banks or federally insured credit unions. The depositor has a claim against the institution, and federal insurance protects the depositor up to applicable limits if the institution fails. This protection is different from protection against market price changes. Deposit insurance does not make stocks, bonds, mutual funds, annuities, or other investment products risk-free.

Demand Deposits

A demand deposit is a deposit that can generally be withdrawn on demand. Checking accounts and similar transaction accounts are common examples. The key characteristic is immediate or near-immediate access to funds.

- **Liquidity:** Very high. Funds are generally available for transactions, withdrawals, or transfers.
- **Return:** Usually low. Some accounts may pay interest, but the main purpose is access and transaction convenience.
- **Risk:** Low if the account is within applicable insurance limits, but balances above those limits can be exposed to institution failure risk.
- **Suitability:** Appropriate for operating cash, emergency reserves, and near-term spending needs.

Certificates of Deposit

A **certificate of deposit**, or CD, is a time deposit. The depositor agrees to leave money with the institution for a stated maturity in exchange for a stated rate or formula. CDs usually pay more than demand deposits because the client gives up some liquidity.

- **Maturity:** Can range from very short-term to multiple years.
- **Early withdrawal:** A bank or credit union CD may impose an early withdrawal penalty if the client withdraws funds before maturity.
- **Insurance:** A CD issued by an insured bank or federally insured credit union can be insured, subject to ownership categories and limits.
- **Brokered or negotiable CDs:** May be purchased through a brokerage platform and may have secondary market price risk if sold before maturity.

FDIC and NCUA Coverage

FDIC insurance applies to deposits at FDIC-insured banks. NCUA share insurance applies to member share accounts at federally insured credit unions. The basic concept is similar: coverage is generally measured by depositor or member-owner, by insured institution, and by ownership category.

Feature	FDIC-insured bank deposits	NCUA-insured credit union shares
Federal insurer	Federal Deposit Insurance Corporation	National Credit Union Administration through the National Credit Union Share Insurance Fund
Basic limit	$250,000 per depositor, per insured bank, for each account ownership category	$250,000 per member-owner, per federally insured credit union, by ownership category
Examples covered	Checking, NOW, savings, money market deposit accounts, CDs	Share draft accounts, share savings accounts, share certificates/time deposits
Examples not covered	Stocks, bonds, mutual funds, crypto assets, life insurance, annuities, municipal securities, safe deposit box contents	Stocks, bonds, mutual funds, life insurance, annuities, municipal securities, digital assets, safe deposit boxes

Exam point
Do not confuse a money market deposit account at a bank with a money market mutual fund. A money market deposit account can be FDIC insured if held at an insured bank and within coverage limits. A money market mutual fund is an investment company product and is not FDIC or NCUA insured.

Coverage With More Than One Depositor

For multiple depositors, the exam usually tests whether you understand aggregation. The number of accounts is not the controlling factor. Coverage depends on the insured institution, the owner or owners, and the ownership category.

- **Single ownership category:** All single-owner deposits of the same depositor at the same insured institution are added together and insured up to $250,000.
- **Joint ownership category:** Each co-owner is generally insured up to $250,000 for that owner's combined interest in all joint accounts at the same insured institution.
- **Equal ownership assumption:** Unless the institution records clearly state otherwise, co-owners are generally treated as equal owners for insurance calculations.
- **Branches do not multiply coverage:** Accounts at separate branches of the same insured bank or credit union are not separately insured as if they were different institutions.

Example	Insurance result	Reason
Two co-owners hold one $500,000 joint CD at the same insured bank.	Fully insured if each owns 50%.	Each co-owner is treated as owning $250,000 in the joint category.
Two co-owners hold joint accounts totaling $600,000 at the same insured bank.	$500,000 insured; $100,000 uninsured if ownership is equal.	Each owner's combined joint-account interest is $300,000, but each is insured only up to $250,000 in that category.
Three equal co-owners hold one $750,000 joint account.	Fully insured if each owns one-third.	Each owner's interest is $250,000.
One client has checking, savings, and CDs totaling $400,000 in single ownership at the same bank.	$250,000 insured; $150,000 uninsured.	The accounts are added together within the same ownership category.

16.4 Money Market Instruments

Money market instruments are short-term debt instruments. They are generally used by issuers for short-term funding and by investors for liquidity and income. They tend to have lower price volatility than long-term bonds because their maturities are short, but they are not all risk-free.

Commercial Paper

Commercial paper is a short-term promissory note issued primarily by corporations. It is commonly used to finance working capital needs such as payroll, inventory, receivables, or

other current transactions. Commercial paper is generally unsecured, so investors rely on the issuer's credit quality and ability to roll over or repay the obligation.

- **Maturity:** Usually very short-term; Federal Reserve commercial paper data describe maturities up to 270 days, with average maturity around 30 days.
- **Issuer:** Primarily corporations and financial companies.
- **Credit risk:** Meaningful. If the issuer cannot repay or refinance, investors may suffer a loss.
- **Investor access:** Often purchased by institutions or indirectly through money market funds.
- **Insurance:** Not FDIC or NCUA insured.

Treasury Bills

Treasury bills, or T-bills, are short-term obligations of the U.S. Treasury. They are backed by the **full faith and credit** of the U.S. government. T-bills do not pay a stated coupon. Instead, they are commonly sold at a discount and mature at face value. The investor's return is the difference between the purchase price and the amount received at maturity.

- **Credit quality:** Very high because they are U.S. Treasury obligations.
- **Maturity:** Short-term Treasury securities, generally one year or less.
- **Return form:** Discount from face value rather than periodic coupon interest.
- **Risks:** Low default risk, but still subject to interest rate risk before maturity, reinvestment risk, and inflation risk.
- **Insurance:** Not FDIC insured, but backed by the full faith and credit of the U.S. government.

16.5 Comparing the Instruments

Instrument	Type	Liquidity	Credit/default risk	FDIC/NCUA?	Series 65 note
Demand deposit	Bank or credit union deposit	Very high	Low	May be FDIC/NCUA insured	Primary purpose is transaction liquidity
Certificate of deposit	Time deposit	Moderate to high; penalties or market risk if sold early	Low if insured and held within limits	May be FDIC/NCUA insured	Higher rate than demand deposit, but less liquid

Instrument	Type	Liquidity	Credit/default risk	FDIC/NCUA?	Series 65 note
Commercial paper	Corporate short-term debt	Generally high in normal markets	Issuer credit risk	No	Unsecured promissory note; usually institutional market
Treasury bill	U.S. government short-term debt	Very high	Very low default risk	No FDIC/NCUA insurance	Backed by full faith and credit of U.S. government

16.6 Suitability and Recommendation Considerations

Cash and cash equivalents are not automatically suitable or unsuitable. The correct recommendation depends on the client's time horizon, liquidity needs, risk tolerance, tax situation, and the role the asset plays in the overall portfolio.

Client situation	Likely suitable emphasis	Reason
Client needs funds for a house down payment in six months.	Insured deposits, T-bills, or very high-quality money market exposure	Principal stability and liquidity are more important than growth.
Client has $800,000 in one single-owner bank account.	Spread funds across ownership categories or institutions if insurance is desired	One account title at one institution may exceed insurance limits.
Client seeks a slightly higher yield and can accept issuer credit risk.	High-quality commercial paper or money market fund exposure may be considered	Higher yield comes with credit and liquidity risk.
Client has a long retirement horizon and too much idle cash.	Maintain emergency cash, but consider diversified growth investments for excess funds	Long-term inflation and opportunity cost may be significant.

16.7 Series 65 Exam Tips

- FDIC and NCUA insurance protect covered deposits or shares if the insured institution fails; they do not protect investments from market loss.
- The basic FDIC rule is $250,000 per depositor, per insured bank, per ownership category.
- For federally insured credit unions, NCUA share insurance generally provides $250,000 per member-owner, per federally insured credit union, by ownership category.
- Joint accounts can increase total coverage because each co-owner has a separate insurance limit in the joint category.
- Multiple accounts in the same ownership category at the same institution are aggregated.
- Commercial paper is short-term corporate debt and usually unsecured; it has credit risk.
- Treasury bills are short-term U.S. government obligations sold at a discount and maturing at face value.
- Liquidity does not eliminate risk. Even cash equivalents can involve inflation risk, reinvestment risk, liquidity risk, or credit risk.

References and Further Reading

NASAA. Series 65 Test Specifications, effective June 12, 2023. Used to identify the covered topic area: cash and cash equivalents, including insured deposits, demand deposits, certificates of deposit, commercial paper, and Treasury bills.

FDIC. Your Insured Deposits. Used for the FDIC insurance coverage framework, covered products, excluded products, and the $250,000 per depositor, per insured bank, per ownership category rule.

FDIC. Electronic Deposit Insurance Estimator. Used for joint account coverage examples and the explanation that each co-owner's shares of joint accounts at the same insured bank are aggregated and insured up to $250,000 per co-owner.

NCUA. Share Insurance Coverage. Used for NCUA coverage limits, covered credit union account types, excluded investment products, and joint ownership account coverage.

Federal Reserve Board. Commercial Paper Rates and Outstanding: About Commercial Paper. Used for the definition of commercial paper as short-term promissory notes issued primarily by corporations with maturities up to 270 days.

U.S. Treasury / TreasuryDirect. Treasury marketable securities and Treasury bills materials. Used for the discussion of Treasury bills as short-term U.S. Treasury obligations sold through auction and generally purchased at a discount.

Practice Questions

1. Which statement best describes a demand deposit?

A. A long-term corporate bond
B. A stock with a stable dividend history
C. A mutual fund that invests only in Treasury securities
D. A deposit generally available for withdrawal on demand

2. A client owns a single-owner checking account and a single-owner CD at the same FDIC-insured bank. How are those balances treated for insurance purposes?

A. The balances are added together within the same ownership category
B. The CD is insured only if purchased through a broker
C. Only the checking account is insured
D. Each account receives a separate $250,000 limit because they are different products

3. Two spouses own one joint CD for $500,000 at an FDIC-insured bank, with equal ownership and no beneficiaries. What is the likely insurance result?

A. The account is uninsured because CDs are securities
B. The account is insured only if held at two different branches
C. Only $250,000 is insured because there is one account
D. The account is fully insured because each co-owner is insured up to $250,000 in the joint category

4. Which product is normally a short-term unsecured promissory note issued primarily by corporations?

A. Demand deposit
B. Fixed annuity
C. Commercial paper
D. Treasury bill

5. Which statement about Treasury bills is most accurate?

A. They are long-term municipal bonds
B. They are short-term U.S. Treasury obligations commonly sold at a discount
C. They are equity securities issued by the Federal Reserve
D. They are FDIC-insured bank deposits

6. A money market deposit account at an FDIC-insured bank differs from a money market mutual fund because:

A. the bank deposit account is always a corporate security
B. the bank deposit account may be FDIC insured if within limits, while the mutual fund is not FDIC insured
C. the mutual fund is always guaranteed by the FDIC
D. the mutual fund cannot hold short-term instruments

7. A client has $600,000 in equal joint accounts with one spouse at the same insured bank. Assuming no other relevant ownership categories, how much is uninsured?

A. $100,000
B. $50,000
C. $0
D. $350,000

8. Which risk remains relevant even for a very safe cash equivalent?

A. Voting dilution risk
B. Proxy contest risk
C. Inflation risk
D. Preemptive-right risk

Answer Key and Explanations

1. D — A deposit generally available for withdrawal on demand

2. A — The balances are added together within the same ownership category

3. D — The account is fully insured because each co-owner is insured up to $250,000 in the joint category

4. C — Commercial paper

5. B — They are short-term U.S. Treasury obligations commonly sold at a discount

6. B — the bank deposit account may be FDIC insured if within limits, while the mutual fund is not FDIC insured

7. A — $100,000

8. C — Inflation risk

Lesson 17: U.S. Government Securities

Learning Objectives

- Distinguish **Treasury bills**, **Treasury notes**, **Treasury bonds**, and **Treasury Inflation-Protected Securities** (TIPS).
- Explain the basic cash-flow structure and maturity profile of major U.S. Treasury securities.
- Identify the primary risks of Treasury securities, including **interest rate risk**, **reinvestment risk**, and **inflation risk**.
- Apply U.S. government securities concepts to Series 65-style suitability and risk questions.

17.1 Overview

U.S. government securities are fixed income securities issued by the U.S. Treasury or by other government-related entities. Treasury securities are often treated as the benchmark for high credit quality because they are backed by the full faith and credit of the U.S. government. That does not mean they are risk-free in every sense. Their market values still change when interest rates change, and their after-inflation purchasing power can decline if inflation is unexpectedly high.

Exam point
Treasury securities have very low default risk, but they still have interest rate risk, inflation risk, reinvestment risk, and purchasing-power risk.

17.2 Treasury Bills, Notes, and Bonds

Security	Typical maturity	Cash-flow structure	Primary exam point
Treasury bills	One year or less	Sold at a discount; mature at face value	Short-term government security; no stated coupon.
Treasury notes	Intermediate-term	Pays stated interest; returns principal at maturity	Used for income and benchmark interest rates.
Treasury bonds	Long-term	Pays stated interest; returns principal at maturity	More sensitive to interest rate changes because of longer maturity.

Security	Typical maturity	Cash-flow structure	Primary exam point
TIPS	Intermediate or long-term	Coupon paid on inflation-adjusted principal	Designed to reduce inflation risk, but market price can still fluctuate.

Treasury bills are commonly used as cash-equivalent or near-cash instruments because of their short maturities and high credit quality. **Treasury notes** and **bonds** are longer-term debt obligations that pay interest, usually semiannually, and return principal at maturity. The longer the maturity, the greater the price sensitivity to changes in market interest rates, all else equal.

17.3 Treasury Inflation-Protected Securities (TIPS)

TIPS are U.S. Treasury securities designed to protect investors from inflation. The principal amount is adjusted based on inflation, and the coupon payment is calculated on the adjusted principal. If inflation rises, the inflation-adjusted principal rises, causing coupon payments in dollars to rise as well. If deflation occurs, principal can be adjusted downward, but at maturity the investor receives at least the original principal amount, assuming the security is held to maturity.

Feature	Plain-language meaning
Inflation adjustment	Principal adjusts with CPI-based inflation measures.
Coupon rate	The stated rate is fixed, but the dollar coupon changes when principal changes.
Tax issue	Inflation adjustments may be taxable in the year credited in taxable accounts.
Suitability	Useful for clients concerned about inflation eroding purchasing power.

17.4 Risks and Suitability

- **Interest rate risk:** Market prices of existing bonds generally fall when market interest rates rise.
- **Inflation risk:** A fixed coupon can lose purchasing power when inflation rises unexpectedly; TIPS are designed to reduce this risk.

- **Reinvestment risk:** Cash flows may need to be reinvested at lower rates in a declining-rate environment.
- **Liquidity risk:** Treasuries are generally highly liquid, but liquidity can vary across maturities and market conditions.
- **Suitability:** Shorter Treasury securities may fit liquidity and capital preservation needs; longer securities may fit income needs but carry greater rate sensitivity.

17.5 Practical Example

Assume a conservative client needs funds for a home down payment in six months. A short-term Treasury bill may be more suitable than a 20-year Treasury bond because the bill has a maturity better aligned with the client's time horizon. The 20-year bond may be high quality, but it could experience meaningful price volatility if interest rates rise before the client needs the money.

17.6 Series 65 Exam Tips

- Do not equate low default risk with no risk. Treasuries can still lose market value before maturity.
- Treasury bills are short-term discount instruments; Treasury notes and bonds pay periodic interest.
- TIPS are designed for inflation protection, not guaranteed short-term price stability.
- Suitability depends on the client's time horizon, income need, liquidity need, tax situation, and risk tolerance.

Key Terms

Term	Definition
Treasury bill	Short-term Treasury security usually sold at a discount and redeemed at face value.
Treasury note	Intermediate-term Treasury security that pays periodic interest.
Treasury bond	Long-term Treasury security that pays periodic interest.
TIPS	Treasury security whose principal adjusts for inflation.
Full faith and credit	The backing of the U.S. government for Treasury obligations.

Term	Definition
Interest rate risk	Risk that bond prices fall when market interest rates rise.

Practice Questions

1. Which Treasury security is most likely to mature in one year or less?

A. Corporate debenture
B. Treasury bond
C. Treasury bill
D. Preferred stock

2. A Treasury note generally differs from a Treasury bill because the note:

A. is issued by a municipality
B. is not backed by the U.S. government
C. typically pays periodic interest
D. has no interest rate risk

3. The principal value of TIPS is adjusted based on changes in:

A. the Consumer Price Index
B. the dividend yield of the S&P 500
C. the unemployment rate
D. the prime rate

4. Which risk remains important for a long-term Treasury bond?

A. Issuer default risk comparable to a junk bond
B. Equity dilution risk
C. Prepayment risk from mortgage refinancing
D. Interest rate risk

5. U.S. Treasury securities are generally best described as:

A. unregistered private funds
B. high-credit-quality fixed income securities
C. equity securities with voting rights
D. insured bank deposits

6. A client concerned about inflation protection may find which Treasury security most directly relevant?

A. Commercial paper
B. Treasury Inflation-Protected Security
C. Noncallable municipal revenue bond
D. Treasury bill

Answer Key and Explanations

1. C — Treasury bills are short-term U.S. Treasury obligations.

2. C — Treasury notes pay stated interest, while bills are typically sold at a discount.

3. A — TIPS principal is adjusted with CPI-based inflation indexing.

4. D — Treasury default risk is very low, but long maturities can be highly sensitive to interest rates.

5. B — Treasuries are marketable fixed income obligations of the U.S. government, not bank deposits.

6. B — TIPS are designed to adjust principal for inflation.

Lesson 18: Asset-Backed Securities

Learning Objectives

- Define an **asset-backed security** and identify common collateral pools.
- Explain the basic **securitization** process in plain language.
- Recognize key ABS risks, including credit risk, prepayment risk, **extension risk**, liquidity risk, and structural risk.
- Apply ABS concepts to Series 65-style suitability questions.

18.1 Overview

An **asset-backed security** (ABS) is a fixed income security backed by a pool of financial assets. The assets may include auto loans, credit card receivables, student loans, equipment leases, or mortgages. Instead of relying only on one issuer's general promise to pay, ABS investors rely on the cash flows generated by the underlying pool and on the legal structure of the securitization.

Plain-language idea
An ABS turns a pool of loans or receivables into securities that investors can buy. The borrowers make payments into the pool, and those cash flows are passed through or allocated to investors.

18.2 How Securitization Works

Step	What happens	Why it matters
1. Origination	A lender makes loans or creates receivables.	Loan quality affects future cash flows.
2. Pooling	Similar assets are grouped into a pool.	Diversification across many borrowers may reduce single-borrower exposure.
3. Special purpose vehicle	Assets are transferred to a separate legal entity.	The structure may separate collateral from the originator.
4. Issuance	Securities are sold to investors.	Investors receive cash flows based on the structure and priority.
5. Servicing	A servicer collects borrower payments.	Servicer quality can affect timing and administration.

18.3 Common Types of ABS

Collateral type	Cash-flow source	Important risk issue
Auto loan ABS	Borrower payments on auto loans	Credit quality and used-car values.
Credit card ABS	Payments on revolving card balances	Consumer credit cycles and payment rates.
Student loan ABS	Payments on student loans	Policy, deferment, and credit factors.
Mortgage-backed securities	Mortgage payments	Prepayment and extension risk.
Equipment lease ABS	Lease payments	Residual value and lessee credit quality.

18.4 Tranches and Credit Enhancement

Many securitizations divide cash flows into tranches. A senior **tranche** may have first priority on cash flows and may receive a higher credit rating. A subordinate tranche absorbs losses earlier and therefore carries more risk. **Credit enhancement** can include overcollateralization, reserve accounts, insurance, excess spread, or subordination.

Exam point
Higher stated yield in an ABS often comes with higher credit, liquidity, prepayment, extension, or structural risk.

18.5 Key Risks

- **Credit risk:** Borrowers in the underlying pool may fail to make payments.
- Prepayment risk: Borrowers may repay earlier than expected, forcing investors to reinvest at lower rates.
- **Extension risk:** Borrowers may repay more slowly than expected, extending the security's expected life.
- **Liquidity risk:** Some ABS may be harder to sell quickly at a fair price.
- **Structural risk:** The payment priority, tranche design, and legal structure can affect investor outcomes.
- **Interest rate risk:** Like other fixed income securities, ABS values can be affected by rate changes.

18.6 Suitability Considerations

ABS may be appropriate for investors seeking income and diversification within a fixed income allocation, but they require careful review. An adviser should evaluate the client's risk tolerance, liquidity needs, time horizon, tax situation, sophistication, and ability to understand the product. A complex ABS is generally less suitable for a client who needs simple, highly liquid, principal-stable investments.

18.7 Series 65 Exam Tips

- Focus on the underlying collateral and cash-flow structure, not just the coupon.
- **Prepayment risk** means principal comes back sooner than expected; extension risk means it comes back later than expected.
- Mortgage-backed securities are especially associated with prepayment and extension risk.
- ABS are not insured bank deposits and are not equivalent to Treasury securities.

Key Terms

Term	Definition
Asset-backed security	Security backed by a pool of loans or receivables.
Securitization	Process of pooling financial assets and issuing securities backed by their cash flows.
Tranche	Class of securities within a securitization with a particular priority and risk profile.
Prepayment risk	Risk that principal is returned earlier than expected.
Extension risk	Risk that principal is returned later than expected.
Credit enhancement	Structural support designed to reduce loss risk for certain investors.

Practice Questions

1. An asset-backed security is generally created by:

A. selling shares of ownership in a corporation
B. pooling loans or receivables and issuing securities backed by their cash flows
C. combining investor capital to buy common stock
D. issuing Treasury bills through the Federal Reserve

2. Which of the following is a common asset type that may back an ABS?

A. Voting rights
B. Common stock dividends
C. Corporate retained earnings
D. Auto loans

3. Prepayment risk is most closely associated with the risk that borrowers:

A. repay loans sooner than expected
B. convert preferred stock
C. default and make no payments
D. issue more common shares

4. Extension risk becomes a concern when borrowers repay principal:

A. before the security is issued
B. faster than expected
C. slower than expected
D. only through common dividends

5. A tranche is best described as:

A. a common stock voting right
B. a maturity date on a Treasury bill
C. a class of securities with a particular priority or risk profile within a securitization
D. a bank deposit insurance category

6. ABS suitability analysis should emphasize:

A. that all ABS are equivalent to insured deposits
B. collateral quality, structure, liquidity, credit risk, and cash-flow uncertainty
C. only the coupon rate
D. that ABS have no credit risk

Answer Key and Explanations

1. B — ABS are backed by pools of financial assets such as loans or receivables.

2. D — Auto loans, credit card receivables, student loans, and mortgages are common collateral pools.

3. A — Prepayment risk is the risk that principal is returned earlier than expected.

4. C — Extension risk is the risk that principal is returned later than expected.

5. C — Tranches divide securitized cash flows into classes with different priorities and risk exposures.

6. B — ABS require analysis of the underlying collateral and deal structure, not just stated yield.

Lesson 19: Corporate Bonds

Learning Objectives

- Explain how a **corporate bond** creates a creditor relationship between investor and issuer.
- Distinguish **secured**, **unsecured**, **subordinated**, **callable**, **putable**, and **convertible** corporate bonds.
- Calculate **coupon income** and **current yield** from a bond quote.
- Recognize the major risks and liquidation priority of corporate debt.

What Is a Corporate Bond?

A **corporate bond** is a debt security issued by a corporation to borrow money. The investor is a creditor, not an owner. The issuer promises to pay stated interest and repay principal according to the bond's terms. Those promises are contractual obligations, but they are subject to the issuer's ability to pay.

Term	Meaning	Example / Exam Cue
Par (face) value	Amount repaid at maturity, commonly $1,000 per bond	A quote of 100 generally means 100% of par
Coupon rate	Stated annual interest rate applied to par value	6% coupon × $1,000 par = $60 annual interest
Maturity	Date principal is scheduled to be repaid	Longer maturity generally increases interest-rate sensitivity
Indenture	Contract governing bondholder and issuer rights	Contains covenants, collateral, call terms, and other provisions
Trustee	Represents bondholders under the indenture	Helps monitor issuer compliance with bond terms

Secured and Unsecured Corporate Debt

- **Secured bond:** Backed by specific collateral. Examples can include mortgage bonds or equipment trust obligations.
- **Debenture:** Unsecured corporate bond backed by the issuer's general credit and ability to pay.

- **Subordinated debenture:** Unsecured debt that ranks behind specified senior debt in liquidation.
- **Exam principle:** Collateral can improve recovery prospects, but it does not eliminate credit or market risk.

Embedded Features

Feature	Who Benefits Most?	Effect / Risk
Callable	Issuer	Issuer may redeem early, often when rates fall; investor faces reinvestment risk
Putable	Investor	Investor may sell the bond back under stated terms; can reduce rate/credit exposure
Convertible	Investor	Bond may be exchanged for common stock; offers equity upside but often a lower coupon
Floating-rate	Investor when rates rise	Coupon resets with a reference rate; usually reduces interest-rate sensitivity versus fixed-rate debt

Corporate Bond Calculations

Annual coupon interest: Coupon Rate × Par Value
Calculated example: A 5.5% bond with $1,000 par pays $55 per year, usually in two $27.50 semiannual payments.

Current yield: Annual Coupon Interest ÷ Current Market Price
Calculated example: A $1,000 par 6% bond pays $60 annually. If it trades at $1,080, current yield = $60 ÷ $1,080 = 5.56%.

Price-yield relationship
For an existing fixed-rate bond, market price and required yield generally move in opposite directions. If market yields rise, the bond's price tends to fall; if market yields fall, the price tends to rise.

Credit Quality and Ratings

Corporate-bond investors face the possibility that the issuer will fail to make interest or principal payments. **Credit ratings** are opinions about creditworthiness, not guarantees. Lower-rated/high-yield bonds generally must offer higher yields to compensate investors for greater expected credit and liquidity risk. A **sinking fund** for a bond is a specialized reserve fund where an issuer sets aside money over time to periodically buy back and retire a portion of the bond issue before its final maturity date. **Restrictive covenants** in the bond **indenture** are legal rules that stop the issuing company from taking certain risky financial actions. Common restrictive covenants include limitations on paying dividends and caps on the amount of debt the issuer can issue. Sinking fund provisions and restrictive covenants generally reduce default risk for investors.

- **Credit spread:** The extra yield over a benchmark Treasury or other reference security. Wider spreads usually indicate greater perceived credit risk.
- **Downgrade risk:** A rating downgrade can lower a bond's market price and increase its yield.
- **Default risk:** The issuer may miss payments or restructure obligations.

Major Risks

- **Interest-rate risk**: bond prices generally fall when market interest rates rise.
- **Credit/default risk**: the corporation may be unable or unwilling to meet obligations.
- **Call/reinvestment risk**: a callable bond may be redeemed when rates are lower.
- **Liquidity risk**: some corporate bonds trade infrequently or with wide bid-ask spreads.
- **Inflation risk**: fixed payments may lose purchasing power.
- **Event risk**: mergers, leveraged transactions, litigation, or business deterioration can affect credit quality.

Liquidation Priority

In a corporate liquidation, debt claims generally rank ahead of preferred and common stock. Within debt, secured and senior claims generally rank ahead of subordinated claims. Exact priority depends on the security agreement, indenture, and bankruptcy law.

Bondholder = creditor. Common shareholder = residual owner.
Creditors generally have a higher claim on assets than equity investors, but bondholders do not normally vote for directors.

Series 65 Exam Cues

- A debenture is unsecured; “unsecured” does not mean worthless or automatically speculative.
- Callable bonds favor issuers and create reinvestment risk for investors.
- Convertible bonds combine debt features with the potential to participate in stock appreciation.
- Corporate-bond interest is generally taxable income; tax treatment differs from many municipal bonds.
- Credit ratings are opinions, not guarantees of payment.

References and Further Reading

- NASAA, Series 65 Test Specifications (effective June 12, 2023), Types of Fixed Income Securities and fixed-income characteristics.
- FINRA and SEC investor-education materials on corporate bonds and bond risks.

Practice Questions

1. A corporate debenture is best described as:

A. Preferred stock with a maturity date
B. An unsecured corporate bond backed by the issuer’s general credit
C. A bond guaranteed by the U.S. Treasury
D. A bond secured by real property

2. A 7% corporate bond has $1,000 par value. How much annual coupon interest does it pay?

A. $140
B. $700
C. $7
D. $70

3. Which feature most directly creates reinvestment risk for a bondholder when interest rates fall?

A. A conversion privilege
B. A sinking fund
C. A put provision
D. A call provision

4. A $1,000 par bond with a 6% coupon trades at $1,200. Its current yield is:

A. 6.00%
B. 4.00%
C. 5.00%
D. 7.20%

5. Which investor generally has the highest liquidation priority?

A. Common shareholder
B. Holder of subordinated debentures
C. Holder of senior secured debt
D. Preferred shareholder

6. If market interest rates rise substantially, the price of an existing fixed-rate corporate bond will generally:

A. Fall
B. Remain exactly at par
C. Rise
D. Become equal to its coupon rate

7. A convertible corporate bond gives the investor the ability to:

A. Exchange the bond for common shares under stated terms
B. Avoid all credit risk
C. Vote as a shareholder before conversion
D. Force the issuer to increase the coupon every quarter

8. A widening corporate credit spread most commonly signals:

A. Lower perceived credit risk
B. Higher perceived credit risk or risk aversion
C. A guaranteed increase in the issuer's earnings
D. That the bond has become a Treasury security

Answer Key and Explanations

1. B — An unsecured corporate bond backed by the issuer's general credit. A debenture is unsecured debt.

2. D — $70. 7% × $1,000 = $70 of annual coupon interest.

3. D — A call provision. When rates fall, the issuer may call higher-coupon debt and the investor must reinvest at lower prevailing rates.

4. C — 5.00%. $60 annual coupon ÷ $1,200 price = 5.00%.

5. C — Holder of senior secured debt. Senior secured creditors generally rank ahead of subordinated debt and equity.

6. A — Fall. Bond prices and market yields generally move inversely.

7. A — Exchange the bond for common shares under stated terms. The conversion feature provides equity-linked upside.

8. B — Higher perceived credit risk or risk aversion. A larger spread is greater yield compensation over the benchmark.

Lesson 20: Municipal Bonds

Learning Objectives

- Define **municipal bonds** and explain why public issuers use them.
- Distinguish **general obligation bonds** from **revenue bonds**.
- Explain how **municipal bond insurance** affects credit analysis without eliminating all risk.
- Calculate **tax-equivalent yield** and use it to compare tax-exempt municipal bonds with taxable corporate bonds.
- Identify key tax considerations, risks, and suitability factors for municipal bond recommendations.

20.1 What Is a Municipal Bond?

A **municipal bond**, often called a muni, is a debt obligation issued by a state or local government, public authority, school district, utility district, or similar governmental issuer. Investors lend money to the issuer and receive interest payments and repayment of principal at maturity, unless the bond is called, refunded, or defaults.

Municipal issuers use bond proceeds to finance public projects such as roads, schools, hospitals, water systems, airports, public utilities, and other infrastructure. Some municipal bonds also finance projects through **conduit issuers**, where a public issuer issues debt on behalf of a private or nonprofit borrower.

For the Series 65 exam, municipal bonds should be understood as fixed-income securities with unique credit sources, tax treatment, and suitability considerations. The key question is not simply “Is it tax free?” but “What backs the bond, what risks remain, and is the after-tax return suitable for this client?”

20.2 General Obligation Bonds

A **general obligation bond**, or GO bond, is backed by the full faith and credit of the issuer. This generally means the issuer pledges its taxing power and general resources to pay principal and interest.

GO bonds are commonly used for public projects that do not directly generate enough revenue to repay bondholders. Examples include public schools, municipal buildings, roads, parks, and public safety facilities.

The credit analysis for a GO bond focuses on the issuer’s tax base, economic strength, population trends, budget discipline, debt burden, pension obligations, and legal limits on taxation or borrowing.

General Obligation vs. Revenue Bonds

Feature	General Obligation Bond	Revenue Bond
Primary source of repayment	Issuer's general credit and taxing power	Revenue from a specific project, system, lease, or dedicated source
Typical project	Schools, roads, parks, public buildings	Toll roads, airports, water systems, utilities, hospitals
Core credit question	Can the issuer raise and allocate tax revenue?	Will the project or revenue source generate enough cash flow?
Exam clue	"Full faith and credit" or "taxing power"	"Payable from revenues of the project" or "not backed by full faith and credit"

20.3 Revenue Bonds

A **revenue bond** is backed by a specific stream of revenue rather than the issuer's broad taxing power. The pledged revenue may come from tolls, utility payments, lease payments, airport fees, hospital revenues, or other dedicated sources.

Revenue bonds are often associated with self-supporting or enterprise-type projects. If the revenue source weakens, bondholders may face higher credit risk even if the sponsoring city or authority remains financially sound.

The credit analysis for a revenue bond focuses on the project's demand, rate-setting power, operating costs, debt service coverage, competition, legal covenants, reserve funds, and the reliability of the revenue stream.

Exam point
GO bonds are usually linked to taxing power. Revenue bonds are linked to project or system revenues. When a question says the bond is payable only from fees, tolls, or user charges, think revenue bond.

20.4 Insured Municipal Bonds

An **insured municipal bond** includes a credit enhancement from a bond insurer. The insurer promises to make scheduled principal and interest payments if the issuer fails to do so.

Bond insurance can reduce credit risk because the investor has an additional source of payment. However, it does not eliminate all risk. The bond can still fluctuate in price when

interest rates change, liquidity can still be limited, call provisions can still affect return, and the insurer's own financial strength matters.

Investors should still analyze the underlying issuer or project. A bond is not automatically suitable merely because it is insured.

Risks That Remain Even When a Muni Is Insured

Risk	Why it still matters
Interest rate risk	Market value can fall when rates rise.
Liquidity risk	Some municipal issues trade infrequently, so selling before maturity may require accepting a lower price.
Call risk	Callable bonds may be redeemed early, especially after rates fall.
Insurer risk	The value of insurance depends on the insurer's ability to pay.
Tax risk	A bond's tax treatment can be affected by tax law, bond structure, or issuer compliance.

20.5 Tax Implications of Municipal Bonds

Many municipal bonds pay interest that is excluded from federal gross income. In some cases, interest may also be exempt from state and local income tax for residents of the issuing state. This is one reason municipal bonds are often most valuable to investors in higher tax brackets holding securities in taxable accounts.

Not all municipal bonds are tax-exempt. Taxable municipal bonds exist, and some private activity bonds may affect the alternative minimum tax calculation. Capital gains from selling a municipal bond at a profit are generally taxable, even if the bond's interest is tax-exempt.

Municipal bonds are usually less attractive inside tax-deferred accounts such as IRAs because the account already provides tax deferral. In that setting, the investor may give up yield without receiving an additional tax benefit.

20.6 Tax-Equivalent Yield and Corporate Bond Comparisons

Tax-equivalent yield helps compare a tax-exempt municipal bond to a taxable alternative, such as a corporate bond. The idea is simple: a lower tax-free yield may be worth as much as, or more than, a higher taxable yield after taxes.

Tax-equivalent yield = Tax-free municipal yield ÷ (1 – investor's marginal tax rate)

Corporate bond after-tax yield = Taxable corporate bond yield × (1 – investor's marginal tax rate)

On the Series 65 exam, use the marginal tax rate provided in the question unless state or local taxes are specifically included. For a simplified federal-only question, a 3.50% tax-exempt municipal bond for an investor in the 30% marginal tax bracket has this tax-equivalent yield:

3.50% ÷ (1 – 0.30) = 3.50% ÷ 0.70 = 5.00%

That means the investor would need a taxable corporate bond yielding more than 5.00% to produce a higher after-tax yield, assuming equal risk, maturity, liquidity, and other features. In practice, those other features are rarely equal, so tax-equivalent yield is a comparison tool, not a complete investment recommendation.

Tax-Equivalent Yield Example

Municipal yield	Marginal tax rate	Tax-equivalent yield	Corporate yield	Better after-tax yield?
3.50%	24%	4.61%	5.00%	Corporate bond
3.50%	32%	5.15%	5.00%	Municipal bond
4.00%	37%	6.35%	6.00%	Municipal bond

20.7 Suitability Considerations

Municipal bonds may be suitable for investors seeking income, capital preservation, and tax efficiency in a taxable account. They are often most compelling for higher-income investors because the value of the tax exemption increases with the investor's marginal tax rate.

Municipal bonds may be less suitable for investors in low tax brackets, investors who need maximum liquidity, investors seeking high growth, or investors using tax-deferred retirement accounts where the tax-exempt feature provides little additional value.

For any recommendation, compare after-tax yield, credit quality, maturity, duration, liquidity, call features, concentration, and the client's income needs, tax status, time horizon, and risk tolerance.

Suitability Summary

Client profile	Municipal bond fit	Reason
High tax bracket, taxable account, income objective	Often suitable	Tax exemption may improve after-tax income.
Low tax bracket, taxable account	Depends	Tax benefit may not offset lower stated yield.
IRA or **tax-deferred account**	Often less attractive	Account already provides tax deferral or tax treatment.
Short-term cash need	Usually avoid long maturities	Price and liquidity risk can matter if sold before maturity.
Conservative income investor	Potentially suitable	Use high-quality, diversified, appropriate maturity exposure.

20.8 Series 65 Exam Tips

- "Full faith and credit" points to a general obligation bond.
- "Fees, tolls, or project revenues" points to a revenue bond.
- Municipal bond insurance reduces default-payment risk but does not remove interest rate, liquidity, call, or tax risk.
- Use tax-equivalent yield to compare tax-exempt municipal yields with taxable corporate bond yields.
- Municipal bonds are usually most attractive in taxable accounts for higher-bracket investors.
- Do not recommend a municipal bond solely because it is tax-exempt. Suitability still requires credit, maturity, liquidity, tax, and client-profile analysis.

Key Terms

Term	Definition
Municipal bond	Debt issued by a state or local government or public authority.
General obligation bond	Muni backed by the issuer's full faith and credit and taxing power.

Term	Definition
Revenue bond	Muni backed by a specific revenue source rather than broad taxing power.
Bond insurance	Credit enhancement in which an insurer promises scheduled principal and interest if the issuer defaults.
Tax-equivalent yield	The taxable yield needed to equal a tax-exempt yield after taxes.
Alternative minimum tax (AMT)	A parallel tax system that may affect some private activity bond interest.
Call risk	Risk that a bond is redeemed early, often when rates have fallen.
Liquidity risk	Risk that a bond cannot be sold quickly at a fair price.

References and Further Reading

- Municipal Securities Rulemaking Board (MSRB). Municipal Bond Basics; Sources of Repayment.
- Internal Revenue Service. Tax-Exempt Private Activity Bonds and Tax-Exempt Bonds educational materials.
- NASAA Series 65 Test Specifications, effective June 12, 2023.

Practice Questions

1. A city issues bonds backed by its full faith and credit and taxing power. What type of municipal bond is this?

A. Revenue bond
B. Corporate debenture
C. General obligation bond
D. Treasury note

2. A bond used to finance a toll bridge will be repaid only from toll revenue. This is most likely a:

A. Treasury bill
B. General obligation bond
C. Certificate of deposit
D. Revenue bond

3. A municipal bond pays 3.6% tax-free interest. An investor is in the 28% marginal tax bracket. What is the approximate tax-equivalent yield?

A. 4.32%
B. 3.60%
C. 5.00%
D. 2.59%

4. Which statement about insured municipal bonds is most accurate?

A. Insurance provides an additional source of scheduled principal and interest payments if the issuer defaults.
B. Insurance makes tax analysis unnecessary.
C. Insurance eliminates all interest rate risk.
D. Insurance guarantees the bond will trade at par.

5. Municipal bonds are generally most attractive for which client?

A. High-bracket investor seeking tax-efficient income in a taxable account
B. Investor buying only inside an IRA
C. Low-bracket investor seeking maximum capital appreciation
D. Investor with a one-month emergency cash need

6. Which risk is especially important when an investor may need to sell a municipal bond before maturity?

A. Business cycle classification risk
B. Liquidity risk
C. Currency conversion risk
D. Mortality risk

7. A taxable corporate bond yields 6%. An investor's marginal tax rate is 30%. What is the corporate bond's after-tax yield?

A. 8.6%
B. 4.2%
C. 1.8%
D. 6.0%

8. Which municipal bond tax statement is correct?

A. Capital gains on municipal bonds are never taxable.
B. All municipal bonds are exempt from all taxes.
C. Municipal bond interest is always exempt from AMT.
D. Tax-exempt interest is generally more valuable to investors in higher marginal tax brackets.

Answer Key and Explanations

1. C — General obligation bond

2. D — Revenue bond

3. C — 5.00%

4. A — Insurance provides an additional source of scheduled principal and interest payments if the issuer defaults.

5. A — High-bracket investor seeking tax-efficient income in a taxable account

6. B — Liquidity risk

7. B — 4.2%

8. D — Tax-exempt interest is generally more valuable to investors in higher marginal tax brackets.

Lesson 21: Foreign-Issued Bonds

Learning Objectives

- Define **foreign-issued bonds** and distinguish **sovereign debt** from **foreign corporate debt**.
- Explain the main risks of foreign bonds, including **currency**, **sovereign**, **credit**, **liquidity**, **interest-rate**, and **geopolitical risk**.
- Compare **dollar-denominated bonds** with **local-currency bonds** from the perspective of a U.S. investor.
- Apply suitability principles when evaluating foreign government and foreign corporate bonds for client portfolios.
- Recognize common Series 65 exam traps involving foreign bonds and diversification.

21.1 What Are Foreign-Issued Bonds?

A **foreign-issued bond** is a debt security issued by a non-U.S. government, agency, supranational organization, or corporation. The bond may be sold in the United States, sold in a foreign market, or sold across multiple international markets. It may be denominated in U.S. dollars or in a foreign currency.

For a U.S. investor, foreign bonds can add diversification and income opportunities, but they also introduce risks that may not be present, or may be less pronounced, in domestic fixed income securities. These risks include currency risk, sovereign or political risk, different legal protections, lower liquidity, and tax complications.

> **Exam point**
> Foreign bonds are still fixed income securities, so price sensitivity to interest rates and credit quality still matter. The foreign element adds another layer of risk, especially currency and political risk.

21.2 Main Categories

Category	Issuer	What the investor is lending to	Primary risks
Foreign government / sovereign debt	A national government or related public issuer	A country or government entity	Sovereign default, currency, political, inflation, interest-rate, liquidity

Category	Issuer	What the investor is lending to	Primary risks
Foreign corporate debt	A corporation organized outside the United States	A foreign business enterprise	Credit/default, currency, legal/regulatory, accounting transparency, sector and liquidity risk

21.3 How Foreign Bonds May Be Issued

The name used for a cross-border bond can depend on where it is sold and the currency in which it is denominated.

Term	Plain-English meaning	Example
Foreign bond	Issued by a foreign borrower in another country's domestic market and usually denominated in that market's currency.	A German company issuing a U.S.-dollar bond in the United States.
Yankee bond	A U.S.-dollar bond issued in the United States by a foreign issuer.	A Canadian bank issues dollar-denominated debt to U.S. investors.
Eurobond	A bond issued outside the country whose currency is used. It does not necessarily mean the bond is denominated in euros.	A dollar-denominated bond issued outside the United States.
Local-currency bond	A bond denominated in the issuer's home currency or another non-dollar currency.	A Brazilian government bond denominated in Brazilian reais.

21.4 Government and Sovereign Debt

Sovereign debt is debt issued by a national government. **Emerging-market sovereign bonds** usually offer higher yields but carry greater default, currency, inflation, political, and liquidity

risks. **Developed-market sovereign bonds** may be viewed as high quality when the issuer has strong fiscal capacity, stable institutions, and deep capital markets.

- **Hard-currency** sovereign bonds are denominated in a major external currency, such as the U.S. dollar or euro. They reduce local-currency risk for a U.S. investor if dollar-denominated, but they do not eliminate sovereign default risk.
- **Local-currency** sovereign bonds are denominated in the issuing country's currency. A U.S. investor's dollar return depends on both bond performance and exchange-rate movement.
- A sovereign issuer may default, restructure debt, impose exchange controls, or experience inflation that reduces real returns.
- A country that borrows in its own currency may have different risks than a country that borrows in a foreign currency. A country may be less likely to run out of its own currency, but inflation and currency depreciation can still hurt investors.

21.5 Foreign Corporate Debt

Foreign corporate bonds are debt obligations of corporations organized outside the United States. These bonds can be issued by large multinational firms, banks, commodity producers, utilities, telecom companies, industrial firms, and other businesses. A U.S. investor analyzes foreign corporate bonds much like domestic corporate bonds, but with additional country, currency, legal, and disclosure considerations.

- Credit analysis focuses on the issuer's ability to make interest and principal payments.
- A dollar-denominated foreign corporate bond removes direct currency translation on scheduled payments, but it does not remove country risk or issuer credit risk.
- A local-currency foreign corporate bond can produce a loss for a U.S. investor even if the company pays exactly as promised, because the foreign currency may decline against the dollar.
- Foreign corporate bonds may have different accounting standards, investor protections, bankruptcy rules, disclosure practices, and market liquidity than comparable U.S. corporate bonds.

21.6 Currency Risk Example

Currency risk is one of the easiest foreign-bond risks to overlook. It arises when the bond's interest or principal is paid in a foreign currency and the investor measures wealth in U.S. dollars.

Year	Euro coupon received	EUR/USD exchange rate	Dollar value of coupon
Year 1	EUR 1,000	1.10 dollars per euro	$1,100
Year 2	EUR 1,000	1.00 dollars per euro	$1,000

Year	Euro coupon received	EUR/USD exchange rate	Dollar value of coupon
Change	No change in euro cash flow	Euro depreciated vs. dollar	Dollar income fell by $100

Interpretation: The issuer paid the same euro coupon in both years, but the U.S. investor received less dollar income in Year 2 because the euro weakened relative to the dollar.

21.7 Key Risks of Foreign-Issued Bonds

Risk	Meaning	Why it matters
Currency risk	Exchange-rate changes affect U.S.-dollar returns.	A foreign currency decline can offset interest income or capital gains.
Sovereign/political risk	Government actions or instability impair repayment or market value.	Examples include default, capital controls, sanctions, regime change, or debt restructuring.
Credit/default risk	Issuer may fail to make promised payments.	Applies to both sovereign and corporate issuers.
Interest-rate risk	Bond prices fall when relevant market rates rise.	Longer maturities and lower coupons generally increase duration risk.
Liquidity risk	Investor may not be able to sell quickly at a fair price.	Bid-ask spreads can widen sharply in stressed foreign markets.
Legal/regulatory risk	Investor protections and bankruptcy rules may differ by jurisdiction.	Recovery rights may be less predictable than in U.S. markets.

Risk	Meaning	Why it matters
Tax risk	Foreign withholding taxes or reporting rules can affect after-tax return.	Tax treatment depends on account type, issuer, country, and investor circumstances.

21.8 Developed-Market vs. Emerging-Market Bonds

Feature	Developed-market foreign bonds	Emerging-market foreign bonds
Typical yield	Often lower	Often higher to compensate for higher risk
Currency stability	Usually more stable, but still variable	Often more volatile
Political/legal risk	Generally lower	Generally higher
Liquidity	Usually deeper markets	May be less liquid, especially in local-currency debt
Suitability	May fit moderate portfolios when diversified	Generally better for investors with higher risk tolerance and long time horizons

21.9 Suitability Considerations

Suitability remains the controlling principle. A foreign-bond recommendation should fit the client's investment objective, time horizon, liquidity needs, tax status, risk tolerance, and existing portfolio exposures.

Client profile	Likely concern	Possible fit
Retiree seeking safety and liquidity	Currency volatility, credit risk, and liquidity risk may be inappropriate.	High-quality, short- to intermediate-term domestic bonds may be more suitable; limited foreign exposure may be appropriate only if conservative and diversified.

Client profile	Likely concern	Possible fit
High-income investor seeking higher yield	May be tempted by emerging-market debt yield.	Evaluate whether the added yield compensates for currency, sovereign, credit, and liquidity risk.
Long-term growth-oriented investor	Can tolerate more volatility.	A diversified global bond fund may add diversification, but should not dominate the fixed income allocation.
Client with foreign-currency expenses	Currency exposure may match future spending needs.	Foreign-currency bonds can be more defensible if liabilities are in the same currency.

21.10 Series 65 Exam Tips

- Foreign bonds are not automatically safer because they are issued by governments. Sovereign issuers can default or restructure debt.
- Higher yield usually signals higher risk, not a free advantage.
- Dollar-denominated foreign bonds reduce direct currency risk for a U.S. investor, but do not eliminate credit, liquidity, legal, or geopolitical risk.
- Local-currency bonds add exchange-rate risk. A U.S. investor's dollar return can be negative even if the issuer pays all coupons and principal in local currency.
- A foreign-bond fund can improve diversification, but diversification does not eliminate systematic global risk or all currency risk.
- Suitability is based on the client, not on the yield alone.

Key Terms

Term	Definition
Foreign-issued bond	A debt security issued by a non-U.S. government or corporation.
Sovereign debt	Debt issued by a national government.
Foreign corporate debt	Debt issued by a corporation organized outside the United States.

Term	Definition
Currency risk	The risk that exchange-rate movements reduce the investor's return.
Hard-currency debt	Debt denominated in a major external currency, such as the U.S. dollar or euro.
Local-currency debt	Debt denominated in the issuer's local currency.
Yankee bond	A U.S.-dollar bond issued in the United States by a foreign issuer.
Eurobond	A bond issued outside the country whose currency is used.
Sovereign risk	The risk that a government issuer defaults, restructures, or takes actions that hurt investors.

References and Further Reading

- NASAA Series 65 Test Specifications, effective June 12, 2023.
- FINRA investor education materials on bonds and international investing.
- U.S. Securities and Exchange Commission investor education materials on international investing and bond risk.
- U.S. Treasury and Federal Reserve educational materials on fixed income risk, interest rates, and global capital markets.

Practice Questions

1. Which statement best describes a foreign-issued bond?

A. A U.S. Treasury bond sold to foreign investors
B. A stock issued by a foreign corporation
C. A municipal bond backed by foreign tax revenue
D. A debt security issued by a non-U.S. government or corporation

2. A U.S. investor buys a euro-denominated bond. The issuer pays every coupon as promised, but the euro falls against the dollar. What risk is illustrated?

A. Reinvestment risk
B. Currency risk
C. Call risk
D. Prepayment risk

3. Which bond is most directly backed by the ability and willingness of a national government to repay?

A. Asset-backed security
B. Foreign corporate bond
C. Sovereign bond
D. Common stock

4. A Yankee bond is generally best described as:

A. A U.S. Treasury bond issued outside the United States
B. A foreign-currency bond issued by a U.S. municipality
C. A U.S.-dollar bond issued in the United States by a foreign issuer
D. An equity security issued by a foreign bank

5. Which risk is most likely to be higher for a thinly traded emerging-market bond than for a frequently traded U.S. Treasury security?

A. Liquidity risk
B. Preemptive-right risk
C. SIPC risk
D. FDIC risk

6. A conservative retiree needs stable principal for near-term living expenses. Which concern is most important when considering emerging-market local-currency debt?

A. It is always exempt from U.S. income tax
B. It cannot decline in value if held in a fund
C. It is guaranteed by the U.S. government
D. It may have significant currency, credit, sovereign, and liquidity risk

Answer Key and Explanations

1. D — A foreign-issued bond is a debt security issued by a non-U.S. issuer.

2. B — The investor's dollar return falls because of the exchange-rate movement.

3. C — Sovereign debt is issued by a national government.

4. C — Yankee bonds are dollar-denominated bonds issued in the U.S. market by foreign issuers.

5. A — Thinly traded bonds may be difficult to sell quickly at a fair price.

6. D — Emerging-market local-currency debt can be volatile and may be unsuitable for near-term safety needs.

Lesson 22: Fixed Income Characteristics

Learning Objectives

- Identify major **fixed income** characteristics that affect risk, return, income, and suitability.
- Explain how taxes, ratings, liquidity, **call features**, **coupon structure**, **duration**, and **yield** affect bond analysis.
- Interpret **par**, **premium**, and **discount** bond pricing and connect price levels to market yields.
- Use duration to estimate the sensitivity of a bond or bond fund to interest rate changes.
- Apply fixed income concepts to Series 65-style client recommendation questions.

22.1 What Fixed Income Securities Promise

A **fixed income security** is an investment that generally promises a stream of income payments and the return of principal at maturity, subject to the issuer's ability to pay. Bonds are the most common fixed income securities. A bond investor is usually a lender, not an owner. The issuer receives capital, and the investor receives contractual payments.

For the Series 65 exam, the key point is not merely that bonds pay interest. The adviser must understand how the bond's features affect market value, risk, yield, liquidity, and suitability for a client.

Major Characteristics at a Glance

Characteristic	What it means	Why it matters
Tax treatment	Whether income is taxable, tax-exempt, or subject to special rules	Affects after-tax return and suitability by account type and tax bracket
Bond rating	Credit quality assessment from rating agencies	Helps estimate default risk and credit spread
Liquidity	Ease of selling without a large price concession	Illiquid bonds may be costly to exit before maturity
Liquidation preference	Order of payment if the issuer is liquidated	Debt generally has priority over preferred stock and common stock
Call feature	Issuer may redeem the bond before maturity	Creates reinvestment risk and can limit upside when rates fall

Characteristic	What it means	Why it matters
Coupon structure	Periodic interest versus no periodic coupon	Affects income timing, price volatility, and tax treatment
Duration	Approximate interest-rate sensitivity	Higher duration means greater price sensitivity to yield changes
Price	Par, premium, or discount relative to face value	Reflects coupon, market yields, time to maturity, credit risk, and call features
Yield	Return measure based on income, price, maturity, and call assumptions	Different yield measures answer different questions

22.2 Tax Implications

Not all bond income is taxed the same way. Tax treatment can materially change the after-tax return that a client keeps. The same stated yield may be more or less attractive depending on the client's tax bracket, account type, and the type of issuer.

- **Corporate bond interest:** Generally taxable as ordinary income at the federal level and may also be subject to state income tax.
- **U.S. Treasury interest:** Taxable at the federal level but generally exempt from state and local income tax.
- **Municipal bond interest:** Often exempt from federal income tax and may be exempt from state income tax if issued in the investor's state. Some bonds may be subject to the alternative minimum tax.
- **Capital gains and losses:** If a bond is sold before maturity for more or less than the investor's tax basis, capital gain or loss treatment may apply.
- **Original issue discount:** Zero-coupon and certain discount bonds can create taxable income even though the investor does not receive regular cash interest payments.
- **Tax-advantaged accounts:** In an IRA or retirement plan, current taxation may be deferred or treated under retirement-account tax rules, making tax-exempt income less valuable than it would be in a taxable account.

22.3 Bond Ratings

Bond ratings are credit-quality opinions. They are not guarantees. Higher-rated bonds are generally considered more likely to make timely interest and principal payments. Lower-rated

bonds usually offer higher yields because investors require compensation for additional credit risk.

Category	Typical meaning	Series 65 interpretation
Investment grade	Higher credit quality; generally BBB-/Baa3 or above, depending on the agency	Lower default risk, lower yield, often more suitable for conservative income needs
Non-investment grade / high yield	Lower credit quality; below investment grade	Higher credit risk and yield; may be unsuitable for conservative clients needing capital preservation
Downgrade	Rating agency lowers the bond's credit rating	Usually negative for price and may widen the credit spread
Upgrade	Rating agency raises the bond's credit rating	May support price appreciation and tighter spreads

22.4 Market Liquidity

Market liquidity is the ability to buy or sell a security reasonably quickly without causing a large change in price. A liquid bond has active buyers and sellers, observable prices, and relatively narrow bid-ask spreads. An illiquid bond may require the seller to accept a lower price, especially during market stress.

Liquidity risk matters because many bonds are designed to be held to maturity, but clients often need flexibility. A client who may need to sell before maturity should usually avoid highly complex, thinly traded, or lower-quality bonds unless the risks are clearly understood.

- Issue size and trading volume: larger, more actively traded issues are generally easier to sell.
- Credit quality: higher-quality bonds are often more liquid, especially in stressed markets.
- Complexity: structured or unusual bonds may have fewer buyers.
- Market environment: liquidity can disappear during credit crises or periods of sharp rate volatility.
- Dealer inventory and **bid-ask spread**: a wide spread is a practical sign of higher transaction cost.

22.5 Liquidation Preference

Liquidation preference is the order in which claimants are paid if a company is liquidated. Bondholders are creditors, so they generally stand ahead of equity holders. Preferred stockholders generally rank ahead of common stockholders but behind creditors.

Priority	Capital source	Typical claim
1	Secured debt	Claim supported by specified collateral
2	Senior unsecured debt	General creditor claim without specific collateral
3	Subordinated debt	Paid after senior debt
4	Preferred stock	Equity security with preference over common stock
5	Common stock	Residual claim; highest risk in liquidation

22.6 Call Features

A **call feature** gives the issuer the right to redeem a bond before maturity according to the bond's terms. Issuers are most likely to call bonds when interest rates have fallen or when the issuer can refinance at a lower cost. This is favorable for the issuer but may be unfavorable for the investor.

- **Call risk**: the risk that a bond will be redeemed before maturity, forcing the investor to reinvest at lower yields.
- **Reinvestment risk**: the risk that income or principal must be reinvested at a lower rate.
- **Call protection**: a period during which the issuer may not call the bond.
- **Call premium**: an amount above par paid to investors if the bond is called during certain periods.
- **Yield to call**: a yield calculation that assumes the bond is called on a specified call date; it may be more relevant than yield to maturity for premium callable bonds.

22.7 Coupon Bonds vs. Zero-Coupon Bonds and Floating Rate Bonds

Feature	Coupon bond	Zero-coupon bond
Cash flow	Pays periodic interest and returns par at maturity	No regular cash interest; purchased at a discount and matures at par
Income planning	Useful for clients seeking periodic cash flow	Less suitable when the client needs current income
Price sensitivity	Depends on coupon, maturity, and yield	Generally more sensitive to rate changes than a similar maturity coupon bond
Tax issue	Interest is usually taxed as received unless held in tax-advantaged account	Imputed interest or OID may be taxable even without cash payments
Duration	Duration is usually shorter than maturity for coupon-paying bonds	Duration is approximately equal to maturity

A **floating rate bond** (also called a floater or variable-rate note) is a debt security with a coupon rate that changes periodically based on a benchmark market index. The values of floating rate bonds are generally less sensitive to changes to interest rates because the payments change with changes in interest rates.

22.8 Duration: Interest-Rate Sensitivity

Duration is one of the most important fixed income concepts for the Series 65 exam. In plain language, duration estimates how sensitive a bond's price is to changes in interest rates. The higher the duration, the more the bond's price is expected to move when market yields change.

Approximation: Percentage price change ≈ -Duration × Change in yield

For example, if a bond fund has a duration of 6 and market yields rise by 1%, the approximate price change is -6%. If market yields fall by 1%, the approximate price change is +6%. This is an approximation; actual price changes can differ because of convexity, credit spread changes, and nonparallel yield curve movements.

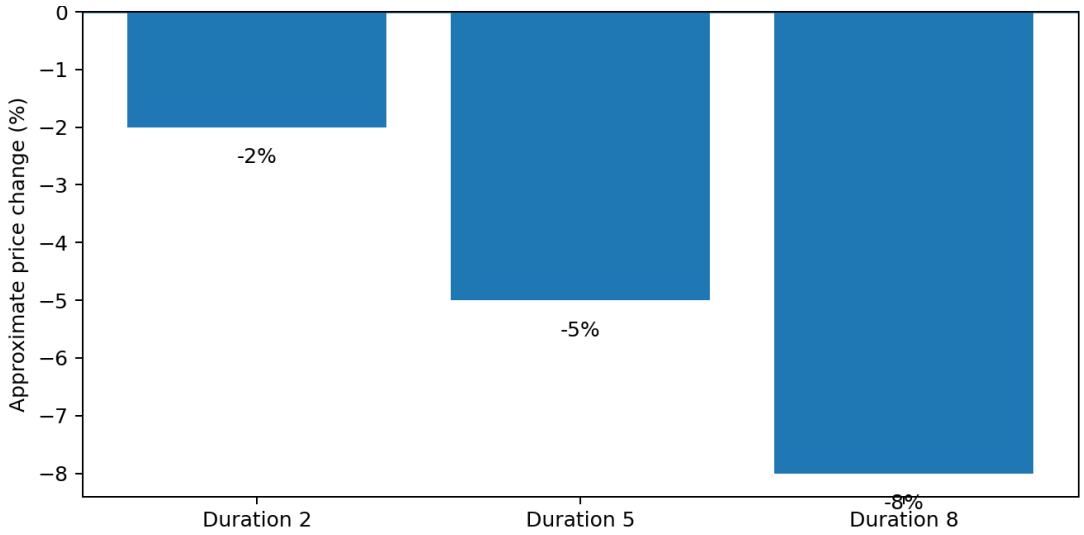


Figure 22.1: Duration estimates price sensitivity to changes in yield. Higher duration means greater interest-rate risk.

What Increases Duration?

- Longer maturity generally increases duration because more cash flows are received farther in the future.
- Lower coupon generally increases duration because less value is received through near-term coupon payments.
- Zero-coupon bonds have high duration because all cash flow arrives at maturity.
- Lower yields can increase duration for many bonds because distant cash flows receive relatively more weight.
- Embedded options, such as calls, can change effective duration because expected cash flows may change when rates move.

22.9 Pricing: Par, Premium, and Discount Bonds

Bond prices are usually quoted as a percentage of par value. A common par value is $1,000, and a quoted price of 100 means the bond trades at par. A price of 98 means approximately $980 per $1,000 of par value. A price of 105 means approximately $1,050 per $1,000 of par value.

Price category	Price relative to par	Coupon compared with market yield	Interpretation
Par bond	Price = 100	Coupon rate roughly equals market yield	Investor pays about face value
Premium bond	Price > 100	Coupon rate is above current market yield	Investor pays extra for above-market coupon income

Price category	Price relative to par	Coupon compared with market yield	Interpretation
Discount bond	Price < 100	Coupon rate is below current market yield	Investor pays less because coupon income is below market

Example: assume a $1,000 par bond pays a 5% coupon, or $50 per year. If comparable new bonds yield 5%, the bond should trade near par. If comparable new bonds yield only 3%, the existing 5% coupon is attractive and the bond may trade at a premium. If comparable new bonds yield 7%, the existing 5% coupon is unattractive and the bond may trade at a discount.

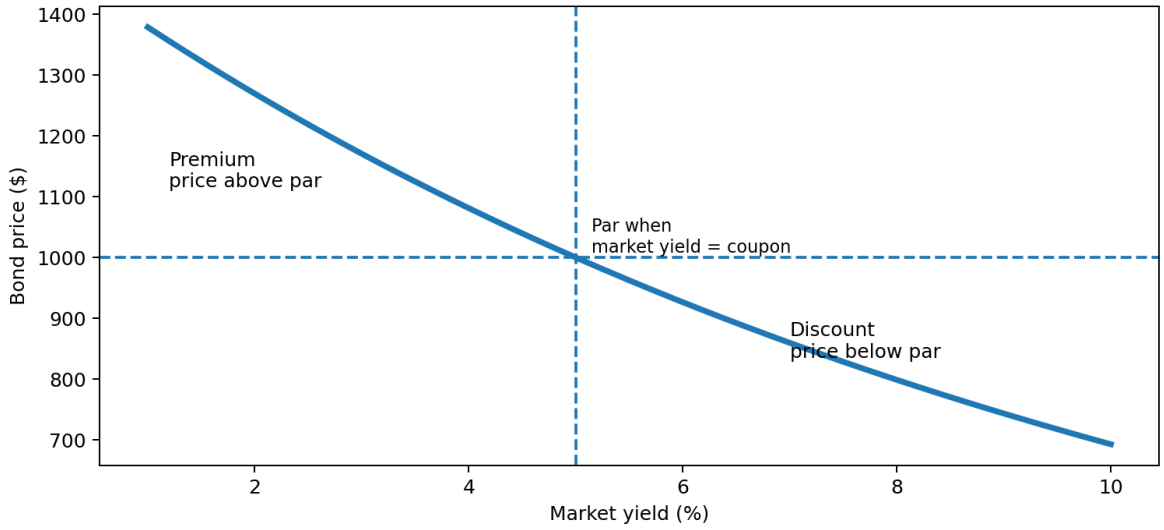


Figure 22.2: Bond prices and yields generally move in opposite directions.

Pull to Par

As a bond approaches maturity, its price tends to move toward par, assuming the issuer remains able to pay and the bond is not called. A premium bond tends to decline toward par as maturity approaches. A discount bond tends to rise toward par as maturity approaches. This movement is sometimes called pull to par.

22.10 Major Fixed Income Risks

Risk	Meaning
Interest rate risk	Bond prices fall when market yields rise; higher duration means more sensitivity.

Risk	Meaning
Credit/default risk	Issuer may fail to make interest or principal payments.
Reinvestment risk	Coupons or principal may need to be reinvested at lower rates.
Call risk	Issuer may redeem the bond early, often when rates have fallen.
Liquidity risk	Investor may be unable to sell quickly without accepting a lower price.
Inflation risk	Fixed payments lose purchasing power when inflation rises.
Prepayment risk	Borrowers may repay principal early, especially in mortgage-related securities.
Currency risk	Foreign-currency bonds can lose value when exchange rates move unfavorably.
Event risk	Unexpected legal, regulatory, operational, or merger-related events may affect the issuer.

22.11 Yield Measures

Different yield measures answer different questions. On the exam, be careful not to treat every yield number as the same.

Yield measure	Interpretation
Nominal yield / coupon rate	Annual coupon divided by par value. It does not change as market price changes.
Current yield	Annual interest divided by current market price. It ignores maturity value and capital gain/loss.

Yield measure	Interpretation
Yield to maturity	Estimated annualized return if held to maturity, assuming payments are made and reinvestment assumptions hold.
Yield to call	Estimated annualized return if the bond is called on a specified call date.
Tax-equivalent yield	Taxable yield needed to equal a tax-exempt yield for a given tax bracket.
Real yield	Return after considering inflation; important for purchasing power analysis.

Current Yield Example

A bond has a $1,000 par value and a 6% coupon, so it pays $60 per year. If it trades at $950, its current yield is $60 ÷ $950 = 6.32%. If it trades at $1,050, its current yield is $60 ÷ $1,050 = 5.71%.

22.12 Suitability and Exam Application

- A conservative income client may prefer higher-quality, shorter- or intermediate-duration bonds over long-duration, lower-rated bonds.
- A client needing predictable cash flow may prefer coupon-paying bonds over zero-coupon bonds.
- A client who may need to sell before maturity should pay attention to liquidity and bid-ask spreads.
- A high-tax-bracket client in a taxable account may benefit from tax-exempt municipal bonds, subject to credit and suitability analysis.
- A premium callable bond requires attention to yield to call because the issuer may redeem the bond before maturity.
- A long-duration bond fund can lose value quickly when interest rates rise, even if the bonds are high quality.

Series 65 Exam Tips

- Bond prices and interest rates move inversely.
- Premium bond: coupon rate is higher than current market yield; price is above par.
- Discount bond: coupon rate is lower than current market yield; price is below par.
- Higher duration means higher interest-rate sensitivity.
- Longer maturity and lower coupon generally increase duration.

- Callable bonds create reinvestment risk and may be called when rates fall.
- Liquidity risk is the risk that the investor cannot sell at a fair price when needed.
- Yield to call can be more relevant than yield to maturity for premium callable bonds.
- Ratings are opinions, not guarantees.

Practice Questions

1. A bond with a duration of 7 would be expected to do which of the following if market yields rise by 1%?

A. Increase by approximately 7%
B. Remain unchanged because duration measures credit risk
C. Decrease by approximately 7%
D. Decrease by exactly 1%

2. A bond is most likely to trade at a premium when:

A. Its coupon rate is below current market yields
B. Its coupon rate is above current market yields
C. The issuer has defaulted
D. Its coupon rate equals current market yields

3. Which feature creates the risk that an investor may have to reinvest principal at a lower rate?

A. Fixed maturity
B. Call feature
C. Senior secured status
D. Investment-grade rating

4. Which statement about zero-coupon bonds is most accurate?

A. They are purchased at a discount and mature at par
B. They always sell at a premium
C. They make large monthly interest payments
D. Their duration is usually much shorter than maturity

5. Market liquidity risk is best described as:

A. The risk that inflation reduces purchasing power
B. The risk that the issuer has too much equity
C. The risk that a bond cannot be sold quickly without a significant price concession
D. The risk that a bond receives a rating upgrade

6. If a company is liquidated, which security generally has the highest priority among the following?

A. Warrants
B. Common stock
C. Preferred stock
D. Senior secured debt

7. A bond's current yield is calculated as:

A. Total return assuming the bond is called
B. Annual interest divided by original purchase price only
C. Annual interest divided by current market price
D. Market price divided by annual interest

8. Which investor is most likely to be concerned about long-duration bond exposure?

A. A client who needs to minimize interest-rate volatility over a short time horizon
B. A client who wants the greatest possible interest-rate sensitivity
C. A client expecting interest rates to fall sharply
D. A client who does not care about interim price changes

9. A downgrade in a bond rating would most likely:

A. Put downward pressure on the bond's market price
B. Increase the coupon on an existing fixed-rate bond automatically
C. Eliminate call risk
D. Reduce credit risk

10. Which yield is often most relevant for a premium bond that is likely to be redeemed early?

A. Book yield only
B. Dividend yield
C. Nominal yield only
D. Yield to call

Answer Key and Explanations

1. C — Decrease by approximately 7%

2. B — Its coupon rate is above current market yields

3. B — Call feature

4. A — They are purchased at a discount and mature at par

5. C — The risk that a bond cannot be sold quickly without a significant price concession

6. D — Senior secured debt

7. C — Annual interest divided by current market price

8. A — A client who needs to minimize interest-rate volatility over a short time horizon

9. A — Put downward pressure on the bond's market price

10. D — Yield to call

Lesson 23: Fixed Income Valuation

Learning Objectives

- Explain how **coupon rate**, **maturity**, **required yield**, and **credit quality** affect a bond's market value.
- Distinguish **yield to maturity** (YTM), **yield to call** (YTC), **current yield**, and coupon rate.
- Use **duration** to estimate a bond's sensitivity to a change in interest rates.
- Calculate **credit spread** and basic **convertible-bond** conversion values.
- Apply discounted cash flow logic to fixed-income securities and interpret **bond ratings**.

23.1 The Core Valuation Idea

A bond is worth the present value of the cash flows the investor expects to receive: periodic interest payments plus repayment of principal. The discount rate used to value those cash flows reflects current market interest rates and the risk of the issuer.

Bond value
Bond Price = Present Value of Coupons + Present Value of Principal
Example: A $1,000 bond paying $60 per year is worth less than $1,000 if investors now require a return greater than 6%, and more than $1,000 if they require less than 6%.

Exam principle
Bond prices and market yields generally move in opposite directions. When required yields rise, existing bond prices fall; when required yields fall, existing bond prices rise.

23.2 Coupon Rate and Coupon Income

The **coupon rate** is the stated annual interest rate applied to the bond's par value. For a traditional fixed-rate bond, the dollar coupon payment does not change merely because the bond's market price changes.

Annual coupon interest
Annual Coupon = Coupon Rate × Par Value
Example: A 6% coupon on $1,000 par pays $60 per year. If interest is paid semiannually, the investor receives $30 every six months.

Exam point
Coupon rate is based on par value, not on the bond's current market price. Current yield, by contrast, uses market price in the denominator.

23.3 Maturity and Price Sensitivity

Maturity is the date on which principal is scheduled to be repaid. All else equal, longer-maturity bonds generally experience larger price changes when market interest rates move because more of their cash flows occur farther in the future.

- Longer maturity generally means greater interest-rate risk.
- Lower coupon generally means greater interest-rate sensitivity, all else equal.
- As a bond approaches maturity, its market price tends to move toward par if the issuer remains able to pay.

23.4 Duration

Duration measures the sensitivity of a bond's price to changes in interest rates. For Series 65 purposes, the key use is estimating the percentage price change for a relatively small change in yield.

Duration approximation
Approximate % Price Change ≈ −Duration × Change in Yield
Example: A bond with duration of 5.2 experiences a 0.75% (0.0075) rise in yield. Estimated price change = −5.2 × 0.0075 = −0.039, or approximately −3.9%.

Interpretation
Higher duration means greater interest-rate sensitivity. Duration typically rises with longer maturity and falls with a higher coupon, other factors held constant.

23.5 Yield Measures: Know What Each One Means

Measure	What It Uses	What It Tells You	Exam Cue
Coupon rate	Coupon ÷ par value	Stated contractual rate	Does not change with market price
Current yield	Annual coupon ÷ market price	Income yield at today's price	Ignores maturity gain/loss
Yield to maturity (YTM)	All cash flows through maturity	Compound return if held to maturity under assumptions	Includes coupon + price pull to par
Yield to call (YTC)	Cash flows through call date and call price	Return if issuer calls the bond	Important for callable premium bonds

Current Yield

Current Yield = Annual Coupon Interest ÷ Market Price
Example: A 6% $1,000 par bond trades at $950. Annual coupon = $60. Current yield = $60 ÷ $950 = 6.32%.

Yield to Maturity (YTM)

YTM is the discount rate that makes the present value of the bond's promised cash flows equal to its current price. It incorporates coupon income plus any gain or loss as the bond price moves toward par by maturity, assuming payments are made as promised and coupons can be reinvested at the calculated yield.

Four-function approximation to YTM
Approx. YTM = [Annual Interest + (Par − Price) ÷ Years] ÷ [(Par + Price) ÷ 2]
Example: A 6% bond with $1,000 par sells for $950 and matures in 5 years: [$60 + ($50 ÷ 5)] ÷ [($1,000 + $950) ÷ 2] = $70 ÷ $975 = 7.18%.

Price/yield relationship
Discount bond: YTM is generally greater than current yield, which is greater than coupon rate.
Premium bond: coupon rate is generally greater than current yield, which is greater than YTM, assuming no unusual features.

Yield to Call (YTC)

YTC assumes the bond is redeemed on its call date for the stated call price. A callable bond may be called when interest rates decline, forcing the investor to reinvest at lower rates. This is reinvestment risk.

Four-function approximation to YTC
Approx. YTC = [Annual Interest + (Call Price − Market Price) ÷ Years to Call] ÷ [(Call Price + Market Price) ÷ 2]
Example: A 7% bond sells for $1,060, is callable in 4 years at $1,020, and pays $70 annually: [$70 + (−$40 ÷ 4)] ÷ [($1,020 + $1,060) ÷ 2] = $60 ÷ $1,040 = 5.77%.

Exam point
For a callable bond selling at a premium, YTC is often lower than YTM because the investor may lose part of the premium sooner if the issuer calls the bond.

23.6 Discounted Cash Flow (DCF) Valuation

Discounted cash flow valuation discounts each expected bond cash flow back to today. Higher required returns produce lower present values. Lower required returns produce higher present values.

Present value concept
PV = Future Cash Flow ÷ (1 + Required Return)^n
Example: If $1,000 is to be received in two years and the required return is 5%, its present value is approximately $1,000 ÷ 1.05 ÷ 1.05 = $907.03 using a four-function calculator.

Series 65 use
You are more likely to be tested on the direction of the relationship than on a long multi-period bond-pricing calculation: higher discount rate → lower present value.

23.7 Bond Ratings and Credit Quality

Credit ratings express an agency's opinion about an issuer's ability and willingness to meet debt obligations. Higher-rated bonds generally offer lower yields than otherwise comparable lower-rated bonds because investors require less compensation for credit risk.

Category	General Meaning	Typical Valuation Effect
Investment grade	Higher credit quality; lower expected default risk	Usually lower required yield and higher price, all else equal
Below investment grade / high yield	Higher credit risk	Usually higher required yield and lower price
Upgrade	Perceived credit quality improves	Price may rise and spread may narrow
Downgrade	Perceived credit quality deteriorates	Price may fall and spread may widen

Important limitation
A rating is not a guarantee and does not eliminate interest-rate, liquidity, call, or market risk.

23.8 Credit Spread

A **credit spread** is the difference between the yield on a risky bond and the yield on a benchmark security of similar maturity, often a U.S. Treasury. It measures the extra yield investors demand for credit and related risks.

Credit spread
Credit Spread = Corporate Bond Yield − Benchmark Yield
Example: A corporate bond yields 6.40% while a similar-maturity Treasury yields 4.80%. Spread = 1.60 percentage points = 160 basis points.

- Widening spread generally signals greater perceived credit risk or weaker demand for the risky bond.
- Narrowing spread generally signals improved perceived credit conditions or stronger demand.
- A spread change can move a corporate bond's price even if the Treasury benchmark yield does not change.

23.9 Convertible Bond Valuation

A **convertible bond** gives the investor the right to convert the bond into a specified number of common shares. Its value can therefore be influenced by both bond fundamentals and the market value of the underlying stock.

Conversion value
Conversion Value = Conversion Ratio × Market Price of Common Stock
Example: A bond is convertible into 20 shares. If the stock trades at $42, conversion value = 20 × $42 = $840.

Conversion price
Conversion Price = Par Value ÷ Conversion Ratio
Example: A $1,000 bond convertible into 20 shares has a conversion price of $50 per share.

Exam principle
If the stock rises substantially, the conversion feature may support the bond's price. If the stock performs poorly, the security may trade more like a conventional bond, subject to the issuer's credit quality and interest rates.

23.10 Reading a Bond Quote

Sample Quote Item	Interpretation
XYZ 6.00% 2034	Issuer XYZ; 6% coupon; matures in 2034
Price: 95.25	95.25% of par; for $1,000 par, price ≈ $952.50
Current yield	Annual coupon $60 ÷ $952.50 ≈ 6.30%
Quoted below par	Bond is selling at a discount
Likely yield relationship	For a conventional discount bond: YTM > current yield > coupon rate

23.11 Valuation Factors at a Glance

Factor	If the Factor Increases	Typical Effect on Bond Value / Risk
Market required yield	Required return rises	Bond price falls
Coupon rate	Coupon cash flow rises	Higher value, all else equal; usually lower duration
Maturity	Time to principal repayment increases	Usually greater interest-rate sensitivity
Duration	Price sensitivity measure increases	Larger price response to yield changes
Credit spread	Extra required yield increases	Corporate bond price generally falls
Credit quality	Issuer quality improves	Required yield may fall; price may rise
Underlying stock price for convertible	Stock value rises	Conversion value rises

Series 65 Exam Decision Rules

- Rates up → bond prices down. Rates down → bond prices up.
- Long maturity + low coupon generally means greater interest-rate sensitivity.
- Higher duration means a larger estimated percentage price change for the same yield movement.
- Discount bond: YTM generally exceeds coupon rate. Premium bond: YTM generally falls below coupon rate.
- Callable premium bonds require attention to YTC because the issuer may redeem early.
- Wider credit spreads and lower ratings generally signal greater perceived credit risk.
- Convertible valuation depends partly on the market value of the shares obtainable through conversion.

Key Takeaways

- Fixed-income valuation is fundamentally a present-value problem.
- Interest rates, credit quality, maturity, coupon, and embedded features determine required yield and price.
- Duration converts an interest-rate change into an approximate percentage price change.
- YTM and YTC capture more of the investor's total return than current yield alone.
- Credit spread and ratings help compare credit risk, while conversion value matters for convertible securities.

Practice Questions

1. A 5% bond with $1,000 par value pays interest semiannually. How much does the investor receive every six months?

A. $50
B. $20
C. $25
D. $100

2. A bond has a duration of 6.0. If market yields rise by 0.50%, approximately how much should the bond's price change, using duration?

A. Rise 3.0%
B. Rise 0.5%
C. Fall 0.5%
D. Fall 3.0%

3. A 7% bond with $1,000 par trades at $875. What is its current yield?

A. 7.00%
B. 8.00%
C. 6.13%
D. 12.50%

4. Which statement best describes yield to maturity?

A. It reflects the return from the bond's cash flows through maturity, including price movement toward par.
B. It is always lower than current yield.
C. It equals annual coupon divided by market price.
D. It measures only the bond's credit spread.

5. A corporate bond yields 6.25% and a comparable Treasury yields 4.70%. What is the credit spread?

A. 625 basis points
B. 470 basis points
C. 95 basis points
D. 155 basis points

6. A $1,000 convertible bond can be converted into 25 shares. If the common stock trades at $44, what is the conversion value?

A. $1,100
B. $44
C. $25
D. $1,000

7. Which bond would generally have the greatest interest-rate sensitivity, all else equal?

A. A 5-year floating-rate note
B. A 20-year low-coupon bond
C. A 2-year Treasury bill
D. A 3-year high-coupon bond

8. A callable bond is trading substantially above par. Which yield measure may be especially important because the issuer can redeem the bond before maturity?

A. Coupon rate
B. Dividend yield
C. Yield to call
D. Current yield only

Answer Key and Explanations

1. C — Annual coupon = 5% × $1,000 = $50. Semiannual payment = $50 ÷ 2 = $25.

2. D — Approximate price change = −6.0 × 0.005 = −0.030, or about a 3.0% decline.

3. B — Annual coupon = $70. Current yield = $70 ÷ $875 = 0.08, or 8.00%.

4. A — YTM incorporates coupon cash flows and the gain or loss associated with the bond moving toward par by maturity, under standard assumptions.

5. D — 6.25% − 4.70% = 1.55 percentage points = 155 basis points.

6. A — Conversion value = 25 shares × $44 = $1,100.

7. B — Long maturity and low coupon both increase interest-rate sensitivity, so the 20-year low-coupon bond is the best answer.

8. C — For a callable premium bond, the investor may receive the call price sooner than maturity; YTC can therefore be more relevant than YTM.

Lesson 24: Types of Equity Securities

Learning Objectives

- Distinguish **common stock** from **preferred stock**.
- Explain **domestic stock**, **foreign stock**, and **American Depositary Receipts** (ADRs).
- Recognize the characteristics of **convertible preferred** and **floating-rate preferred stock**.
- Compare **voting rights**, **income priority, liquidation priority**, and risk among equity types.

24.1 Common Stock

Common stock represents residual ownership in a corporation. Common shareholders generally have voting rights, may receive dividends when declared, and participate in appreciation if the company grows. They also bear the greatest residual risk because creditors and preferred shareholders generally rank ahead of common shareholders in liquidation.

- Voting rights commonly include electing directors and voting on major corporate matters.
- Dividends are not guaranteed and can be reduced or omitted by the board of directors.
- Common stock has no maturity date and no promise to repay a fixed principal amount.
- Potential return comes from dividends and capital appreciation.

Domestic, Foreign, and ADR Exposure

Security	How Investor Gets Exposure	Important Risks / Features
Domestic common stock	Shares of a U.S. corporation	Business, market, sector, and issuer-specific risk
Foreign common stock	Shares traded in the company's home or another foreign market	Currency, political, accounting/disclosure, market-access, and geopolitical risks
ADR	U.S.-traded receipt representing shares of a foreign issuer	Convenient U.S. trading but does not eliminate foreign-company or currency-related risks

ADR example
A U.S. investor buys an ADR for a European company in dollars through a U.S. broker. The receipt simplifies trading and settlement, but the underlying company's value can still be affected by its home-country economy and exchange-rate movements.

24.2 Preferred Stock

Preferred stock is equity but has features that resemble fixed income. Preferred shareholders typically receive a stated dividend rate and have dividend and liquidation priority over common shareholders. Preferred dividends are not the same as bond interest: they are generally not a contractual debt obligation in the same way bond interest is.

Preferred dividend example: Stated Dividend Rate × Par Value
Calculated example: A 6% preferred stock with $100 par value has a stated annual dividend of $6 per share.

- **Cumulative preferred:** Unpaid dividends accumulate as dividends in arrears and generally must be paid before common dividends resume.
- **Noncumulative preferred:** Skipped dividends do not accumulate.
- **Callable preferred:** The issuer may redeem shares under stated terms.
- **Participating preferred:** May receive additional dividends under stated conditions; less common in exam questions.

Convertible Preferred Stock

Convertible preferred stock can be exchanged for a stated number of common shares. It combines preferred dividend and liquidation priority with the possibility of participating in common-stock appreciation after conversion. The conversion feature can make the preferred stock more sensitive to the common stock's market value.

Example
A preferred share converts into 4 common shares. If the common stock trades at $30, the conversion value is approximately 4 × $30 = $120. If the preferred stock trades far below that amount and conversion is currently available, the conversion feature becomes valuable.

Floating-Rate Preferred Stock

Floating-rate preferred stock pays a dividend rate that resets periodically based on a reference rate or formula. Because the dividend can adjust with market rates, floating-rate preferred generally has less interest-rate sensitivity than a comparable fixed-rate preferred, although credit, liquidity, and equity-subordination risks remain.

Equity Priority Comparison

Feature	Common Stock	Preferred Stock	Corporate Bonds
Ownership status	Owner / residual claimant	Owner with preference	Creditor

Feature	Common Stock	Preferred Stock	Corporate Bonds
Voting rights	Usually yes	Usually limited or none	No normal shareholder voting
Income	Dividend if declared	Stated/preferred dividend if declared	Contractual interest obligation
Liquidation priority	Lowest of the three	Ahead of common	Generally ahead of preferred/common
Upside potential	Highest direct participation	Usually more limited; convertible can add upside	Usually limited to interest/principal unless convertible

Series 65 Exam Cues

- Common stock = residual ownership and usually voting rights.
- Preferred stock = equity with dividend and liquidation preference over common stock.
- ADRs simplify U.S. access to foreign issuers but do not remove foreign-investment risks.
- Convertible preferred adds an equity-conversion option; floating-rate preferred resets its dividend formula.

References and Further Reading

- NASAA, Series 65 Test Specifications (effective June 12, 2023), Types of Equity Securities.
- SEC Investor.gov materials on stocks and international investing.

Practice Questions

1. Which security normally has residual ownership and voting rights?

A. Corporate bond
B. Commercial paper
C. Preferred stock
D. Common stock

2. An ADR is best described as:

A. An option to buy U.S. Treasury securities
B. A municipal revenue bond
C. A U.S.-traded receipt representing shares of a foreign issuer
D. A guaranteed currency hedge

3. Which security generally has dividend priority over common stock?

A. Treasury bill
B. Preferred stock
C. Common stock
D. **Warrant**

4. A 5% preferred stock has $100 par value. Its stated annual dividend is:

A. $5
B. $50
C. $20
D. $10

5. What is the principal distinguishing feature of convertible preferred stock?

A. It is automatically senior to secured bonds.
B. It guarantees common-stock voting rights before conversion.
C. Its dividend can never be changed.
D. It can be exchanged for common stock under stated terms.

6. Floating-rate preferred stock is designed primarily so that:

A. Its dividend rate can reset with a reference rate or formula.
B. It avoids issuer credit risk.
C. Its market value is fixed at par.
D. It becomes a bond at maturity.

7. Which statement about ADRs is correct?

A. They cannot pay dividends.
B. They eliminate currency and geopolitical risk.
C. They can provide foreign-company exposure while trading in U.S. markets.
D. They represent only U.S. companies.

8. In liquidation, which ordering is generally correct from higher to lower priority?

A. Common, preferred, debt
B. Debt, preferred, common
C. Preferred, debt, common
D. Preferred, common, debt

Answer Key and Explanations

1. D — Common stock. Common shareholders are residual owners and normally have voting rights.

2. C — A U.S.-traded receipt representing shares of a foreign issuer. An ADR represents foreign shares in a form that trades in U.S. markets.

3. B — Preferred stock. Preferred dividends have priority over common dividends.

4. A — $5. 5% × $100 par = $5 annual stated dividend.

5. D — It can be exchanged for common stock under stated terms. Conversion is the defining additional feature.

6. A — Its dividend rate can reset with a reference rate or formula. The reset feature reduces, but does not eliminate, rate sensitivity.

7. C — They can provide foreign-company exposure while trading in U.S. markets. ADRs simplify access but preserve underlying foreign investment risks.

8. B — Debt, preferred, common. Creditors generally rank ahead of equity; preferred ranks ahead of common.

Lesson 25: Characteristics of Equity Securities

Learning Objectives

- Explain the basic rights that may attach to equity ownership, including **voting rights**, **preemptive** or **antidilution protections**, and liquidation preferences.
- Distinguish freely tradable shares from **restricted** and **control securities**.
- Describe **cash dividends**, **stock dividends**, **preferred dividends**, and the major dividend dates.
- Explain the basic structure of **employee stock options**, including **incentive stock options** and **nonqualified stock options**.
- Apply equity-security characteristics to suitability, liquidity, **concentration risk**, and tax-aware recommendation questions.

Exam point
Equity securities are ownership interests, but the rights, risks, income expectations, liquidity, tax treatment, and liquidation priority can vary significantly by security type.

25.1 Why Equity Characteristics Matter

Equity securities represent ownership interests rather than creditor claims. A bondholder is generally owed principal and interest according to the bond contract. A shareholder owns a residual claim on the issuer. This means the shareholder may benefit from growth in the value of the business, but the shareholder also bears risk if earnings decline, dividends are reduced, or the business fails.

For Series 65 purposes, the exam usually tests equity characteristics through suitability questions. The issue is not only whether a security is a stock; it is whether the specific stock feature fits the client. Voting rights may matter to a control-oriented investor, dividends may matter to an income investor, restricted stock may create liquidity problems, and employee stock options may create concentrated employer-stock exposure.

Feature	What it affects	Common exam issue
Voting rights	Ability to vote on directors and major corporate actions	Common stock often has voting rights; preferred stock may have limited voting rights.
Preemptive or antidilution rights	Ability to maintain proportional ownership if new shares are issued	These rights are not always automatic; they depend on governing documents and applicable law.

Feature	What it affects	Common exam issue
Liquidation preference	Priority of payment if the issuer liquidates	Debt is paid before preferred stock; preferred stock is paid before common stock.
Restricted stock	Ability to resell shares freely	Liquidity and resale limitations are suitability concerns.
Dividends	Cash flow and income expectations	Dividends are not guaranteed unless contractually specified for certain preferred shares.
Employee stock options	Compensation, taxes, and concentrated exposure	Options can be valuable but may expire worthless and may create tax complexity.

25.2 Shareholder Rights

Shareholder rights are the legal and economic rights that come with owning stock. Not every class of stock has the same rights. A corporation may have multiple classes of common stock, preferred stock with special dividend terms, or shares that have limited voting rights. Always read the security terms rather than assuming all equity securities are identical.

Voting Rights

Voting rights allow shareholders to participate in certain corporate decisions. Common shareholders usually vote for directors and may vote on mergers, major corporate reorganizations, amendments to the corporate charter, and other significant matters. Voting may occur in person or by proxy, which allows the shareholder to authorize another party to vote the shares.

One common structure is one vote per share, but some corporations issue multiple classes of common stock with different voting power. A founder-controlled company, for example, may have Class B shares with superior voting rights and publicly traded Class A shares with fewer voting rights.

Exam point: voting rights are a characteristic of common stock, but the exact voting power depends on the class of shares. Preferred stock often has limited or no voting rights unless specific protective provisions are triggered.

Antidilution and Preemptive Rights

Dilution occurs when a company issues additional shares and an existing shareholder's ownership percentage is reduced. For example, if an investor owns 10,000 shares out of 100,000 shares outstanding, the investor owns 10% of the company. If the company later issues another 100,000 shares and the investor does not buy additional shares, the investor's ownership percentage falls to 5%.

A **preemptive right** is a shareholder right to buy enough of a new stock issuance to maintain the shareholder's proportional ownership. Preemptive rights are a form of antidilution protection. They are important because they may help protect an investor from having ownership percentage and voting influence reduced by later share issuances.

Preemptive rights are not automatically attached to every share of common stock. They generally exist only if provided by corporate charter, statute, or agreement. For Series 65 questions, the safest wording is that preemptive rights allow shareholders to maintain proportionate ownership when new shares are issued, if those rights apply.

Term	Plain-language meaning	Investment significance
Dilution	Existing ownership percentage is reduced by new shares.	Can reduce voting power and claim on future earnings.
Preemptive right	Right to buy additional shares before or with a new offering.	Helps the shareholder maintain proportional ownership.
Antidilution protection	Contractual protection against dilution.	Often important for preferred stock or private-company investors.

Key Terms

- **Voting rights:** The shareholder's right to vote on directors and certain major corporate matters.
- **Proxy:** Authorization for another person or entity to vote shares on the shareholder's behalf.
- **Dilution:** Reduction in ownership percentage caused by issuance of additional shares.
- **Preemptive right:** Right to buy additional shares to maintain proportional ownership when new shares are issued.
- **Liquidation preference:** Priority right to receive assets before lower-priority claimants in liquidation.
- **Restricted stock:** Stock subject to resale limitations.
- **Control securities:** Securities held by an affiliate or control person of the issuer.

- **Dividend:** Distribution by a corporation to shareholders.
- **Ex-dividend date:** First day the stock trades without the right to the upcoming dividend.
- **Employee stock option:** Right to buy employer stock at a stated exercise price before expiration.
- **ISO:** Incentive stock option, a statutory employee stock option with potential favorable tax treatment.
- **NQSO/NSO:** Nonqualified stock option; generally taxable as ordinary compensation income at exercise based on the spread.

Liquidation Preferences

A liquidation preference determines who gets paid first if a company is liquidated. Equity owners are behind creditors. Within equity, preferred shareholders usually have priority over common shareholders. Common shareholders are residual claimants: they receive value only after higher-priority claims have been satisfied.

Priority level	Claim type	Why it matters
1	Secured debt	Backed by collateral and generally has the strongest claim.
2	Unsecured debt	Creditor claim, but without specific collateral.
3	Preferred stock	Equity security with priority over common stock.
4	Common stock	Residual claim; highest upside but lowest liquidation priority.

Exam point
Common stock has the greatest residual upside, but common shareholders are last in liquidation priority.

25.3 Restricted Stock and Resale Restrictions

Restricted stock is stock that cannot be freely resold to the public because it was acquired in a transaction that was not registered with the SEC or because resale is limited by securities law, contract, or company policy. Restricted stock often arises from private placements, employee compensation arrangements, venture investments, and issuer transactions involving insiders.

A related concept is **control securities**. Control securities are securities held by an affiliate of the issuer, such as a director, executive officer, or large shareholder who can influence management or policies. Control securities may be subject to resale limitations even if the shares themselves were originally acquired in an ordinary market purchase.

Rule 144 Overview

Rule 144 is a commonly used SEC safe harbor for reselling restricted and control securities without registering the resale. It is not a guarantee that every sale is permitted. The rule imposes conditions that may include a holding period, availability of current public information, limits on the amount sold, manner-of-sale requirements, notice filings, and removal of the restrictive legend.

For restricted securities of a reporting company, the holding period is generally at least six months. For restricted securities of a non-reporting company, the holding period is generally at least one year. Investors should not treat restricted shares as immediately liquid.

Restriction issue	Meaning	Suitability concern
Holding period	Shares may have to be held before public resale.	May not fit a client who needs liquidity soon.
Restrictive legend	The certificate or book-entry position may show transfer limits.	A transfer **agent** usually needs proper authorization to remove the legend.
Volume limits	Affiliates may be limited in how much they can sell.	Large positions may take time to unwind.
Marketability discount	Restricted shares may be worth less than freely tradable shares.	Illiquidity can reduce value.

Exam point
Restricted stock is less liquid than freely tradable stock. Liquidity needs, concentration risk, time horizon, and tax consequences are central suitability issues.

25.4 Dividends

A **dividend** is a distribution from a corporation to shareholders. Dividends are commonly paid in cash, but they may also be paid in additional shares or other property. The board of directors generally decides whether to declare a dividend. Common stock dividends are not guaranteed, even when a company has a history of paying them.

Types of Dividends

Dividend type	Description	Exam significance
Cash dividend	Distribution of cash to shareholders.	Income-oriented investors may value regular cash dividends, but payment is not guaranteed for common stock.
Stock dividend	Distribution of additional shares.	Increases share count; value per share may adjust downward after the distribution.
Preferred dividend	Dividend associated with preferred stock.	Often stated as a fixed dollar amount or percentage of par value.
Cumulative preferred dividend	Unpaid dividends accumulate and must usually be paid before common dividends.	Stronger income feature than noncumulative preferred.
Noncumulative preferred dividend	Missed dividends do not accumulate.	Less protective than cumulative preferred.

Dividend Dates

Dividend questions often focus on the dates that determine who receives a dividend. The declaration date is when the board announces the dividend. The record date is when the company checks its records to identify shareholders entitled to the dividend. The **ex-dividend date** is the first day the stock trades without the right to the upcoming dividend. The payable date is when the dividend is actually paid.

Date	Plain-language meaning
Declaration date	Board announces the dividend.
Ex-dividend date	First trading day when a buyer does not receive the upcoming dividend.

Date	Plain-language meaning
Record date	Company determines which shareholders are entitled to the dividend.
Payable date	Dividend is paid.

Exam point
Buying on or after the ex-dividend date means the buyer does not receive the upcoming dividend. The stock price often adjusts downward by roughly the amount of the dividend, although market forces can also move the price.

25.5 Employee Stock Options

An **employee stock option** gives the holder the right, but not the obligation, to buy shares of employer stock at a stated exercise price, sometimes called the **strike price**. Options usually vest over time and expire if not exercised before the **expiration date**. Employee stock options can be valuable compensation, but they are not the same thing as owning shares.

Term	Meaning
Grant date	Date the employer grants the option.
Exercise price / strike price	Price the employee must pay to buy the stock.
Vesting	The process by which the employee earns the right to exercise the option.
Exercise	Using the option to buy shares at the exercise price.
Spread / bargain element	Difference between market value and exercise price at exercise.
Expiration date	Final date the option can be exercised.

Incentive Stock Options

Incentive stock options, or ISOs, are statutory options that may receive favorable federal tax treatment if the employee satisfies the applicable holding-period and plan requirements. ISOs are generally available only to employees. Under regular federal income tax rules, the employee generally does not include income at grant or exercise, but exercising an ISO may create

alternative minimum tax issues. Taxable income or loss generally occurs when the shares are sold.

Nonqualified Stock Options

Nonqualified stock options, or NQSOs/NSOs, do not receive the same statutory ISO treatment. They are more flexible because they may be granted to employees and certain nonemployees, such as directors or consultants. In general, if the option does not have a readily determinable fair market value at grant, ordinary compensation income is recognized when the option is exercised based on the spread between fair market value and the exercise price.

Feature	Incentive stock option (ISO)	Nonqualified stock option (NQSO/NSO)
Who can receive it	Employees only.	Employees and sometimes directors, consultants, or other service providers.
Regular tax at grant	Generally no income at grant.	Usually no income at grant if the option lacks a readily determinable fair market value.
Regular tax at exercise	Generally no regular income tax at exercise, but AMT may apply.	Spread is generally ordinary compensation income at exercise.
Tax complexity	Potentially favorable, but holding-period and AMT rules matter.	Often simpler; ordinary income at exercise is the key concept.
Suitability issue	Concentrated employer-stock exposure and tax planning.	Concentrated employer-stock exposure and exercise timing.

Exam point
Employee stock options can increase concentration risk because the client's job, income, and investment exposure may all depend on the same employer.

25.6 Suitability and Investor Recommendations

Equity characteristics matter most when they affect a client's ability to meet financial objectives. An adviser should consider liquidity needs, risk tolerance, time horizon, tax situation, income needs, concentration risk, and whether the security's rights and restrictions are appropriate for the client.

Client situation	Potential issue	Appropriate analysis
Retiree needs predictable income	Common stock dividends may be reduced or suspended.	Consider dividend history, financial strength, and whether preferred shares or bonds fit better.
Executive holds restricted stock	Large position may not be immediately saleable.	Assess Rule 144 restrictions, trading windows, liquidity needs, and concentration risk.
Employee has vested options	Options may expire or create tax consequences on exercise.	Analyze exercise price, market price, taxes, diversification, and cash needs.
Client wants voting influence	Some share classes have limited voting rights.	Verify voting terms before recommending the security.

25.7 Worked Examples

Example 1: Dilution and Preemptive Rights

A shareholder owns 1,000 shares of a company with 10,000 shares outstanding. The shareholder owns 10% of the company. The company issues 10,000 new shares. If the shareholder does not buy additional shares, the shareholder now owns 1,000 out of 20,000 shares, or 5%. A preemptive right would allow the shareholder to buy enough new shares to maintain the original 10% ownership percentage.

Example 2: Liquidation Priority

A company liquidates and has $2 million available after selling assets. It owes $1.5 million to bondholders and has $700,000 in preferred stock claims. Bondholders are paid first. After paying bondholders, only $500,000 remains for preferred shareholders. Common shareholders receive nothing. This illustrates why common stock is the residual claim.

Example 3: Employee Options and Concentration Risk

A client works for the same company that granted the client stock options. The options are valuable because the market price is above the exercise price. However, the client also depends on that employer for salary and benefits. Exercising and holding all of the shares may increase concentration risk. A suitable recommendation may include tax-aware diversification rather than treating the options only as a chance for upside.

References and Further Reading

- NASAA. Series 65 Test Specifications, effective June 12, 2023.
- U.S. Securities and Exchange Commission. Rule 144: Selling Restricted and Control Securities.
- Investor.gov. Restricted Securities and Securities Act Rule 144 glossary resources.
- Internal Revenue Service. Topic No. 427, Stock Options.

Practice Questions

1. Which right allows a shareholder to help elect the board of directors?

A. Voting right
B. Conversion right
C. Call protection
D. Sinking fund right

2. A preemptive right is most directly designed to protect shareholders against:

A. dividend reinvestment risk.
B. dilution of proportional ownership.
C. interest rate risk.
D. bond default.

3. In a corporate liquidation, common shareholders are generally paid:

A. before secured creditors.
B. before bondholders but after preferred shareholders.
C. after creditors and preferred shareholders.
D. at the same priority as bondholders.

4. Restricted stock is most likely to raise which suitability concern?

A. The stock has no market risk.
B. The stock cannot pay dividends.
C. The stock is always senior to debt.
D. The stock may not be immediately liquid.

5. Which dividend date determines whether a buyer receives the upcoming dividend?

A. Conversion date
B. Maturity date
C. Ex-dividend date
D. Call date

6. A cumulative preferred stock feature means:

A. the preferred stock must convert into common stock.
B. the shareholder can vote cumulatively in every election.
C. missed preferred dividends accumulate and generally must be paid before common dividends.
D. dividends are automatically reinvested.

7. Which statement best describes an employee stock option?

A. A guaranteed bonus payable in cash.
B. A right to buy employer stock at a stated exercise price.
C. A debt obligation of the employer.
D. A right to receive dividends before shareholders.

8. Which statement about incentive stock options is generally correct?

A. They eliminate employer-stock concentration risk.
B. They are available to any public investor.
C. They always create ordinary income at grant.
D. They may receive favorable tax treatment if requirements are met.

9. A nonqualified stock option generally creates ordinary compensation income when:

A. the option is exercised and there is a spread between market value and exercise price.
B. the option expires worthless.
C. the company declares a cash dividend.
D. the employee receives proxy materials.

10. A client owns a large amount of employer stock and vested employee options. The most important suitability concern is likely:

A. guaranteed loss of principal.
B. lack of voting power only.
C. absence of any tax issue.
D. concentrated exposure to the employer.

Answer Key and Explanations

1. A — Voting right

2. B — dilution of proportional ownership.

3. C — after creditors and preferred shareholders.

4. D — The stock may not be immediately liquid.

5. C — Ex-dividend date

6. C — missed preferred dividends accumulate and generally must be paid before common dividends.

7. B — A right to buy employer stock at a stated exercise price.

8. D — They may receive favorable tax treatment if requirements are met.

9. A — the option is exercised and there is a spread between market value and exercise price.

10. D — concentrated exposure to the employer.

Lesson 26: Employee Stock Options

Learning Objectives

- Define an **employee stock option** and the terms **grant**, **vesting**, **exercise price**, **exercise**, and expiration.
- Distinguish **incentive stock options** (ISOs) from **nonqualified/nonstatutory stock options** (NQSOs/NSOs).
- Recognize the basic tax timing differences between ISOs and NQSOs.
- Identify **concentration**, **valuation**, **expiration**, **liquidity**, and **tax risks** when advising a client who receives stock options.

26.1 Employee Stock Option Basics

An **employee stock option** gives an employee the right, but not the obligation, to buy employer stock at a stated exercise (strike) price during a specified period, subject to vesting and plan terms. Options are a form of compensation and can create a large exposure to the employee's company.

Term	Meaning	Example
Grant date	Date the employer awards the option	1,000 options granted on March 1
Exercise/strike price	Price paid per share when the option is exercised	$25 per share
Vesting	Conditions that must be met before exercise	25% of options vest each year for four years
Exercise	Employee pays strike price and acquires shares	Exercise 200 options at $25 when stock is $40
Spread / bargain element	Market value minus exercise price at exercise	$40 − $25 = $15 per share
Expiration	Last date the option can be exercised	Unexercised options expire after the plan term

26.2 Incentive Stock Options (ISOs)

ISOs are statutory stock options that can receive favorable federal tax treatment if statutory requirements and holding periods are met. The IRS generally does not include income in regular

taxable income when an ISO is granted or exercised, although exercising an ISO can create an Alternative Minimum Tax (AMT) adjustment.

- For favorable qualifying-disposition treatment, the stock generally must be held more than 2 years from grant and more than 1 year from exercise.
- If the holding requirements are met, gain on sale is generally capital gain rather than compensation income.
- A sale before the required holding periods is a disqualifying disposition and can cause part of the gain to be treated as ordinary compensation income.
- ISOs are subject to statutory plan and employee requirements; not every employer option qualifies as an ISO.

ISO example
An employee exercises an ISO with a $20 strike price when the stock is worth $35. The $15 spread is generally not regular taxable income at exercise, but it may create an AMT adjustment. The tax result at sale depends on whether the ISO holding-period requirements are satisfied.

26.3 Nonqualified / Nonstatutory Stock Options (NQSOs or NSOs)

Most nonstatutory options do not have a readily determinable fair market value at grant. In that common case, there is generally no taxable event at grant. At exercise, the spread between the stock's fair market value and the exercise price is generally treated as ordinary compensation income. Subsequent appreciation or decline after exercise is generally capital gain or loss when the shares are sold.

NQSO ordinary income at exercise (common case): (Fair Market Value at Exercise − Exercise Price) × Shares Exercised
Calculated example: Exercise 500 options at $30 when the stock is $46: ($46 − $30) × 500 = $8,000 of ordinary compensation income.

ISO vs. NQSO — Exam Comparison

Feature	ISO	NQSO / NSO
Type	Statutory option	Nonstatutory option
Regular taxable income at exercise	Generally none, but AMT may apply	Generally spread is ordinary compensation income
Favorable capital-gain treatment	Possible if statutory holding periods are met	Post-exercise change in value is generally capital gain/loss

Feature	ISO	NQSO / NSO
Primary exam trap	Forgetting AMT / holding periods	Forgetting ordinary income at exercise

26.4 Investment Planning Issues

- **Concentration risk:** The client's salary, career prospects, retirement plan, and stock options may all depend on the same employer.
- **Expiration risk:** An option can expire worthless if the stock remains below the strike price or the employee fails to exercise in time.
- **Liquidity and cash needs:** Exercising may require cash for the strike price and taxes before shares are sold.
- **Tax risk:** Exercise and sale timing can materially change the tax result; advisers should recognize the issue and coordinate with tax professionals where appropriate.
- **Behavioral risk:** Employees may be reluctant to diversify because of familiarity or loyalty to the employer.

Series 65 Exam Cues

- Option holder has a right, not an obligation, to purchase shares.
- ISO: potentially favorable capital-gain treatment, but holding periods and AMT matter.
- NQSO: spread at exercise is generally ordinary compensation income in the common case.
- Employee options can create severe employer-stock concentration risk.

References and Further Reading

- NASAA, Series 65 Test Specifications (effective June 12, 2023), Characteristics of Equity Securities: employee stock options.
- Internal Revenue Service, Topic No. 427, Stock Options: https://www.irs.gov/taxtopics/tc427
- Internal Revenue Service, Publication 525, Taxable and Nontaxable Income: https://www.irs.gov/publications/p525
- Tax rules are summarized for exam preparation; individual tax circumstances can require professional tax advice.

Practice Questions

1. An employee stock option gives the employee the right to:

A. Receive a guaranteed dividend
B. Vote shares before the option is exercised
C. Buy employer stock at a stated price subject to plan terms
D. Sell employer bonds back at par

2. The difference between a stock's market value at exercise and the option exercise price is commonly called the:

A. Conversion ratio
B. Spread or bargain element
C. Coupon
D. Current yield

3. Which statement generally describes a nonqualified stock option without a readily determinable fair value at grant?

A. It is subject only to municipal-bond tax rules.
B. All gain is automatically long-term capital gain at exercise.
C. The option is tax-free at exercise and sale.
D. The spread at exercise is generally ordinary compensation income.

4. Which statement about an ISO is most accurate?

A. Exercise generally does not create regular taxable income, although AMT may apply.
B. The option is always transferable.
C. Exercise can never affect AMT.
D. The employee always recognizes ordinary income equal to the spread at exercise.

5. A client has 1,000 NQSOs with a $25 exercise price. The stock is $40 when the client exercises all options. What is the typical compensation spread?

A. $65,000
B. $40,000
C. $15,000
D. $25,000

6. Which planning risk is especially important for employees with large employer stock-option grants?

A. Municipal call risk
B. FDIC insurance risk
C. Treasury reinvestment risk
D. Concentration risk

7. For an ISO to receive favorable qualifying-disposition treatment, the employee generally must satisfy holding periods measured from:

A. Both the grant date and exercise date
B. The employer's fiscal year-end only
C. Only the sale date
D. Only the exercise date

8. An option is "vested" when:

A. The employer guarantees a profit.
B. The employee has satisfied the conditions needed to exercise the option, subject to plan terms.
C. The strike price equals zero.
D. The employee has automatically sold the shares.

Answer Key and Explanations

1. C — Buy employer stock at a stated price subject to plan terms. An option is a contractual right to buy shares at the exercise price.

2. B — Spread or bargain element. The spread is fair market value minus exercise price.

3. D — The spread at exercise is generally ordinary compensation income. That is the common tax treatment of NQSOs when fair value was not readily determinable at grant.

4. A — Exercise generally does not create regular taxable income, although AMT may apply. ISO exercise can create an AMT adjustment even though regular taxable income is generally not recognized at exercise.

5. C — $15,000. ($40 − $25) × 1,000 = $15,000.

6. D — Concentration risk. Employment income and investment wealth can become tied to the same company.

7. A — Both the grant date and exercise date. The statutory holding requirements are measured from both dates.

8. B — The employee has satisfied the conditions needed to exercise the option, subject to plan terms. Vesting determines when the option becomes exercisable under the plan.

Lesson 27: Equity Valuation

Learning Objectives

- Distinguish **technical analysis** from **fundamental analysis**.
- Explain how **dividend-discount** and **discounted-cash-flow** approaches estimate **intrinsic value**.
- Calculate a basic **constant-growth dividend-discount value**.
- Recognize how **discount rates**, **expected growth**, **cash flows**, and **market expectations** affect estimated equity value.

Two Broad Approaches

Approach	Primary Focus	Typical Inputs	What It Tries to Answer
Technical analysis	Market behavior	Price, volume, trends, support/resistance, momentum	What does market action suggest about likely price direction?
Fundamental analysis	Economic value of the business	Revenue, earnings, cash flow, assets, liabilities, industry and economy	What is the security worth based on underlying business fundamentals?

27.1 Technical Analysis

Technical analysis evaluates market-generated data rather than estimating the present value of a company's future cash flows. It commonly studies price trends, trading volume, chart patterns, support and resistance, momentum, moving averages, and relative strength.

- **Support:** A price area where buying interest has historically emerged.
- **Resistance:** A price area where selling pressure has historically emerged.
- **Volume confirmation:** A price move accompanied by strong volume may be viewed as more meaningful than a move on very light volume.
- **Exam cue:** Technical analysis is about market action; it does not primarily analyze financial statements or intrinsic value.

27.2 Fundamental Analysis

Fundamental analysis evaluates the company, industry, and economic environment to estimate intrinsic value. Analysts review financial statements, profitability, cash generation, growth prospects, competitive position, capital structure, management, and valuation ratios such as P/E and price-to-book.

Simple fundamental example
Two companies have similar earnings, but Company A has less debt, stronger free cash flow, and a more durable competitive position. A fundamental analyst may assign Company A a higher valuation even if current earnings are the same.

27.3 Dividend Discount Model (DDM)

The **dividend discount** approach values stock as the present value of expected future dividends. A common simplified model for a mature company assumes dividends grow at a constant rate forever.

Constant-growth (Gordon) DDM: $P_0 = D_1 \div (r - g)$
Calculated example: Expected dividend next year D_1 = \$2.10, required return r = 9%, growth g = 4%. Value = \$2.10 ÷ (0.09 − 0.04) = \$42.00.

- A higher expected dividend increases estimated value.
- A higher required return/discount rate decreases estimated value.
- A higher sustainable growth rate increases estimated value, all else equal.
- The constant-growth model requires r > g and is most appropriate when long-run growth is reasonably stable.

27.4 Discounted Cash Flow (DCF)

DCF valuation estimates the present value of future cash flows. Depending on the model, analysts may discount cash flow to equity or cash flow to the entire firm and then adjust for debt and other claims. For Series 65 purposes, the key concept is present value: cash expected farther in the future is worth less today, and a higher discount rate reduces estimated value.

Present value of one expected cash flow: PV = Future Cash Flow ÷ $(1 + r)^n$
Calculated example: If \$110 is expected one year from now and the required return is 10%, PV = \$110 ÷ 1.10 = \$100.

DCF exam insight
If expected future cash flows fall, estimated intrinsic value falls. If the discount rate rises because interest rates or perceived risk increase, estimated value also falls, all else equal.

27.5 Market Price vs. Estimated Value

Valuation models produce estimates, not guaranteed prices. If an analyst estimates intrinsic value above the market price, the security may appear undervalued; if estimated value is below market price, it may appear overvalued. Different analysts can reach different estimates because their assumptions differ.

27.6 Common Valuation Pitfalls

- Treating a model output as certain rather than assumption-dependent.
- Using unsustainable growth rates indefinitely.
- Ignoring changes in interest rates or risk that affect the discount rate.
- Comparing P/E or P/B ratios across businesses with very different economics without context.
- Confusing technical signals with fundamental intrinsic-value estimates.

Series 65 Exam Cues

- Technical analysis = price/volume/market behavior.
- Fundamental analysis = business and financial statement information.
- Dividend discount = present value of expected dividends.
- DCF = present value of expected future cash flows.
- Higher discount rate → lower present value, all else equal.

References and Further Reading

- NASAA, Series 65 Test Specifications (effective June 12, 2023), Methods Used to Determine the Value of Equity Securities.
- Commonly accepted finance principles for technical analysis, fundamental analysis, dividend-discount models, and discounted cash flow.

Practice Questions

1. Which information is most central to technical analysis?

A. Price and trading volume
B. Audited cash-flow projections only
C. The company's tax return
D. The liquidation value of bonds only

2. Fundamental analysis most directly focuses on:

A. Only the bid-ask spread
B. Only short interest
C. Earnings, cash flows, assets, industry conditions, and economic factors
D. Only chart patterns

3. Under a dividend discount model, an increase in the required return, with all else unchanged, will generally:

A. Have no effect
B. Decrease estimated value
C. Increase estimated value
D. Double the dividend

4. A stock is expected to pay a $3 dividend next year. Required return is 10% and constant growth is 4%. Using the Gordon model, estimated value is:

A. $18
B. $30
C. $75
D. $50

5. Which valuation method explicitly discounts future cash flows to present value?

A. Technical trend analysis
B. Odd-lot theory
C. Breadth analysis
D. Discounted cash flow analysis

6. Support and resistance are terms most closely associated with:

A. IRA distribution rules
B. Technical analysis
C. Bond indentures
D. Fundamental analysis

7. If expected future cash flows decline while the discount rate remains unchanged, a DCF estimate should generally:

A. Fall
B. Become equal to book value
C. Remain unchanged
D. Increase

8. Which statement best describes intrinsic value?

A. It is always the same for every analyst.
B. It is guaranteed to equal the next market price.
C. It is an estimate based on assumptions about future benefits and risk.
D. It equals the stock's par value.

Answer Key and Explanations

1. A — Price and trading volume. Technical analysis studies market-generated data such as price, volume, trends, and momentum.

2. C — Earnings, cash flows, assets, industry conditions, and economic factors. Those are core fundamental inputs.

3. B — Decrease estimated value. A higher discount rate lowers the present value of future benefits.

4. D — $50. $3 ÷ (0.10 − 0.04) = $3 ÷ 0.06 = $50.

5. D — Discounted cash flow analysis. DCF explicitly discounts expected future cash flows.

6. B — Technical analysis. Support and resistance are chart/price concepts.

7. A — Fall. Lower expected cash flows reduce present value if other assumptions are unchanged.

8. C — It is an estimate based on assumptions about future benefits and risk. Valuation is model- and assumption-dependent, not guaranteed.

Lesson 28: Equity Public Offerings

Learning Objectives

- Define an **initial public offering** and explain why companies use IPOs to access public capital markets.
- Distinguish **IPOs**, **secondary offerings**, and **secondary-market trading**.
- Explain the basic structure, risks, and suitability issues associated with **SPACs**, **blind pools**, and **blank-check companies**.
- Identify how equity public offerings affect **dilution**, **proceeds**, disclosure, liquidity, and investor risk.
- Apply offering concepts to Series 65-style suitability questions.

28.1 Why Public Equity Offerings Matter

A **public equity offering** is a sale of stock to public investors. Public offerings help companies raise capital, create liquidity for existing owners, broaden the shareholder base, and establish a public market price for the company's shares. For investors, public offerings create access to companies that may have previously been privately held, but they also involve disclosure, valuation, liquidity, and suitability considerations.

For Series 65 purposes, you should focus on the investor-facing concepts: who is selling the shares, who receives the cash, whether new shares are being created, whether existing shareholders are selling, and what risks the client is taking.

Primary Market vs. Secondary Market

Concept	Meaning	Investor takeaway
Primary market	The issuer sells securities to investors. New capital flows to the issuer when new shares are sold.	Often associated with IPOs and follow-on offerings. Investors should review offering documents and issuer risk.
Secondary market	Investors buy and sell previously issued securities with each other, such as on an exchange.	Cash generally goes to the selling investor, not to the company. Liquidity and market price matter.
Secondary offering	A public offering after the IPO. It may involve new shares sold by the company, existing shares sold by shareholders, or both.	Do not confuse a secondary offering with ordinary secondary-market trading.

28.2 Initial Public Offerings (IPOs)

An **initial public offering**, or IPO, is the first time a company offers its shares to the investing public. Before the IPO, the company is privately held. After the IPO, its shares may trade publicly on an exchange or other market, depending on the offering and listing arrangements.

Common reasons companies pursue an IPO

- Raise capital to fund growth, acquisitions, debt repayment, research and development, or operations.
- Create liquidity for founders, early investors, or employees, often subject to lock-up agreements.
- Increase public visibility and establish a market price for the company's shares.
- Use publicly traded shares as compensation or acquisition currency.

Typical IPO process

1. Company prepares disclosure documents and financial statements.

2. Underwriters help structure, price, and distribute the offering.

3. Investors receive a prospectus that describes the company, risks, use of proceeds, management, financial information, and offering terms.

4. The offering is priced, shares are sold, and trading begins after the offering.

IPO investor risks

- Limited public operating history may make valuation difficult.
- IPO prices can be volatile after trading begins.
- Insiders and early investors may have different incentives than new public investors.
- The company may be unprofitable, highly levered, dependent on future growth, or operating in an emerging industry.
- Allocation access may be limited, and retail investors may buy only after the stock begins trading.

IPO example

Assume a private software company sells 10 million newly issued shares to the public at $20 per share. Before underwriting costs and other expenses, the company raises $200 million. Because the shares are newly issued by the company, this is a primary offering and the proceeds go to the issuer. Public investors now own part of the company, and the total number of shares outstanding has increased.

28.3 Secondary Offerings

A **secondary offering** is a public offering of shares after a company has already completed its IPO. In practice, secondary offerings can be structured in different ways, so you should focus on who is selling the shares.

Type of secondary offering	Who sells?	Who receives proceeds?	Potential investor issue
Issuer follow-on offering	The company sells newly issued shares.	The issuer.	New shares may dilute existing shareholders.
Selling-shareholder offering	Existing shareholders sell shares they already own.	The selling shareholders.	Company does not receive new capital; selling may signal liquidity needs or portfolio rebalancing.
Mixed offering	Both the company and selling shareholders sell shares.	Issuer receives proceeds from new shares; selling holders receive proceeds from their shares.	Investors should separate use of proceeds from insider or sponsor liquidity.

Dilution example

Assume a public company has 100 million shares outstanding and sells 20 million new shares in a follow-on offering. After the offering, there are 120 million shares outstanding. If total earnings do not immediately increase, earnings per share will decline because the same earnings are spread across more shares. This is dilution. A secondary offering can still be beneficial if the company uses the proceeds productively, but investors must evaluate the tradeoff.

28.4 SPACs, Blind Pools, and Blank-Check Companies

A **special purpose acquisition company**, or SPAC, is a company formed to raise money from public investors and later acquire or merge with an operating business. A SPAC normally has no operating business when it raises money. Investors are largely relying on the sponsors' ability to identify and complete a future transaction.

SPAC lifecycle

1. SPAC IPO: the SPAC raises money from investors, often placing much of the proceeds in a trust account.

2. Search period: sponsors look for a private operating company to acquire or merge with.

3. Announcement: the SPAC announces a proposed business combination.

4. Shareholder decision and redemption: investors may vote on the deal and may have redemption rights depending on the structure.

5. De-SPAC transaction: if completed, the private company becomes publicly traded through the SPAC merger.

Blind pools and blank-check companies

The terms **blind pool** and **blank-check company** emphasize that investors may provide capital before knowing the exact business or assets that will be acquired. That creates a major suitability issue: the investor is buying a vehicle whose eventual business risk may not yet be known. The Series 65 exam may use these terms to test whether the adviser recognizes speculative risk, limited operating history, sponsor conflicts, and the need for careful disclosure review.

Common SPAC and blank-check risks

- Uncertain target risk: investors may not know the eventual operating business at the time of investment.
- Sponsor conflict risk: sponsors may have economic incentives to complete a deal even if the deal is not ideal for public shareholders.
- Dilution risk: sponsor shares, warrants, redemptions, and financing arrangements can dilute public investors.
- Projection risk: future growth projections may be optimistic or difficult to verify.
- Liquidity and volatility risk: shares and warrants may trade with significant volatility.
- Suitability risk: speculative offerings may be inappropriate for conservative clients, short time horizons, or clients needing stable income.

28.5 Comparing the Offering Types

Feature	IPO	Secondary offering	SPAC / blank-check structure
Main idea	Private company sells shares to public investors for the first time.	Already-public company or existing holders sell shares after the IPO.	Shell or acquisition vehicle raises money to acquire a future target.
Known business?	Yes, but public history may be limited.	Yes, because company is already public.	Often not fully known when investors first buy the SPAC IPO.
Who gets proceeds?	Usually the issuer when new shares are sold.	Issuer, selling shareholders, or both.	SPAC trust/vehicle initially; later transaction funds depend on deal structure.

Feature	IPO	Secondary offering	SPAC / blank-check structure
Key risk	Valuation uncertainty and volatility.	Dilution or selling-shareholder signal.	Sponsor conflicts, dilution, target uncertainty, speculative projections.
Typical suitable investor	Risk-tolerant investor who understands IPO risk.	Depends on issuer quality, use of proceeds, valuation, and client objective.	Speculative investor with high risk tolerance and ability to withstand loss/volatility.

28.6 Suitability and Client Recommendation Considerations

- Risk tolerance: IPOs and SPACs can be speculative and volatile.
- Time horizon: clients needing short-term liquidity or principal stability may not be suitable.
- Income needs: equity offerings generally do not provide predictable income like high-quality bonds or insured deposits.
- Concentration: clients should avoid excessive concentration in a single new issue or speculative offering.
- Disclosure review: advisers should understand the prospectus, risk factors, fees, sponsor incentives, lock-ups, and dilution.
- Client understanding: the adviser should confirm that the client understands the nature of the offering and its risks.

28.7 Series 65 Exam Tips

- An IPO is the first public sale of a company's shares.
- A secondary offering is not the same thing as normal secondary-market trading.
- If the issuer sells new shares, the company receives proceeds and existing shareholders may be diluted.
- If existing shareholders sell shares, the sellers receive the proceeds, not the company.
- SPACs, blind pools, and blank-check companies are speculative because investors may not know the ultimate operating business at the time of investment.
- Suitability remains central: a risky offering is not appropriate merely because it is popular or recently listed.

References and Further Reading

- SEC Office of Investor Education and Advocacy, Updated Investor Bulletin: Investing in an IPO.
- Investor.gov, Blank Check Company and SPAC glossary entries.
- SEC Office of Investor Education and Advocacy, What You Need to Know About SPACs.
- SEC, Special Purpose Acquisition Companies, Shell Companies, and Projections final rules and investor-protection materials.

Practice Questions

1. Which statement best describes an IPO?

A. A mutual fund's annual distribution
B. A private sale of shares only to company founders
C. A bond issued by a state government
D. A company's first public offering of shares

2. In a primary IPO of newly issued shares, who generally receives the offering proceeds?

A. The stock exchange
B. The issuer, after underwriting and offering expenses
C. The transfer agent
D. Existing public shareholders only

3. Which statement about a secondary offering is most accurate?

A. It is the same as ordinary secondary-market trading
B. It always occurs before an IPO
C. It can only be used for municipal securities
D. It may involve new shares, existing shares, or both

4. A company issues additional common shares after its IPO. What is a possible effect on existing shareholders?

A. FDIC insurance coverage increases
B. Existing shareholders may be diluted
C. The offering eliminates market risk
D. The shares become Treasury bills

5. What is a key feature of a SPAC at the time it raises money from public investors?

A. It must already own the target company
B. It is always guaranteed by the U.S. Treasury
C. It normally has no operating business yet
D. It is always suitable for conservative income investors

6. Why can blind pools and blank-check companies raise suitability concerns?

A. Investors may not know the specific business or assets to be acquired
B. They eliminate all sponsor conflicts
C. They are insured deposits
D. They are required to pay fixed dividends

7. A retired client needs stable income, principal preservation, and low volatility. Which investment is least likely to be suitable as a major recommendation?

A. A diversified conservative bond fund
B. An insured bank deposit within coverage limits
C. A speculative SPAC concentrated position
D. Short-term Treasury securities

8. Which detail should an adviser review when evaluating a SPAC for a client?

A. Sponsor incentives, dilution, redemption terms, and target uncertainty
B. Whether the investment has FDIC insurance
C. Only the color of the company logo
D. Whether all market risk is eliminated

Answer Key and Explanations

1. D — A company's first public offering of shares
2. B — The issuer, after underwriting and offering expenses
3. D — It may involve new shares, existing shares, or both
4. B — Existing shareholders may be diluted
5. C — It normally has no operating business yet
6. A — Investors may not know the specific business or assets to be acquired
7. C — A speculative SPAC concentrated position
8. A — Sponsor incentives, dilution, redemption terms, and target uncertainty

Lesson 29: Mutual Funds

Learning Objectives

- Define a **mutual fund** and explain why it is considered a **pooled investment**.
- Distinguish **open-end mutual funds** from **closed-end funds**.
- Explain **net asset value**, **forward pricing**, premiums, discounts, and exchange trading.
- Recognize the main benefits and risks of mutual funds for Series 65-style suitability questions.
- Apply mutual fund concepts to client recommendations and basic exam scenarios.

29.1 What Is a Mutual Fund?

A **mutual fund** is a pooled investment vehicle that collects money from many investors and uses that money to buy a portfolio of securities. The portfolio may hold stocks, bonds, money market instruments, or a combination of assets. Each investor owns shares of the fund rather than owning each underlying security directly.

Mutual funds are important on the Series 65 exam because they combine investment management, diversification, professional oversight, fees, liquidity, tax considerations, and suitability issues. A recommendation involving a mutual fund should match the client's investment objective, risk tolerance, time horizon, liquidity needs, and tax situation.

29.2 Why Investors Use Mutual Funds

Mutual funds give investors access to a diversified portfolio that would be difficult for many individuals to build directly. They can be used for long-term growth, income, capital preservation, sector exposure, balanced allocation, or money market liquidity. However, diversification does not eliminate market risk, and professional management does not guarantee a profit.

- Diversification: A single fund may hold dozens, hundreds, or thousands of securities.
- Professional management: Portfolio managers select and monitor investments consistent with the fund's objective.
- Convenience: Investors can gain exposure to an asset class or strategy through one investment.
- Liquidity: Open-end fund shares can generally be redeemed at net asset value; closed-end fund shares can generally be sold on an exchange.
- Transparency: Funds provide disclosure through prospectuses, shareholder reports, and ongoing performance reporting.

29.3 Open-End Mutual Funds

An **open-end mutual fund** continuously offers new shares to investors and redeems shares from investors. The number of shares outstanding changes as investors buy and redeem shares. Open-end mutual fund shares do not trade intraday on an exchange. Instead, transactions are

priced at the next calculated net asset value after the order is received in good order. This is called forward pricing.

Net asset value, or NAV, is calculated by subtracting the fund's liabilities from the market value of its assets and dividing by the number of shares outstanding. In simplified form:

NAV per share = (Fund assets - Fund liabilities) / Shares outstanding

For example, if a fund has $100,000,000 of assets, $2,000,000 of liabilities, and 4,900,000 shares outstanding, its NAV is $20 per share: ($100,000,000 - $2,000,000) / 4,900,000 = $20.

- Purchases and redemptions are processed by the fund or its transfer agent.
- Orders are executed at the next NAV calculated after the order is received.
- Open-end funds are not bought at a premium or discount to NAV in the same way closed-end funds are.
- Most open-end funds calculate NAV once each business day after the market closes.
- Open-end funds may have sales charges, operating expenses, redemption fees, or other costs, depending on the fund.

29.4 Closed-End Funds

A **closed-end fund** also holds a pooled portfolio of securities, but it has a different capital structure from an open-end mutual fund. A closed-end fund typically raises money through an initial public offering and then has a fixed number of shares outstanding. After the offering, investors generally buy and sell shares from one another on an exchange or in the secondary market.

Because closed-end fund shares trade in the market, the trading price can be above or below the fund's NAV. If the market price is above NAV, the fund trades at a premium. If the market price is below NAV, the fund trades at a discount.

- Closed-end fund shares trade intraday at market prices.
- The fund does not normally redeem shares directly from investors at NAV.
- Market price can differ from NAV because of investor demand, liquidity, distribution rate, leverage, tax exposure, and market sentiment.
- Closed-end funds may use leverage, which can increase income and magnify gains, but also increases risk.
- Closed-end funds can be suitable for some income-seeking or specialized investors, but the adviser must evaluate liquidity, price volatility, leverage, and discount/premium risk.

29.5 Open-End vs. Closed-End Funds

Feature	Open-End Mutual Fund	Closed-End Fund
How shares are issued	Continuously offered and redeemed by the fund	Usually fixed number of shares after IPO

Feature	Open-End Mutual Fund	Closed-End Fund
How investors transact	Buy from or redeem with the fund	Buy and sell with other investors on an exchange
Pricing	Next calculated NAV after order receipt	Market price throughout the trading day
Premium/discount to NAV	Generally not a key feature	Can trade at premium or discount to NAV
Liquidity source	Fund redemption process	Secondary market trading
Common exam issue	Forward pricing and NAV redemption	Market price may differ from NAV

29.6 Understanding Premiums and Discounts

Closed-end funds have two values that you should distinguish: NAV and market price. NAV reflects the value of the fund's underlying portfolio. Market price is the price at which investors buy or sell the fund's shares in the market.

Example: A closed-end fund has an NAV of $20 per share, but it trades in the market at $18 per share. The fund is trading at a $2 discount, or a 10% discount to NAV. The discount percentage is calculated as:

Discount = (Market price - NAV) / NAV = ($18 - $20) / $20 = -10%

If the same fund trades at $22 when NAV is $20, it trades at a 10% premium to NAV. A premium or discount can narrow or widen over time, creating an additional source of return or risk separate from the underlying portfolio's performance.

29.7 Benefits and Risks

Concept	Series 65 Interpretation
Diversification	May reduce unsystematic risk by holding many securities.
Professional management	Manager skill may help, but outperformance is not guaranteed.

Concept	Series 65 Interpretation
Market risk	Fund values can decline when the overall market or asset class declines.
Liquidity risk	Open-end redemptions are generally at NAV; closed-end funds depend on market trading liquidity.
Expense risk	Fees and expenses reduce investor returns.
Tax risk	Funds may distribute taxable income or capital gains to shareholders.
Premium/discount risk	Closed-end fund market price may move away from NAV.
Leverage risk	Some closed-end funds use borrowing or preferred shares, increasing volatility and potential losses.

29.8 Suitability Considerations

The correct fund recommendation depends on the client. An open-end mutual fund may be easier to explain, easier to value at NAV, and appropriate for investors who want ongoing purchases or redemptions through the fund. A closed-end fund may appeal to investors seeking exchange-traded access to a professionally managed portfolio, but it adds market-price risk, possible leverage risk, and premium/discount risk.

- A conservative investor who needs predictable liquidity may prefer a lower-risk open-end fund or money market fund over a leveraged closed-end fund.
- A long-term investor making regular contributions may benefit from open-end fund structure and dollar-cost averaging.
- An income investor considering a closed-end fund should understand whether the distribution is supported by income, capital gains, return of capital, or leverage.
- A tax-sensitive client should review turnover, capital gain distributions, dividend character, and whether the fund holds tax-exempt securities.
- A client who does not understand premiums, discounts, or leverage may not be suitable for a complex closed-end fund recommendation.

29.9 Series 65 Exam Tips

- Open-end mutual funds are priced at NAV using forward pricing.

- Closed-end funds trade in the secondary market and may trade above or below NAV.
- A **premium** means market price is above NAV; a discount means market price is below NAV.
- Diversification can reduce issuer-specific risk but cannot eliminate market risk.
- Professional management does not guarantee a profit or protect against loss.
- Suitability depends on the client's objectives, time horizon, risk tolerance, liquidity needs, and tax situation.

Key Terms

Term	Definition
Mutual fund	A pooled investment company that invests money from many investors in a portfolio of securities.
Open-end fund	A fund that continuously offers and redeems shares at NAV.
Closed-end fund	A fund with a generally fixed number of shares that trade in the secondary market.
Net asset value (NAV)	Fund assets minus liabilities divided by shares outstanding.
Forward pricing	Pricing fund orders at the next calculated NAV after the order is received.
Premium	A closed-end fund market price above NAV.
Discount	A closed-end fund market price below NAV.
Redemption	Selling shares back to the fund, common with open-end mutual funds.

References and Further Reading

- SEC Investor.gov. Mutual Funds and Closed-End Funds investor education materials.
- FINRA. Mutual fund and closed-end fund investor education resources.
- Investment Company Institute. Investment company and fund structure resources.

Practice Questions

1. Which statement best describes an open-end mutual fund?

A. It trades throughout the day at a market price.
B. It continuously offers and redeems shares at NAV.
C. It can only invest in municipal bonds.
D. It normally has a fixed number of shares after an IPO.

2. A closed-end fund has an NAV of $25 and trades at $22.50. How is it trading?

A. At par with NAV
B. At a 10% premium to NAV
C. At a 2.5% premium to NAV
D. At a 10% discount to NAV

3. What does forward pricing mean for an open-end mutual fund?

A. Orders are executed at the next calculated NAV after the order is received.
B. Orders are executed only once per month.
C. Orders are executed at the prior day's closing market price.
D. Orders are always executed at the bid price.

4. Which risk is especially associated with closed-end funds but not normally with open-end mutual funds in the same way?

A. Business cycle risk
B. Market risk
C. Premium/discount risk
D. Inflation risk

5. Which statement is most accurate regarding diversification in a mutual fund?

A. It can reduce issuer-specific risk but does not eliminate market risk.
B. It eliminates all investment risk.
C. It guarantees a positive return over one year.
D. It makes tax consequences irrelevant.

6. A conservative retiree needs predictable access to cash and does not understand leverage. Which concern is most relevant before recommending a leveraged closed-end fund?

A. The fund cannot hold bonds.
B. The fund may be too liquid.
C. The fund may involve leverage, market-price volatility, and premium/discount risk.
D. The fund is guaranteed by the exchange.

7. Which formula correctly states NAV per share?

A. Market price divided by earnings
B. (Fund assets - fund liabilities) divided by shares outstanding
C. Fund income divided by expense ratio
D. Assets divided by liabilities

8. Which statement about closed-end fund trading is correct?

A. Closed-end funds cannot trade at a discount.
B. Closed-end funds are risk-free if diversified.
C. Closed-end funds are bought and sold only at the next NAV.
D. Closed-end fund shares generally trade intraday at market prices.

Answer Key and Explanations

1. B — An open-end mutual fund continuously offers and redeems shares at NAV.
2. D — At a 10% discount to NAV
3. A — Orders are executed at the next calculated NAV after the order is received.
4. C — Premium/discount risk
5. A — It can reduce issuer-specific risk but does not eliminate market risk.
6. C — The fund may involve leverage, market-price volatility, and premium/discount risk.
7. B — (Fund assets - fund liabilities) divided by shares outstanding
8. D — Closed-end fund shares generally trade intraday at market prices.

Lesson 30: Private Funds

Learning Objectives

- Define **private funds** and distinguish them from **registered investment companies** such as **mutual funds**.
- Explain the basic characteristics of **hedge funds, private equity funds**, and **venture capital funds**.
- Identify common risks, including **illiquidity**, **leverage**, **valuation uncertainty**, **concentration**, and **manager risk**.
- Apply suitability principles when evaluating whether a **private fund** investment is appropriate for a client.
- Recognize common Series 65 exam contrasts among hedge funds, private equity funds, venture capital funds, and mutual funds.

30.1 What Is a Private Fund?

A private fund is a pooled investment vehicle that raises money from investors through a private offering. Unlike a mutual fund, a private fund is not generally available to the public in the same manner and does not provide the same daily redemption structure or standardized public disclosure framework. Private funds often rely on exemptions from registration requirements and are commonly limited to investors who meet wealth, income, investment, or sophistication standards.

Feature	Registered Mutual Fund	Private Fund
Investor access	Generally available to retail investors through a prospectus.	Usually limited to accredited investors, qualified purchasers, or other eligible investors.
Liquidity	Open-end mutual funds typically offer daily redemption at NAV.	Often includes lockups, limited redemption windows, or multi-year illiquidity.
Pricing	NAV is usually calculated daily.	Valuation may be monthly, quarterly, or based on models for hard-to-value assets.
Disclosure	Prospectus, periodic reports, and standardized public disclosures.	Private placement memorandum and fund documents; disclosure is less standardized.

Feature	Registered Mutual Fund	Private Fund
Strategy flexibility	Subject to detailed restrictions and diversification/liquidity rules.	Often has broader flexibility, including leverage, short selling, derivatives, or private company investments.

Investor eligibility. Many private funds are sold only to investors who meet legal investor-qualification standards. These tests are access rules, not suitability rules. A client can be eligible to invest in a private fund and still be an unsuitable candidate because of liquidity needs, risk tolerance, concentration, tax complexity, or lack of understanding.

Investor Qualification Standards

Private fund questions often use several similar-sounding terms. The most important distinction is that **accredited investor** status generally relates to access to private offerings, while **qualified purchaser** status is a higher standard commonly used by funds relying on the 3(c)(7) private fund exemption. **Qualified client** status is a separate Investment Advisers Act concept that matters when an adviser charges performance-based compensation.

Investor category	Common individual test	Series 65 teaching point
Accredited investor	Net worth over $1 million excluding the primary residence, individually or with a spouse/spousal equivalent; or income over $200,000 individually or $300,000 jointly in each of the two most recent years, with a reasonable expectation of the same level in the current year.	Usually the basic private-offering eligibility standard. It allows access to certain private placements, but does not make the investment suitable by itself.
Qualified purchaser	Natural person or certain family-owned company with at least $5 million in investments. Certain entities or investment managers generally must own and invest at least $25 million in investments.	Higher than accredited investor. Often relevant for 3(c)(7) hedge funds, private equity funds, and venture capital funds. The test focuses on investments, not merely income.

Investor category	Common individual test	Series 65 teaching point
Qualified client	Current SEC thresholds allow performance-based fees for clients with at least $1.4 million under management with the adviser or net worth over $2.7 million, subject to rule details and grandfathering.	Separate from accredited investor and qualified purchaser. Relevant to performance fees, incentive allocations, or carried-interest-style compensation. Thresholds are adjusted periodically.

Accredited investor examples. A client with $1.3 million of net worth excluding the primary residence may qualify under the net worth test. A client with $240,000 of individual income in each of the last two years and a reasonable expectation of similar income this year may qualify under the income test. A client with $900,000 of net worth and $150,000 of income would generally not qualify as an accredited investor based on those financial tests alone.

Professional and entity criteria. Certain financial professionals with specified licenses, such as Series 7, Series 65, or Series 82, may qualify as accredited investors if the credentials are in good standing. Certain entities may also qualify, often because they are regulated financial institutions or have more than $5 million in assets and were not formed solely to buy the offered securities.

Qualified purchaser examples. A client with $5.2 million in investment assets may meet the individual qualified purchaser standard. A wealthy client with a $4 million investment portfolio and a $3 million primary residence may be accredited, but may not be a qualified purchaser because the qualified purchaser test generally focuses on investments rather than the value of the primary residence.

Exam point
Do not treat these labels as recommendations. Eligibility answers the question, “May the investor be allowed to buy this offering?” Suitability answers the question, “Should this investment be recommended to this specific client?”

30.2 Hedge Funds

A **hedge fund** is a private pooled investment vehicle that typically uses flexible investment strategies in an effort to produce returns that may differ from traditional long-only stock or bond portfolios. The word “hedge” can be misleading: some hedge funds reduce risk, while others take substantial risk.

Common hedge fund strategies

- Long/short equity: buys securities expected to rise and sells short securities expected to fall.

- Event-driven: invests around mergers, restructurings, spin-offs, bankruptcies, or other corporate events.
- Global macro: invests based on views about interest rates, currencies, commodities, economies, or geopolitical events.
- Relative value/arbitrage: seeks to profit from pricing relationships among related securities.
- Market neutral: attempts to reduce broad market exposure, though neutrality is not guaranteed.

Key hedge fund risks

Risk	How it affects investors
Leverage risk	Borrowing or derivatives can magnify gains and losses.
Short-selling risk	Potential losses can be large if a shorted security rises sharply.
Liquidity risk	Investors may be unable to redeem quickly, especially during market stress.
Complexity risk	Strategies can be difficult for investors to evaluate and monitor.
Manager risk	Performance depends heavily on the skill, discipline, and controls of the manager.

Exam point
Do not assume hedge funds are automatically conservative because they are called “hedge” funds. The suitability analysis depends on the specific strategy, liquidity terms, leverage, transparency, fees, and client profile.

30.3 Private Equity Funds

Private equity funds invest in companies that are not publicly traded, or in public companies that the fund may seek to acquire and take private. Private equity strategies often involve active ownership, operational improvement, financial restructuring, and eventual sale or public offering of portfolio companies.

Private equity characteristic	Explanation
Long investment horizon	Funds commonly require capital for many years, often 10 or more.
Capital commitments	Investors commit capital up front, and the fund later makes capital calls as opportunities arise.
Illiquidity	Investors generally cannot redeem on demand. Secondary sales may be limited and discounted.
J-curve pattern	Early returns may be negative due to fees and startup costs before investments mature.
Exit dependence	Returns often depend on a sale, recapitalization, IPO, or other exit event.

Private equity is not the same as buying publicly traded stocks. Public stocks can usually be sold quickly at market prices. Private equity interests are often illiquid, valued less frequently, and dependent on manager judgment and exit timing.

30.4 Venture Capital Funds

Venture capital funds are a specialized type of private equity fund that invest in early-stage or high-growth companies. These companies may have limited operating history, negative earnings, uncertain cash flows, and significant financing needs. Venture capital funds seek large gains from a small number of successful investments that can offset losses from companies that fail or never scale.

Common venture capital stages

Stage	Typical use of capital	Risk profile
Seed stage	Develop concept, prototype, early team, or product testing.	Very high risk; limited evidence of commercial success.
Early stage	Launch product, hire staff, build initial customers.	High risk; business model may still be unproven.

Stage	Typical use of capital	Risk profile
Growth stage	Expand sales, operations, technology, or geographic reach.	Still risky, but company has more operating history.
Late stage/pre-IPO	Prepare for scale, acquisition, or public offering.	Lower than seed-stage risk, but valuation risk may be high.

Exam point
Venture capital is generally most suitable only for investors with high risk tolerance, long time horizons, adequate liquidity elsewhere, and the ability to tolerate the loss of part or all of the investment.

30.5 Comparing Hedge Funds, Private Equity, and Venture Capital

Fund type	Primary focus	Liquidity	Typical investor concern
Hedge fund	Flexible trading strategies using public securities, derivatives, leverage, or short sales.	Varies; may have lockups and periodic redemptions.	Complexity, leverage, strategy risk, fee structure.
Private equity	Ownership stakes in private companies or buyouts of public companies.	Usually highly illiquid for years.	Capital calls, valuation uncertainty, exit timing.
Venture capital	Early-stage and high-growth private companies.	Highly illiquid; exits may take many years or never occur.	Very high company failure risk and uncertain valuation.

30.6 Suitability Considerations

Private funds are not automatically unsuitable, but they require careful client analysis. A Series 65-style question will often test whether the adviser recognizes the mismatch between the product's risk/liquidity profile and the client's needs.

- Liquidity needs: A client who may need the money soon is generally a poor match for a long **lockup**.
- Risk tolerance: Private funds can involve leverage, concentrated holdings, high failure rates, and valuation uncertainty.
- Time horizon: Private equity and venture capital often require multi-year or decade-long horizons.
- Income needs: Many private funds do not provide reliable current income.
- Tax complexity: Funds may generate partnership tax reporting, unrelated business taxable income issues for some investors, or state tax complexity.
- Concentration: A private fund position should be evaluated within the client's total portfolio.
- Fees: Management fees, incentive fees, **carried interest**, and expenses can reduce investor returns.
- Transparency: Investors may receive less frequent and less standardized reporting than with registered funds.

30.7 Practical Examples

Example 1: Unsuitable private equity recommendation

A 70-year-old retiree needs portfolio withdrawals for living expenses and wants low volatility. A private equity fund with a 10-year term, capital calls, and limited redemption rights would generally be difficult to justify unless it represents a very small part of a larger liquid portfolio and the client fully understands the risks.

Example 2: Potentially suitable venture capital allocation

A wealthy client has substantial liquid assets, a long time horizon, high risk tolerance, and experience with private investments. A small allocation to venture capital may be suitable if the client understands that the investment may be illiquid for years and could lose substantial value.

Example 3: Hedge fund due diligence issue

A client asks about a hedge fund that advertises stable returns. The adviser should examine the strategy, leverage, valuation practices, redemption terms, manager background, fees, conflicts, and whether the client is eligible and suitable. Stable past returns do not eliminate risk.

30.8 Series 65 Exam Tips

- Private funds are generally less liquid and less transparent than mutual funds.
- Hedge funds can use leverage, short selling, derivatives, and flexible strategies; "hedge" does not mean risk-free.
- Private equity funds usually require long time horizons and may use capital calls.
- Venture capital focuses on early-stage or high-growth private companies and involves very high business risk.

- Suitability questions usually turn on liquidity needs, time horizon, risk tolerance, investor qualification, and concentration.
- A client's accredited investor status does not automatically make a private fund suitable.

Key Terms

Term	Definition
Private fund	A pooled investment vehicle offered privately rather than broadly to the public through a registered public offering.
Accredited investor	An investor who meets specified financial, professional, or institutional criteria allowing participation in certain private offerings. Common individual financial tests include net worth over $1 million excluding the primary residence or income over $200,000 individually / $300,000 jointly.
Qualified purchaser	A higher private fund eligibility category commonly associated with 3(c)(7) funds. Individuals generally need at least $5 million in investments; some entities or investment managers generally need at least $25 million in investments.
Lockup	A period during which investors cannot redeem or withdraw capital.
Capital call	A demand by a private fund for investors to contribute a portion of their committed capital.
Carried interest	A performance-based share of profits paid to the fund sponsor or manager, commonly associated with private equity and venture capital.
J-curve	A private equity return pattern in which early returns may be negative before later gains emerge.

Term	Definition
Qualified client	A client meeting Investment Advisers Act standards that permit an adviser to charge performance-based compensation; current dollar thresholds are adjusted periodically.

References and Further Reading

- U.S. Securities and Exchange Commission, Investor.gov: Hedge Funds.
- U.S. Securities and Exchange Commission, Investor.gov: Private Equity Funds.
- U.S. Securities and Exchange Commission: Accredited Investors and Private Funds educational materials.
- U.S. Securities and Exchange Commission, Investor.gov: Private Placements under Regulation D.

U.S. Securities and Exchange Commission: Accredited Investors educational materials; common financial and professional investor qualification criteria.

15 U.S.C. § 80a-2(a)(51) and related SEC rules: qualified purchaser standards for certain private funds.

U.S. Securities and Exchange Commission, Rule 205-3 qualified client threshold adjustment orders; performance-based compensation thresholds are adjusted periodically.

Practice Questions

1. Which feature most clearly distinguishes many private funds from open-end mutual funds?

A. They must redeem shares daily at NAV.
B. They are prohibited from charging management fees.
C. They often have limited liquidity and investor eligibility restrictions.
D. They are always federally insured.

2. Which statement about hedge funds is most accurate?

A. All hedge funds are conservative because they hedge risk.
B. Hedge funds may use flexible strategies such as leverage, short selling, and derivatives.
C. Hedge funds must invest only in Treasury securities.
D. Hedge funds are always suitable for income-oriented retirees.

3. A private equity fund is most likely to be inappropriate for which client?

A. A client with a long time horizon and high risk tolerance.
B. A client with substantial liquid assets outside the investment.
C. A client who understands that capital may be locked up for years.
D. A client who needs the funds for a home purchase next year.

4. Venture capital funds primarily invest in:

A. Short-term Treasury bills.
B. Early-stage or high-growth private companies.
C. FDIC-insured bank deposits.
D. Fully diversified municipal bond portfolios.

5. What is a capital call?

A. A requirement that investors contribute committed capital when requested by the fund.
B. A guarantee that the fund will return capital on demand.
C. A shareholder vote on common stock dividends.
D. A rating upgrade issued by a credit rating agency.

6. Which statement best reflects Series 65 suitability analysis for private funds?

A. Accredited investor status alone makes a private fund suitable.
B. Suitability depends on the client's liquidity needs, risk tolerance, time horizon, objectives, and overall portfolio.
C. Private funds are suitable whenever expected returns are high.
D. Private funds eliminate market and business risk.

7. Which risk is especially important when a private fund invests in assets that do not trade regularly?

A. Prepayment penalty risk on a bank CD.
B. FDIC coverage risk.
C. Valuation uncertainty.
D. Call protection risk.

8. A hedge fund with a two-year lockup would be least suitable for a client who:

A. Needs the invested money for living expenses within six months.
B. Has a high risk tolerance.
C. Has an emergency fund and long investment horizon.
D. Has substantial assets outside the hedge fund.

9. Which investor is most clearly described as an accredited investor based on the common individual net worth test?

A. Any client who signs a private placement memorandum.
B. A client who wants higher expected returns.
C. A client with $700,000 of total net worth including a primary residence.
D. A client with net worth over $1 million excluding the value of the primary residence.

10. Which statement best describes a qualified purchaser in the private fund context?

A. Any retail investor who buys a closed-end fund.
B. Any client with $200,000 in annual income.
C. A higher eligibility category that generally requires substantial investment assets, such as $5 million in investments for an individual.
D. A person who has passed the Series 65 exam.

11. Which statement best reflects the relationship between investor eligibility and suitability?

A. Qualified purchaser status eliminates liquidity risk.
B. Suitability matters only for mutual funds, not private funds.
C. If a client is accredited, the recommendation is automatically suitable.
D. Investor eligibility permits access, but the adviser must still evaluate liquidity needs, risk tolerance, time horizon, objectives, and concentration.

Answer Key and Explanations

1. C — Private funds commonly have eligibility restrictions and limited redemption rights.

2. B — Hedge funds are flexible private funds and can vary substantially in risk.

3. D — A near-term liquidity need conflicts with the long-term illiquid nature of private equity.

4. B — Venture capital is focused on early-stage and high-growth private companies.

5. A — Private equity and venture capital funds often draw investor commitments over time through capital calls.

6. B — Eligibility is not the same as suitability. The adviser must evaluate the whole client profile.

7. C — Illiquid assets may require estimates or models, creating valuation uncertainty.

8. A — The lockup is inconsistent with near-term liquidity needs.

9. D — The common individual net worth test requires net worth over $1 million, excluding the primary residence.

10. C — Qualified purchaser status is a higher standard often associated with 3(c)(7) private funds.

11. D — Eligibility is an access rule; suitability remains a client-specific recommendation standard.

Lesson 31: UITs, ETFs, and REITs

Learning Objectives

- Define **unit investment trusts**, **exchange traded funds**, and **real estate investment trusts**.
- Distinguish UITs from **mutual funds**, **closed-end funds**, and ETFs.
- Explain how ETF trading, **NAV**, **bid-ask spreads**, and **premiums** or **discounts** affect investors.
- Compare liquid **publicly-traded REITs** with **non-traded REITs**.
- Describe the difference between **equity REITs** and **mortgage REITs**.
- Apply suitability principles to pooled investment recommendations.

Exam focus
For the Series 65, this topic is primarily about recognizing the structure, risks, liquidity, costs, tax characteristics, and suitability issues of pooled investment products.

31.1 Big Picture: What These Products Have in Common

UITs, ETFs, and REITs are pooled investments, but they are not interchangeable. Each gives investors exposure to a collection of assets or a specialized investment strategy, yet they differ in how they are organized, priced, traded, managed, and taxed.

Product	Main idea	Typical pricing/trading	Core exam issue
UIT	A fixed portfolio of securities assembled for a defined life.	Redeemable at approximate NAV; some sponsors maintain a secondary market.	Fixed portfolio, one-time offering, termination date, limited active management.
ETF	An investment company whose shares trade on an exchange like a stock.	Intraday market price; may trade at a premium or discount to NAV.	Exchange trading, bid-ask spread, tracking, tax efficiency, liquidity.
REIT	A company that owns, operates, or finances income-producing real estate or real estate-related assets.	Public REITs trade on exchanges; non-traded REITs do not.	Real estate exposure, income, liquidity differences, equity vs. mortgage REITs.

31.2 Unit Investment Trusts (UITs)

A **unit investment trust** is an investment company that raises money in a one-time public offering and invests that money in a generally fixed portfolio of securities, such as stocks, bonds, or other investments. Investors buy units of the trust. The trust normally has a stated termination date, at which point the portfolio is liquidated and proceeds are distributed to investors.

Core Characteristics of UITs

- **One-time offering:** UITs generally issue a fixed number of units during an initial offering period rather than continuously issuing shares like an open-end mutual fund.
- **Fixed portfolio:** The portfolio is usually set when the UIT is created and is not actively traded, except for limited events such as mergers, defaults, or other specified changes.
- **Defined life:** A UIT has a termination date. Bond UITs may terminate when the underlying bonds mature; equity UITs may have a stated life such as 12, 15, or 24 months.
- **Redeemable units:** Investors can usually redeem units at approximate net asset value. Some UIT sponsors may also maintain a secondary market.
- **No active management:** UITs typically do not have a board of directors or an investment adviser making day-to-day portfolio decisions during the life of the trust.
- **Transparency:** Because the portfolio is relatively fixed, investors can see the securities they are expected to hold for the life of the trust.

UIT Example

A brokerage firm sponsors a 24-month equity income UIT. At launch, the trust buys 30 dividend-paying stocks selected according to a published screen. Investors buy units at the offering price, which includes the value of the portfolio plus applicable sales charges and expenses. The sponsor does not actively trade the portfolio each month. At the end of 24 months, the trust terminates, sells the remaining securities, and distributes the proceeds to unitholders unless investors elect to roll into a new UIT.

UIT Suitability Issues

- UITs may be suitable for investors who want a transparent, rules-based, fixed portfolio for a specific holding period.
- UITs may be less suitable for clients who need continuous active management or very high liquidity.
- Sales charges and rollover recommendations are important conflict-of-interest issues. A recommendation to roll from one UIT into another should have a client-centered reason, not merely generate a new sales charge.
- Bond UITs still carry interest-rate risk, credit risk, reinvestment risk, and market risk. A fixed portfolio does not mean the unit value is fixed.

31.3 Exchange Traded Funds (ETFs)

An **exchange traded fund** is a pooled investment product whose shares trade on an exchange. Many ETFs are registered investment companies that provide exposure to a portfolio of

securities, often by tracking an index. ETFs combine features of mutual funds and stocks: like mutual funds, they offer pooled diversification; like stocks, they trade intraday at market prices.

Core Characteristics of ETFs

- **Exchange trading:** ETF shares trade throughout the trading day at market prices. Investors can use market orders, limit orders, stop orders, and other trading tools.
- **NAV vs. market price:** An ETF calculates a net asset value based on its portfolio, but investors buy and sell shares at market prices that may be slightly above or below NAV.
- **Premium or discount:** If the ETF share price is above NAV, it trades at a premium. If the price is below NAV, it trades at a discount.
- **Bid-ask spread:** The investor pays the ask price to buy and receives the bid price to sell. Wider spreads increase trading cost, especially in less liquid ETFs.
- **Creation and redemption process:** Authorized participants can create or redeem large blocks of ETF shares, helping keep market price close to NAV.
- **Tracking error:** An index ETF may not perfectly match the return of its target benchmark because of fees, sampling, trading costs, cash drag, or market conditions.
- **Expense ratio:** ETF investors pay ongoing fund expenses. Low expense ratios are a common advantage, but not all ETFs are low cost.

ETF Example

An investor buys 100 shares of an S&P 500 ETF at $500 per share. The ETF owns or samples the securities in the index. During the day, the ETF may trade at $500.10 while its estimated NAV is $500.00, a small premium. If trading volume is high and underlying stocks are liquid, the bid-ask spread may be narrow. If the ETF holds thinly traded assets or trades during market stress, the spread may widen and the market price may move farther from NAV.

ETF Suitability Issues

- ETFs can be suitable for low-cost diversification, tactical allocation, sector exposure, income exposure, or tax-efficient taxable-account investing.
- A client using frequent ETF trades should understand commissions if any, spreads, market impact, and short-term trading behavior.
- A market order can be risky for an illiquid ETF or during volatile periods. A limit order may provide more price control.
- Leveraged and inverse ETFs are specialized products and are generally not suitable as long-term buy-and-hold substitutes for ordinary index ETFs.

31.4 Real Estate Investment Trusts (REITs)

A **real estate investment trust** is a company that owns, operates, or finances income-producing real estate or real estate-related assets. REITs allow investors to gain real estate exposure without directly buying and managing properties. REITs may be publicly traded, publicly registered but non-traded, or private. For the Series 65, the most important distinction is often liquidity: publicly traded REITs are generally liquid; non-traded REITs can be illiquid and difficult to value.

REIT Tax Framework

To maintain REIT tax status, a REIT generally must meet income, asset, shareholder, and distribution requirements. A key exam-friendly point is that REITs generally must distribute at least 90% of taxable income to shareholders. Because of this required distribution framework, REITs are often used by income-oriented investors, but the dividends are not the same as qualified corporate dividends in every case. REIT distributions may include ordinary income, capital gain distributions, or return of capital, depending on the REIT and tax year.

Liquid vs. Non-Liquid REITs

Feature	Publicly traded REIT	Non-traded REIT
Trading	Listed on a stock exchange and bought or sold like common stock.	Not listed on an exchange; redemption programs may be limited or suspended.
Liquidity	Generally liquid during market hours, subject to normal market risk.	Often illiquid; investors may have limited exit options before a liquidity event.
Price visibility	Market price is readily observable.	Valuation may be periodic, estimated, or sponsor-provided.
Costs	Brokerage costs and fund/company expenses.	May have substantial selling commissions, offering costs, and management fees.
Suitability	May fit investors seeking real estate exposure with market liquidity.	Requires careful suitability review, especially for liquidity needs, time horizon, costs, and risk tolerance.

Equity REITs vs. Mortgage REITs

Type	What it owns	Primary income source	Major risks	Typical investor appeal
Equity REIT	Physical properties such as apartments, offices, warehouses, healthcare facilities, hotels, shopping centers, or data centers.	Rent, lease income, property operating income, and property sales.	Real estate market risk, tenant risk, vacancy risk, property operating costs, leverage, sector concentration.	Real estate ownership exposure, income, and potential property appreciation.
Mortgage REIT	Mortgages, mortgage-backed securities, or other real estate debt.	Interest income and spread between asset yields and financing costs.	Interest-rate risk, prepayment risk, credit risk, leverage risk, liquidity risk, funding risk.	High income potential, exposure to real estate credit rather than direct property ownership.
Hybrid REIT	A mix of property equity and real estate debt.	Combination of rental income and interest income.	Combination of equity REIT and mortgage REIT risks.	Diversified real estate exposure within one REIT structure.

REIT Suitability Issues

- A client who needs daily liquidity is generally better matched with a publicly traded REIT or REIT fund than a non-traded REIT.
- A retiree seeking income may be attracted to REIT dividends, but the adviser must evaluate income stability, dividend sustainability, interest-rate sensitivity, and liquidity.
- A client already concentrated in real estate, such as a real estate professional or property owner, may not need additional REIT exposure.
- Mortgage REITs are not the same as equity REITs. They may be more sensitive to interest rates, leverage, prepayments, and financing conditions.
- Non-traded REITs may present conflicts from upfront commissions or sponsor compensation. Suitability documentation should be especially strong.

31.5 Comparing UITs, ETFs, and REITs

Question	UIT	ETF	REIT
Is it a pooled investment?	Yes	Yes	Yes
Does it generally trade intraday on an exchange?	Usually no	Yes	Public REITs yes; non-traded REITs no
Is there a fixed termination date?	Usually yes	Usually no	No; REITs are ongoing companies, not fixed-term funds
Is the portfolio actively managed?	Usually no	Depends; many are index based	Company manages/finances real estate assets
Main valuation concept	Approximate NAV and trust value	Market price vs. NAV	Real estate income/assets and market price or estimated value
Major risk to test	Rollover costs, fixed portfolio, liquidity, market risk	Market price, spread, tracking error, liquidity, complexity	Real estate risk, liquidity, leverage, dividend sustainability

31.6 Practical Suitability Examples

Example 1: Retiree considering a non-traded REIT

A 72-year-old retiree needs predictable liquidity for medical expenses and living costs. A non-traded REIT offering a high stated distribution rate may appear attractive, but it may be unsuitable if the client cannot tolerate illiquidity, potential valuation uncertainty, and limited redemption options. A publicly traded REIT fund or a diversified income portfolio may be more appropriate, depending on the client profile.

Example 2: Taxable investor using ETFs

A high-income investor wants diversified equity exposure in a taxable brokerage account. A broad-market ETF may be suitable because it provides diversification, low ongoing expenses,

intraday liquidity, and potential tax efficiency. The investor should still understand market risk, bid-ask spreads, and the possibility of trading at a premium or discount to NAV.

Example 3: Investor attracted to a bond UIT

A client wants a defined stream of bond income and likes the transparency of a fixed portfolio. A bond UIT may be appropriate if the maturity structure, credit quality, fees, and termination date match the client's objectives. The adviser should explain that the UIT can still lose value if interest rates rise or credit quality deteriorates.

31.7 Series 65 Exam Tips

- UIT = fixed portfolio, one-time offering, redeemable units, termination date.
- ETF = pooled investment that trades like a stock; know NAV, market price, bid-ask spread, premium/discount, and tracking error.
- REIT = real estate company structure; know publicly traded vs. non-traded liquidity differences.
- Equity REITs own properties and usually earn rent; mortgage REITs own or finance real estate debt and usually earn interest income.
- Non-traded REITs can have limited liquidity and significant costs, making suitability especially important.
- Do not assume "income-producing" means "low risk." UITs, ETFs, and REITs all carry investment risk.

References and Further Reading

- Investor.gov, Unit Investment Trusts (UITs). Used for UIT structure, fixed portfolio, redeemable units, and termination-date discussion.
- Investor.gov, Updated Investor Bulletin: Exchange-Traded Funds (ETFs), February 23, 2023. Used for ETF structure, exchange trading, and Investment Company Act discussion.
- FINRA, Exchange-Traded Funds and Products. Used for ETF/ETP regulatory and structural distinctions.
- Investor.gov, Investor Bulletin: Publicly Traded REITs. Used for publicly traded vs. non-traded REIT liquidity and price-visibility discussion.
- Internal Revenue Service, Instructions for Form 1120-REIT. Used for the general 90% REIT distribution requirement.

Practice Questions

1. Which statement best describes a unit investment trust?

A. A fixed portfolio investment company that usually has a specified termination date
B. A corporate debt security backed only by the issuer's promise to pay
C. An actively managed open-end fund with continuous share issuance
D. A real estate company that must distribute taxable income

2. A key difference between an ETF and a traditional open-end mutual fund is that an ETF:

A. cannot hold bonds.
B. has no investment expenses.
C. can never trade below NAV.
D. trades intraday on an exchange at market prices.

3. An ETF trading at $50.25 when its NAV is $50.00 is trading:

A. at par.
B. as a closed-end fund.
C. at a premium.
D. at a discount.

4. Which client concern is most important before recommending a non-traded REIT?

A. Whether the client needs liquidity and clear market pricing
B. Whether the client wants Treasury-backed principal protection
C. Whether the client wants FDIC insurance
D. Whether the client wants a security that matures in 90 days

5. Which statement best distinguishes an equity REIT from a mortgage REIT?

A. Equity REITs do not pay dividends, while mortgage REITs must pay dividends monthly.
B. Equity REITs are always illiquid, while mortgage REITs are always exchange traded.
C. Equity REITs are bonds, while mortgage REITs are common stocks.
D. Equity REITs own or operate properties, while mortgage REITs invest in real estate debt.

6. A UIT sponsor recommends that a client repeatedly roll over UITs before termination. The adviser should be especially concerned about:

A. FDIC coverage limits.
B. sales charges and whether the rollovers are in the client's best interest.
C. whether the UIT uses margin accounts.
D. tax-equivalent yield.

7. Which investment is generally most liquid?

A. A private real estate partnership
B. A publicly traded REIT listed on a national exchange
C. A non-traded REIT with limited redemption programs
D. A restricted private REIT share class

8. Which risk is especially important for mortgage REITs?

A. Antidilution rights in common stock
B. Call protection on Treasury bills
C. Prepayment and interest-rate risk
D. FDIC insurance risk

Answer Key and Explanations

1. A — A fixed portfolio investment company that usually has a specified termination date

2. D — trades intraday on an exchange at market prices.

3. C — at a premium.

4. A — Whether the client needs liquidity and clear market pricing
5. D — Equity REITs own or operate properties, while mortgage REITs invest in real estate debt.
6. B — sales charges and whether the rollovers are in the client's best interest.
7. B — A publicly traded REIT listed on a national exchange
8. C — Prepayment and interest-rate risk

Lesson 32: Pooled Investment Characteristics

Learning Objectives

- Explain why pooled investments may have different **share classes** and **fee structures**.
- Compare liquidity across **open-end mutual funds**, **closed-end funds**, **ETFs**, and **less-liquid pooled vehicles**.
- Describe common tax implications of pooled investments, including **dividend** and **capital gain distributions**.
- Calculate **net asset value** and explain **premiums** and **discounts** to NAV.
- Identify benefits, risks, and key comparison points such as **benchmarks**, **manager tenure**, **investment policy**, and **style**.
- Apply Series 65 suitability logic when comparing pooled investment choices.

Exam point
A pooled investment combines money from many investors and uses that pool to buy a portfolio of securities or other assets. Investors own shares or units of the pooled vehicle rather than owning each portfolio security directly. For the Series 65 exam, the key task is usually not to memorize every fund type, but to compare features, costs, liquidity, taxation, pricing, and suitability.

32.1 Share Classes

A **share class** is a version of the same pooled investment with a different fee arrangement, sales charge, expense ratio, or eligibility requirement. The underlying portfolio is usually the same, but the investor's net return can differ because expenses and sales charges differ.

Share classes are especially important for mutual funds. An unsuitable share class can make an otherwise reasonable fund recommendation inappropriate because the client may pay unnecessary costs.

Share class concept	Typical feature	Series 65 point
Class A	Often has a front-end sales load; may have lower ongoing expenses than other retail classes.	May suit longer holding periods if breakpoints reduce the initial sales charge.
Class B	Historically associated with deferred sales charges and higher ongoing expenses; less common today.	Exam questions may test the tradeoff between no front-end load and possible back-end charges.

Share class concept	Typical feature	Series 65 point
Class C	Often has level load or higher annual distribution/12b-1 fees.	May be more expensive for long holding periods.
Institutional / adviser / no-load class	Lower expense ratio or no sales load; may require minimum investment or advisory platform access.	Lower expenses can improve suitability if client is eligible.
Different share class performance	Same portfolio, but different expenses.	Higher expenses reduce investor return over time.

Suitability example
A client investing $500,000 for a long-term goal may qualify for breakpoint discounts on Class A shares. A client with a short expected holding period may be harmed by a large front-end load. The exam often asks which class is suitable given holding period, investment amount, and cost structure.

32.2 Liquidity

Liquidity is the ability to convert an investment into cash without a large price concession or delay. Pooled investments vary widely in liquidity.

Vehicle	How investors enter/exit	Liquidity considerations
Open-end mutual fund	Purchases and redemptions occur directly with the fund at end-of-day NAV.	Generally liquid, but trades execute after the market close at the next calculated NAV.
ETF	Trades intraday on an exchange at market prices.	Liquidity depends on trading volume, bid-ask spread, and liquidity of underlying holdings.
Closed-end fund	Fixed number of shares trade on an exchange.	Investor sells to another investor; market price may be above or below NAV.

Vehicle	How investors enter/exit	Liquidity considerations
Money market fund	Designed for liquidity and stability, but it is not the same as an insured bank deposit.	Appropriate for short-term cash management, but still an investment product.
Interval fund / nontraded fund	May permit redemptions only periodically or subject to limits.	Higher liquidity risk; must be matched carefully to client needs.

Exam point
Do not assume that all pooled investments are equally liquid. Exchange trading may add intraday liquidity, but it may also introduce bid-ask spreads and market price deviation from NAV. Limited redemption products can be unsuitable for clients who need short-term access to cash.

32.3 Tax Implications

Pooled investments can create taxable events for investors even when the investor does not sell fund shares. A fund may distribute income, dividends, interest, and capital gains to shareholders. In a taxable account, these distributions may be taxable whether taken in cash or reinvested.

Tax item	What it means	Practical effect
Dividend or interest income	Income generated by the portfolio and passed through to shareholders.	May be taxable as ordinary income or qualified dividend income depending on the source and rules.
Capital gain distribution	A fund sells securities at a gain and distributes gains to shareholders.	Investor may owe tax even if the fund share price fell during the year.
Investor sale of fund shares	Investor sells shares for more or less than **cost basis**.	Creates a capital gain or loss for the investor.
Portfolio turnover	How frequently the fund buys and sells holdings.	Higher turnover can increase taxable distributions and trading costs.

Tax item	What it means	Practical effect
ETF tax efficiency	Many ETFs use in-kind creation and redemption mechanics.	ETFs often distribute fewer capital gains than comparable mutual funds, though this is not guaranteed.
Tax-advantaged account	IRA, **Roth IRA**, qualified plan, etc.	Current taxation may be deferred or eliminated depending on account type and withdrawals.

Tax suitability example
A high-income client investing in a taxable account may prefer a tax-efficient index ETF or municipal bond fund over a high-turnover actively managed fund, assuming the recommendation also fits the client's risk tolerance, objectives, and time horizon.

32.4 Fee Structures and Other Costs

Fees matter because they reduce the investor's return. Series 65 questions often test whether the adviser recognizes the full cost of ownership rather than focusing only on the stated return.

Cost	Description	Why it matters
Expense ratio	Annual fund operating expenses as a percentage of assets.	Reduces return every year.
Management fee	Fee paid to the investment adviser managing the fund.	Part of operating expenses.
12b-1 fee	Distribution or marketing fee paid from fund assets.	May compensate intermediaries; affects share-class comparison.
Front-end load	Sales charge paid at purchase.	Reduces amount invested initially.
Back-end load / CDSC	Sales charge paid when shares are redeemed, often declining over time.	Can penalize early redemptions.

Cost	Description	Why it matters
Transaction costs and spreads	Brokerage costs, trading costs, and bid-ask spreads.	Especially relevant for ETFs and thinly traded funds.
Advisory or wrap fee	Fee charged by adviser or platform.	Should be considered in total cost and potential conflict analysis.

Cost comparison example
Fund A has an expense ratio of 0.05%. Fund B has an expense ratio of 1.00%. If both funds hold similar securities and produce similar gross performance, Fund A leaves more return for the investor. However, cost is not the only suitability factor; strategy, risk, tax treatment, and client needs still matter.

32.5 Pricing: NAV, Premium, and Discount

Net asset value, or NAV, is the per-share value of the fund's assets after subtracting liabilities. For an open-end mutual fund, investor purchases and redemptions are based on NAV calculated after the market close.

NAV formula
NAV per share = (Total assets - Total liabilities) / Shares outstanding

Example: A fund has $102 million in assets, $2 million in liabilities, and 5 million shares outstanding. NAV = ($102 million - $2 million) / 5 million = $20 per share.

Closed-end funds and ETFs have both NAV and a market price. The market price may differ from NAV because shares trade between investors on an exchange.

Premium / discount formula
Premium or discount to NAV = (Market price - NAV) / NAV

Example	NAV	Market price	Result
Trading at par	$20.00 $20.00th		Market price equals NAV.

Example	NAV	Market price	Result
Trading at a premium	$20.00	$21.00	Premium = ($21 - $20) / $20 = 5%.
Trading at a discount	$20.00	$18.50	Discount = ($18.50 - $20) / $20 = -7.5%.

Exam point
Open-end mutual funds are priced at NAV. ETFs and closed-end funds trade at market prices that may be above or below NAV. A discount is not automatically a bargain; it may reflect leverage, poor performance, low demand, high expenses, liquidity concerns, or market stress.

32.6 Benefits and Risks

Potential benefits	Potential risks
Diversification across many securities.	Market risk remains; diversification does not eliminate systematic risk.
Professional portfolio management.	Manager risk and strategy risk may reduce performance.
Convenient access to asset classes, sectors, and strategies.	Investor may not fully understand underlying holdings or leverage.
Daily or intraday liquidity for many pooled investments.	Some vehicles have liquidity limits, discounts to NAV, or wide bid-ask spreads.
Economies of scale and simplified recordkeeping.	Fees, turnover, and taxes may reduce net return.

32.7 Relative Comparisons

A pooled investment should be compared to an appropriate benchmark and peer group. The comparison should fit the fund's objective, style, asset class, and risk profile. Comparing a small-cap value fund to the S&P 500 may be misleading because the benchmark does not match the strategy.

Comparison factor	What to examine	Why it matters
Benchmark	Index used to evaluate performance and risk.	Must match fund strategy; otherwise performance comparison is misleading.
Manager tenure	How long the manager or team has run the strategy.	Long past record may be less relevant if the current manager is new.
Change in investment policy	Changes in objective, strategy, risk, or permitted holdings.	A fund may no longer fit the client's purpose.
Style	Growth, value, blend, income, sector, domestic, international, active, passive.	Style affects risk, expected return, diversification, and suitability.
Expense ratio and turnover	Ongoing costs and portfolio trading activity.	High costs and turnover can reduce net returns and tax efficiency.
Risk-adjusted performance	Performance relative to volatility and downside risk.	Higher return alone may not be better if risk is materially higher.

Suitability example
A retiree needing stable income and low volatility may not be suited for a leveraged closed-end emerging market bond fund simply because its yield is high. A younger investor seeking broad market exposure may be well suited for a low-cost diversified index ETF, assuming the investor understands market risk.

Series 65 Exam Tips

- Match the pooled investment to the client's liquidity needs, tax situation, time horizon, risk tolerance, and objective.
- Remember that share classes can hold the same portfolio but produce different net returns because expenses differ.
- Open-end mutual funds are priced at NAV; ETFs and closed-end funds trade at market prices that may be at a premium or discount to NAV.

- Taxable fund distributions may create tax liability even if the investor reinvests the distribution.
- A benchmark should match the fund's strategy; otherwise the comparison can be misleading.
- Do not treat higher yield or higher historical return as automatically better. Consider risk, fees, leverage, liquidity, and suitability.

References and Further Reading

- NASAA. Series 65 Test Specifications, effective June 12, 2023.
- SEC Investor.gov. Mutual Funds and ETFs: A Guide for Investors.
- SEC Investor.gov. Mutual Fund and ETF Fees and Expenses Investor Bulletin.
- SEC Investor.gov. Mutual Funds and Exchange-Traded Funds product pages.
- SEC Investor.gov. How to Read a Mutual Fund or ETF Shareholder Report.
- SEC Investor.gov. Mutual Fund Prospectus overview.

Practice Questions

1. Which statement best describes a mutual fund share class?

A. A type of FDIC-insured bank deposit
B. A version of a fund with a different fee or sales-charge arrangement
C. A different portfolio managed by a different adviser
D. A guarantee that the fund will have lower risk

2. An open-end mutual fund is typically bought and sold at:

A. The next calculated NAV
B. A fixed $1.00 price guaranteed by the FDIC
C. The price selected by the **broker-dealer**
D. The intraday exchange price

3. A closed-end fund has an NAV of $20 and trades at $18. What is it trading at?

A. A 2% premium
B. A 20% discount
C. A 10% discount
D. A 10% premium

4. Which cost is paid from fund assets and reduces shareholder return over time?

A. SIPC insurance premium
B. Expense ratio
C. Tax-equivalent yield
D. Redemption priority

5. Which comparison is most appropriate for a small-cap value fund?

A. A large-cap growth index
B. A money market fund peer group
C. A small-cap value benchmark
D. The 3-month Treasury bill only

6. A client in a high tax bracket is investing through a taxable account. Which feature may matter most?

A. Tax efficiency and expected taxable distributions
B. Whether the fund has no benchmark
C. Whether the fund has a long ticker symbol
D. Whether the shares are issued in certificate form

7. Which vehicle normally trades intraday on an exchange?

A. Certificate of deposit
B. Traditional fixed annuity
C. Open-end mutual fund
D. Exchange-traded fund

8. A fund changes its investment policy from conservative income to aggressive growth. What should an adviser do?

A. Evaluate whether the fund still fits the client's objective and risk tolerance
B. Assume the change eliminates market risk
C. Recommend the fund to all clients to improve diversification
D. Ignore the change if prior performance was strong

9. Which factor would most directly reduce an investor's net return from an otherwise identical fund portfolio?

A. Lower turnover
B. Lower expense ratio
C. Higher expense ratio
D. A matched benchmark

10. A discount to NAV in a closed-end fund is best interpreted as:

A. A sign the fund is risk-free
B. An automatic bargain
C. A guarantee that the discount will disappear
D. A market price below per-share NAV that requires further analysis

Answer Key and Explanations

1. B — A version of a fund with a different fee or sales-charge arrangement

2. A — The next calculated NAV

3. C — A 10% discount

4. B — Expense ratio

5. C — A small-cap value benchmark

6. A — Tax efficiency and expected taxable distributions

7. D — Exchange-traded fund

8. A — Evaluate whether the fund still fits the client's objective and risk tolerance

9. C — Higher expense ratio

10. D — A market price below per-share NAV that requires further analysis

Lesson 33: Derivative Securities

Learning Objectives

- Define **derivative** securities and explain why they are considered higher-risk instruments.
- Distinguish options, warrants, and futures contracts at a Series 65 exam level.
- Identify the basic rights and obligations of option buyers, option writers, and **futures contract** participants.
- Explain why derivatives can be used for hedging, speculation, income generation, or leverage.
- Apply derivative concepts to basic suitability and risk questions.

33.1 What Is a Derivative Security?

A **derivative** security is a financial contract whose value is derived from the value of another asset, security, index, rate, or commodity. The underlying item could be common stock, a stock index, an interest rate, a foreign currency, an agricultural commodity, or another financial asset.

Derivatives can change the risk and return characteristics of a portfolio. They may be used to hedge an existing risk, speculate on price movements, generate income, or obtain leveraged exposure. The same features that make derivatives useful also make them unsuitable for many conservative or inexperienced clients.

Derivative	Definition	Main Series 65 point
Option	Contract that gives the buyer a right, but not an obligation.	Option buyers risk the premium; option writers may have larger obligations.
Warrant	Long-term right to buy issuer stock, usually issued by the company.	Similar to a **call option**, but usually issued by the corporation and may dilute shareholders.
Future	Standardized contract requiring future delivery or cash settlement.	Both sides have obligations and the contract is marked to market.

33.2 Options

An **option** is a contract that gives the buyer the right, but not the obligation, to buy or sell an underlying asset at a specified price within a specified time period. The buyer pays a premium for this right. The option writer, or seller, receives the premium but takes on a potential obligation if the option is exercised or assigned. An **American-style option** allows the option to

be exercised at any time through expiration. A **European-style option** generally only allows exercise at expiration.

Calls and Puts

Option type	Buyer has the right to...	Buyer generally benefits if...	Basic use
Call option	Buy the underlying asset at the strike price.	The underlying price rises.	Speculation on price increase or hedging a short position.
Put option	Sell the underlying asset at the strike price.	The underlying price falls.	Downside protection or speculation on price decline.

Important Option Terms

Term	Meaning
Underlying asset	The security, index, commodity, or other item on which the option is based.
Strike or exercise price	The price at which the option buyer may buy or sell the underlying asset.
Expiration date	The date after which the option no longer exists.
Premium	The price paid by the buyer and received by the seller for the option contract.
Intrinsic value	The amount by which an option is in-the-money, if any.
Time value	The portion of the option premium reflecting the chance that the option may become more valuable before expiration.

Option Buyers and Option Writers

Position	What the investor gets	Primary risk
Call buyer	Right to buy the underlying asset.	Loss of premium if the option expires worthless.
Put buyer	Right to sell the underlying asset.	Loss of premium if the option expires worthless.
Call writer	Premium income; obligation to sell if assigned.	Potentially large loss if the underlying rises sharply, especially if uncovered.
Put writer	Premium income; obligation to buy if assigned.	Loss if the underlying falls significantly.

Simple Option Example

Assume an investor buys one call option on XYZ stock with a strike price of $50 and pays a premium of $3 per share. If the stock rises to $60, the call has $10 of intrinsic value. Ignoring commissions, the investor paid $3 and has an option worth $10, producing a $7 per-share gain. If the stock finishes below $50 at expiration, the option expires worthless and the investor loses the $3 premium.

This example illustrates **leverage**. A relatively small option premium can create exposure to a larger price movement in the underlying stock. Leverage can magnify gains, but it can also result in rapid losses.

33.3 Warrants

A **warrant** is a security that gives the holder the right to purchase a company's stock at a specified price, often for a longer period than an exchange-traded option. Warrants are typically issued by the company itself, sometimes as part of a financing package or attached to bonds or preferred stock.

Feature	How feature applies to a warrant
Issuer	Usually issued by the corporation whose stock may be purchased.
Typical maturity	Often longer-term than listed options.

Feature	How feature applies to a warrant
Dilution	Exercise may result in new shares being issued, which can dilute existing shareholders.
Investor appeal	Provides leveraged upside potential if the issuer's common stock rises.
Risk	May expire worthless if the stock price does not rise above the exercise price.

Options vs. Warrants

Feature	Listed option	Warrant
Who creates it?	Usually created through the options market.	Usually issued by the corporation.
Underlying shares	Generally existing shares change hands if exercised.	New shares may be issued by the company.
Typical term	Often shorter-term.	Often longer-term.
Dilution	Usually no direct dilution from exercise.	May dilute existing shareholders.

33.4 Futures

A **futures contract** is a standardized agreement to buy or sell an underlying asset, commodity, financial instrument, or index at a future date at a price agreed upon today. Unlike an option, a futures contract creates an obligation for both parties. The long side agrees to buy or receive the economic benefit of price increases. The short side agrees to sell or receive the economic benefit of price decreases.

Key Features of Futures Contracts

- Standardized contract terms allow exchange trading and clearing.
- Both the buyer and seller have obligations, not merely rights.
- Futures often use margin, which can create substantial leverage.
- Positions are marked to market, meaning gains and losses are settled regularly.
- Many financial futures are cash-settled rather than settled through physical delivery.

Simple Futures Example

Assume a food producer is concerned that wheat prices may rise. The company can buy wheat futures to lock in or hedge exposure to higher wheat prices. If wheat prices rise, gains on the futures contract may offset the higher cost of buying wheat in the physical market. If wheat prices fall, the futures contract may lose money, but the company may benefit from cheaper wheat purchases.

A speculator could also buy wheat futures without owning or needing wheat. In that case, the investor is not hedging a business exposure; the investor is taking leveraged risk based on a price forecast.

33.5 Benefits, Risks, and Suitability

Potential benefit	Explanation
Hedging	Derivatives can reduce or offset an existing risk, such as stock-market risk, interest-rate risk, or commodity-price risk.
Leverage	A small initial outlay can control a larger economic exposure.
Income generation	Some options strategies generate premium income, although the income comes with risk.
Price discovery and liquidity	Futures and options markets can help investors observe market expectations and transact efficiently.

Risk	Explanation
Leverage risk	Small price changes in the underlying asset can cause large gains or losses.
Market risk	The underlying asset may move in an unfavorable direction.
Liquidity risk	Some contracts may be difficult to close at a fair price.

Risk	Explanation
Complexity risk	Clients may not understand the payoff, assignment risk, margin requirements, or tax consequences.
Counterparty/clearing risk	Some derivatives involve counterparty exposure, although exchange-traded contracts reduce this through clearinghouses.
Suitability risk	Derivatives are often inappropriate for clients who need safety of principal, liquidity, or simple income.

33.6 Series 65 Exam Tips

- An option gives the buyer a right; a futures contract creates an obligation.
- A call option gives the buyer the right to buy; a put option gives the buyer the right to sell.
- The option buyer pays the premium and can lose the premium if the option expires worthless.
- The option writer receives the premium but may have a significant obligation.
- A warrant is usually issued by the corporation and may lead to dilution if exercised.
- Futures are standardized, exchange-traded contracts that are often highly leveraged.
- Derivatives may be suitable for hedging or sophisticated strategies, but they are not automatically suitable for conservative clients.

Key Terms

Term	Definition
Derivative	A contract whose value is based on an underlying asset, index, rate, or commodity.
Call option	An option giving the buyer the right to buy the underlying asset at the strike price.
Put option	An option giving the buyer the right to sell the underlying asset at the strike price.
Premium	The price paid for an option.

Term	Definition
Strike price	The price at which the option may be exercised.
Warrant	A company-issued right to buy the company's stock at a specified price.
Futures contract	A standardized contract obligating parties to buy or sell an asset or settle the price difference in the future.
Leverage	The use of a smaller amount of capital to control a larger economic exposure.

Practice Questions

1. Which statement best describes a derivative security?

A. A stock that pays a fixed dividend
B. A security whose value is based on another asset or benchmark
C. A mutual fund that is priced only at NAV
D. A bond that is always issued at a discount

2. A call option gives the buyer the right to:

A. Buy the underlying asset at the strike price
B. Vote for the board of directors
C. Sell the underlying asset at the strike price
D. Receive a fixed coupon payment

3. Which statement about an option buyer is most accurate?

A. The buyer has an obligation to perform if assigned
B. The buyer receives the premium and has unlimited income
C. The buyer pays a premium for a right
D. The buyer must hold the option until expiration

4. A warrant is most similar to:

A. A short-term Treasury bill
B. A mutual fund share
C. A certificate of deposit
D. A long-term call option issued by a corporation

5. Which feature distinguishes a futures contract from an option?

A. A futures contract cannot be standardized
B. A futures contract creates obligations for both parties
C. A futures contract is never leveraged
D. A futures contract always gives the buyer voting rights

6. A conservative retiree who needs safety of principal and liquidity would generally find speculative derivatives:

A. Potentially unsuitable because of leverage, complexity, and risk
B. Suitable only if held in a tax-deferred account
C. Risk-free if traded on an exchange
D. Automatically suitable because they can increase return

Answer Key and Explanations

1. B — A derivative security's value is based on another asset or benchmark.

2. A — Buy the underlying asset at the strike price

3. C — The buyer pays a premium for a right

4. D — A long-term call option issued by a corporation

5. B — A futures contract creates obligations for both parties

6. A — Potentially unsuitable because of leverage, complexity, and risk

Lesson 34: Derivative Characteristics

Learning Objectives

- Explain why **derivatives** are different from direct ownership of stocks, bonds, commodities, or currencies.
- Identify the main costs of using derivatives, including **premiums**, **margin**, **bid-ask spreads**, **commissions**, and **opportunity costs**.
- Describe common benefits of derivatives, including **hedging**, **income generation**, **price discovery**, and **capital efficiency**.
- Recognize the major risks of derivatives, including **leverage risk**, **market risk**, **liquidity risk**, **counterparty risk**, **time decay**, and **complexity risk**.
- Apply derivative suitability principles to Series 65-style client recommendation questions.

Core idea
A derivative is a financial instrument whose value is derived from an underlying asset, index, rate, or event. Options, warrants, and futures do not have value in isolation. Their value depends on something else, such as a stock price, bond price, commodity price, interest rate, currency exchange rate, or market index.

Exam point
For the exam, you should know the purpose, costs, benefits, risks, and suitability concerns associated with derivatives. The exam is more likely to test conceptual understanding and investor suitability than advanced pricing formulas.

34.1 Why Derivatives Are Used

Derivatives can be used for several different purposes. The same derivative can be prudent or speculative depending on how it is used and whether it fits the client's objectives, risk tolerance, experience, time horizon, liquidity needs, and financial situation.

Use	Definition	Example
Hedging	Reducing or offsetting an existing risk.	An investor owns a stock portfolio and buys put options to reduce downside exposure.
Income generation	Seeking additional income in exchange for accepting an obligation or giving up some upside.	An investor sells covered calls on stock already owned.

Use	Definition	Example
Speculation	Seeking profit from a directional view, often with leverage.	A trader buys call options expecting a stock to rise quickly.
Arbitrage / pricing efficiency	Attempting to profit from price differences across related markets.	Institutional traders compare futures prices with spot prices and financing costs.
Exposure management	Obtaining or changing market exposure without buying or selling the underlying asset directly.	A portfolio manager uses index futures to adjust equity exposure temporarily.

34.2 Costs of Derivative Securities

The cost of a derivative is not limited to the visible price paid. Derivatives often involve explicit costs, implicit trading costs, and economic trade-offs.

Cost	How It Works	Exam Point
Option premium	The buyer of an option pays a premium for the right to buy or sell the underlying security.	The premium is the maximum loss for the buyer of a standard listed option.
Commissions and fees	Trades may involve brokerage commissions, contract fees, exchange fees, and advisory fees.	Costs reduce the net return to the client.
Bid-ask spread	The buyer may pay the ask price and the seller may receive the bid price.	Wider spreads increase trading cost and often signal lower liquidity.
Margin requirements	Futures and some option strategies require margin deposits and possible additional collateral.	Margin creates liquidity pressure if the market moves against the investor.

Cost	How It Works	Exam Point
Opportunity cost	A hedge can reduce risk but may also limit gain or use capital that could be invested elsewhere.	Risk reduction usually has a trade-off.
Time decay	Options lose time value as expiration approaches, all else equal.	Time decay is especially important for option buyers.

Example: Protective put cost. An investor owns 100 shares of a stock trading at $50. The investor buys one put option with a $45 strike price for a $2 premium. The put may limit downside below $45 before expiration, but the investor pays $200 for the protection. If the stock never falls, the option may expire worthless. The cost of protection reduces the investor's total return.

Example: Covered call trade-off. An investor owns 100 shares of a stock trading at $40 and sells one call option with a $45 strike price for a $1.50 premium. The investor receives income, but if the stock rises above $45, the investor may have to sell the shares at $45 and give up additional upside.

34.3 Benefits of Derivative Securities

Benefit	Explanation	Important Limitation
Risk management	Derivatives can reduce exposure to price changes, interest rates, currencies, or commodities.	A hedge can be imperfect and may not eliminate all risk.
Capital efficiency	A smaller upfront amount may control exposure to a larger asset value.	Capital efficiency also increases leverage risk.
Income generation	Selling options can produce premiums.	Income is compensation for assuming an obligation or limiting upside.

Benefit	Explanation	Important Limitation
Portfolio flexibility	Derivatives can adjust exposure without buying or selling a large securities position.	The strategy must still be suitable and understood.
Price discovery	Futures and options markets can reflect market expectations about future prices and volatility.	Market prices can be volatile and influenced by liquidity conditions.

34.4 Major Risks of Derivative Securities

Derivatives can be useful, but they can also introduce risks that are greater or different from directly owning the underlying investment.

Risk	Meaning	Explanation
Leverage risk	Small changes in the underlying asset may cause large percentage gains or losses in the derivative.	A call option may lose most or all of its value after a modest stock decline.
Market risk	The derivative can lose value because the underlying asset, rate, index, or commodity moves unfavorably.	An investor buys S&P 500 call options before a broad market decline.
Liquidity risk	The investor may not be able to exit the position quickly at a reasonable price.	A thinly traded option has a wide bid-ask spread.
Counterparty risk	One party may fail to perform under the contract.	This is more relevant for over-the-counter derivatives than standardized exchange-traded contracts.

Risk	Meaning	Explanation
Time decay	Options may lose value as expiration approaches.	An option buyer can be directionally correct but still lose money if the move is too small or too late.
Basis risk	A hedge may not move perfectly opposite the risk being hedged.	A portfolio hedge using an index future may not perfectly match the client's actual portfolio.
Volatility risk	Changes in expected volatility can change option prices.	An option can fall in value if implied volatility declines.
Complexity risk	Clients may misunderstand payoff patterns, margin obligations, expiration, or tax consequences.	A complex option strategy may be unsuitable for a conservative client.

Exam point
Derivatives are not unsuitable by definition. They become unsuitable when the strategy, risk, cost, or complexity does not match the client's profile. A covered call on a stock the client already owns is very different from writing uncovered calls or speculating in futures contracts.

34.5 Risk and Reward by Derivative Position

Position	Potential Benefit	Primary Risk
Long call	Profit if the underlying security rises enough before expiration.	Premium may be lost if the price does not rise enough or quickly enough.
Long put	Profit from a decline or hedge an existing long position.	Premium may be lost if the expected decline does not occur.
Covered call	Premium income on stock already owned.	Upside is limited if the stock rises above the strike price.

Position	Potential Benefit	Primary Risk
Uncovered call writing	Premium income.	Potential loss can be extremely large because the underlying price can rise substantially.
Futures contract	Efficient exposure or hedge.	Daily gains and losses can create large obligations and margin calls.
Warrant	Long-term right to buy issuer stock at a set price.	May expire worthless; often more speculative and issuer-specific.

34.6 Suitability Considerations

Before recommending derivative strategies, an adviser must consider whether the client understands the product and whether the risk-return profile is consistent with the client's objectives.

- **Risk tolerance**: Can the client tolerate rapid losses, loss of the entire premium, margin calls, or potentially large losses?
- **Investment objective**: Is the derivative being used for hedging, income, speculation, or exposure management?
- **Time horizon**: Does the contract expiration fit the client's investment horizon?
- **Liquidity needs**: Could the client meet margin calls or collateral requirements without forced selling?
- **Experience and understanding**: Does the client understand expiration, exercise, assignment, leverage, and possible obligations?
- **Concentration risk**: Does the strategy increase exposure to one issuer, sector, commodity, currency, or market factor?
- **Tax and account type**: Some derivative strategies may have tax consequences or may not be permitted in certain account types.

Client Situation	More Suitable Approach	Less Suitable Approach
Conservative retiree needing stable income	High-quality income portfolio; possibly simple hedges only if clearly understood.	Speculative futures or uncovered option writing.
Long-term stock investor worried about short-term downside	Protective put or diversified risk management if cost is acceptable.	Selling all long-term holdings solely because of short-term volatility.
Experienced investor seeking income from existing stock position	Covered call strategy with clear discussion of capped upside and tax effects.	Naked calls or complex spreads without understanding.
Business with fuel price exposure	Futures or options hedge designed to reduce operating cost risk.	Speculation unrelated to business exposure.

34.7 Series 65 Exam Tips

- Derivative value is derived from an underlying asset, index, rate, or event.
- A derivative can be used to hedge risk, but it can also increase risk when used speculatively.
- Option buyers generally risk the premium paid, while some option sellers can face much larger losses.
- Futures contracts can create daily margin obligations and may be riskier than many clients expect.
- Liquidity risk is higher when contracts are thinly traded or have wide bid-ask spreads.
- A hedge can reduce risk but may limit upside or introduce basis risk.
- Suitability analysis is essential. The fact that a strategy is sophisticated does not make it appropriate for every client.

Key Terms

Term	Definition
Derivative	A security or contract whose value depends on an underlying asset, index, rate, or event.
Premium	The price paid by an option buyer and received by an option seller.

Term	Definition
Strike price	The price at which the underlying asset may be bought or sold under an option contract.
Expiration date	The date on which an option or futures contract expires.
Exercise	The option buyer uses their right to buy or sell the underlying asset at the strike price specified in the contract.
Assignment	The option seller is required to fulfill the contract to sell or buy the underlying asset at the strike price.
Breakeven point	The breakeven point is the underlying price at which the trade or strategy neither makes a profit nor incurs a loss, after accounting for the premium paid or received
Leverage	The use of a smaller investment amount to control a larger exposure.
Margin	Collateral required to support certain derivative positions.
Covered call	A call option sold against stock already owned by the investor.
Protective put	A put option purchased to help protect an existing long position from downside risk.
Counterparty risk	The risk that the other party to a contract will fail to perform.
Basis risk	The risk that a hedge does not move exactly opposite the exposure being hedged.

Practice Questions

1. Which statement best describes a derivative security?

A. Its value is derived from an underlying asset, index, rate, or event.
B. It can only be used by institutional investors.
C. It is always insured against loss.
D. It is always a direct ownership claim on a company.

2. An investor buys a put option on stock already owned. What is the primary purpose of this strategy?

A. To eliminate all investment risk
B. To avoid paying any premium
C. To increase dividend income
D. To hedge downside risk

3. Which cost is most directly associated with buying an option?

A. Dividend payout ratio
B. FDIC insurance premium
C. Option premium
D. Bond coupon

4. Which risk is created by the ability of a derivative to produce large gains or losses from a relatively small investment?

A. Reinvestment risk
B. Prepayment risk
C. Call risk
D. Leverage risk

5. A covered call strategy may be unsuitable for an investor who:

A. Seeks income from option premiums
B. Wants unlimited upside potential in the stock
C. Owns the underlying stock
D. Is willing to sell the stock at the strike price

6. Why can option buyers lose money even if their directional forecast is partly correct?

A. Because time decay and insufficient price movement can reduce option value
B. Because the premium is always refunded
C. Because option contracts have no expiration dates
D. Because options cannot trade before expiration

7. Which derivative-related risk is most associated with a wide bid-ask spread and difficulty exiting a position?

A. Liquidity risk
B. Political risk
C. Inflation risk
D. Currency translation risk

8. Which strategy has potentially very large risk because the underlying security can rise substantially?

A. Buying a put option
B. Writing an uncovered call option
C. Buying a Treasury bill
D. Buying a covered bond

9. A hedge that does not move perfectly opposite the exposure being hedged creates:

A. Custody risk
B. Mortality risk
C. Basis risk
D. Reinvestment risk

10. For Series 65 suitability purposes, which factor is most important before recommending derivatives?

A. Whether the client wants the highest possible return
B. Whether the derivative is exchange traded
C. Whether the product is complex enough
D. Whether the strategy fits the client's objectives, risk tolerance, experience, and financial situation

Answer Key and Explanations

1. A — A derivative's value depends on another underlying reference item.

2. D — A protective put can reduce downside exposure, although it has a cost and does not eliminate all risk.

3. C — The option buyer pays a premium to obtain the option right.

4. D — Leverage magnifies the effect of price movements.

5. B — Covered calls generate income but cap upside above the strike price.

6. A — The underlying must move enough and soon enough to overcome the premium and time decay.

7. A — Liquidity risk concerns the ability to trade quickly at a reasonable price.

8. B — An uncovered call writer may suffer large losses if the underlying rises sharply.

9. C — Basis risk occurs when the hedge and the exposure do not match perfectly.

10. D — Suitability depends on the client profile and the specific strategy.

Lesson 35: Alternative Investments

Learning Objectives

- Define **limited partnerships**, **exchange traded notes**, **leveraged funds**, **inverse funds**, and **structured products**.
- Distinguish **ownership interests**, **debt obligations**, **pooled funds**, and **derivative-linked securities**.
- Explain the primary costs, benefits, risks, and liquidity concerns of each alternative investment type.
- Apply Series 65 suitability analysis to complex or nontraditional investment products.
- Recognize why **leverage**, **inverse exposure**, **issuer credit risk**, and complex payoff formulas can create investor harm when misunderstood.

35.1 Why Alternative Investments Matter

Alternative investments are investments that differ from traditional long-only stocks, bonds, cash, and ordinary mutual funds. The Series 65 exam usually tests them through definitions, risk recognition, liquidity, complexity, tax considerations, and suitability rather than detailed modeling.

Many alternative investments have legitimate uses, such as diversification, income, hedging, or access to specialized markets. The key regulatory and suitability issue is that they may also have higher fees, less transparency, limited liquidity, leverage, complicated payoff formulas, or risk of substantial loss.

Product type	Core idea	Primary risk
Limited partnership	Investor owns a partnership interest, usually with limited liability for limited partners.	Illiquidity, pass-through tax reporting, sponsor risk, and loss of capital.
Exchange traded note (ETN)	Unsecured debt obligation whose return is linked to an index or benchmark.	Issuer credit risk plus market, liquidity, tracking, call, and complexity risk.
Leveraged fund	Seeks a multiple of a benchmark return, often for a single day.	Daily reset, compounding effects, volatility drag, and suitability concerns for buy-and-hold investors.
Inverse fund	Seeks the opposite of a benchmark return, often for a single day.	Losses if the benchmark rises; daily reset makes long holding periods risky.

Product type	Core idea	Primary risk
Structured product	Packaged investment with payoff linked to one or more underlying assets or indexes.	Complex payoff, issuer credit risk, limited secondary market, caps/barriers, and embedded derivatives.

35.2 Limited Partnerships

A **limited partnership** is a business arrangement with at least one general partner and one or more limited partners. The general partner manages the partnership and usually has unlimited liability. Limited partners contribute capital and generally have limited liability, but they typically do not control day-to-day operations.

Role	Rights and responsibilities	Risk and return implication
General partner	Manages the partnership, controls business decisions, and may receive management fees or incentive compensation.	Has greater control and usually greater liability exposure.
Limited partner	Provides capital and shares in income, gains, losses, and deductions according to the partnership agreement.	Usually has limited liability, but may have little control and limited liquidity.

Limited partnership examples

- A real estate limited partnership may acquire apartment buildings. Investors receive partnership interests, may receive income distributions, and may receive a Schedule K-1 for tax reporting.
- An oil and gas limited partnership may participate in drilling or production projects. The potential return may be high, but business, commodity price, tax, and liquidity risks may also be high.
- A **master limited partnership** (MLP) is often publicly traded and is commonly associated with energy infrastructure. Although publicly traded MLPs may be more liquid than private partnerships, they still involve partnership tax reporting and sector-specific risk.

Limited partnership risks and suitability

Risk	Explanation
Liquidity risk	Private partnership interests may be difficult or impossible to sell before the partnership terminates or allows redemption.
Tax complexity	Investors may receive a Schedule K-1 and may have tax items that differ from cash distributions.
Manager/sponsor risk	Performance depends heavily on the sponsor, general partner, and underlying business plan.
Concentration risk	A partnership may own a narrow set of assets or focus on one industry or project.
Loss of capital	Limited liability does not mean the investment is safe; the investor can still lose the amount invested.

35.3 Exchange Traded Notes (ETNs)

An **exchange traded note** is a senior unsecured debt obligation of an issuer, usually a financial institution. ETNs trade on an exchange, but they are not the same as ETFs. An ETF typically represents shares of a fund that owns a portfolio of assets. An ETN is debt; the investor relies on the issuer's promise to pay according to the note's formula.

Feature	ETF	ETN
Legal form	Generally a registered investment company or trust holding assets.	Unsecured debt obligation of the issuer.
Investor exposure	Exposure through a portfolio of underlying securities or assets.	Exposure through a payoff formula linked to an index or benchmark.
Credit risk	Usually limited issuer credit risk because assets are held in the fund.	Meaningful issuer credit risk; the note depends on the issuer's ability to pay.

Feature	ETF	ETN
Tracking	May have tracking error from fund expenses and portfolio implementation.	May track the formula closely, but value also reflects issuer credit and market factors.

ETN exam points

- ETNs may be useful for accessing commodities, currencies, volatility, or specialized indexes, but they are complex.
- An ETN can lose value because the linked index declines or because the issuer's credit quality deteriorates.
- ETNs may have call, acceleration, or early redemption features that affect investor outcomes.
- The fact that an ETN trades on an exchange does not guarantee deep liquidity or a fair exit price in stressed markets.

35.4 Leveraged Funds

A **leveraged fund** seeks to magnify the return of an underlying benchmark, such as two times or three times the daily return of an index. These funds often use derivatives, swaps, futures, and borrowing-like exposure. Many leveraged funds are designed to meet their stated objective over a short period, commonly one trading day.

Daily reset and compounding example

Assume an index starts at 100 and a 2x leveraged fund starts at 100. The index rises 10% on Day 1 and falls 9.09% on Day 2, ending back at 100. The 2x fund rises 20% on Day 1 to 120, then falls 18.18% on Day 2 to about 98.18. The index is flat over the two days, but the leveraged fund lost value because of the daily reset and compounding path.

Day	Index return	Index value	2x fund return	2x fund value
Start	-	$100.00	-	$100.00
Day 1	+10.00%	$110.00	+20.00%	$120.00
Day 2	-9.09%	$100.00	-18.18%	$98.18

Exam tip
A leveraged fund may not deliver two or three times the benchmark return over periods longer than its stated reset period. This is especially important when volatility is high.

35.5 Inverse Funds

An **inverse fund** seeks to move in the opposite direction of a benchmark. For example, an inverse S&P 500 fund might seek to return approximately -1x the daily return of the S&P 500. Some inverse funds are also leveraged, such as -2x or -3x daily exposure.

- Inverse funds may be used for short-term hedging or tactical trading by investors who understand the product.
- They are generally unsuitable as simple long-term substitutes for cash, bonds, or defensive equity exposure.
- An investor can lose money if the underlying benchmark rises.
- Daily reset and compounding can cause long-term results to differ substantially from the simple inverse of the benchmark's cumulative return.

35.6 Structured Products

A **structured product** is a packaged investment whose return is based on a formula tied to one or more underlying assets, such as an equity index, basket of stocks, interest rate, commodity, or currency. A common form is a structured note, which combines a debt obligation with derivative-linked payoff features.

Feature	Definition	Investor concern
Participation rate	The percentage of the underlying asset's gain credited to the investor.	A 70% participation rate means the investor receives less than the full upside.
Cap	A maximum return or payment.	Investor may give up upside above the cap.
Barrier / buffer	A threshold affecting downside protection or loss exposure.	Protection may disappear if the underlying asset breaches the barrier.
Principal protection	A promise to repay some or all principal at maturity, subject to issuer ability to pay.	Protection may apply only at maturity and may be subject to issuer credit risk.
Call feature	Issuer may redeem the product early.	Investor may lose future upside or income if called.

Structured product example

A five-year structured note is linked to a stock index. It promises 100% principal repayment at maturity if the issuer remains solvent, plus 80% of the index gain, capped at 20%. If the index

rises 40%, the formula would produce 32% before the cap, but the investor receives only the 20% capped return. If the issuer defaults, the investor may lose money even if the index performed well.

35.7 Suitability Framework

Alternative investments are not automatically unsuitable, but they require careful matching to the client's profile. The adviser should assess whether the client understands the product, can tolerate loss, can accept illiquidity, and has an investment objective consistent with the product's purpose.

Suitability question	Why it matters
Does the client understand how the product makes or loses money?	Complexity creates risk of unsuitable recommendations when clients misunderstand the payoff.
Can the client tolerate loss of principal?	Many alternatives can produce large or sudden losses.
Does the client need liquidity?	Partnerships and structured products may have limited secondary markets or long holding periods.
Is the holding period appropriate?	Leveraged and inverse funds may be designed for short-term exposure rather than long-term holding.
Are costs and tax consequences clear?	High fees, spreads, embedded costs, and K-1 reporting can materially affect after-tax returns.

35.8 Comparing Alternative Investments

Investment	Potential use	Main risk	Series 65 suitability warning
Limited partnerships	Income, real estate/energy exposure, private business exposure	Illiquidity, sponsor risk, tax complexity	Not suitable for clients needing easy access to cash.

Investment	Potential use	Main risk	Series 65 suitability warning
ETNs	Specialized index exposure	Issuer credit risk and product complexity	Exchange trading does not eliminate credit or liquidity risk.
Leveraged funds	Short-term amplified tactical exposure	Daily reset and magnified losses	Generally not a buy-and-hold product.
Inverse funds	Short-term hedging or tactical bearish exposure	Losses when benchmark rises; compounding effects	Not a long-term substitute for conservative investing.
Structured products	Customized payoff, possible income or buffered exposure	Complex formula, issuer credit risk, liquidity risk	Must evaluate full payoff, cap, barrier, and issuer risk.

35.9 Series 65 Exam Tips

- Alternative does not mean safer. It usually means different structure, different risks, and potentially less transparency.
- A limited partner has limited liability but can still lose the amount invested.
- An ETN is unsecured debt of the issuer; it is not a fund that owns the underlying index components.
- Leveraged and inverse funds are often designed around daily objectives. Long holding periods can produce unexpected results.
- Structured products must be evaluated by their actual payoff terms: cap, participation, barrier, maturity, call feature, and issuer credit quality.
- Suitability analysis is central: complexity, liquidity, risk tolerance, time horizon, investment objective, and client understanding matter.

References and Further Reading

- SEC Investor.gov. Investor Bulletin: Exchange-Traded Notes (ETNs).
- SEC Investor.gov. Exchange-Traded Products (ETPs) glossary.
- FINRA. Exchange-Traded Funds and Products.
- SEC Investor.gov. Investor Bulletin: Structured Notes.
- FINRA Regulatory Notice 22-08. Complex Products and Options.

Practice Questions

1. Which statement best describes a limited partnership?

A. It is always publicly traded on an exchange.
B. All partners must manage daily operations.
C. Limited partners have unlimited liability.
D. It has at least one general partner and one limited partner.

2. Which risk is especially important for ETNs?

A. Preemptive rights risk
B. Issuer credit risk
C. Voting rights dilution risk
D. Municipal tax preference risk

3. A 2x leveraged fund that resets daily is usually most appropriate for:

A. Conservative retirees seeking principal protection.
B. Short-term tactical investors who understand daily reset risk.
C. Clients who need insured deposits.
D. Long-term income investors seeking stable dividends.

4. An inverse fund is designed primarily to:

A. Move opposite to a benchmark over the stated period.
B. Eliminate market risk completely.
C. Track the exact same return as the benchmark.
D. Guarantee a positive return during recessions.

5. Which feature of a structured product limits the investor's upside?

A. CUSIP number
B. Prospectus delivery
C. Cap
D. Settlement date

6. Which recommendation is most likely unsuitable?

A. A leveraged inverse fund held indefinitely by a conservative retiree seeking safety.
B. A small tactical inverse fund position for an experienced investor seeking a short-term hedge.
C. A diversified ETF for a long-term growth investor.
D. A Treasury bill for a client needing short-term liquidity.

Answer Key and Explanations

1. D — A limited partnership has at least one general partner and one or more limited partners.

2. B — ETNs are unsecured debt obligations of the issuer.

3. B — Leveraged funds are typically designed for short-term exposure and require client understanding.

4. A — Inverse funds seek the opposite of the benchmark for the stated reset period, often daily.

5. C — A cap sets a maximum return or payment.

6. A — A leveraged inverse fund is complex and generally not appropriate as a long-term safety holding for a conservative retiree.

Lesson 36: Annuities

Learning Objectives

- Define an **annuity** and identify the **owner**, **annuitant**, **beneficiary**, **accumulation phase**, and **payout phase**.
- Compare **fixed**, **variable**, and **indexed annuities** by **guarantee**, **investment risk**, **return potential**, **liquidity**, and **regulation**.
- Recognize major annuity costs and contract features, including **surrender charges**, **riders**, **death benefits,** and **annuitization**.
- Explain the tax treatment commonly tested for annuities, including **tax deferral**, ordinary income taxation of gains, and potential early-withdrawal penalties.
- Apply annuity characteristics to Series 65-style suitability questions.

36.1 What Is an Annuity?

An **annuity** is a contract between a client and an insurance company. The client pays the insurer either a lump sum or a series of premiums. In return, the insurer promises to make payments to the client either immediately or at a future date. Annuities are commonly used for retirement income planning, tax-deferred accumulation, and protection against outliving assets.

Annuities are insurance-based products rather than ordinary savings accounts. The guarantees in the contract depend on the claims-paying ability of the insurance company. They are not bank deposits and are not FDIC insured.

Exam point
The exam is likely to test what an annuity does, how the main types differ, and whether a recommendation is suitable for the client. It is less likely to require complex actuarial calculations.

Term	Definition
Owner	The person or entity that owns and controls the contract. The owner chooses beneficiaries and usually controls withdrawals.
Annuitant	The person whose life expectancy may be used to calculate lifetime payments. The owner and annuitant may be the same person.

Term	Definition
Beneficiary	The person who may receive death benefits if the owner or annuitant dies, depending on contract terms.
Accumulation phase	The period when money is being contributed or growing in the contract.
Payout or annuitization phase	The period when the insurer makes scheduled payments to the annuity owner or annuitant.
Surrender period	A period during which withdrawals above a free-withdrawal amount may trigger a surrender charge.

36.2 Immediate vs. Deferred Annuities

The timing of payments is one of the first distinctions. An **immediate annuity** begins making payments soon after the premium is paid. A **deferred annuity** begins payments at a later date and is often used first as an accumulation vehicle.

Type	How It Works	Typical Use
Immediate annuity	The client pays a lump sum and begins receiving income payments almost immediately.	Converting savings into a predictable retirement income stream.
Deferred annuity	The client contributes now and delays income payments until a later date.	Tax-deferred retirement accumulation and future income planning.

36.3 Fixed Annuities

A **fixed annuity** is an insurance contract in which the insurer promises a stated minimum interest rate during the accumulation phase and fixed or determinable payments during the payout phase. The insurance company bears the investment risk needed to support the promised rate and payments.

- Principal and interest guarantees are backed by the insurer, not by the federal government.
- Assets supporting the guarantee are generally held in the insurer’s general account.

- The client gives up some liquidity because withdrawals may be subject to surrender charges.
- Fixed annuities may be appropriate for conservative clients seeking predictable income, but inflation risk remains important.

Example: fixed annuity
A 68-year-old retiree invests $100,000 in an immediate fixed annuity that pays $600 per month for life. The benefit is predictable income. The trade-off is that the client may lose liquidity and inflation may reduce the purchasing power of the fixed payment over time.

36.4 Variable Annuities

A **variable annuity** is an annuity contract that allows the client to allocate premiums among investment options, often called subaccounts, that resemble mutual funds. Because the value of the contract varies with the performance of the selected investments, the client bears investment risk.

- Variable annuities are securities and are regulated by the SEC; sales also involve insurance regulation and FINRA rules when sold by broker-dealers.
- The separate account supports the variable investment options, while certain guarantees may depend on the insurer.
- Variable annuities can offer tax-deferred growth, optional riders, death benefits, and lifetime income features.
- They often have significant fees, including mortality and expense charges, administrative fees, underlying fund expenses, surrender charges, and rider charges.
- They are generally designed for long-term retirement goals, not short-term liquidity needs.

Example: variable annuity
A 45-year-old client invests in a deferred variable annuity and allocates premiums to equity subaccounts. If the subaccounts perform well, the account value may increase. If the markets perform poorly, the account value can decline. The client should understand the fees, surrender period, market risk, and tax treatment before purchasing.

36.5 Indexed Annuities

An **indexed annuity** credits interest based in part on the performance of a market index, such as a broad stock index. The client does not directly own the index or the stocks in the index. The insurer credits interest according to the contract formula.

- Indexed annuities usually provide more upside potential than traditional fixed annuities but less direct market exposure than variable annuities.
- Returns are commonly limited by participation rates, caps, spreads, or other crediting formulas.

- Many indexed annuities include a floor that limits downside under the crediting formula, but the contract may still impose surrender charges and other restrictions.
- Indexed annuities can be complex, and the headline index return may not equal the client's credited interest.
- Some indexed annuities are securities; fixed indexed annuities are typically regulated primarily as insurance products rather than SEC-registered securities.

Crediting Feature	Plain-English Meaning
Participation rate	The percentage of the index gain used in the interest calculation. A 70% participation rate means only 70% of the index gain counts before other adjustments.
Cap	A maximum credited return for the period. If the cap is 6%, a 12% index gain may still credit only 6%.
Spread or margin	A percentage subtracted from the index return before interest is credited.
Floor	A minimum credited return, often 0%, that limits negative crediting under the formula.

36.6 Comparing Fixed, Variable, and Indexed Annuities

Feature	Fixed Annuity	Variable Annuity	Indexed Annuity
Primary return source	Insurer-declared rate or guaranteed payment	Performance of investment subaccounts	Formula linked partly to index performance
Investment risk to client	Lower market risk; insurer credit risk remains	Higher market risk; value can decline	Limited market exposure; formula and surrender risks
Return potential	Generally lower but more predictable	Higher potential, no guaranteed market return	Between fixed and variable, depending on terms

Feature	Fixed Annuity	Variable Annuity	Indexed Annuity
Liquidity	May have surrender charges	May have surrender charges and tax penalties	May have surrender charges and complex terms
Regulation focus	State insurance regulation	SEC/FINRA and state insurance regulation	Depends on product; fixed indexed generally insurance-regulated, securities versions SEC-regulated
Best fit	Conservative income need	Long-term growth plus insurance features	Client wants index-linked upside with some downside limits

36.7 Costs, Features, and Risks

Annuity recommendations require careful analysis because annuities often combine investment, insurance, tax, and income features. A feature that benefits one client may be unnecessary or costly for another.

Item	Why It Matters
Surrender charges	Make the product less suitable for clients who may need near-term liquidity.
Mortality and expense charge	Common in variable annuities; compensates the insurer for insurance risks and guarantees.
Administrative fees	Contract-level costs that reduce net return.
Underlying fund expenses	Variable annuity subaccounts have investment management costs.
Rider charges	Optional death benefit or living benefit riders can be valuable but increase costs.

Item	Why It Matters
Insurer credit risk	Guarantees depend on the insurance company's ability to pay.
Inflation risk	Fixed payments may lose purchasing power over time.
Market risk	Variable annuity values can decline when subaccounts perform poorly.

36.8 Tax Treatment Commonly Tested

Annuities are often marketed for tax-deferred growth. **Tax deferral** means the client generally does not pay tax each year on gains inside the annuity. Taxes are paid when earnings are withdrawn or paid out. For nonqualified annuities, gains are generally taxed as ordinary income rather than capital gains. Withdrawals before age 59½ may also be subject to a 10% federal tax penalty on taxable earnings.

- Tax deferral is less valuable inside qualified retirement accounts that already provide tax deferral.
- A client who needs liquidity may be harmed by surrender charges and tax penalties.
- Annuities do not receive the same capital gains and qualified dividend tax treatment that taxable brokerage accounts may receive.
- Clients should receive tax advice before withdrawals, exchanges, or annuitization decisions.

Exam point
A common exam trap is recommending a variable annuity inside an IRA primarily for tax deferral. Because the IRA already has tax deferral, the recommendation must be justified by other annuity features, such as insurance guarantees or lifetime income benefits, and those benefits must be worth the costs.

36.9 Suitability and Recommendation Issues

The most suitable annuity usually depends on the client's objectives, liquidity needs, time horizon, risk tolerance, tax situation, and understanding of costs. An annuity is not automatically suitable just because a client wants retirement income.

Client Fact Pattern	Likely Analysis
Retiree wants predictable income and has adequate emergency savings.	A fixed immediate annuity may be considered if the client accepts reduced liquidity and insurer credit risk.
Client wants long-term tax-deferred growth and can tolerate market risk.	A variable annuity may be considered, but fees, surrender charges, and retirement account alternatives must be reviewed.
Client wants some upside tied to the stock market but is afraid of market losses.	An indexed annuity may be considered, but the client must understand caps, participation rates, spreads, and surrender charges.
Client expects to need the money in two years.	Most deferred annuities are likely unsuitable because of surrender charges and tax issues.
Client is already investing inside an IRA.	Tax deferral alone is not a strong reason to buy an annuity; other benefits must justify the cost.

36.10 Worked Examples

Example 1: Indexed annuity cap

A client buys an indexed annuity with a 100% participation rate, a 5% annual cap, and a 0% floor. If the index rises 12% during the measurement period, the contract credits 5%, not 12%, because the cap limits the credited return. If the index falls 8%, the contract credits 0% under the formula, although surrender charges and other contract terms may still matter.

Example 2: Variable annuity suitability

A 40-year-old client has a high risk tolerance, has already built an emergency fund, and wants long-term retirement accumulation with optional income benefits. A variable annuity might be suitable if the client understands the fees, market risk, surrender period, and tax consequences. It would be less suitable if the client needed the funds soon or already had low-cost retirement options that met the same objective.

Example 3: Fixed annuity trade-off

A 72-year-old client wants guaranteed monthly income for essential expenses. A fixed immediate annuity may help match income to spending needs. The main trade-offs include reduced liquidity, insurer credit risk, and inflation risk if payments do not adjust for rising prices.

36.11 Series 65 Exam Tips

- Variable annuities are securities; fixed annuities are generally insurance products.
- Fixed annuities emphasize guarantees; variable annuities emphasize investment choice and market risk.
- Indexed annuity returns are linked to an index but are limited by contract formulas such as caps, participation rates, and spreads.
- Annuities are long-term products; surrender charges and tax penalties make liquidity analysis critical.
- Tax deferral alone is usually not a sufficient reason to buy an annuity inside a tax-deferred retirement account.
- Guarantees are only as strong as the issuing insurance company.
- The suitability answer should match the annuity type to the client's objective, time horizon, liquidity needs, risk tolerance, and tax situation.

Key Terms

Annuity: A contract with an insurance company designed to provide future or immediate payments.

Fixed annuity: An annuity that promises a minimum rate or fixed payment based on the insurer's guarantee.

Variable annuity: A security in which returns vary with selected investment subaccounts.

Indexed annuity: An annuity that credits interest based partly on a market index formula.

Annuitization: The process of converting an annuity value into a stream of payments.

Surrender charge: A fee for withdrawing funds during the surrender period.

Subaccount: An investment option inside a variable annuity.

Rider: An optional contract feature, often for an additional cost.

References and Further Reading

- U.S. Securities and Exchange Commission, Investor.gov. Annuities, Variable Annuities, Indexed Annuities, and Fixed Annuity investor education resources.
- FINRA. Annuities investor education resources and variable annuity guidance.
- FINRA, 2024 Annual Regulatory Oversight Report: Variable Annuities. Used for suitability and sales-practice issues such as surrender charges, fees, liquidity needs, tax penalties, and market risk.

Practice Questions

1. Which statement best describes an annuity?

A. A short-term bank deposit insured by the FDIC
B. A type of municipal bond backed by property taxes
C. A contract with an insurance company that can provide future or immediate payments
D. A stock option issued by an employer

2. Which annuity type generally exposes the owner to the greatest market risk?

A. Immediate fixed annuity
B. Variable annuity
C. Traditional savings account
D. Fixed annuity

3. A client wants market-index-linked upside but does not directly own the underlying index. Which product is most likely being described?

A. Indexed annuity
B. Common stock
C. Treasury bill
D. Money market fund

4. Which feature most directly reduces annuity liquidity?

A. A death benefit
B. A beneficiary designation
C. A participation rate
D. A surrender charge

5. A variable annuity is generally regulated as:

A. A bank deposit only
B. A municipal security only
C. A commodity future only
D. A security and an insurance product

6. A 58-year-old client may need the invested funds next year for a home purchase. Which concern is most important before recommending a deferred annuity?

A. Whether the client likes the stock market
B. Surrender charges and tax consequences
C. Whether the index is well known
D. Whether the annuity has a beneficiary form

7. Which statement about tax treatment is most accurate for gains withdrawn from a nonqualified annuity?

A. They avoid all penalties regardless of age
B. They are generally tax free
C. They are generally taxed as ordinary income
D. They are always long-term capital gains

8. Why can a variable annuity inside an IRA be a questionable recommendation if tax deferral is the only stated reason?

A. The IRA already provides tax deferral
B. Variable annuities cannot be held in retirement accounts
C. Variable annuities never have insurance features
D. The client must always annuitize immediately

Answer Key and Explanations

1. C — A contract with an insurance company that can provide future or immediate payments
2. B — Variable annuity
3. A — Indexed annuity
4. D — A surrender charge
5. D — A security and an insurance product
6. B — Surrender charges and tax consequences
7. C — They are generally taxed as ordinary income
8. A — The IRA already provides tax deferral

Lesson 37: Life Insurance

Learning Objectives

- Define **life insurance** and explain the basic roles of the **insured**, **owner**, **beneficiary**, **premium**, **death benefit**, and **cash value**.
- Distinguish **term life insurance** from **permanent life insurance**.
- Compare **whole life**, **universal life**, and **variable life insurance**.
- Recognize how **cash value**, **investment risk**, **policy loans**, **surrender charges**, and **insurance costs** affect policy suitability.
- Apply Series 65-style suitability reasoning to life insurance recommendations.

37.1 Life Insurance Basics

Life insurance is a contract in which an insurance company agrees to pay a death benefit to a beneficiary when the insured person dies, provided the policy is in force. In exchange, the policy owner pays premiums. The policy owner, insured person, and beneficiary may be the same person or different people, depending on how the policy is structured.

For the Series 65 exam, life insurance is usually tested as an insurance-based product rather than as a full insurance licensing topic. You should understand the purpose, general structure, investment features, risks, costs, tax characteristics, and suitability concerns of each major type.

Term	Definition
Insured	The person whose life is covered by the policy.
Policy owner	The person or entity that controls the policy, pays premiums, and may change beneficiaries if permitted.
Beneficiary	The person or entity designated to receive the death benefit.
Premium	The payment required to keep the policy in force.
Death benefit	The amount paid to the beneficiary when the insured dies.
Cash value	A savings or investment component found in permanent policies, not ordinary term insurance.

37.2 Term Life Insurance

Term life insurance provides coverage for a specified period, such as 10, 20, or 30 years. If the insured dies while the policy is active, the beneficiary receives the death benefit. If the term ends and the insured is still living, ordinary term insurance generally pays nothing.

- Primary purpose: provide death-benefit protection for a defined period.
- Premiums: typically lower than permanent insurance in the early years because the policy does not build cash value.
- Cash value: none in ordinary term insurance.
- Best fit: temporary insurance needs, such as income replacement while children are young, mortgage protection, or coverage during working years.
- Key risk: coverage may expire before the client's insurance need ends; renewal premiums may be much higher because the insured is older.

Term life insurance example
A 38-year-old parent wants coverage until a child finishes college and a mortgage is mostly paid down. A 20-year level-premium term policy may be appropriate because the need is large but temporary, and the client may not need permanent cash-value insurance.

37.3 Permanent Life Insurance and Cash Value

Permanent life insurance is designed to remain in force for the insured's lifetime if sufficient premiums are paid and policy requirements are met. Permanent policies normally include both a death benefit and a cash value component. Whole life, universal life, and variable life are common forms of permanent insurance.

- Permanent policies generally cost more than term insurance for the same initial death benefit.
- Cash value may be accessed through policy loans or withdrawals, but those actions can reduce the death benefit and may create tax issues if the policy lapses or is surrendered.
- Surrender charges may apply if the policy is terminated in early years.
- Guarantees depend on the claims-paying ability of the insurance company, not on FDIC or SIPC insurance.

37.4 Whole Life Insurance

Whole life insurance is a permanent policy with fixed premiums, a guaranteed death benefit, and guaranteed cash value growth according to the contract, assuming premiums are paid as required. Some whole life policies may pay dividends, but dividends are generally not guaranteed.

- Premiums are usually fixed and scheduled.
- Cash value grows based on policy guarantees and insurer crediting rules.
- The death benefit is generally guaranteed if the policy remains in force.

- The policy is often used when the client wants permanent protection and values predictability.
- The policy may be less flexible than universal life and usually more expensive than term insurance.

Whole life insurance example
A client wants permanent death-benefit protection for estate liquidity and prefers predictable premiums. A whole life policy may be more suitable than term insurance if the permanent need and cost are justified.

37.5 Universal Life Insurance

Universal life insurance is a permanent policy with flexible premiums and an adjustable death benefit, subject to policy limits and underwriting rules. The cash value is credited with interest according to the policy terms. Because charges are deducted from the policy value, insufficient premiums or poor crediting experience can cause the policy to lapse.

- Premium flexibility can be useful for clients with variable cash flow.
- The policy owner may be able to adjust the death benefit, though increases may require evidence of insurability.
- Cash value is affected by interest credited, premium payments, policy expenses, and mortality charges.
- A universal life policy requires monitoring. Flexible premiums do not mean the policy can be ignored.
- Suitability depends on whether the client understands the need to fund the policy adequately.

Universal life insurance example
A business owner with uneven income wants permanent coverage but values premium flexibility. Universal life may fit the flexibility objective, but the adviser must explain that underfunding the policy can cause lapse risk.

37.6 Variable Life Insurance

Variable life insurance combines life insurance with investment subaccounts. The policy owner allocates cash value among investment options, often similar to mutual fund portfolios. Because cash value depends on investment performance, the policy owner assumes investment risk.

- Variable life has a death benefit and investment component.
- Cash value fluctuates based on the performance of selected subaccounts, fees, and policy expenses.

- The policy may offer growth potential, but cash value is not guaranteed in the same way as a traditional whole life policy.
- Variable life and variable universal life are securities as well as insurance products, so they involve insurance regulation and securities regulation.
- The product is generally suitable only for clients who need life insurance, can tolerate investment risk, understand the costs, and have a long-term time horizon.

Exam point
Do not recommend variable life merely as an investment. The insurance need must be real, and the client must understand investment risk, policy charges, surrender charges, and the possibility that poor investment performance may require additional premiums to keep the policy in force.

37.7 Comparing the Major Types

Policy Type	Coverage Period	Cash Value	Premium Pattern	Main Risk or Limitation
Term life	Specified term	No ordinary cash value	Level or increasing depending on contract	Coverage expires; renewal may be costly.
Whole life	Lifetime if premiums are paid	Guaranteed cash value based on contract	Typically fixed	Less flexible and more expensive than term.
Universal life	Lifetime if adequately funded	Interest-crediting cash value	Flexible subject to policy needs	Policy can lapse if underfunded.
Variable life	Lifetime if adequately funded	Investment-based cash value	Depends on contract	Investment losses, fees, and complexity.

37.8 Tax and Regulatory Considerations

Life insurance tax rules can be complex, and advisers should avoid giving tax advice outside their competence. For exam purposes, the broad concepts are more important than specialized planning rules.

- Death benefit. Life insurance proceeds received by a beneficiary because of the insured's death are generally not included in gross income, although interest paid on proceeds may be taxable.
- Cash value growth. Inside buildup in a permanent policy is generally tax-deferred while it remains in the policy.
- Loans and withdrawals. Policy loans are often not taxable when taken, but they can reduce the death benefit and may become taxable if the policy lapses or is surrendered with gain.
- Surrender. If a policy is surrendered for more than the owner's cost basis, the gain may be taxable as ordinary income.
- Variable products. Variable life policies involve securities features; clients should receive and understand the prospectus and the fees, risks, and investment options.

37.9 Suitability Considerations

A suitable life insurance recommendation starts with the client's insurance need. The adviser should consider dependents, debts, income replacement, estate liquidity, business continuity, cash flow, tax situation, risk tolerance, time horizon, and whether the client can maintain the policy.

Client Situation	Potentially Suitable Direction	Why
Young family with temporary income-replacement need	Term life	Large death benefit can be obtained at lower initial cost.
Client needs lifetime coverage and wants predictability	Whole life	Fixed premiums and guaranteed cash value may fit a conservative objective.
Client needs permanent coverage but has irregular cash flow	Universal life	Flexible premium structure may help, but policy must be monitored.
Client has insurance need, long time horizon, and risk tolerance	Variable life	Investment subaccounts may fit growth objective, but costs and risk must be understood.
Client only wants low-cost investment exposure	Not variable life	A variable life policy should not be sold solely as an investment substitute.

37.10 Series 65 Exam Tips

- Term life is temporary protection and generally has no cash value.
- Permanent life insurance combines death-benefit protection with cash value.
- Whole life emphasizes guarantees and fixed premiums.
- Universal life emphasizes premium flexibility but creates funding and lapse risk.
- Variable life shifts investment risk to the policy owner through subaccounts.
- Variable life is both an insurance product and a securities product.
- Suitability depends on insurance need first, not only investment return potential.
- Higher complexity, surrender charges, and ongoing funding requirements require stronger client understanding.

References and Further Reading

- NAIC Life Insurance Buyer's Guide and consumer resources on term, whole, universal, and variable life insurance.
- FINRA investor resources on insurance products and variable life insurance.
- Investor.gov Investor Bulletin: Variable Life Insurance.
- IRS guidance on life insurance and disability insurance proceeds.

Practice Questions

1. Which statement best describes ordinary term life insurance?

A. It allows the owner to choose investment subaccounts.
B. It provides lifetime coverage with guaranteed cash value.
C. It provides coverage for a specified period and usually has no cash value.
D. It always pays a benefit when the term expires.

2. Which policy type is most closely associated with fixed premiums, lifetime coverage, and guaranteed cash value if premiums are paid?

A. Variable annuity
B. Term life
C. Whole life
D. Commercial paper

3. A universal life policy may lapse primarily because:

A. The policy is underfunded and charges exhaust the cash value.
B. The policy has a death benefit.
C. The insurer is required to cancel all flexible premium policies.
D. The client has named a beneficiary.

4. What makes variable life different from traditional whole life?

A. Variable life cash value depends in part on investment subaccount performance.
B. Variable life has no death benefit.
C. Variable life cannot be regulated as a securities product.
D. Variable life is always risk-free.

5. Which client is least likely to be suitable for variable life insurance?

A. A client seeking permanent coverage and willing to review policy performance.
B. A client with a legitimate insurance need and high risk tolerance.
C. A client who understands investment risk and policy costs.
D. A client who wants only low-cost temporary protection and no investment risk.

6. Which of the following is the best approach for recommending life insurance?

A. Always recommend variable life for younger clients.
B. Start with the commission paid on the product.
C. Treat life insurance as identical to mutual funds.
D. Start with the client's insurance need and suitability profile.

7. Life insurance death benefits paid because of the insured's death are generally:

A. Included in income only when paid by a mutual fund.
B. Excludable from the beneficiary's gross income, although interest may be taxable.
C. Taxable as capital gains.
D. Taxable as dividend income.

8. Which statement is most accurate about policy loans?

A. They always increase the death benefit.
B. They can reduce the death benefit and may create tax issues if the policy lapses.
C. They are available in ordinary term policies because term always has cash value.
D. They eliminate the need to monitor a universal life policy.

Answer Key and Explanations

1. C — Term covers a specified period and usually has no cash value.

2. C — Whole life is linked to fixed premiums and guaranteed cash value.

3. A — Universal life can lapse if charges exceed available value.

4. A — Variable life cash value depends on subaccount performance.

5. D — Variable life is not a low-cost, risk-free temporary coverage solution.

6. D — Suitability begins with the client's insurance need and profile.

7. B — Death proceeds are generally excludable; interest may be taxable.

8. B — Loans can reduce benefits and create tax issues if the policy lapses.

Lesson 38: Other Assets: Commodities, Precious Metals, and Digital Assets

Learning Objectives

- Define **commodities** and **precious metals** and explain how investors commonly gain exposure.
- Distinguish **physical commodity exposure** from **futures-based**, **fund-based**, and **note-based exposure**.
- Identify the main characteristics and risks of commodities, precious metals, and **digital** assets.
- Explain why a digital asset may function as a **security**, **currency-like medium of exchange**, commodity, **collectible**, **tool**, or **general asset** depending on the facts.
- Apply a Series 65-style framework to client recommendations involving these assets.

38.1 Commodities and Precious Metals

Commodities are different from stocks and bonds because they do not represent ownership in a business or a promise by an issuer to repay debt. They are raw materials or primary goods whose prices are driven by supply, demand, inventories, weather, geopolitics, industrial production, interest rates, currency values, and market positioning.

Common Commodity Categories

- Energy: crude oil, natural gas, gasoline, heating oil.
- Metals: gold, silver, copper, platinum, palladium.
- Agriculture: corn, wheat, soybeans, coffee, sugar, livestock.
- Precious metals: often discussed separately because they may have investment demand, safe-haven demand, industrial demand, and jewelry demand.

How Clients Commonly Gain Exposure

Exposure Method	Definition	Exam Cue
Physical ownership	Coins, bullion, bars, or stored metals. Key issues include storage, insurance, authenticity, spreads, and liquidity.	Think custody, insurance, liquidity, spreads.
Futures contracts	Direct exposure to price changes but with margin, leverage, roll, liquidity, and complexity risks.	Think leverage, margin, roll yield.

Exposure Method	Definition	Exam Cue
Commodity funds or ETPs	May hold physical commodities, futures contracts, or commodity-linked instruments. Structure matters.	Think structure, costs, tracking error.
Mining or producer stocks	Equity exposure to companies tied to commodity prices. These are still stocks, with company-specific operating and financial risks.	Think equity risk plus commodity sensitivity.
Commodity-linked notes	Debt instruments whose payoff is linked to a commodity index or price. These introduce issuer credit risk and product complexity.	Think issuer credit risk and payoff formula.

Precious Metals: Characteristics

- Gold is often viewed as a store-of-value or crisis hedge, but it does not produce income and can be volatile.
- Silver has both investment demand and industrial demand, which can make it sensitive to economic activity.
- Platinum and palladium have significant industrial demand, especially in catalytic converters and other manufacturing uses.
- Precious metals may diversify some portfolios, but they can also go through long periods of weak returns.

Commodity and Precious Metal Risks

Price volatility: Prices can move sharply because of supply shocks, geopolitical events, weather, demand changes, or investor sentiment.

No income stream: Physical commodities and metals do not pay dividends or interest.

Storage and insurance: Physical assets require safekeeping; fund structures charge expenses.

Futures roll risk: Futures-based funds may diverge from spot commodity returns.

Liquidity and spreads: Coins, bars, thin contracts, or niche funds may involve wide bid-ask spreads.

Tax treatment: Some commodity and precious-metal vehicles may have less favorable or more complex tax treatment than ordinary stock funds.

Product complexity: ETNs, structured products, leveraged products, and inverse products can behave differently than clients expect.

38.2 Digital Assets: Definition, Distinctions, and Characteristics

A **digital asset** is a digital representation of value recorded on a cryptographically secured distributed ledger or similar technology. The term is broad. It can include cryptocurrencies, stablecoins, non-fungible tokens, tokenized securities, tokenized real-world assets, and other blockchain-based rights or records.

Exam point
The important skill is not memorizing every token type. The important skill is recognizing the function, product structure, legal classification, risks, and client suitability issues.

Digital Asset Distinctions

Type	Description	Primary Exam Question
Cryptocurrency / convertible virtual currency	May function as a medium of exchange, store of value, speculative asset, or network token. Examples often include Bitcoin or similar transferable tokens.	What rights does the holder actually have, and what risk does the client take?
Stablecoin	Designed to maintain value relative to a reference asset such as the U.S. dollar. Risks include reserves, redemption rights, custody, operational controls, and regulatory treatment.	What rights does the holder actually have, and what risk does the client take?
NFT / digital collectible	A unique token tied to digital art, media, access, gaming, identity, or collectible rights. Value can depend on scarcity, rights, creator reputation, and market demand.	What rights does the holder actually have, and what risk does the client take?

Type	Description	Primary Exam Question
Digital tool / utility token	May be used for access to a network, software function, service, or protocol. Utility alone does not eliminate securities analysis.	What rights does the holder actually have, and what risk does the client take?
Digital security / tokenized security	A traditional security or investment contract represented on a blockchain or distributed ledger. Securities laws may apply.	What rights does the holder actually have, and what risk does the client take?
Tokenized real-world asset	A digital representation of an interest in another asset, such as a fund interest, receivable, commodity, or real estate-related interest. The underlying rights matter.	What rights does the holder actually have, and what risk does the client take?

Can a Digital Asset Function as a Security, Currency, or Asset?

It depends on the facts and the legal context. A digital asset can have multiple roles at the same time. The same item may be discussed as a payment tool, a taxable asset, a commodity for derivatives purposes, or a security if it is a tokenized security or part of an investment contract.

Function	How to Think About It	Exam Cue
Security	A tokenized stock, bond, fund interest, or investment contract may be a security. The Howey investment contract analysis asks whether there is an investment of money in a common enterprise with an expectation of profits from the efforts of others.	Think registration, exemption, disclosure, antifraud, broker-dealer/adviser rules.

Function	How to Think About It	Exam Cue
Currency-like medium of exchange	Some digital assets can be used to pay for goods or services or transferred as value. This practical use does not automatically make them legal tender or ordinary currency for tax purposes.	Think payment function, but do not ignore volatility and tax treatment.
Commodity or other asset	Some non-security crypto assets may be treated as commodities under commodities law, and digital assets are generally treated as property for federal tax purposes.	Think property, custody, valuation, gains/losses, and product structure.

The Howey Investment Contract Framework

A digital asset analysis often turns on whether a transaction involves an investment contract. Under Howey, the core elements are:

- Investment of money or other value.
- A common enterprise.
- A reasonable expectation of profits.
- Profits expected primarily from the efforts of others.

Exam point
A digital asset being useful in a network does not automatically prevent securities treatment, and digital technology alone does not automatically create securities treatment. The facts of the offer, sale, marketing, rights, promoter efforts, and purchaser expectations matter.

Digital Asset Risks

Volatility: Digital asset prices can change rapidly and may be driven by sentiment, liquidity, leverage, token supply, or network adoption rather than cash flows.

Valuation risk: Many digital assets do not have earnings, dividends, coupons, or conventional valuation anchors.

Custody and private key risk: Loss, theft, transfer error, wallet compromise, or custodian failure can lead to irreversible loss.

Cybersecurity and smart contract risk: Code vulnerabilities, protocol attacks, bridge failures, or exchange hacks can impair value.

Liquidity and market structure risk: Trading can be fragmented, thin, or dependent on platforms that may fail or restrict withdrawals.

Regulatory risk: Classification and compliance obligations can affect trading, custody, disclosure, taxation, and product availability.

Stablecoin risk: A stablecoin may break its peg if reserves, redemption mechanisms, collateral quality, governance, or confidence are weak.

Fraud and promotion risk: Digital asset markets can involve misleading claims, celebrity promotion, pump-and-dump schemes, and conflicts of interest.

Tax and recordkeeping risk: Dispositions, exchanges, income, staking rewards, and payments can create reporting obligations and basis-tracking problems.

Adviser Application: Recommendation Checklist

- Client profile: risk tolerance, objectives, time horizon, liquidity needs, tax situation, experience, and concentration risk.
- Product structure: physical asset, futures strategy, grantor trust, mutual fund, ETF, ETN, private fund, token, wallet, or managed account.
- Economic exposure: spot price, futures roll, issuer credit, equity beta, network adoption, stablecoin reserves, or collectible demand.
- Costs and taxes: expense ratios, spreads, storage, custody, tax reporting, and potentially less favorable tax treatment.
- Custody and control: who holds the asset, what happens if keys are lost, whether there is insurance, and how transfers are authorized.
- Disclosure and documentation: why the recommendation is suitable and in the client's best interest given the risks.

Exam-Focused Takeaways

- Commodities are not stocks or bonds; they are raw materials or exposure to raw material prices.
- Precious metals may diversify a portfolio but do not pay income and can be volatile.
- Futures-based commodity products can differ meaningfully from spot commodity returns because of roll yield and fund structure.
- Digital assets are broad: cryptocurrency, stablecoins, NFTs, digital tools, tokenized securities, and other blockchain-based interests.
- A digital asset can be analyzed as a security, currency-like item, commodity, property, collectible, or general asset depending on facts and legal context.
- Do not answer "all crypto is a security" or "no crypto is a security." The best answer is usually a facts-and-circumstances analysis.
- For U.S. federal tax purposes, digital assets are generally treated as property, not currency.

- Suitability analysis should include volatility, custody, liquidity, regulation, tax, fraud, and product-structure risks.

Key Terms

Term	Definition
Commodity	A basic good or raw material that is interchangeable with other goods of the same type, such as crude oil, wheat, copper, or gold.
Precious metal	A commodity metal valued for scarcity, durability, industrial use, or monetary/investment demand. Common examples include gold, silver, platinum, and palladium.
Spot price	The current market price for immediate purchase or sale of a commodity.
Futures contract	A standardized agreement to buy or sell an asset at a future date and price, commonly used for commodity exposure or hedging.
Roll yield	The gain or loss created when a futures-based strategy replaces an expiring contract with a later-dated contract.
Digital asset	A digital representation of value recorded on a cryptographically secured distributed ledger or similar technology.
Cryptocurrency	A digital asset commonly designed to be transferred electronically, sometimes used as a medium of exchange or store of value.
Stablecoin	A digital asset designed to maintain value relative to a reference asset, such as the U.S. dollar.

Term	Definition
NFT	A non-fungible token representing a unique or non-interchangeable digital item, right, or collectible.
Investment contract	A securities-law concept often analyzed under Howey: investment of money, common enterprise, and expectation of profits from the efforts of others.

Practice Questions

1. Which statement best describes commodities as an investment category?

A. They are insured bank deposits with fixed maturities.
B. They are physical or contractual interests in goods such as energy, metals, or agricultural products.
C. They are ownership claims on an issuing corporation.
D. They are always exempt from price volatility.

2. A client buys a gold grantor trust ETP. What is the most accurate description of the ETP?

A. A municipal revenue bond backed by mine production.
B. A share of a registered open-end investment company that holds common stocks.
C. A federally insured savings account.
D. A pooled product that may provide exposure to physical gold and may not be registered under the Investment Company Act of 1940.

3. Which risk is especially important for precious metals?

A. No cash flow and high dependence on market price changes.
B. FDIC insurance limits.
C. Call risk from the issuer.
D. Coupon reinvestment risk.

4. A futures-based commodity fund can underperform the spot commodity because:

A. Futures prices can be affected by roll yield and the shape of the futures curve.
B. Spot prices are guaranteed by the CFTC.
C. Futures contracts have no market prices.
D. Futures eliminate leverage and margin risk.

5. For federal tax purposes, the IRS generally treats digital assets as:

A. Currency, not property.
B. FDIC-insured deposits.
C. Property, not currency.
D. Municipal securities.

6. Which statement about whether digital assets are securities is most accurate?

A. No digital asset transaction can ever involve a security.
B. Classification depends only on whether the asset trades on an exchange.
C. Classification depends on the asset and transaction; a tokenized stock or an investment contract can be a security.
D. Every digital asset is automatically a security.

7. Under the Howey investment contract analysis, which factor points toward a security?

A. A purchaser uses the asset only to buy goods immediately.
B. A purchaser expects profits primarily from the essential managerial efforts of others.
C. The asset exists only as a collectible with no promoter.
D. The asset is held in cold storage.

8. Which digital asset is designed to maintain a relatively stable value against a reference asset such as the U.S. dollar?

A. Stablecoin.
B. Treasury bill.
C. Leveraged inverse fund.
D. Non-fungible token.

9. Which is the best description of an NFT?

A. A fungible claim where every unit is interchangeable.
B. A derivative contract requiring physical delivery of grain.
C. A unique or non-fungible digital token often associated with digital art, access rights, or collectibles.
D. A fixed annuity with a guaranteed minimum rate.

10. Which risk is unique or especially pronounced in self-custodied crypto assets?

A. The issuer may call the asset at par.
B. FDIC coverage may be reduced at maturity.
C. The dividend may be reduced by the board.
D. Loss of private keys can permanently prevent access to the asset.

11. A client says, "Bitcoin is legal tender for U.S. tax purposes because it can be used as payment." What is the best correction?

A. Payment use eliminates volatility risk.
B. Digital assets that can be used for payment are generally treated as property for U.S. federal tax purposes.
C. Use as payment automatically makes the asset a registered security.
D. Digital assets are never taxable.

12. An investment adviser considering commodity or digital asset exposure for a client should focus first on:

A. Whether the asset recently had the highest one-month return.
B. Whether the asset avoids all regulation.
C. Whether online comments describe the asset as safe.
D. The client's objectives, risk tolerance, liquidity needs, time horizon, tax situation, product structure, and custody risks.

Answer Key and Explanations

1. B — Commodities are raw materials or primary goods, commonly accessed through futures, funds, grantor trusts, or commodity-linked notes rather than direct corporate ownership.

2. D — Some commodity ETPs are structured as grantor trusts and are not the same as ordinary registered mutual funds or ETFs.

3. A — Gold, silver, platinum, and palladium do not produce dividends or interest; return depends primarily on price movement, net of storage, fund, spread, or tax costs.

4. A — When a fund rolls expiring futures contracts into later contracts, contango or backwardation can affect returns separately from spot price movement.

5. C — For federal income tax purposes, digital assets are generally treated as property; purchases, sales, exchanges, and payments can create tax reporting issues.

6. C — The Series 65 exam is likely to test the principle that classification is facts-and-circumstances based. Some digital assets or transactions may be securities; others may be commodities, property, collectibles, tools, or other assets.

7. B — Howey focuses on an investment of money in a common enterprise with an expectation of profits derived from the efforts of others.

8. A — A stablecoin is designed to track or maintain value relative to a reference asset, but it still has risks such as reserve, redemption, operational, and regulatory risks.

9. C — NFTs are commonly digital collectibles or unique tokens. Their investment characteristics depend on scarcity, utility, authenticity, market demand, and legal rights attached to the token.

10. D — Private key loss, wallet compromise, blockchain transfer error, or custodian failure can cause irreversible loss or loss of access.

11. B — Some digital assets can function as a medium of exchange, but federal tax treatment generally treats them as property, not currency.

12. D — Exam questions often test suitability and **fiduciary** analysis. The adviser must understand both the client profile and the product-specific risks before recommending exposure.

Lesson 39: Types of Clients

Learning Objectives

- Identify the **client** before recommending an investment strategy.
- Distinguish **individual clients** and **sole proprietorships** from separate legal entities.
- Explain how **partnerships**, **LLCs**, and **corporations** differ in **authority**, **liability**, **tax treatment**, and **investment purpose**.
- Apply **fiduciary** and document-based analysis to **trusts**, **estates**, **foundations**, and **charities**.
- Use the client type to shape **risk tolerance**, **time horizon**, **liquidity needs,** tax considerations, and constraints.

39.1 Why Client Type Matters

A recommendation is not suitable merely because an investment has attractive risk and return characteristics. The adviser must first know who the client is, who has authority to act, what the client is trying to accomplish, and what legal or practical constraints apply.

- Investment authority: who may open, trade, or change the account.
- Risk tolerance: willingness and ability to accept losses.
- Time horizon: when the money may be needed.
- Liquidity needs: payroll, distributions, tax payments, grants, or personal spending.
- Tax profile: taxable individual, pass-through entity, corporation, tax-exempt organization, trust, or estate.
- Legal constraints: governing documents, donor restrictions, fiduciary duties, and investment policies.

Client type	Decision maker	Primary planning issue	Common exam trap
Individual	The individual or joint owners	Personal goals, risk, liquidity, taxes	Ignoring spouse or joint owner objectives
Business entity	Authorized owners, officers, partners, managers, or members	Operating cash, reserves, corporate purpose	Trading without verifying authority
Trust	Trustee under the trust document	Beneficiary needs and fiduciary duties	Treating one beneficiary as the only client

Client type	Decision maker	Primary planning issue	Common exam trap
Estate	Executor or personal representative	Liquidity for debts, taxes, expenses, distributions	Using a long horizon when assets will be distributed soon
Foundation or charity	Board, investment committee, or authorized officers	Mission, spending policy, donor restrictions	Ignoring mission and endowment constraints

39.2 Individual Clients and Natural Persons

An **individual client** is a natural person investing for personal, household, retirement, education, or other personal goals. When an account has more than one owner, the adviser should understand the objectives, risk tolerance, liquidity needs, and time horizon of each relevant party.

- Personal circumstances matter: age, employment, dependents, income, net worth, cash reserves, tax status, and insurance needs.
- Capacity for risk may differ from willingness to take risk.
- A recommendation should match the client's objective and constraints, not the adviser's market opinion.
- For joint accounts, identify whether the recommendation fits the account as a whole and whether both owners have agreed to the strategy.

Sole Proprietorship

A **sole proprietorship** is owned by one individual and is not a separate legal entity. The business owner reports business activity personally and may be personally liable for business obligations. For investment analysis, the adviser should consider both the owner's personal profile and the business purpose of the funds.

- Business cash may be needed for payroll, taxes, inventory, rent, or seasonal expenses.
- Emergency reserves and operating liquidity normally receive priority over speculative investments.
- Because the business and owner are closely linked, a business loss can affect the owner's total financial position.

39.3 Business Entities

A business entity may have a different legal identity, tax profile, investment purpose, and authorized decision maker than its owners. Before recommending or executing an investment strategy, the adviser should verify the entity's governing documents and the authority of the person giving instructions.

- Review the partnership agreement, operating agreement, bylaws, corporate resolution, trust document, board authorization, or other governing document as applicable.
- Identify whether the account is for operating cash, reserves, pension or benefit assets, endowment assets, or long-term investment capital.
- Consider liquidity needs, cash flow cyclicality, debt covenants, tax treatment, and concentration in the business owner's own industry.
- Document the rationale for the recommendation and the person authorized to act for the entity.

Business Entity Comparison

Entity	Separate legal entity?	Management / authority	Tax idea	Investment considerations
General partnership	Usually not fully separate from partners for liability purposes	Partners typically share authority unless agreement says otherwise	Pass-through	Verify partner authority; partners may have personal liability; strategy may need liquidity for business needs.
Limited partnership	Partnership form with liability distinctions	General partner manages; limited partners are generally passive	Pass-through	Limited partnership interests may themselves be securities; follow partnership agreement.
LLC	Yes	Member-managed or manager-managed under operating agreement	Usually pass-through unless elects corporate tax treatment	Flexible structure; verify who can trade and whether funds are operating cash or investment reserves.

Entity	Separate legal entity?	Management / authority	Tax idea	Investment considerations
C corporation	Yes	Board and officers act under bylaws and resolutions	Entity-level taxation; shareholders taxed on dividends	Corporate treasury objectives often emphasize safety, liquidity, and cash management.
S corporation	Yes	Board and officers act under corporate authority	Pass-through with eligibility restrictions	Similar governance to a corporation; tax and shareholder restrictions can affect planning.

General Partnerships

In a **general partnership**, partners often share both management authority and exposure to business liabilities. The partnership agreement controls the details. For advisory accounts, authority is a central issue because one partner's ability to bind the partnership may depend on the agreement and the scope of the business.

- Confirm who can open the account, place trades, and change the strategy.
- Consider the partnership's operating cycle and near-term obligations.
- A partner's personal risk tolerance is not automatically the partnership's risk tolerance.

Limited Partnerships

A **limited partnership** has at least one general partner who manages the partnership and one or more limited partners who contribute capital. Limited partners usually do not participate in day-to-day management. Limited partnership interests may be investment products and may be securities, depending on the facts.

- The adviser usually receives direction from the general partner or another authorized person.
- The investment objective should match the partnership purpose, not the personal goal of one limited partner.
- Liquidity and distribution expectations should be understood before recommending illiquid assets.

Limited Liability Companies

An **LLC** combines flexible management with limited liability for members. The operating agreement is the key document. An LLC may be member-managed or manager-managed, and its tax treatment can vary.

- Verify whether a member, manager, officer, or other agent has investment authority.
- Understand whether funds are business working capital or excess reserves.
- Avoid recommending high-risk or illiquid investments for money needed in the business.

C Corporations and S Corporations

A corporation is a separate legal entity. Officers, directors, and authorized agents act for the corporation. The adviser should verify corporate authority, usually through bylaws, resolutions, account forms, or similar records.

- A **C corporation** is taxed as a separate entity, and shareholders may also be taxed on dividends.
- An **S corporation** generally passes income and deductions through to shareholders but must satisfy eligibility restrictions.
- Corporate investment accounts often focus on treasury management, reserves, or strategic investment capital.
- The shareholder's personal objective is not automatically the corporation's objective.

39.4 Trusts and Estates

Trust and estate accounts require close attention to legal authority, fiduciary responsibilities, and the governing document. The adviser should identify the fiduciary, understand the document, and tailor recommendations to the account's purpose and beneficiaries.

Trusts

A **trust** separates legal control from beneficial ownership. The trustee holds and manages property for beneficiaries according to the trust document. The trust may be revocable or irrevocable, and it may have income beneficiaries, remainder beneficiaries, or both.

- Key roles: grantor or settlor, trustee, current beneficiary, remainder beneficiary.
- The trustee is the decision maker; beneficiaries may have economic interests but may not have trading authority.
- The trust document controls investment powers, distribution rules, and beneficiary priorities.
- Trustees generally must act prudently, diversify when appropriate, and balance competing beneficiary interests.

Trust issue	Why it matters	Exam cue
Income beneficiary vs remainder beneficiary	One may prefer current income while another may prefer long-term growth.	Do not recommend solely for one beneficiary when duties run to the trust as a whole.
Revocable vs irrevocable	Authority, control, and tax treatment can differ.	Identify who can amend, revoke, or direct investments.
Fiduciary duty	The trustee must follow the document and act prudently.	Risk tolerance is fiduciary and document-based, not simply personal.
Trust distributions	Cash needs may be required by the document or beneficiary needs.	Liquidity can be more important than maximum return.

Estates

An **estate** is administered after a person dies. The executor or personal representative manages estate assets, pays debts and expenses, addresses taxes, and distributes remaining property according to the will or applicable law. The investment horizon may be short if assets will soon be distributed.

- Preservation and liquidity often matter more than aggressive long-term growth.
- Large cash needs may arise from taxes, debts, administration expenses, and distributions.
- The adviser should verify authority through estate documentation and account forms.
- Recommendations should reflect the expected settlement period and the interests of heirs or beneficiaries.

39.5 Foundations and Charities

Foundations and **charities** invest to support an organizational mission. Their decisions often involve boards, investment committees, donor restrictions, spending policies, grants, tax-exempt status, and public accountability.

- Mission: assets should support the organization's charitable, educational, religious, or public purpose.
- Governance: investment authority may rest with a board, committee, officer, or outside manager.
- Spending policy: endowment assets often have long horizons but recurring distribution needs.
- Donor restrictions: some gifts are restricted as to purpose, timing, or principal preservation.

- Tax status: many charities are tax-exempt, but unrelated business taxable income and private foundation rules can still matter.
- Reputation: investments may be screened for alignment with mission or values.

Organization	Typical objective	Key constraint	Recommendation implication
Public charity	Support charitable operations and programs	Mission, board governance, budget needs	Balance growth with operating liquidity and policy restrictions.
Private foundation	Make grants and preserve long-term assets	Distribution requirements, tax rules, donor intent	Develop policy-driven portfolio with grant liquidity.
Endowment	Provide long-term support	Spending policy and donor restrictions	Total-return approach with prudent spending and diversification.
Donor-restricted fund	Use assets for a specified purpose	Purpose or timing restriction	Confirm restrictions before recommending strategy.

39.6 Recommendation Checklist by Client Type

1. Identify the exact client: individual, joint account, sole proprietorship, entity, trust, estate, foundation, or charity.
2. Verify authority: owner, partner, manager, officer, trustee, executor, board, or committee.
3. Review governing documents: account agreements, partnership agreement, operating agreement, corporate resolution, trust document, will, donor restriction, or investment policy statement.
4. Define the objective: personal goal, operating reserve, treasury account, trust purpose, estate settlement, grant making, or endowment support.
5. Determine time horizon and liquidity needs.
6. Evaluate tax status and reporting issues.
7. Identify legal, ethical, mission, donor, or fiduciary constraints.
8. Document why the recommendation fits this specific client type.

Exam-Focused Takeaways

- The client type determines who has authority, what documents matter, and which constraints apply.

- A sole proprietorship is not separate from the owner; most other business entities are distinct from their owners for many legal and investment purposes.
- Business accounts often require more emphasis on liquidity, safety, and operating needs than a personal long-term account.
- In entity accounts, verify authority before accepting instructions or making changes.
- A trust recommendation must fit the trust document, trustee authority, fiduciary duties, and beneficiary interests.
- Estate accounts often have short or uncertain horizons and significant liquidity needs.
- Foundations and charities invest to support mission, spending policy, donor intent, and organizational governance.
- The exam often tests whether the adviser recognizes the decision maker and the constraints, not just the investment product.

Key Terms

Term	Plain-English Meaning
Natural person	An individual human client, either acting alone or jointly with another person.
Sole proprietorship	A business owned by one person that is not legally separate from the owner.
General partnership	A business association in which partners usually share management, profits, losses, and personal liability.
Limited partnership	A partnership with at least one general partner and one or more limited partners.
LLC	A limited liability company; a flexible business entity that separates the business from its owners.
C corporation	A corporation taxed separately from its shareholders.
S corporation	A corporation that generally passes income, deductions, and credits through to shareholders and is subject to eligibility restrictions.

Term	Plain-English Meaning
Trust	A legal arrangement in which a trustee manages property for beneficiaries under the trust document.
Estate	The property and obligations of a deceased person, managed by an executor or personal representative.
Foundation or charity	An organization that invests assets to support a charitable, religious, educational, or similar mission.
Fiduciary	A person or organization required to act in another party's best interest.
Investment policy statement	A written statement of objectives, constraints, roles, and portfolio guidelines for an account.

Practice Questions

1. Which statement best describes a sole proprietorship for investment-advisory purposes?

A. It must have a board of directors before opening an advisory account.
B. It cannot hold investment assets.
C. It is a business owned by one person and is not legally separate from the owner.
D. It is owned by shareholders and taxed as a separate corporation.

2. An adviser is opening an advisory account for an LLC. What should the adviser do first?

A. Ignore business liquidity because LLC members have limited liability.
B. Review the operating agreement or other documentation to identify who has authority.
C. Assume the LLC must be taxed as a C corporation.
D. Treat every member as automatically authorized to trade.

3. Which feature is most associated with a general partnership?

A. Partners may share management authority and personal liability.
B. The corporation pays tax before distributions to shareholders.
C. A trustee manages assets for beneficiaries.
D. All owners are passive investors with no management authority.

4. In a limited partnership, who normally manages the partnership?

A. The **state securities administrator**.
B. The custodian.
C. Every limited partner equally.
D. The general partner.

5. Which statement best distinguishes a C corporation from an S corporation?

A. A C corporation cannot maintain an investment account.
B. A C corporation is generally taxed separately, while an S corporation generally passes income through to shareholders.
C. Only an S corporation can have officers and directors.
D. Only a C corporation is a separate legal entity.

6. For a trust account, whose authority should an adviser primarily verify before making recommendations or accepting instructions?

A. The trustee's authority under the trust document.
B. The custodian's preferred model portfolio.
C. Any beneficiary who requests a trade.
D. The trust grantor's accountant in all cases.

7. An estate account is expected to distribute most assets within six months. Which investment objective is usually most appropriate?

A. Speculative growth because heirs have long investment horizons.
B. Highly illiquid private equity exposure.
C. Preservation of capital and liquidity for expenses and distributions.
D. Maximum long-term capital appreciation.

8. A charity's endowment portfolio should generally be designed around:

A. A requirement to avoid all equities.
B. Only the personal risk tolerance of the board chair.
C. The tax bracket of the largest donor.
D. Mission, spending policy, donor restrictions, time horizon, and governance.

9. A trustee manages a trust with current income beneficiaries and remainder beneficiaries. What is the best exam answer?

A. Invest only for current income because current beneficiaries receive distributions first.
B. Invest only for growth because remainder beneficiaries have a longer horizon.
C. Consider the trust document and balance the interests prudently.
D. Ignore beneficiary interests and follow the trustee's personal objective.

10. A corporation holds cash needed for payroll and taxes in three months. Which recommendation is most consistent with that need?

A. A low-risk, liquid cash-management strategy.
B. An illiquid private fund.
C. A long-duration speculative bond fund.
D. A concentrated small-cap growth portfolio.

11. Which document is most likely to show who may trade for a corporation?

A. The charity's donor-restricted gift agreement.
B. The personal budget of one shareholder.
C. The beneficiary designation of an unrelated IRA.
D. Corporate resolution or similar authorization.

12. Which statement is most accurate about business entity accounts?

A. Business accounts never need liquidity.
B. The adviser should identify the entity's purpose, authority, liquidity needs, tax treatment, and governing documents.
C. The owner's personal investment objective always controls the entity account.
D. All entities are taxed the same way.

Answer Key and Explanations

1. C — A sole proprietorship is owned by one person and is not legally separate from the owner.

2. B — The adviser must verify who has authority to act for the LLC, usually through the operating agreement or other documentation.

3. A — General partners commonly share management authority and may have personal liability.

4. D — The general partner normally manages the limited partnership; limited partners are usually passive.

5. B — A C corporation is generally taxed separately, while an S corporation generally passes tax items through to shareholders.

6. A — The trustee acts under the trust document; beneficiaries may not have trading authority.

7. C — A short estate settlement horizon usually calls for preservation and liquidity.

8. D — A charity or foundation portfolio should fit mission, governance, spending needs, donor restrictions, and time horizon.

9. C — Trust investment decisions should follow the trust document and prudently balance beneficiary interests.

10. A — Short-term payroll and tax needs require liquidity and principal stability.

11. D — Corporate resolutions, bylaws, or similar documents identify authorized corporate actors.

12. B — Entity accounts require analysis of purpose, authority, liquidity, tax treatment, and governing documents.

Part III. Client Investment Recommendations and Strategies

Lesson 40: Client Profile, Part 1

Learning Objectives

- Identify the **client profile information** an investment adviser representative must gather before making a recommendation.
- Differentiate **financial goals** from **financial constraints** and current financial facts.
- Use cash flow and balance sheet data to evaluate **liquidity**, **risk capacity**, and **time horizon**.
- Explain how existing investments, tax situation, Social Security, and pension benefits affect recommendations.
- Apply profile information to Series 65-style suitability and fiduciary decision questions.

40.1 Why the Client Profile Comes First

A **recommendation** is suitable only when it is based on the client's full circumstances. The investment product is the last step, not the first. The adviser begins by learning what the client is trying to accomplish, what resources are available, what risks the client can tolerate, and what restrictions apply.

- Goals explain what the money is for.
- Current financial data shows where the client stands today.
- Future financial data shows how the client's needs may change.
- Cash flow shows savings capacity, spending needs, and liquidity pressure.
- The balance sheet shows assets, liabilities, net worth, and concentrations.
- Existing investments reveal current risk exposure, tax consequences, and duplication issues.
- Taxes, Social Security, and pensions affect account location, withdrawal planning, and risk capacity.

> **Exam point**
> A recommendation should match the client profile before it matches the adviser's market opinion.

40.2 Financial Goals and Objectives

Financial goals translate the client's life needs into investment priorities. A goal should be specific enough to guide portfolio design and ongoing review. The adviser should identify the goal, amount needed, time horizon, priority level, and acceptable tradeoffs.

Goal	What it means	Recommendation impact
Capital preservation	Protect principal and maintain liquidity.	Money needed soon or client cannot absorb loss.

Goal	What it means	Recommendation impact
Current income	Generate periodic cash flow from the portfolio.	Retiree or client with spending needs.
Growth / capital appreciation	Increase portfolio value over time.	Longer time horizon and ability to accept volatility.
Total return	Balance income and appreciation.	Client needs both current return and long-term growth.
Tax efficiency	Improve after-tax return.	Taxable accounts, high tax bracket, large unrealized gains.
Education funding	Fund future tuition or related costs.	Defined time horizon and known spending date.
Retirement income	Create sustainable income during retirement.	Must coordinate with Social Security, pensions, and required spending.
Estate or charitable goal	Transfer wealth or support a charity.	May involve trusts, beneficiary designations, gifting, or donor-advised funds.

Prioritizing Goals

- Ask whether each goal is essential, important, or discretionary.
- Separate short-term goals from long-term goals because they usually require different risk levels.
- Identify conflicts, such as wanting high current income while also needing strong capital preservation.
- Document the client's preference when two reasonable goals compete.

Exam point
When two goals conflict, the best answer usually protects the goal with the shorter time horizon or higher necessity.

40.3 Current and Future Financial Situation

The client's **financial situation** includes both today's facts and foreseeable changes. The adviser should not assume that current income, expenses, tax rate, family needs, employment status, or retirement income will remain unchanged.

Profile item	Examples	Why it matters
Current income	Salary, business income, investment income, pensions, Social Security, rental income.	Shows current savings ability and tax bracket.
Current expenses	Housing, food, insurance, health care, debt payments, education, dependents.	Shows required liquidity and available surplus.
Future income changes	Retirement, job change, business sale, inheritance, spouse entering or leaving work.	May increase or reduce risk capacity.
Future expense changes	College, elder care, health costs, mortgage payoff, major purchase, relocation.	May shorten time horizon or increase liquidity needs.
Family and dependents	Spouse, children, parents, special needs, support obligations.	Affects insurance, emergency reserves, beneficiary planning, and risk capacity.
Legal or contractual obligations	Divorce decree, buy-sell agreement, trust limits, debt covenants.	May restrict investment choices or distribution timing.

40.4 Cash Flow

Cash flow measures the timing and reliability of money coming in and money going out. It helps the adviser determine whether the client can invest new money, needs portfolio withdrawals, should maintain a larger emergency reserve, or should avoid illiquid investments.

Cash flow condition	What it indicates	Likely planning response
Positive cash flow	Income exceeds expenses.	Client may have capacity for periodic investing, dollar-cost averaging, debt repayment, or increased retirement savings.
Negative cash flow	Expenses exceed income.	Client may need budget changes, emergency reserves, or a conservative withdrawal plan before taking more investment risk.
Variable cash flow	Commission income, business owner income, seasonal work, uncertain bonuses.	Larger cash reserve and flexible contribution strategy may be appropriate.
Large near-term spending need	Home purchase, taxes, tuition, medical expenses.	Funds needed soon should generally not be placed in volatile or illiquid investments.
Debt service pressure	High-interest debt or large required payments.	Debt repayment can sometimes be a better first use of cash than new investment risk.
Emergency reserve gap	Little or no liquid savings.	Recommendation may prioritize cash equivalents before long-term investments.

Cash Flow Questions to Ask

- How stable is the client's income?
- How much can the client save or invest each month?
- Will the portfolio need to provide regular withdrawals?
- Are there known large expenses in the next one to three years?
- Does the client have enough emergency cash before investing for long-term goals?

40.5 Balance Sheet

A **balance sheet** is a snapshot of what the client owns, what the client owes, and the resulting net worth. It helps the adviser evaluate liquidity, leverage, concentrations, and financial flexibility.

Basic formula: Assets - Liabilities = Net Worth

Balance sheet item	**Examples**	**Recommendation significance**
Liquid assets	Checking, savings, money market funds, Treasury bills.	Available for emergencies and near-term spending.
Investment assets	Brokerage accounts, retirement accounts, mutual funds, ETFs, individual securities.	Primary source of portfolio risk and return.
Real assets	Home, rental property, land, business property, commodities, collectibles.	May be illiquid, concentrated, or hard to value.
Retirement assets	IRAs, 401(k)s, 403(b)s, pensions with lump-sum values.	Tax rules and time horizon may differ from taxable assets.
Liabilities	Mortgage, student loans, credit cards, business debt, tax liabilities.	High debt can reduce risk capacity and liquidity.
Concentrations	Employer stock, inherited stock, closely held business, single property.	May increase unsystematic risk and require diversification planning.

Balance Sheet Red Flags

- High-interest debt with no emergency reserve.
- Large illiquid assets but little spendable cash.
- A single stock or employer stock position that dominates net worth.
- A client who appears wealthy on paper but cannot meet short-term obligations without selling long-term assets.

- A portfolio recommendation that ignores debt, liquidity needs, or concentrated risk.

40.6 Existing Investments

Existing investments must be reviewed before recommending new investments. The adviser should evaluate account types, holdings, asset allocation, performance, risk, fees, restrictions, tax basis, and whether proposed trades duplicate or conflict with current exposures.

Review area	What to examine	Why it matters
Asset allocation	Current mix of stocks, bonds, cash, alternatives, and sector exposures.	Shows whether the client is already too aggressive, too conservative, or poorly diversified.
Account registration	Individual, joint, trust, retirement, business, custodial.	Determines authority, tax treatment, and documentation needed.
Cost basis and holding period	Unrealized gains/losses, tax lots, short-term or long-term status.	Selling may create taxable gains, losses, or wash sale issues.
Fees and expenses	Advisory fees, fund expenses, surrender charges, commissions.	Recommendations should consider total cost and conflicts.
Restrictions	Employer stock limits, restricted securities, annuity surrender periods, lockups.	May limit liquidation or make replacement unsuitable.
Income characteristics	Dividends, interest, bond maturities, annuity payments.	Affects cash flow, taxes, and reinvestment decisions.
Risk exposure	Duration, credit risk, equity concentration, currency risk, leverage.	Identifies whether risk aligns with profile.
Purpose of each account	Emergency reserve, college, retirement, legacy, business liquidity.	Different accounts may require different investment strategies.

Exam point
Do not recommend a new product before knowing what the client already owns and what tax or liquidity consequences a sale would create.

40.7 Tax Situation

Taxes affect the after-tax value of a recommendation. The adviser does not need to act as a tax professional, but should recognize when tax status, account type, cost basis, and income character affect suitability.

Tax factor	Examples	Recommendation impact
Tax bracket	Client's marginal income tax rate.	Higher brackets may increase the value of tax-efficient investing.
Taxable vs tax-advantaged accounts	Brokerage account, traditional IRA, Roth IRA, 401(k), HSA, 529 plan.	Account location affects whether income, gains, and withdrawals are taxable.
Capital gains and losses	Unrealized gains, unrealized losses, holding period.	Selling appreciated assets can trigger taxes; losses may offset gains.
Income character	Ordinary income, qualified dividends, tax-exempt interest, capital gains.	Different income types can have different tax treatment.
Municipal bonds	Tax-exempt interest for many investors.	More suitable for taxable accounts and higher tax brackets than low tax brackets.
Tax-loss harvesting	Realizing losses to offset taxable gains.	Must consider wash sale rules and investment replacement choices.
Required distributions	Retirement account withdrawals that may be required at older ages.	Can affect taxable income and portfolio withdrawal strategy.

Tax factor	Examples	Recommendation impact
Estate and gift tax issues	Large estates, gifting plans, beneficiary designations.	May require coordination with tax and estate professionals.

40.8 Social Security and Pensions

Social Security and pension benefits can provide a base layer of retirement income. Because these benefits may be relatively predictable, they can affect how much investment risk the client can take and how much income the portfolio must produce.

Benefit factor	What it means	Recommendation impact
Social Security retirement benefit	Monthly benefit based on earnings history and claiming age.	May reduce the portfolio income needed in retirement.
Claiming age	Benefits may differ depending on when the client claims.	Earlier claiming can provide income sooner but may reduce monthly benefit.
Spousal or survivor benefits	Benefits available to a spouse or survivor.	Important for household income planning and widowhood risk.
Cost-of-living adjustment	Some benefits may increase with inflation.	Can reduce inflation risk relative to fixed payments.
Defined benefit pension	Employer promises a lifetime payment formula.	Acts like an income asset; credit quality and survivor option matter.
Lump-sum pension option	Client may choose a single payment instead of lifetime income.	Requires evaluating longevity, investment risk, taxes, and spending discipline.
Defined contribution plan	401(k), 403(b), or similar account with individual account balance.	Investment allocation and withdrawal strategy remain central.

Benefit factor	What it means	Recommendation impact
Coordination issue	Benefit start date, taxes, required withdrawals, spouse's income, life expectancy.	Retirement recommendations should integrate all income sources.

Exam point
Guaranteed or predictable income can increase risk capacity, but it does not eliminate the need for liquidity, diversification, and appropriate withdrawals.

40.9 Client Profile Integration Checklist

- State the specific goal and time horizon.
- Identify required liquidity and emergency reserves.
- Review current and expected cash flow.
- Review the balance sheet for net worth, debt, and concentrations.
- Analyze existing investments before recommending changes.
- Consider tax consequences before selling or replacing holdings.
- Coordinate recommendations with Social Security and pension income.
- Distinguish risk tolerance from risk capacity.
- Document assumptions, constraints, and the reason for the recommendation.
- Revise the recommendation when the client's profile changes.

Case Application

A 62-year-old client plans to retire in three years. The client owns a taxable account with highly appreciated employer stock, a traditional IRA, a small Roth IRA, and a home with no mortgage. The client has strong positive cash flow today, but expects income to fall sharply after retirement. A pension will provide monthly income, but the client has not decided whether to take a single-life benefit or a joint-and-survivor option for the spouse.

- Key profile issues: short retirement time horizon, concentrated employer stock, tax consequences of diversification, future cash flow change, pension survivor decision, and the spouse's income security.
- A recommendation should not simply chase growth. It should coordinate diversification, taxes, liquidity, retirement income, and household risk protection.
- Before recommending liquidation of the employer stock, the adviser should evaluate cost basis, unrealized gain, concentration risk, and the client's tax situation.

Exam-Focused Takeaways

- Financial goals define what the portfolio is supposed to accomplish.

- Cash flow shows whether the client can invest, must withdraw, or needs more liquidity.
- A balance sheet shows net worth, debt, liquidity, and concentrated risk.
- Risk tolerance is willingness; risk capacity is financial ability.
- Existing investments must be reviewed before recommending additions or replacements.
- Tax consequences can make an otherwise reasonable transaction unsuitable or require a different implementation.
- Social Security and pension income affect retirement income needs and risk capacity, but do not replace individualized suitability analysis.
- The best Series 65 answer usually gathers missing client profile information before recommending a product.

Key Terms

Term	Definition
Financial goal	A desired financial outcome, such as retirement income, education funding, wealth accumulation, home purchase, or capital preservation.
Investment objective	The primary result the client wants from the portfolio, commonly income, growth, preservation, liquidity, or a combination.
Risk tolerance	The client's willingness to accept volatility and potential loss.
Risk capacity	The client's financial ability to absorb loss without jeopardizing required goals or obligations.
Cash flow	Money coming in and going out over a period; it shows savings capacity and liquidity pressure.
Balance sheet	A snapshot of assets, liabilities, and net worth at a point in time.
Net worth	Assets minus liabilities.
Liquidity need	The need to have cash or near-cash assets available for expected or unexpected uses.

Term	Definition
Cost basis	The amount used to calculate taxable gain or loss when an investment is sold.
Tax-deferred account	An account in which taxes are generally delayed until withdrawal, such as a traditional IRA or 401(k).
Tax-free account	An account in which qualified withdrawals are generally not taxable, such as a Roth IRA.
Pension	Employer-provided retirement benefit, often paid as a lifetime income stream or sometimes offered as a lump sum.
Social Security	Government retirement, survivor, or disability benefit that may provide a base layer of retirement income.

Practice Questions

1. Which item best describes a client's financial goal?

A. The client's balance sheet liabilities.
B. The client's current holdings in a taxable brokerage account.
C. The client's marginal tax bracket.
D. A desired outcome, such as retirement income or education funding.

2. An adviser is evaluating whether a client can tolerate an aggressive allocation. Which profile item best measures risk capacity?

A. The client's desire to avoid tax paperwork.
B. The client's ability to absorb loss without jeopardizing required goals.
C. The client's willingness to discuss market volatility.
D. The client's preference for individual stocks over mutual funds.

3. A client has negative monthly cash flow and no emergency reserve. Which recommendation is generally most appropriate before increasing equity exposure?

A. Use margin to improve expected return.
B. Move all assets into long-term illiquid alternatives.
C. Establish liquidity and address the cash flow shortfall.
D. Buy a concentrated portfolio of growth stocks.

4. What does a balance sheet primarily show?

A. The client's annual tax return details.
B. The client's Social Security claiming age.
C. The client's investment performance for the past year.
D. The client's assets, liabilities, and net worth at a point in time.

5. Before recommending the sale of a highly appreciated stock in a taxable account, what should an adviser review?

A. Cost basis, unrealized gain, tax impact, concentration risk, and client objectives.
B. Only the stock's most recent price chart.
C. Whether the adviser personally likes the company.
D. Whether the stock pays a dividend.

6. Which client profile factor most directly affects the suitability of municipal bonds in a taxable account?

A. The client's preferred brokerage website.
B. The client's favorite industry sector.
C. The client's tax situation.
D. The number of checks the client writes each month.

7. A client will need a large cash payment for a home purchase in six months. Which investment approach best fits that money?

A. Invest it in speculative small-cap stocks.
B. Keep it in cash or high-quality short-term instruments.
C. Use it for an illiquid private placement.
D. Buy a long-term bond fund with high interest-rate sensitivity.

8. Why should an adviser review existing investments before recommending a new fund?

A. To identify current allocation, duplication, risks, fees, tax basis, and restrictions.
B. To guarantee the new fund will outperform.
C. To avoid reviewing the client's goals.
D. To determine whether the client can avoid all taxes.

9. A pension that pays reliable lifetime income may affect which part of the retirement recommendation?

A. It guarantees the client should use the most aggressive allocation.
B. It makes tax planning irrelevant.
C. It eliminates the need to review the client's investment accounts.
D. It may reduce required portfolio withdrawals and affect risk capacity.

10. Which statement best distinguishes risk tolerance from risk capacity?

A. Risk capacity is based only on the client's age.
B. Risk tolerance and risk capacity always produce the same recommendation.
C. Risk tolerance is willingness to take risk; risk capacity is financial ability to take risk.
D. Risk tolerance is always more important than risk capacity.

11. A client is retiring soon and expects earned income to fall sharply. Which profile area is most directly involved?

A. The client's preferred fund family.
B. Future financial situation and cash flow.
C. The client's desire for frequent account statements.
D. The adviser's market forecast.

12. Which is the best first response when a client asks for a recommendation but has not provided income, expenses, assets, liabilities, tax status, or existing investments?

A. Gather and document the missing client profile information.
B. Recommend cash for all clients until they retire.
C. Recommend the product with the lowest expense ratio.
D. Recommend a balanced fund because it is diversified.

Answer Key and Explanations

1. D — A financial goal is the result the client wants to accomplish with money. Tax bracket, existing holdings, and liabilities are profile data, but they are not goals.

2. B — Risk capacity is the financial ability to withstand loss. Willingness is risk tolerance, not risk capacity.

3. C — Negative cash flow and no emergency reserve point to liquidity needs. Additional volatile or illiquid exposure is usually inappropriate until the shortfall is addressed.

4. D — A balance sheet is a snapshot of assets, liabilities, and net worth.

5. A — Selling appreciated stock can create taxable gain. The adviser should evaluate tax consequences along with concentration risk and objectives.

6. C — Municipal bond interest may be tax-exempt, so the client's tax bracket and account type are central to suitability.

7. B — A six-month spending need creates a short time horizon and high liquidity need. Cash or high-quality short-term instruments are generally more suitable.

8. A — Existing investments reveal current exposures and practical constraints. Recommendations should be integrated with what the client already owns.

9. D — Reliable pension income may reduce portfolio income needs and can affect risk capacity, but it does not eliminate suitability analysis.

10. C — Risk tolerance is psychological willingness. Risk capacity is based on financial circumstances such as time horizon, cash flow, and net worth.

11. B — A major income change is a future financial situation and cash flow issue that can change liquidity and risk needs.

12. A — The adviser needs sufficient client profile information before making a recommendation. A product-first response is usually not the best Series 65 answer.

Lesson 41: Client Profile, Part 2

Learning Objectives

- Distinguish **risk tolerance**, **risk capacity**, and **risk need** when evaluating client suitability.
- Identify nonfinancial investment considerations, including **values-based criteria**, **investor experience**, **life events**, **life stage**, and **behavioral finance** concerns.
- Explain how **client identification**, **questionnaires**, and **interviews** support a reasonable basis for recommendations.
- Use **time horizon** to connect financial goals with appropriate **investment strategy**, **liquidity**, and **asset allocation** decisions.

41.1 Why the Client Profile Matters

A client profile is not complete until the adviser understands both the client's financial facts and the client's ability to live with the recommended strategy. A portfolio that is mathematically sound can still be unsuitable if the client will abandon it during normal market volatility, needs the money soon, or has values-based restrictions that the recommendation ignores.

- **Risk tolerance** addresses willingness to bear volatility and potential losses.
- **Risk capacity** addresses whether the client can financially afford the risk.
- Nonfinancial considerations explain preferences, restrictions, experience, life events, and behavioral tendencies.
- Client data gathering creates the factual record that supports the recommendation.
- Time horizon links the investment choice to when the client expects to use the money.

> **Exam point**
> Suitability and fiduciary analysis should not rely on a single score. Advisers should reconcile client statements, financial facts, objectives, and constraints.

41.2 Risk Tolerance

Risk tolerance is the client's willingness to accept uncertainty, volatility, and possible loss in pursuit of an investment objective. It is partly psychological and partly educational: a client may become more comfortable with risk after learning how a diversified portfolio behaves, but an adviser should not pressure a client into risks the client cannot accept.

Question	What it reveals	Investment impact
How would you react to a 20% decline?	Emotional tolerance for short-term losses.	Helps estimate whether the client can remain invested during volatility.

Question	What it reveals	Investment impact
What losses could prevent you from meeting obligations?	Financial capacity and liquidity pressure.	May require lower volatility, more reserves, or a shorter-duration strategy.
Have you invested through a bear market?	Experience with real market stress.	Limited experience may call for more education and gradual implementation.
Is this money for a required goal or a discretionary goal?	Whether the goal can be delayed or resized.	Required goals generally support more conservative positioning as the date approaches.

Risk Tolerance, Risk Capacity, and Risk Need

The Series 65 exam commonly tests the distinction among three related but different ideas. They should be evaluated together, not substituted for one another.

Concept	Primary question	Example	Recommendation impact
Risk tolerance	How much risk is the client willing to take?	A client says a 15% decline would cause severe stress.	Avoid strategies likely to trigger abandonment.
Risk capacity	How much risk can the client financially afford?	A client has high net worth, low debt, and no near-term withdrawals.	Financial ability may support growth assets if other factors also fit.
Risk need	How much risk is needed to pursue the goal?	A client needs a return far above what safe assets can reasonably produce.	Adviser may need to revise the goal, contribution rate, or time horizon rather than simply increase risk.

Exam point
A client with high risk tolerance but low risk capacity may still need a conservative portfolio. Willingness does not create financial ability.

Common Risk Profile Mismatches

Mismatch	What it looks like	Adviser response
High tolerance, low capacity	Client enjoys risk but has limited emergency reserves or near-term withdrawals.	Do not let enthusiasm override financial constraints.
Low tolerance, high capacity	Client has substantial wealth but is emotionally uncomfortable with volatility.	Use education, scenario analysis, and a portfolio the client can maintain.
High return goal, low risk willingness	Client wants aggressive returns but cannot accept equity-like declines.	Reframe the goal, increase savings, extend the time horizon, or lower expected outcome.
Outdated risk profile	Client's situation changed because of retirement, job loss, divorce, inheritance, disability, or family change.	Update the profile before making or maintaining recommendations.

41.3 Nonfinancial Investment Considerations

Nonfinancial considerations do not eliminate the need for sound investment analysis. They help the adviser understand what the client is trying to accomplish, what restrictions must be respected, and what implementation problems may arise.

- Values-based criteria may affect security selection, fund selection, proxy voting, tax choices, and reporting expectations.
- Investor experience affects the level of education and explanation needed before implementing a strategy.
- Life events can change income, liquidity needs, tax status, beneficiaries, insurance needs, and time horizon.
- Life stage affects the relative importance of accumulation, preservation, income, gifting, and estate planning.
- Behavioral finance helps advisers recognize decision patterns that may harm long-term results.

Values-Based Criteria: ESG and Religious Considerations

Consideration	Examples	Practical effect
Environmental	Climate exposure, energy transition, pollution, water use, natural resource management.	May lead to exclusions, thematic allocations, or preference for issuers with specific practices.
Social	Labor practices, community impact, product safety, human rights, privacy, supply-chain issues.	May affect industries or companies the client will hold.
Governance	Board independence, executive compensation, shareholder rights, accounting quality.	May be used as a risk screen or quality screen.
Religious or faith-based	Avoiding alcohol, tobacco, gambling, weapons, adult entertainment, interest-based products, or other screens depending on the client's tradition.	May narrow the investment universe and affect diversification, costs, and tracking error.

Exam point
Values-based investing is not automatically suitable or unsuitable. The adviser should document the client's preference, explain trade-offs, and select investments consistent with the client's objectives and constraints.

Experience

A client's investment experience helps an adviser judge how much explanation is needed and whether the client understands the product or strategy. Experience does not guarantee suitability. A sophisticated client can still receive an unsuitable recommendation if the strategy does not fit the client's objectives, time horizon, liquidity needs, or risk profile.

- Review products the client has previously used, such as mutual funds, ETFs, individual stocks, bonds, options, annuities, private placements, or digital assets.
- Ask whether the client understands volatility, interest rate risk, credit risk, liquidity risk, tax risk, and product fees.
- Do not confuse account size with investment sophistication.

- Use plain-language explanations when products have complex structures, restrictions, or risks.

Life Events and Life Stage

Event or stage	Possible profile change	Recommendation impact
Marriage, divorce, or domestic partnership change	Income, expenses, ownership, beneficiaries, tax filing status, estate documents.	Update goals, account titling, beneficiaries, and liquidity needs.
Birth, adoption, or caregiving responsibility	Higher expenses, education goals, insurance needs, time constraints.	May require education funding, emergency reserves, or lower risk for required goals.
Job change, business sale, or unemployment	Cash flow, concentrated wealth, tax situation, retirement plan options.	May require liquidity, diversification, rollover analysis, and tax planning.
Retirement or approaching retirement	Shift from accumulation to income, longevity risk, health costs, required withdrawals.	May call for income planning, lower sequence-of-returns risk, and tax-aware withdrawals.
Inheritance or major gift	Higher net worth, new tax considerations, emotional decision-making.	Pause before investing, verify goals, and avoid rushed implementation.

Behavioral Finance

Behavioral finance helps advisers identify predictable mistakes. The adviser's role is not to diagnose the client; it is to build a process that reduces avoidable harm from emotional or biased decisions.

Behavioral issue	Definition	Possible adviser response
Loss aversion	Losses feel more painful than similar gains feel rewarding.	Discuss drawdowns before investing and match risk to a portfolio the client can hold.

Behavioral issue	Definition	Possible adviser response
Recency bias	Recent market events feel more important than long-term evidence.	Use historical ranges, not just recent performance.
Overconfidence	Client overestimates forecasting ability or control.	Use written objectives, diversification, and limits on concentrated positions.
Anchoring	Client relies too heavily on one reference point, such as original purchase price.	Focus on current facts, opportunity cost, taxes, and the goal.
Herd behavior	Client wants to follow a popular trade because others are doing it.	Review suitability, risk, liquidity, and whether the trade serves the plan.

41.4 Client Data Gathering

Client data gathering is the process of collecting, verifying, and updating the information needed to make and monitor recommendations. It supports the adviser's fiduciary duty, creates a record of the recommendation basis, and helps prevent recommendations based on assumptions.

- Client identification verifies who the client is and who has legal authority to act.
- Questionnaires collect standardized information about goals, risk profile, financial facts, and constraints.
- Interviews add context that forms alone often miss, including concerns, priorities, trade-offs, and inconsistencies.
- Follow-up questions are necessary when information is incomplete, contradictory, stale, or unusual.
- Ongoing updates are needed when markets, client circumstances, or objectives change materially.

Client Identification

Item	Why it matters
Legal name, address, date of birth, and identifying information	Confirms identity and supports account opening and records.

Item	Why it matters
Citizenship or residency information	May affect tax forms, withholding, account eligibility, and cross-border issues.
Authority to act	Determines who may open accounts, provide instructions, or approve transactions for trusts, estates, businesses, minors, or incapacitated persons.
Trusted contact or emergency contact	May help address suspected exploitation, cognitive decline, or inability to reach the client.
Beneficiaries and account titling	Affects transfer at death, estate planning, taxation, and control.

Questionnaires

Questionnaires are useful because they impose structure, promote consistency, and document the information used in the recommendation process. They are not a substitute for professional judgment.

- Good questionnaires ask about objectives, income, net worth, liquidity, tax status, time horizon, investment experience, and risk preferences.
- Poor questionnaires overemphasize a risk score without reconciling the score to the client's actual financial capacity.
- Advisers should review inconsistent answers. For example, a client who wants aggressive growth but cannot tolerate losses needs follow-up discussion.
- Questionnaires should be updated after major life events and at reasonable review intervals.

Interviews

Interviews help the adviser understand priorities and resolve ambiguity. A client may complete a form quickly, misunderstand a question, or describe goals in emotional terms. The interview turns the profile into a usable planning record.

Interview prompt	Information sought
Which goals are essential, important, and discretionary?	Goal priority and trade-offs.

Interview prompt	Information sought
What would make you uncomfortable about this strategy?	Risk tolerance and behavior under stress.
When do you expect to use this money?	Time horizon and liquidity need.
What investments or industries do you want to avoid?	Values-based and nonfinancial restrictions.
What has changed since the last review?	Need for profile update and possible recommendation changes.

41.5 Time Horizon

Time horizon is the period between the investment decision and the expected use of the funds. It is one of the most important determinants of asset allocation. Longer horizons can usually absorb more market volatility because there is more time to recover from losses; shorter horizons generally require greater liquidity and capital preservation.

Time horizon	Common goal examples	Typical investment implication
Short term	Emergency fund, home down payment in one year, tuition due next semester, tax payment.	Emphasize liquidity, stability, and low volatility.
Intermediate term	Vehicle replacement in three years, tuition beginning in five years, planned relocation.	Balance preservation with modest growth, depending on flexibility.
Long term	Retirement in 20 years, legacy goals, young child's college funding.	Greater ability to use growth assets if risk tolerance and capacity also support it.

Multiple Time Horizons

Clients often have several goals with different time horizons. A single account may need to support near-term liquidity, medium-term purchases, and long-term retirement income. Advisers should segment goals rather than force all assets into one risk profile.

- Emergency reserves usually require immediate liquidity, even if the client has a long retirement horizon.
- A long retirement horizon can still include short-term cash needs for the first years of withdrawals.
- A short-term goal should not be funded with assets that may need to be sold during market stress.
- Time horizon should be considered with liquidity needs, tax consequences, return needs, and the client's ability to tolerate volatility.

Exam point
A long time horizon can support higher equity exposure, but it does not automatically make an aggressive portfolio suitable. The client still needs sufficient risk tolerance and risk capacity.

Putting the Profile Together

Profile input	What the adviser learns	How it affects recommendations
Risk tolerance	Client's willingness to accept loss and volatility.	Shapes how much portfolio fluctuation is acceptable.
Risk capacity	Financial ability to absorb loss without missing essential goals.	May limit risk even when the client is willing to speculate.
Nonfinancial preferences	Values, restrictions, experience, life events, and behavioral concerns.	Affects product selection, exclusions, communication, and monitoring.
Data gathering	Facts and documentation supporting the recommendation.	Builds the reasonable basis for advice and helps identify missing information.
Time horizon	When the client expects to use the money.	Guides liquidity, duration, equity exposure, and withdrawal planning.

Case Application

A 42-year-old client wants to invest $150,000 after selling a business interest. The client says he wants aggressive growth because a friend recently made money in technology stocks. During

the interview, he says he becomes anxious during market declines, needs $40,000 for a home remodel in eighteen months, and wants to avoid investments that conflict with his religious criteria.

- The $40,000 remodel money has a short time horizon and should not be invested aggressively.
- The client's stated desire for aggressive growth conflicts with his low emotional tolerance for declines.
- The adviser should document the religious criteria and explain how those screens may affect diversification, costs, and tracking error.
- A reasonable recommendation may separate the funds into a short-term liquidity reserve and a longer-term diversified portfolio consistent with the client's risk profile and restrictions.

Exam-Focused Takeaways

- Risk tolerance is willingness; risk capacity is financial ability; risk need is the risk required to pursue a target goal.
- High willingness to take risk does not make a risky recommendation suitable when risk capacity is low.
- Nonfinancial considerations can materially affect recommendations and should be documented.
- Values-based investing requires clear client instructions and disclosure of trade-offs.
- Client data gathering includes identification, questionnaires, interviews, follow-up, and ongoing updates.
- Questionnaires are tools, not final answers.
- Time horizon must be tied to each goal, not merely to the client's age.
- Short time horizons generally require liquidity and lower volatility; long horizons may support growth assets if other profile factors also fit.

Key Terms

Term	Definition
Risk tolerance	A client's psychological willingness to accept uncertainty, volatility, and possible loss.
Risk capacity	The client's financial ability to take risk based on income, assets, liabilities, liquidity, age, dependents, and goals.
Risk need	The amount of risk that may be necessary to pursue a stated return or goal.

Term	Definition
Time horizon	The length of time until invested assets are expected to be used for a goal.
ESG criteria	Environmental, social, and governance considerations used to include, exclude, or evaluate investments.
Religious criteria	Faith-based investment screens or objectives, such as avoiding certain industries or favoring specific stewardship principles.
Questionnaire	A structured tool used to collect client data and document preferences, constraints, and risk profile.
Behavioral finance	The study of how psychology affects financial decision-making.
Loss aversion	The tendency to feel the pain of losses more strongly than the satisfaction of similar gains.
Recency bias	The tendency to overemphasize recent events when making investment decisions.
Overconfidence	The tendency to overestimate knowledge, forecasting ability, or control over outcomes.

Practice Questions

1. Which statement best describes risk tolerance?

A. The amount of risk required by the adviser's model portfolio.
B. The client's net worth divided by annual expenses.
C. The client's willingness to accept uncertainty, volatility, and possible loss.
D. The return needed to reach a financial goal.

2. A client says she enjoys speculative investments, but she has no emergency fund, unstable income, and tuition payments due in six months. What is the most important concern?

A. Her stated preference automatically controls the recommendation.
B. Her time horizon is long enough for aggressive growth.
C. Her investment experience eliminates the need for additional review.
D. Her risk capacity may be low despite high risk tolerance.

3. Which client preference is an example of a nonfinancial investment consideration?

A. The client's expected retirement benefit.
B. The client's marginal income tax bracket.
C. The client's desire to avoid investments that conflict with religious criteria.
D. The client's current account balance.

4. What is the primary purpose of client data gathering?

A. To replace the adviser's fiduciary duty with a signed form.
B. To determine the highest possible return for every client.
C. To avoid updating recommendations after the account is opened.
D. To collect and document the facts needed to make suitable recommendations.

5. A risk questionnaire produces an aggressive score, but the interview shows that the client would sell everything after a 10% decline. What should the adviser do?

A. Ignore the interview because the questionnaire is more objective.
B. Reconcile the inconsistency before making a recommendation.
C. Recommend the most aggressive model because the form permits it.
D. Treat the client as unsuitable for all investments.

6. Which situation most clearly creates a short time horizon?

A. A child's college expense due next semester.
B. A legacy goal for heirs.
C. Retirement expected in 30 years.
D. A charitable fund intended to operate indefinitely.

7. Which behavioral finance issue is shown when a client wants to buy an asset mainly because it has risen sharply in the past month?

A. Dollar-cost averaging.
B. Capital preservation.
C. Recency bias.
D. Tax-loss harvesting.

8. Why should advisers ask about a client's investment experience?

A. Experience guarantees that a recommendation is suitable.
B. Experience helps determine the level of explanation and whether the client understands relevant risks.
C. Experience is the only factor needed to determine an asset allocation.
D. Experienced clients never need risk disclosure.

9. A client has a long-term retirement goal but also needs cash for a home purchase in one year. What is the best approach?

A. Treat the entire portfolio as long-term because retirement is the largest goal.
B. Treat the entire portfolio as short-term because some cash is needed soon.
C. Use only illiquid alternatives because the client has multiple goals.
D. Separate the goals and match each portion of assets to its own time horizon.

10. Which statement about ESG or religious investment criteria is most accurate?

A. They remove the need to consider suitability.
B. They may affect diversification, costs, tracking error, and investment selection.
C. They must always be ignored because they are nonfinancial.
D. They automatically make a portfolio lower risk.

11. Which client event should generally trigger an update to the client profile?

A. The client experiences divorce, job loss, retirement, or a major inheritance.
B. The client receives a routine monthly statement.
C. The adviser changes office locations.
D. The S&P 500 closes unchanged for the day.

12. A client wants a return target that requires substantial risk but says he cannot tolerate any loss. What is the best adviser response?

A. Explain the trade-off and consider revising the goal, savings rate, or time horizon.
B. Refuse to discuss alternatives.
C. Recommend only one concentrated stock to reach the target faster.
D. Increase the risk anyway because the goal requires it.

Answer Key and Explanations

1. C — Risk tolerance is the client's willingness to accept volatility and possible loss.

2. D — The client may want risk, but near-term tuition, unstable income, and no emergency reserve limit financial ability to take risk.

3. C — Religious criteria are a nonfinancial investment consideration that may restrict the investment universe.

4. D — Data gathering creates the factual basis for a recommendation and documents the adviser's understanding of the client.

5. B — A questionnaire score should be reconciled with interview responses and financial facts.

6. A — A college expense due next semester creates a short time horizon and a liquidity need.

7. C — Recency bias occurs when recent performance is overemphasized.

8. B — Experience affects the education, explanation, and risk discussion required. It does not guarantee suitability.

9. D — Different goals can have different horizons and should be matched to appropriate assets.

10. B — Values-based criteria can affect implementation, diversification, tracking error, and costs.

11. A — Major life events can change goals, risk profile, liquidity needs, tax status, and account structure.

12. A — When risk need conflicts with tolerance, the adviser should discuss trade-offs instead of forcing risk into the portfolio.

Lesson 42: Capital Market Theory and CAPM Extensions

Learning Objectives

- Explain why **capital market theory** matters when building client portfolios and evaluating investment recommendations.
- Use the **Capital Asset Pricing Model (CAPM)** to connect **expected return**, **beta**, the **risk-free rate**, and the **market risk premium**.
- Apply **Modern Portfolio Theory (MPT)** concepts, including **diversification**, **correlation**, **systematic risk**, **unsystematic risk**, and the **efficient frontier**.
- Distinguish the **weak**, **semi-strong**, and **strong forms** of the **Efficient Market Hypothesis (EMH)**.
- Recognize common Series 65 exam traps involving beta, **alpha**, diversification, market efficiency, and risk-return trade-offs.

42.1 Why Capital Market Theory Matters

Capital market theory gives advisers a framework for turning client facts into portfolio recommendations. The theories do not guarantee outcomes, but they help explain why advisers diversify, why higher expected return usually requires higher risk, and why market forecasts should be treated carefully.

- CAPM focuses on the relationship between expected return and systematic market risk.
- MPT focuses on portfolio construction and the risk reduction that can come from combining assets.
- EMH focuses on how quickly market prices reflect information and what that means for active management.

> **Exam point**
> The exam often tests the relationship among risk, return, diversification, and suitability. A recommendation can be theoretically efficient but still unsuitable if it conflicts with the client profile.

42.2 Investment Theories, Models, and Hypotheses

This section uses three related but different ideas. A model simplifies reality to estimate a result. A theory explains relationships among variables. A hypothesis is a testable claim about how markets behave.

Concept	Primary Question	Exam Focus
CAPM	What expected return should an investment offer for its systematic risk?	Beta, risk-free rate, market risk premium, expected return, alpha
Modern Portfolio Theory	How can a portfolio be constructed to improve the risk-return trade-off?	Diversification, correlation, efficient frontier, systematic vs. unsystematic risk
Efficient Market Hypothesis	How much information is already reflected in market prices?	Weak, semi-strong, and strong forms; active vs. passive implications

42.3 Capital Asset Pricing Model (CAPM)

The **Capital Asset Pricing Model** estimates the required or expected return for an investment based on the return available from a risk-free asset plus compensation for market risk. CAPM focuses on systematic risk because unsystematic risk can be reduced through diversification.

CAPM formula
Expected return = Risk-free rate + Beta x (Market return - Risk-free rate)

CAPM Inputs

Input	Meaning	Series 65 Interpretation
Risk-free rate	The baseline return for taking minimal default risk.	Often represented by a Treasury bill, note, or bond rate depending on the time horizon.
Beta	The investment's market sensitivity.	Beta measures systematic risk, not total risk.
Market return	Expected return of the broad market portfolio.	Usually given in the question.
Market risk premium	Market return minus the risk-free rate.	The extra return required for taking market risk.

Example: Calculating Expected Return

1. Assume the risk-free rate is 4%.
2. Assume the expected market return is 10%.
3. The market risk premium is 6%: 10% - 4%.
4. A stock has a beta of 1.2.
5. CAPM expected return = 4% + 1.2 x 6% = 11.2%.

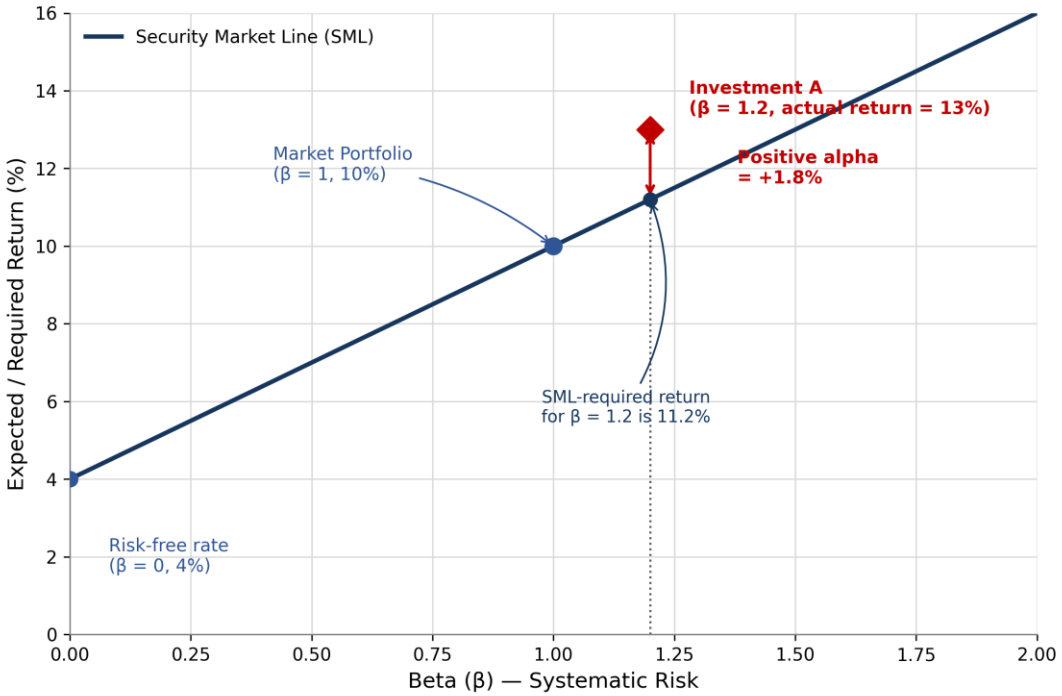


Figure 42.1: A graph of the Security Market Line (SML) demonstrating a positive alpha investment.

Exam point
If a stock's actual or forecast return is above the CAPM required return, the stock has positive alpha. If it is below the required return, the stock has negative alpha.

Beta and Portfolio Meaning

Beta	Meaning	Portfolio Implication
0.0	No market sensitivity in the model.	Return does not move with the market in CAPM terms.

Beta	Meaning	Portfolio Implication
0.5	Half as sensitive as the market.	Expected to move less than the market in broad swings.
1.0	Same sensitivity as the market.	Market-level systematic risk.
1.5	More sensitive than the market.	Greater market risk and higher required return under CAPM.
Negative beta	Moves opposite the market in the model.	May reduce portfolio market risk, but the exam rarely uses this except conceptually.

Alpha and the Security Market Line

The security market line plots expected return against beta. Under CAPM, fairly priced securities lie on the line. Securities above the line have returns that are high relative to their beta; securities below the line have returns that are low relative to their beta.

- Positive alpha: return exceeds the CAPM-required return.
- Negative alpha: return is below the CAPM-required return.
- Zero alpha: return equals the CAPM-required return.

The example above (Fig. 42.1) of the SML shows that Investment A has an expected return of 11.2% based on a risk-free rate of 4%, a market risk premium of 6%, and a beta of 1.2. An actual return of 13% results in an alpha of 13%-11.2%=1.8%.

Key CAPM Assumptions and Limitations

Assumption or limitation	Advisor-level meaning
Single-factor model	CAPM uses market beta as the only rewarded risk factor.
Historical beta may not persist	A security or portfolio can become more or less market-sensitive over time.
Expected returns are uncertain	Inputs are estimates, not guarantees.

Assumption or limitation	Advisor-level meaning
Risk-free rate choice matters	Different Treasury maturities can produce different CAPM outputs.
Diversification assumed	CAPM assumes investors are not paid for bearing avoidable issuer-specific risk.
Does not replace suitability analysis	A mathematically attractive expected return does not make the investment suitable for every client.

42.4 Modern Portfolio Theory

Modern Portfolio Theory emphasizes the portfolio as a whole rather than viewing each investment in isolation. The key idea is that combining assets with imperfectly correlated returns can reduce portfolio risk without necessarily reducing expected return by the same amount.

Core MPT idea
Portfolio risk depends on how investments behave together, not just on the risk of each investment by itself.

Diversification and Correlation

Correlation	Meaning	Diversification Effect
+1.0	Assets move perfectly together.	No diversification benefit from combining them.
Between 0 and +1	Assets tend to move together, but not perfectly.	Some diversification benefit.
0	No consistent relationship.	Meaningful diversification benefit.
Between -1 and 0	Assets tend to move in opposite directions.	Strong diversification benefit.

Correlation	Meaning	Diversification Effect
-1.0	Assets move perfectly opposite.	Maximum theoretical risk reduction.

Systematic and Unsystematic Risk

Risk Type	Examples	Can diversification reduce it?
Systematic risk	Recessions, inflation shocks, interest-rate changes, marketwide risk aversion	No. It remains even in a diversified portfolio.
Unsystematic risk	Company lawsuit, product failure, management scandal, plant fire, single-industry disruption	Yes. It can be reduced by holding a diversified portfolio.

Exam point
A diversified portfolio reduces unsystematic risk. It does not eliminate systematic risk.

Efficient Frontier

The efficient frontier represents portfolios that are efficient in a risk-return sense. A portfolio on the frontier offers the highest expected return available for a given level of risk, or the lowest risk available for a given expected return. Portfolios below the frontier are inefficient because another portfolio offers either more expected return for the same risk or less risk for the same expected return.

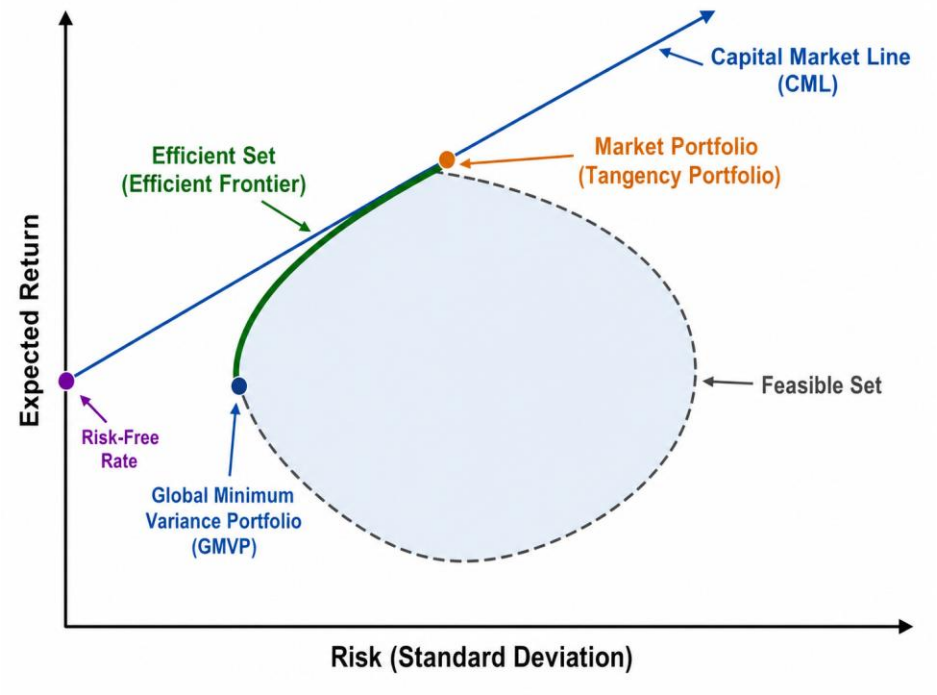


Figure 42.2: A graph of the Feasible Set, Efficient Set (or Efficient Frontier), and the Capital Market Line

Portfolio Position	Meaning	Adviser Implication
On the efficient frontier	Best available risk-return trade-off for a given set of assumptions.	May be considered efficient, subject to client suitability.
Below the efficient frontier	Inferior risk-return trade-off.	Usually not preferred if a better portfolio is available.
Above the efficient frontier	Not available under the current assumptions.	Would be unrealistic unless assumptions change.

Assumptions and Limitations

- Expected returns, standard deviations, and correlations are estimates, not guarantees.
- Correlation can change during market stress, reducing diversification benefits when they are most needed.
- MPT does not replace suitability analysis; client objectives, liquidity needs, taxes, and constraints still matter.

- A mathematically efficient portfolio may still be inappropriate for a client who cannot tolerate the volatility.

42.5 Efficient Market Hypothesis

The Efficient Market Hypothesis addresses how quickly and accurately security prices reflect information. If markets are highly efficient, it is difficult for investors to consistently earn excess risk-adjusted returns using widely available information.

Form of EMH	Information Reflected in Price	Implication
Weak form	Past price and volume data.	Technical analysis should not consistently produce excess returns.
Semi-strong form	All publicly available information.	Fundamental analysis should not consistently produce excess returns after information is public.
Strong form	All public and private information.	Even insider information would not create consistent excess returns; this is the strictest and least realistic form.

Exam point
Weak form challenges technical analysis. Semi-strong form challenges fundamental analysis based on public information. Strong form says even private information is reflected in price.

Active and Passive Management Implications

View of Market Efficiency	Likely Strategy Preference	Reasoning
More efficient	Passive or low-cost index approach	Harder to justify higher fees if excess return is unlikely.
Less efficient	Selective active management	Mispricing may be more likely in less-covered markets.

View of Market Efficiency	Likely Strategy Preference	Reasoning
Client-specific need	Either active or passive, depending on fit	Taxes, risk, liquidity, and preferences still matter.

42.6 How the Three Ideas Work Together

Question	Best Concept	How to Think About It
What return should this stock require for its market risk?	CAPM	Use beta and the market risk premium.
How should assets be combined in a portfolio?	MPT	Use diversification, correlation, and the efficient frontier.
Can the adviser consistently beat the market using public information?	EMH	Consider how efficiently prices reflect information.
Is the recommendation suitable for this client?	Client profile and fiduciary analysis	Capital market theory supports the analysis but does not replace client-specific facts.

42.7 Case Application

A 45-year-old client wants long-term growth and can tolerate moderate volatility. The client currently owns five technology stocks and asks whether adding another technology stock would create adequate diversification.

- CAPM question: What beta and expected return does the proposed stock add to the portfolio?
- MPT question: Does the new stock reduce portfolio risk, or is it highly correlated with existing holdings?
- EMH question: Is the recommendation based on publicly available information that may already be reflected in the price?
- Suitability question: Does the resulting portfolio match the client's objectives, risk tolerance, time horizon, liquidity needs, and tax situation?

Best recommendation frame
Adding one more stock in the same sector may not provide meaningful diversification. A broader mix of assets may better address unsystematic risk.

Key Takeaways

- CAPM links expected return to systematic risk using beta.
- MPT focuses on portfolio construction and diversification benefits.
- Diversification can reduce unsystematic risk but cannot eliminate systematic risk.
- The efficient frontier identifies efficient risk-return combinations based on assumptions.
- EMH describes how information may be reflected in prices and explains why consistent risk-adjusted outperformance can be difficult.
- For the Series 65 exam, theory must be applied through the client profile, not in isolation.

42.8 Factor Models as Extensions of CAPM

CAPM is a one-factor model: market risk explains expected return. Factor models extend this idea by adding other broad, persistent return drivers that may help explain why portfolios with different characteristics perform differently.

- A factor is a measurable source of risk or return that affects many securities.
- Factor exposure, sometimes called factor loading, measures how sensitive a portfolio is to a factor.
- Factor models are often used for performance attribution, risk analysis, and portfolio construction.
- Factor tilts can increase tracking error, periods of underperformance, and client-behavior risk.

42.9 Fama-French Three-Factor Model

The **Fama-French three-factor model** extends CAPM by adding size and value factors to the market factor. It is often used to evaluate whether a manager or portfolio return is explained by broad factor exposure rather than security selection skill.

Three-factor model
Portfolio excess return = Market factor + Size factor + Value factor + unexplained return

Factor	Common label	What it captures	Simple interpretation
Market	Mkt-RF	Market return above the risk-free rate.	Equity market risk exposure.

Factor	Common label	What it captures	Simple interpretation
Size	SMB	Small minus big.	Exposure to smaller companies relative to larger companies.
Value	HML	High minus low book-to-market.	Exposure to value stocks relative to growth stocks.

Interpreting Three-Factor Exposure

- A positive SMB exposure means the portfolio behaves more like small-cap stocks than large-cap stocks.
- A positive HML exposure means the portfolio behaves more like value stocks than growth stocks.
- A portfolio can outperform the market because it had factor exposure, not necessarily because the adviser selected superior securities.
- When discussing factor tilts with clients, explain the potential benefits and the risk of long periods of underperformance.

42.10 Fama-French Five-Factor Model

The **Fama-French five-factor model** extends the three-factor model by adding profitability and investment factors. It is more detailed than the three-factor model and is designed to explain a broader set of differences in stock returns.

Five-factor model
Portfolio excess return = Market + Size + Value + Profitability + Investment + unexplained return

Factor	Common label	What it captures	Simple interpretation
Market	Mkt-RF	Market return above the risk-free rate.	Broad equity market exposure.
Size	SMB	Small minus big.	Small-cap exposure.
Value	HML	High minus low book-to-market.	Value versus growth exposure.

Factor	Common label	What it captures	Simple interpretation
Profitability	RMW	Robust minus weak profitability.	Exposure to firms with stronger profitability.
Investment	CMA	Conservative minus aggressive investment.	Exposure to firms that invest conservatively rather than aggressively.

Practical Advisor Uses

- Explain why a portfolio outperformed or underperformed a benchmark.
- Identify hidden factor bets inside mutual funds, ETFs, or separately managed accounts.
- Compare active management returns to returns that could be explained by passive factor exposure.
- Build more deliberate allocations to size, value, profitability, or investment factors when suitable.
- Prepare clients for tracking error and multi-year periods in which a factor tilt may lag the broad market.

Suitability and Communication Considerations

Issue	Advisor response
Complexity	Use plain-language explanations and avoid implying that the model predicts returns with certainty.
Risk tolerance	Higher beta or strong factor tilts may be unsuitable for clients who cannot tolerate volatility.
Time horizon	Factor strategies generally require patience because premiums can be negative for long periods.
Diversification	A factor-tilted portfolio still needs diversification across issuers, sectors, and asset classes.

Issue	Advisor response
Disclosure	Explain that models are based on assumptions, estimates, and historical relationships.

42.15 Series 65 Exam Traps

42.8 Common Series 65 Exam Traps

- Beta measures systematic market risk, not total risk.
- Diversification reduces unsystematic risk, not systematic risk.
- Correlation is about how investments move together, not how high their returns are.
- The efficient frontier is based on estimates and does not guarantee future performance.
- Weak-form EMH is mainly about past price and volume information.
- Semi-strong-form EMH is mainly about public information.
- CAPM does not say investors are rewarded for unsystematic risk.
- A beta above 1.0 generally implies higher systematic risk than the market.
- The market risk premium is the expected market return minus the risk-free rate.
- Fama-French models add factors beyond CAPM, but they do not guarantee superior performance.
- Factor exposure can explain performance that might otherwise be mistaken for manager skill.
- Model output does not replace client-specific suitability analysis.

Quick Review

Model	Primary idea	Main exam point
CAPM	Expected return is tied to systematic risk measured by beta.	Know the formula and how to interpret beta.
Fama-French Three-Factor Model	Adds size and value factors to the market factor.	Recognize SMB and HML as extensions beyond CAPM.
Fama-French Five-Factor Model	Adds profitability and investment factors to the three-factor model.	Recognize RMW and CMA and understand factor exposure.

Key Terms

Term	Definition
Beta	A measure of an investment's sensitivity to broad market movements. A beta above 1.0 implies greater market volatility than the market; a beta below 1.0 implies less.
Alpha	Return above or below what would be expected for the level of risk taken, commonly measured relative to CAPM or a benchmark.
Risk-free rate	The theoretical return on an investment with no default risk, often represented by a U.S. Treasury rate in exam questions.
Market risk premium	The extra return investors expect for taking market risk instead of holding the risk-free asset.
Systematic risk	Marketwide risk that cannot be diversified away, such as recession risk, interest-rate shocks, or broad market declines.
Unsystematic risk	Company-specific or industry-specific risk that can be reduced through diversification.
Efficient frontier	The set of portfolios that offers the highest expected return for each level of risk, or the lowest risk for each expected return.
Efficient Market Hypothesis	The hypothesis that security prices reflect available information, making consistent risk-adjusted outperformance difficult.

Practice Questions

1. Under CAPM, which risk is rewarded with a higher expected return?

A. Unsystematic risk
B. Systematic risk
C. Diversified risk
D. Accounting risk

2. A stock has a beta of 1.4. Compared with the market, it is generally expected to be:

A. Equally volatile as the market
B. More sensitive to market movements
C. Less volatile than the market
D. Unrelated to market movements

3. The risk-free rate is 3%, the expected market return is 9%, and a stock has a beta of 1.5. What is the CAPM expected return?

A. 12%
B. 9%
C. 13.5%
D. 10.5%

4. Which statement best describes unsystematic risk?

A. It is company-specific risk that can be reduced through diversification.
B. It is the risk measured by the market risk premium.
C. It is marketwide risk that cannot be diversified away.
D. It is the required return under CAPM.

5. Which pair of assets offers the greatest diversification benefit?

A. Two assets with correlation of 0
B. Two assets with correlation of +0.8
C. Two assets with correlation of +1.0
D. Two assets with correlation of -0.6

6. A portfolio below the efficient frontier is generally considered:

A. Risk-free because it is below the frontier
B. Efficient because it has lower return
C. Impossible because all portfolios lie on the frontier
D. Inefficient because a better risk-return combination is available

7. The weak form of EMH most directly challenges the usefulness of:

A. Asset allocation
B. Fundamental analysis using public financial statements
C. Technical analysis
D. Insider trading

8. The semi-strong form of EMH says prices reflect:

A. Private information only
B. Past prices only
C. No useful information
D. Public information

9. A stock earns 14% when CAPM indicates it should have earned 11% for its beta. The stock has:

A. Zero alpha
B. Positive alpha
C. No systematic risk
D. Negative alpha

10. Which statement is most accurate for adviser recommendations?

A. Capital market theory supports, but does not replace, suitability analysis.
B. CAPM guarantees the future return of a security.
C. MPT eliminates the need to evaluate client risk tolerance.
D. EMH proves active management is always illegal.

11. Under CAPM, which risk is expected to be rewarded with higher expected return?

A. Unsystematic risk
B. Liquidity risk only
C. Systematic risk
D. Inflation risk only

12. A stock has a beta of 1.4. Which statement is most accurate?

A. It has no market risk.
B. It is expected to be more sensitive to market movements than the market.
C. It is expected to be less volatile than the market.
D. It must have a negative alpha.

13. The risk-free rate is 3%, the expected market return is 9%, and beta is 1.5. What is the CAPM expected return?

A. 12.0%
B. 6.0%
C. 16.5%
D. 9.0%

14. What does the market risk premium equal?

A. Beta minus alpha
B. Portfolio return minus the standard deviation
C. Expected market return minus the risk-free rate
D. Risk-free rate plus beta

15. Which statement best describes unsystematic risk?

A. It is issuer-specific risk that diversification can reduce.
B. It is market-wide risk that cannot be diversified away.
C. It is the same as beta.
D. It is measured only by the risk-free rate.

16. Which factor is added by the Fama-French three-factor model but not by CAPM?

A. CMA
B. Risk-free rate
C. SMB
D. RMW

17. In the Fama-French models, HML is most closely associated with:

A. interest-rate sensitivity
B. conservative investment
C. value versus growth exposure
D. profitability

18. Which factors are added in the Fama-French five-factor model?

A. Inflation and liquidity
B. Duration and convexity
C. Currency and commodity exposure
D. Profitability and investment

19. A manager outperforms the S&P 500 because the portfolio had heavy small-cap and value exposure during a period when those factors performed well. What is the best interpretation?

A. The portfolio had no systematic risk.
B. The portfolio was risk-free.
C. The manager necessarily generated alpha.
D. The outperformance may be explained by factor exposure.

20. Which statement is most appropriate when discussing factor strategies with a client?

A. Factor models eliminate the need for diversification.
B. Factor premiums can vary and may underperform for long periods.
C. Factor strategies always outperform broad market indexes.
D. A high beta makes a portfolio suitable for every client.

21. A portfolio plots below the Security Market Line. Under CAPM, this most likely means:

A. expected return is lower than required for its beta
B. expected return is higher than required for its beta
C. the portfolio is guaranteed to lose money
D. the portfolio has no market risk

22. Which statement best summarizes how the Fama-French models relate to CAPM?

A. They reject the idea of systematic risk entirely.
B. They eliminate the need for a benchmark.
C. They only apply to bonds.
D. They add additional factors to the market factor used in CAPM.

Answer Key and Explanations

1. B — CAPM rewards systematic risk because unsystematic risk can be reduced through diversification.

2. B — A beta of 1.4 means the stock is more sensitive to market movements than the market portfolio.

3. A — Market risk premium = 9% - 3% = 6%. Expected return = 3% + 1.5 x 6% = 12%.

4. A — Unsystematic risk is specific to a company or industry and can be reduced through diversification.

5. D — Lower correlation creates more diversification benefit. Negative correlation is especially helpful.

6. D — A portfolio below the efficient frontier is inefficient because another portfolio offers a better risk-return trade-off.

7. C — Weak-form EMH says past price and volume information are already reflected in current prices.

8. D — Semi-strong-form EMH says all publicly available information is reflected in prices.

9. B — The stock outperformed the CAPM-required return, so it has positive alpha.

10. A — Capital market theory helps structure recommendations, but the adviser must still evaluate the client profile and suitability.

11. C — CAPM rewards systematic market risk measured by beta, not diversifiable issuer-specific risk.

12. B — A beta above 1.0 means the stock is more sensitive to market movements than the broad market.

13. A — Market risk premium is 9% - 3% = 6%. CAPM return is 3% + 1.5 x 6% = 12%.

14. C — The market risk premium is the expected return on the market above the risk-free rate.

15. A — Unsystematic risk is company-specific or industry-specific risk that can generally be reduced through diversification.

16. C — The three-factor model adds size (SMB) and value (HML) to the market factor.

17. C — HML is high minus low book-to-market and is commonly interpreted as value versus growth exposure.

18. D — The five-factor model adds profitability (RMW) and investment (CMA) to the market, size, and value factors.

19. D — Factor models help distinguish factor-driven performance from unexplained excess return.

20. B — Factor strategies involve risk and tracking error; premiums are not guaranteed and can lag for extended periods.

21. A — Below the SML means the expected return is too low relative to CAPM-required return for that level of beta.

22. D — Fama-French models extend the CAPM framework by adding factors beyond market beta.

Lesson 43: Modern Portfolio Theory

Learning Objectives

- Define **Modern Portfolio Theory (MPT)** and explain why diversification depends on **correlation** and **covariance**.
- Calculate and interpret expected portfolio return for a multi-asset portfolio.
- Explain why **portfolio risk** is not a simple weighted average of each holding's risk.
- Identify **efficient**, **inefficient**, and **unattainable** portfolios using the efficient frontier.
- Explain how a risk-free asset changes the investment opportunity set through the **capital market line**.
- Apply MPT concepts to Series 65 suitability and portfolio recommendation questions.

43.1 Core Idea of Modern Portfolio Theory

Modern Portfolio Theory is a framework for building portfolios by combining expected return, risk, and the relationships among assets. The theory was developed from the insight that a portfolio's risk depends not only on the risk of the individual securities, but also on how those securities move relative to one another.

- **Portfolio focus:** An adviser should evaluate how a new investment changes the client's total portfolio, not just whether the investment looks attractive by itself.
- **Risk-return tradeoff:** Investors generally require a higher expected return to accept higher expected risk.
- **Diversification benefit:** Risk reduction is strongest when assets have low or negative correlation.
- **Efficiency:** A portfolio is efficient if no other portfolio offers higher expected return for the same risk or lower risk for the same expected return.

Exam point
On the exam, MPT questions often test the practical idea: adding a volatile investment can reduce overall portfolio risk if it has low correlation with the rest of the portfolio.

43.2 MPT Inputs

MPT uses estimates, not guarantees. The model requires assumptions about future returns, volatility, and relationships among assets. Advisers should understand the inputs and the limitations of relying on them.

Input	Meaning	Client-facing interpretation
Expected return	The anticipated average return for an asset or portfolio.	What the client may reasonably expect over the relevant time horizon, not a promise.
Standard deviation	A common measure of volatility around the expected return.	How much returns may vary from the average.
Variance	Standard deviation squared.	Used in portfolio risk calculations.
Covariance	Measures whether two assets tend to move together or in opposite directions.	A positive covariance means assets usually move together; a negative covariance means they often offset each other.
Correlation	Standardized measure from -1 to +1 showing the strength and direction of co-movement.	Lower correlation generally creates a larger diversification benefit.

43.3 Expected Portfolio Return

Expected portfolio return is the weighted average of the expected returns of the holdings:

Expected Portfolio Return = (Weight 1 x Return 1) + (Weight 2 x Return 2) + … + (Weight n x Return n)

Example: A portfolio has 60% in equities with an expected return of 8% and 40% in bonds with an expected return of 4%.

- Expected return = (0.60 x 8%) + (0.40 x 4%)
- Expected return = 4.8% + 1.6% = 6.4%

Exam point Portfolio return is a weighted average. Portfolio risk is not usually a weighted average because correlation affects how the holdings interact.

43.4 Portfolio Risk and Diversification

Portfolio risk depends on each holding's volatility and on the relationships among holdings. The variance of a two-asset portfolio is calculated as follows.

Two-asset portfolio risk formula
Portfolio variance = $w_a^2\sigma_a^2 + w_b^2\sigma_b^2 + 2w_a w_b \sigma_a \sigma_b \rho_{ab}$,
where w is the weight of the asset in the portfolio, σ is the standard deviation of the asset's return, and ρ is the correlation coefficient.

- **Positive correlation:** Assets tend to move in the same direction. Diversification benefit is limited.
- **Zero correlation:** Assets have no consistent relationship. Diversification can reduce portfolio volatility.
- **Negative correlation:** Assets tend to move in opposite directions. Diversification benefit can be strong.
- **Perfect positive correlation (+1.0):** The assets move together exactly; diversification does not reduce volatility beyond averaging the positions.
- **Perfect negative correlation (-1.0):** The assets move exactly opposite one another; risk can theoretically be greatly reduced or eliminated at the right weights.

Correlation	Meaning	Diversification impact
+1.0	Perfectly positive relationship	No true diversification benefit from combining the assets.
+0.6	Assets often move together	Some benefit, but limited.
0.0	No consistent relationship	Meaningful risk reduction is possible.
-0.3	Assets sometimes offset each other	Stronger risk reduction is possible.
-1.0	Perfectly negative relationship	Theoretically strongest risk reduction.

43.5 Diversifiable and Nondiversifiable Risk

MPT helps explain why holding many securities can reduce company-specific risk, but it cannot eliminate broad market risk.

Risk type	Also called	Can diversification reduce it?	Examples
Unsystematic risk	Specific, unique, diversifiable risk	Yes	Bad earnings report, product recall, loss of a major customer, management scandal.
Systematic risk	Market, nondiversifiable risk	No	Recession, interest rate shock, broad inflation surprise, market-wide liquidity crisis.

Exam point
An adviser should not claim that diversification eliminates all investment risk. It reduces unsystematic risk but does not eliminate systematic risk.

43.6 Efficient Frontier

The efficient frontier (aka efficient set) is the set of portfolios that offer the highest expected return for each level of risk, or the lowest risk for each level of expected return. Portfolios below the frontier are inefficient because a better risk-return combination is available.

- **Efficient portfolio:** No other available portfolio has a higher expected return for the same risk or lower risk for the same expected return.
- **Inefficient portfolio:** Another portfolio offers a better risk-return tradeoff.
- **Unattainable point:** A combination that cannot be achieved with the available asset set.
- **Minimum-variance portfolio:** The portfolio on the frontier with the lowest expected volatility.
- **Feasible set:** The set of expected returns and standard deviations of all possible sets of risky assets.

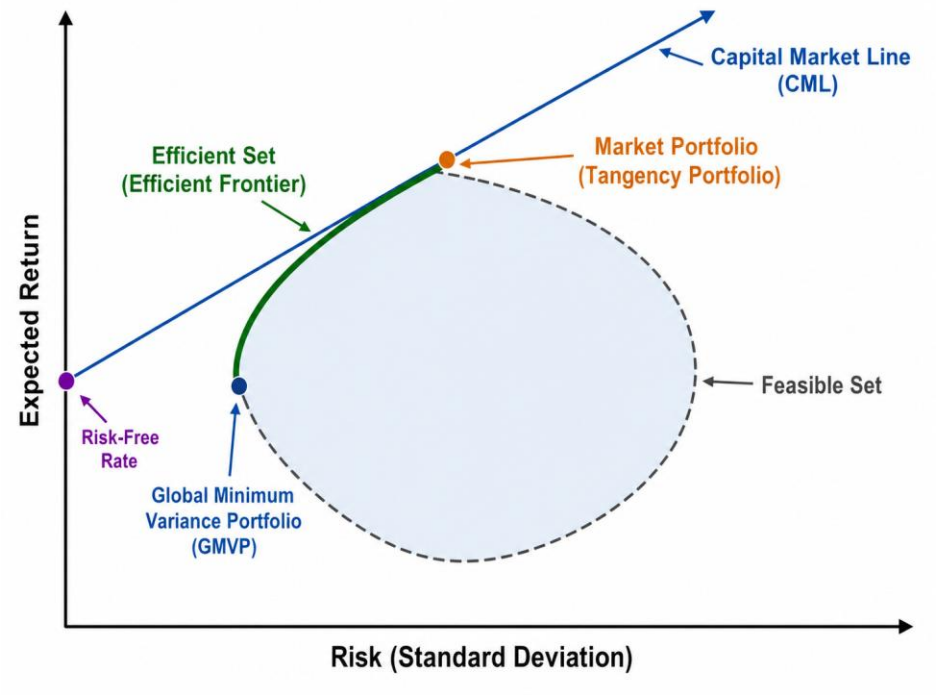


Figure 43.1: A graph of the Feasible Set, Efficient Set (or Efficient Frontier), and the Capital Market Line

Exam point
The efficient frontier does not identify one perfect portfolio for every client. The best portfolio depends on the client's risk tolerance, risk capacity, liquidity needs, time horizon, and objectives.

43.7 Risk-Free Asset, Capital Market Line, and Separation

When a risk-free asset is available, investors can combine the risk-free asset with a risky portfolio. In capital market theory, the line from the risk-free rate tangent to the efficient frontier is the **capital market line (CML)**. The tangent portfolio is often called the market portfolio in the theoretical model.

- **Capital market line:** Shows combinations of the risk-free asset and the optimal risky portfolio.
- **Conservative investor:** May hold more risk-free assets and less of the risky portfolio.
- **Aggressive investor:** May hold more of the risky portfolio and, in theory, borrow at the risk-free rate to increase exposure.
- **Separation idea:** Portfolio selection can be separated into choosing the best risky portfolio and deciding how much risk the client should take.

Exam point
Do not overstate the model. Real clients cannot always borrow at a risk-free rate, and an adviser must still evaluate suitability, liquidity needs, taxes, costs, and constraints.

43.8 Applying MPT to Client Recommendations

MPT is useful for portfolio construction, but the adviser's recommendation must still be client-specific. The same efficient portfolio may be unsuitable for one client and appropriate for another.

Client factor	How it affects MPT implementation
Risk tolerance	Determines how much volatility the client is emotionally willing to accept.
Risk capacity	Determines how much risk the client can financially afford to accept.
Time horizon	Longer horizons may allow more exposure to volatile assets; shorter horizons usually require more stability.
Liquidity needs	Assets needed soon should not be placed in highly volatile or illiquid investments.
Tax situation	Asset location, turnover, realized gains, and tax-exempt income may affect the recommendation.
Existing investments	A new holding should be evaluated by its effect on the total portfolio, including concentration and correlation.

43.9 Assumptions and Limitations

- Expected returns, standard deviations, and correlations are estimates and may change over time.
- The model often assumes normally distributed returns, but real-world returns can include fat tails and extreme events.
- The model generally treats volatility as risk, while clients may think of risk as permanent loss, income shortfall, or failure to meet goals.

- Taxes, transaction costs, liquidity constraints, and behavioral mistakes can reduce the usefulness of a mathematically efficient portfolio.
- Correlations can rise during market stress, reducing diversification exactly when the client most wants it.
- Inputs can be manipulated to produce misleading optimization results. A small change in assumptions can produce a very different recommended portfolio.

Advisor standard
MPT is a tool, not a substitute for a reasonable basis, client-specific suitability, and ongoing review.

43.10 Worked Example

A client currently owns a concentrated portfolio of large U.S. growth stocks. The client asks whether adding a short-term bond fund is sensible even though its expected return is lower than the stock portfolio.

- The bond fund has a lower expected return than the stock portfolio.
- The bond fund also has lower volatility and low correlation with the existing equity holdings.
- Adding the bond fund may reduce total portfolio risk and make the portfolio more suitable for a moderate-risk client.
- The recommendation should still consider taxes, time horizon, liquidity needs, investment policy, and the client's required return.

Key conclusion
Under MPT, a lower-return asset can improve a portfolio if it improves the total risk-return tradeoff or better aligns the portfolio with the client's needs.

Series 65 Exam Tips

Question clue	Likely concept
"An investment is risky by itself but lowers total portfolio risk."	Low or negative correlation; diversification benefit.
"Highest expected return for a given level of risk."	Efficient frontier.
"Risk that remains after diversification."	Systematic risk.

Question clue	Likely concept
“Company-specific risk reduced by owning many securities.”	Unsystematic risk.
“Portfolio risk calculation includes relationship among assets.”	Covariance or correlation.
“Model is mathematically precise but depends heavily on estimates.”	MPT limitations.

Practice Questions

1. Which statement best describes Modern Portfolio Theory?

A. It assumes all portfolios should hold only risk-free assets.
B. It ranks securities only by their individual expected returns.
C. It eliminates the need to consider a client’s objectives.
D. It evaluates investments based on how they affect the risk and return of the total portfolio.

2. A portfolio is 70% invested in an asset expected to return 9% and 30% invested in an asset expected to return 3%. What is the expected portfolio return?

A. 7.2%
B. 4.8%
C. 5.1%
D. 12.0%

3. Which pair of assets generally offers the greatest diversification benefit?

A. Two assets with a correlation of -0.6
B. Two assets with a correlation of 0.0
C. Two assets with a correlation of +1.0
D. Two assets with a correlation of +0.8

4. Which risk is most directly reduced through diversification?

A. Interest rate risk
B. Systematic risk
C. Market risk
D. Unsystematic risk

5. What does the efficient frontier represent?

A. Portfolios selected after ignoring correlation.
B. Portfolios made only of risk-free assets.
C. Portfolios that offer the best expected return for each level of risk.
D. Portfolios with the lowest tax cost regardless of risk.

6. A portfolio below the efficient frontier is best described as:

A. efficient.
B. unattainable.
C. inefficient.
D. risk-free.

7. Which statement about portfolio risk is correct?

A. It depends only on expected return.
B. It is always the weighted average of the risks of individual holdings.
C. It is eliminated by holding 20 or more securities.
D. It depends on volatility and the correlation among holdings.

8. A client owns only the stock of one employer. Which MPT concern is most directly present?

A. Perfect negative correlation
B. Excessive unsystematic risk
C. Too much diversification
D. Absence of any systematic risk

9. Which statement is a limitation of MPT?

A. It requires every client to own the same portfolio.
B. It is based solely on realized tax losses.
C. Correlations and expected returns can change over time.
D. It never uses estimates.

10. The capital market line shows combinations of:

A. unsystematic risk and diversifiable risk.
B. the risk-free asset and the optimal risky portfolio.
C. two individual common stocks only.
D. municipal bonds and tax shelters only.

11. An adviser adds a low-return bond fund to an equity portfolio, lowering expected return but significantly reducing volatility. Under MPT, this recommendation may be appropriate if:

A. the client's objectives and risk profile support the lower-risk portfolio.
B. the client wants the highest possible return regardless of risk.
C. the bond fund has perfect positive correlation with the equities.
D. the adviser guarantees the bond fund cannot lose money.

12. Which concept explains why a volatile asset can reduce a portfolio's total risk?

A. Tax equivalency
B. Low correlation with existing holdings
C. Margin borrowing
D. Dividend exclusion

Answer Key and Explanations

1. D — MPT evaluates securities in the context of the overall portfolio, including diversification and correlation.

2. A — Expected return = (0.70 x 9%) + (0.30 x 3%) = 6.3% + 0.9% = 7.2%.

3. A — Lower and negative correlations generally produce stronger diversification benefits.

4. D — Diversification can reduce security-specific or unsystematic risk, but not broad systematic risk.

5. C — The efficient frontier contains portfolios with the best risk-return tradeoffs from the available opportunity set.

6. C — A portfolio below the frontier is inefficient because a better risk-return combination is available.

7. D — Portfolio risk is affected by the standard deviation of holdings and by covariance/correlation among them.

8. B — A concentrated employer-stock position exposes the client to substantial company-specific risk.

9. C — MPT depends on inputs such as expected return, volatility, and correlation, which may change.

10. B — The CML represents combinations of the risk-free asset and the tangent or optimal risky portfolio.

11. A — The recommendation may be suitable if it creates a better client-specific risk-return tradeoff.

12. B — A volatile asset may reduce total portfolio risk when it has low or negative correlation with existing holdings.

Lesson 44: Efficient Market Hypothesis

Learning Objectives

- Define the **Efficient Market Hypothesis** (EMH) and explain what it does and does not claim.
- Distinguish weak-form, semi-strong-form, and strong-form market efficiency.
- Apply EMH to technical analysis, fundamental analysis, active management, indexing, and market timing.
- Recognize common market anomalies and behavioral finance critiques.
- Use EMH concepts when evaluating client investment recommendations and portfolio strategy.

> **Exam Point**
> EMH is usually tested through recognition. Key trigger phrases are past prices, public information, and private or insider information.

44.1 Core Idea

The **Efficient Market Hypothesis** is an investment theory that examines how quickly and completely security prices reflect information. The central idea is that in a competitive market with many informed participants, it is difficult to consistently earn abnormal risk-adjusted returns by using information that is already incorporated into market prices.

EMH does not say that all prices are always correct, that investors cannot lose money, or that every client should own the same portfolio. It says that consistently beating a properly adjusted benchmark is difficult when the information used to make the decision is already reflected in price.

Important Distinctions

- Positive return is not the same as abnormal return. An investor may earn a positive return because the market rises or because the investor takes more risk.
- Abnormal return means return above what would be expected after adjusting for risk, costs, and the relevant benchmark.
- Market efficiency is about information and prices; it is not the same as low trading costs or a perfectly fair market.
- A market can be generally efficient while still experiencing temporary mispricing, bubbles, panics, or client behavior problems.

44.2 Forms of Market Efficiency

The three common forms of EMH differ based on the type of information assumed to be reflected in current security prices.

Form	Information reflected in price	Most direct implication	Series 65 trigger phrase
Weak form	Past price and trading-volume data	Technical analysis should not consistently produce abnormal risk-adjusted returns.	Past prices; chart patterns; trading history
Semi-strong form	All publicly available information	Fundamental analysis should not consistently beat the market after risk and costs if information is public.	News, earnings, financial statements, public filings
Strong form	All public and private information	Even investors with private information could not consistently earn abnormal returns. This is the most extreme form.	Private information; insider information; material nonpublic information

Weak-Form Efficiency

Weak-form efficiency states that current prices reflect past price and trading-volume information. If this form holds, technical analysis and chart reading should not consistently generate abnormal risk-adjusted returns because historical price patterns are already incorporated into current prices.

- Technical analysis is the main strategy challenged by weak-form EMH.
- The weak form does not rule out fundamental analysis, because it focuses only on historical market data.
- Random walk language is often associated with weak-form efficiency because price changes should be difficult to predict from past price changes alone.

Semi-Strong-Form Efficiency

Semi-strong-form efficiency states that current prices reflect all publicly available information. Public information includes past prices, company financial statements, SEC filings, earnings announcements, dividend changes, product news, analyst reports, macroeconomic news, and other information available to market participants.

- Fundamental analysis is the main strategy challenged by semi-strong-form EMH.

- Prices may move when new public information is released, but they should adjust quickly if the market is semi-strong efficient.
- This form supports the practical case for low-cost index funds and diversified passive exposure for many clients.

Strong-Form Efficiency

Strong-form efficiency states that current prices reflect all information, including private information. This is the strongest and least realistic version of EMH. In practice, securities law treats material nonpublic information as important because insiders may have an informational advantage and because trading on such information can be unlawful.

- Strong-form efficiency is usually discussed as a theoretical benchmark.
- The phrase private information or insider information is the exam clue for strong-form EMH.
- Strong-form efficiency does not make insider trading legal; legal and ethical rules still apply.

44.3 EMH and Investment Strategy

Efficient markets do not remove the need for investment advice. They shift the emphasis from short-term prediction toward disciplined portfolio construction, cost control, diversification, tax awareness, risk management, and suitability or fiduciary analysis.

Common Strategy Implications

- Passive investing: EMH supports the use of broad, low-cost index funds or ETFs when the investor does not have a clear reason to expect successful active management.
- Active management: EMH does not prove active management can never work, but it raises the hurdle. The manager must overcome costs, taxes, trading frictions, and benchmark risk.
- Market timing: EMH challenges repeated attempts to move in and out of markets based only on widely known information.
- Diversification: EMH complements diversification because clients still bear systematic risk even when markets process information efficiently.
- Client-centered advice: recommendations should fit the client's goals, risk tolerance, liquidity needs, tax situation, time horizon, and legal constraints.

What EMH Does Not Mean

- It does not mean prices are always exactly equal to intrinsic value.
- It does not mean all investments have the same risk or expected return.
- It does not mean investors should ignore taxes, fees, liquidity, or diversification.
- It does not mean every active manager is wrong in every period.
- It does not eliminate the adviser's duty to make suitable or fiduciary recommendations.

44.4 Anomalies and Critiques

A market anomaly is an observed pattern that appears inconsistent with a simple version of EMH. Anomalies are important because they help explain why some investors use factor

investing, behavioral finance, or active management approaches. They also remind us that EMH is a model, not a guarantee that prices are always perfect.

Anomaly or critique	Basic idea	Why it matters
Momentum	Recent winners may continue to outperform for a period.	Challenges the idea that past price trends never help.
Value effect	Lower valuation stocks have at times produced higher long-run returns.	Can be interpreted as risk compensation, mispricing, or both.
Size effect	Small-company stocks have sometimes earned higher long-run returns.	May reflect risk, liquidity, or market segmentation.
Post-earnings announcement drift	Prices may continue moving after earnings surprises.	Suggests prices may not fully adjust instantly.
Behavioral biases	Investors may overreact, underreact, herd, or anchor on irrelevant information.	Can contribute to temporary mispricing.
Limits to arbitrage	Trading costs, risk, short-sale constraints, and funding limits may prevent quick correction.	Mispricing can persist even when informed traders notice it.

Exam point
An anomaly does not automatically prove markets are useless or that a client should speculate. Client objectives, risk, costs, taxes, and time horizon still control the recommendation.

44.5 Applying EMH to Client Recommendations

For Series 65 purposes, EMH matters because an investment adviser representative must explain strategies in a balanced way. A recommendation should not depend on unsupported claims that the adviser can reliably predict market moves from widely known information or simple chart patterns.

Questions an Adviser Should Ask

- Is the proposed strategy based on information that is already public or already reflected in price?
- Does the strategy have a reasonable basis after considering risk, fees, taxes, liquidity, and trading costs?
- Is the strategy appropriate for this client's time horizon, objectives, cash-flow needs, and risk tolerance?
- Would a low-cost diversified alternative provide similar exposure with less complexity?
- Is the performance claim based on risk-adjusted results and an appropriate benchmark, or only on selected past returns?

EMH and Common Analysis Methods

Method	What it uses	EMH form most relevant	Practical takeaway
Technical analysis	Charts, price trends, volume patterns	Weak form	Weak-form EMH questions whether this information can reliably produce abnormal returns.
Fundamental analysis	Financial statements, valuation, business and economic data	Semi-strong form	Semi-strong EMH says public fundamentals should already be reflected in price.
Insider information	Material nonpublic information	Strong form	Strong-form EMH is theoretical; legal restrictions still apply.
Index investing	Broad market exposure at low cost	Semi-strong form	A common response to the difficulty of consistently identifying mispriced securities.

44.6 Worked Examples

Example 1: Technical trading system

An adviser says a moving-average pattern consistently predicts which stocks will rise next month. The EMH issue is weak-form efficiency because the claim is based on past prices. A compliant discussion should address evidence, risk, costs, tax effects, and whether the strategy is suitable for the client.

Example 2: Earnings announcement

A stock rises immediately after the company releases unexpected earnings growth. This is consistent with semi-strong efficiency because new public information was quickly incorporated into the price.

Example 3: Material nonpublic information

A corporate officer tells a friend about an unannounced merger. The EMH category is strong-form efficiency because the information is private. The legal issue is separate: trading on material nonpublic information can create insider-trading liability.

Example 4: Index recommendation

A client has a long time horizon, moderate risk tolerance, and no special desire for active management. EMH supports considering low-cost diversified funds, but the recommendation still must consider the client's goals, tax situation, liquidity needs, and overall portfolio.

44.7 Series 65 Exam Triggers

If the question says...	Think...
Past prices, price charts, trading volume, technical analysis	Weak-form efficiency
Public information, earnings, financial statements, news releases	Semi-strong-form efficiency
Private information, insider information, material nonpublic information	Strong-form efficiency
Quick price reaction to new public information	Semi-strong-form efficiency
Claim that no one can consistently beat the market after risk and costs	General EMH concept
Claim that prices are always correct or risk disappears	Incorrect overstatement of EMH

Key Takeaways

- EMH focuses on how information is reflected in security prices.
- Weak-form efficiency involves past prices and trading data.
- Semi-strong-form efficiency involves all public information.
- Strong-form efficiency involves all public and private information.
- EMH supports skepticism toward market-timing and unsupported stock-picking claims, but it does not eliminate the need for client-specific advice.
- Anomalies and behavioral finance provide important qualifications, not permission to ignore suitability, costs, taxes, and risk.

Practice Questions

1. Under the weak form of the Efficient Market Hypothesis, which analysis is least likely to consistently produce abnormal risk-adjusted returns?

A. Fundamental analysis of financial statements
B. Tax analysis of a client portfolio
C. Asset allocation based on risk tolerance
D. Technical analysis based on historical prices

2. A company releases unexpectedly strong earnings before the market opens, and the stock price adjusts almost immediately. Which form of efficiency does this best illustrate?

A. Weak-form efficiency
B. Strong-form efficiency
C. Operational efficiency
D. Semi-strong-form efficiency

3. Which statement is most consistent with the Efficient Market Hypothesis?

A. Security prices are always equal to intrinsic value.
B. It is difficult to consistently earn abnormal risk-adjusted returns using information already reflected in prices.
C. No investor can ever earn a positive return.
D. Diversification is unnecessary if markets are efficient.

4. An adviser claims that a proprietary chart pattern can reliably identify undervalued stocks because investors have not noticed a recurring price trend. Which EMH form most directly challenges that claim?

A. Weak form
B. Capital market line
C. Strong form
D. Semi-strong form

5. Which type of information is assumed to be reflected in prices under the semi-strong form of EMH?

A. All public and private information
B. Only dividend announcements
C. All public information
D. Only past stock prices

6. A market where even investors using material nonpublic information cannot consistently earn abnormal returns would be described as:

A. Inefficient by definition
B. Weak-form efficient
C. Strong-form efficient
D. Semi-strong-form efficient

7. Which recommendation implication is most consistent with EMH for many retail clients?

A. Use low-cost, diversified exposure when the client does not have a clear active-management reason.
B. Avoid rebalancing because prices are efficient.
C. Concentrate the account in recent winners.
D. Rely primarily on market timing.

8. Which of the following is an example of a market anomaly often discussed as a challenge to simple versions of EMH?

A. Momentum may persist over intermediate periods.
B. Prices may reflect public information quickly.
C. Bonds have interest rate risk.
D. Diversification reduces unsystematic risk.

9. Which statement best describes the relationship between EMH and behavioral finance?

A. Behavioral finance applies only to bonds, not stocks.
B. Behavioral finance studies investor biases that may contribute to mispricing or anomalies.
C. Behavioral finance eliminates the need to assess client risk tolerance.
D. Behavioral finance proves all markets are perfectly efficient.

10. For Series 65 purposes, the phrase 'all publicly available information is reflected in price' most directly points to:

A. Weak-form EMH
B. Semi-strong-form EMH
C. Strong-form EMH
D. Dollar-cost averaging

Answer Key and Explanations

1. D — Weak-form efficiency says current prices already reflect past price and volume data, so chart patterns should not consistently produce abnormal risk-adjusted returns.

2. D — Semi-strong-form efficiency focuses on how quickly publicly available information is reflected in prices.

3. B — EMH is about abnormal risk-adjusted returns, not guaranteed accuracy, zero returns, or the irrelevance of diversification.

4. A — Past price trends and trading patterns are the focus of weak-form efficiency.

5. C — Semi-strong efficiency includes all publicly available information, including past prices, financial statements, and news.

6. C — Strong-form efficiency is the most demanding version because it assumes both public and private information are already reflected in prices.

7. A — EMH supports the case for low-cost diversified investing, while client suitability, taxes, and goals still matter.

8. A — Momentum, value, size, post-earnings announcement drift, and some calendar effects are common examples of observed anomalies.

9. B — Behavioral finance focuses on biases and decision errors, which can help explain why markets may not be perfectly efficient at every point in time.

10. B — Public information is the key trigger phrase for semi-strong-form efficiency.

Lesson 45: Strategic and Tactical Asset Allocation

Learning Objectives

- Distinguish **strategic asset allocation** from **tactical asset allocation**.
- Explain how each strategy fits within a client investment policy statement and recommendation process.
- Identify the client profile factors that should drive a long-term policy allocation.
- Recognize the risks, costs, and documentation needs associated with **tactical tilts**.
- Apply Series 65 exam logic to common client scenarios involving allocation, rebalancing, and market timing.

> **Exam point**
> Know which facts point to a long-term policy allocation, which facts point to a short-term active tilt, and when a recommendation becomes unsuitable because it ignores client constraints.

45.1 Core Strategy Concept

Asset allocation is the process of dividing a portfolio among broad asset classes such as equities, fixed income, cash, real assets, and alternatives. For most clients, the asset allocation decision is more important than the selection of any single security because it drives the portfolio's expected risk, expected return, liquidity profile, and diversification.

- Strategic asset allocation sets the long-term policy mix for the portfolio.
- Tactical asset allocation makes shorter-term deviations from the policy mix when market or economic conditions create a reason to tilt the portfolio.
- Both approaches must be grounded in the client's objectives, risk tolerance, time horizon, liquidity needs, tax situation, and constraints.
- The adviser's duty is not to chase performance; it is to make recommendations that are suitable and consistent with the client profile.

45.2 Strategic Asset Allocation

Strategic asset allocation (SAA) is a long-term allocation framework that assigns target weights to asset classes based on the client's investment objectives and constraints. It usually appears in an investment policy statement as the portfolio's policy allocation or target allocation.

Purpose of Strategic Asset Allocation

- Translate the client's goals into a disciplined portfolio structure.
- Set a reasonable mix of growth, income, stability, and liquidity assets.
- Create a benchmark for evaluating performance and adviser recommendations.
- Reduce emotional decision-making by establishing allocation targets before markets become volatile.

- Provide rebalancing bands so the portfolio does not drift too far from its intended risk level.

Client input	How it affects strategic allocation
Financial goal	Defines the required return, income need, or capital preservation priority.
Risk tolerance	Limits the amount of volatility, drawdown risk, and equity exposure that may be appropriate.
Time horizon	Longer horizons can generally support more growth assets; shorter horizons require more liquidity and stability.
Cash flow needs	Ongoing withdrawals may require income-producing assets, cash reserves, or lower volatility.
Tax situation	Taxable clients may need tax-efficient funds, tax-loss harvesting, municipal bonds, or asset-location planning.
Existing holdings	Concentrated positions, legacy securities, or unrealized gains can affect how quickly a new policy allocation is implemented.
Legal and personal constraints	Trust provisions, employer stock rules, liquidity restrictions, or client values may limit certain investments.

Rebalancing Within a Strategic Strategy

A strategic allocation is not the same as ignoring the portfolio. The adviser should monitor the portfolio and rebalance when holdings move outside acceptable ranges or when the client profile changes.

- Calendar rebalancing uses a fixed schedule, such as quarterly, semiannually, or annually.
- Threshold rebalancing occurs when an asset class moves outside a stated tolerance band, such as plus or minus 5 percentage points from target.
- Cash-flow rebalancing uses deposits, withdrawals, dividends, or interest payments to move the portfolio toward target weights.
- Tax-aware rebalancing considers capital gains, losses, wash sale issues, and the client's tax bracket.

Exam point
Strategic allocation usually points to discipline, long-term objectives, target weights, benchmark selection, and periodic rebalancing rather than prediction of next month's winners.

45.3 Tactical Asset Allocation

Tactical asset allocation (TAA) is an active strategy that temporarily overweights or underweights asset classes relative to the strategic policy mix. Tactical decisions are usually based on valuation, economic outlook, interest-rate expectations, credit conditions, market momentum, volatility, or other risk indicators.

Typical Tactical Tilts

- Overweight equities when the adviser believes expected return justifies the added risk.
- Underweight equities when valuations, recession risk, or client spending needs suggest a more defensive posture.
- Shift between large-cap, mid-cap, small-cap, value, growth, domestic, and international equity exposures.
- Alter fixed income duration or credit exposure based on rate and spread expectations.
- Increase cash or high-quality short-term bonds when liquidity or downside protection is a priority.
- Add or reduce real assets, commodities, or alternatives when inflation or diversification considerations support the change.

Tactical input	Possible portfolio response	Key suitability concern
Equity valuations appear high	Reduce equity overweight or favor less expensive segments.	Does the shift still fit the client's required return and time horizon?
Yield curve changes	Adjust duration, bond quality, or cash exposure.	Will the client understand interest-rate risk and reinvestment risk?
Widening credit spreads	Reduce lower-quality bonds or increase quality.	Does the portfolio still meet income needs?
Inflation risk rises	Consider inflation-sensitive assets or shorter-duration bonds.	Are the assets liquid and appropriate for the client?

Tactical input	Possible portfolio response	Key suitability concern
Market volatility increases	Rebalance, reduce risk, or use cash-flow planning.	Is the change defensive discipline or emotional market timing?

Risks of Tactical Allocation

- Forecasting risk: the adviser's market view may be wrong or early.
- Timing risk: the portfolio may move out of an asset class before a recovery occurs.
- Tracking error: the portfolio may perform very differently from the strategic benchmark.
- Transaction costs and taxes: frequent changes can increase expenses and taxable gains.
- Behavioral risk: tactical changes can become performance chasing or panic selling if not controlled by a disciplined process.
- Disclosure and documentation risk: the adviser must be able to explain why the tactical move was suitable for that client.

45.4 Strategic vs. Tactical Asset Allocation

Feature	Strategic asset allocation	Tactical asset allocation
Main idea	Long-term policy mix based on client goals and constraints.	Shorter-term deviation from the policy mix based on market views or risk conditions.
Time frame	Long term; often years or full investment horizon.	Short to intermediate term; should have a defined rationale and review process.
Primary driver	Client profile and capital market assumptions.	Valuation, economic outlook, interest rates, spreads, momentum, or risk signals.
Portfolio action	Set target weights and rebalance back to target ranges.	Temporarily overweight or underweight asset classes or segments.
Benchmark	Policy benchmark built from the strategic weights.	Measured against both the policy benchmark and the stated tactical rationale.

Feature	Strategic asset allocation	Tactical asset allocation
Main risk	May not respond quickly to changing market conditions.	May underperform due to bad forecasts, timing errors, taxes, and costs.
Series 65 clue	Long-term, disciplined, client-specific, rebalancing, IPS.	Temporary tilt, active decision, market outlook, valuation view, tactical limit.

45.5 Applying the Strategies to Client Recommendations

An investment adviser representative should begin with the client profile and then decide whether the recommendation belongs in the long-term policy allocation, a temporary tactical tilt, or neither. The recommendation should be documented with the facts that make it suitable.

1. Confirm the client's goals, time horizon, risk tolerance, liquidity needs, tax situation, and investment restrictions.
2. Establish or review the strategic allocation and any target ranges.
3. Determine whether the proposed change is a routine rebalance, a client-profile change, or a tactical market view.
4. Evaluate costs, taxes, concentration risk, liquidity risk, and impact on the portfolio's total risk.
5. Explain the rationale in plain language and document why the recommendation fits the client.

Situation	Likely strategy	Reasoning
A 35-year-old client begins retirement saving and has no near-term withdrawals.	Strategic allocation	The main task is to set a long-term policy mix that matches the retirement objective.
A retiree's equity allocation rises from 45% to 62% after a strong market.	Strategic rebalancing	The portfolio has drifted away from the intended risk level and should be reviewed against target bands.
The adviser temporarily reduces high-yield bond exposure because credit spreads are very tight.	Tactical allocation	The change is based on a market risk assessment and should have a defined review process.

Situation	Likely strategy	Reasoning
A client loses a job and needs a larger cash reserve.	Client-profile change	The change is driven by liquidity and cash-flow needs, not market prediction.

45.6 Series 65 Exam Triggers

If the question says...	Think...
Long-term target mix, policy weights, IPS, risk tolerance, time horizon	Strategic asset allocation
Rebalance to target, tolerance band, portfolio drift	Strategic rebalancing
Temporary overweight or underweight based on market outlook	Tactical asset allocation
Valuation signal, recession forecast, yield curve view, credit spread view	Tactical decision
Client job loss, large upcoming purchase, changed retirement date	Client-profile change; revisit the strategic allocation
Adviser changes allocations repeatedly after recent performance	Potential performance chasing or unsuitable market timing
Taxable account with large embedded gains	Tax-aware implementation and documentation are required

45.7 Worked Examples

Example 1: Strategic allocation for retirement

A 42-year-old client is saving for retirement in 23 years, has stable income, moderate-to-high risk tolerance, and no need for current income. A long-term policy allocation with a meaningful equity component is appropriate because the recommendation is driven by goals, time horizon, and risk tolerance. The adviser should not present the allocation as a guarantee of return.

Example 2: Rebalancing after a market rally

A client's policy allocation is 60% equities and 40% fixed income with a 5% tolerance band. Equities rise to 68%. Rebalancing is appropriate because the portfolio now carries more risk than intended. The recommendation is a strategic rebalancing action, not a tactical bearish prediction.

Example 3: Tactical duration shift

An adviser expects rates to rise and shortens bond duration for several clients. This is a tactical decision. It may be suitable for some clients, but the adviser still must consider each client's income needs, tax situation, liquidity needs, risk tolerance, and time horizon.

Example 4: Unsuitable tactical move

A retired client depends on portfolio withdrawals for living expenses. The adviser moves the entire account into small-cap stocks because small caps recently outperformed. This is not prudent tactical allocation. It creates concentration risk, ignores cash-flow needs, and appears to be performance chasing.

Key Takeaways

- Strategic asset allocation sets the long-term policy mix for the client.
- Tactical asset allocation temporarily deviates from the policy mix based on market or risk views.
- Strategic allocation is client-profile driven; tactical allocation is market-view driven but still must be client suitable.
- Rebalancing is a disciplined part of strategic allocation, not a forecast.
- Tactical tilts require clear limits, a review process, and documentation of suitability.
- Series 65 questions usually reward the answer that ties the recommendation back to objectives, risk tolerance, time horizon, taxes, liquidity, and constraints.

Practice Questions

1. A client's investment policy statement calls for a long-term mix of 60% equities, 35% fixed income, and 5% cash. This is best described as:

A. Market timing
B. Security selection
C. Strategic asset allocation
D. Tactical asset allocation

2. An adviser temporarily increases a portfolio's allocation to short-term bonds because the adviser expects interest rates to rise. This is best described as:

A. Buy-and-hold investing
B. Tactical asset allocation
C. Dollar-cost averaging
D. Strategic asset allocation

3. Which client fact is most important when setting a strategic asset allocation?

A. The client's risk tolerance and time horizon
B. The best-performing sector last month
C. The adviser's prediction for next week's market return
D. The current share price of one stock

4. A portfolio target is 50% equities, with a permitted range of 45% to 55%. Equities rise to 58%. The most appropriate policy-based action is to:

A. Move all assets to cash
B. Ignore the portfolio because long-term strategies are never adjusted
C. Increase equities because they have recently performed well
D. Review and consider rebalancing toward the target range

5. Which is a primary risk of tactical asset allocation?

A. Forecasts and timing decisions may be wrong
B. It cannot create tracking error
C. It never causes taxes
D. It eliminates market risk

6. A retired client needs monthly withdrawals. Which concern is most important before making a tactical increase to illiquid alternatives?

A. Whether the asset performed well last quarter
B. Whether other clients are buying the same asset
C. Whether the recommendation fits the client's liquidity and cash-flow needs
D. Whether the investment has a high stated return

7. Which statement about tactical allocation is most accurate?

A. It removes the adviser's duty to consider risk tolerance
B. It is always more suitable than strategic allocation
C. It must be temporary and consistent with the client's constraints
D. It cannot involve bonds

8. A client loses employment and needs a larger emergency reserve. The adviser reduces equity exposure to build cash. This is primarily:

A. A violation because strategic allocations can never change
B. A change driven by the client profile
C. A tactical market timing decision
D. A technical analysis strategy

9. Which action is most likely to be unsuitable?

A. Rebalancing a portfolio that has drifted above its equity target
B. Documenting the rationale for a temporary tactical tilt
C. Setting a policy mix based on the client's goals and risk tolerance
D. Moving a conservative income client entirely into a volatile sector because it recently outperformed

10. In a taxable account, what should an adviser consider before rebalancing or making tactical changes?

A. Taxes, transaction costs, and the client's objectives
B. Only the projected return
C. Only whether the trade increases risk
D. Nothing, because asset allocation changes are tax-free

Answer Key and Explanations

1. C — A long-term target mix based on the client's policy is strategic asset allocation.

2. B — The change is a temporary tilt based on an interest-rate view, so it is tactical.

3. A — Strategic allocation is driven by the client profile, especially objectives, risk tolerance, and time horizon.

4. D — A move outside the tolerance band is a trigger to review and potentially rebalance.

5. A — Tactical allocation depends on market views, which may be incorrect or poorly timed.

6. C — Liquidity and cash-flow needs are central suitability factors for a retired client taking withdrawals.

7. C — Tactical changes should have a defined rationale and remain suitable for the client.

8. B — The recommendation is driven by changed cash-flow and liquidity needs, not a market forecast.

9. D — Moving the whole portfolio into a volatile sector based on recent performance ignores suitability and creates concentration risk.

10. A — Taxable trades can create gains, costs, and after-tax consequences that matter to suitability.

Lesson 46: Investment Styles

Learning Objectives

- Define **investment style** and explain how style affects portfolio recommendations.
- Distinguish **active management** from **passive management**.
- Compare **growth**, **value**, **income**, and **capital appreciation** styles.
- Identify common risks, costs, tax effects, and suitability concerns for each style.
- Apply Series 65 exam logic to client scenarios involving style selection and portfolio construction.

Exam point
Investment style should follow the client profile. A style can be reasonable in general but unsuitable for a specific client if it conflicts with risk tolerance, time horizon, liquidity needs, taxes, or objectives.

46.1 Investment Style: Core Concept

An investment style is the framework used to select, weight, and monitor investments. Style describes how an adviser or portfolio manager tries to earn return, manage risk, and meet a client objective. It may refer to a manager's process, an asset class segment, or the role a portfolio is expected to play for the client.

- Active and passive describe how the portfolio is managed relative to a benchmark.
- Growth and value describe the type of equity characteristics emphasized.
- Income and capital appreciation describe the main investor objective or return source emphasized.
- Style labels are not guarantees. A growth portfolio can lose money, an income portfolio can be risky, and a passive portfolio can still be unsuitable.

Style question	What the adviser is deciding
Active or passive?	Should the strategy attempt to outperform a benchmark or track it at low cost?
Growth or value?	Should the strategy emphasize companies with high expected growth or companies trading at lower valuations?
Income or capital appreciation?	Should the portfolio emphasize current cash flow or long-term price growth?

Style question	What the adviser is deciding
Client fit?	Does the style match the client's goals, risk tolerance, time horizon, tax position, and liquidity needs?

46.2 Active Management

Active management uses research, security selection, sector rotation, duration positioning, market timing, or other judgments in an effort to outperform a benchmark or achieve a specific risk-adjusted outcome.

Common Active Techniques

- Security selection: choosing individual securities believed to be mispriced or attractive.
- Sector or industry rotation: overweighting areas expected to outperform and underweighting others.
- Style tilts: emphasizing growth, value, quality, size, momentum, dividend yield, or other factors.
- Risk management: changing duration, credit quality, cash levels, or hedges as conditions change.
- Tax management: realizing losses, managing gains, or customizing holdings for taxable investors.

Active Management: Strengths and Risks

Potential strengths	Key risks or trade-offs
Can exploit perceived mispricing or special opportunities.	May underperform the benchmark, even over long periods.
Can customize around taxes, restrictions, values, or concentrated positions.	Usually has higher fees, research costs, trading costs, and turnover.
Can manage risk differently from a benchmark.	Creates manager risk: results depend on the skill and discipline of the adviser or manager.
May be useful in less efficient or specialized markets.	May add tax inefficiency through short-term gains and frequent trading.

Exam point
Active management is not automatically unsuitable. The concern is whether the added cost, risk, turnover, and manager discretion are justified for that client.

46.3 Passive Management

Passive management seeks to track the performance of a market index or defined benchmark rather than consistently beat it. Passive portfolios are commonly implemented through index mutual funds, exchange-traded funds, or separately managed index strategies.

Common Passive Features

- Benchmark-driven portfolio construction.
- Lower portfolio turnover than many active strategies.
- Lower expenses in many index fund or ETF implementations.
- Broad diversification when the underlying index is broad.
- Transparent exposure to a defined market segment.

Passive Management: Strengths and Risks

Potential strengths	Key risks or trade-offs
Low-cost, transparent, and easy to benchmark.	Will generally not outperform the tracked index before or after fees.
Reduces manager-selection risk.	Still exposes the client to full market risk of the index.
Often tax-efficient because turnover is lower.	Index construction may create concentration risk, sector tilts, or valuation risk.
Useful for core market exposure.	Tracking error and fund structure still matter.

Exam point
Passive does not mean risk-free. A passive S&P 500 fund can be volatile and may be unsuitable for a client who needs safety or near-term liquidity.

46.4 Active versus Passive: Recommendation Logic

Client or portfolio fact	Likely style implication
Client wants low cost and broad market exposure.	Passive core index exposure may be appropriate.
Client has tax constraints, restricted securities, or values-based exclusions.	Active or customized indexing may be useful.
Client wants to outperform a benchmark and accepts tracking error.	Active management may be considered if costs and risks are disclosed.
Client has low risk tolerance and short time horizon.	Neither active nor passive equity exposure solves the suitability problem by itself.
Market segment is narrow, inefficient, or specialized.	Active expertise may add value, but the adviser must assess fees and risks.

46.5 Growth Style

Growth investing focuses on companies expected to increase revenue, earnings, cash flow, or market share faster than the overall market or their peers. Growth investors are often willing to pay higher valuation multiples for stronger expected future growth.

- Typical characteristics: above-average earnings growth, high reinvestment, innovative products, or expanding markets.
- Common valuation features: higher price-to-earnings, price-to-sales, or price-to-book ratios than the market average.
- Return source: future business growth that may translate into higher stock prices.
- Risks: valuation compression, earnings disappointments, interest-rate sensitivity, concentration in fast-growing sectors, and low current income.

Exam point
Growth style often fits investors seeking long-term capital appreciation, but it may be inappropriate for clients who need current income, low volatility, or short-term liquidity.

46.6 Value Style

Value investing focuses on securities that appear inexpensive relative to fundamentals such as earnings, book value, cash flow, dividends, or assets. A value investor generally expects the market to eventually recognize the security's underlying worth.

- Typical characteristics: lower valuation ratios, established businesses, out-of-favor industries, or temporary business problems.
- Common valuation features: lower price-to-earnings, price-to-book, or price-to-cash-flow ratios.
- Return source: valuation improvement, dividends, business stabilization, or asset value recognition.
- Risks: value traps, deteriorating fundamentals, cyclical exposure, dividend cuts, and long periods of underperformance.

Exam point
Value does not always mean safe. A cheap stock may be cheap because the business is weakening or because risk is high.

46.7 Income Style

Income investing emphasizes investments expected to generate current cash flow, such as dividends, interest, preferred stock dividends, distributions from funds, or bond coupon payments.

- Common holdings: bonds, preferred stock, dividend-paying stocks, REITs, income-oriented mutual funds, and income ETFs.
- Client fit: investors who need current cash flow or want lower reliance on selling assets to fund spending.
- Risks: interest-rate risk, credit risk, dividend cuts, call risk, inflation risk, concentration in high-yielding sectors, and tax inefficiency in taxable accounts.
- Important distinction: higher yield usually means higher risk or lower expected growth, not a free benefit.

46.8 Capital Appreciation Style

Capital appreciation emphasizes long-term growth in the market value of the portfolio. The investor's return comes primarily from price increases rather than current income.

- Common holdings: common stocks, growth funds, broad equity funds, small-cap funds, sector funds, and other assets with long-term growth potential.
- Client fit: investors with longer time horizons, adequate liquidity reserves, and the ability to tolerate volatility.
- Risks: market risk, sequencing risk if withdrawals begin during a downturn, valuation risk, and lack of dependable current cash flow.
- Tax note: unrealized capital appreciation may allow some tax deferral, while dividends and interest may be taxable when received.

46.9 Style Combinations and Portfolio Fit

Styles can overlap. A portfolio may be passive growth, active value, passive income-oriented, or actively managed for capital appreciation. The adviser should understand what each fund or manager actually owns, not rely only on the label.

Combination	Example	Primary suitability issue
Passive growth	Index fund tracking a large-cap growth index.	Broad exposure may still be concentrated in high-valuation sectors.
Active value	Manager selects undervalued stocks after fundamental research.	Manager risk and value-trap risk.
Income equity	Dividend-focused stock fund.	Dividend cuts and sector concentration.
Capital appreciation	Long-term equity portfolio with limited distributions.	Volatility and time horizon.
Balanced style blend	Core portfolio split among growth, value, income, and bonds.	Maintaining the mix through rebalancing and monitoring.

Best practice
Tie each style allocation to a specific role in the portfolio, such as growth engine, income source, inflation hedge, liquidity reserve, or diversifier.

46.10 Suitability and Disclosure Issues

- Costs: active strategies often cost more, but passive funds still have expenses, spreads, and tracking error.
- Risk tolerance: volatile growth strategies may be unsuitable for conservative clients even if long-term returns are attractive.
- Time horizon: capital appreciation requires time to recover from market declines; short horizons favor liquidity and stability.
- Tax situation: high-turnover active strategies and income strategies can create current taxable income or short-term gains.
- Liquidity needs: a client needing cash soon should not depend heavily on volatile assets regardless of style label.

- Concentration: a style fund may have heavy exposure to a sector, factor, issuer type, or market-cap segment.
- Client expectations: the adviser should explain that style performance rotates and no style outperforms in every environment.

46.11 Series 65 Exam Quick Hits

Style	Key exam association	Main caution
Active	Attempts to outperform or manage risk differently from a benchmark.	Higher cost, turnover, tracking error, and manager risk.
Passive	Seeks benchmark return at low cost.	Still has market risk and may have index concentration.
Growth	Long-term capital appreciation from faster-growing companies.	High valuations and volatility.
Value	Lower-priced securities relative to fundamentals.	Value traps and long underperformance periods.
Income	Current dividends, interest, or distributions.	Yield is not the same as safety.
Capital appreciation	Long-term increase in portfolio value.	Requires appropriate time horizon and risk capacity.

Practice Questions

1. A client wants broad equity exposure at low cost and does not want the adviser to attempt market timing. Which style is most consistent with this objective?

A. Concentrated value investing
B. Passive indexing
C. Active sector rotation
D. High-yield income investing

2. Which statement best describes active management?

A. It seeks to track an index as closely as possible.
B. It always has lower expenses than passive management.
C. It eliminates market risk through diversification.
D. It uses investment judgment in an attempt to outperform or achieve a specific risk-adjusted result.

3. A growth strategy is most likely to emphasize companies with:

A. Fixed coupon payments and stated maturity dates.
B. Lower price-to-book ratios and declining sales.
C. Higher expected earnings growth and higher valuation multiples.
D. Guaranteed dividends and minimal price volatility.

4. Which is the best caution about value investing?

A. Value investing is identical to passive indexing.
B. Value investing is always more volatile than growth investing.
C. Value stocks cannot pay dividends.
D. A low valuation can reflect deteriorating fundamentals rather than a bargain.

5. A retired client needs predictable cash flow from the portfolio. Which style objective is most directly aligned with that need?

A. Momentum trading
B. Income
C. Pure growth
D. Aggressive capital appreciation

6. A young investor has a long time horizon, stable employment, adequate emergency reserves, and a high willingness to accept volatility. Which objective may be suitable for a meaningful portion of the portfolio?

A. Zero-risk income
B. Immediate liquidity only
C. Capital appreciation
D. Avoiding all equity exposure

7. Which is a risk of passive investing?

A. It still exposes the investor to the risks and concentrations of the tracked index.
B. It has no expenses or tracking error.
C. It automatically outperforms active managers after taxes.
D. It cannot be diversified.

8. An actively managed fund has high turnover. Which issue should the adviser consider for a taxable client?

A. It may create taxable distributions or short-term gains.
B. It eliminates tax reporting needs.
C. It avoids all transaction costs.
D. It guarantees lower tax liability than indexing.

9. Which client fact most directly challenges a recommendation to use a volatile capital appreciation strategy?

A. The client has a 25-year time horizon.
B. The client needs most of the funds for a home purchase in 18 months.
C. The client has adequate insurance coverage.
D. The client has no current income need from the account.

10. Which statement is most accurate?

A. Investment style labels replace the need for suitability analysis.
B. Passive funds are risk-free because they do not rely on manager forecasts.
C. Growth and income are the same objective.
D. Higher yield generally deserves review because it may reflect higher risk.

Answer Key and Explanations

1. B — Passive indexing is designed to provide broad benchmark exposure at relatively low cost without attempting to time the market.

2. D — Active management relies on judgment and discretion; it may outperform, underperform, or produce a different risk profile.

3. C — Growth strategies emphasize faster expected business growth and often trade at higher valuation multiples.

4. D — A low price can be a value opportunity or a warning sign that fundamentals are weakening.

5. B — Income investing emphasizes dividends, interest, or distributions that can support spending needs.

6. C — A long horizon and ability to tolerate volatility can support an allocation to capital appreciation strategies.

7. A — Passive investing tracks the index, including its market risk, sector exposures, and concentration risks.

8. A — High turnover may produce taxable distributions, realized gains, and transaction costs.

9. B — An 18-month funding need creates a short time horizon and high liquidity need, making volatile growth exposure problematic.

10. D — Higher yield often compensates investors for higher credit, interest-rate, liquidity, or business risk.

Lesson 47: Investment Techniques

Learning Objectives

- Explain **diversification**, **sector rotation**, **dollar-cost averaging**, **options**, **leverage**, **volatility management**, **inverse strategies**, and **high-frequency trading**.
- Identify the **objective** and **principal risk** of each technique.
- Apply techniques to client-specific **risk tolerance**, **time horizon**, **liquidity**, and **objectives**.
- Recognize common Series 65 traps, especially leverage and inverse-product compounding risk.

Diversification

Diversification spreads exposure across securities, issuers, sectors, asset classes, or regions. Its primary portfolio benefit is reducing unsystematic or security-specific risk. Diversification cannot eliminate broad systematic market risk.

Example
A portfolio holding one biotechnology stock has substantial issuer and sector risk. Adding companies from multiple sectors and asset classes can reduce the effect of one company or industry performing poorly.

Sector Rotation

Sector rotation shifts portfolio exposure among economic sectors based on the manager's view of the business cycle, valuations, earnings trends, or market leadership. It is an active strategy and can underperform if timing or sector forecasts are wrong.

Example
An investor who expects accelerating economic growth might increase exposure to economically sensitive sectors and later rotate toward defensive sectors if growth appears to slow. The forecast can be wrong, so the strategy adds active-management risk.

Dollar-Cost Averaging (DCA)

Dollar-cost averaging invests a fixed dollar amount at regular intervals regardless of market price. The investor buys more shares when prices are low and fewer when prices are high. DCA can promote discipline, but it does not guarantee a profit or prevent loss.

DCA share purchases: Fixed Dollar Investment ÷ Share Price
Calculated example: Invest $600 at $30 = 20 shares; $600 at $20 = 30 shares; $600 at $24 = 25 shares. Total: $1,800 invested for 75 shares; average cost = $24 per share.

Purchasing or Selling Options

Position	Typical Objective	Key Risk
Buy call	Bullish exposure / right to buy	Maximum loss generally premium paid
Buy put	Bearish exposure or portfolio protection / right to sell	Maximum loss generally premium paid
Sell covered call	Generate premium income on stock already owned	Upside is limited; stock downside remains
Sell uncovered option	Collect premium	Can create very large or, for uncovered calls, theoretically unlimited loss

Leverage

Leverage uses borrowed money or derivatives to increase market exposure relative to invested capital. Leverage magnifies both gains and losses and can create margin calls or forced liquidation.

Simple leverage example: Return on Investor Equity ≈ Change in Position Value ÷ Investor Equity (ignoring interest/costs)
Calculated example: $100,000 position financed with $50,000 investor equity. A 10% asset decline = $10,000 loss, which is 20% of the investor's $50,000 equity before financing costs.

Volatility Management

Volatility management techniques reduce or adjust portfolio risk when measured or expected volatility changes. Approaches can include changing equity exposure, increasing cash or high-quality fixed income, using hedges, or applying risk-budget/volatility-target rules. These techniques can reduce downside participation but may also reduce upside if markets recover quickly.

Inverse Strategies

Inverse funds seek gains when a reference index declines. Many inverse exchange-traded products target the inverse of DAILY index performance. Because of daily reset and compounding, returns over periods longer than one day can differ materially from the simple inverse of the index's cumulative return, especially in volatile markets.

Compounding example
Index starts at 100, rises 10% to 110, then falls 9.09% back to 100. The two-day index return is 0%. A daily −1× product falls 10% from 100 to 90, then rises 9.09% to about 98.18 — a loss of about 1.82% despite the index ending unchanged.

High-Frequency Trading (HFT)

High-frequency trading uses automated systems, very fast data processing, and short holding periods to execute large numbers of trades. HFT is primarily a market-structure and institutional technique rather than a typical retail-client strategy. Potential issues include technology failures, execution competition, liquidity that can disappear in stress, and market-integrity concerns if manipulative tactics are used.

Series 65 Exam Cues

- Diversification reduces unsystematic risk, not systematic market risk.
- DCA = fixed dollars at regular intervals; it does not guarantee profit.
- Leverage magnifies both gains and losses.
- Long options generally limit the buyer's loss to premium; uncovered option writing can create very large risk.
- Inverse products often target DAILY inverse performance, so long-horizon results can diverge because of compounding.
- HFT refers to speed/automation/very short holding periods, not long-term fundamental investing.

References and Further Reading

- NASAA, Series 65 Test Specifications (effective June 12, 2023), Portfolio Management Strategies, Styles and Techniques.
- Commonly accepted investment-management principles regarding diversification, DCA, options, leverage, volatility management, inverse strategies, and market structure.

Practice Questions

1. The primary risk-reduction benefit of diversification is that it can reduce:

A. Unsystematic company-specific risk
B. All investment losses
C. Systematic market risk to zero
D. Inflation risk in every asset

2. Dollar-cost averaging involves:

A. Borrowing to double every purchase
B. Selling all holdings after a market decline
C. Investing a fixed dollar amount at regular intervals
D. Investing only when prices reach a new high

3. An investor buys a call option. The investor's maximum loss is generally:

A. The premium paid
B. The strike price
C. The market value of the underlying stock
D. Unlimited

4. A portfolio uses $50,000 of investor equity to control a $100,000 position. Ignoring financing costs, a 10% decline in the position produces approximately what loss relative to investor equity?

A. 15%
B. 20%
C. 10%
D. 5%

5. Which statement about a daily inverse ETF is most accurate?

A. It guarantees a profit whenever the market is volatile.
B. It has no path dependence.
C. It always equals the inverse of the index over any holding period.
D. Its multi-day return can differ from the simple inverse of the index's multi-day return because of compounding.

6. Sector rotation is best described as:

A. A passive strategy that never changes weights
B. An active shift among sectors based on market or economic views
C. A guaranteed hedge against recession
D. A tax rule for retirement accounts

7. Which option position can create theoretically unlimited loss?

A. Long call
B. Long put
C. Uncovered short call
D. Covered call

8. High-frequency trading is most closely associated with:

A. Guaranteed best execution for retail investors
B. Only municipal bonds
C. Multi-decade holding periods and annual rebalancing
D. Automated, very fast execution of large numbers of short-horizon trades

Answer Key and Explanations

1. A — Unsystematic company-specific risk. Diversification primarily reduces idiosyncratic risk.

2. C — Investing a fixed dollar amount at regular intervals. That is the definition of DCA.

3. A — The premium paid. A long option can expire worthless, leaving the buyer out the premium.

4. B — 20%. A 10% decline on $100,000 is $10,000; $10,000 ÷ $50,000 equity = 20%.

5. D — Its multi-day return can differ from the simple inverse of the index's multi-day return because of compounding. Daily reset creates path-dependent multi-day performance.

6. B — An active shift among sectors based on market or economic views. Sector rotation is a tactical/active allocation technique.

7. C — Uncovered short call. A stock price can theoretically rise without limit, so an uncovered call writer can face theoretically unlimited loss.

8. D — Automated, very fast execution of large numbers of short-horizon trades. That is the defining HFT characteristic.

Lesson 48: Income Tax Fundamentals: Individuals

Learning Objectives

- Explain how individual income tax concepts affect investment recommendations and client suitability.
- Distinguish **realized gains** from **unrealized appreciation** and **short-term gains** from **long-term gains**.
- Define **qualified dividends**, **tax basis**, **adjusted basis**, **marginal tax bracket**, and **alternative minimum tax**.
- Identify how **pensions**, **retirement plan distributions**, and **required minimum distributions** can affect taxable income.
- Recognize when investment income may affect government benefits, including **Medicare IRMAA surcharges**.

> **Exam point**
> Series 65 questions often test whether the adviser recognizes a tax issue and recommends coordination with a tax professional, not whether the adviser prepares a tax return.

Why Tax Fundamentals Matter in Client Recommendations

Taxes can change the after-tax return, liquidity, and timing of an investment recommendation. Two portfolios with the same pre-tax return can create very different results for clients depending on account type, holding period, income level, and benefit eligibility.

- **After-tax return:** Investment performance should be evaluated after considering taxes when recommendations are made in taxable accounts.
- **Timing:** Selling an appreciated position, taking a retirement distribution, or receiving a large dividend can shift income into a higher tax year.
- **Suitability:** A tax-efficient strategy for one client may be inappropriate for another client with a different tax bracket, time horizon, or liquidity need.
- **Coordination:** Advisers should understand tax concepts well enough to identify issues and coordinate with qualified tax professionals when needed.

Basic Tax Flow for an Individual

Step	Concept	Investment relevance
1	Income is recognized	Interest, dividends, realized gains, wages, pensions, and taxable retirement distributions may enter the tax calculation.

Step	Concept	Investment relevance
2	Deductions and adjustments are applied	Deductions can reduce taxable income, but some calculations such as IRMAA use modified adjusted gross income rather than taxable income.
3	Taxable income is placed into brackets	Additional income is taxed at the marginal rate applicable to the next dollar of income.
4	Credits and special taxes are considered	AMT, net investment income tax, credits, withholding, and estimated payments can change the final result.

48.1 Capital Gains

A capital gain occurs when a capital asset is sold for more than its adjusted basis. A capital loss occurs when the asset is sold for less than its adjusted basis. For investments, the tax issue usually begins when a gain or loss is realized through a sale or exchange.

- **Unrealized appreciation:** An investment has increased in value, but the client has not sold it. No capital gain has been realized yet.
- **Realized gain:** The client sells or exchanges the investment for more than adjusted basis.
- **Short-term gain or loss:** Generally applies to assets held one year or less. Short-term gains are generally taxed as ordinary income.
- **Long-term gain or loss:** Generally applies to assets held more than one year. Long-term capital gains generally receive preferential tax rates.
- **Loss harvesting:** Selling a position at a loss may offset gains, but the adviser must consider suitability, wash sale rules, and whether the sale changes the client's intended exposure.

Exam point
Do not assume a client should sell an appreciated security simply because it has reached a price target. The tax cost, diversification need, liquidity need, and investment thesis all matter.

Capital Gain Example

Item	Amount	Explanation
Purchase price plus acquisition costs	$40,000	Starting basis
Sale proceeds	$55,000	Amount realized on sale
Capital gain	$15,000	Sale proceeds minus adjusted basis

48.2 Qualified Dividends

Dividends are distributions from corporate earnings. Ordinary dividends are included in ordinary income. Qualified dividends meet tax requirements that allow them to be taxed at lower long-term capital gain rates rather than ordinary income rates.

- **Ordinary dividends:** Taxable as ordinary income unless they qualify for preferential treatment.
- **Qualified dividends:** Generally paid by a U.S. corporation or qualifying foreign corporation and subject to holding-period requirements.
- **1099-DIV reporting:** Brokerage firms generally report ordinary dividends and qualified dividends separately.
- **Suitability issue:** Dividend-paying securities may help an income objective, but taxable dividends may increase income taxes or affect benefits.

Exam point
A high dividend yield is not the same as a high after-tax return. The adviser should consider tax status, risk, and whether the income is needed.

48.3 Tax Basis

Tax basis is the reference amount used to determine gain or loss when property is sold. For purchased securities, basis generally begins with the purchase cost, then changes for items such as reinvested dividends, return of capital, stock splits, gifts, and inheritance rules.

- **Adjusted basis:** Basis after required increases or decreases.
- **Reinvested dividends:** Usually increase basis because the client uses taxable dividend income to purchase additional shares.
- **Return of capital:** Generally reduces basis first; once basis reaches zero, additional return of capital is generally treated as capital gain.
- **Stock splits:** Usually divide the same aggregate basis over a larger number of shares.

- **Inherited property:** May receive a basis adjustment under estate tax rules. Advisers should avoid giving definitive tax advice without a tax professional.

Basis Tracking Example

Transaction	Cash flow	Shares	Basis effect
Initial purchase	$10,000	100	Basis begins at $10,000.
Dividend reinvested	$300	3	Basis increases by $300 because the dividend bought more shares.
2-for-1 split	$0	206	Aggregate basis stays $10,300; basis per share is reduced.
Partial sale	Varies	50	Gain or loss depends on proceeds minus basis allocated to sold shares.

48.4 Marginal Bracket

A marginal tax bracket is the rate that applies to the next dollar of taxable income. It is different from an average tax rate, which compares total tax to total income. Individual income tax is progressive, so not every dollar is taxed at the client's highest bracket.

- **Marginal rate:** Rate applied to the next dollar of taxable income.
- **Average rate:** Total tax divided by total income or taxable income, depending on the calculation.
- **Planning use:** A client near a bracket threshold may care about the timing of capital gains, Roth conversions, retirement distributions, or charitable deductions.

Exam point
A common exam trap is to treat the marginal rate as if it applies to all income. Only income within a bracket is taxed at that bracket rate.

48.5 Alternative Minimum Tax

The alternative minimum tax is a parallel federal tax calculation intended to ensure that certain taxpayers with preference items pay at least a minimum amount of tax. A taxpayer computes regular tax and AMT; if AMT is higher, the additional AMT is owed.

- **Parallel calculation:** AMT starts from taxable income and makes adjustments under AMT rules.
- **Preference items and adjustments:** Certain deductions, exclusions, and timing items may receive different treatment.
- **Investment relevance:** Tax-exempt interest from some private activity bonds may be an AMT preference item.
- **Adviser action:** Recognize when a recommendation may create AMT exposure and coordinate with the client's tax professional.

48.6 Pension and Retirement Plan Distributions

Retirement account distributions can affect taxable income, liquidity, investment allocation, and government benefits. The tax treatment depends on the account type, whether contributions were pre-tax or after-tax, the client's age, and whether the distribution is qualified.

- **Traditional IRA and pre-tax qualified plans:** Distributions are generally taxed as ordinary income to the extent they were not previously taxed.
- **Roth accounts:** Qualified distributions are generally tax-free; nonqualified distributions may have tax and penalty consequences.
- **Early distributions:** May trigger income tax and additional penalties unless an exception applies.
- **Rollovers and transfers:** May preserve tax deferral if handled correctly.
- **Required minimum distributions:** RMDs are minimum annual withdrawals required from certain retirement accounts after the applicable beginning age.

Exam point
RMDs can force taxable income even when the client does not need cash. That income may increase marginal tax rates, Medicare premiums, and the taxation of Social Security benefits.

RMD Planning Concepts

Concept	What it means	Planning issue
Required distribution	A minimum amount must be withdrawn each year from covered accounts.	The withdrawal is generally taxable unless it represents basis or a tax-free Roth distribution.

Concept	What it means	Planning issue
More than the minimum	A client may take more than the RMD.	Taking extra income may affect brackets, benefits, and portfolio longevity.
Roth treatment	Roth IRAs and designated Roth accounts generally are not subject to lifetime RMDs for the owner.	Beneficiary rules still matter after death.
Timing coordination	Distribution timing interacts with other income events.	Capital gains, pensions, Social Security, and IRMAA all may be affected by income timing.

48.7 Government Benefit Implications

Government benefits can be affected by investment income, retirement distributions, realized capital gains, and account balances. The adviser should identify when a recommendation may affect eligibility, premiums, or taxation of benefits.

- **Social Security benefit taxation:** Higher income can cause a larger portion of Social Security benefits to be taxable.
- **Medicare IRMAA:** Income-related monthly adjustment amount is an additional amount added to Medicare Part B and Part D premiums for higher-income beneficiaries.
- **MAGI focus:** IRMAA uses modified adjusted gross income, generally based on income reported to the IRS from two years earlier.
- **Means-tested benefits:** Programs such as Medicaid or Supplemental Security Income may have income or asset limits.
- **Planning concern:** A sale, Roth conversion, annuity distribution, or RMD may improve one goal but harm another by increasing reportable income.

Government Benefit Examples

Client event	Possible tax or benefit effect	Adviser concern
Large capital gain in taxable account	Increases income in the sale year.	May trigger higher marginal bracket or IRMAA surcharge.

Client event	Possible tax or benefit effect	Adviser concern
RMD begins	Ordinary income increases even without a portfolio sale.	May affect Social Security taxation and Medicare premiums.
Roth conversion	Accelerates taxable income now for possible tax-free income later.	May be useful, but timing and benefit effects matter.
Municipal bond interest	May be federally tax-exempt.	Some tax-exempt interest still counts in certain MAGI calculations, including IRMAA.

Suitability Checklist

Question	Why it matters
Is the account taxable, tax-deferred, or tax-free?	Tax location can change the preferred investment vehicle.
Will the recommendation realize a gain or loss?	Realization determines whether taxes are triggered now.
What is the holding period?	Short-term and long-term gains are generally taxed differently.
Does the client need income or total return?	Dividend and interest income may be taxable even when reinvested.
Is the client near retirement or already taking RMDs?	Retirement distributions can drive taxable income and benefit effects.
Could the action affect Medicare premiums or other benefits?	Income-sensitive programs may change the true after-tax value of a recommendation.
Has the tax professional been consulted?	Complex situations require coordination rather than guesswork.

Series 65 Quick Hits

Concept	Know this
Capital gain	Sale price above adjusted basis creates a gain.
Unrealized gain	No sale has occurred; tax has not usually been triggered.
Qualified dividend	Dividend eligible for long-term capital gain rates if requirements are met.
Basis	Amount used to measure gain or loss.
Marginal bracket	Rate on the next dollar, not the rate on every dollar.
AMT	Parallel tax calculation that may add tax when preference items are present.
RMD	Minimum withdrawal required from covered retirement accounts after applicable age.
IRMAA	Additional Medicare Part B and D premium amount for higher-income beneficiaries.

Practice Questions

1. A client purchased stock for $20,000 and sold it several years later for $31,000. What is the basic tax result?

A. $31,000 ordinary income
B. No taxable event because the stock was held several years
C. $11,000 capital gain
D. $11,000 capital loss

2. Which statement best describes an unrealized gain?

A. A gain that is exempt from all federal tax
B. Appreciation in an investment that has not yet been sold
C. A gain from selling an asset held one year or less
D. A gain that has been reported on Form 1099-DIV

3. Qualified dividends are generally important because they may be:

A. Treated as a return of capital in every case
B. Deductible by the shareholder
C. Excluded from all income calculations
D. Taxed at lower long-term capital gain rates

4. A client reinvests taxable dividends to buy more shares of the same fund. What usually happens to basis?

A. Basis decreases
B. Basis is eliminated
C. Basis becomes irrelevant
D. Basis increases

5. A marginal tax bracket is best defined as:

A. Total tax divided by total income
B. The rate applied to the next dollar of taxable income
C. The tax rate applied to every dollar of income
D. A rate that applies only to tax-exempt income

6. Which investment-related item may create alternative minimum tax concerns?

A. A tax-free transfer between two brokerage firms only
B. Interest from a regular checking account only
C. Interest from certain private activity municipal bonds
D. A qualified Roth distribution only

7. Required minimum distributions are best described as:

A. Minimum annual withdrawals required from certain retirement accounts after the applicable beginning age
B. Optional withdrawals from taxable accounts
C. Required deposits into retirement accounts
D. Penalty-free withdrawals from all accounts before age 59 1/2

8. A retired Medicare beneficiary realizes a large capital gain. What additional issue should the adviser consider?

A. The gain must be reinvested in the same security
B. Medicare premiums are based only on age
C. Capital gains never affect any government benefit calculation
D. The gain may affect IRMAA and increase Medicare premiums

9. Which statement about tax basis is most accurate?

A. It is relevant only for bonds, not stocks
B. It cannot change after purchase
C. It is used to determine gain or loss when property is sold
D. It is always equal to current market value

10. The most appropriate adviser response to a complex tax question is to:

A. Prepare the client's tax return
B. Recognize the issue and coordinate with a qualified tax professional
C. Guarantee that the client will owe no tax
D. Ignore taxes because they are outside investing

11. A client needs income but is in a high tax bracket. Which concern is most relevant when recommending high-dividend stock in a taxable account?

A. Dividends may increase taxable income even if the client reinvests them
B. Dividends are never taxable
C. Dividends eliminate the need for asset allocation
D. Dividend-paying stock has no market risk

12. Which situation is most likely to require coordination before implementing a recommendation?

A. A client near an IRMAA threshold considering a large Roth conversion
B. A client reviewing last year's budget
C. A client depositing cash into a checking account
D. A client reading a brokerage statement

Answer Key and Explanations

1. C — Sale proceeds exceed adjusted basis by $11,000.

2. B — The investment has appreciated, but no sale has realized the gain.

3. D — Qualified dividends generally receive preferential long-term capital gain rates.

4. D — Reinvested taxable dividends buy additional shares and generally increase basis.

5. B — The marginal bracket applies to the next dollar of taxable income.

6. C — Certain private activity bond interest can be an AMT preference item.

7. A — RMDs are minimum required annual withdrawals from covered retirement accounts after the applicable age.

8. D — Capital gains increase income and may affect Medicare IRMAA calculations.

9. C — Basis is used to calculate gain or loss on sale.

10. B — Advisers should identify tax issues and coordinate rather than provide unauthorized tax advice.

11. A — Taxable dividends can increase income even if reinvested.

12. A — A large Roth conversion can increase MAGI and potentially trigger IRMAA.

Lesson 49: Income Tax Fundamentals: Corporations, Trusts, and Pass-Through Entities

Learning Objectives

- Distinguish **entity-level taxation** from **pass-through taxation**.
- Explain how **C corporations** and **S corporations** differ for income tax purposes.
- Identify the basic tax flow for **trusts** and **estates**, including income distributed to beneficiaries.
- Recognize key tax features of **REITs**, **MLPs**, **LLCs**, and **other pass-through entities**.
- Apply entity tax concepts to investment suitability, account placement, liquidity, and tax-professional coordination.

Exam point
The Series 65 tests recognition and application. You should be able to identify when taxes may affect suitability, not prepare an entity tax return.

Why Entity Taxation Matters

Investment recommendations often involve entities, not just individuals. A client may own a private business, serve as trustee, inherit an estate interest, hold REIT or MLP units, or invest through an LLC. The tax form of the entity can change after-tax return, timing of income, recordkeeping burden, and suitability.

- **Who pays the tax:** The entity, the owner, the beneficiary, or some combination.
- **When income is recognized:** Income may be taxable even if cash is not distributed to the investor.
- **What is reported:** Investors may receive Form 1099 reporting, Schedule K-1 reporting, or trust/estate beneficiary reporting.
- **How basis changes:** Distributions, losses, and return of capital can increase or decrease basis.
- **Where the asset is held:** A security that is tax-efficient in a taxable account may create complications in a retirement account, and vice versa.

Tax question	Why it matters for recommendations
Is income taxed at the entity level or passed through?	Affects after-tax return, reporting burden, and whether owners may owe tax without receiving cash.

Tax question	Why it matters for recommendations
Does the investment produce ordinary income, qualified dividends, capital gains, or return of capital?	Different categories may be taxed differently and may affect cash-flow planning.
Will the investor receive a 1099 or a K-1?	A K-1 can delay filing, require more detailed tax reporting, or create state tax issues.
Does the investor have enough basis to deduct losses or receive distributions tax-free?	Losses and distributions may be limited or taxable depending on basis and other rules.
Is the entity suitable for the client's account type?	MLPs, REITs, and private pass-throughs may be inappropriate for certain clients or accounts.

49.1 C Corporations

A **C corporation** is a separate taxable entity. The corporation pays income tax on its taxable income. If the corporation distributes after-tax earnings to shareholders as dividends, the shareholders may also owe tax on the dividend income.

- **Separate taxpayer:** The corporation files its own return and pays its own income tax.
- **Potential double taxation:** Corporate profit is taxed when earned by the corporation and again when distributed as a shareholder dividend.
- **No pass-through of operating losses:** Shareholders generally cannot deduct corporate losses on their personal returns.
- **Dividend treatment:** Corporate dividends may be ordinary or qualified, depending on the rules and the investor's holding period.
- **Investor perspective:** Public common stocks are usually C corporation equity interests. The investor receives dividends and capital gains or losses, not a K-1 from ordinary operations.

Exam point
A C corporation shareholder usually does not report the corporation's business income each year unless the shareholder receives a dividend or sells the stock.

49.2 S Corporations

An S corporation is a corporation that has made a federal tax election to pass corporate income, losses, deductions, and credits through to shareholders. The shareholder generally reports

these items on the shareholder's individual tax return, whether or not the corporation distributes cash.

- **Pass-through treatment:** Income, losses, deductions, and credits flow through to shareholders.
- **Avoids most corporate-level income tax:** S corporations generally avoid the classic C corporation double tax, although entity-level taxes can apply in specific situations.
- **Schedule K-1:** Shareholders typically receive a K-1 showing their share of income, deductions, credits, and distributions.
- **Basis matters:** Loss deductions and distribution treatment depend on shareholder stock and debt basis.
- **Private-business relevance:** S corporation tax issues often arise when a client owns a closely held business rather than publicly traded stock.

Feature	C Corporation	S Corporation
Who generally pays income tax on operating income?	Corporation pays tax at entity level.	Shareholders report pass-through items.
Common investor reporting	1099-DIV for dividends and 1099-B for sales.	Schedule K-1 for pass-through items and distributions.
Losses to owners	Shareholders generally cannot deduct corporate losses.	Losses may pass through but are limited by basis and other rules.
Dividend/distribution concept	Dividends from after-tax earnings may be taxable to shareholders.	Distributions may be tax-free to extent of basis, depending on facts.
Series 65 focus	Double taxation and dividend/capital gain reporting.	Pass-through taxation, basis, K-1, and private-business suitability.

49.3 Trusts and Estates

A trust or estate may be a separate taxpayer. The fiduciary may file Form 1041 to report income, deductions, gains, losses, and distributions. Taxable income can be taxed to the trust or estate, to beneficiaries, or partly to both, depending on the type of income and whether it is distributed.

- **Fiduciary income tax:** A trust or estate can have its own taxable income and deductions.

- **Beneficiary reporting:** Distributions may carry income out to beneficiaries, often reported on Schedule K-1.
- **Distributable net income (DNI):** DNI is a key concept used to determine how much income can be deducted by the trust or estate and included by beneficiaries.
- **Grantor trust concept:** Some trusts are disregarded for income tax purposes, meaning the grantor reports the income.
- **Investment relevance:** Trust tax rules can make income retention costly, but fiduciary duties and beneficiary needs may be more important than tax minimization alone.

Trust or estate issue	Recommendation implication
Income retained by trust	May be taxed at trust rates; adviser should coordinate with the fiduciary and tax professional.
Income distributed to beneficiaries	Beneficiaries may report income on K-1s; timing may affect their personal tax situations.
Principal vs income	Trust accounting rules may affect whether a receipt benefits income beneficiaries or remainder beneficiaries.
Concentrated inherited position	Diversification may be prudent, but tax basis, liquidity needs, and trust instructions matter.
Multiple beneficiaries	Recommendation must consider the trust document, fiduciary duties, time horizon, and fairness among beneficiaries.

Exam point
For a trust account, suitability belongs to the trust's objectives and governing document, not merely to one beneficiary's personal preference.

49.4 Pass-Through Entities

A pass-through entity generally does not pay federal income tax in the same way a C corporation does. Instead, items of income, loss, deduction, and credit flow through to owners. The owner may owe tax even if the entity retains cash.

- **Partnerships:** Income and losses generally pass through to partners. Partners receive a Schedule K-1.

- **LLCs:** An LLC is a state-law entity. For tax purposes, it may be disregarded, treated as a partnership, or elect corporate treatment.
- **S corporations:** A corporation with a valid S election is also a pass-through entity for most operating income.
- **Publicly traded partnerships and MLPs:** These provide pass-through exposure in public markets but can create complex reporting.
- **Investor concern:** Pass-through investments may produce taxable income without cash distributions and may require basis tracking.

Pass-through concept	Why it matters
K-1 reporting	The client may receive detailed tax reporting instead of a simple Form 1099.
Phantom income	The client may owe tax on allocated income even if cash was not distributed.
Basis adjustments	Income increases basis; losses, deductions, and certain distributions may reduce basis.
Passive activity rules	Losses may be limited if the investor does not materially participate.
State tax exposure	Partnership or MLP investments may create tax reporting in multiple states.

Real Estate Investment Trusts (REITs)

A REIT is an entity that owns or finances real estate and elects tax treatment that generally allows it to avoid entity-level tax if it meets requirements, including distributing most taxable income to shareholders. Public REIT investors often receive Form 1099-DIV rather than a partnership K-1.

- **Income orientation:** REITs are often used for income and real estate exposure.
- **Dividend character:** REIT distributions may include ordinary income, capital gain distributions, and return of capital.
- **Not always qualified dividends:** REIT dividends are often not qualified dividends, though tax treatment depends on classification.
- **Risk factors:** Interest rates, leverage, property type, occupancy, refinancing needs, and real estate cycles affect REIT performance.
- **Suitability issue:** High income does not make a REIT conservative. Price volatility, sector concentration, and rate sensitivity still matter.

Master Limited Partnerships (MLPs) and Publicly Traded Partnerships

An MLP is generally a publicly traded partnership. Many MLPs operate in energy infrastructure or natural resources. Investors buy partnership units rather than corporate shares and often receive a Schedule K-1.

- **Distributions are not the same as dividends:** MLP cash distributions often include return of capital that reduces basis.
- **K-1 reporting:** The investor receives allocations of income, deductions, credits, and distributions.
- **Tax-deferred cash flow:** Return of capital can defer tax until sale, but lower basis can increase future gain.
- **Retirement account issue:** MLPs can create unrelated business taxable income (UBTI), which may complicate IRA or qualified plan ownership.
- **Risk factors:** Commodity exposure, leverage, regulatory risk, interest rates, project risk, and distribution sustainability.

Limited Liability Companies (LLCs)

An LLC is created under state law. It can provide limited liability while allowing flexible tax classification. For tax purposes, a single-member LLC may be disregarded, a multi-member LLC is often treated as a partnership, and an LLC may elect corporate taxation if eligible.

- **Legal form and tax form differ:** LLC status does not automatically tell you how the entity is taxed.
- **Pass-through by default in many cases:** A multi-member LLC is often taxed as a partnership unless it elects otherwise.
- **Private investment relevance:** Clients may own LLC interests in real estate, operating businesses, or private funds.
- **Liquidity risk:** LLC interests may be illiquid and subject to transfer restrictions.
- **Suitability issue:** Private LLC investments require due diligence on cash flow, valuation, conflicts, fees, tax reporting, and exit rights.

Entity/investment	Typical tax flow	Common investor form	Common suitability concern
C corporation stock	Entity pays corporate tax; shareholders pay tax on dividends and gains.	1099-DIV / 1099-B	Double tax; dividend policy; concentration risk.
S corporation	Income/loss generally passes through to shareholders.	Schedule K-1	Basis limits, illiquidity, private-business risk.

Entity/investment	Typical tax flow	Common investor form	Common suitability concern
Trust or estate	Income may be taxed to entity, beneficiaries, or both.	Form 1041 / K-1	Fiduciary duty, trust terms, beneficiary tax impact.
REIT	Generally distributes taxable income to shareholders.	Usually 1099-DIV	Ordinary income, rate sensitivity, property-sector risk.
MLP/PTP	Partnership items pass through to unit holders.	Schedule K-1	UBTI, basis tracking, state tax filing, commodity risk.
LLC	Depends on tax election; often disregarded or partnership.	K-1 or owner reporting	Illiquidity, valuation, tax complexity, transfer limits.

Account Placement and After-Tax Suitability

Tax characteristics should be considered as part of the overall suitability analysis. Tax efficiency does not override the client's objective, risk tolerance, liquidity need, time horizon, concentration risk, or fiduciary constraints.

- **Taxable accounts:** Basis, realized gains, loss harvesting, qualified dividends, and return of capital may matter.
- **Tax-deferred accounts:** Current taxable income may be sheltered, but UBTI and **prohibited transaction** issues may matter for certain investments.
- **Roth accounts:** Tax-free growth potential can be valuable, but investment risk and account rules still apply.
- **Trust accounts:** The trust document, fiduciary duty, distribution standards, and beneficiary circumstances shape the recommendation.
- **Business-owner clients:** Advisers should understand cash flow, K-1 income, salary/dividend/distribution distinctions, and concentration in the business.

Exam point
A tax-driven recommendation is still unsuitable if it conflicts with the client's risk tolerance, liquidity need, time horizon, or governing account documents.

Common Exam Traps

- Assuming pass-through means tax-free. Pass-through means the tax items flow to the owner; the owner may owe tax.
- Treating MLP distributions as corporate dividends. MLP distributions often reduce basis and are reported through a K-1.
- Assuming all REIT dividends are qualified dividends. REIT distributions often include ordinary income and may include other categories.
- Ignoring phantom income. A partner, S corporation shareholder, or MLP unit holder may report income without receiving matching cash.
- Assuming LLC status determines tax treatment. An LLC's federal tax classification depends on ownership and elections.
- Applying one beneficiary's risk profile to a trust. The trust document and fiduciary duty control the account's purpose.

Practice Questions

1. Which statement best describes a C corporation for federal income tax purposes?

A. It cannot pay dividends.
B. Its shareholders deduct corporate losses directly.
C. It always passes income directly to shareholders.
D. It is generally a separate taxable entity.

2. An S corporation shareholder may owe tax on pass-through income even when:

A. the corporation is publicly traded.
B. the corporation distributes no cash.
C. the shareholder sells the shares.
D. the shareholder receives only qualified dividends.

3. A trust distributes current income to beneficiaries. Which document commonly reports the beneficiary's share of income?

A. Form 8-K
B. Form 1099-R
C. Form W-2
D. Schedule K-1

4. Which investment commonly uses a Schedule K-1 and can create basis-tracking complexity?

A. Money market fund
B. Corporate bond
C. Master limited partnership
D. Treasury bill

5. Which statement about REIT distributions is most accurate?

A. They are reported only when the REIT property is sold.
B. They may include ordinary income, capital gain, and return of capital components.
C. They are always qualified dividends.
D. They are always tax-free.

6. A client owns units of an MLP in an IRA. The adviser should be alert to:

A. unrelated business taxable income.
B. FDIC insurance limits.
C. qualified dividend holding periods only.
D. wash sale rules on deposits.

7. Which statement about LLCs is correct?

A. An LLC is a state-law entity whose federal tax classification may vary.
B. An LLC can never be a pass-through entity.
C. An LLC interest is always publicly traded.
D. An LLC is always taxed as a C corporation.

8. For a trust account, the adviser should primarily base suitability on:

A. the highest expected pre-tax return.
B. the trustee's personal brokerage account objectives.
C. the youngest beneficiary's risk tolerance only.
D. the trust document, fiduciary duties, objectives, liquidity needs, and beneficiary circumstances.

9. Which is the best Series 65 response when a recommendation has complex entity-tax consequences?

A. Recommend the highest-yielding entity investment.
B. Ignore taxes because only return matters.
C. Coordinate with a qualified tax professional while evaluating suitability.
D. Guarantee the client's tax result.

10. Which statement best explains phantom income?

A. Income allocated to an owner even when the owner did not receive matching cash.
B. Income that is exempt from tax.
C. Income that appears only on a brokerage statement.
D. Income paid only by municipal issuers.

Answer Key and Explanations

1. D — C corporation generally pays entity-level tax.

2. B — Pass-through income can be taxable without cash distributions.

3. D — Trust/estate beneficiary income is commonly reported on a K-1.

4. C — MLPs commonly issue K-1s and require basis tracking.

5. B — REIT distributions can have several tax components.

6. A — MLPs can create UBTI in retirement accounts.

7. A — LLC tax classification depends on ownership and elections.
8. D — Trust suitability follows trust terms and fiduciary duties.
9. C — Advisers recognize tax issues and coordinate with tax professionals.
10. A — Phantom income is taxable income without matching cash.

Lesson 50: Wealth Transfer, Estate, and Gift Tax

Learning Objectives

- Distinguish **estate tax** from **gift tax** and **income tax**.
- Explain how the **unified transfer tax system** connects **lifetime gifts** and **transfers at death**.
- Recognize the difference between **annual exclusion gifts** and **lifetime exemption planning**.
- Identify how **portability**, **basis rules**, and **liquidity needs** affect investment recommendations.
- Apply wealth-transfer concepts to client profiling, suitability, and referral decisions.

Exam point
Recognize the planning issue, not compute a full estate or gift tax return.

50.1 Why Wealth Transfer Matters

Wealth transfer planning concerns how a client's assets move during life and at death. For an investment adviser representative, the topic is usually tested as a suitability and client-profiling issue rather than as detailed tax preparation.

- A client may need liquidity to pay estate expenses, taxes, debts, or administrative costs.
- Large unrealized gains may make the difference between gifting assets during life and holding them until death important.
- Beneficiary designations, account titling, trusts, and estate documents may override a client's informal wishes.
- An IAR should coordinate with attorneys and tax professionals when recommendations affect estate or gift tax results.

Core Vocabulary

Term	Definition
Estate tax	A transfer tax imposed on the right to transfer property at death. It is based on the value of property owned or controlled by the decedent at death, subject to deductions and credits.
Gift tax	A transfer tax that may apply when a donor gives money, securities, or other property during life. The donor, not the recipient, is generally responsible for gift tax reporting and payment.

Term	Definition
Gross estate	The total value of property included in the estate before deductions. It may include assets passing by will, beneficiary designation, joint ownership, or other legal arrangements.
Taxable estate	The amount remaining after allowable deductions, such as certain debts, expenses, charitable transfers, and marital transfers.
Donee	The person receiving a gift.
Executor or personal representative	The person responsible for administering an estate and coordinating required filings and distributions.

50.2 Estate Tax Fundamentals

- Estate tax is tied to transfers at death, not ordinary investment income.
- The valuation starting point is generally fair market value of included property at the date of death, subject to the applicable rules.
- The estate, through its executor or personal representative, may have filing and payment responsibilities.
- Not every estate owes federal estate tax because credits and exclusions may offset the tentative tax.
- Some states may impose their own estate or inheritance taxes, which can create planning issues even when no federal estate tax is due.

Exam point
Estate tax is a transfer tax at death; it is not a tax on the beneficiary's investment return.

50.3 Gift Tax Fundamentals

- Gift tax applies to certain transfers made during life for less than full consideration.
- The donor is generally responsible for gift tax reporting, not the donee.
- Most ordinary smaller gifts do not create current tax because annual exclusion and lifetime exemption rules may apply.
- A taxable gift can reduce the amount the client can later transfer free of estate tax.

- Gifts to spouses and charities may receive special treatment, but details should be coordinated with qualified tax counsel.

Annual Exclusion vs. Lifetime Exemption

Feature	Annual exclusion gifts	Lifetime exemption / unified credit
Basic idea	A donor can give up to an annual exclusion amount to each eligible recipient without using the lifetime exemption.	Taxable gifts above available exclusions may use part of the donor's lifetime exemption through the unified credit system.
Timing	Applies each year and generally per recipient.	Applies cumulatively over the donor's lifetime and at death.
Reporting	Often avoids gift tax reporting when requirements are met, but facts matter.	Usually requires gift tax reporting when a taxable gift is made.
Planning use	Useful for gradual wealth transfer and education about gifting discipline.	Useful for larger transfers, business succession, estate reduction, or advanced planning.
Series 65 point	Annual is about yearly per-donee exclusion.	Lifetime is about cumulative transfer capacity tied to estate and gift taxes.

50.4 Unified Credit and Unified Transfer Tax System

Estate and gift tax are coordinated under a unified transfer tax system. Large lifetime taxable gifts can use part of the same exemption that would otherwise be available at death. The applicable credit amount reduces or eliminates transfer tax that would otherwise be due.

- A taxable gift does not necessarily mean current gift tax is owed; it may use part of the client's lifetime exemption.
- Using exemption during life can reduce remaining exemption at death.
- The unified credit is a credit against estate and gift tax, not a deduction from ordinary income.
- Dollar thresholds can change by tax year, so an exam question will usually provide any required numerical amount.

50.5 Portability

Portability allows a surviving spouse to use a deceased spouse's unused exclusion amount when the required election is properly made. This is often discussed as the deceased spousal unused exclusion, or DSUE.

- Portability is a spouse-related estate planning concept.
- It generally requires a timely election by filing an estate tax return for the deceased spouse's estate.
- It can help married couples avoid wasting the first spouse's unused exclusion.
- It does not eliminate the need to review titling, beneficiary designations, state law, trust design, and investment liquidity.

Exam point
Portability is not automatic in the practical sense; the required election must be handled correctly.

50.6 Basis: Gifts vs. Inherited Assets

Transfer type	Typical basis concept	Investment recommendation issue
Lifetime gift	The recipient often receives carryover basis from the donor, subject to specific tax rules.	Gifting highly appreciated securities may transfer embedded capital gain to the recipient.
Inheritance at death	Inherited property often receives a basis adjustment to fair market value at death, subject to specific rules.	Holding appreciated assets until death may reduce capital gain exposure for heirs, but estate and liquidity needs must still be evaluated.
Charitable transfer	Charitable gifts may have special income, estate, and gift tax consequences.	Charitable goals may affect asset location, security selection, and timing of transfers.
Marital transfer	Transfers to a spouse often receive favorable transfer-tax treatment.	Advisers should still consider control, remarriage, creditor, and beneficiary concerns.

50.7 Common Planning Tools and Investment Issues

Tool or issue	What it does	Investment advisory implication
Will	Directs probate assets at death.	Does not usually control assets with beneficiary designations or certain joint ownership arrangements.
Revocable trust	Can help manage assets during life and after death; usually remains changeable by the grantor.	May require retitling assets and aligning investment management with trust provisions.
Irrevocable trust	Can remove some control from the grantor and may support tax or asset-protection planning.	Recommendations must account for trustee duties, liquidity, beneficiaries, and trust tax rules.
Beneficiary designation	Controls transfer of accounts such as IRAs, retirement plans, and insurance contracts.	Must be coordinated with the client's estate plan and beneficiary circumstances.
Concentrated position	May be a major part of family wealth.	Estate and gift planning can affect diversification, tax basis, and liquidity strategy.

50.8 Suitability and Client Data Gathering

- Identify intended beneficiaries, family circumstances, charitable goals, and major life events.
- Review account titling and beneficiary designations as part of the client profile.
- Ask about existing estate documents, but do not interpret legal documents beyond professional competence.
- Assess liquidity needs for taxes, debts, final expenses, and estate administration costs.
- Consider time horizon: lifetime gifting, retirement income, legacy goals, and expected estate settlement period may require different portfolios.
- Coordinate with the client's estate attorney, CPA, and trustee when recommendations affect legal or tax outcomes.

Common Exam Traps

- Confusing estate tax with income tax. Estate tax is about transfer at death; income tax is about taxable income.
- Assuming the recipient of a gift generally pays gift tax. The donor generally has the gift tax responsibility.
- Treating annual exclusion and lifetime exemption as the same concept. Annual exclusion is yearly; lifetime exemption is cumulative.
- Forgetting that a taxable gift may use exemption without requiring current tax payment.
- Assuming a will controls all assets. Beneficiary designations and account titling can control many transfers outside the will.
- Ignoring tax basis. Gifted assets and inherited assets can have very different basis outcomes.
- Providing legal or tax advice instead of coordinating with qualified professionals.

Quick Reference

Concept	Remember
Estate tax	Transfer at death.
Gift tax	Lifetime transfer by donor.
Annual exclusion	Yearly, often per recipient.
Lifetime exemption	Cumulative estate and gift transfer capacity.
Unified credit	Credit against transfer tax, not income tax.
Portability	Surviving spouse may use deceased spouse's unused exclusion if elected properly.
Gift basis	Often carryover basis.
Inherited basis	Often adjusted at death.
IAR role	Identify planning issues, recommend suitable investments, and coordinate with professionals.

Practice Questions

1. Which statement best describes the federal estate tax?

A. It is a tax on ordinary income earned by heirs.
B. It is paid only by corporations.
C. It applies only to securities accounts.
D. It is a tax on the right to transfer property at death.

2. A client gives appreciated stock to an adult child during life. Which issue should the adviser recognize?

A. The transfer converts the stock to tax-free municipal income.
B. The child always receives a full step-up in basis immediately.
C. The donor can never owe gift tax on securities.
D. The gift may involve carryover basis and embedded capital gain.

3. Which statement about gift tax is generally correct?

A. The donor generally has the gift tax reporting and payment responsibility.
B. Gift tax applies only when property is sold.
C. Gift tax is the same as capital gains tax.
D. The recipient always pays the gift tax.

4. The annual gift tax exclusion is best described as:

A. a credit that applies only to corporate gifts.
B. a yearly exclusion that may apply per recipient.
C. a once-in-a-lifetime exclusion.
D. a deduction from ordinary wages.

5. What is the unified credit designed to do?

A. Convert ordinary income into qualified dividends.
B. Eliminate all state inheritance taxes.
C. Coordinate estate and gift tax exemption use.
D. Guarantee tax-free investment income.

6. Portability most directly relates to:

A. transferring a retirement account to a new custodian.
B. a surviving spouse’s potential use of a deceased spouse’s unused exclusion.
C. moving assets from one brokerage firm to another.
D. avoiding all probate without filing any forms.

7. Which asset-transfer method may override instructions in a will?

A. A valid beneficiary designation on a retirement account.
B. A risk tolerance questionnaire.
C. A handwritten investment objective.
D. A model portfolio label.

8. Why might an estate need liquidity?

A. To guarantee that heirs never pay income tax.
B. To avoid all market risk permanently.
C. To pay debts, expenses, taxes, or administrative costs.
D. To make all securities exempt from registration.

9. Which statement is most appropriate for an IAR?

A. Promise that no estate tax will ever apply.
B. Coordinate investment recommendations with the client's attorney and tax professional.
C. Draft a trust document for the client.
D. Tell the client to ignore beneficiary designations.

10. Which statement about inherited property is generally relevant to investment planning?

A. It cannot be sold by the beneficiary.
B. It is always taxed as ordinary income when inherited.
C. It always has the same basis as the donor's original purchase price.
D. It may receive a basis adjustment at death, subject to applicable rules.

Answer Key and Explanations

1. D — Estate tax concerns the transfer of property at death.

2. D — Lifetime gifts of appreciated property often raise carryover-basis and embedded-gain issues.

3. A — The donor is generally responsible for gift tax reporting and payment.

4. B — The annual exclusion is a yearly per-recipient concept when requirements are met.

5. C — The unified credit coordinates estate and gift tax exemption use.

6. B — Portability involves a deceased spouse's unused exclusion amount.

7. A — Beneficiary designations can control transfers outside the will.

8. C — Estates may need cash for debts, expenses, taxes, and administration.

9. B — An IAR should coordinate with qualified legal and tax professionals.

10. D — Inherited property may receive a basis adjustment at death, subject to applicable rules.

Lesson 51: Traditional and Roth IRAs

Learning Objectives

- Compare **contribution**, **deduction**, **taxation**, and **distribution rules** for **traditional** and **Roth IRAs.**
- Apply the 2026 IRA contribution limit and basic income-limit concepts.
- Recognize **traditional IRA RMD rules** and the **Roth IRA owner's lifetime RMD treatment**.
- Distinguish a **Roth conversion** from a **regular annual contribution**.

IRA Overview

An **Individual Retirement Arrangement (IRA)** is a tax-advantaged retirement account. Traditional and Roth IRAs share the same combined annual contribution limit, but they differ significantly in when tax benefits are received and how qualified withdrawals are treated.

2026 contribution limit
For 2026, total regular contributions to all of an individual's traditional and Roth IRAs generally cannot exceed $7,500, or taxable compensation if lower. For an individual age 50 or older, the 2026 limit is $8,600 because the catch-up amount is $1,100.

51.1 Traditional IRA

- **Contribution:** Requires taxable compensation (subject to spousal IRA rules). The contribution may be deductible, partly deductible, or nondeductible depending on income and workplace-plan coverage.
- **Growth:** Generally tax-deferred while assets remain in the IRA.
- **Distribution:** Taxable amounts are generally ordinary income when withdrawn; basis from nondeductible contributions is recovered tax-free under pro-rata rules.
- **RMD:** Traditional IRA owners generally must begin required minimum distributions under current RMD rules. The IRS currently describes the general starting age as 73.
- **Early distribution:** A taxable distribution before age 59½ may also be subject to a 10% additional tax unless an exception applies.

51.2 Roth IRA

- **Contribution:** Never deductible. Direct contributions are subject to modified adjusted gross income limits.
- **Growth:** Potentially tax-free if distribution requirements are met.
- **Qualified distribution:** Generally tax-free if the Roth five-year requirement is met and the distribution occurs after age 59½, death, disability, or for qualifying first-home costs up to the statutory lifetime limit.

- **RMD:** The original Roth IRA owner is not required to take lifetime RMDs; beneficiaries are subject to post-death distribution rules.
- **Ordering:** Roth IRA distributions generally come from regular contributions first, which is one reason Roth contributions can be more flexible than earnings.

51.3 Traditional vs. Roth IRA

Feature	Traditional IRA	Roth IRA
2026 regular contribution limit	Combined $7,500; $8,600 age 50+ (subject to compensation)	Same combined limit
Contribution deduction	May be deductible depending on circumstances	Never deductible
Income limits	Can affect deductibility if covered by workplace plan; contribution itself may still be allowed	Direct contribution eligibility phases out at higher modified AGI
Tax on qualified/normal withdrawal	Taxable to extent not previously taxed	Qualified distributions are tax-free
Lifetime RMDs for owner	Generally yes	No
Best fit conceptually	Current deduction may be valuable when tax rate is high today	Future tax-free qualified withdrawals may be valuable, especially if future tax rate is expected to be high

51.4 2026 Income-Range Examples

For 2026, the IRS increased the income ranges used for traditional IRA deduction phase-outs and Roth IRA direct-contribution phase-outs. For example, direct Roth IRA contributions phase out for single/head-of-household filers from $153,000 to $168,000 of modified AGI and for married filing jointly from $242,000 to $252,000. These figures are indexed and can change from year to year.

Exam point
If a Series 65 question gives specific contribution or income limits, use the figures in the question. Focus first on the conceptual distinction: traditional IRA = possible deduction now/taxable later; Roth IRA = no deduction now/potentially tax-free qualified withdrawals later.

51.5 Roth Conversion

A Roth conversion moves eligible pre-tax traditional IRA or retirement-plan assets into a Roth IRA. The taxable portion converted is generally included in income for the conversion year. A conversion is not the same as a regular annual Roth contribution and is not limited by the annual IRA contribution dollar cap in the same way.

Simple contribution example: Combined Traditional IRA + Roth IRA Regular Contributions ≤ Annual Limit
Calculated example: A 40-year-old contributes $3,000 to a traditional IRA in 2026. The maximum remaining regular contribution to a Roth IRA for that year is generally $4,500, assuming sufficient compensation and Roth eligibility: $7,500 − $3,000 = $4,500.

51.6 Client Recommendation Considerations

- Current vs. expected future marginal tax rate.
- Whether the client qualifies for a deductible traditional IRA contribution or direct Roth contribution.
- Need for future tax diversification and flexibility.
- Time horizon and ability to leave Roth assets invested without lifetime RMDs.
- Interaction with workplace plans, conversions, estate planning, and Medicare/other income-sensitive considerations.

Series 65 Exam Cues

- Traditional IRA contribution may be deductible; Roth contribution is never deductible.
- Traditional IRA distributions are generally taxable as ordinary income to the extent not previously taxed.
- Qualified Roth distributions are tax-free.
- Traditional IRA owners generally face RMDs; Roth IRA owners generally do not during life.
- The annual contribution limit is combined across traditional and Roth IRAs.

References and Further Reading

- NASAA, Series 65 Test Specifications (effective June 12, 2023), Retirement Plans: Individual Retirement Accounts (traditional and Roth).

- IRS, IRA Contribution Limits (2026): https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-ira-contribution-limits
- IRS, COLA Increases for Dollar Limitations on Benefits and Contributions: https://www.irs.gov/retirement-plans/cola-increases-for-dollar-limitations-on-benefits-and-contributions
- IRS, Required Minimum Distributions: https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-required-minimum-distributions-rmds
- IRS, Publication 590-A and Publication 590-B for contribution and distribution rules. Tax rules are summarized for exam preparation and change over time.

Practice Questions

1. For 2026, the combined regular contribution limit for a person under age 50 across traditional and Roth IRAs is generally:

A. $24,500
B. $8,600
C. $15,000
D. $7,500

2. Which statement about Roth IRA contributions is correct?

A. They are always deductible.
B. They are deductible only if the account owner has no workplace plan.
C. They are never deductible.
D. They are deductible only after age 59½.

3. Which statement best describes traditional IRA withdrawals?

A. They are always long-term capital gains.
B. Taxable amounts are generally included in ordinary income.
C. They are always tax-free.
D. They are never subject to an additional tax before age 59½.

4. Which IRA generally has no required minimum distributions for the original account owner during life?

A. Roth IRA
B. Traditional IRA
C. **SIMPLE IRA**
D. **SEP IRA**

5. A 35-year-old contributes $2,500 to a traditional IRA in 2026. Assuming sufficient compensation and Roth eligibility, how much of the $7,500 combined regular IRA limit remains for a Roth contribution?

A. $5,000
B. $2,500
C. $10,000
D. $7,500

6. Which statement about a Roth conversion is most accurate?

A. It is always tax-free.
B. It is the same as a deductible traditional IRA contribution.
C. It can generally cause the taxable converted amount to be included in income for the conversion year.
D. It is prohibited once the client has a workplace retirement plan.

7. A qualified Roth IRA distribution generally requires the five-year rule plus which type of condition?

A. The account earns at least 5% annually.
B. The owner takes an annual RMD.
C. The owner is employed by a public company.
D. A qualifying event such as age 59½, death, disability, or qualifying first-home use.

8. Which statement is most accurate about traditional IRA contribution deductibility?

A. Every contribution is fully deductible regardless of income or workplace-plan coverage.
B. Deductibility can depend on income and whether the taxpayer or spouse is covered by a workplace retirement plan.
C. Only investors over age 50 can deduct contributions.
D. No traditional IRA contribution is deductible.

Answer Key and Explanations

1. D — $7,500. The 2026 regular IRA contribution limit is $7,500 for individuals under age 50, subject to taxable compensation.

2. C — They are never deductible. Roth IRA contributions are made with after-tax dollars.

3. B — Taxable amounts are generally included in ordinary income. Traditional IRA distributions are generally ordinary income to the extent not previously taxed.

4. A — Roth IRA. Original Roth IRA owners generally have no lifetime RMD requirement.

5. A — $5,000. $7,500 combined limit − $2,500 traditional contribution = $5,000 remaining.

6. C — It can generally cause the taxable converted amount to be included in income for the conversion year. Conversions commonly accelerate tax into the conversion year.

7. D — A qualifying event such as age 59½, death, disability, or qualifying first-home use. The five-year rule plus a qualifying event generally defines a qualified Roth distribution.

8. B — Deductibility can depend on income and whether the taxpayer or spouse is covered by a workplace retirement plan. Traditional contributions can be deductible, partially deductible, or nondeductible depending on circumstances.

Lesson 52: Solo 401(k) Plans: Traditional and Roth

Learning Objectives

- Define a **Solo 401(k)**, also called a one-participant 401(k), individual 401(k), Solo K, or Uni-K.
- Distinguish **traditional pre-tax treatment** from **designated Roth treatment**.
- Explain the **employee deferral** and **employer contribution** structure for owner-only businesses.
- Identify suitability issues, compliance limits, and common exam traps.
- Apply Solo 401(k) concepts to retirement plan recommendations for self-employed clients.

52.1 Why Solo 401(k) Plans Matter

A **Solo 401(k)** is a qualified retirement plan designed for a self-employed business owner with no common-law employees other than a spouse. It can be used by an incorporated or unincorporated business. For exam purposes, the key point is that the owner can wear two contribution hats: employee and employer.

- As employee, the owner may make elective salary deferrals, subject to the annual 401(k) deferral limit.
- As employer, the business may make profit-sharing contributions, subject to compensation and plan limits.
- The plan may offer traditional pre-tax deferrals, designated Roth deferrals, or both, depending on the plan document.
- If eligible non-spouse employees must be covered, the plan is no longer a simple owner-only Solo 401(k) arrangement.

Exam point
Solo 401(k) = owner-only business, higher savings potential, plan-document and compliance responsibilities.

Core Vocabulary

Term	Definition
One-participant 401(k)	A qualified defined contribution plan covering a business owner and possibly the owner's spouse, but not other common-law employees.

Term	Definition
Traditional deferral	Employee elective deferral made on a pre-tax basis; taxable income is generally reduced now, and future distributions are taxable as ordinary income.
Designated Roth deferral	Employee elective deferral made with after-tax dollars; qualified distributions may be tax-free.
Employer contribution	A business contribution, often described as profit sharing. It is generally pre-tax unless the plan permits Roth treatment.
Annual additions limit	The overall defined contribution limit for combined employee and employer contributions, not counting permitted catch-up contributions.
Plan document	The written document that determines available features, such as Roth accounts, loans, hardship withdrawals, and contribution formulas.

52.2 Traditional vs. Roth Solo 401(k)

Feature	Traditional Solo 401(k)	Roth Solo 401(k)
Tax treatment of employee deferral	Generally pre-tax; lowers current taxable income.	After-tax; no current income tax deduction for the deferral.
Taxation of qualified withdrawals	Taxed as ordinary income when distributed.	Qualified distributions may be federal income tax-free.
Best fit	Client wants current tax reduction and expects lower future tax rates.	Client can pay tax now and wants potential tax-free retirement income.

Feature	Traditional Solo 401(k)	Roth Solo 401(k)
RMD issues	Subject to retirement plan RMD rules unless rolled to another account type where rules differ.	Designated Roth accounts generally avoid lifetime RMDs under current law; beneficiary rules still matter.
Employer contribution	Generally pre-tax employer contribution.	Some plans may permit Roth employer contributions if plan terms allow.

Advisor conversation point

The traditional-versus-Roth recommendation is not only a tax-rate forecast. It also depends on cash flow, plan features, retirement income sources, estate goals, government benefit effects, and whether the client values tax diversification.

52.3 Contribution Structure

Solo 401(k) planning starts with the combined employee and employer contribution structure. Exact dollar limits are indexed and change over time, so an adviser should verify current-year limits before making implementation recommendations.

- Employee elective deferral: the owner can defer compensation into the plan up to the annual 401(k) elective deferral limit, or 100% of compensation if lower.
- Catch-up deferrals: participants who meet the age requirement may contribute additional catch-up amounts if permitted by the plan.
- Employer profit-sharing contribution: the business may contribute additional amounts subject to compensation, entity-type, and overall plan limits.
- Overall defined contribution limit: employee and employer contributions are capped by the annual additions limit; permitted catch-up contributions are added on top of that limit.
- One person, one deferral limit: elective deferrals are aggregated across plans of unrelated employers, so a side-business Solo 401(k) does not create a second employee deferral limit.

For 2026, IRS tables list a 401(k) elective deferral limit of $24,500 and a defined contribution annual additions limit of $72,000 before catch-up contributions.

52.4 Suitability and Recommendation Issues

Client fact pattern	Why it matters	Planning implication
Self-employed consultant with no employees	Potentially eligible for owner-only plan design.	Solo 401(k) may allow larger contributions than an IRA and may support Roth deferrals.
Owner has eligible employees	Employees generally cannot be excluded if they meet plan eligibility rules.	Consider a regular 401(k), SIMPLE IRA, SEP IRA, or other employer plan structure.
Irregular business income	Contributions require earned income or compensation and adequate cash flow.	Avoid overfunding; coordinate with tax preparer before year-end.
High current tax bracket	Pre-tax contributions may reduce current taxable income.	Traditional deferrals and employer contributions may be attractive.
Long time horizon and tax diversification goal	Roth assets can reduce future tax uncertainty.	Designated Roth deferrals may be suitable if the client can pay current tax.
Needs access to funds before retirement	Qualified plan assets are restricted; early withdrawals may face tax and penalty.	Plan loans may help only if the plan document permits them and loan rules are followed.

52.5 Administration, Compliance, and Distribution Rules

- The plan must be formally adopted and operated according to the written plan document.
- A one-participant plan may have an annual Form 5500-EZ filing requirement when plan assets exceed the threshold or in the final plan year.
- Loans and hardship withdrawals are available only if allowed by the plan document and administered under plan rules.
- Traditional distributions are generally taxable as ordinary income, and early distributions may trigger an additional penalty unless an exception applies.
- Rollovers may be available to another qualified plan or IRA, subject to traditional-to-traditional and Roth-to-Roth rules.
- Required minimum distribution rules apply to retirement plans, with special treatment for designated Roth accounts under current law.

52.6 Comparison With Other Retirement Vehicles

Plan type	Key strength	Key limitation
Traditional or Roth IRA	Simple, low administrative burden.	Lower contribution limits and income restrictions may apply to Roth contributions or deductibility.
SEP IRA	Simple employer-funded option for self-employed people and small businesses.	No employee salary deferral feature; Roth and loan features are generally not available in the same way as a 401(k).
SIMPLE IRA	Designed for small employers with lower administrative complexity.	Lower contribution limits than 401(k) arrangements and required employer contribution rules.
Solo 401(k)	High savings potential through employee and employer contribution roles; may offer Roth and loan features.	Only for owner-only businesses with no eligible non-spouse employees; requires plan administration.
Regular 401(k)	Can cover employees and support larger employer-sponsored plan features.	More testing, notices, administration, and fiduciary responsibilities.

Common Exam Traps

- A Solo 401(k) is not an IRA; it is a qualified employer retirement plan.
- Traditional and Roth labels describe tax treatment, not the investment choices inside the account.
- A business owner may contribute as both employee and employer, but total contributions remain subject to limits.
- A spouse may be covered if the spouse earns compensation from the business.
- Eligible non-spouse employees generally change the plan from an owner-only arrangement to a broader employer plan.
- Roth deferrals do not provide a current deduction, but qualified distributions can be tax-free.
- Plan loans are not automatic; they must be allowed by the plan document.

Quick Reference

Concept	Exam takeaway
Best-fit client	Self-employed owner-only business; spouse may be included if compensated by the business.
Traditional tax treatment	Pre-tax now; taxable ordinary income later.
Roth tax treatment	After-tax now; qualified distributions may be tax-free.
Contribution roles	Owner can contribute as employee and employer, subject to limits.
Employee issue	Eligible non-spouse employees can make owner-only treatment inappropriate.
Administration	Plan document, possible Form 5500-EZ, records, deadlines, and operational compliance.

Practice Questions

1. Which client is the best fit for a Solo 401(k)?

A. A minor child who received interest income from a bank account.
B. A corporation with 75 full-time employees looking for a low-cost employee benefit plan.
C. A retiree with no earned income who wants to make a deductible retirement contribution.
D. A self-employed graphic designer with no employees other than a spouse who works in the business.

2. What is the main tax distinction between a traditional Solo 401(k) deferral and a Roth Solo 401(k) deferral?

A. Traditional deferrals are after-tax; Roth deferrals are pre-tax.
B. Traditional deferrals are generally pre-tax; Roth deferrals are made with after-tax dollars.
C. Traditional deferrals can only invest in bonds.
D. Roth deferrals are deductible only if the client itemizes deductions.

3. Why can a Solo 401(k) allow larger contributions than an IRA for some self-employed clients?

A. It combines an employee elective deferral role with an employer contribution role, subject to limits.
B. It permits unlimited contributions if the business is profitable.
C. It avoids all IRS reporting rules.
D. It ignores earned income requirements.

4. Which statement about employees is generally correct?

A. A Solo 401(k) can freely exclude all employees as long as the owner contributes less than the maximum.
B. Employee status affects investment selection but not retirement plan eligibility.
C. If a business has eligible non-spouse employees, an owner-only Solo 401(k) may no longer be appropriate.
D. A Solo 401(k) is required whenever a business has more than 100 employees.

5. A client wants current taxable income reduction from retirement plan contributions and expects to be in a lower tax bracket in retirement. Which contribution type is most consistent with that goal?

A. Roth Solo 401(k) deferral.
B. Taxable brokerage account contribution.
C. Nonqualified deferred annuity purchase only.
D. Traditional pre-tax Solo 401(k) contribution.

6. Which feature is available only if the Solo 401(k) plan document permits it?

A. Plan loans.
B. The requirement to follow annual contribution limits.
C. The owner's ability to earn business income.
D. Ordinary income tax treatment for traditional distributions.

Answer Key and Explanations

1. D — A self-employed owner with no employees other than a spouse is the classic Solo 401(k) fact pattern.

2. B — Traditional deferrals are generally pre-tax; designated Roth deferrals are after-tax with potential tax-free qualified distributions.

3. A — The owner can contribute as employee and employer, subject to contribution limits and compensation.

4. C — Eligible non-spouse employees generally create broader plan coverage issues.

5. D — Traditional pre-tax contributions best match a current tax deduction goal when future tax rates are expected to be lower.

6. A — Loans are not automatic; the plan document must allow them and rules must be followed.

Lesson 53: Qualified and Nonqualified Retirement Plans

Learning Objectives

- Distinguish **qualified retirement plans** from **nonqualified retirement plans**.
- Compare **defined benefit plans** and **defined contribution plans**.
- Recognize core features of company **401(k)**, **403(b)**, **457**, **SIMPLE IRA**, and **SEP plans**.
- Explain how plan type affects taxes, liquidity, creditor exposure, and suitability.
- Identify common Series 65 exam traps involving retirement plan recommendations.

Exam point Connect plan features to client suitability. The best recommendation depends on tax situation, employment status, savings capacity, liquidity needs, and employer-plan features.

53.1 Why Retirement Plan Type Matters

Retirement plans differ in who sponsors the plan, who may participate, who contributes, how contributions are taxed, how investments are selected, and how distributions are taxed.

For a Series 65 exam question, the best answer usually turns on suitability: client employment status, business ownership, tax bracket, cash-flow needs, savings capacity, employer match, liquidity needs, and time horizon.

Do not treat all retirement accounts as interchangeable. A 401(k), SEP, SIMPLE IRA, 403(b), 457, defined benefit pension, and nonqualified deferred compensation arrangement can all serve retirement goals, but they solve different planning problems.

53.2 Qualified Retirement Plans

A **qualified retirement plan** is an employer-sponsored retirement plan that satisfies Internal Revenue Code requirements. Qualified plans generally receive favorable tax treatment if they comply with rules on eligibility, vesting, funding, nondiscrimination, distributions, and reporting.

Common qualified plans include defined benefit pension plans, defined contribution plans, profit-sharing plans, money purchase plans, and company 401(k) plans.

Qualified plans are generally designed to benefit a broad employee group, not just owners and highly compensated employees. That is why coverage and nondiscrimination requirements matter.

Exam point
Qualified does not mean risk-free or best for every client. It means the plan meets tax qualification rules and receives favorable tax treatment if operated properly.

53.3 Defined Benefit Plans

A **defined benefit plan** promises a determinable retirement benefit, often based on compensation, age, and years of service. The employer bears the actuarial and investment risk of funding the promised benefit.

The plan sponsor must fund the plan using actuarial assumptions. This makes defined benefit plans more complex and expensive to administer, but they can allow large deductible contributions for employers with predictable cash flow.

Defined benefit plans are most often associated with traditional pensions and can be attractive for older business owners who want accelerated retirement accumulation and can commit to required funding.

53.4 Defined Contribution Plans

A **defined contribution plan** does not promise a specific retirement benefit. Instead, contributions go into an individual account for the participant. The participant's ending balance depends on contributions, investment performance, fees, loans or withdrawals, and distributions.

The employee generally bears the investment risk. The plan sponsor may offer matching contributions, profit-sharing contributions, investment menus, and administrative services.

Common defined contribution examples include 401(k), 403(b), 457(b), profit-sharing, SEP, SIMPLE IRA, and money purchase arrangements.

Feature	Qualified plan	Nonqualified plan
Primary purpose	Broad employee retirement benefits	Executive or selective compensation planning
Tax treatment	Favorable if qualification rules are met	Tax deferral possible if properly structured
Coverage rules	Must satisfy eligibility and nondiscrimination rules	May be limited to selected employees
Contribution limits	Subject to statutory limits	Not subject to the same qualified plan limits
Creditor protection	Plan assets generally held in trust	Often subject to employer creditor risk
Series 65 cue	Mainstream employee retirement plan	Executive deferral and employer credit risk

53.5 Company 401(k) Plans

A **company 401(k) plan** is a qualified defined contribution plan sponsored by an employer. Employees may make elective deferrals, and employers may make matching or nonelective contributions.

Plans may permit traditional pre-tax deferrals and, if the plan allows, designated Roth contributions. Traditional deferrals reduce current taxable income; Roth deferrals are after-tax but can produce tax-free qualified distributions.

For suitability, an employee who has access to an employer match usually should consider contributing enough to capture the match before using taxable accounts for long-term retirement savings.

53.6 403(b) Plans

A **403(b)** plan is a tax-favored retirement plan commonly used by public schools, certain tax-exempt organizations, and some ministers.

The account structure often resembles a 401(k), but the eligible employer group is different. Investments may include annuity contracts and mutual fund custodial accounts.

Series 65 questions often test recognition: 403(b) plans are associated with nonprofit, public education, and certain religious or charitable employers, not regular for-profit corporations.

53.7 457 Plans

A **457 plan** is a deferred compensation arrangement typically associated with governmental employers and certain tax-exempt organizations.

Governmental 457(b) plans can be valuable because distributions after separation from service are generally not subject to the same early distribution penalty framework that applies to many qualified plans and IRAs, although ordinary income tax still applies to pre-tax amounts.

Non-governmental 457(b) plans can carry employer-creditor risk because assets are often subject to the claims of the employer's general creditors. That difference matters in suitability analysis.

53.8 SIMPLE IRA Plans

A **SIMPLE IRA** is a retirement plan designed for small employers. It is easier to administer than a full 401(k), but it has lower contribution capacity and mandatory employer contribution requirements.

SIMPLE IRA plans are generally used by small businesses with 100 or fewer employees and no other retirement plan. Employees may make salary deferrals, and the employer generally must make either matching or nonelective contributions.

SIMPLE IRA plans can fit small employers that want a straightforward retirement plan without the administrative burden of a full 401(k).

53.9 SEP Plans

A **SEP** allows an employer to make contributions to traditional IRAs established for employees. A business of any size, including a self-employed person, can establish a SEP.

SEP contributions are employer contributions. The plan is relatively easy to establish and administer, but employees do not make elective salary deferrals in a standard SEP arrangement.

A SEP may fit a self-employed person or small business owner who wants administrative simplicity and flexible annual contribution decisions.

Plan	Typical sponsor or user	Best fit	Primary caution
Defined benefit pension	Employer with predictable cash flow	Promised retirement benefit; large required funding	Complexity, actuarial cost, required contributions
401(k)	For-profit employer	Employee salary deferrals plus possible employer match	Plan menu, fees, vesting, loans, leakage
403(b)	Public schools and tax-exempt organizations	Tax-favored savings for eligible nonprofit/public employees	Investment options and annuity costs vary
457(b)	Governmental and certain tax-exempt employers	Additional deferral opportunity; useful for public employees	Non-governmental versions may carry creditor risk
SIMPLE IRA	Small employer	Lower-cost plan with mandatory employer contribution	Lower contribution capacity than 401(k)
SEP	Self-employed or any size business	Employer-only contributions with simple administration	No standard employee salary deferral

53.10 Nonqualified Retirement Plans

A **nonqualified retirement plan** is an employer arrangement that does not satisfy, or is not intended to satisfy, the tax qualification requirements that apply to qualified plans.

Common examples include nonqualified deferred compensation plans, supplemental executive retirement plans (SERPs), excess benefit plans, and certain bonus or executive retention arrangements.

Nonqualified plans are often used for executives or highly compensated employees because qualified plan rules limit how much can be contributed and require broad employee coverage.

Exam point
A nonqualified plan can create tax deferral, but it may also concentrate the client in employer credit risk and restrict distribution timing.

53.11 Key Risks of Nonqualified Plans

Nonqualified deferred compensation is usually an unsecured promise by the employer to pay compensation in the future. If the employer becomes insolvent, the participant may become a general creditor.

Tax deferral depends on compliance with rules such as Internal Revenue Code Section 409A. Poorly structured arrangements can accelerate taxation and penalties.

Nonqualified plans may be useful for high-income clients, but they are not substitutes for diversified retirement assets that are outside the employer's credit risk.

53.12 Suitability Framework

For exam purposes, recommendations should begin with the client's objective and constraints, not with a preferred product. Use the plan type to solve a planning problem.

Client situation	Likely planning direction
Employee receives a 401(k) match	Consider contributing enough to capture the full match before taxable investing.
Public school employee with access to 403(b)	Evaluate tax deferral, investment menu, annuity fees, and Roth/pre-tax choice if available.
Government employee with 457(b) access	Consider using 457(b) alongside other plans when savings capacity is high.
Self-employed client with uneven income	SEP may fit because employer contributions can be flexible year to year.

Client situation	Likely planning direction
Small employer wants simple retirement benefit	SIMPLE IRA may fit if employee count and other-plan requirements are satisfied.
High-income executive offered deferred compensation	Analyze employer credit risk, 409A restrictions, distribution timing, and concentration in employer risk.

Common Exam Traps

- A defined benefit plan promises a benefit; a defined contribution plan defines contributions to an account.
- A 403(b) is not the standard plan for a regular for-profit corporation; it is tied to public schools and tax-exempt organizations.
- A SEP is funded by employer contributions, including contributions by a self-employed person for themselves.
- A SIMPLE IRA is designed for small employers and usually requires employer contributions.
- A nonqualified plan may provide tax deferral, but it can expose the participant to employer creditor risk.
- Capturing an employer match is often a high-priority retirement savings step, assuming the client can afford the deferral.

Quick Review

Term	Core idea
Qualified plan	Meets tax qualification rules; generally broad-based and tax-favored.
Defined benefit	Employer promises a determinable retirement benefit.
Defined contribution	Contributions go to individual accounts; account value varies.
401(k)	Employer-sponsored salary deferral plan, often with match.
403(b)	Plan for public schools and certain tax-exempt organizations.

Term	Core idea
457(b)	Deferred compensation arrangement often used by governmental employers.
SIMPLE IRA	Small-employer plan with salary deferrals and required employer contributions.
SEP	Employer-funded IRA arrangement; common for self-employed and small businesses.
Nonqualified plan	Selective deferred compensation; may involve employer creditor risk.

Key Takeaways

- Qualified plans receive tax-favored treatment because they follow strict rules on coverage, eligibility, vesting, funding, distributions, and reporting.
- Defined benefit plans promise a benefit; defined contribution plans provide an account balance that depends on contributions and investment results.
- 401(k), 403(b), 457, SIMPLE IRA, and SEP plans differ by sponsor type, contribution structure, administrative burden, and suitability use case.
- Nonqualified plans are often executive compensation tools and require careful analysis of employer credit risk and distribution rules.
- For Series 65 questions, the most suitable plan recommendation generally aligns with the client's employment status, tax profile, cash flow, time horizon, and liquidity needs.

Practice Questions

1. A plan promises employees a monthly retirement benefit based on salary and years of service. Which type of plan is this?

A. SEP
B. Defined contribution plan
C. SIMPLE IRA
D. Defined benefit plan

2. Which plan is most closely associated with public schools and certain tax-exempt organizations?

A. SEP
B. Nonqualified deferred compensation plan
C. 403(b) plan
D. SIMPLE IRA

3. A self-employed consultant wants a relatively simple retirement plan funded with employer contributions. Which plan is most likely to fit?

A. SEP
B. Governmental 457(b)
C. Traditional defined benefit pension only
D. 403(b)

4. Which statement best describes a nonqualified deferred compensation plan?

A. It may be used selectively for executives and can carry employer credit risk.
B. It must cover all full-time employees equally.
C. It is always protected from employer creditors.
D. It is the same as a Roth IRA.

5. A small business with 40 employees wants a simple plan that allows employee salary deferrals but does not want a full 401(k). Which plan is most likely to be considered?

A. Nonqualified SERP
B. SIMPLE IRA
C. 403(b)
D. Governmental 457(b)

6. A client asks whether to contribute to a 401(k) while the employer offers a dollar-for-dollar match up to a limited percentage of pay. What is the strongest planning point?

A. The client should use only a nonqualified plan.
B. The match eliminates all tax and investment risks.
C. The match is usually a valuable benefit if the client can afford the deferral.
D. The client should avoid all retirement plans because of market risk.

Answer Key and Explanations

1. D — A defined benefit plan promises a determinable benefit. The employer bears the funding and actuarial risk.

2. C — 403(b) plans are used by public schools, certain tax-exempt organizations, and some ministers.

3. A — A SEP can be established by a self-employed person and is funded with employer contributions to SEP-IRAs.

4. A — Nonqualified plans are often selective executive arrangements and are usually unsecured promises subject to employer credit risk.

5. B — A SIMPLE IRA is designed for small employers and allows employee salary deferrals with required employer contributions.

6. C — Employer matching contributions are generally valuable, but the recommendation still depends on cash flow, liquidity, and suitability.

Lesson 54: ERISA Issues

Learning Objectives

- Explain when **ERISA** issues arise in investment advisory work.
- Identify who may be an ERISA **fiduciary** and what **fiduciary duties** apply.
- Describe fiduciary responsibilities for **investment menus**, **QDIAs**, **and diversification choices**.
- Explain how an **investment policy statemen**t supports a prudent investment process.
- Recognize **prohibited transactions**, **conflicts of interest**, and common Series 65 exam traps.

Exam point ERISA questions are usually about process, loyalty, prudence, diversification, documentation, and avoiding conflicts of interest.

54.1 Why ERISA Matters

ERISA, the Employee Retirement Income Security Act, sets fiduciary and operational standards for many employer-sponsored retirement plans. It matters to investment advisers because a recommendation to a plan, plan sponsor, plan fiduciary, or plan participant may carry legal and compliance obligations that are different from a recommendation to an ordinary taxable account client.

- The plan exists for the benefit of participants and beneficiaries.
- Fiduciaries must make decisions in the interest of the plan, not the employer, adviser, recordkeeper, or other service provider.
- The standard emphasizes prudent process, informed decision-making, monitoring, and documentation.
- Participant-directed plans still require fiduciary oversight of the investment lineup and default investment option.

Key ERISA Concepts

Concept	Meaning for Series 65
Plan fiduciary	A person or entity with discretionary authority over plan management, control over plan assets, plan administration, or investment advice for compensation.

Concept	Meaning for Series 65
Participant and beneficiary	The people for whom the plan is operated. Fiduciary decisions must be made for their benefit.
Named fiduciary	The person or committee identified in the plan document as responsible for fiduciary decisions.
Plan assets	Assets held in the retirement plan. These must be used according to ERISA and the plan documents.
Service provider	A recordkeeper, adviser, custodian, TPA, fund company, attorney, or other provider hired by the plan. Fees and conflicts must be reviewed.
Party in interest	A person or entity with a close relationship to the plan, such as the employer, fiduciaries, service providers, certain owners, and affiliates. Transactions with these parties require careful review.

54.2 Fiduciary Issues

A **fiduciary** is not defined only by job title. A person can become a fiduciary by what they do. In the Series 65 context, the key issue is whether the adviser has discretionary authority, control over plan assets, administrative responsibility, or is being paid for investment advice involving plan assets.

- A plan sponsor acting as employer may make business decisions about whether to create, amend, or terminate a plan.
- The same employer becomes a fiduciary when selecting plan service providers, choosing the investment menu, monitoring fees, or selecting a QDIA.
- An adviser who provides plan-level investment advice for a fee may be acting as an ERISA fiduciary.
- Fiduciary status increases the importance of written process, clear role definitions, fee review, and conflict management.

Core Fiduciary Duties

Duty	Plain-English Meaning	Planning Application
Loyalty	Act solely in the interest of participants and beneficiaries.	Do not recommend an option because it pays the adviser, affiliate, or recordkeeper more.
Prudence	Use the care, skill, prudence, and diligence of a knowledgeable fiduciary.	Compare fees, performance, risk, benchmarks, share classes, and alternatives before selecting or retaining an option.
Diversification	Diversify plan investments to reduce the risk of large losses unless clearly imprudent not to do so.	Offer a menu that allows broad diversification across major asset classes.
Follow plan documents	Operate the plan according to its written terms, unless the terms conflict with ERISA.	Follow the plan document and investment policy statement consistently.
Reasonable expenses	Pay only reasonable plan expenses.	Review recordkeeping fees, fund expense ratios, advisory fees, and revenue sharing arrangements.
Exam cue: ERISA does not require the best-performing fund. It requires a loyal, prudent, documented process for selecting and monitoring plan investments.		

54.3 Investment, QDIA, and Diversification Choices

In a participant-directed retirement plan, fiduciaries typically choose the investment menu from which participants may select investments. The fiduciary duty applies to both the individual options and the overall lineup.

- The lineup should be understandable and broad enough for participants to construct diversified portfolios.
- Funds should be reviewed for fees, risk, performance, benchmarks, manager changes, asset class role, and share class availability.

- Offering many funds does not automatically satisfy the duty of prudence if the menu includes imprudent or duplicative options.
- The fiduciary should monitor options over time and document reasons for retaining, placing on watch, or replacing investments.

Qualified Default Investment Alternative (QDIA)

A **QDIA** is a default investment used when a participant has plan contributions but does not give investment instructions. The QDIA rules are important because many employees are automatically enrolled in retirement plans or fail to make active investment elections.

Common QDIA Type	General Description	Series 65 Point
Target-date or lifecycle fund	An asset allocation fund designed for an expected retirement year or age range.	Often the most common default because it adjusts risk exposure as retirement approaches.
Balanced fund	A diversified mix of equities and fixed income with a relatively stable allocation.	May be appropriate for a broad participant group if the risk level is reasonable.
Professionally managed account	A managed portfolio using participant information such as age, income, account balance, or retirement date.	Personalized but requires careful review of fees, data inputs, and methodology.
Capital preservation option	May be used in limited situations, often temporarily for short initial periods.	Not generally the long-term default for younger workers because it may not meet long-term growth needs.

- Using a QDIA does not eliminate the fiduciary duty to prudently select and monitor the QDIA.
- Participants should receive required notices and must be able to move assets out of the QDIA according to plan rules.
- A target-date fund should be compared to appropriate target-date benchmarks and peer groups, not only to an equity index.

Diversification Choices

Diversification is a central ERISA concept. The plan should make it possible for participants to spread risk across asset classes, issuers, sectors, and risk levels. Concentrated positions can create fiduciary concerns, especially if participants have limited practical alternatives.

Diversification Issue	Why It Matters	Prudent Response
Too few options	Participants may be unable to build portfolios aligned with age, risk tolerance, and retirement needs.	Offer a core lineup covering cash/stable value, bonds, U.S. equity, international equity, and diversified allocation options.
Too many overlapping options	Participants may be confused and the fiduciary may be retaining unnecessary or inferior choices.	Use clear asset class roles and remove duplicative options when appropriate.
Employer stock concentration	Employees may already depend on the employer for wages and benefits.	Provide diversification alternatives and warnings; monitor plan design carefully.
High-cost legacy funds	Excess fees can reduce participant balances over long periods.	Review share classes, revenue sharing, and lower-cost alternatives.

54.4 Investment Policy Statement

An **investment policy statement**, often called an IPS, is a governance document that explains how fiduciaries will manage the plan investment process. ERISA does not automatically require every plan to have a separate IPS, but an IPS is commonly used as evidence of a thoughtful and repeatable fiduciary process.

- Defines roles and responsibilities of the plan committee, adviser, recordkeeper, custodian, and investment managers.
- States the purpose of the investment menu and the criteria used to select and monitor investments.
- Identifies benchmarks and peer groups for each investment option.
- Explains review frequency, watchlist criteria, replacement standards, and documentation expectations.
- Addresses fees, share class review, QDIA selection, and participant education materials.

Sample IPS Outline

IPS Section	Purpose
Plan purpose and participant profile	Connects investment options to participant needs, plan design, and retirement objectives.
Fiduciary roles	Clarifies who selects, monitors, recommends, approves, and documents investment decisions.
Investment menu structure	Explains the asset classes and types of options that should be available.
Selection criteria	Lists factors such as fees, benchmark fit, risk, style consistency, manager tenure, and performance history.
Monitoring criteria	Describes periodic review, watchlist triggers, and replacement process.
QDIA policy	Explains why the default option was selected and how it will be reviewed.
Documentation standards	Requires minutes, reports, comparison data, and reasons for decisions.
Exam cue: A strong IPS helps, but failing to follow the IPS can hurt. The policy should be useful, realistic, and consistently applied.	

54.5 Prohibited Transactions

ERISA prohibits certain transactions because they create a risk that plan assets will be used to benefit someone other than participants and beneficiaries. The exam usually tests recognition of parties in interest, self-dealing, unreasonable compensation, and conflicts of interest.

Category	Example	Why It Is a Problem
Party-in-interest transaction	The plan sells, exchanges, leases property, lends money, or provides goods or services to a party in interest without an exemption.	The party may influence the plan or benefit from plan assets.
Fiduciary self-dealing	A fiduciary uses plan assets to benefit the fiduciary or an affiliate.	The fiduciary is acting for personal benefit instead of participant benefit.
Acting on both sides	A fiduciary represents both the plan and the counterparty in the same transaction.	The fiduciary cannot give undivided loyalty to the plan.
Conflicted compensation	An adviser recommends investments that increase the adviser's compensation without proper handling of the conflict.	Compensation can distort advice and violate loyalty or prohibited transaction rules.
Unreasonable fees	The plan pays excessive recordkeeping, advisory, or investment expenses.	Participants bear unnecessary costs that reduce retirement savings.

- Some transactions may be permitted if a statutory or administrative exemption applies and all conditions are satisfied.
- Common service-provider arrangements generally require reasonable compensation, necessary services, and proper disclosure.
- Disclosure alone is not a substitute for loyalty, prudence, and reasonable compensation.
- When a conflict exists, the adviser or fiduciary should consider independent review, recusal, fee leveling, or another conflict-control process.

54.6 Advisor Application

Client Situation	Advisor Concern	Appropriate Response
Small business owner asks for a company 401(k) menu	The recommendation may be plan-level fiduciary advice.	Clarify role, compensation, fiduciary status, investment process, and monitoring responsibility.
Plan sponsor wants to use affiliated funds	Potential self-dealing or conflicted compensation.	Evaluate costs and alternatives; use independent review and disclose/avoid conflicts as required.
Participants are defaulted into a money market fund for years	Default may not match long-term retirement needs.	Review whether a target-date, balanced, or managed account QDIA is more prudent.
Plan has high-cost legacy share classes	Fees may be unreasonable if lower-cost shares are available.	Benchmark fees and document the decision to replace, retain, or renegotiate.
Plan committee has an IPS but ignores it	Bad documentation and inconsistent fiduciary process.	Update the IPS or follow it consistently; document meetings and decisions.

Common Exam Traps

- Participant choice does not remove the fiduciary duty to prudently select and monitor the investment menu.
- A QDIA provides limited fiduciary relief for participant default investments, not a free pass for poor selection or monitoring.
- The cheapest fund is not automatically the prudent choice; cost must be evaluated with risk, services, asset class role, and quality.
- The best-performing fund is not automatically the prudent choice; fiduciary decisions are judged by process, not hindsight.
- An IPS is valuable only if it is realistic, current, and followed.
- Conflicted compensation can create prohibited transaction concerns even when the investment itself appears suitable.

Key Takeaways

- ERISA questions emphasize fiduciary process, loyalty, prudence, diversification, documentation, and reasonable fees.
- Fiduciary status depends on function, not merely job title.
- A plan fiduciary must prudently select and monitor the investment menu, service providers, and QDIA.
- An IPS supports a repeatable process, but it should be followed and kept current.
- Prohibited transactions involve parties in interest, self-dealing, conflicted compensation, and misuse of plan assets.

References and Further Reading

- U.S. Department of Labor, Employee Benefits Security Administration, Meeting Your Fiduciary Responsibilities.
- U.S. Department of Labor, Default Investment Alternatives Under Participant-Directed Individual Account Plans.
- U.S. Department of Labor, ERISA Fiduciary Advisor, Prohibited Transactions.
- 29 CFR 2550.404c-5, Qualified Default Investment Alternatives.
- ERISA sections 404 and 406, fiduciary duties and prohibited transactions.

Practice Questions

1. A plan sponsor asks an adviser to recommend the investment menu for the company 401(k) plan. Which issue is most important for the adviser to recognize?

A. ERISA applies only to defined benefit plans.
B. The adviser is never a fiduciary if the plan sponsor makes the final decision.
C. The adviser only needs to consider the employer's tax deduction.
D. The adviser may be providing ERISA fiduciary investment advice.

2. Which statement best describes the duty of prudence under ERISA?

A. A fiduciary must avoid all equity investments.
B. A fiduciary must select the investment with the highest trailing return.
C. A fiduciary must use a careful, informed, and documented process.
D. A fiduciary must use only government securities.

3. A qualified default investment alternative is used primarily when:

A. The employer wants to avoid making payroll contributions.
B. The plan invests only in employer stock.
C. The plan wants to avoid offering any participant investment choices.
D. A participant fails to make an investment election for plan contributions.

4. Which investment is commonly used as a QDIA for a broad group of retirement plan participants?

A. A speculative options strategy
B. A sector fund concentrated in energy stocks
C. A target-date fund series
D. A single micro-cap stock

5. Which item would normally belong in a retirement plan investment policy statement?

A. Instructions to select funds that pay the adviser the highest compensation
B. The plan committee's investment selection and monitoring criteria
C. A guarantee that participants will not lose money
D. A promise that every investment will outperform its benchmark

6. A plan fiduciary causes plan assets to be used in a transaction that benefits the fiduciary's own company. This most directly raises concern about:

A. Fiduciary self-dealing and prohibited transactions
B. Tactical asset allocation
C. Qualified dividend treatment
D. Dollar-cost averaging

7. Which statement about diversification is most consistent with ERISA?

A. A plan lineup should allow participants to build diversified portfolios.
B. A plan fiduciary may ignore concentration risk if the fund has low expenses.
C. Diversification is unnecessary if participants can borrow from the plan.
D. A plan should hold only the employer's stock if the employer is financially strong.

8. A plan has an IPS requiring quarterly review of funds, but the committee has not met in two years. What is the best conclusion?

A. The IPS eliminates all fiduciary liability.
B. The IPS helps only if the fiduciaries follow and document the process.
C. The IPS is illegal because ERISA prohibits written investment policies.
D. The plan is exempt from prohibited transaction rules.

Answer Key and Explanations

1. D — Providing plan-level investment advice for compensation can create ERISA fiduciary status or fiduciary implications.

2. C — Prudence focuses on a reasonable process using appropriate information, not guaranteed performance.

3. D — A QDIA is the default investment for participant contributions when the participant has not provided investment instructions.

4. C — Target-date funds are commonly used QDIAs because they provide diversified age-based allocations.

5. B — An IPS should describe the criteria and process used to select, monitor, and replace plan investments.

6. A — Using plan assets for personal or affiliate benefit is a classic prohibited transaction/self-dealing concern.

7. A — ERISA fiduciary duties include diversification to reduce the risk of large losses unless clearly imprudent not to do so.

8. B — An IPS can support fiduciary process, but ignoring it may create evidence of a weak or inconsistent process.

Lesson 55: Special Types of Accounts

Learning Objectives

- Distinguish the **account owner**, **beneficiary**, **custodian**, and **trustee** roles used by each account type.
- Explain the federal tax treatment of **contributions**, **earnings**, and **distributions**.
- Compare **529 plans** with **Coverdell Education Savings Accounts**.
- Recognize that a **UTMA/UGMA transfer** is an irrevocable gift owned by the minor.
- Identify the eligibility requirements and tax advantages of a **Health Savings Account**.
- Select an account structure that fits a client's purpose, time horizon, control needs, and tax situation.

Exam point
Start with four questions: What is the account for? Who owns the money? Who controls it? What makes a distribution tax-favored?

55.1 Education-Related Accounts

Education accounts combine a specific savings purpose with tax advantages. The adviser must distinguish an account's tax treatment from its ownership and control rules. A tax-favored account may still have investment risk, fees, state-law consequences, and financial-aid effects.

529 Plans

A **529 plan** is a tax-advantaged education program authorized by Internal Revenue Code Section 529. Plans are sponsored by states, state agencies, or eligible educational institutions. The formal tax-law term is qualified tuition program (QTP).

Two Types of 529 Plans

Type	How It Works	Primary Risk or Limitation
Education savings plan	The account owner selects from the plan's investment options. The account value changes with investment performance.	Market risk, investment restrictions, plan fees, and a potentially short withdrawal horizon.
Prepaid tuition plan	The owner purchases tuition units or credits for future use, usually at participating institutions.	Residency or school restrictions, limited flexibility, and possible sponsor or funding risk if benefits are not guaranteed.

Account Roles and Control

- Account owner: opens and controls the account, selects investments from the plan menu, chooses the beneficiary, and directs distributions.
- Designated beneficiary: the person whose qualified education expenses may be paid from the account. The owner and beneficiary may be the same person.
- The owner generally retains control even though contributions may be treated as completed gifts for federal gift-tax purposes.
- The beneficiary can usually be changed to an eligible family member without current federal income tax, subject to the applicable rules.

Tax Treatment

- Contributions are not deductible for federal income-tax purposes. A state may offer a deduction, credit, matching grant, or other benefit, often for using the in-state plan.
- Earnings accumulate tax deferred inside the account.
- Distributions are generally federal income-tax-free when used for qualified expenses.
- For a nonqualified distribution, the earnings portion is taxable and is generally subject to an additional 10% federal tax. The contribution basis is not taxed again. Exceptions may apply.

Qualified Uses

Qualified uses can include postsecondary tuition, required fees, books, supplies, equipment, certain computer costs, limited room and board for an eligible student enrolled at least half-time, certain K–12 expenses, registered apprenticeship expenses, limited student-loan repayments, and certain postsecondary credentialing expenses. The precise federal limits and a state's conformity can change.

Exam point
Series 65 questions usually emphasize structure, control, and tax treatment. Verify current dollar limits and state tax rules before making a client recommendation.

Investments, Fees, and Risk

- Education savings plans commonly offer age-based portfolios, static portfolios, mutual funds, ETFs, or principal-protected options.
- Age-based portfolios generally become more conservative as the beneficiary approaches the expected enrollment date.
- The owner normally cannot trade freely among individual securities. Federal rules limit how often investment selections can be changed, except when the beneficiary changes.
- Direct-sold and adviser-sold plans can have different fees and sales charges. The offering circular explains plan expenses and restrictions.

- State sponsorship does not mean the investments are federally guaranteed. Market losses are possible.

529-to-Roth IRA Rollover

Limited unused 529 assets may be transferred directly to a Roth IRA for the same beneficiary. The rollover is subject to the annual Roth IRA contribution limit, a $35,000 lifetime limit, a 15-year account-age requirement, and a five-year seasoning rule for the transferred contributions and related earnings. This provision can reduce overfunding risk, but it does not eliminate the need for careful planning.

Worked Example: Matching Risk to the Education Horizon

A family has a 529 education savings account for a child who will begin college in two years. The account is invested 90% in equities. Because the withdrawal date is close, the family faces significant sequence-of-returns risk. A prudent review would compare the portfolio with the timing and amount of expected tuition payments and may support a shift toward lower-volatility investments.

Coverdell Education Savings Account

A **Coverdell Education Savings Account (ESA)** is a trust or custodial account used to pay qualified education expenses for a designated beneficiary. It is not technically an IRA, even though it is sometimes informally called a "Coverdell IRA."

Core Rules

- Contributions are made in cash and are not federally deductible.
- The combined annual contribution limit is $2,000 per beneficiary across all Coverdell ESAs.
- An individual contributor's ability to contribute is subject to modified adjusted gross income limits. Organizations can contribute without the same income limitation.
- The beneficiary generally must be under age 18 when contributions are made, unless the beneficiary has special needs.
- Remaining assets generally must be distributed shortly after the beneficiary reaches age 30, unless an exception or a permitted beneficiary change applies.
- Qualified distributions can cover eligible elementary, secondary, and postsecondary education expenses.
- The account can offer broader investment selection than many 529 plans, depending on the custodian.

529 Plan and Coverdell ESA Comparison

Feature	529 Plan	Coverdell ESA
Primary purpose	Education savings or prepaid tuition	Education savings

Feature	529 Plan	Coverdell ESA
Federal contribution deduction	No	No
Annual federal contribution cap	Plan limits are generally high; gift-tax rules apply	$2,000 per beneficiary
Contributor income limit	No federal income limit to contribute	Individual contributors are subject to MAGI limits
Beneficiary age rules	Generally no age limit	Contribution and distribution age rules generally apply
Qualified education levels	Postsecondary plus specified other education uses	Elementary, secondary, and postsecondary
Investment control	Limited to plan menu and change rules	Potentially broader custodian investment menu
Control	Account owner generally retains control	Responsible individual or custodian controls for beneficiary

55.2 UTMA and UGMA Custodial Accounts

The **Uniform Transfers to Minors Act (UTMA)** and **Uniform Gifts to Minors Act (UGMA)** provide simplified ways to transfer property to a minor without creating a formal trust. State law governs the account, including the termination age and the custodian's authority.

Ownership and Control

- Donor: transfers property to the account.
- Minor beneficiary: becomes the legal owner of the transferred property when the gift is made.
- Custodian: manages and invests the property for the minor's benefit until the custodianship ends.
- The transfer is irrevocable. The donor cannot reclaim the property merely because circumstances change.
- At the applicable termination age, the custodian must transfer control to the beneficiary. The age varies by state and by how the custodianship was created.

UGMA Compared with UTMA

Account	Typical Permitted Property	Key Point
UGMA	Cash, securities, mutual funds, and certain insurance property	Traditionally narrower asset authority
UTMA	Generally includes UGMA property and may permit additional assets such as real estate or other property	Broader model act; actual state law controls

Tax and Planning Considerations

- Income and gains generally belong to the child for federal tax purposes because the child owns the property.
- The kiddie-tax rules may cause some of the child's unearned income to be taxed using the parent's tax rate.
- The account has no special tax-free education distribution rule. It is a general custodial ownership account, not an education account.
- Because the assets belong to the child, the account can affect financial-aid analysis differently from a parent-owned 529 plan.
- The beneficiary gains control at the statutory termination age and may use the property for any lawful purpose—not necessarily education.
- The custodian must use withdrawals for the beneficiary's benefit and should keep records supporting distributions and investment decisions.

Worked Example: Control Is the Deciding Factor

A grandparent wants to help a 10-year-old grandchild with college but does not want the child to gain unrestricted control at age 18 or 21. A UTMA/UGMA account may conflict with that objective because the child owns the property and receives control when the custodianship ends. A 529 plan may better preserve owner control, subject to the client's tax, estate, and education-planning needs.

Exam point
In a UTMA/UGMA account, the minor owns the property; the adult only manages it as custodian.

55.3 Health Savings Accounts

A **Health Savings Account (HSA)** is a tax-exempt trust or custodial account used to pay or reimburse qualified medical expenses. The individual owns the account, and unused amounts remain available for future years.

Eligibility to Contribute

To contribute for a month, an individual generally must meet all of the following requirements:

- Be covered by a qualifying high-deductible health plan (HDHP).
- Have no disqualifying health coverage, subject to permitted exceptions.
- Not be enrolled in Medicare.
- Not be eligible to be claimed as another person's tax dependent.

Losing eligibility stops or reduces future contribution eligibility, but it does not require the owner to close the account or prevent tax-free reimbursement of qualified expenses incurred after the HSA was established.

The Triple Tax Advantage

Stage	Federal Tax Treatment
Contribution	Eligible personal contributions may be deductible; employer contributions may be excluded from income.
Growth	Interest, dividends, and investment earnings accumulate tax free inside the HSA.
Qualified distribution	Withdrawals for qualified medical expenses are tax free.

Distributions and Age 65

- A distribution for qualified medical expenses is generally tax free if the expense was incurred after the HSA was established and was not reimbursed from another source.
- A nonmedical distribution is taxable. Before age 65 it is generally also subject to a 20% additional tax.
- After age 65, disability, or death, the 20% additional tax does not apply. A nonmedical distribution is still generally taxable.
- The owner may delay reimbursement and take a later tax-free distribution for a prior qualified expense if adequate records are retained and the expense was not otherwise reimbursed or deducted.

Ownership, Investing, and Portability

- The HSA belongs to the individual, not the employer. It remains with the owner after a job change or retirement.
- Balances carry forward from year to year; there is no general use-it-or-lose-it rule.
- Many providers allow investment in mutual funds or other securities after a cash threshold is met. Investment risk and near-term medical liquidity should be considered separately.
- The owner should coordinate the HSA investment policy with expected medical spending, emergency reserves, insurance deductibles, and retirement objectives.
- If the spouse is the beneficiary at death, the account generally becomes the spouse's HSA. A nonspouse beneficiary generally recognizes taxable income and the account stops being an HSA.

Worked Example: Spend Now or Invest for Later?

An HSA owner has sufficient cash outside the HSA to pay a $1,500 qualified medical bill. The owner may reimburse the bill immediately or leave the HSA invested and retain documentation for a later tax-free reimbursement. The second strategy may improve tax-deferred compounding, but it introduces market risk and requires disciplined recordkeeping.

Exam point
HSA contribution eligibility depends on coverage status; HSA ownership does not disappear when eligibility ends.

55.4 Comprehensive Comparison

Feature	529	Coverdell ESA	UTMA/UGMA	HSA
Primary purpose	Education	Education	General transfer to minor	Medical expenses
Legal owner/control	Account owner	Responsible individual/custodian	Minor owns; custodian manages	Individual HSA owner
Tax-deferred growth	Yes	Yes	No special deferral	Yes
Tax-free qualified use	Qualified education	Qualified education	No special account rule	Qualified medical expenses

Feature	529	Coverdell ESA	UTMA/UGMA	HSA
Contributor income limit	Generally no federal limit	Yes for individuals	No account-specific limit	No income limit; eligibility rules apply
Control transfer	Owner generally retains control	Age and beneficiary rules apply	Beneficiary receives control at state-law age	Owner retains control
Major planning risk	Fees, market risk, nonqualified use	Low contribution limit and age rules	Irrevocable gift and loss of control	Eligibility, records, medical liquidity

55.5 Adviser Recommendation Framework

1. Define the purpose. Education, general gifting to a minor, and medical spending require different account structures.
2. Identify the legal owner and decision maker. Do not confuse the beneficiary with the person who controls the account.
3. Match the time horizon to the investment allocation. A tax advantage does not eliminate market risk.
4. Evaluate federal and state tax treatment, including current limits, state conformity, and potential recapture rules.
5. Review liquidity and nonqualified-withdrawal consequences.
6. Consider financial aid, estate planning, beneficiary changes, and the client's desire to retain control.
7. Compare fees, investment menus, and provider restrictions.
8. Document why the recommended account and investment allocation fit the client profile.

Common Series 65 Traps

Trap	Correct Rule
529 beneficiary vs. owner	The beneficiary receives the education benefit; the owner generally controls the account.
529 tax deduction	Contributions are not federally deductible, although a state may offer a benefit.

Trap	Correct Rule
Coverdell terminology	A Coverdell ESA is not an IRA.
Coverdell limit	The $2,000 limit applies per beneficiary across all accounts.
UTMA/UGMA ownership	The gift is irrevocable and belongs to the minor.
Custodian authority	The custodian's authority ends when the custodianship terminates under state law.
HSA eligibility vs. ownership	Medicare enrollment can stop contributions, but the existing HSA remains the individual's property.
HSA after age 65	The additional 20% tax ends, but nonmedical withdrawals remain taxable.

Key Takeaways

- A 529 plan separates the account owner from the beneficiary and generally preserves owner control.
- A Coverdell ESA has a low annual contribution limit, contributor income restrictions, and broad qualified education uses.
- A UTMA/UGMA transfer is an irrevocable gift owned by the minor; the custodian's role is temporary.
- An HSA combines contribution, growth, and qualified-distribution tax advantages, but contribution eligibility depends on health coverage.
- The best account recommendation depends on purpose, control, time horizon, tax consequences, fees, and investment risk.

References and Further Reading

- North American Securities Administrators Association, Uniform Investment Adviser Law Examination (Series 65) Overview, test specifications effective June 12, 2023.
- Internal Revenue Service, Publication 970 (2025), Tax Benefits for Education.
- Internal Revenue Service, Publication 590-A (2025), Contributions to Individual Retirement Arrangements.
- Internal Revenue Service, Publication 969 (2025), Health Savings Accounts and Other Tax-Favored Health Plans.

- U.S. Securities and Exchange Commission, Investor.gov, An Introduction to 529 Plans and 10 Questions to Consider Before Opening a 529 Account, January 28, 2026.
- FINRA Regulatory Notice 20-07, Responsibilities for Supervising UTMA and UGMA Accounts.
- Internal Revenue Service, Topic No. 553, Tax on a Child's Investment and Other Unearned Income.

Practice Questions

1. Which statement best describes control of a typical 529 education savings account?

A. The educational institution controls the account before enrollment.
B. The account owner generally controls the account and directs distributions.
C. The beneficiary controls all investment changes and distributions.
D. Control automatically transfers to the beneficiary at age 18.

2. Which statement correctly distinguishes the two primary types of 529 plans?

A. Education savings plans invest through a plan menu; prepaid tuition plans purchase future tuition units or credits.
B. Only prepaid plans can have tax-free qualified distributions.
C. Education savings plans are federally guaranteed; prepaid plans are not.
D. Prepaid tuition plans allow unrestricted security selection.

3. A nonqualified 529 distribution generally causes which result?

A. No federal tax consequence applies if the owner approved the withdrawal.
B. The contribution basis is taxed again but the earnings are tax free.
C. The earnings portion is taxable and is generally subject to an additional federal tax.
D. The entire distribution is taxed as ordinary income.

4. Which feature is most characteristic of a Coverdell ESA?

A. A $2,000 annual contribution limit per beneficiary across all Coverdell ESAs
B. Unlimited contributions by each donor
C. Mandatory investment in a state-selected age-based portfolio
D. Contributions are deductible for federal income tax purposes

5. Which education account generally allows qualified elementary and secondary school expenses and may offer a broader custodian investment menu?

A. HSA
B. UTMA only
C. Traditional IRA
D. Coverdell ESA

6. When property is transferred to a UTMA/UGMA account, who generally becomes the legal owner?

A. The minor beneficiary
B. The custodian
C. The donor
D. The brokerage firm

7. A parent wants to keep permanent control over assets gifted for a child. Which fact creates the greatest concern about using a UTMA/UGMA account?

A. The gift is revocable until the child enters college.
B. The account cannot hold securities.
C. The account can only pay medical expenses.
D. The beneficiary receives control when the custodianship terminates.

8. Which statement best compares UGMA and UTMA accounts?

A. UGMA accounts are tax free while UTMA accounts are taxable.
B. UTMA accounts are federal retirement plans.
C. UTMA laws generally permit a broader range of property than UGMA laws.
D. Only UGMA accounts are owned by the minor.

9. Which individual is generally eligible to contribute to an HSA?

A. Any taxpayer with earned income
B. An individual enrolled in Medicare
C. Any employee participating in a traditional health FSA
D. An individual covered by a qualifying HDHP with no disqualifying coverage

10. Before age 65, a nonmedical HSA distribution is generally:

A. Prohibited under all circumstances
B. Taxable and subject to a 20% additional tax
C. Tax free if the account has been open five years
D. Taxable only on earnings

11. After an HSA owner reaches age 65, a nonmedical distribution is generally:

A. Tax free
B. Required to be rolled into an IRA
C. Taxable but not subject to the 20% additional tax
D. Subject to both income tax and the 20% additional tax

12. A client wants education tax advantages, broad contribution capacity, and continued owner control if the child does not attend college. Which account is generally the best initial account to evaluate?

A. UTMA account
B. Parent-owned 529 plan
C. HSA
D. Margin account

Answer Key and Explanations

1. B — The account owner generally controls investment selections, beneficiary changes, and distributions.

2. A — An education savings plan is an investment account; a prepaid plan purchases future tuition benefits.

3. C — The earnings portion is generally taxable and subject to an additional 10% federal tax unless an exception applies.

4. A — The annual $2,000 limit applies per beneficiary across all Coverdell ESAs.

5. D — Coverdell ESAs can pay qualified K–12 and postsecondary expenses and may offer broad investment choices through the custodian.

6. A — The minor becomes the owner when the irrevocable gift is completed; the custodian manages the property.

7. D — The beneficiary receives control at the applicable state-law termination age and may use the assets for any lawful purpose.

8. C — UTMA generally permits a wider range of assets, although the governing state statute determines the details.

9. D — HSA contribution eligibility generally requires qualifying HDHP coverage and no disqualifying coverage, Medicare enrollment, or dependent status.

10. B — A nonmedical distribution before age 65 is generally taxable and subject to the additional 20% tax.

11. C — After age 65, the 20% additional tax no longer applies, but a nonmedical withdrawal remains taxable.

12. B — A parent-owned 529 plan combines education tax advantages with continued owner control and beneficiary flexibility.

Lesson 56: Ownership and Estate Planning Techniques

Learning Objectives

- Distinguish **JTWROS**, **tenants in common**, **tenancy by the entirety**, and **community property with right of survivorship**.
- Explain **TOD/POD** registrations and **beneficiary designations**, including **per stirpes**.
- Identify whether an asset is controlled by **title**, **contract**, **trust terms**, a **will**, or **intestacy**.
- Explain the basic roles of wills and trusts and why **trust funding** matters.
- Describe the purpose of a **qualified domestic relations order (QDRO)**.
- Explain the basic structure and planning role of **donor-advised funds**.
- Apply a priority-of-transfer framework to Series 65-style scenarios.

Exam point
Do not begin with the will. Begin with the asset. Identify how it is titled and whether it has a contractual beneficiary or transfer-on-death instruction. The will generally controls only probate property that has not already been directed elsewhere.

56.1 Priority of Transfer: What Controls First?

Estate-planning questions often present several documents that appear to conflict. The correct approach is to determine which legal mechanism applies to the specific asset. Many assets pass outside probate and therefore are not distributed under the will.

Step	Ask	Typical controlling mechanism	Exam consequence
1	How is the asset owned or titled?	Survivorship title, trust ownership, individual ownership	Title may determine whether the asset enters probate at all.
2	Is there a contract or account designation?	TOD/POD, retirement beneficiary, insurance beneficiary	A valid designation generally controls the named account and can supersede a will.
3	Is the asset actually owned by a trust?	Trust instrument	The trustee follows the trust terms for trust property.

Step	Ask	Typical controlling mechanism	Exam consequence
4	If it is probate property, is there a valid will?	Will	The will directs probate property that remains in the decedent's estate.
5	If no valid will controls the probate asset, what then?	State intestacy law	State law determines the heirs and shares.

Special constraints can alter the result. Federal retirement-plan rules, a QDRO, spousal rights, creditors, taxes, and state property law may limit what an owner can transfer. For Series 65 questions, focus first on the stated title and beneficiary instructions unless the question supplies one of these special constraints.

Memory device: TITLE → CONTRACT → TRUST → WILL → INTESTACY
This is not a universal legal ranking for every possible dispute. It is a practical exam sequence for identifying the document or registration that normally controls the disposition of a particular asset.

56.2 Types of Ownership

The form of ownership determines who has rights during life and what happens to an owner's interest at death. The exact availability and legal consequences of ownership forms vary by state.

Joint Tenants with Right of Survivorship (JTWROS)

- Two or more co-owners hold interests with a right of survivorship.
- When one owner dies, the deceased owner's interest generally passes automatically to the surviving joint owner or owners.
- The transferred interest generally avoids probate and is not redirected by the deceased owner's will.
- **JTWROS** is common for brokerage accounts and real property, but creation and severance rules are governed by state law.

Priority example
Alex and Jordan own a brokerage account JTWROS. Alex's will leaves "all investment accounts" to Alex's sister. Alex dies first. Assuming the JTWROS registration is valid, Jordan receives the account by survivorship; the will does not redirect Alex's interest to the sister.

Tenants in Common (TIC)

- Each co-owner owns a separate fractional interest; percentages may be equal or unequal.
- There is generally no right of survivorship.
- At death, the decedent's share passes under the decedent's estate plan or another valid transfer mechanism applicable to that share.
- The surviving co-owner keeps only the survivor's own interest; the survivor does not automatically receive the decedent's share.

Priority example
Priya owns 60% of an investment account as TIC with Omar, who owns 40%. Priya's will leaves her estate to her children. At Priya's death, Omar keeps his 40%; Priya's 60% does not automatically become Omar's and generally passes through Priya's estate plan.

Tenancy by the Entirety (TBE)

- A form of joint ownership available only to married spouses in jurisdictions that recognize it.
- Includes a right of survivorship: a deceased spouse's interest generally passes automatically to the surviving spouse.
- Neither spouse generally can unilaterally transfer the interest in the same way a TIC owner can.
- Some jurisdictions provide creditor-protection features, but those protections vary and should not be generalized across states.

Community Property with Right of Survivorship (CPWROS)

- Available only where state law recognizes community property and this survivorship form.
- Spouses generally own the community property together, and the survivorship feature causes the deceased spouse's interest to pass automatically to the surviving spouse.
- Because the survivorship feature controls the transfer, the asset generally avoids probate.
- Do not confuse ordinary community property with CPWROS. Ordinary community property rules may permit the decedent to dispose of the decedent's share; CPWROS adds an automatic survivorship feature.

Ownership Comparison

Ownership	Who may own?	Survivorship?	Can shares differ?	Typical death result
JTWROS	Two or more persons	Yes	Typically joint interests; details vary	Surviving owner(s) receive deceased owner's interest.
TIC	Two or more persons	No	Yes	Decedent's share follows estate plan/other valid transfer mechanism.
TBE	Married spouses	Yes	Generally equal/undivided	Surviving spouse receives deceased spouse's interest.
CPWROS	Spouses where recognized	Yes	Community property framework	Surviving spouse receives deceased spouse's interest.

56.3 Transfer-on-Death (TOD) and Pay-on-Death (POD)

TOD and **POD** registrations are will substitutes. The owner retains control during life, but the named beneficiary becomes entitled to the asset at the owner's death, subject to applicable law and account procedures.

- TOD is commonly used with securities and brokerage accounts; POD is commonly used with bank deposit accounts.
- The beneficiary generally has no ownership rights while the owner is alive.
- The owner can generally change or revoke the beneficiary while competent and alive.
- At death, a valid TOD/POD generally transfers the named asset outside probate.
- A TOD/POD designation generally supersedes conflicting instructions in the owner's will for that same asset.

Exam point
A will saying "divide everything equally among my three children" does not normally override a brokerage TOD naming only one child. For that account, start with the TOD registration.

56.4 Beneficiary Designations

Retirement plans, IRAs, life insurance contracts, annuities, and many financial accounts permit a beneficiary designation. The governing contract or plan procedures determine who receives the asset. Some employer plans also impose spousal-consent or plan-specific requirements.

- Primary beneficiary: first in line to receive the designated asset.
- Contingent beneficiary: receives the asset if no primary beneficiary is entitled to receive it.
- Beneficiary designations should be coordinated with the client's overall estate plan and updated after marriage, divorce, births, deaths, and account transfers.
- A stale beneficiary form can defeat the intent expressed in a later will.

Per Stirpes

Per stirpes means "by branch." If a beneficiary predeceases the account owner, the deceased beneficiary's share generally passes down that beneficiary's family branch to the beneficiary's descendants, rather than being reallocated only among the surviving named beneficiaries.

Per stirpes example
Morgan names children Avery and Blake as equal beneficiaries, per stirpes. Blake dies before Morgan and leaves two children. At Morgan's death, Avery receives 50%; Blake's two children split Blake's 50% branch, receiving 25% each.

56.5 Trusts and Wills: Basic Concepts

Trusts

- A **trust** separates legal control from beneficial enjoyment: the trustee holds/manages trust property for beneficiaries under the trust instrument.
- A **settlor/grantor** creates the trust; a **trustee** administers it; **beneficiaries** receive benefits according to its terms.
- A **revocable living trust** can function as a will substitute for assets actually transferred to or otherwise made subject to the trust.
- Funding matters. Merely signing a trust does not automatically cause every asset to become trust property.
- Assets properly owned by the trust are generally administered under the trust instrument rather than the decedent's will.

Wills

- A **will** is a testamentary document that directs disposition of probate property at death.

- A will generally does not control assets that pass by survivorship, TOD/POD, beneficiary designation, or ownership in a funded trust.
- If a person dies without a valid will for probate assets, state intestacy law determines who receives those assets.
- Probate also includes administration tasks such as collecting assets, paying allowable debts and taxes, and distributing remaining property.

The most important comparison
A will speaks to the probate estate. A survivorship title, valid beneficiary designation, TOD/POD registration, or funded trust can remove a specific asset from the will's distribution path.

56.6 Priority-of-Transfer Scenarios

Scenario A: JTWROS vs. will
Jamie and Riley own a $200,000 brokerage account JTWROS. Jamie's will leaves all securities to Jamie's children. Jamie dies. Result: Riley generally receives the account by survivorship.

Scenario B: TOD vs. will
Taylor's individual brokerage account names Casey as TOD beneficiary. Taylor's later will leaves the estate to Drew. Result: Casey generally receives the brokerage account; Drew may receive other probate assets.

Scenario C: TIC vs. survivorship assumption
Lee and Sam own property 50/50 as tenants in common. Lee dies. Result: Sam keeps Sam's 50%; Lee's 50% follows Lee's estate plan rather than passing automatically to Sam.

Scenario D: funded trust vs. will
A brokerage account is titled "Jordan Lee, Trustee of the Jordan Lee Revocable Trust." Jordan's will gives the account to a sibling, while the trust gives it to two children. Result: the trust terms generally govern because the trust owns the account.

Scenario E: beneficiary designation vs. later will
An IRA lists an adult child as beneficiary. A later will leaves all assets to a spouse. Result: the IRA beneficiary form generally controls, subject to applicable plan and spousal rules.

Scenario F: individual probate asset
A solely owned investment account has no TOD or beneficiary designation and is not in a trust. Result: it generally becomes probate property and is distributed under a valid will, or under intestacy law if no valid will exists.

56.7 Qualified Domestic Relations Orders (QDROs)

A **QDRO** is a domestic relations order that meets federal requirements and creates or recognizes an alternate payee's right to receive all or part of a participant's benefit under a covered retirement plan.

- The alternate payee may be a spouse, former spouse, child, or other dependent as permitted by law.
- A plan administrator determines whether a domestic relations order is qualified under the plan and federal requirements.
- Once qualified, the plan must pay benefits in accordance with the QDRO.
- For exam purposes, treat a valid QDRO as a special legal claim on the retirement benefit; the participant cannot simply defeat it with a conflicting beneficiary choice or will.

QDRO priority concept
If a QDRO assigns 50% of a participant's 401(k) benefit to a former spouse, the participant's later beneficiary designation cannot simply erase the former spouse's rights under the QDRO. The plan must honor the qualified order.

56.8 Donor-Advised Funds

A **donor-advised fund** (DAF) is a separately identified charitable account maintained by a sponsoring public charity. The donor contributes assets to the sponsoring organization and may retain advisory privileges over investment and grant recommendations, but the sponsoring organization has legal ownership and control of the contributed assets.

- Contribution is generally irrevocable: the donor no longer owns the contributed property.
- The donor may recommend grants and investments, subject to the sponsoring organization's control and policies.
- DAFs can be used to organize charitable giving and may accept appreciated assets, depending on sponsor rules.
- A DAF is not a personal investment account and cannot be used to provide impermissible private benefits to the donor or related persons.
- Because the sponsoring organization legally controls the assets after contribution, the donor's will does not later reclaim those contributed assets.

56.9 Adviser Application: Ask These Questions in Order

- What exact asset are we analyzing?
- Whose name is on the title or registration?
- Does the title contain survivorship language?
- Is there a TOD/POD or beneficiary designation?
- Is the asset owned by a trust, or is the trust merely mentioned elsewhere?
- If the asset is individually owned probate property, what does the will say?

- If there is no valid will, what intestacy rule would apply?
- Is there a special constraint such as a QDRO, spousal right, creditor claim, or plan-specific rule?

56.10 Common Series 65 Traps

“The newest document wins.” Not necessarily. A later will does not automatically override an older but still-valid TOD or beneficiary designation.

“The will controls everything.” False. Many important financial assets are nonprobate assets.

“A joint account always goes to the survivor.” Only if the ownership form includes survivorship. TIC does not.

“A trust controls any asset mentioned in the trust.” Not necessarily. Determine whether the asset is actually owned by or otherwise properly transferred to the trust.

“Per stirpes means surviving beneficiaries split the deceased beneficiary’s share.” No. Per stirpes sends the deceased beneficiary’s share down that beneficiary’s branch.

“A donor can take back DAF property.” No. The sponsoring charity has legal control after the contribution.

“A participant can ignore a QDRO by changing the beneficiary.” No. A valid QDRO creates enforceable rights that the plan must honor.

Key Takeaways

- Asset title is often the first clue to who receives property at death.
- JTWROS, TBE, and CPWROS generally include survivorship; TIC generally does not.
- TOD/POD and beneficiary designations are nonprobate transfer mechanisms and generally override a conflicting will for the designated asset.
- A trust controls assets that are actually trust property; funding and title matter.
- A will generally controls only probate assets that remain individually owned without another controlling transfer mechanism.
- Per stirpes sends a deceased beneficiary’s share down that beneficiary’s family branch.
- A QDRO can create enforceable rights in retirement benefits that the plan must honor.
- A donor-advised fund is legally controlled by its sponsoring charity after contribution.

References and Further Reading

- FINRA, “Plan Now to Smooth the Transfer of Your Brokerage Account Assets on Death,” January 17, 2023.
- Investor.gov, “Transferring Assets” (Transfer on Death registration).
- U.S. Department of Labor, Employee Benefits Security Administration, “Qualified Domestic Relations Orders: An Overview.”
- Internal Revenue Service, “Donor-advised funds,” updated June 28, 2026.

- Cornell Legal Information Institute, Wex entries: right of survivorship; tenancy in common; tenancy by the entirety; community property with right of survivorship; per stirpes; trust; revocable trust; probate assets; probate.

Estate and property law varies by state, and retirement-plan terms can impose additional requirements. Course examples are designed to test Series 65 concepts rather than provide legal advice.

Practice Questions

1. Pat and Robin own a brokerage account JTWROS. Pat's will leaves all securities to Pat's son. Pat dies first. Who generally receives the account?

A. Robin
B. The executor chooses
C. Pat's estate and Robin equally
D. Pat's son

2. Dana and Chris own an investment account as tenants in common, 70% to Dana and 30% to Chris. Dana dies with a will leaving the estate to Dana's daughter. What generally happens?

A. Chris automatically receives 100%
B. The account must be liquidated and split 50/50
C. Dana's 70% follows Dana's estate plan; Chris keeps 30%
D. Dana's 70% escheats to the state

3. An individual brokerage account names Kim as TOD beneficiary. The owner later signs a will leaving all property to Jordan but never changes the TOD. At death, who generally receives the brokerage account?

A. Jordan, because the will is newer
B. The estate, because TODs expire at death
C. Kim and Jordan equally
D. Kim, because the TOD controls the account

4. A client's revocable trust says a brokerage account should pass equally to two children, but the account remains solely titled in the client's individual name with no TOD. The client's will leaves the residue to a spouse. Which document generally controls that account?

A. Neither; the broker decides
B. The will, because the account is probate property unless properly transferred to the trust
C. The children's oral understanding
D. The trust automatically

5. A client names two children, Ava and Ben, as 50/50 beneficiaries per stirpes. Ben dies before the client and leaves two children. How is the designated property generally divided at the client's death?

A. All to the estate
B. Ava 50%; Ben's two children 25% each
C. Ava 1/3; each grandchild 1/3
D. Ava 100%

6. Spouses own property as tenancy by the entirety where that form is recognized. One spouse's will leaves that property to a sibling. The spouse dies first. Who generally receives the property?

A. The estate
B. The sibling
C. The state
D. The surviving spouse through survivorship

7. Which asset is MOST likely to be controlled directly by a will?

A. IRA with a valid named beneficiary
B. JTWROS brokerage account
C. Solely owned brokerage account with no TOD and not held in trust
D. Bank account with a valid POD beneficiary

8. A valid QDRO awards a former spouse 40% of a participant's qualified retirement benefit. The participant later names a new spouse as 100% beneficiary. Which statement is most accurate?

A. The will determines the allocation
B. The plan generally must honor the QDRO rights
C. The new beneficiary designation automatically cancels the QDRO
D. QDROs apply only after both spouses die

9. Which statement about a donor-advised fund is TRUE?

A. The sponsoring charity has legal control, while the donor may retain advisory privileges
B. The donor retains legal ownership of contributed property
C. The donor may freely withdraw contributions for personal use
D. The donor's will controls the contributed assets after death

10. A married couple owns an asset as CPWROS in a jurisdiction that recognizes the form. One spouse dies and the will leaves that asset to a child. What is the general result?

A. The surviving spouse receives the deceased spouse's interest by survivorship
B. The property becomes TIC automatically
C. The executor decides
D. The child receives the deceased spouse's half under the will

11. An IRA beneficiary form names a former partner. A later will leaves the entire estate to the owner's children. The beneficiary form was never changed. What should an adviser recognize first?

A. The children automatically split the IRA
B. The executor can rewrite the beneficiary form
C. The IRA beneficiary designation generally controls the IRA, subject to applicable plan and legal rules
D. The will necessarily overrides the IRA form

12. Which sequence is the BEST exam approach when several estate-planning documents conflict?

A. Read the will first, then ignore account title
B. Choose the newest dated document
C. Assume all assets enter probate
D. Identify the asset, check title/survivorship and account designations, then determine whether trust, will, or intestacy governs what remains

Answer Key and Explanations

1. A — JTWROS includes survivorship. The surviving joint owner generally receives the account outside probate, so Pat's will does not redirect the account.

2. C — TIC has no automatic survivorship. Chris keeps the 30% interest; Dana's 70% follows Dana's estate plan or other applicable transfer mechanism.

3. D — A valid TOD designation generally supersedes conflicting will instructions for the registered account.

4. B — A trust controls trust property. If the account was never transferred to the trust and has no nonprobate feature, it generally remains probate property governed by the will.

5. B — Per stirpes preserves Ben's family branch. Ben's 50% share passes to Ben's descendants, split equally between the two children.

6. D — TBE includes a right of survivorship. The surviving spouse generally receives the deceased spouse's interest automatically.

7. C — The individually owned account with no beneficiary/TOD and no trust ownership is a classic probate asset that a will can control.

8. B — A qualified domestic relations order creates enforceable rights to plan benefits. The participant cannot erase those rights merely by filing a later beneficiary designation.

9. A — The sponsoring charity owns and controls DAF assets after contribution; the donor retains advisory privileges, not ownership.

10. A — CPWROS includes survivorship. The survivorship feature generally controls the transfer rather than the deceased spouse's will.

11. C — Beneficiary-designated retirement assets generally follow the plan/account designation, not the will, subject to plan terms and applicable spousal or legal restrictions.

12. D — The exam-safe method starts with the specific asset and its title/registration. Only property remaining in the probate estate is then distributed under a will or intestacy.

Lesson 57: Trading Securities: Terminology and Account Types

Learning Objectives

- Define **bids**, **offers**, **bid-ask spreads**, and the economic meaning of quoted prices.
- Distinguish **market**, **limit**, and **stop orders** and identify which tradeoff each order type creates.
- Explain how a **short sale** works and why short selling has special risk characteristics.
- Compare **cash accounts** and **margin accounts** from a client-risk and suitability perspective.
- Distinguish **principal trades** from **agency trades** and recognize how compensation may differ.
- Define **payment for order flow** and identify why it creates a conflict that must be managed through best execution and disclosure.

57.1 Trading Terminology

Trading questions often start with a quote. The quote tells you what market participants are willing to pay and accept at a point in time. The adviser should be able to interpret the quote and explain the practical result to the client.

Term	Meaning	Example
Bid	The highest price a buyer is currently willing to pay for a security.	If ABC is quoted 25.00 bid / 25.05 offer, a client entering a market sell order would generally expect execution near the bid, because the client is selling to a buyer.
Offer / Ask	The lowest price a seller is currently willing to accept for a security.	If ABC is quoted 25.00 bid / 25.05 offer, a client entering a market buy order would generally expect execution near the offer, because the client is buying from a seller.
Bid-Ask Spread	The difference between the bid and the offer. It is one measure of trading cost and market liquidity.	A quote of 25.00 bid / 25.05 offer has a five-cent spread. If the spread widens to 25.00 / 25.25, trading is more expensive and may indicate less liquidity.

Exam point
A buyer usually pays the offer/ask. A seller usually receives the bid. The bid-ask spread is an implicit transaction cost.

57.2 Market, Limit, and Stop Orders

Order types let a client prioritize speed, price control, or risk management. No order type is perfect. The Series 65 often tests the tradeoff: execution certainty versus price certainty.

Order Type	Definition	Main Tradeoff	Example
Market order	An instruction to buy or sell promptly at the best available price.	Execution is likely, but final price is uncertain.	A client wants to buy 100 shares of XYZ immediately. XYZ is quoted 40.00 bid / 40.08 offer. A market buy order will likely execute near 40.08, but the exact price can change before execution.
Limit order	An instruction to buy only at or below a stated price, or sell only at or above a stated price.	Price is controlled, but execution is not guaranteed.	XYZ trades at 40.08. A client places a buy limit order at 39.50. The order executes only if shares can be purchased at 39.50 or better.
Stop order	An order that becomes a market order when the stop price is reached or passed.	Useful as a trigger, but the execution price after the trigger is not guaranteed.	A client owns XYZ at 50 and enters a sell stop at 46 to reduce downside exposure. If XYZ trades at or below 46, the stop is triggered and becomes a market order.

Buy and Sell Order Examples

- Buy market order: prioritizes immediate purchase. Example: “Buy 100 XYZ at the market.”
- Sell market order: prioritizes immediate sale. Example: “Sell 100 XYZ at the market.”
- Buy limit order: sets the maximum acceptable purchase price. Example: “Buy 100 XYZ at 39.50 or lower.”
- Sell limit order: sets the minimum acceptable sale price. Example: “Sell 100 XYZ at 45.00 or higher.”
- Sell stop order: normally placed below the current market price to limit a loss or protect a gain. Example: “Sell XYZ if it falls to 46.”
- Buy stop order: normally placed above the current market price, often to cover a short position or enter after upward momentum. Example: “Buy XYZ if it rises to 55.”

Exam point
A stop order is not a guaranteed-price order. Once triggered, it becomes a market order and can execute at a price worse than the stop price in a fast market.

57.3 Short Sales

A short sale is a bearish transaction. The investor sells borrowed shares first and later attempts to buy them back at a lower price. Because the investor must return borrowed shares, gains are limited but losses can be very large if the stock price rises.

1. The investor borrows shares, usually through a margin account.
2. The investor sells the borrowed shares in the market.
3. At a later time, the investor buys shares to “cover” the short position.
4. The purchased shares are returned to the lender.
5. Profit or loss equals the short sale proceeds minus the cost to buy back the shares, before expenses, dividends, and borrowing costs.

Short Sale Example	Result	Explanation
Short 100 shares at $40; cover at $35	Approximate gain of $500 before costs	The investor sold for $4,000 and bought back for $3,500.
Short 100 shares at $40; cover at $60	Approximate loss of $2,000 before costs	The investor sold for $4,000 but had to buy back for $6,000.
Short seller during a dividend period	Must account for dividend-related costs	A short seller generally owes payments in lieu of dividends to the share lender.

Short Sale Risk Characteristics

- Directional risk: the investor profits if the price falls and loses if the price rises.
- Potentially unlimited loss: a stock price can rise far above the short sale price.
- Margin risk: short sales generally require a margin account and can generate margin calls.
- Borrowing risk: shares may be difficult or expensive to borrow, and the position may be subject to forced closeout.
- Suitability risk: short selling is generally unsuitable for conservative clients seeking capital preservation.

57.4 Cash Accounts and Margin Accounts

The account type determines whether the client is paying in full or borrowing against securities. This distinction is important for risk disclosure and suitability.

Account Type	Definition	Example
Cash account	The client pays the full purchase price and does not borrow from the broker-dealer.	A client buys $5,000 of an ETF in a cash account. The client must have or deliver sufficient cash by settlement. Regular-way U.S. securities transactions generally use T+1 settlement under current rules.
Margin account	The client may borrow from the broker-dealer, using eligible securities as collateral.	A client buys $10,000 of stock with $5,000 cash and a $5,000 margin loan. If the stock value falls, the client can face a margin call or forced liquidation.

Cash Account Considerations

- Simpler risk profile than margin because the client is not borrowing to buy securities.
- The client must pay for purchases by the settlement date.
- Using unsettled sale proceeds to buy and then sell another security before the first sale settles can create cash-account trading violations.
- Cash accounts may fit clients who want to avoid leverage and margin interest.

Margin Account Considerations

- Margin magnifies gains and losses because the client controls more securities than the client fully paid for with cash.

- The client pays interest on the margin loan.
- The broker-dealer can require additional collateral if the account value falls.
- The broker-dealer may sell securities without first obtaining the client's approval if the client does not meet margin requirements.
- Margin is usually inappropriate when the client cannot tolerate loss, needs liquidity, or does not understand leverage.

Suitability focus
An adviser should not treat margin as just a trading feature. Margin changes the client's risk exposure, liquidity needs, potential losses, and costs.

57.5 Principal and Agency Trades

The capacity in which the broker-dealer acts affects how the trade is executed and how the broker-dealer may be compensated.

Trade Capacity	Definition	Compensation/Conflict	Example
Agency trade	The broker-dealer acts as an agent for the customer and seeks execution with another party or venue.	Broker-dealer may charge a commission or fee.	A broker routes a client's order to buy 100 shares of XYZ and charges a commission.
Principal trade	The broker-dealer buys from or sells to the customer from its own account or inventory.	Broker-dealer may earn a **markup** or **markdown** and may have inventory-related conflicts.	A dealer sells a municipal bond from inventory to a client at a price that includes a markup.

Principal vs. Agency: Exam Contrast

- **Agency**: the broker is arranging the trade for the client.
- **Principal**: the broker-dealer is the counterparty to the client's trade.
- Agency compensation is often described as a commission.
- Principal compensation is often described as a markup, markdown, or spread.
- Both structures can be appropriate, but conflicts and costs must be considered.

57.6 Payment for Order Flow

Payment for order flow occurs when a broker-dealer receives compensation or another economic benefit for routing customer orders to a particular trading venue or market maker. It is not automatically prohibited, but it creates a conflict because the routing decision can benefit the broker-dealer.

- The broker-dealer still has a duty to seek best execution for customer orders.
- The economic benefit may be cash, rebates, credits, services, or other compensation.
- Payment for order flow is one reason a retail platform may offer low-commission or no-commission trades.
- The key client issue is not only the visible commission; it is whether the total execution quality is fair and appropriately disclosed.

Payment for order flow example
A retail brokerage routes small customer equity orders to a wholesale market maker. The market maker pays the brokerage a small amount per share or per order. The client may see a zero-dollar commission, but the adviser should still understand routing, price improvement, execution quality, and conflicts.

57.7 Adviser Checklist for Trading Conversations

- What is the client trying to accomplish: immediate execution, price control, risk reduction, speculation, or liquidity?
- Does the order type match that goal?
- Does the client understand the difference between trigger price and execution price for stop orders?
- Is the strategy consistent with the client's risk tolerance, investment objective, time horizon, and liquidity needs?
- Does the trade involve leverage, short selling, margin interest, or potentially unlimited loss?
- Is the broker-dealer acting as agent or principal, and how is it compensated?
- Could order routing or payment for order flow create a conflict that affects execution quality?

57.8 Summary Table

Concept	Core Rule	Example
Bid	Price buyers are willing to pay.	Client sells at/near bid on a market sell order.
Offer/ask	Price sellers are willing to accept.	Client buys at/near offer on a market buy order.

Concept	Core Rule	Example
Market order	Execution priority, price uncertainty.	Client wants immediate execution.
Limit order	Price control, no execution guarantee.	Buy XYZ only at $50 or lower.
Stop order	Triggered order that becomes a market order.	Sell stop below market to reduce downside.
Short sale	Sell borrowed shares; profit if price falls.	Short at $40, cover at $35.
Cash account	No broker loan for purchases.	Client pays full purchase price by settlement.
Margin account	Borrowing against securities.	Client buys $10,000 with $5,000 cash plus a loan.
Agency trade	Broker arranges trade for customer.	Commission-based execution.
Principal trade	Broker-dealer trades from inventory/account.	Dealer sells bond from inventory with markup.
Payment for order flow	Broker receives benefit for routing customer orders.	Zero-commission broker receives routing compensation.

Key Takeaways

- Buyers look to the offer/ask; sellers look to the bid.
- Market orders favor execution; limit orders favor price; stop orders create a trigger but do not guarantee final execution price.
- Short sales profit from price declines but can create large losses if prices rise.
- Cash accounts avoid borrowing; margin accounts introduce leverage, interest, margin calls, and forced liquidation risk.
- Agency trades involve arranging execution; principal trades involve the broker-dealer trading from its own account or inventory.

- Payment for order flow is a conflict-sensitive routing arrangement and does not replace the best execution obligation.

References and Further Reading

- SEC Investor Bulletin: New "T+1" Settlement Cycle – What Investors Need To Know.
- FINRA Regulatory Notice 24-04: FINRA rules amended to conform to the T+1 settlement cycle.
- SEC disclosure materials on order execution and routing practices, including payment for order flow.
- FINRA Regulatory Notice 21-23: Best execution and payment for order flow guidance.

Practice Questions

1. ABC is quoted 20.00 bid / 20.06 offer. A client enters a market order to sell 100 shares. Which price is most relevant to the expected execution?

A. The previous day's closing price
B. 20.00 bid
C. The average of the bid and offer
D. 20.06 offer

2. A client wants to buy DEF but will not pay more than $35 per share. Which order best matches the instruction?

A. Buy limit order at $35
B. Market buy order
C. Market-on-close order
D. Sell stop order at $35

3. A client owns GHI at $60 and wants an order that will trigger a sale if the price drops to $54. Which order is most appropriate?

A. Sell limit at $54
B. Buy limit at $54
C. Sell stop at $54
D. Buy stop at $54

4. Which statement about stop orders is correct?

A. A stop order eliminates downside risk.
B. A stop order can only be used to buy securities.
C. A stop order guarantees execution at the stop price.
D. A stop order becomes a market order once triggered.

5. An investor shorts 100 shares at $42 and covers at $37. What is the approximate result before costs?

A. $3,700 loss
B. $500 gain
C. $4,200 gain
D. $500 loss

6. Which client is least likely to be suitable for short selling?

A. An aggressive trader who understands margin risk
B. A hedge fund using short exposure for hedging
C. A conservative retiree seeking capital preservation
D. A client with high risk tolerance and excess liquidity

7. Which statement best describes a cash account?

A. The client may borrow from the broker-dealer to buy securities.
B. The client must pay the full purchase price without a broker margin loan.
C. The account can only hold Treasury securities.
D. The broker-dealer always acts as principal.

8. A client buys $20,000 of stock using $10,000 in cash and a $10,000 broker-dealer loan. What type of account feature is being used?

A. Payment for order flow
B. Agency capacity
C. Cash settlement
D. Margin

9. In an agency trade, the broker-dealer is best described as:

A. Guaranteeing a profit on the transaction
B. Trading with the client from its own inventory
C. Arranging execution for the customer
D. Issuing the security directly to the client

10. A dealer sells a bond from its own inventory to a customer at a price that includes a markup. What type of trade is this?

A. Cash-account violation
B. Short sale
C. Agency trade
D. Principal trade

11. Payment for order flow most directly refers to:

A. Compensation received by a broker-dealer for routing customer orders
B. Interest paid on a margin debit balance
C. A penalty for late settlement
D. A dividend paid by an issuer

12. Which statement is the best exam conclusion about payment for order flow?

A. It may create a conflict that must be managed through disclosure and best execution.
B. It eliminates the duty of best execution.
C. It is always illegal.
D. It applies only to municipal bonds.

Answer Key and Explanations

1. B — A seller generally receives the bid because the seller is selling to a willing buyer.

2. A — A buy limit order sets the maximum price the client is willing to pay.

3. C — A sell stop is commonly placed below the current market price to trigger a sale if the stock declines.

4. D — A stop order becomes a market order when the stop price is reached or passed; the final execution price is not guaranteed.

5. B — The investor sold for $4,200 and bought back for $3,700, producing a $500 gain before costs.

6. C — Short selling involves margin, potentially large losses, and complexity, which generally conflicts with capital preservation.

7. B — In a cash account, the client pays in full rather than borrowing against the securities.

8. D — Borrowing from the broker-dealer to buy securities is margin.

9. C — In an agency trade, the broker-dealer acts on behalf of the customer to arrange the execution.

10. D — The dealer is trading from its own inventory, so it is acting as principal.

11. A — Payment for order flow is compensation or another economic benefit received for routing customer orders.

12. A — Payment for order flow is not automatically illegal, but it can create routing conflicts and does not remove best execution obligations.

Lesson 58: Trading Roles: Broker-Dealers, Custodians, Market Makers, and Exchanges

Learning Objectives

- Distinguish the client-facing role of the **introducing broker-dealer** from the **carrying role** of the **clearing firm**.
- Explain the role of **custodians** in safeguarding client assets and providing **independent records**.
- Identify the **market maker's liquidity role** and **principal/dealer capacity**.
- Explain what **exchanges** do and how they differ from **market makers** and **clearing firms**.
- Apply role distinctions to Series 65-style responsibility and conflict questions.

58.1 The Core Idea: Follow the Function

A single securities trade may involve multiple regulated entities. The Series 65 exam often tests whether you can identify which party performs a particular function. The best approach is to locate the verb in the question: recommend, accept, route, execute, clear, settle, hold, safeguard, quote, or list.

Function in the question	Most likely role
Meets with client, recommends, accepts order	Introducing broker-dealer or advisory firm
Carries the account, posts trade, sends official statement	Clearing broker-dealer/carrying firm
Safeguards client funds and securities	Custodian or carrying broker-dealer
Stands ready to buy or sell at quoted prices	Market maker
Provides a marketplace, trading rules, and listings	Exchange

58.2 Introducing Broker-Dealers

An introducing broker-dealer is the firm that introduces customer accounts and trades to another broker-dealer for clearing and carrying services. It is commonly the customer-facing firm. The client may know the introducing firm, the registered representative, and the local office, while a separate clearing firm handles the operational account records.

Typical responsibilities

- Opening or helping open customer accounts.
- Soliciting and accepting customer orders.
- Employing or supervising representatives who communicate with clients.
- Making recommendations and handling suitability or advisory relationship issues when applicable.
- Transmitting orders to the appropriate execution or clearing channel.

Example

A client meets with a registered representative at Prairie Capital Brokerage. The representative recommends purchasing a municipal bond and enters the order. Prairie Capital does not hold the customer securities itself; instead, a larger clearing firm carries the account. Prairie Capital is functioning as the introducing broker-dealer.

Exam clue

When a question focuses on the client relationship, the representative, recommendations, or order acceptance, the correct role is usually the introducing broker-dealer rather than the clearing firm or exchange.

58.3 Clearing Broker-Dealers and Carrying Firms

A **clearing broker-dealer**, often called a **carrying firm**, provides the back-office infrastructure that supports customer brokerage accounts. The clearing firm may carry the account, maintain records of securities positions and cash balances, settle trades, and send official account statements. In a fully disclosed arrangement, the customer is informed that the introducing broker-dealer uses the carrying firm.

Typical responsibilities

- Carrying customer accounts for introducing broker-dealers.
- Processing trade clearance and settlement after execution.
- Maintaining records of positions, balances, margin debit balances, and account activity.
- Safeguarding funds and securities when acting as the carrying/custodial firm.
- Preparing or transmitting confirmations and account statements as assigned by the carrying agreement.

Example

The client places a stock order through Prairie Capital Brokerage. The order executes in the market. The clearing firm then posts the transaction, adjusts the cash balance, records the securities position, and shows the position on the next account statement. The clearing firm is performing the carrying and settlement role.

58.4 Custodians

A custodian holds client funds or securities. A custodian may be a bank, broker-dealer, or other **qualified custodian** depending on the regulatory context. For advisory clients, custodian

statements are important because they give the client an independent record of assets, balances, and activity.

Typical responsibilities

- Safekeeping client cash and securities.
- Providing account statements directly to clients.
- Reflecting deposits, withdrawals, trades, income, and fees.
- Helping separate investment advice from physical or legal possession of assets.
- Supporting client protection by creating independent records outside the adviser's internal reports.

Example

A registered investment adviser builds a portfolio for a client, but the assets remain at a brokerage custodian. The adviser can view the account and submit authorized instructions, but the custodian holds the assets and sends statements directly to the client.

Exam point
The custodian is not automatically the adviser and does not make an investment suitable merely by holding it. Custody answers questions about possession, safekeeping, records, and statements. Advice answers questions about recommendations, fiduciary duty, and investment selection.

58.5 Fully Disclosed and Omnibus Clearing Arrangements

In a fully disclosed clearing arrangement, the customer knows the identity of both the introducing broker-dealer and the carrying firm. The account is carried by the clearing firm in the customer's name. In an omnibus arrangement, the clearing firm may carry the introducing firm's aggregate customer activity, while the introducing firm maintains detailed customer-level records. The Series 65 exam most often tests the basic division of responsibility rather than the operational mechanics.

Type of arrangement	Basic idea	Exam emphasis
Fully disclosed	The customer is disclosed to the clearing firm, and the customer is notified of the carrying relationship.	Responsibilities are allocated between introducing and carrying firms.

Type of arrangement	Basic idea	Exam emphasis
Omnibus	The clearing firm may see the introducing firm's aggregate account rather than each underlying customer.	Recordkeeping and operational responsibilities must be clearly understood.

58.6 Carrying Agreements

A carrying agreement allocates responsibilities between the introducing broker-dealer and the carrying broker-dealer. For exam purposes, the key is that the agreement determines who performs operational functions such as account records, statements, margin credit, and delivery of funds and securities.

- Opening and approving accounts.
- Accepting and transmitting orders.
- Executing trades or routing orders for execution.
- Extending credit in margin accounts.
- Receiving and delivering funds and securities.
- Preparing confirmations, account statements, books and records, and supervisory reports.

Example

If a question says the carrying agreement assigns margin credit and account statements to the clearing firm, then the clearing firm is responsible for those functions even though the client's representative works for the introducing firm.

58.7 Market Makers

A market maker is a firm that stands ready to buy or sell a security at publicly quoted prices. Market makers provide liquidity by being willing to trade when a natural buyer or seller may not be immediately available. Because a market maker buys and sells for its own account, it generally acts as a dealer or principal.

Typical responsibilities and characteristics

- Quotes a bid price at which it is willing to buy and an ask or offer price at which it is willing to sell.
- Uses the firm's capital and inventory to facilitate trading.
- Earns compensation through the bid-ask spread and trading economics rather than a traditional agency commission.
- Assumes inventory risk because the security price can move while the firm holds a position.
- May operate in exchange-listed securities or over-the-counter markets, depending on the market structure.

Bid-ask example

A market maker quotes XYZ at 49.95 bid and 50.05 ask. A seller can sell to the market maker at 49.95. A buyer can buy from the market maker at 50.05. The 0.10 difference is the bid-ask spread. The spread is both a transaction cost to traders and a potential source of compensation to the market maker.

Exam point
Phrases such as “stands ready to buy and sell,” “quotes bid and ask,” and “trades for its own account” point to a market maker or dealer/principal role.

58.8 Exchanges

An exchange is an organized market center where securities can be bought and sold under established trading rules. National securities exchanges are registered with the SEC. Exchanges support trading, price discovery, market rules, member regulation, and in many cases listing standards for securities.

Typical exchange functions

- Providing a marketplace or electronic system where orders can interact.
- Maintaining trading rules and member obligations.
- Supporting price discovery through quotations and executed trades.
- Establishing listing standards for securities listed on that exchange.
- Monitoring trading activity on the exchange and enforcing exchange rules.

Example

A stock may be listed on the New York Stock Exchange, but a broker-dealer may route a customer order to the NYSE, another exchange, or a market maker if that routing is consistent with execution obligations. The listing exchange is not necessarily the only execution venue.

58.9 Execution, Clearing, Settlement, and Custody

Term	Meaning	Example
Execution	The order is filled.	A customer buys 100 shares at $40.25 on an exchange or through a market maker.
Clearing	Trade details are matched and prepared for settlement.	The clearing broker records the buyer, seller, security, quantity, and price.

Term	Meaning	Example
Settlement	Cash and securities are exchanged and records updated.	The buyer pays cash and receives the securities position in the account.
Custody	Assets are held and reported.	The custodian statement shows the 100-share position and cash balance.

58.10 Role Comparison Summary

Role	What it does	What it does not automatically do
Introducing broker-dealer	Maintains customer relationship, accepts orders, and may make recommendations.	Does not necessarily hold assets or send official statements.
Clearing broker-dealer/custodian	Carries accounts, clears/settles trades, safeguards assets, and sends records.	Does not automatically make the recommendation suitable.
Market maker	Provides liquidity by quoting buy and sell prices and trading as principal.	Does not merely match orders as a neutral marketplace.
Exchange	Provides a trading venue, rules, listings, order interaction, and price discovery.	Does not hold each investor's account assets.

58.11 Common Exam Traps

- Do not assume the introducing broker-dealer holds the client's securities. The clearing firm or custodian often does that.
- Do not confuse execution with settlement. Execution fills the order; settlement updates cash and securities ownership.

- Do not treat a market maker as an agent merely because it helps complete a trade. Market makers generally trade as principals.
- Do not assume a trade must execute on the listing exchange. Orders may route to other market centers.
- Do not assume a custodian is responsible for investment suitability. Custody and advice are different functions.

Practice Questions

1. A client meets with a registered representative at a small brokerage firm. The representative recommends a municipal bond and accepts the client's order. Which party is most likely performing the client-facing broker-dealer role?

A. The custodian bank
B. The clearing agency
C. The exchange specialist
D. The introducing broker-dealer

2. A customer receives an official account statement showing securities positions and cash balances from the firm that carries the account. Which role is most directly described?

A. The issuer's transfer agent
B. The listing exchange
C. The clearing broker-dealer or custodian
D. The market maker

3. A firm continuously quotes prices at which it is willing to buy and sell a stock from its own account. What is the firm acting as?

A. A transfer agent
B. A market maker
C. An investment adviser
D. An introducing firm only

4. Which statement best describes a national securities exchange?

A. A dealer that trades only with institutional clients
B. A back-office firm that sends monthly statements
C. An SEC-registered marketplace for securities trading
D. A firm that holds client assets for advisers

5. An adviser manages portfolios, but client assets are held at an independent brokerage firm that sends quarterly statements. What role is the brokerage firm performing for the advisory clients?

A. Custodian
B. Underwriter
C. Issuer
D. Beneficiary

6. In a fully disclosed clearing arrangement, which statement is most accurate?

A. The introducing firm must always hold all customer securities.
B. The exchange becomes the legal custodian of the account.
C. The customer has no right to know the clearing firm exists.
D. The carrying agreement allocates responsibilities between the introducing and clearing firms.

7. A market maker sells shares to a customer from the market maker's own inventory. In what capacity is the market maker acting?

A. As principal/dealer
B. As trustee
C. As issuer
D. As agent only

8. A broker routes a customer's order to a venue where buy and sell orders are matched under formal trading rules. Which market participant is most directly involved?

A. Investment adviser
B. Transfer agent
C. Exchange
D. Custodian

9. After an order is executed, another firm updates the client's account records, prepares settlement, and reflects the position on the statement. Which role is this firm most likely performing?

A. Clearing broker-dealer
B. Issuer
C. Market commentator
D. State securities administrator

10. A client asks why the brokerage statement differs from the adviser's performance report. Which document should generally be treated as the independent custody record?

A. The adviser's marketing brochure
B. The exchange rulebook
C. The issuer's annual report
D. The custodian or carrying firm statement

11. Which phrase most strongly signals market maker activity?

A. Evaluates whether a stock is suitable for a customer
B. Stands ready to buy and sell at quoted prices
C. Prepares a client financial plan
D. Registers ownership changes for the issuer

12. A client claims that her representative made an unsuitable recommendation. Which entity is most likely responsible for supervising the representative's recommendation conduct?

A. The stock exchange where the trade executed
B. The introducing broker-dealer employing or supervising the representative
C. The market maker that filled the order
D. The custodian holding the account

Answer Key and Explanations

1. D — The introducing broker-dealer is the client-facing firm that solicits or accepts the order.

2. C — The carrying/clearing firm or custodian usually sends the official account statement.

3. B — A market maker stands ready to buy or sell at publicly quoted prices from its own account.

4. C — A national securities exchange is an SEC-registered securities marketplace.

5. A — Holding assets and sending account statements are custody functions.

6. D — Fully disclosed arrangements identify the carrying firm and allocate responsibilities between the firms.

7. A — Trading from the firm's own inventory is principal or dealer activity.

8. C — An exchange is a market center that provides trading rules and a venue for order interaction.

9. A — Clearing firms process post-trade records, clearance, settlement, and statements.

10. D — Custodian/carrying firm statements are the independent custody records of positions and balances.

11. B — Standing ready to buy and sell at quoted prices is the classic market maker clue.

12. B — Recommendation conduct and representative supervision usually point to the introducing broker-dealer/advisory firm.

Lesson 59: Trading Costs and Best Execution

Learning Objectives

- Distinguish **commissions**, **markups**, **markdowns**, and **bid-ask spreads**.
- Identify which costs usually apply to **agency trades**, **principal trades**, and **market-maker transactions**.
- Calculate basic total transaction costs from quotes and fees.
- Explain why **best execution** is based on the overall quality of execution, not simply the lowest commission.
- Recognize common conflicts that can affect **order routing**, including **payment for order flow**, **soft dollars**, **affiliated brokers**, and directed **brokerage**.

59.1 The Big Idea: Trading Costs Affect Client Returns

Trading securities creates explicit and implicit costs. Series 65 questions often test whether the adviser can recognize which cost applies, who receives the compensation, and whether the total execution is fair to the client.

Exam framework: ask three questions
Capacity: Is the firm acting as agent, principal, market maker, custodian, or adviser?
Cost type: Is the cost a commission, markup, markdown, bid-ask spread, or order-routing conflict?
Best execution: Did the firm seek a favorable overall result for the client under the circumstances?

59.2 Commissions

A **commission** is compensation paid for executing a transaction as agent. The broker-dealer is not selling from its own inventory; it is arranging the trade for the customer and charging a fee or service charge.

- Common in agency trades.
- May be flat-dollar, per-share, percentage-based, or embedded in a platform charge.
- A zero-dollar commission does not mean the trade has no cost; spreads and order-routing quality still matter.
- For exam purposes, commissions usually pair with agency capacity.

Example: commission
A customer buys 100 shares at $40.00 through a broker acting as agent.
The broker charges a $4.95 commission.
Total cost = $4,000.00 stock cost + $4.95 commission = $4,004.95.

59.3 Markups and Markdowns

A **markup** or **markdown** usually occurs when a broker-dealer acts as principal. The dealer trades from or into its own inventory rather than merely arranging a trade between the customer and another party.

- Markup: dealer sells to the customer at a price above the prevailing market price.
- Markdown: dealer buys from the customer at a price below the prevailing market price.
- Fairness is based on all relevant circumstances, not a single mechanical percentage.
- FINRA's 5% policy is a guide, not a safe harbor. A markup below 5% can still be unfair.

Example: markup and markdown
Markup: The dealer's prevailing market price for a bond is 98, but the dealer sells to the customer at 99. The extra point is the markup.
Markdown: The dealer buys a bond from the customer at 97 when the prevailing market price is 98. The one-point difference is the markdown.

59.4 Bid-Ask Spread

The **bid-ask spread** is the difference between the highest price buyers are generally willing to pay and the lowest price sellers are generally willing to accept. It is an implicit trading cost because the client may not see a separate fee line item.

- Bid: price at which a dealer or market participant is willing to buy.
- Ask or offer: price at which a dealer or market participant is willing to sell.
- Narrow spreads are associated with higher liquidity and competition.
- Wider spreads are more common in thinly traded, volatile, low-priced, or hard-to-value securities.

Example: spread
Stock quote: $24.95 bid / $25.05 ask.
Spread = $25.05 - $24.95 = $0.10.
A client buying usually pays near the ask; a client selling usually receives near the bid.

59.5 Comparing the Cost Terms

Term	Usually Connected To	Client Impact	Simple Example
Commission	Agency trade	Explicit fee added to or deducted from trade	Buy $10,000 of stock and pay a $5 commission

Term	Usually Connected To	Client Impact	Simple Example
Markup	Principal sale by dealer	Customer pays above prevailing market price	Dealer sells from inventory at 101 when market is 100
Markdown	Principal purchase by dealer	Customer receives below prevailing market price	Dealer buys from customer at 99 when market is 100
Spread	Market making and liquidity	Implicit cost from buying near ask and selling near bid	25.00 bid / 25.10 ask creates a $0.10 spread

59.6 Best Execution

Best execution is the obligation to use reasonable diligence to seek a favorable execution result for the customer or client under the circumstances. For investment advisers, the duty is part of the adviser's fiduciary duty when the adviser has responsibility for selecting broker-dealers or directing client trades. For broker-dealers, FINRA rules also require reasonable diligence to find the best market and achieve a favorable price under prevailing market conditions.

- Best execution does not mean the lowest commission in every situation.
- Price is important, but price is not the only factor.
- Relevant factors include price, speed, likelihood of execution, order size, liquidity, market conditions, transaction costs, execution capability, and the terms of the order.
- A firm should have a regular process for reviewing execution quality rather than evaluating trades only after a complaint.

Exam point
Do not choose an answer that says best execution always means the lowest commission or lowest explicit cost. The better answer usually emphasizes the most favorable total result under the circumstances.

59.7 Best Execution Factors

- Quoted price and ability to obtain price improvement.
- Speed of execution and likelihood that the order will be filled.
- Size and type of order, including whether the order is a market, limit, or stop order.
- Liquidity, volatility, and market depth in the security.

- Number and accessibility of markets checked.
- Commission rate, spread, markup, markdown, and other transaction costs.
- Execution capability, financial responsibility, and responsiveness of the broker-dealer.
- Potential conflicts such as payment for order flow, soft-dollar arrangements, affiliated brokers, or directed brokerage.

59.8 Common Conflicts and Red Flags

Conflicts do not automatically make an execution improper, but the existence of a conflict raises the need for careful analysis, disclosure when required, and evidence that client interests were not subordinated.

- Payment for order flow: a broker receives compensation for routing orders to a particular venue.
- Soft dollars: an adviser may receive research or brokerage services from a broker used for client trades.
- Affiliated broker-dealers: an adviser may have a relationship with the executing broker.
- Directed brokerage: a client instructs the adviser to use a particular broker, which may affect execution quality.
- Internalization: customer order flow is executed internally or through an affiliated venue.
- Failure to review: the firm cannot demonstrate that it periodically evaluated execution quality.

59.9 Mini Case: Choosing Between Two Brokers

An adviser can execute a block trade through Broker A or Broker B.

- Broker A charges a lower commission but has poor execution speed and frequently misses fills in this thinly traded stock.
- Broker B charges a slightly higher commission but reliably completes the order with less market impact.
- The adviser may use Broker B if the adviser reasonably concludes that Broker B provides the better overall execution result for clients.
- The adviser should document the reasoning and periodically review whether the conclusion remains valid.

59.10 Key Takeaways

- Commissions are explicit fees most commonly associated with agency trades.
- Markups and markdowns are principal-trade compensation and must be fair in relation to the prevailing market price.
- Spreads are implicit costs tied to liquidity and market making.
- Best execution is about total quality of execution, not a mechanical lowest-cost rule.
- Conflicts such as payment for order flow or soft dollars must not override the obligation to seek favorable client execution.

References and Further Reading

- FINRA Rule 2121, Fair Prices and Commissions.
- FINRA Rule 5310, Best Execution and Interpositioning.
- SEC investment adviser fiduciary duty and best execution guidance.

Practice Questions

1. A client buys 100 shares through a broker-dealer acting as agent. The broker charges a $6 trade fee. Which term best describes that $6 fee?

A. A commission
B. A markup
C. A markdown
D. A bid-ask spread

2. A dealer owns bonds in inventory and sells them to a customer at a price above the prevailing market price. What is the dealer charging?

A. A commission
B. A bid discount
C. A markdown
D. A markup

3. A stock is quoted 24.95 bid and 25.05 ask. A customer who immediately buys and then sells at those quotes would face which implicit trading cost?

A. The mutual fund expense ratio
B. The $0.10 bid-ask spread
C. The stated commission only
D. The dealer markdown only

4. Which statement best describes best execution?

A. It is satisfied whenever a broker discloses payment for order flow.
B. It requires using the broker with the lowest commission in every trade.
C. It requires avoiding all principal trades.
D. It requires seeking the most favorable overall execution under the circumstances.

5. Which statement about FINRA's 5% markup policy is most accurate?

A. A 5% markup is always permitted.
B. A 5% markup is always prohibited.
C. The 5% policy is a guide, not a fixed rule.
D. Only stock trades are subject to fairness standards.

6. An investment adviser routes trades to a broker mainly because the broker gives the adviser a personal benefit. What is the primary regulatory concern?

A. The trade becomes exempt from all documentation requirements.
B. The client cannot own listed stocks.
C. The adviser may be placing its own interest ahead of the client's best execution.
D. The trade must automatically be converted to a cash-account trade.

7. Which security would generally be expected to have the widest bid-ask spread, all else equal?

A. A thinly traded low-priced stock
B. A Treasury bill
C. A highly liquid large-cap stock
D. An S&P 500 ETF with heavy volume

8. A dealer buys securities from a customer at a price below the prevailing market price. What is the dealer charging?

A. A margin debit
B. A markdown
C. A sales load
D. A placement fee

9. Which statement about payment for order flow is most consistent with best execution principles?

A. It is always prohibited for all securities transactions.
B. It automatically proves the customer received best execution.
C. It eliminates the need to evaluate execution quality.
D. It creates a conflict that must not prevent the firm from seeking favorable execution for the customer.

10. A customer buys 200 shares at an ask price of $20.10 and pays a $5 commission. What is the total dollar amount paid?

A. $4,020
B. $4,005
C. $4,025
D. $4,015

11. A registered representative says, "This trade has no commission, so there are no trading costs." What is the best response?

A. The statement ignores possible implicit costs such as spreads and execution quality.
B. The statement is correct for all listed securities.
C. The statement is correct only in a margin account.
D. The statement is correct only if the trade is unsolicited.

12. A firm reviews execution quality only when a customer complains. What is the best exam conclusion?

A. That is sufficient if trades are small.
B. Firms should have a systematic process for reviewing execution quality.
C. That is sufficient if the firm discloses all commissions.
D. Best execution does not apply to agency trades.

Answer Key and Explanations

1. A — In an agency trade, the broker-dealer executes for the customer and is typically compensated through a commission or service charge.

2. D — When a dealer sells securities from its own inventory to a customer, the extra amount above the prevailing market price is a markup.

3. B — The bid-ask spread is the difference between the price buyers are willing to pay and the price sellers are asking. It is often an implicit cost of liquidity.

4. D — Best execution considers the overall execution result, including price, speed, likelihood of execution, size, costs, liquidity, and service quality. It is not limited to the lowest commission.

5. C — The 5% policy is a guideline. A markup below 5% can still be unfair, and a fair markup depends on all relevant circumstances.

6. C — An adviser with authority over brokerage selection must seek best execution for clients and must not allow personal benefit or self-interest to control trade routing.

7. A — Spreads are often wider when securities are illiquid, volatile, low-priced, or difficult to trade.

8. B — When a dealer buys from a customer as principal, the reduction from the prevailing market price is called a markdown.

9. D — Payment for order flow is a conflict and routing factor. It does not automatically violate best execution, but it also does not excuse failure to seek favorable customer execution.

10. C — The trade price is 200 x $20.10 = $4,020. Adding the $5 commission gives a total cost of $4,025.

11. A — Zero commission does not mean zero cost. Spreads, price improvement or disimprovement, markups, markdowns, and order routing quality can still affect the client's outcome.

12. B — Best execution includes a process obligation. Firms and advisers should evaluate execution quality through regular reviews, not only after complaints.

Lesson 60: Portfolio Performance Measures

Learning Objectives

- Distinguish total return, **holding period return**, **annualized return**, **expected return**, **indexed return**, **inflation-adjusted return**, and **after-tax return**.
- Explain why **time-weighted return** isolates investment performance while **dollar-weighted return** and **IRR** reflect the timing and size of client cash flows.
- Calculate common portfolio performance measures using straightforward Series 65-style examples.
- Recognize when **risk-adjusted performance** is more useful than a simple return comparison.
- Apply the correct return measure to common client and advisor evaluation scenarios.

60.1 Why Performance Measurement Matters

A portfolio return is not a single idea. The right measure depends on the question being asked. A client may want to know how much wealth changed, whether the advisor added value, whether the return compensated the client for risk, or whether the portfolio preserved purchasing power after taxes and inflation.

Exam point The exam often tests whether you can select the appropriate return measure, not just whether you can perform a calculation.

Quick Reference: Major Return Measures

Measure	What it answers	Basic formula or idea
Total return	How much the investment gained or lost including income.	(Ending value - Beginning value + Income) / Beginning value
Holding period return	What was earned over the full holding period.	(Ending value - Beginning value + Income) / Beginning value
Annualized return	What the multi-period return equals per year.	(1 + total return)^(1/years) - 1
Expected return	What return is anticipated across possible outcomes.	Sum of each outcome probability times its return

Measure	What it answers	Basic formula or idea
Indexed return	How performance compares to a base value, often 100.	Ending index / Beginning index - 1
Inflation-adjusted return	How much purchasing power increased.	(1 + nominal return) / (1 + inflation rate) - 1
After-tax return	What the investor keeps after taxes.	Pre-tax return x (1 - tax rate), when the return is fully taxable
Risk-adjusted return	How much return was earned per unit of risk.	Example: Sharpe ratio = (Portfolio return - Risk-free rate) / Standard deviation
Time-weighted return	How the investment strategy performed, removing the effect of external cash flows.	Geometrically link each subperiod return
Dollar-weighted return / IRR	How the client's money actually performed considering timing and size of cash flows.	Discount rate that sets cash inflows and outflows equal

60.2 Total Return

Total return includes both price change and income, such as dividends or interest. It is often the broadest simple measure of investment performance.

Calculated Example
An investor buys a fund for $10,000. One year later it is worth $10,700 and paid $300 in dividends. Total return = ($10,700 - $10,000 + $300) / $10,000 = 10.0%.

60.3 Holding Period Return

Holding period return measures the return over the specific period the investment was held. It does not automatically convert the result to an annual rate.

Calculated Example
A stock is purchased at $40, sold at $46, and pays $2 in dividends. Holding period return = ($46 - $40 + $2) / $40 = 20.0%.

60.4 Annualized Return

Annualized return converts a return from a period longer or shorter than one year into a per-year compounded rate. This makes investments with different holding periods easier to compare.

Calculated Example
A portfolio gains 30% over three years. Annualized return = (1.30)^(1/3) - 1 = 9.14% per year, not 10% per year.

60.5 Indexed Return

Indexed performance expresses growth from a base value, often 100. It is useful when comparing several investments or benchmarks over time.

Calculated Example
If a portfolio index begins at 100 and ends at 118, indexed return = 118 / 100 - 1 = 18%. If a benchmark ends at 112, the portfolio outperformed by 6 percentage points.

60.6 Expected Return

Expected return is a probability-weighted average of possible outcomes. It is an estimate, not a promise.

Calculated Example
A portfolio has a 30% chance of earning 12%, a 50% chance of earning 6%, and a 20% chance of losing 4%. Expected return = (0.30 x 12%) + (0.50 x 6%) + (0.20 x -4%) = 5.8%.

60.7 Inflation-Adjusted Return

Inflation-adjusted return, also called **real return**, measures the increase in purchasing power after accounting for inflation.

Calculated Example
If the nominal return is 8% and inflation is 3%, real return = (1.08 / 1.03) - 1 = 4.85%. The approximation is 8% - 3% = 5%, but the exact compounded result is 4.85%.

60.8 After-Tax Return

After-tax return measures the return the investor keeps after taxes. Taxable accounts require special attention because different income types may be taxed at different rates.

Calculated Example
If a bond fund earns 7% and the entire return is taxed at a 24% marginal rate, after-tax return = 7% x (1 - 0.24) = 5.32%.

60.9 Risk-Adjusted Return

Risk-adjusted return evaluates performance relative to the risk taken. A portfolio with a higher raw return is not necessarily better if it took substantially more risk.

Calculated Example
Portfolio A returned 8%, the risk-free rate was 3%, and Portfolio A had a 10% standard deviation. Sharpe ratio = (8% - 3%) / 10% = 0.50. Portfolio B returned 9% with an 18% standard deviation: Sharpe ratio = (9% - 3%) / 18% = 0.33. Portfolio A had better risk-adjusted performance.

60.10 Time-Weighted Return

Time-weighted return is commonly used to evaluate an investment manager because it removes the effect of external client contributions and withdrawals. Each subperiod return is calculated separately, and the subperiod returns are geometrically linked.

Calculated Example
A client starts with $100,000. The portfolio grows to $110,000, then the client adds $20,000, making the account $130,000. Later the account ends at $125,000. Subperiod 1 return = $110,000 / $100,000 - 1 = 10.0%. Subperiod 2 return = $125,000 / $130,000 - 1 = -3.85%. Time-weighted return = (1.10 x 0.9615) - 1 = 5.77%.

60.11 Dollar-Weighted Return and IRR

Dollar-weighted return is the internal rate of return for the actual cash flows. It is affected by when the client adds or withdraws money. Large cash flows near market highs or lows can materially change the result.

Calculated Example
Using the prior cash flows: -$100,000 at the beginning, -$20,000 after six months, and +$125,000 at year-end. The dollar-weighted return is the annual discount rate that solves: -100,000 - 20,000/(1+r)^0.5 + 125,000/(1+r) = 0. The result is approximately 4.55%, lower than the 5.77% time-weighted return because more money was invested before the second subperiod loss. Note: The Series 65 Exam will generally not ask you to calculate the Dollar-weighted return as it generally requires the use of a financial calculator or spreadsheet.

60.12 Choosing the Correct Measure

Question	Best measure
How much did the account grow including dividends and interest?	Total return or holding period return
How did the manager perform independent of client deposits and withdrawals?	Time-weighted return
How did the client's actual money perform considering cash-flow timing?	Dollar-weighted return / IRR
How much purchasing power was gained?	Inflation-adjusted return
How much did the investor keep after taxes?	After-tax return
Was the return attractive given the risk taken?	Risk-adjusted return
What is the compounded annual rate over several years?	Annualized return

Common Exam Traps

- Do not confuse total return with price return. Total return includes income.
- Do not annualize by simply dividing a multi-year return by the number of years when compounding is required.

- Use time-weighted return to judge advisor or strategy performance when the advisor does not control client cash flows.
- Use dollar-weighted return or IRR when the timing and size of cash flows matter to the client's actual experience.
- Real return is not exactly nominal return minus inflation unless the question asks for the approximation.
- After-tax return depends on the applicable tax treatment, not just the pre-tax return.

Key Takeaways

- The right performance measure depends on the decision being made.
- Total return includes income and price change; holding period return measures the full return over the time held.
- Annualized return converts performance into a compounded yearly rate.
- Time-weighted return is the cleanest measure of manager performance when external cash flows are outside the manager's control.
- Dollar-weighted return and IRR measure the investor's actual experience with cash-flow timing.
- Inflation-adjusted and after-tax returns are often more relevant to client goals than nominal pre-tax returns.

Practice Questions

1. A client invests $50,000. One year later the account is worth $53,500 and paid $1,500 in dividends during the year. What is the total return?

A. 10.0%
B. 8.0%
C. 7.0%
D. 13.0%

2. A stock is purchased for $40, sold for $46, and pays $2 in dividends while held. What is the holding period return?

A. 5.0%
B. 12.5%
C. 15.0%
D. 20.0%

3. An account grows from $100,000 to $110,000, receives a $20,000 contribution, and later ends at $125,000. What is the approximate time-weighted return?

A. 10.00%
B. 4.55%
C. 25.00%
D. 5.77%

4. Which return measure is most directly affected by the timing and size of client contributions and withdrawals?

A. Indexed return
B. Nominal return
C. Dollar-weighted return
D. Time-weighted return

5. A portfolio earns 30% over three years. What is the approximate annualized return?

A. 9.14%
B. 6.67%
C. 30.00%
D. 10.00%

6. If a portfolio earns 8% and inflation is 3%, what is the exact inflation-adjusted return?

A. 5.00%
B. 4.85%
C. 3.00%
D. 8.00%

7. A bond fund earns 7%, and the return is fully taxable at a 24% marginal rate. What is the after-tax return?

A. 4.24%
B. 7.00%
C. 5.32%
D. 1.68%

8. A portfolio has a 30% chance of earning 12%, a 50% chance of earning 6%, and a 20% chance of losing 4%. What is the expected return?

A. 4.80%
B. 6.00%
C. 5.80%
D. 7.20%

9. A portfolio returns 8%, the risk-free rate is 3%, and the standard deviation is 10%. What is the Sharpe ratio?

A. 0.50
B. 0.80
C. 0.30
D. 0.10

10. A portfolio index begins at 100 and ends at 115. What is the indexed return?

A. 1.15%
B. 15%
C. 100%
D. 115%

11. Which measure is generally preferred to evaluate an advisor's investment management skill when the advisor does not control deposits and withdrawals?

A. Dollar-weighted return
B. After-tax return
C. Expected return
D. Time-weighted return

12. What does internal rate of return measure in a portfolio performance context?

A. The simple average return across years
B. The discount rate that equates cash inflows and outflows
C. The return earned without considering cash flows
D. The return after inflation only

Answer Key and Explanations

1. A — Total return = ($53,500 - $50,000 + $1,500) / $50,000 = 10.0%.

2. D — Holding period return = ($46 - $40 + $2) / $40 = 20.0%.

3. D — Subperiod returns are 10.0% and -3.85%; (1.10 x 0.9615) - 1 = 5.77%.

4. C — Dollar-weighted return reflects the investor's actual cash-flow timing.

5. A — Annualized return = 1.30^(1/3) - 1 = approximately 9.14%.

6. B — Real return = 1.08 / 1.03 - 1 = 4.85%.

7. C — After-tax return = 7% x (1 - 0.24) = 5.32%.

8. C — Expected return = 3.6% + 3.0% - 0.8% = 5.8%.

9. A — Sharpe ratio = (8% - 3%) / 10% = 0.50.

10. B — Indexed return = 115 / 100 - 1 = 15%.

11. D — Time-weighted return removes the effect of client-directed cash flows.

12. B — IRR is the discount rate that equates the present value of inflows and outflows.

Lesson 61: Current Yield and Relevant Benchmarks

Learning Objectives

- Calculate **current yield** for bonds, preferred stock, and dividend-paying common stock.
- Distinguish **current yield** from **coupon rate**, **yield to maturity**, **total return**, and **holding period return**.
- Select a relevant **benchmark** based on the portfolio's **asset class**, **risk**, **style**, **geography**, **tax status**, and **time horizon**.
- Identify when a benchmark comparison is misleading because the benchmark does not match the client's portfolio.

61.1 Current Yield

Current yield measures the annual income produced by a security as a percentage of its current market price. It is a simple income measure, not a complete performance measure.

Formula: Current Yield = Annual Income / Current Market Price

Security	Annual income	Current price	Current yield
Bond	$60 annual interest	$960	$60 / $960 = 6.25%
Preferred stock	$4 annual dividend	$80	$4 / $80 = 5.00%
Common stock	$2 annual dividend	$40	$2 / $40 = 5.00%

61.2 What Current Yield Includes and Excludes

- Includes recurring annual income, such as bond interest or dividends.
- Uses today's market price rather than par value or original cost.
- Excludes capital gains and losses.
- Excludes reinvestment income.
- Excludes the effect of holding a bond to maturity or selling before maturity.
- Does not measure total return or risk-adjusted return.

61.3 Current Yield Compared with Related Measures

Measure	What it answers	Series 65 exam focus
Coupon rate	How much interest does the bond pay based on par value?	Coupon rate stays fixed for most bonds; current yield changes as market price changes.

Measure	What it answers	Series 65 exam focus
Current yield	How much income does the security produce relative to its current price?	Useful for income comparison, but incomplete because it ignores price change.
Yield to maturity	What return is expected if the bond is held to maturity and payments are made as promised?	More complete for bonds because it includes the pull toward par at maturity.
Total return	What was the total gain or loss, including income and price change?	Better for evaluating overall performance.
Holding period return	What did the investor earn during the specific period the investment was held?	Depends on beginning value, ending value, and income received.

61.4 Calculated Examples

Example 1 - Bond current yield: A $1,000 par bond has a 5% coupon and trades for $925. Annual income is $50. Current yield = $50 / $925 = 5.41%.

Example 2 - Premium bond: A $1,000 par bond pays $70 per year and trades for $1,120. Current yield = $70 / $1,120 = 6.25%. The yield to maturity may be lower because the investor may lose $120 of premium if the bond is held to maturity.

Example 3 - Dividend stock: A stock pays $0.40 each quarter and trades for $32. Annual dividend = $1.60. Current yield = $1.60 / $32 = 5.00%.

Example 4 - Portfolio income yield: A portfolio worth $250,000 generates $9,500 of annual dividends and interest. Current income yield = $9,500 / $250,000 = 3.80%.

61.5 Relevant Benchmarks

A relevant benchmark is a comparison standard that reasonably matches the portfolio or manager being evaluated. It should reflect the portfolio's objective, asset classes, risk level, style, geography, and time horizon.

- Asset class: equity, fixed income, cash, real estate, commodities, or alternatives.
- Market segment: large-cap, small-cap, growth, value, investment-grade, high-yield, municipal, or international.
- Risk profile: volatility, duration, credit quality, concentration, and use of leverage.

- Tax status: taxable, tax-exempt, tax-deferred, or after-tax reporting objective.
- Client objective: capital appreciation, income, preservation, liquidity, or balanced growth.

61.6 Benchmark Examples

Portfolio or strategy	Possible benchmark	Why it is relevant
U.S. large-cap core equity portfolio	S&P 500 Index or Russell 1000 Index	Matches broad U.S. large-cap equity exposure.
U.S. small-cap value manager	Russell 2000 Value Index	Matches both market capitalization and value style.
Intermediate investment-grade bond portfolio	Bloomberg U.S. Aggregate Bond Index or a duration-matched aggregate bond benchmark	Matches fixed-income exposure and interest-rate sensitivity more closely than an equity index.
Tax-exempt municipal bond portfolio	Municipal bond benchmark with similar duration and credit quality	Reflects tax-exempt income and municipal credit risk.
60% equity / 40% bond balanced portfolio	60% equity index / 40% bond index blended benchmark	Reflects the policy allocation instead of judging the whole portfolio against one asset class.
Cash reserve portfolio	Treasury bill or money market benchmark	Matches liquidity and capital preservation objective.

61.7 Blended Benchmark Example

Assume a client's long-term policy allocation is 60% U.S. stocks, 30% U.S. bonds, and 10% cash. During the year, the U.S. stock index earns 12%, the bond index earns 4%, and the cash benchmark earns 2%.

Blended benchmark return = (0.60 x 12%) + (0.30 x 4%) + (0.10 x 2%) = 7.20% + 1.20% + 0.20% = 8.60%.

If the portfolio earns 8.10%, the relative performance is 8.10% - 8.60% = -0.50%. This comparison is more meaningful than comparing the entire portfolio to the S&P 500 alone.

61.8 Common Benchmark Problems

- Asset-class mismatch: comparing a bond portfolio to an equity index.

- Style mismatch: comparing a value strategy to a growth index.
- Risk mismatch: comparing a conservative income portfolio to a high-volatility equity benchmark.
- Time-horizon mismatch: judging a long-term allocation based on a very short period.
- Tax mismatch: comparing after-tax client results to a pretax index return.
- Fee mismatch: comparing a client's net-of-fee return to a no-fee index without understanding the difference.

61.9 Quick Decision Rules for the Exam

- Use current yield when the question asks for annual income divided by current price.
- Use yield to maturity when the question asks for the expected return on a bond held to maturity.
- Use total return or holding period return when price change and income both matter.
- Use a blended benchmark when the portfolio holds more than one major asset class.
- A benchmark is relevant only if it matches the portfolio's objective and risk exposure.

Practice Questions

1. A bond has a $1,000 par value, a 6% coupon, and a current market price of $960. What is its current yield?

A. 6.40%
B. 6.25%
C. 5.76%
D. 6.00%

2. Which statement best describes current yield?

A. It is the discount rate that equates price to all future cash flows.
B. It equals the investor's total return over the holding period.
C. It measures annual income relative to current market price.
D. It assumes all cash flows are reinvested at the same rate.

3. A preferred stock pays an annual dividend of $4 and trades at $80. What is the current yield?

A. 8.0%
B. 6.0%
C. 4.0%
D. 5.0%

4. A client owns a diversified 70% U.S. large-cap equity / 30% investment-grade bond portfolio. Which benchmark is most relevant?

A. The 3-month Treasury bill rate only
B. A broad commodities index
C. The Nasdaq Composite only
D. A 70% S&P 500 / 30% Bloomberg U.S. Aggregate Bond blended benchmark

5. Why can current yield be misleading for a bond bought at a premium?

A. It automatically assumes the bond will default.
B. It ignores the capital loss that may occur if the bond is held to maturity.
C. It treats the bond as if it has no maturity date.
D. It ignores the bond's annual coupon payment.

6. A portfolio earned 8% while its relevant benchmark earned 10%. What is the portfolio's excess return relative to the benchmark?

A. 8%
B. 2%
C. -2%
D. 18%

7. A municipal bond fund should generally be compared with which type of benchmark?

A. A municipal bond index with similar maturity and credit characteristics
B. A taxable high-yield corporate bond index
C. A real estate investment trust index
D. A global equity index

8. A common stock pays quarterly dividends of $0.50 and trades at $40. What is its current yield?

A. 10.00%
B. 5.00%
C. 2.50%
D. 1.25%

9. Which benchmark would be least appropriate for a small-cap value equity manager?

A. A custom small-cap value peer benchmark
B. Russell 2000 Value Index
C. A broad small-cap value index
D. S&P 500 Index

10. A portfolio is designed to preserve principal over a one-year horizon. Which benchmark may be most relevant?

A. A short-term Treasury bill or money market benchmark
B. A small-cap growth index
C. A leveraged technology index
D. A long-term emerging markets equity index

11. A bond pays $45 of annual interest and trades at $1,125. What is the current yield?

A. 3.25%
B. 4.50%
C. 4.00%
D. 3.75%

12. An adviser compares a conservative income portfolio to a 100% stock index and concludes the portfolio underperformed during a bull market. What is the main problem?

A. The benchmark does not match the portfolio's objective and risk profile.
B. The comparison uses a benchmark that is too conservative.
C. The comparison ignores the difference in investment expenses only.
D. Stock indexes cannot ever be used as benchmarks.

Answer Key and Explanations

1. B — Current yield = annual interest / current price. The annual interest is $60, so $60 / $960 = 6.25%.

2. C — Current yield focuses on annual income divided by current price. It does not include capital gains or losses.

3. D — Current yield = $4 / $80 = 5.0%.

4. D — A blended benchmark should reflect the portfolio's strategic allocation and major sources of risk.

5. B — A premium bond may have a current yield above its yield to maturity because current yield ignores the loss from price moving toward par.

6. C — Excess return relative to a benchmark is portfolio return minus benchmark return: 8% - 10% = -2%.

7. A — The benchmark should match the fund's tax status, asset class, credit quality, and duration profile.

8. B — Annual dividend = $0.50 x 4 = $2. Current yield = $2 / $40 = 5.00%.

9. D — The S&P 500 is primarily large-cap U.S. equity, so it does not match a small-cap value strategy.

10. A — A short horizon and principal preservation objective calls for a low-risk cash or short-term government benchmark.

11. C — Current yield = $45 / $1,125 = 4.00%.

12. A — A benchmark must be relevant. A conservative income portfolio should not be judged solely against a 100% equity index.

Part IV. Laws, Regulations, and Guidelines Including Prohibition on Unethical Business Practices

Lesson 62: Regulation of Investment Advisers

- Define who qualifies as an **"investment adviser"** under the Investment **Advisers Act of 1940** and applicable state law, and recognize common exclusions.
- Distinguish **state-registered investment advisers** from **federal covered advisers**, including how **assets under management** determines registration jurisdiction and what qualifies a firm as an exempt reporting adviser.
- Identify **notice filing requirements** and explain how they differ from full registration for federal covered advisers operating in a state.
- Explain the **core registration** and **post-registration requirements** for investment advisers, including **recordkeeping** and **books-and-records** obligations.
- Apply a decision framework to Series 65 exam scenarios involving adviser registration status, IAR supervision, and jurisdiction questions.

Exam Focus

Concept	Series 65 task	Common exam trap
Investment adviser definition	Apply the compensation-business-securities advice test.	A title such as “planner” or “consultant” does not control the result.
Federal covered adviser	Know when SEC registration generally replaces state registration.	Federal covered advisers may still have state notice filings and state-registered IARs.
Notice filing	Identify the filing as informational, not state registration.	Do not treat notice filing as state approval.
Books and records	Recognize key records and retention concepts.	“Easy to retrieve” is required even when records are electronic.
IAR supervision	Connect supervisory systems to client protection.	A firm cannot delegate away responsibility for supervising its representatives.

62.1 Investment Adviser Definitions

An **investment adviser** is generally a person or firm that, for compensation, is in the business of giving advice about securities or issuing reports or analyses about securities. The key exam issue

is not the business title. It is whether the activity involves compensation, a regular business activity, and securities advice.

- Person or firm: The definition can apply to individuals and entities.
- For compensation: Compensation can be direct advisory fees, wrap fees, subscriptions, referral compensation, or other economic benefit.
- In the business: Advice must be part of the person's business, not an isolated personal comment.
- Advice about securities: Advice on stocks, bonds, mutual funds, ETFs, variable products, or portfolio allocation involving securities can trigger adviser status.

Example: Adviser status
A financial planner charges clients $1,500 for retirement plans and recommends specific mutual funds and ETFs. Even if the planner calls the work "financial coaching," the securities advice for compensation makes adviser regulation relevant.

Example: Not investment adviser activity by itself
A person gives general budgeting advice and never discusses securities, investment products, portfolio allocation, or securities reports. That activity alone is not investment advice about securities.

Exam point
Common exclusions often tested include certain banks, broker-dealers whose advice is solely incidental to brokerage activity and who receive no special compensation for advice, publishers of bona fide general and regular publications, and lawyers, accountants, engineers, or teachers whose advice is solely incidental to their profession.

62.2 State-Registered and Federal Covered Advisers

Registration responsibility is divided between state securities regulators and the SEC. The general dividing line is regulatory assets under management (RAUM), but exceptions matter.

- Small advisers are generally state-registered rather than SEC-registered.
- Mid-sized advisers generally have $25 million to $100 million of RAUM and are generally state-registered if the home state requires registration and examines advisers.
- Large advisers generally have more than $100 million of RAUM and are generally SEC-registered federal covered advisers.
- An adviser may generally register with the SEC at $100 million and is generally required to remain SEC-registered above $110 million; an SEC-registered adviser generally does not have to withdraw until RAUM falls below $90 million.
- SEC registration does not eliminate state anti-fraud authority, state notice filing requirements, or state registration of investment adviser representatives where required.

Example: Mid-sized adviser
A firm with $60 million in RAUM and a principal office in a state that registers and examines advisers is generally state-registered, not SEC-registered.

Example: Federal covered adviser
A firm with $250 million in RAUM is generally an SEC-registered investment adviser. It may still have to make notice filings in states where it has clients or a place of business, and its IARs may need state registration.

Exempt Reporting Advisers

An **exempt reporting adviser** (ERA) is an adviser that is exempt from full SEC registration but still reports certain information, generally through a limited **Form ADV** filing. ERAs are commonly connected to private funds, such as venture capital funds or certain private fund advisers with less than $150 million in U.S. private fund assets under management.

- ERAs are not the same as unregulated advisers.
- ERAs file limited information, but they do not complete all of Form ADV like registered advisers.
- Depending on state law, an adviser that is an ERA federally may still have state obligations.

Example: Exempt reporting adviser
A venture capital fund adviser that qualifies for the federal venture capital adviser exemption may report as an ERA rather than register fully with the SEC. The adviser still has reporting obligations.

62.3 Notice Filing Requirements

A notice filing is generally a state filing made by an SEC-registered federal covered adviser. The state receives specified documents and fees, usually through IARD, but the adviser is not registering with the state as a state-registered adviser.

- Typical notice filing materials include Form ADV information and required state fees.
- Notice filing lets the state know that the federal covered adviser is doing business in the state.
- A state generally may not impose full adviser registration requirements on a federal covered adviser, but it can require notice filings and enforce anti-fraud rules.
- Investment adviser representatives of federal covered advisers may still need state registration if they meet the state's definition of IAR and have a place of business or clients in that state.

Example: Notice filing
Blue River Advisors is SEC-registered and opens an office in State A. State A may require Blue River to notice file through IARD and pay a state fee, even though Blue River remains SEC-registered rather than state-registered.

62.4 Registration and Post-Registration Requirements

Investment adviser registration and reporting are handled primarily through the Investment Adviser Registration Depository (IARD). Form ADV is the core document. Please note: a sample Form ADV follows the practice questions at the end of this lesson.

- Form ADV Part 1: Business, ownership, affiliations, disciplinary history, custody, client types, and other operating information.
- Form ADV Part 2: Client brochure describing services, fees, conflicts, disciplinary information, and business practices.
- Form CRS/Part 3: A brief relationship summary for advisers that serve retail investors.
- SEC registration generally becomes effective after SEC review; the SEC generally has 45 days to grant registration or institute proceedings to deny it when an application is complete.
- Exempt reporting advisers submit a limited Form ADV report; the report is deemed filed once accepted by IARD.

Example: ADV update
A registered adviser changes its fee schedule and adds a material conflict involving an affiliated custodian. The adviser should amend its disclosure documents according to the Form ADV updating rules and deliver updated disclosure when required.

Post-registration maintenance focuses on keeping registration and disclosure current.

- Annual updating amendment: Advisers generally update Form ADV annually, commonly within 90 days after fiscal year-end.
- Prompt amendments: Certain material changes must be updated promptly, according to Form ADV instructions and applicable law.
- Renewal and fees: Adviser and IAR registrations, notice filings, and related fees are usually renewed through IARD/CRD systems.
- IAR continuing education: In jurisdictions that have adopted NASAA's model IAR CE rule, covered IARs generally complete 12 credits each year: 6 Products and Practice and 6 Ethics and Professional Responsibility.
- IAR **Form U4**/U5 maintenance: Representative registration information must be kept current, and terminations must be reported when required.

62.5 Books and Records Requirements

Books and records rules are designed to make adviser conduct reviewable. The records must be true, accurate, current, and readily available for examination.

- Business and accounting records: journals, ledgers, income and expense records, bank statements, bills, and financial statements.
- Trading and client records: order memoranda, recommendations, trade instructions, confirmations, holdings, and discretionary authority records.

- Advisory records: client agreements, client profiles, suitability or best-interest support, investment policy statements, performance calculations, and billing records.
- Compliance records: policies and procedures, code of ethics, access person holdings and transaction reports, complaints, advertising/marketing materials, solicitor/promoter records, and privacy records.
- Retention: Many adviser records must generally be kept for at least five years, with the first two years in an appropriate office of the adviser. Specific rules vary by record type and regulator.
- Electronic records are allowed if they are organized, indexed, retrievable, and capable of being produced in a legible, complete format.

Example: Books and records violation
An adviser recommends a complex ETF strategy but keeps no record of the recommendation, no client objective data, and no basis for the allocation. Even if the investment performs well, the missing documentation is a regulatory problem.

62.6 Investment Adviser Representative Supervision

Investment adviser firms must supervise advisory personnel to reduce the risk of client harm, inaccurate disclosures, unsuitable advice, conflicts of interest, and unethical practices. Supervision is a system, not a single signature.

- Written policies and procedures should describe how advice is reviewed, how conflicts are disclosed, how client complaints are escalated, and how records are maintained.
- Training should cover fiduciary duty, prohibited practices, cybersecurity, privacy, disclosure, custody, marketing, and outside business activities.
- Review systems may include approval of new accounts, periodic client file reviews, billing reviews, personal trading review, marketing review, and correspondence review.
- Supervision applies to employees and other supervised persons who provide advice or support advisory activity.
- A firm cannot avoid responsibility by saying a representative acted independently if the firm failed to maintain reasonable supervisory systems.

Example: IAR supervision
An IAR posts model portfolio performance on social media. The adviser should have a process to review marketing, verify performance claims, retain the communication, and address misleading statements before or after publication according to its policies.

62.7 Exam Decision Framework

Use this sequence when a question asks who must register, file, update, or supervise:

1. Is the person or firm giving securities advice for compensation as a business? If no, investment adviser regulation may not apply.

2. If adviser regulation applies, is the firm state-registered, SEC-registered as a federal covered adviser, or exempt/reporting?
3. If SEC-registered, ask whether a state notice filing or state IAR registration is still required.
4. If registered or reporting, identify post-registration duties: Form ADV updates, books and records, brochure delivery, fees, renewals, and compliance policies.
5. If an IAR is involved, identify the firm's supervision responsibility and the IAR's registration/CE obligations where required.

Quick Comparison Table

Status	Primary regulator	Key filing	Series 65 emphasis
State-registered adviser	State securities administrator	Form ADV through IARD and state-required materials	Full state registration and state compliance obligations
Federal covered adviser	SEC, with limited state authority	Form ADV through IARD; state notice filings where required	Not state registered, but may notice file and have state-registered IARs
Exempt reporting adviser	SEC and/or state reporting framework, depending on exemption and jurisdiction	Limited Form ADV report	Exempt from full registration, not exempt from all regulation
Investment adviser representative	State securities administrator	Form U4/CRD and state registration where required	Individual supervised by adviser firm; CE may apply in adopting jurisdictions

Practice Questions

1. A planner charges a fixed fee for written retirement plans and recommends specific mutual funds. Which conclusion is most accurate?

A. The planner is not an investment adviser because the fee is fixed rather than asset-based.
B. The planner is automatically an exempt reporting adviser.
C. The planner may be an investment adviser because the activity involves compensation, a business, and securities advice.
D. The planner is not an investment adviser because retirement planning is not securities advice.

2. A firm has $45 million in RAUM and its home state requires adviser registration and examines advisers. The firm does not advise a registered investment company. How is it generally regulated?

A. It is generally state-registered.
B. It can choose SEC registration without regard to state law.
C. It is automatically exempt from all registration.
D. It must register with the SEC because it has more than $25 million.

3. What is a notice filing?

A. A notice to clients that the adviser has no fiduciary duty.
B. A filing that causes the state to approve a federal covered adviser.
C. A state filing by a federal covered adviser, usually involving Form ADV materials and fees, without full state registration.
D. A substitute for Form ADV.

4. Which statement about an exempt reporting adviser is best?

A. It must complete all parts of Form ADV as if it were SEC-registered.
B. It is free from all SEC reporting requirements.
C. It cannot advise private funds.
D. It is exempt from full registration but still files limited information, generally through Form ADV.

5. An SEC-registered adviser opens an office in a new state and has IARs working there. Which statement is most accurate?

A. The adviser may have a state notice filing obligation and the IARs may have state registration obligations.
B. The adviser must file **Form U5** for every client in the state.
C. The state has no authority of any kind over the adviser or its IARs.
D. The adviser must terminate SEC registration and become state-registered.

6. Which item is most clearly part of investment adviser books and records?

A. Client trade order memoranda and records supporting recommendations.
B. A competitor's internal research files.
C. A newspaper article never used by the adviser.
D. A client's unrelated personal tax return held by a different accountant.

7. Many adviser books and records must generally be retained for how long?

A. Only until the client account closes.
B. At least five years, with the first two years generally in an appropriate office.
C. One year, unless a complaint is filed.
D. Permanently in paper form only.

8. Which is the best example of investment adviser representative supervision?

A. Reviewing client files only after a regulatory examination begins.
B. Having written policies, training, review of recommendations, marketing review, and complaint escalation.
C. Supervising only new representatives during their first month.
D. Allowing each IAR to decide independently whether advertising rules apply.

9. A registered adviser materially changes its fee schedule. What should it generally consider?

A. Nothing, because fees are private business terms.
B. Filing a criminal report with FINRA.
C. Amending disclosure documents and delivering updated disclosure when required.
D. Only changing invoices, because Form ADV never includes fee information.

10. In an adopting jurisdiction, the NASAA IAR CE model generally requires which annual credit mix?

A. 10 total credits: all compliance.
B. 12 credits: 6 Products and Practice and 6 Ethics and Professional Responsibility.
C. 20 credits: 10 law and 10 accounting.
D. No CE for IARs under any circumstances.

11. Which statement best describes Form ADV Part 2?

A. It is the broker-dealer trade confirmation form.
B. It is used only to terminate IARs.
C. It is the state tax return for investment advisers.
D. It is the client brochure describing services, fees, conflicts, and business practices.

12. A teacher occasionally tells a class that diversification is important but receives no compensation for individualized securities recommendations. Which answer is most likely?

A. The teacher is a federal covered adviser.
B. The teacher must register as an SEC adviser.
C. The teacher must notice file in every state.
D. The teacher is not an investment adviser based only on that incidental classroom discussion.

Answer Key and Explanations

1. C — The investment adviser definition focuses on compensation, business activity, and advice about securities. A fixed fee can still be compensation.

2. A — A mid-sized adviser with $25 million to $100 million in RAUM is generally state-registered if its home state registers and examines advisers.

3. C — Notice filing is informational and fee-based. It does not make the federal covered adviser state-registered or state-approved.

4. D — ERAs file limited reports and are not fully registered, but they are not unregulated.

5. A — SEC registration generally preempts state registration of the firm, but states may require notice filing and state registration of IARs.

6. A — Order memoranda, recommendations, client records, advisory contracts, and related support are classic adviser records.

7. B — The common Series 65 retention rule is five years, with the first two years readily accessible in an appropriate office. Certain records have special rules.

8. B — Supervision is a structured compliance system: policies, training, review, documentation, and escalation.

9. C — Material changes to fees and conflicts generally require ADV/brochure updates and appropriate client disclosure.

10. B — The NASAA model requires 12 annual credits split equally between Products and Practice and Ethics and Professional Responsibility.

11. D — Part 2 is the narrative disclosure brochure for clients and prospective clients.

12. D — General education or advice solely incidental to teaching is not, by itself, investment adviser activity.

SAMPLE FORM ADV

Prairie View Wealth Management, LLC

Fictional, Condensed Example for Educational Use

Important: This sample is fictional and has been shortened and simplified for educational use. It is not an actual SEC filing and should not be used to satisfy federal or state registration, disclosure, or compliance requirements.

Part 1A - Registration Information

Part 1A provides regulators and the public with information about the investment adviser's ownership, business activities, clients, assets under management, affiliations, custody, and disciplinary history.

Item 1 - Identifying Information

Legal Name: Prairie View Wealth Management, LLC

Principal Office: 1000 Market Street, Suite 400, Topeka, Kansas 66603

Telephone: (555) 555-2400

Website: www.prairieviewwealth.example

Fiscal Year End: December 31

Prairie View Wealth Management, LLC is organized as a limited liability company.

Registration: SEC-registered investment adviser

Item 5 - Information About the Advisory Business

Prairie View provides investment management and financial planning services.

Approximate number of clients: 425

Types of clients:

- Individuals
- High-net-worth individuals
- Trusts and estates
- Charitable organizations
- Retirement plans

Regulatory assets under management:

Type	Assets
Discretionary	$172,500,000
Non-discretionary	$7,500,000

Type	Assets
Total	**$180,000,000**

Advisory Activities

- Portfolio management for individuals and small businesses
- Financial planning
- Retirement planning
- Investment advice to retirement plans

The firm does not sponsor a wrap-fee program.

Item 7 - Financial Industry Affiliations

Prairie View is not affiliated with a broker-dealer, bank, insurance company, mutual fund company, or other investment adviser.

Item 9 - Custody

Client assets are maintained with an independent qualified custodian. Prairie View generally does not have custody of client funds or securities except where the firm's authority to deduct advisory fees from client accounts constitutes custody under applicable regulations.

Item 11 - Disclosure Information

Neither Prairie View nor any of its management persons has a reportable disciplinary event.

Part 2A - Firm Brochure

Item 1 - Cover Page

Prairie View Wealth Management, LLC

1000 Market Street, Suite 400

Topeka, Kansas 66603

(555) 555-2400

www.prairieviewwealth.example

March 31, 2026

This brochure provides information about the qualifications and business practices of Prairie View Wealth Management, LLC. Registration as an investment adviser does not imply a particular level of skill or training.

Additional information about registered investment advisers is available through the SEC's Investment Adviser Public Disclosure system.

Item 2 - Material Changes

Since our previous annual update, Prairie View has:

6. Increased its minimum recommended household account size from $100,000 to $250,000.
7. Revised its advisory fee schedule for accounts exceeding $2 million.

No other material changes have occurred since our previous annual update.

Item 3 - Table of Contents

1. Cover Page
2. Material Changes
3. Table of Contents
4. Advisory Business
5. Fees and Compensation
6. Performance-Based Fees
7. Types of Clients
8. Methods of Analysis, Investment Strategies, and Risk of Loss
9. Disciplinary Information
10. Other Financial Industry Activities and Affiliations
11. Code of Ethics and Personal Trading
12. Brokerage Practices
13. Review of Accounts
14. Client Referrals and Other Compensation
15. Custody
16. Investment Discretion
17. Voting Client Securities
18. Financial Information

Item 4 - Advisory Business

Prairie View Wealth Management, LLC was formed in 2012. The firm is owned by Sarah Morgan, CFA, who owns 70%, and Daniel Lee, CFP®, who owns 30%.

Prairie View primarily provides discretionary investment management and financial planning services.

Before managing a portfolio, we obtain information concerning the client's:

- investment objectives
- risk tolerance
- income needs
- tax circumstances
- time horizon
- other assets and liabilities

Clients may impose reasonable restrictions on their accounts, such as prohibiting investment in a particular company or industry.

As of December 31, 2025, Prairie View managed approximately:

- $172.5 million on a discretionary basis
- $7.5 million on a non-discretionary basis

Total client assets under management were approximately $180 million.

Item 5 - Fees and Compensation

Prairie View generally charges an annual asset-based management fee.

Assets Under Management	Annual Fee
First $500,000	1.00%
Next $500,000	0.85%
$1 million-$2 million	0.70%
Above $2 million	0.55%

Fees are generally calculated quarterly and deducted directly from the client's custodial account. Fees are negotiable depending upon the size and complexity of the relationship.

Fee Example

Assume a client has a $1.5 million portfolio. The annual advisory fee would be approximately:

- First $500,000 × 1.00% = $5,000
- Next $500,000 × 0.85% = $4,250
- Remaining $500,000 × 0.70% = $3,500

Total annual advisory fee = $12,750

Clients may also pay expenses that are not included in Prairie View's advisory fee, including:

- mutual fund and ETF operating expenses
- brokerage charges
- custodial fees
- transaction fees
- other expenses imposed by third parties

Prairie View does not receive commissions for recommending securities.

Item 6 - Performance-Based Fees and Side-by-Side Management

Prairie View does not charge performance-based fees. All portfolio-management clients are charged asset-based fees.

Item 7 - Types of Clients

Prairie View generally provides services to:

- individuals
- high-net-worth individuals
- trusts
- estates
- charitable organizations
- retirement plans

The firm's general minimum account size is $250,000, although Prairie View may waive this requirement.

Item 8 - Methods of Analysis, Investment Strategies, and Risk of Loss

Fundamental Analysis

We evaluate factors such as:

- earnings
- cash flow
- financial condition
- valuation
- interest rates
- economic conditions
- expected risk and return

Asset Allocation

We allocate client portfolios among asset classes such as:

- U.S. equities
- international equities
- fixed-income securities
- real estate securities
- cash equivalents

Long-Term Investment Strategy

Prairie View generally follows a long-term investment strategy and normally does not engage in frequent trading.

Risk of Loss

Investing in securities involves risk of loss, including the possible loss of principal.

Equity risk: Stock prices may decline because of economic conditions, industry developments, or company-specific events.

Interest-rate risk: Bond prices generally decline when market interest rates rise.

Credit risk: A bond issuer may be unable to make required interest or principal payments.

International investment risk: Foreign investments can involve currency fluctuations, political risks, different regulatory systems, and greater market volatility.

ETF and mutual fund risk: Investment funds are subject to the risks of their underlying investments and charge expenses that reduce investor returns.

Item 9 - Disciplinary Information

Prairie View and its management personnel have no legal or disciplinary events that are material to a client's evaluation of the firm or its management.

Item 10 - Other Financial Industry Activities and Affiliations

Prairie View is not registered as a broker-dealer. Prairie View and its management personnel are not registered representatives of a broker-dealer.

Prairie View is not affiliated with:

- a broker-dealer
- an insurance agency
- a bank
- an accounting firm

- another investment adviser
- a securities issuer

Item 11 - Code of Ethics, Participation in Client Transactions, and Personal Trading

Prairie View has adopted a Code of Ethics designed to promote ethical conduct and protect clients.

Employees must:

- place client interests ahead of their personal interests
- comply with federal securities laws
- report certain personal securities holdings and transactions
- obtain approval before participating in certain securities transactions

Prairie View employees may invest in securities that the firm also recommends to clients. This creates a potential conflict of interest. For example, an employee might benefit by purchasing a security before recommending it to clients.

Prairie View addresses this conflict through personal-trading restrictions, reporting requirements, compliance reviews, and restrictions on trading ahead of client transactions. Clients may request a copy of Prairie View's Code of Ethics.

Item 12 - Brokerage Practices

Prairie View generally recommends that clients maintain their accounts with an independent qualified custodian.

When recommending a custodian or broker, Prairie View considers:

- execution quality
- financial strength
- transaction costs
- available securities
- custodial services
- technology
- client service

Prairie View does not receive compensation for directing brokerage transactions to a particular broker. Prairie View may combine orders for several client accounts when it believes doing so is fair and advantageous to clients. Participating clients generally receive the same average execution price.

Item 13 - Review of Accounts

Portfolio accounts are reviewed at least quarterly. Reviews may occur more frequently when:

- market conditions change substantially
- the client's financial circumstances change
- the client changes investment objectives
- large deposits or withdrawals occur
- the adviser believes changes to the portfolio are appropriate

Clients receive account statements directly from their qualified custodian. Prairie View also provides clients with quarterly performance reports.

Item 14 - Client Referrals and Other Compensation

Prairie View does not currently pay non-employees for client referrals. The firm does not receive compensation from mutual fund companies, ETF sponsors, broker-dealers, or other product providers for recommending their investment products.

Item 15 - Custody

Client assets are held with independent qualified custodians. The custodian sends account statements directly to clients. Prairie View generally has authority to deduct its advisory fees from client accounts. Clients should compare Prairie View's reports with the statements received directly from their custodian.

Item 16 - Investment Discretion

Most Prairie View clients grant the firm discretionary authority. This authority permits Prairie View to decide:

- which securities to buy or sell
- the amount of securities to buy or sell
- when transactions should occur

Clients grant this authority through their investment-management agreement and custodial documents. Clients may place reasonable restrictions on this authority.

Item 17 - Voting Client Securities

Prairie View does not accept authority to vote proxies for client securities. Clients receive proxy materials directly from their custodian or another service provider and are responsible for voting their securities. Clients may contact Prairie View with questions concerning a proxy solicitation.

Item 18 - Financial Information

Prairie View does not require clients to prepay more than six months of advisory fees. Prairie View is not aware of any financial condition that is reasonably likely to impair its ability to meet contractual commitments to clients. Prairie View has not been the subject of a bankruptcy petition.

Part 2B - Brochure Supplement

Sarah Morgan, CFA

Prairie View Wealth Management, LLC

Educational Background and Business Experience

Sarah Morgan, born in 1982, earned a Bachelor of Business Administration in Finance in 2004 and an MBA in 2008. She has worked in investment management since 2004 and has served as Prairie View's Chief Investment Officer since 2012. Morgan holds the Chartered Financial Analyst (CFA) designation.

Disciplinary Information

None.

Other Business Activities

None.

Additional Compensation

Morgan receives salary and distributions as an owner of Prairie View Wealth Management. She does not receive commissions for recommending investment products.

Supervision

Morgan's advisory activities are subject to the firm's compliance policies and annual compliance review.

Part 3 - Form CRS (Relationship Summary)

Prairie View Wealth Management, LLC

March 31, 2026

Prairie View Wealth Management is registered with the Securities and Exchange Commission as an investment adviser. Brokerage and investment advisory services and fees differ, and investors should understand these differences.

What investment services and advice can you provide me?

We offer investment-management and financial-planning services to retail investors. For investment-management clients, we regularly monitor your portfolio. Most clients give us discretionary authority, which means we can buy and sell investments without asking you before each transaction. Our general minimum account size is $250,000.

What fees will I pay?

Our principal fee is based on the value of assets we manage for you. Our annual fee generally ranges from 0.55% to 1.00%. Because our fee increases as the amount of assets we manage increases, we have an incentive to encourage you to increase the assets in your advisory account. You may also pay fees and expenses charged by custodians, mutual funds, ETFs, and other third parties.

What are your legal obligations to me?

When we act as your investment adviser, we must act in your best interest and not put our interests ahead of yours. At the same time, the way we make money can create conflicts of interest.

How do your financial professionals make money?

Our financial professionals receive salaries and may receive bonuses based partly on firm profitability. Owners of the firm also receive distributions from firm profits. They do not receive commissions for selling particular investment products.

Do you or your financial professionals have legal or disciplinary history?

No.

Additional Information

Additional information concerning Prairie View's investment advisory services is available in the firm's Form ADV Part 2A brochure.

Lesson 63: Regulation of Investment Adviser Representatives

Learning Objectives

- Define an **Investment Adviser Representative (IAR)** and distinguish the individual IAR from the investment adviser firm.
- Identify activities that usually require **IAR registration** and activities that are excluded from registration.
- Explain why IAR registration is primarily a state-level function, even when the IAR works for a **federal covered adviser**.
- Describe **post-registration maintenance obligations**, including updates to uniform forms, **IAR continuing education**, and **reportable events**.
- Apply the rules to common Series 65 fact patterns involving solicitors, clerical staff, portfolio managers, supervisors, and dual registrants.

Exam point
The investment adviser is the firm. The Investment Adviser Representative is the individual who performs advisory, portfolio management, solicitation, or supervisory functions on behalf of the firm.

63.1 What Is an Investment Adviser Representative?

An **Investment Adviser Representative** is an individual associated with an investment adviser or federal covered investment adviser who performs advisory-related functions. Most state definitions follow the Uniform Securities Act approach: focus on what the person does, not merely the person's title.

- Makes recommendations or otherwise gives investment advice about securities.
- Manages client accounts or portfolios.
- Determines which securities recommendations or advisory guidance should be given.
- Solicits, offers, negotiates for, or sells investment advisory services for compensation.
- Supervises employees who perform advisory, portfolio management, recommendation, or solicitation functions.

Example
A portfolio manager at a registered advisory firm selects model portfolios for clients and periodically meets with clients about allocation changes. The individual is performing advisory and portfolio management functions and generally must be registered as an IAR in the appropriate state or states.

Role	Typically an IAR?	Reason
Financial planner giving securities advice for a fee	Yes	Provides investment advice about securities for compensation.
Portfolio manager assigning accounts to models	Yes	Manages accounts or determines recommendations.
Solicitor paid to refer advisory clients	Often yes	Soliciting or selling advisory services can trigger IAR registration under state law.
Receptionist scheduling client meetings	No	Performs only clerical or ministerial work.
Broker giving incidental advice without special compensation	Generally no	Broker-dealer agent exclusion may apply when advice is solely incidental and no special advisory compensation is received.

Firm Registration vs. Individual Registration

- The investment adviser firm registers either with the SEC or with one or more states, unless exempt or excluded.
- Individuals do not register with the SEC as IARs. IAR registration is handled by the states.
- An IAR may need state registration even if the advisory firm itself is an SEC-registered federal covered adviser.
- The Series 65 is the usual qualification exam for IAR registration. The Series 66 plus the Series 7 can also satisfy the qualification requirement in many states.

63.2 Activities Requiring Registration

A person's title is less important than the person's activities. Registration analysis should begin by asking whether the individual is giving advice, managing portfolios, determining advice, soliciting advisory business for compensation, or supervising those who do.

Activity	Why it matters	Series 65 example
Giving individualized securities advice	Direct advisory activity	"Given your tax bracket and risk tolerance, I recommend reducing individual growth stocks and increasing municipal bonds."
Managing accounts or portfolios	Discretion or portfolio oversight can make the person an IAR	A model manager assigns client assets to a balanced ETF strategy and rebalances quarterly.
Determining recommendations	Behind-the-scenes decision makers may still be IARs	An analyst has final authority over the model portfolio recommended to clients.
Soliciting advisory clients for compensation	Referral or solicitation compensation can trigger registration	A retired adviser receives a referral fee for sending prospects to an RIA.
Supervising advisory personnel	Supervision of advisory activities is itself covered	A branch manager reviews and approves advisory recommendations made by junior planners.

Exam point
A person can be an IAR even without placing trades. The triggering activity may be advice, portfolio management, solicitation, or supervision.

Exclusions from Registration or from the IAR Definition

Several persons are not treated as IARs, or may not need registration, because their work is outside the advisory function or because the law provides an exclusion. Always check the facts carefully.

- Clerical or ministerial personnel: employees who schedule meetings, prepare mailings, maintain files, or process paperwork without giving advice or soliciting advisory services.
- Broker-dealer agents whose investment advice is solely incidental to brokerage activity and who receive no special compensation for advisory services.
- Certain personnel of federal covered advisers who do not have a place of business in the state or who do not meet the federal rule's IAR test.

- Persons excluded by state rule or order.

Example
An administrative assistant at an advisory firm calls clients to schedule annual reviews and uploads signed forms. The assistant does not recommend securities, explain portfolio choices, solicit advisory services, or supervise advisory staff. The assistant is performing clerical or ministerial work and generally is not an IAR.

63.3 Registration Authority

- States register IARs. The SEC registers qualifying advisory firms, but not individual IARs.
- The state administrator can require registration, review filings, deny or condition registration, and bring enforcement actions under state securities law.
- A federal covered adviser may make notice filings with states, and its IARs may still need state registration depending on place of business and state rules.
- Registration is normally completed through Form U4 and the IARD/CRD system.

Question	Series 65 answer
Who registers the advisory firm?	Either the SEC or one or more states, depending on assets under management and other criteria.
Who registers the IAR?	The states, not the SEC.
What form is used for the individual?	Form U4, the Uniform Application for Securities Industry Registration or Transfer.
Where can the public view registration and disclosure information?	Investor-facing databases such as IAPD and BrokerCheck, depending on the person's registration history.

63.4 Registration and Post-Registration Duties

After becoming registered, an IAR must keep registration information current and satisfy any state requirements for continuing education, disclosure updates, and renewal.

Requirement	What you should remember
Initial registration	Usually involves Form U4, qualification exam results or waiver, state selection, fingerprints/background information if required, and fees.
Form updates	The IAR's Form U4 must be updated when information becomes inaccurate or when reportable events occur.
Continuing education	In states that have adopted the NASAA IAR CE model rule, IARs complete 12 CE credits annually: 6 Products and Practice and 6 Ethics and Professional Responsibility.
Renewal	Registrations must be renewed according to state and system deadlines. Failure to satisfy CE or disclosure duties may affect renewal.
Termination	When an IAR leaves a firm, Form U5 is generally used to terminate the registration and report required information.

Continuing education example
An IAR registered in a state that has adopted the NASAA IAR CE rule completes 8 Products and Practice credits and 4 Ethics credits. Even though the IAR completed 12 total credits, the annual requirement is not satisfied because the required split is 6 Products and Practice and 6 Ethics and Professional Responsibility.

Disclosure of Reportable Events

Reportable events are facts that regulators and clients may need to know about a representative's background or conduct. These items are reported through the uniform forms and may appear as disclosures on public systems.

- Criminal events, especially securities-related or financial offenses.
- Regulatory actions or findings by securities, commodities, insurance, banking, or other financial regulators.
- Customer complaints, arbitrations, civil litigation, or settlements involving investment-related conduct.

- Financial events such as bankruptcy, unsatisfied judgments, or liens when reportable under the form instructions.
- Employment terminations involving allegations of misconduct.

Timing point
For exam purposes, remember that disclosure updates are not optional. The representative and firm must keep the uniform forms current. Specific deadlines can vary by rule and event type, but 30 days is a common benchmark for many U4 updates, and statutory disqualification events may require faster reporting.

63.5 Series 65 Decision Framework

1. Identify the person's actual activity. Are they giving advice, managing accounts, determining advice, soliciting advisory business, or supervising those who do?
2. Identify the firm. Does the person work for a state-registered adviser, federal covered adviser, broker-dealer, or another entity?
3. Look for exclusions. Clerical staff, incidental brokerage advice without special advisory compensation, and some personnel of federal covered advisers may be excluded.
4. Determine the state connection. Does the individual have a place of business in the state or otherwise meet that state's registration trigger?
5. Apply post-registration duties. Is the IAR keeping Form U4 current, completing CE where required, and disclosing reportable events?

Scenario	Likely result	Reason
A planner meets clients and recommends a securities allocation for an advisory fee.	IAR registration required	The planner gives individualized securities advice for compensation.
A marketing employee is paid a referral fee for bringing advisory prospects to an RIA.	Often IAR registration required	Soliciting or selling advisory services can trigger IAR status under state law.
A service associate helps clients reset passwords and schedule reviews.	Generally not an IAR	The person performs clerical or ministerial work.
An SEC-registered adviser has an adviser representative with a regular office in State A.	State A may require IAR registration	IARs of federal covered advisers may still be state-registered when they have a place of business in the state.

Common Exam Traps

- Do not confuse the adviser firm with the IAR. The firm registers with the SEC or state; the individual registers with states.
- Do not assume a person must place trades to be an IAR. Advice, portfolio management, solicitation, and supervision can be enough.
- Do not treat all employees of an advisory firm as IARs. Clerical and ministerial staff are excluded.
- Do not assume that employment by a federal covered adviser eliminates state registration. The IAR may still be subject to state registration rules.
- Do not ignore continuing education. In adopting states, IAR CE is part of registration maintenance.

Practice Questions

1. A registered investment adviser hires Jordan to meet with clients and recommend securities portfolios for an advisory fee. Which statement is most accurate?

A. Jordan needs SEC registration as an individual adviser.
B. Jordan is likely an Investment Adviser Representative and may need state registration.
C. Jordan is excluded because only firms register.
D. Jordan is excluded unless Jordan also executes trades.

2. Which person is least likely to be considered an Investment Adviser Representative?

A. An employee who only schedules meetings and processes paperwork
B. A solicitor paid for advisory referrals
C. A supervisor who reviews advisory recommendations
D. A portfolio manager who allocates client assets

3. Who registers Investment Adviser Representatives?

A. The Federal Reserve
B. FINRA only
C. State securities administrators
D. The SEC only

4. An employee does not meet with clients but has final authority over model portfolio recommendations used by advisory representatives. What is the best answer?

A. The employee is exempt because model portfolios are never individualized.
B. The employee is an agent, not an IAR, because models are not securities.
C. The employee is automatically excluded because there is no client contact.
D. The employee may be an IAR because determining recommendations can be an IAR activity.

5. In a state that adopted NASAA's IAR CE model rule, an IAR completes 8 Products and Practice credits and 4 Ethics and Professional Responsibility credits. What is the result?

A. The IAR has not satisfied the requirement because the required 6/6 split was not met.
B. The IAR satisfies the requirement because total credits equal 12.
C. The IAR satisfies the requirement if the firm approves the courses.
D. The IAR is exempt because CE applies only to broker-dealer agents.

6. Which item is most likely a reportable event on an IAR's uniform forms?

A. A routine client birthday card
B. A securities-related customer arbitration or regulatory action
C. A change in the firm's office paint color
D. A client's decision to rebalance a portfolio

7. A broker-dealer agent gives investment advice that is solely incidental to brokerage activity and receives no special advisory compensation. Under the usual exclusion, what is the likely result?

A. The agent is generally excluded from IAR status for that incidental advice.
B. The agent must register as an IAR in every state where clients reside.
C. The agent must register with the SEC as an IAR.
D. The agent becomes a federal covered adviser.

8. An IAR works for an SEC-registered adviser and maintains a regular office in State X where clients meet with the IAR. Which statement is best?

A. The IAR registers only with FINRA.
B. State X cannot regulate the IAR because the firm is SEC registered.
C. The IAR is excluded because federal covered advisers never have IARs.
D. State X may require the IAR to register because IAR registration remains state-based.

9. Which filing is generally used to establish an individual representative's securities-industry registration?

A. Schedule 13D
B. Form 10-K
C. Form ADV Part 2A
D. Form U4

10. Which statement best describes registration maintenance for IARs?

A. Only the advisory firm has disclosure obligations.
B. Once registered, an IAR never needs to update any filing.
C. IARs must keep required forms and disclosures current after registration.
D. Continuing education is always a federal SEC requirement in every state.

11. A person supervises employees who solicit advisory clients for compensation. What is the best answer?

A. The person is excluded if paid a salary instead of commissions.
B. The person is an issuer representative, not an IAR.
C. The person may be an IAR because supervising advisory solicitation activity can be covered.
D. Supervision never creates IAR status.

12. Which statement is the most accurate Series 65 summary?

A. Only portfolio managers can be IARs.
B. IAR status depends on advisory-related functions such as advice, portfolio management, solicitation, or supervision.
C. IARs are always exempt when their advisory firm is registered.
D. IARs are registered only if they custody client securities.

Answer Key and Explanations

1. B — Giving individualized securities advice for compensation is a core IAR function. IAR registration is state-based.

2. A — Clerical or ministerial personnel are generally excluded from the IAR definition.

3. C — The SEC registers eligible advisory firms, but IARs are registered at the state level.

4. D — Determining what advice or recommendations will be given can bring a person within the IAR definition.

5. A — The model rule requires 12 credits annually, split into 6 Products and Practice and 6 Ethics and Professional Responsibility.

6. B — Customer complaints/arbitrations and regulatory actions involving investment-related conduct are common reportable events.

7. A — Broker-dealer agents may be excluded when advice is solely incidental to brokerage activity and no special advisory compensation is paid.

8. D — IARs of federal covered advisers may still be required to register in states where they have a place of business.

9. D — Form U4 is the Uniform Application for Securities Industry Registration or Transfer.

10. C — IARs must keep required information current; CE requirements depend on state adoption.

11. C — Supervising employees who perform advisory or advisory-solicitation functions is itself part of the IAR definition.

12. B — The definition focuses on advisory functions, not titles or trading authority alone.

Lesson 64: Regulation of Broker-Dealers and Agents

Learning Objectives

- Define **agent**, **broker-dealer**, and **issuer** and be able to distinguish between them.
- Recognize common exclusions for broker-dealers and agents of broker-dealers.
- Apply definitions and exclusions to Series 65 exam-type questions.

64.1 Core Distinction: Firm vs. Individual

The Series 65 frequently tests whether you recognize the correct regulatory category. **Broker-dealers are firms or persons in the securities transaction business; agents are individuals who represent a broker-dealer or issuer in those transactions.**

Term	Who/what it is	Primary activity	Exam cue
Broker-dealer	A person or firm	Effects securities transactions for others or for its own account	The business entity or securities firm
Agent	A natural person	Represents a broker-dealer or issuer in effecting or attempting to effect securities transactions	The individual representative or salesperson
Issuer	The entity issuing securities	Raises capital by selling its own securities	Not automatically a broker-dealer
Investment adviser / IAR	Advisory firm / individual representative	Provides securities advice or advisory services	Advice role, not transaction role

64.2 Definition of Broker-Dealer

A broker-dealer is generally a person engaged in the business of effecting transactions in securities for the account of others or for the person's own account. **The definition combines two related roles: broker and dealer.**

Broker Role

- A broker acts for the account of others, typically customers.

- Example: A securities firm accepts a customer's order to buy 100 shares of a listed stock and routes the trade for execution.
- Exam cue: For customer account, transaction facilitation, commission or transaction-based compensation.

Dealer Role

- A dealer trades for its own account as part of a securities business.
- Example: A firm regularly quotes bid and ask prices and buys or sells a corporate bond from its own inventory.
- Exam cue: Own account, principal capacity, inventory, market maker, spread.

64.3 Common Broker-Dealer Exclusions

- Agents are excluded because they are individuals representing a broker-dealer or issuer; they are not the broker-dealer firm.
- Issuers are generally excluded when selling their own securities because issuing securities is not the same as being in the business of effecting transactions for others.
- Banks, savings institutions, and trust companies may be excluded when acting within applicable banking or fiduciary activities.
- A person with no place of business in a state may be excluded if transactions in that state are limited to certain institutional or professional counterparties, such as issuers, other broker-dealers, banks, insurance companies, investment companies, pension trusts, or other institutional buyers.

Broker-Dealer Examples

Situation	Likely category	Reason
Retail brokerage firm	Broker-dealer	It effects securities transactions for customer accounts.
Market maker in OTC securities	Broker-dealer	It regularly buys and sells securities for its own account as a business.
Manufacturer issuing common stock	Issuer	It is selling its own securities, not acting as an intermediary for others.
Bank trust department acting as trustee	Usually excluded from broker-dealer definition	Ordinary trust/fiduciary activities are treated differently from securities brokerage.

Situation	Likely category	Reason
Personal investor trading in a brokerage account	Not a broker-dealer	Personal investing is not being in the business of effecting securities transactions.

64.4 Definition of Agent of a Broker-Dealer

An agent is generally an individual, other than a broker-dealer, who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities.

- The word individual matters. A corporation, LLC, or partnership is not an agent.
- The person must be involved in securities transactions, not merely administrative support.
- An individual can be an agent even if the transaction does not ultimately close; attempting to effect a transaction can be enough.
- Partners, officers, directors, or similar persons are agents only if they otherwise perform transaction-related functions.

Agent Examples

Individual's activity	Agent?	Why
Calls prospects to recommend buying securities through the firm	Yes	Soliciting securities transactions for a broker-dealer is agent activity.
Takes a customer's order to sell shares	Yes	Taking orders is part of effecting securities transactions.
Files new-account paperwork and schedules appointments only	No	Pure clerical or ministerial activity is not transaction activity.
Officer of a broker-dealer who manages facilities only	No	Title alone does not create agent status.
Officer of a broker-dealer who begins soliciting customers	Yes	The officer now otherwise comes within the agent definition.

Individual's activity	Agent?	Why
Issuer employee sells company stock to existing employees with no commission	Maybe excluded	Issuer-agent exclusions may apply depending on state law and facts.

Issuer Agents and Important Exclusions

Many exam questions involving agents turn on whether the individual represents a broker-dealer or an issuer. **Exclusions are usually narrower for issuer representatives and do not automatically apply to individuals representing broker-dealers.**

- Individuals who represent issuers in certain exempt securities or exempt transactions may be excluded from the definition of agent.
- An issuer employee may be excluded when selling to existing employees, partners, or directors if no commission or other remuneration is paid for soliciting.
- A person representing a broker-dealer in customer securities transactions is much more likely to be an agent.

Exam Traps

Trap	Correct reasoning
Agent is a person, right?	On the exam, an agent is an individual. Business entities are not agents.
All broker-dealer employees are agents.	No. Clerical, operational, or administrative employees are not agents unless they effect or attempt to effect securities transactions.
All officers and directors are agents.	No. A title is not enough. They must perform transaction-related activity.
An issuer is automatically a broker-dealer when it sells its stock.	No. Issuers are generally excluded from the broker-dealer definition when selling their own securities.
A personal trader is a dealer.	No. Dealer status requires being in the business of buying and selling securities for one's own account.

Quick Decision Rules

- Ask first: Is the actor a firm/business or an individual?
- If it is a firm effecting securities transactions, think broker-dealer.
- If it is an individual representing a broker-dealer in transactions, think agent.
- If it is an individual representing an issuer, check whether an issuer-agent exclusion applies.
- If the activity is only clerical, administrative, or ministerial, agent status usually does not apply.
- If the person is giving securities advice for compensation rather than transacting securities, consider investment adviser/IAR concepts instead.

Practice Questions

1. Under the Uniform Securities Act, which description best identifies a broker-dealer?

A. A person engaged in the business of effecting securities transactions for the account of others or for its own account.
B. An issuer selling its own securities directly to investors.
C. A natural person who solicits advisory clients for a fee.
D. A bank acting only within ordinary banking activities.

2. Which person is most clearly acting as an agent of a broker-dealer?

A. A bank trust department acting as trustee for an estate.
B. An employee who solicits customers to purchase securities through the broker-dealer.
C. A corporation registered as a broker-dealer.
D. A payroll clerk who enters time records for broker-dealer employees.

3. A corporation hires representatives to sell securities to retail customers. In Series 65 terminology, the corporation itself is most likely the:

A. issuer-agent only.
B. agent.
C. broker-dealer.
D. investment adviser representative.

4. A partner of a broker-dealer handles accounting, leases, and employee benefits, but never solicits, takes orders, or executes securities trades. Under the agent definition, the partner is:

A. automatically excluded because partners can never be agents.
B. an agent only if the partner otherwise performs transaction-related functions.
C. automatically an agent because all partners of a broker-dealer are agents.
D. an issuer, because the partner works for the firm.

5. Which statement best distinguishes a broker from a dealer?

A. A broker must always be an individual; a dealer must always be a corporation.
B. A broker is regulated only by states; a dealer is regulated only by the SEC.
C. A broker provides investment advice; a dealer only provides tax advice.
D. A broker acts for customer accounts; a dealer trades for its own account as part of a securities business.

6. A person buys and sells securities only for the person's own long-term investment account and does not hold out as being in the business of securities trading. The person is generally considered a:

A. trader/investor, not a broker-dealer.
B. dealer.
C. registered agent.
D. broker.

7. Which of the following is generally excluded from the broker-dealer definition under state law?

A. A firm that solicits the public to buy securities.
B. An agent, issuer, or bank acting within an applicable exclusion.
C. A firm executing customer securities trades for compensation.
D. A market-making firm that regularly buys and sells securities for its own account.

8. An issuer's employee sells the issuer's own securities to existing employees and receives no commission or other transaction-based compensation. This fact pattern most likely points to:

A. automatic federal covered adviser status.
B. an investment adviser representative relationship.
C. a possible issuer-agent exclusion, depending on state law and the transaction details.
D. a broker-dealer acting as principal.

9. An employee of a broker-dealer only schedules meetings and files account documents. The employee never solicits, recommends, takes orders, or participates in executions. The employee is most likely:

A. a broker-dealer because clerical employees represent the firm.
B. an agent because all broker-dealer employees are agents.
C. an issuer because the person works for the firm.
D. not an agent because the work is clerical or ministerial.

10. Which statement is most accurate for Series 65 purposes?

A. A broker-dealer and an investment adviser representative are the same regulatory role.
B. An agent can be either an individual or a corporation.
C. An agent is an individual who represents a broker-dealer or issuer in securities transactions.
D. A broker-dealer is always a natural person.

11. A firm with no office in State A effects transactions in State A only with other broker-dealers and institutional buyers. Under many state broker-dealer definitions, this fact pattern most likely indicates:

A. the firm becomes an issuer.
B. the firm is automatically an agent in State A.
C. the firm must register every employee as an investment adviser representative.
D. the firm may be excluded from state broker-dealer registration in State A.

12. Why are broker-dealers separate from agents?

A. Because the broker-dealer is the securities business entity or person, while the agent is the individual acting for the broker-dealer or issuer in transactions.
B. Because agents register federally and broker-dealers register only with counties.
C. Because broker-dealers can sell only exempt securities, while agents can sell any security.
D. Because broker-dealers provide only investment advice, while agents provide tax advice.

Answer Key and Explanations

1. A — A broker-dealer is a person or firm in the securities transaction business, either for customers or for its own account. Agents and issuers are excluded from the broker-dealer definition.

2. B — An agent is an individual who represents a broker-dealer or issuer in effecting or attempting to effect securities transactions. Pure clerical work does not trigger agent status.

3. C — A broker-dealer may be a business entity. An agent is an individual, not the firm.

4. B — Partners, officers, and directors are agents only if they otherwise come within the agent definition by effecting or attempting to effect securities transactions.

5. D — A broker effects transactions for others. A dealer buys and sells securities for its own account as part of a regular securities business.

6. A — Trading for one's own account as a personal investor is not enough to be a dealer. Dealer status requires being in the business of buying and selling securities for one's own account.

7. B — The Uniform Securities Act excludes agents, issuers, and certain banks from the broker-dealer definition.

8. C — The agent definition can exclude certain individuals representing issuers, including some noncommissioned employee transactions, but the details matter.

9. D — Clerical or ministerial work does not equal effecting or attempting to effect securities transactions.

10. C — The exam heavily tests the firm-versus-individual distinction. Broker-dealers are firms or persons in the transaction business; agents are individuals.

11. D — State law often excludes firms with no place of business in the state when their transactions are limited to issuers, other broker-dealers, or institutional buyers.

12. A — This is the core exam distinction: firm or business role versus individual representative role.

Lesson 65: Regulation of Securities and Issuers

Learning Objectives

- Define a **security** and recognize common examples.
- Separate the **issuer**, the **security**, and the **transaction** when determining whether state registration is required.
- Distinguish **state registration** from **notice filing** for **federal covered securities**.
- Recognize **basic exemptions**, **exclusions**, and **post-registration obligations**.
- Apply a practical decision process to exam-style scenarios.

The Regulatory Question

Issuer registration analysis starts with a simple but important sequence: identify the item being sold, decide whether it is a security, then determine whether the security or the transaction must be registered in the state.

Exam Anchor: Three different questions
Is the item a security? This is a definition question.
Is the security or transaction exempt? This is a registration question.
Did the issuer or seller make false or misleading statements? This is an antifraud question.

65.1 Securities: Definition and Examples

A security is a financial interest or investment instrument that is regulated under securities law. The definition is intentionally broad. It includes familiar instruments, such as stocks and bonds, and flexible categories, such as investment contracts, that capture investment arrangements with economic substance similar to securities.

Instrument or interest	Why it is usually a security	Example
Stock	Represents an equity ownership interest in an issuer.	Common shares of a corporation sold to investors.
Bond or debenture	Represents an issuer borrowing from investors.	A corporation issues 10-year unsecured debentures.
Note	May be a security when it is an investment note rather than ordinary commercial debt.	A company sells notes to investors to finance expansion.

Instrument or interest	Why it is usually a security	Example
Investment contract	Investors provide money and expect profits primarily from others' efforts.	Investors buy interests in a passive real estate development.
Limited partnership interest	Limited partners usually rely on the general partner to operate the business.	Investors buy LP units in an oil and gas project.
Fractional oil, gas, or mineral interest	Investors buy an interest in production managed by another party.	A fractional mineral royalty interest sold to passive investors.
Viatical settlement or similar investment	Purchasers acquire an investment interest in another person's policy-related cash flows.	Investors buy interests in pooled life-settlement contracts.

Investment Contracts

Investment contracts are an important flexible category because promoters can create investment arrangements that do not look like traditional stock or bonds. The exam often asks whether the investor is relying primarily on someone else to produce the return.

- Common exam framing: investors contribute money or assets, participate in a common enterprise, expect profits, and rely mainly on the efforts of others.
- Example: A promoter sells fractional interests in a citrus grove, real estate development, crypto mining operation, or equipment lease program and handles the management work for investors.
- Practical test: If the investor is passive and the promoter controls the profit-producing activity, it may be a security even if the label avoids the word stock or bond.

Items Commonly Excluded from the Definition

An **exclusion** means the item is not a security in the first place. If the item is excluded, securities registration rules do not apply to that item. This is different from an **exemption**, which applies to an item that is a security but does not have to be registered.

Item	Treatment	Example
Insurance policy or fixed annuity	Generally excluded from the securities definition because the insurance company bears the contractual risk.	A fixed annuity paying a guaranteed minimum rate.
Bank deposit or traditional certificate of deposit	Generally treated as a bank product, not a security.	FDIC-insured bank CD bought directly from the bank.
Personal residence or ordinary real estate purchase	Not a security unless packaged as a passive profit arrangement.	Client buys a house to live in.
Collectibles and commodities owned directly	Usually assets rather than securities, unless sold through an investment contract or pooled vehicle.	Client buys physical gold coins for storage.
Currency held directly	Generally not a security by itself.	Client exchanges U.S. dollars for euros before travel.

65.2 State Registration Requirements

A security offered or sold in a state generally must be registered in that state unless it is federally covered, the security is exempt, or the transaction is exempt. The key issue is not whether the issuer is honest or whether the investment is good; the key issue is whether the legal registration requirement applies.

Method	Basic use	Exam example
Registration by coordination	Used when a securities offering is also registered with the SEC under the Securities Act of 1933.	A regional food manufacturer files a federal registration statement and also registers the offering in a state.
Registration by qualification	Used when the issuer registers directly with the state, often when no federal registration is being used.	A small local issuer conducts an intrastate offering that must be qualified with the state Administrator.

Method	Basic use	Exam example
Notice filing	Used for certain federal covered securities; the state cannot require registration but may require copies of federal filings, consent to service, and fees.	A mutual fund or Rule 506 private placement files notice materials with the state.

Federal Covered Securities and Notice Filing

Federal covered securities are securities for which federal law limits state registration authority. States generally cannot require full state registration for these securities, but they may be permitted to require a notice filing, filing fee, consent to service of process, and antifraud compliance.

- Examples include many exchange-listed securities, investment company securities such as mutual funds, and certain private placements.
- Notice filing is not the same as state registration. The state receives information and fees but does not perform full registration review.
- Antifraud rules still apply. A federal covered security can still be sold fraudulently.

Post-Registration Requirements

Registration is not a one-time filing that ends all obligations. Issuers may need to maintain the registration, keep documents current, file amendments, deliver required information, and comply with Administrator conditions.

Requirement	What it means	Example
Effective registration	A state-registered offering may be sold after the registration is effective and no stop order is in place.	Issuer waits until the Administrator allows effectiveness before selling shares.
Amendments	Material changes generally require updates to registration documents.	Issuer revises use of proceeds and files an amendment.
Duration and renewal	State registrations commonly remain effective for a limited period and may need renewal if the offering continues.	Issuer renews or updates its registration before continuing sales after the original period.

Requirement	What it means	Example
Reports and records	Administrators may require sales reports, prospectus delivery evidence, escrow records, or similar documentation.	Issuer tracks subscribers and funds during an offering.
Antifraud obligations	Registration or exemption never permits false statements, omissions, or deceptive practices.	An exempt nonprofit bond offering still cannot misstate how proceeds will be used.

65.3 Exemptions and Exclusions from Registration

The Series 65 commonly tests the difference between exempt securities and exempt transactions. Exempt securities are exempt because of what the security is or who issued it. Exempt transactions are exempt because of how the sale occurs.

Exempt Securities

Exempt security	Core idea	Example
Government and municipal securities	Certain government issuers are viewed as sufficiently regulated or creditworthy for registration exemption.	U.S. Treasury note or municipal bond.
Bank and savings institution securities	Issued by certain regulated depository institutions.	Stock issued by a state-chartered bank may be exempt; bank holding company stock is a common trap.
Insurance company securities	Certain securities issued by regulated insurance companies may be exempt.	Traditional insurance company debt may be exempt; variable products are securities.

Exempt security	Core idea	Example
Exchange-listed securities	Securities listed on specified national exchanges are generally federally covered or state-exempt.	NYSE-listed common stock.
Nonprofit organization securities	Issued by organizations operated for charitable, religious, educational, or similar non-profit purposes.	Bond issued by a qualifying charitable organization.
High-quality short-term commercial paper	Short-term business paper meeting maturity, denomination, and quality conditions under state law.	Top-rated 180-day commercial paper in large denominations.

Exempt Transactions

Exempt transaction	Core idea	Example
Isolated nonissuer transaction	A one-off secondary trade by someone other than the issuer, underwriter, or dealer.	Investor sells a small personal holding to another investor.
Unsolicited brokerage transaction	Customer initiates the trade without solicitation by the broker-dealer or agent.	Client calls to buy a specific bond without any recommendation.
Private placement	Limited offering to investors meeting state or federal exemption conditions.	Issuer sells securities privately to a small group of sophisticated investors.
Fiduciary transaction	Sales by certain fiduciaries acting in an official capacity may be exempt.	Executor sells securities from an estate.
Institutional transaction	Transactions with certain financial institutions or institutional investors may be exempt.	Sale to a bank, insurance company, or investment company.

Exclusion vs. Exemption

Concept	Meaning	Example	Exam consequence
Excluded item	Not a security under the definition.	Traditional fixed annuity or bank deposit.	Securities registration analysis generally stops.
Exempt security	It is a security, but the security is exempt from registration.	U.S. Treasury, municipal bond, or qualifying nonprofit security.	Registration is not required, but antifraud rules still apply.
Exempt transaction	It is a security, but this transaction is exempt from registration.	Unsolicited customer transaction or qualifying private placement.	The transaction is exempt, but other transactions in the same security may not be.
Federal covered security	It is a security subject to federal preemption of state registration.	NYSE-listed stock, mutual fund share, or Rule 506 offering.	State registration is preempted, but notice filing and antifraud authority may remain.

Exam point
Never confuse registration exemption with antifraud exemption. No registration exemption permits misstatements, omissions, or deception. The Administrator retains antifraud authority over securities transactions, including exempt securities and exempt transactions. Exam wording such as exempt from registration does not mean exempt from regulation.

Exam Decision Process

- Step 1: Is the item a security? If it is excluded from the definition, securities registration rules do not apply.
- Step 2: Is the security federally covered? If yes, the state generally cannot require registration, but may require notice filing and can enforce antifraud rules.
- Step 3: If not federally covered, is the security itself exempt? If yes, state registration is not required for that security.

- Step 4: If the security is not exempt, is the transaction exempt? If yes, registration is not required for that transaction.
- Step 5: If no exemption applies, use the proper state registration method before sales occur.

Worked Examples

Scenario	Analysis	Conclusion
Local manufacturer sells stock publicly to residents of one state.	Stock is a security. If no federal covered status or exemption applies, the offering must be registered with the state.	Likely state registration by qualification or coordination, depending on whether federal registration is used.
Client buys an NYSE-listed stock through a broker-dealer.	The stock is a security, but exchange-listed securities are generally federally covered or state-exempt.	No state registration of the security is required; antifraud rules still apply.
Investor buys a fixed annuity from an insurance company.	Traditional fixed annuity is generally excluded from the securities definition.	Securities registration rules generally do not apply to the fixed annuity.
Issuer sells units in a passive equipment-leasing program.	Even if labeled units or contracts, investors rely on promoter management for profits.	Likely an investment contract and therefore a security.
Broker executes a client-initiated unsolicited sale of a nonexempt security.	The security may not be exempt, but the transaction may qualify as exempt because it is unsolicited.	The transaction may be exempt from registration, but antifraud rules apply.

Practice Questions

1. A small business sells common stock to the public in one state. The stock is not federally covered and no exemption applies. What must generally happen before the shares are sold?

A. The issuer must register the offering with the state or qualify for an exemption.
B. The issuer may sell the stock immediately because all stock is exempt.
C. Only the agent must register; the security never needs registration.
D. The stock becomes exempt if the issuer discloses its financial statements.

2. Which item is least likely to be treated as a security for state securities registration purposes?

A. A limited partnership interest sold to passive investors.
B. An investment contract in a passive real estate venture.
C. A corporate debenture.
D. A traditional bank certificate of deposit purchased directly from a bank.

3. A security is listed on the NYSE. Which statement is most accurate for state registration purposes?

A. It is exempt from all antifraud rules.
B. It must be registered by qualification in every state where it is sold.
C. It is not a security because exchange listing removes it from the securities definition.
D. It is generally federally covered or state-exempt from registration, though antifraud authority remains.

4. Which registration method is most closely associated with an offering that is also registered federally under the Securities Act of 1933?

A. Notice filing.
B. Registration by exclusion.
C. Registration by coordination.
D. Unsolicited transaction exemption.

5. Which statement best describes an exempt transaction?

A. The security may be a security, but the way it is sold removes that transaction from registration.
B. The Administrator has no antifraud authority.
C. The issuer is permanently excluded from all state regulation.
D. The instrument is not a security at all.

6. A client buys interests in a pooled real estate project where investors expect profit from the promoter's management. The best classification is usually:

A. An insurance product.
B. An investment contract.
C. A personal-use asset.
D. A bank deposit.

7. What is the most important practical difference between an exclusion and an exemption?

A. An exclusion applies only to agents; an exemption applies only to issuers.
B. An exclusion eliminates antifraud rules; an exemption does not.
C. An exclusion means the item is not a security; an exemption means it is a security but registration is not required.
D. An exclusion requires qualification; an exemption requires coordination.

8. A Rule 506 private placement is a federal covered security. What may the state generally require?

A. A public exchange listing before any sale.
B. Notice filing, fees, and consent to service of process, plus antifraud compliance.
C. Full state registration by qualification.
D. Merit review before the offering can proceed.

9. Which fact most strongly suggests a note is being sold as a security rather than ordinary commercial debt?

A. It is signed by the borrower.
B. It is sold broadly to investors to finance the issuer's business expansion.
C. It has a written maturity date.
D. It is payable in U.S. dollars.

10. An issuer materially changes the use of proceeds after filing a state registration statement. What is the best response?

A. Treat the offering as exempt solely because the issuer changed its plan.
B. Continue selling because use of proceeds is never material.
C. File an amendment or update as required before continuing the offering.
D. Cancel all previously completed sales automatically.

11. Which item is a common exam trap when applying securities exemptions?

A. Municipal bonds may be exempt from state registration.
B. Government securities are commonly treated as exempt securities.
C. Exempt securities are never subject to antifraud rules.
D. Bank securities may be exempt, but bank holding company securities may not be.

12. An issuer cannot find a security exemption or a transaction exemption and the security is not federally covered. What is the correct exam conclusion?

A. The offering generally must be registered with the state before sale.
B. The offering is automatically exempt because the issuer is small.
C. The offering is outside state jurisdiction because all securities law is federal.
D. The offering can proceed if investors orally agree to waive registration.

Answer Key and Explanations

1. A — Common stock is a security. If it is not federally covered and no exemption applies, state registration is generally required before offers or sales.

2. D — A traditional bank CD is generally treated as a bank deposit rather than a security. The other items are common securities examples.

3. D — Exchange-listed securities are generally not subject to state registration, but regulators still retain antifraud authority.

4. C — Coordination is used when state registration is coordinated with a federal registration statement.

5. A — An exempt transaction focuses on how the sale occurs. The security may still be a security, and antifraud rules still apply.

6. B — Passive investment in a common enterprise with expected profits from others' efforts is typically an investment contract.

7. C — Exclusions remove the item from the definition of security. Exemptions apply to securities or transactions that do not need registration.

8. B — States cannot require full registration of federal covered securities, but they may require notice filings and retain antifraud authority.

9. B — Notes sold as investments to finance a business are more likely to be securities than ordinary commercial or consumer debt.

10. C — Material changes generally require amendments or updates to registration documents.

11. D — Bank securities may receive an exemption, but the exemption commonly does not extend automatically to bank holding company securities.

12. A — If the instrument is a security, not federally covered, and no exemption applies, state registration is generally required.

Lesson 66: Issuers, Issuer Agents, Finders, and State Enforcement

Learning Objectives

- Define an **issuer** and distinguish the issuer from the **security**, **agent**, broker-dealer, and underwriter.
- Identify when an individual representing an issuer may need agent registration and when common exclusions may apply.
- Recognize why **finders** create regulatory risk when they solicit investors or receive transaction-based compensation.
- Apply state enforcement and antifraud authority to securities and issuer scenarios, including exempt and federally covered offerings.

Exam analysis sequence
First identify the security and the issuer.
Then ask whether the person selling or soliciting is representing a broker-dealer or issuer.
Next test for agent registration requirements or exclusions.
Finally remember that antifraud authority remains even when registration is not required.

66.1 Issuers

Core definition. An issuer is the person or entity that issues or proposes to issue a security. In the most common exam examples, the issuer is the corporation, limited partnership, trust, government entity, or other organization whose securities are being offered to investors.

Concept	Meaning	Example
Issuer	The person or entity that creates or proposes to create the security.	ABC Robotics, Inc. sells newly issued common stock to raise expansion capital. ABC Robotics is the issuer.
Security	The investment instrument being offered or sold.	The common shares sold by ABC Robotics are the securities.
Issuer agent	An individual representing the issuer in effecting or attempting to effect securities transactions.	An employee paid a commission to sell ABC Robotics shares to outside investors may be an issuer agent.

Concept	Meaning	Example
Broker-dealer	A firm in the business of effecting securities transactions for customers or for its own account.	A registered brokerage firm hired to place the offering may be a broker-dealer, not the issuer.

Issuer status does not automatically solve the whole problem

- An issuer is not a broker-dealer merely because it sells its own securities.
- The securities offered by the issuer may still need registration unless the security is exempt, the transaction is exempt, or the security is federally covered.
- Individuals who sell for the issuer may need agent registration depending on their activities, compensation, the security, the transaction, and the state involved.
- Antifraud rules apply to issuer sales even when the security or transaction is exempt from registration.

Scenario	Issuer?	Key point
Corporation sells newly issued preferred stock.	Corporation	The company created and sold the security.
Limited partnership sells limited partnership units.	Limited partnership or sponsor entity	LP interests are commonly securities; the issuer is the entity offering the interest.
Municipality sells municipal bonds.	Municipality or issuing authority	The bond may be exempt, but antifraud authority remains.
Real estate sponsor sells passive fractional interests in a project.	Sponsor or offering entity	An investment contract analysis may be required.

66.2 Registration of Issuer Agents

An individual who represents an issuer in effecting or attempting to effect securities transactions may be an agent. If the individual is an agent and no exclusion applies, state registration is generally required before the person solicits or sells securities in the state.

Question	Why it matters	Exam example
What activity is the person doing?	Soliciting, recommending, negotiating, or closing securities sales points toward agent status.	A founder calls investors to pitch stock and answer suitability-type questions.
Who is the person representing?	Issuer agent analysis applies when the person represents the issuer rather than a broker-dealer.	A company employee sells shares directly for the company.
How is the person compensated?	Commissions or success fees strongly support registration concerns.	A consultant receives 5% of the capital raised.
What security or transaction is involved?	Certain exempt securities, exempt transactions, or employee-plan transactions may support an exclusion.	No commission is paid for sales to existing employees under a stock plan.

Common issuer agent exclusions

For exam purposes, an individual representing an issuer may be excluded from the agent definition in several common situations. The details vary by statute and state adoption, but the high-yield concept is that low-risk issuer transactions may not require the same agent registration treatment as compensated public solicitation.

Common exclusion area	Core idea	Example
Certain exempt securities	Individuals representing issuers in specified exempt securities transactions may be excluded.	An issuer employee assists with a municipal bond sale.
Certain exempt transactions	Private placements, institutional transactions, or isolated transactions can reduce agent registration issues.	Issuer employee coordinates a sale to a bank or insurance company.

Common exclusion area	Core idea	Example
Existing employees, partners, or directors	Transactions with existing insiders may support an exclusion if no sales commission or similar compensation is paid.	HR administers an employee stock purchase plan without commissions.
Clerical or ministerial work	Purely administrative activity does not usually make someone an agent.	A receptionist schedules investor meetings but does not solicit or discuss the investment.
Registration authority: exam focus State registration analysis is tied to the state where offers or sales occur and the person's activity in that state. An issuer agent is not effectively registered if the issuer transaction itself is unlawful or the underlying registration requirement has not been met. Passing an exam is not the same as being registered; registration also involves filing, consent to service of process, fees, and effectiveness by the Administrator.		

66.3 Finders

A **finder** is a person who introduces an issuer to possible investors or helps locate potential investors. The term can be misleading because a person called a finder may actually be acting as an agent or broker-dealer if the person participates in securities sales.

Activity	Lower registration concern	Higher registration concern
Introductions	One-time introduction with no sales discussion.	Repeatedly introduces investors and follows up to encourage investment.
Compensation	Fixed administrative fee not tied to sale success.	Success fee, percentage of capital raised, or commission.
Investor communication	No discussion of deal terms, merits, risks, or valuation.	Pitches the investment, answers investor objections, or negotiates terms.

Activity	Lower registration concern	Higher registration concern
Role in closing	No involvement after introduction.	Helps collect subscription documents or coordinates funding.

Finder examples

- Example 1: A retired executive gives an issuer the name of one potential investor and receives a fixed consulting fee whether or not any investment occurs. This creates less concern, but state law may still need to be checked.
- Example 2: A consultant emails a pitch deck to dozens of investors, speaks with them about expected returns, and receives 4% of all capital raised. This is a high-risk finder arrangement and may require registration as an agent or broker-dealer.
- Example 3: An attorney introduces a client to a potential investor while providing legal services and does not receive transaction-based compensation. This is less likely to be treated as securities sales activity, assuming the attorney does not solicit or negotiate the investment.

Exam point
Labels do not control. Calling someone a finder, consultant, business development advisor, or capital introduction specialist does not avoid registration requirements. The analysis depends on activities, compensation, investor contact, and the connection to a securities transaction. Transaction-based compensation is one of the strongest signs that registration may be required.

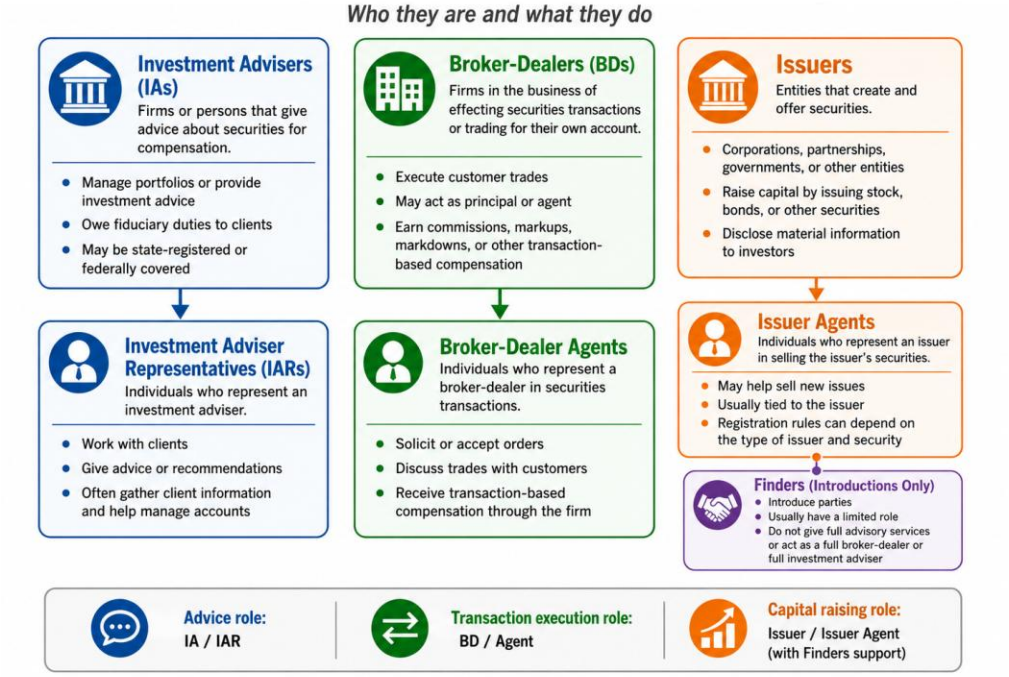


Figure 66.1: Roles in the Securities Industry. This figure summarizes the roles each institution and individual plays regarding regulated advice and transactions in for clients.

66.4 State Enforcement and Antifraud Authority

Core rule. State securities Administrators have authority to enforce securities laws against issuers, issuer agents, finders, broker-dealers, investment advisers, and others involved in securities transactions. Antifraud authority generally remains even when a security is exempt, a transaction is exempt, or a security is federally covered.

Administrator power	What it allows	Example
Investigations	Review possible violations and gather facts.	The Administrator investigates a private offering that used misleading projections.
Subpoenas and testimony	Require documents, records, and witness testimony.	An issuer must produce investor emails and offering materials.

Administrator power	What it allows	Example
Administrative orders	Deny, suspend, revoke, condition, or bar registrations; issue stop or cease-and-desist orders.	An issuer agent registration is suspended after undisclosed sales misconduct.
Court action	Seek injunctions, restitution, receivership, or other relief where authorized.	The Administrator asks a court to stop an ongoing fraudulent offering.
Criminal referral	Refer willful violations to the appropriate prosecuting authority.	Forgery in subscription documents is referred for prosecution.

Antifraud basics for issuer offerings

- Do not make untrue statements of material fact.
- Do not omit material facts needed to make statements not misleading.
- Do not use schemes, devices, or practices that operate as a fraud or deceit.
- Do not assume that an exemption from registration is an exemption from honesty.

Fact pattern	Likely issue	Reasoning
Issuer says a major customer signed a contract, but only a nonbinding letter of intent exists.	Antifraud	The status of a major customer relationship is material to investors.
Finder receives a success fee while actively pitching securities.	Unregistered agent/broker issue and antifraud risk	Sales activity plus transaction-based compensation is a red flag.
Issuer sells a federally covered security using materially misleading offering materials.	State antifraud authority	Federal covered status may preempt registration review but does not block state antifraud enforcement.
Company files a proper notice but conceals related-party payments.	Antifraud and disclosure issue	A filing does not make misleading disclosure lawful.

Exam point
Registration exemptions answer one question: Does this security, transaction, or person need a specific registration? Antifraud rules answer a different question: Was the conduct truthful, complete, and not misleading? On the exam, when in doubt, separate registration analysis from antifraud analysis.

Worked Examples

Scenario	Analysis	Conclusion
Issuer employee sells nonexempt preferred stock to outside investors for a commission.	Individual represents the issuer in securities transactions and receives sales compensation.	Likely issuer agent registration required.
Issuer employee administers an employee stock purchase plan with no commission.	Existing employee plan and no sales compensation support an exclusion.	Likely excluded from agent registration, but antifraud rules still apply.
Consultant introduces investors and earns 3% of all money raised.	Activity and compensation are tied to securities sales.	Finder may be an unregistered agent or broker-dealer.
Municipal issuer employee helps sell municipal securities.	Municipal securities are commonly exempt securities.	Issuer representative may be excluded, but antifraud authority remains.

References and Further Reading

- NASAA, Uniform Securities Acts, including the 1956 Act with NASAA updates and commentary and the Uniform Securities Act of 2002 model materials.
- NASAA Electronic Filing Depository information for issuer and corporation finance filing categories.
- SEC materials describing federal-state securities regulation, covered securities, and retained state antifraud authority.

Practice Questions

1. A corporation sells newly issued shares to investors to raise money for expansion. In this transaction, what is the corporation?

A. An agent
B. An underwriter
C. A broker-dealer
D. An issuer

2. An employee of an issuer is paid a commission for selling the issuer's nonexempt securities to outside investors in several states. Which statement is most accurate?

A. Only the corporation, not the employee, is regulated by state securities law.
B. The employee may need agent registration in the states where offers or sales occur.
C. The employee is never an agent because the employer is the issuer.
D. The employee is automatically exempt because the securities are sold by the issuer.

3. Which activity most likely creates a finder registration concern?

A. Working as an attorney and drafting corporate formation documents only.
B. Publishing a general newspaper article about small business financing.
C. Providing a list of investors to an issuer for a flat administrative fee, with no further contact.
D. Introducing potential investors and receiving transaction-based compensation if the sale closes.

4. An issuer sells municipal bonds through an employee. Under typical Uniform Securities Act concepts, the employee is most likely excluded from the agent definition because:

A. Municipal securities are commonly exempt securities.
B. The bonds mature in more than one year.
C. The employee works full time for the issuer.
D. All issuer employees are excluded regardless of what they sell.

5. Which statement best describes state antifraud authority?

A. It applies only to broker-dealers and investment advisers.
B. It applies only when the security must be registered with the state.
C. It can apply even when the security or transaction is exempt from registration.
D. It disappears if the buyer is accredited.

6. A start-up founder tells investors that a patent has already been approved when the patent is only pending. The offering is otherwise exempt. Which result is most consistent with state law principles?

A. No violation is possible because the offering is exempt.
B. The statement is irrelevant because patents are not securities.
C. The state Administrator may still pursue antifraud enforcement.
D. Only FINRA may act because the offering is private.

7. Which document or filing issue is most directly associated with issuer agent registration?

A. A state filing or registration for individuals selling for the issuer
B. A qualified domestic relations order
C. A margin agreement
D. Form ADV Part 2A

8. An issuer sells common stock only to existing employees under an employee stock purchase plan, and the employees receive no sales commission. How should this be analyzed for exam purposes?

A. State antifraud rules do not apply to employee purchases.
B. The individuals involved may be excluded from agent registration if they only handle employee-plan transactions without sales compensation.
C. The stock is not a security because it is sold to employees.
D. The issuer becomes a broker-dealer immediately.

9. Which of the following is most accurate about a finder?

A. A finder is never regulated unless the issuer is public.
B. A finder is always exempt from registration if called a consultant.
C. A finder can avoid all regulation by using a written disclaimer.
D. A finder may need registration if the person solicits investors, negotiates terms, or receives compensation tied to securities sales.

10. The Administrator receives evidence that an issuer is selling unregistered, nonexempt securities in the state. Which action is most consistent with state enforcement authority?

A. Impose an ERISA plan correction
B. Investigate, subpoena records, and seek a cease-and-desist order or injunction
C. Issue a tax deficiency notice
D. Approve the issuer's financial statements

11. A securities offering is federally covered and therefore not subject to state registration review. What authority does the state generally retain?

A. Antifraud enforcement and, where allowed, notice filing and fee authority
B. Exclusive authority over federal prospectus delivery rules
C. Authority to rewrite the issuer's charter
D. Full merit review and mandatory state registration

12. An investor asks whether a person is an issuer agent. Which question is most useful first?

A. Did the person pass the Series 65?
B. Does the issuer have audited financial statements?
C. Is the person representing the issuer in effecting or attempting to effect securities transactions?
D. Is the person associated with a bank?

Answer Key and Explanations

1. D — The issuer is the person or entity that issues or proposes to issue the security. A corporation selling its own newly issued stock is the issuer.

2. B — Individuals representing issuers in securities transactions may be agents. Commission compensation and sales to outside investors are strong signs that registration is required.

3. D — Transaction-based compensation and investor introductions tied to successful sales are classic red flags that a finder may be acting as an agent or broker-dealer.

4. A — Many government and municipal securities are exempt securities. Individuals representing issuers in transactions involving certain exempt securities are commonly excluded from the agent definition.

5. C — Exemptions generally remove a registration requirement; they do not permit fraud, material omissions, or deceptive sales practices.

6. C — The offering exemption does not eliminate antifraud standards. A false statement about a material business asset can trigger enforcement.

7. A — Issuer agent registration concerns the individuals who represent the issuer in selling or attempting to sell securities. It is separate from adviser brochure, retirement plan, or margin documentation.

8. B — Transactions with existing employees, partners, or directors may support an exclusion for issuer representatives if no commission or similar sales compensation is paid. The stock remains a security and antifraud rules still apply.

9. D — Labels do not control. The actual activities and compensation arrangement determine whether registration is required.

10. B — Administrators have investigative and enforcement powers under state securities law, including subpoenas and administrative or court remedies.

11. A — Federal covered status can preempt state registration review, but states retain antifraud authority and may require notice filings and fees for certain covered securities.

12. C — The core agent analysis asks whether the individual represents a broker-dealer or issuer in securities transactions. Registration and exclusions are evaluated after that threshold question.

Lesson 67: Remedies and Administrative Provisions

Learning Objectives

- Explain the authority of the **state securities Administrator.**
- Identify **common administrative actions** used to enforce state securities laws.
- Distinguish **administrative remedies** from **civil liability** and **criminal penalties**.
- Apply enforcement concepts to Series 65 exam-style fact patterns.

Exam point
For the Series 65, the key is not memorizing every statutory penalty amount. The key is recognizing what the state securities Administrator can do, what process is generally required, and how administrative, civil, and criminal remedies differ.

67.1 Authority of the State Securities Administrator

The state securities Administrator is the state official or agency responsible for administering and enforcing the state securities act. The Administrator has broad authority to protect investors and the public interest.

- **Registration authority:** grant, deny, suspend, revoke, cancel, or withdraw registrations when statutory grounds exist.
- **Examination authority:** inspect required books and records of registrants and certain persons subject to the act.
- **Investigative authority:** investigate suspected violations, take testimony, and gather documentary evidence.
- **Subpoena authority:** compel witnesses, testimony, and records when allowed by law.
- **Rulemaking authority:** adopt rules, forms, and orders necessary to administer the state securities act.
- **Order authority:** issue stop orders, cease-and-desist orders, summary orders, and other orders authorized by statute.

State Administrator Authority: Examples

Authority	Example
Investigate	A complaint alleges that an adviser is advertising guaranteed returns. The Administrator opens an investigation and requests records.

Authority	Example
Subpoena	A former agent refuses to provide emails related to a suspected unregistered offering. The Administrator subpoenas the records.
Examine records	A registered broker-dealer is examined to determine whether required customer records are being maintained.
Registration action	An IAR fails to disclose a reportable disciplinary event. The Administrator may pursue denial, suspension, or revocation.
Cease-and-desist	A person is selling securities without registration or an exemption. The Administrator orders the activity to stop.

Exam point
The Administrator enforces state securities law. The Administrator does not guarantee investments, eliminate risk, or personally impose federal criminal sentences. Criminal matters are generally prosecuted through the appropriate criminal process.

67.2 Administrative Actions

Administrative actions are regulatory actions brought by the state securities Administrator. They are designed to stop violations, protect the public, discipline registrants, and enforce compliance.

Action	What It Does	Exam Example
Denial	Refuses an application for registration.	A person with a material undisclosed disciplinary history applies to register.
Suspension	Temporarily removes the ability to act under a registration.	An agent is under investigation for serious customer abuse.
Revocation	Terminates a registration.	A registrant engaged in fraudulent conduct.

Action	What It Does	Exam Example
Cancellation	Ends a registration for reasons such as death, dissolution, or no longer existing.	A firm has ceased operations.
Cease-and-desist order	Orders a person to stop unlawful conduct.	Unregistered securities are being offered to state residents.
Stop order	Stops or suspends the effectiveness of a securities registration.	An issuer filing contains materially misleading information.
Bar, censure, fine, or condition	Disciplines or limits future activity.	A representative is barred from supervisory roles or fined for violations.

Administrative Process

The Administrator generally must provide notice and an opportunity for a hearing before final sanctions are imposed. In some situations, a summary or temporary order may be issued first when immediate action is needed to protect the public. The affected person is then usually entitled to prompt notice and an opportunity to be heard.

- Notice tells the affected party what action is being taken and why.
- A hearing gives the affected party a chance to respond.
- Findings or orders explain the legal basis for the Administrator's decision.
- Summary authority is used when delay could harm investors or the public interest.

Example: Summary Order

A promoter is actively soliciting elderly investors for an unregistered oil-and-gas investment using false financial projections. The Administrator may issue a summary cease-and-desist order to stop the sales activity quickly, then provide the required procedural opportunity to contest the order.

67.3 Other Penalties and Liabilities

Series 65 questions often test whether the remedy is administrative, civil, or criminal. The same misconduct can sometimes create more than one type of consequence.

Category	Who Brings It?	Main Purpose	Possible Result
Administrative	State securities Administrator	Regulate conduct and protect the public.	Denial, suspension, revocation, bar, censure, fine, cease-and-desist order, stop order.
Civil liability	Injured investor or other permitted claimant	Compensate the harmed person.	Rescission, damages, interest, costs, and attorney fees where allowed.
Criminal	Government prosecutor	Punish serious willful violations.	Criminal fines, probation, or imprisonment if proven under the applicable law.
Injunction or court order	Administrator or enforcement authority through court	Prevent future violations or enforce compliance.	Court order stopping conduct, freezing assets, or requiring corrective action where allowed.

Civil Liability: Practical Meaning

Civil liability is about making the investor whole, not merely disciplining the violator. A common Series 65 concept is rescission: the investor gives back the security and receives the purchase price plus allowed interest, less any income received. If the investor no longer owns the security, damages may be available instead.

Examples of Penalties and Liabilities

- **Administrative example:** An IAR is suspended for failing to disclose a reportable regulatory event.
- **Civil example:** A customer sues after buying a security sold through a material misrepresentation and seeks rescission.
- **Criminal example:** A promoter knowingly steals investor funds and is referred for criminal prosecution.
- **Court order example:** The Administrator seeks an injunction to stop an ongoing fraudulent offering.

Common Exam Traps

- Do not confuse administrative sanctions with customer compensation. Administrative sanctions discipline or restrict the violator; civil liability compensates the investor.
- Do not assume every violation is criminal. Criminal penalties usually require willful misconduct and prosecution.
- Do not assume a state Administrator guarantees or approves an investment as safe.
- Do not ignore due process. Notice and opportunity for hearing are important, even when summary orders are permitted first.
- Do not assume federal covered status eliminates all state antifraud authority. States retain antifraud enforcement authority.

Quick Comparison: What Should the Administrator Do?

Situation	Likely Administrative Response
Unregistered person selling securities to state residents.	Investigate; issue cease-and-desist order; pursue sanctions or referral if appropriate.
Issuer registration statement contains a material misstatement.	Issue or seek a stop order; require correction; investigate related violations.
Registrant fails to maintain required books and records.	Examine records; require correction; impose administrative sanctions if warranted.
IAR omits a disciplinary event from registration forms.	Require update; investigate; consider suspension, revocation, denial, or other sanctions.
Investor harmed by a fraudulent sale.	Administrator may enforce; investor may have separate civil remedies such as rescission or damages.

Practice Questions

1. A state securities Administrator believes an adviser is using misleading brochures with prospective clients. Which action is most clearly within the Administrator's authority?

A. Void all client contracts automatically
B. Impose federal criminal penalties directly
C. Investigate, subpoena records, and start an administrative proceeding
D. Order the adviser to provide restitution without notice or process in every case

2. Which statement best describes a cease-and-desist order?

A. It is the same thing as a private lawsuit for damages
B. It directs a person to stop an actual or threatened violation
C. It permanently bars a person from the securities industry in every case
D. It is only available after a final criminal conviction

3. An agent's registration application contains materially incomplete disciplinary information. Which administrative action is most likely available to the Administrator?

A. Deny, suspend, or revoke the registration after the required process
B. Require the issuer to redeem all outstanding shares
C. Convert the agent into an investment adviser representative
D. Require the client to remain in the investment

4. Which choice best describes the Administrator's inspection authority over required records?

A. The Administrator may inspect only public advertising and not account records
B. The Administrator may inspect only after a customer has already suffered a loss
C. The Administrator may inspect only federal covered advisers' internal tax returns
D. The Administrator may inspect required books and records, often without needing to prove fraud first

5. Which remedy is most directly designed to compensate a harmed investor for an unlawful securities transaction?

A. A public press release from the Administrator
B. Automatic conversion of common stock into bonds
C. A change in the issuer's board of directors
D. Civil liability such as rescission or damages

6. Which statement about administrative penalties is most accurate for Series 65 purposes?

A. They can be imposed by a broker-dealer without government involvement
B. They may include sanctions such as denial, suspension, revocation, bar, censure, fines, or cease-and-desist relief
C. They are available only against issuers, not registrants
D. They replace all civil liability owed to customers

7. An Administrator learns that an unregistered person is soliciting advisory clients in the state. Which is the best exam answer?

A. The Administrator may investigate and pursue administrative remedies for unregistered activity
B. The Administrator has no authority unless the SEC first brings an action
C. The activity is permitted if the person does not call themself an adviser
D. Only the customer may sue; the Administrator cannot act

8. Which fact would most strongly support an emergency or summary administrative action?

A. A client dislikes a lawful fee that was fully disclosed
B. A representative passes a licensing exam
C. A firm changes its office address and files the proper update
D. Ongoing conduct appears to pose immediate harm to the investing public

9. Which statement best distinguishes administrative liability from criminal liability?

A. Criminal liability can involve prosecution and possible fines or imprisonment; administrative liability involves regulatory sanctions
B. Administrative liability is always imposed by a jury
C. Criminal liability is imposed only by state Administrators
D. Administrative liability never affects a registration

10. A broker-dealer is accused of using deceptive sales scripts. Before final sanctions are imposed, what process issue is required?

A. The firm always loses its registration automatically
B. No hearing is ever required in administrative matters
C. Orders normally require notice and an opportunity for hearing, subject to special summary procedures
D. The Administrator must wait for a customer arbitration award

11. Which item is most likely to be treated as a reportable or enforcement-relevant event?

A. A representative's choice of office furniture
B. A client's birthday
C. A material disciplinary event, injunction, or order related to securities activity
D. A routine market decline in a recommended mutual fund

12. Which statement about the Administrator's power is most accurate?

A. The Administrator can rewrite federal securities statutes
B. The Administrator can enforce state securities law to protect investors and the public interest
C. The Administrator can approve an investment as risk-free
D. The Administrator can guarantee investment returns

Answer Key and Explanations

1. C — Investigate, subpoena records, and start an administrative proceeding

2. B — It directs a person to stop an actual or threatened violation

3. A — Deny, suspend, or revoke the registration after the required process

4. D — The Administrator may inspect required books and records, often without needing to prove fraud first

5. D — Civil liability such as rescission or damages

6. B — They may include sanctions such as denial, suspension, revocation, bar, censure, fines, or cease-and-desist relief

7. A — The Administrator may investigate and pursue administrative remedies for unregistered activity

8. D — Ongoing conduct appears to pose immediate harm to the investing public

9. A — Criminal liability can involve prosecution and possible fines or imprisonment; administrative liability involves regulatory sanctions

10. C — Orders normally require notice and an opportunity for hearing, subject to special summary procedures

11. C — A material disciplinary event, injunction, or order related to securities activity

12. B — The Administrator can enforce state securities law to protect investors and the public interest

Lesson 68: Communication with Clients and Prospects

Learning Objectives

- Identify the **disclosures** that **investment advisers** and **representatives** must give clients and prospects.
- Recognize **unlawful statements** that imply registration is regulatory approval or endorsement.
- Distinguish **performance discussion** from **prohibited performance guarantees**.
- Identify **key provisions** and **prohibited terms** in **client advisory contracts**.
- Apply communication standards to **correspondence**, **advertising**, **social media**, **email**, **websites**, and other internet communications.

Exam point
The medium does not control the rule. A misleading claim is still misleading whether it appears in a formal brochure, seminar slide, email, text message, social media post, website, or one-on-one conversation.

Communication Compliance Flow

Disclose material facts	Do not imply regulatory approval	Do not guarantee performance	Use fair client contracts	Supervise and retain communications

68.1 Required Disclosures to Clients

- Investment advisers must give clients enough material information to make an informed decision about the advisory relationship.
- Important disclosures include services offered, fees and compensation, conflicts of interest, disciplinary history, custody, discretionary authority, brokerage practices, and material changes.
- For registered advisers, Form ADV Part 2A is the narrative brochure; Part 2B is the brochure supplement for supervised persons who provide advice to the client.
- SEC-registered advisers serving retail investors may also have Form CRS obligations. State-registered advisers should follow the applicable state requirements and Form ADV requirements.

Exam point
A disclosure is useful only if it is timely, clear, and complete enough for a reasonable client to understand the conflict or limitation.

Example: An advisory firm charges a 1.00% asset-based fee and receives a referral payment from a custodian. The client must be told about the fee, the referral compensation, and the conflict it creates.

68.2 Unlawful Representations Concerning Registration

- Registration is not approval, endorsement, certification, or a finding of competence by the SEC, a state Administrator, FINRA, or another regulator.
- A firm or individual may accurately state that it is registered, but it may not imply that registration means the regulator has reviewed the merits of the adviser, the adviser representative, or any investment recommendation.
- You should distinguish between a factual statement of status and a misleading statement of regulatory approval.

Permitted

"Our firm is registered as an investment adviser with the state securities Administrator."

Not permitted

"Because we are registered, the state has approved our investment process."

68.3 Performance Guarantees Prohibition

- Advisers and representatives may not guarantee that a client will earn profits, avoid losses, beat a benchmark, or receive a specific investment return.
- Statements about expected performance must be balanced with risks, assumptions, limitations, fees, taxes, and uncertainty.
- Performance advertising may be allowed when presented fairly and in compliance with the marketing rules, but past performance is not a promise of future results.

Prohibited

"You cannot lose money in this strategy."

Better

"The strategy is designed to reduce volatility, but it can still lose money, especially during stressed markets."

68.4 Client Contracts

- An advisory contract should clearly identify the services to be provided, fees and billing method, discretionary authority, custody arrangements, termination provisions, and any conflicts that affect the relationship.

- Contracts should not assign the advisory contract without client consent when consent is required, waive non-waivable legal rights, or misstate the client's rights and remedies.
- Performance-based fees are restricted and generally may be charged only when the client meets the applicable qualified client or other permitted standard.

Problem provision

The client agrees never to sue the adviser for violations of securities law.

Appropriate contract provision

The client may terminate the advisory agreement on written notice and will receive any required refund of prepaid unearned fees.

68.5 Correspondence and Advertising

- Communications with clients and prospects must be truthful, balanced, and not misleading, whether delivered in print, email, text, social media, websites, seminars, or video.
- Advertisements should avoid cherry-picking, unsupported claims, exaggerated credentials, misleading testimonials, and performance presentations that hide fees or risks.
- Firms must supervise and retain required records of business communications, including digital communications when they are used for advisory business.

Exam point

The medium does not remove the rule: a misleading claim is still misleading when it appears in a tweet, email, blog post, webinar, or website.

Example: A brochure showing a model portfolio's 18% return must explain the time period, whether returns are net or gross of fees, and the material assumptions and risks.

68.6 Social Media

- Social media posts can be advertisements or business communications when they promote advisory services, discuss performance, or solicit prospects.
- Testimonials, endorsements, rankings, likes, reviews, and influencer content raise disclosure, conflict, oversight, and recordkeeping issues.
- Employees should use approved channels and avoid unapproved off-channel advisory communications.

Problem

A paid influencer says an adviser is "the safest way to retire rich" without disclosing compensation or risks.

Better

A firm-approved post explains a planning topic, avoids promises, and links to disclosures.

68.7 Email and Digital Messaging

- Email, texting, chat, and direct messaging may be correspondence, advertising, or books-and-records material depending on content and use.
- Firms should supervise, archive, and control business communications and should not allow representatives to conduct advisory business through unapproved personal accounts.
- Digital messages should identify recommendations, limitations, conflicts, and next steps clearly enough that the client is not misled.

Problem

An IAR texts, "Buy this fund today; it always beats the market," from a personal phone number with no firm record.

Better

The IAR uses an approved channel and sends a balanced recommendation with risks, fees, and documentation.

68.8 Website and Internet Communications

- Websites are often advertisements because they offer advisory services to prospects and current clients.
- The site should keep disclosures current, avoid misleading rankings, identify limitations of calculators or model portfolios, and remove outdated or inaccurate statements.
- Internet communications should not imply regulatory approval, guaranteed results, or exclusive access to risk-free opportunities.

Problem

A website states, "SEC-approved retirement income strategy" and shows only the best year of performance.

Better

The website explains services, fees, risks, conflicts, and links to current Form ADV information.

Quick Comparison: What You Should Spot

Issue	Usually acceptable	Usually problematic	Exam trigger
Registration	"We are registered."	"The regulator approved us."	Approval, endorsement, certification
Performance	Balanced past performance with fees and risks	Guaranteed profit or no-loss claim	Promise of return or safety
Contract	Clear fees, services, authority, termination	Waiver of non-waivable legal rights	Hedge clause, assignment, performance fee
Digital communication	Approved, archived, supervised channel	Personal texts with recommendations	Off-channel business communication
Advertising	Fair and balanced description	Cherry-picked results or hidden conflicts	Misleading omissions

Practice Questions

1. A prospective advisory client asks for the main plain-English disclosure document that explains the adviser's services, fees, conflicts, and disciplinary information. Which document is most directly responsive?

A. Form U4
B. Customer account transfer form
C. Form ADV Part 2A brochure
D. Trade confirmation

2. An IAR tells a prospect, "Our state registration means the Administrator has approved our investment recommendations." Which statement is best?

A. This is acceptable if the adviser also provides Form ADV.
B. This is misleading because registration is not regulatory approval or endorsement.
C. This is acceptable only for SEC-registered advisers.
D. This is acceptable if the adviser is in fact registered.

3. Which statement is most clearly prohibited when communicating with a client?

A. This model is based on several assumptions.
B. This strategy cannot lose money.
C. This portfolio seeks long-term capital appreciation.
D. This fund has experienced substantial volatility.

4. An advisory firm sells its book of client contracts to another adviser and transfers the contracts without obtaining required client consent. What is the primary issue?

A. The adviser failed to disclose a dividend reinvestment choice.
B. The adviser failed to use a market order.
C. The adviser used an exempt security.
D. The advisory contract was assigned without required client consent.

5. A social media influencer is paid by an adviser to praise the adviser's services but does not disclose the payment. What is the concern?

A. The endorsement may be misleading because compensation and conflicts were not clearly disclosed.
B. The post is exempt because it appears on social media.
C. The adviser may avoid supervision because the influencer is not an employee.
D. The influencer automatically becomes a clearing broker.

6. An adviser emails a prospect a chart showing only its single best-performing account and omits fees, risks, and the time period. Which principle is most relevant?

A. The email is acceptable if no trade was placed.
B. Performance information is never allowed in adviser communications.
C. Performance communications must be fair, balanced, and not misleading.
D. The email is exempt because it was sent digitally.

7. Which contract clause is most likely improper in an advisory agreement?

A. The client waives all rights to sue the adviser for violations of securities law.
B. The adviser will bill fees quarterly in arrears.
C. The adviser may trade with discretion if the client grants written authority.
D. The client may terminate the agreement by written notice.

8. Which statement about registration is most appropriate?

A. Registration is a legal status and does not imply endorsement of skill, character, or investment merit.
B. Registration means the regulator guarantees the adviser's performance.
C. Registration means the regulator has reviewed and approved each model portfolio.
D. Registration means the adviser's representatives cannot commit fraud.

9. A firm permits IARs to give advice by text message. What must the firm consider?

A. Text messages are exempt from securities regulation if the client requested them.
B. Business-related digital messages may need to be supervised, archived, and retained.
C. Text messages are never records.
D. Text messages are allowed only if they include emojis.

10. A performance advertisement presents gross returns but does not present net returns or explain fees. What is the best answer?

A. This is acceptable if the adviser has fewer than five clients.
B. This is required whenever an adviser uses a benchmark.
C. This may be misleading because clients need to understand the effect of fees and expenses.
D. This is acceptable because gross returns are always more accurate.

11. Which communication is most likely acceptable?

A. A brochure stating that registration proves superior investment skill.
B. An email guaranteeing a 12% return.
C. A testimonial from a compensated client with no disclosure.
D. A balanced website page describing advisory services, fees, risks, and conflicts without promising results.

12. What is the primary purpose of Form ADV Part 2B brochure supplement?

A. To replace the advisory contract.
B. To guarantee that the client will receive a positive return.
C. To confirm every securities trade.
D. To provide information about supervised persons who provide advisory services to the client.

Answer Key and Explanations

1. C — Form ADV Part 2A is the narrative brochure used to disclose the adviser's business practices, fees, conflicts, and disciplinary information.

2. B — A registrant may state that it is registered, but may not imply that a regulator has approved the firm, person, or advice.

3. B — A guarantee against loss is a prohibited performance guarantee.

4. D — Advisory contracts generally require client consent before assignment when consent is required by law or contract.

5. A — Paid testimonials and endorsements raise disclosure, conflict, oversight, and recordkeeping requirements.

6. C — Performance may be presented only in a manner that is not misleading and that gives appropriate context.

7. A — A hedge clause or waiver that misleads clients into giving up non-waivable legal rights is problematic.

8. A — Registration is a regulatory status, not an approval or guarantee.

9. B — Business communications through digital channels can trigger supervision and books-and-records requirements.

10. C — Performance presentations should not mislead investors about the impact of fees and expenses.

11. D — Balanced, factual communication that avoids misleading claims and promises is generally appropriate.

12. D — Part 2B gives clients information about the supervised persons who provide advice or interact with the client.

Lesson 69: Ethical Practices and Fiduciary Obligations

Learning Objectives

- Explain the investment adviser **fiduciary duty** and its **duties of care** and **loyalty**.
- Recognize **material conflicts of interest** and the importance of **full and fair disclosure**.
- Identify common **unethical** or **impermissible activities** involving **compensation**, **trading**, **client assets**, **confidentiality**, and **personal conduct**.
- Use an exam decision framework to evaluate whether conduct puts the client's interests first.

69.1 The Fiduciary Standard

Investment advisers owe fiduciary duties to their clients. The duty is principles-based and applies to the advisory relationship. The adviser must act in the client's best interest, provide appropriate advice based on the client's circumstances, seek to avoid or properly address conflicts, and provide full and fair disclosure of material facts and conflicts so the client can give informed consent where consent is possible.

Core Duty	What It Means in Practice	Common Exam Application
Duty of care	Understand the client, develop a reasonable basis for advice, seek best execution where applicable, monitor as agreed	Recommendation must fit objectives, risk, time horizon, liquidity, tax and other constraints
Duty of loyalty	Do not subordinate client interests to the adviser's interests; address conflicts through avoidance or full and fair disclosure	Compensation, proprietary products, personal trading, referral arrangements, principal transactions
Ongoing fiduciary relationship	Duties apply to the scope of the agreed advisory relationship	Monitoring and updating advice depend on the services the adviser agreed to provide

69.2 Conflicts of Interest

A conflict exists when the adviser has an incentive that could affect the advice or treatment of the client. The exam often asks whether the conflict was identified, disclosed, mitigated, or avoided—and whether the client had enough information to understand its significance.

- Higher compensation for recommending one product or account type over another.

- Receiving referral fees, revenue sharing, soft-dollar benefits, or third-party compensation.
- Trading the same securities personally that are being recommended or traded for clients.
- Acting as principal or engaging in agency cross transactions where additional requirements apply.
- Outside business activities or securities transactions that create divided loyalties.

Exam point
Disclosure is not a magic cure for every conflict. Some conduct is prohibited even if disclosed. When a conflict can be addressed through disclosure, the disclosure must be full and fair enough for the client to understand the conflict and its effect.

69.3 Compensation and Fees

- Fees must be disclosed and should not be unreasonable or misleading.
- Commissions and transaction-based compensation can create incentives for excessive trading or product selection.
- Performance-based fees are restricted and generally require a qualifying client or another applicable exception.
- Soft-dollar arrangements can create conflicts because client commissions may produce research/brokerage benefits for the adviser; applicable conditions and disclosure matter.
- Compensation arrangements that create material conflicts must be appropriately disclosed and managed.

69.4 Client Funds, Securities, and Trading Authority

- **Custody:** Having possession of client funds/securities or authority that allows withdrawal can trigger custody safeguards and financial requirements.
- **Discretion:** Authority to decide what, how much, or when to trade without trade-by-trade approval requires proper authorization and supervision.
- **Trading authorization:** The scope of written authority matters; price/time discretion can be treated differently from full investment discretion under applicable rules.
- **Best execution:** An adviser should seek the best overall execution reasonably available under the circumstances, not simply the lowest quoted commission.

69.5 Unethical and Impermissible Conduct

Conduct	Why It Is a Problem	Exam Cue
Churning / excessive trading	Trading designed primarily to generate compensation rather than benefit the client	Look for turnover inconsistent with objectives and account needs

Conduct	Why It Is a Problem	Exam Cue
Front-running	Trading ahead of client orders/recommendations for personal or firm benefit	Personal benefit before client execution
Insider trading	Trading or tipping on material nonpublic information	MNPI must not be misused
Selling away	Securities transactions outside the firm without required approval/supervision	Outside transaction + no firm authorization
Market manipulation	Creates false or misleading appearance of trading/price	Wash trades, matched orders, marking the close, spoofing
Unauthorized trading	Trade placed without required client authority	Profitability does not make an unauthorized trade permissible
Misrepresentation / guarantee	False statements, omissions, or guarantees of investment performance	Registration is not an endorsement; performance cannot be guaranteed

69.6 Client Confidentiality and Protection

Advisers must safeguard client information and disclose it only as permitted or required. Ethical duties also include protecting vulnerable clients, following privacy and cybersecurity procedures, and escalating suspected exploitation or diminished capacity according to law and firm procedures.

69.7 Personal Securities Transactions and Compliance Controls

- Codes of ethics commonly require access persons to report holdings and personal securities transactions.
- Pre-clearance and restricted lists can help prevent front-running, insider trading, and conflicts.
- Outside securities accounts may have to be disclosed so the firm can supervise personal trading.
- Political contributions can trigger pay-to-play restrictions when advisory business with government entities is involved.

- Written policies, books and records, cybersecurity controls, and business continuity plans support compliance with fiduciary obligations.

Series 65 Ethical Decision Framework

1. Identify the client and the capacity in which the financial professional is acting.
2. Identify the duty or rule that applies: fiduciary duty, registration rule, custody/discretion rule, antifraud rule, or specific prohibition.
3. Ask whether the recommendation or conduct is based on the client's objectives and constraints.
4. Identify any compensation, personal benefit, or other conflict.
5. Determine whether the conflict must be avoided, mitigated, disclosed, or whether the activity is prohibited.
6. Check authorization, documentation, supervision, and recordkeeping.
7. Choose the answer that best protects the client and complies with the applicable rule—not the answer that merely produces the highest return.

Series 65 Exam Cues

- Investment adviser = fiduciary; think duty of care + duty of loyalty.
- Material conflicts require full and fair disclosure, but some conduct is prohibited regardless of disclosure.
- Never confuse registration with regulator approval or endorsement.
- Client authorization matters for discretion and trading, but authorization does not permit fraud, manipulation, or other prohibited activity.
- When two answers seem plausible, prefer the one that addresses the client's interests, disclosure, authorization, and supervisory requirements most completely.

References and Further Reading

- NASAA, Series 65 Test Specifications (effective June 12, 2023), Ethical Practices and Fiduciary Obligations.
- U.S. Securities and Exchange Commission, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, IA-5248: https://www.sec.gov/rules-regulations/2019/06/ia-5248
- SEC and NASAA rules/model rules applicable to custody, codes of ethics, adviser conduct, pay-to-play, privacy, and business continuity. This Lesson is an exam overview; later course Lessons provide the detailed rule requirements.

Practice Questions

1. Which statement best describes an investment adviser's fiduciary duty?

A. The adviser must act in the client's best interest and satisfy duties of care and loyalty.
B. The adviser must always select the security with the highest historical return.
C. The duty applies only when the adviser has custody.
D. The adviser may place its own interests first if the client is sophisticated.

2. An adviser receives substantially higher compensation for recommending Product X. What is the first ethical issue to recognize?

A. A guaranteed-return opportunity
B. A securities-registration exemption
C. A material **conflict of interest**
D. A client's voting right

3. Which activity is most clearly an example of front-running?

A. Selling a Treasury bill at maturity
B. Buying a stock after reading its public annual report
C. Rebalancing a client account according to the IPS
D. Buying personally before executing a large client purchase that is expected to move the price

4. An IAR places a trade in a nondiscretionary account without obtaining the client's approval. The trade later earns a profit. The conduct is:

A. Permissible if the firm's commission was low
B. Permissible because the client benefited
C. Permissible if the security was suitable
D. Improper because required client authorization was not obtained

5. Which statement about conflicts is most accurate?

A. Any conflict becomes permissible if mentioned in small print.
B. Full and fair disclosure may be required, but some conflicts or practices must be avoided or are prohibited.
C. A conflict is irrelevant if the account rises in value.
D. Conflicts matter only for broker-dealers, not advisers.

6. Which practice is designed to create a false appearance of market activity?

A. Tax-loss harvesting
B. Market manipulation such as wash trades or matched orders
C. Dollar-cost averaging
D. Diversification

7. Why are personal securities transaction reports and restricted lists used?

A. To monitor and manage conflicts such as front-running and misuse of material nonpublic information
B. To eliminate the need for supervision
C. To replace client account statements
D. To guarantee investment returns

8. A client's circumstances change materially after retirement and the adviser has agreed to provide ongoing portfolio management. The adviser should generally:

A. Guarantee the prior return target.
B. Continue the old strategy permanently.
C. Reassess the client profile and recommendations consistent with the agreed advisory relationship.
D. Ignore the change until the client requests a specific trade.

Answer Key and Explanations

1. A — The adviser must act in the client's best interest and satisfy duties of care and loyalty. The SEC describes the adviser fiduciary duty as applying to the advisory relationship and including care and loyalty.

2. C — A material conflict of interest. Differential compensation can influence recommendations and must be identified and properly addressed.

3. D — Buying personally before executing a large client purchase that is expected to move the price. Front-running puts personal/firm trading ahead of client interests.

4. D — Improper because required client authorization was not obtained. A profitable unauthorized trade is still unauthorized.

5. B — Full and fair disclosure may be required, but some conflicts or practices must be avoided or are prohibited. Disclosure is important but does not legalize every practice.

6. B — Market manipulation such as wash trades or matched orders. These practices can create artificial or misleading market activity.

7. A — To monitor and manage conflicts such as front-running and misuse of material nonpublic information. Compliance controls are designed to detect and prevent conflicts and misuse.

8. C — Reassess the client profile and recommendations consistent with the agreed advisory relationship. Ongoing management requires advice to remain consistent with material changes in the client's circumstances.

Lesson 70: Client Funds and Securities

Learning Objectives

- Distinguish **custody** from **discretion** and **trading authorization**.
- Identify examples of custody and the safeguards required when an adviser has custody of **client funds** or **securities**.
- Explain how **discretionary authority** should be documented and supervised.
- Apply the adviser recommendation/advice **standard of care** to client fact patterns.
- Recognize basic **anti-money laundering** concepts and common red flags.

Exam point
• Custody is about access to client assets.
• Discretion is about authority to make investment decisions.
• Trading authorization is about authority to enter orders.
• The standard of care is about whether the advice is in the client's best interest and based on the client's circumstances.
• AML is about detecting and escalating suspicious financial activity.

The Big Picture: Three Different Types of Authority

Concept	Main question	Typical authority	Exam emphasis
Custody	Can the adviser hold, access, or obtain possession of client assets?	Access to funds or securities; ability to withdraw; trustee/GP/managing member authority	Safeguards, disclosure, qualified custodian, account statements, surprise examination
Discretion	Can the adviser decide what to buy or sell without asking before each trade?	Authority to select security, amount, timing, or action	Written authority, suitability/fiduciary duties, supervision, avoidance of excessive trading
Trading authorization	Can the adviser place orders for trades the client has directed or authorized?	Order-entry authority, often limited to executing client instructions	Not the same as discretion; does not by itself mean custody

70.1. Custody

Custody exists when an adviser holds client funds or securities, directly or indirectly, or has authority to obtain possession of them. Custody does not require the adviser to physically hold assets. Access or control can be enough.

- Physical possession of client checks, cash, stock certificates, or other securities can create custody unless the assets were received inadvertently and returned promptly.
- Authority to withdraw client funds or securities from an account generally creates custody.
- Deducting advisory fees directly from a client account commonly creates custody-related obligations.
- Serving as trustee, general partner, or managing member of an entity that holds client assets can create custody.
- Having discretion to trade securities, without authority to withdraw assets, is usually treated differently from custody.

Custody examples
• A client gives the adviser a check made payable to the adviser for investment. The adviser has custody.
• An adviser is authorized to deduct quarterly advisory fees from a custodial account. This can create custody under applicable rules.
• An adviser serves as trustee for a trust that is also an advisory client. The adviser likely has custody because of legal access to the trust assets.
• A client accidentally mails a stock certificate to the adviser and the adviser returns it within the required time. This inadvertent receipt may avoid custody treatment if handled properly.

Custody Safeguards

- Notify the securities regulator/Administrator as required, often through Form ADV.
- Maintain client assets with a qualified custodian such as a bank, broker-dealer, or other permitted custodian.
- Keep client assets segregated from the adviser's own assets and clearly identified as client property.
- Provide required notices to clients when accounts are opened or changed.
- Have a reasonable basis for believing that the qualified custodian sends account statements directly to clients, generally at least quarterly.
- Obtain an annual surprise examination by an independent public accountant when required.
- Maintain detailed records of client funds, securities positions, movements, confirmations, and account activity.

Exam point
Custody is broader than holding a paper certificate in the office. Authority to withdraw assets is custody even if the adviser never actually withdraws anything. Discretionary trading authority by itself is not the same as custody when the adviser cannot remove assets from the account.

70.2. Discretion

Discretion means the adviser has authority to make investment decisions for the client without obtaining the client's approval before each trade. Discretion is often appropriate for managed accounts, but it must be documented, supervised, and exercised in the client's best interest.

- Discretion may include authority to choose which securities to buy or sell.
- Discretion may include authority to decide the number of shares, principal amount, or allocation percentage.
- Discretion can include timing and price decisions, although time-and-price discretion is often treated as a limited exception.
- Written discretionary authority is generally required or should be obtained promptly under applicable state rules.
- Discretionary accounts require careful supervision to prevent excessive trading, unauthorized transactions, unsuitable recommendations, preferential treatment, and self-dealing.

Discretion examples
• A client signs an advisory agreement allowing the adviser to select ETFs and rebalance the account within a target allocation. The adviser has discretion.
• A client tells the adviser, "Use your judgment to decide whether to sell my ABC shares this week." This is discretionary authority unless limited to time and price under the applicable rule.
• A client says, "Buy 100 shares of ABC today, but get the best price you can." This is generally time-and-price authority, not broad discretion.

70.3. Trading Authorization

Trading authorization gives an adviser or representative authority to place orders in a client account. The key question is whether the adviser is merely executing a client's instruction or deciding the trade for the client.

- Non-discretionary trading authorization allows the adviser to enter a trade after the client decides the security, action, and amount.
- Limited trading authorization may let an adviser place trades but not withdraw money, change account ownership, or transfer assets to third parties.

- Full trading authority or a broad power of attorney can raise custody or supervisory concerns if it gives access to assets beyond trade entry.
- Advisers should keep clear documentation of client instructions and the scope of authority granted.

Trading authorization examples
• Client-directed order: The client says, "Sell 50 shares of XYZ." The adviser enters the order. That is trading authorization, not discretion.
• Limited authority: The adviser may enter trades but cannot withdraw cash or transfer securities out of the account. That normally reduces custody concerns.
• Broad authority: A power of attorney that lets the adviser withdraw or move assets can create custody and requires additional safeguards.

70.4. Recommendation/Advice to Client Standard of Care

Investment advisers owe clients fiduciary duties. For Series 65 purposes, this means recommendations and advice must be based on the client's circumstances, be in the client's best interest, and include full and fair disclosure of material conflicts.

- Know the client: goals, risk tolerance, time horizon, liquidity needs, tax situation, income needs, current holdings, and constraints.
- Have a reasonable basis: understand the investment or strategy before recommending it.
- Match the recommendation to the client: a product may be suitable for one client and inappropriate for another.
- Disclose material conflicts: compensation, affiliated products, referral arrangements, and other incentives must be disclosed.
- Monitor when required: ongoing advisory relationships and discretionary accounts require ongoing attention consistent with the advisory agreement.

Standard-of-care examples
• Appropriate: Recommending a diversified income portfolio after reviewing the client's income needs, tax bracket, time horizon, and risk tolerance.
• Inappropriate: Recommending a concentrated private placement to a conservative retiree without considering liquidity needs or risk tolerance.
• Conflict issue: Recommending an affiliated fund without disclosing that the adviser receives additional compensation from the fund sponsor.

70.5. Anti-Money Laundering (AML)

Anti-money laundering rules and procedures are designed to prevent the financial system from being used to move or disguise funds connected with illegal activity. Series 65 candidates

should know the basic concepts, the red flags, and the need to escalate suspicious activity through the firm's compliance procedures.

- Customer identification and due diligence help the firm understand who the customer is and why the account activity makes sense.
- Suspicious activity may involve unexplained source of funds, unusual transfer patterns, structuring, rapid movement of money, or refusal to provide information.
- Broker-dealers and custodians have established federal AML program obligations; advisers should understand and follow applicable firm, custodian, state, and federal requirements.
- Investment adviser AML regulation is an evolving area. The FinCEN IA AML Rule has been postponed to January 1, 2028, but the exam focus remains the concept: identify, escalate, and avoid facilitating suspicious activity.
- When in doubt, representatives should not ignore red flags; they should follow the firm's escalation and compliance procedures.

AML red-flag examples
• A new client refuses to provide identity information or source-of-funds details.
• Funds come from unrelated third parties with no clear business purpose.
• The client rapidly deposits and withdraws funds with little investment activity.
• The client asks how to avoid reporting thresholds or sanctions screening.
• Account activity is inconsistent with the client's stated occupation, income, net worth, or investment objective.

Comparison: Custody, Discretion, and Trading Authorization

Question	Custody	Discretion	Trading authorization
What does it involve?	Access to client assets	Authority to make investment decisions	Authority to enter orders
Key risk	Misappropriation or misuse of client funds/securities	Unsuitable, excessive, or self-interested trading	Unauthorized order entry or misunderstanding client instructions
Common documentation	ADV disclosure, custody records, custodian notices, account statements, audits if required	Written discretionary authority and advisory agreement	Trading authorization form or limited power of attorney

Question	Custody	Discretion	Trading authorization
Typical exam clue	Can withdraw assets, deduct fees, hold certificates, or serve as trustee/GP	Can decide what, when, or how much to trade	Client gives trade instructions; adviser places the order

Key Takeaways

- Do not confuse account access with investment authority: custody, discretion, and trading authorization are related but separate concepts.
- Custody focuses on safeguarding client assets and preventing misuse.
- Discretion focuses on who makes investment decisions and whether that authority is documented and supervised.
- Trading authorization focuses on who may enter orders.
- Advice must be reasonable for the specific client and consistent with fiduciary duties.
- AML concerns should be escalated, not ignored.

Practice Questions

1. An adviser has a general power of attorney allowing it to withdraw client funds from the client's brokerage account. What is the best characterization?

A. No custody if the client receives confirmations
B. AML authority, but not custody
C. Trading authorization only
D. Custody, because the adviser can obtain possession of client assets

2. Which situation is usually not custody by itself under the current custody concept?

A. Serving as trustee for a client trust
B. Holding a client stock certificate overnight
C. Having discretion to trade securities but no authority to withdraw assets
D. Having authority to deduct advisory fees directly from a client account

3. A client accidentally mails a stock certificate to an investment adviser. The adviser can generally avoid being treated as having custody if it returns the certificate promptly, generally within:

A. The next quarterly statement cycle
B. Thirty calendar days
C. Three business days
D. Ten business days

4. An adviser deducts advisory fees directly from a client account at the qualified custodian. This generally means the adviser:

A. May be treated as having custody and must follow applicable safeguards
B. Has no special obligation because the custodian holds the account
C. Must register as a broker-dealer
D. Cannot charge asset-based fees

5. A client signs an agreement allowing the adviser to choose which securities to buy and sell without calling the client before each trade. This is best described as:

A. Custody only
B. Discretionary authority
C. Payment for order flow
D. A prohibited transaction in all cases

6. A client tells an adviser to buy 100 shares of ABC today, and the adviser enters the order through the custodian. The adviser does not choose the security or amount. This is best described as:

A. A discretionary account
B. Custody
C. Trading authorization without investment discretion
D. A prohibited AML transaction

7. Under common state investment adviser rules, an adviser exercising client discretion should generally have:

A. Written discretionary authority or prompt written confirmation as required
B. Only oral authority from the client forever
C. Custody of the account at the adviser's office
D. No written records if the account is profitable

8. The adviser's recommendation/advice standard of care is best summarized as requiring the adviser to:

A. Recommend the product with the highest expected return
B. Act in the client's best interest based on a reasonable understanding of the client's circumstances
C. Avoid all investments that can lose money
D. Match every client to the same model portfolio

9. Which fact pattern raises the strongest concern in a discretionary account?

A. The adviser documents the client's investment objective
B. The adviser makes frequent unnecessary trades that generate additional compensation
C. The client receives quarterly statements from the custodian
D. The adviser rebalances to the client's target allocation

10. Which is a common AML red flag?

A. A client invests through a diversified mutual fund
B. A client updates a mailing address after moving
C. A client asks for a copy of the adviser's privacy policy
D. A client refuses to provide identity information or source-of-funds information

11. For a securities brokerage account, the party most directly subject to federal broker-dealer AML program obligations is usually the:

A. Financial journalist covering the markets
B. Portfolio model provider
C. Client's estate planning attorney
D. Broker-dealer or custodian carrying the account

12. Which recommendation most clearly violates the adviser's standard of care?

A. Recommending a concentrated illiquid investment without considering the client's goals, liquidity needs, or risk tolerance
B. Declining to recommend a product because the adviser lacks adequate information
C. Explaining both risks and costs before recommending a strategy
D. Recommending a balanced allocation after reviewing income needs and risk tolerance

13. Which role most likely creates custody for an adviser?

A. Entering a client-directed trade order
B. Providing a market update to a client
C. Recommending a mutual fund allocation
D. Serving as trustee of a trust that contains advisory client assets

14. What is the best distinction between discretion and trading authorization?

A. Trading authorization always creates custody; discretion never does
B. Discretion allows the adviser to decide the trade; trading authorization allows the adviser to place a trade the client has already authorized
C. They are the same concept under investment adviser rules
D. Discretion applies only to bonds; trading authorization applies only to stocks

15. A client gives the adviser a check made payable to the client's college. The adviser forwards it promptly and keeps a record. This is best treated as:

A. Generally not custody when handled promptly as a third-party payable check under applicable rules
B. An issuer-agent transaction
C. An unlawful performance guarantee
D. Automatic custody requiring an annual surprise examination in every case

16. Which statement best describes the purpose of AML policies and procedures?

A. To eliminate all investment risk
B. To make clients invest only in government securities
C. To identify customers, monitor activity, and detect or report suspicious transactions as required
D. To guarantee investment performance

Answer Key and Explanations

1. D — Custody: Authority to withdraw client funds or securities is custody even if the adviser never physically holds the assets.

2. C — Custody vs discretion: Authorized trading discretion alone is different from authority to withdraw or possess client assets.

3. C — Custody: Inadvertently received client funds or securities should be returned promptly, commonly within three business days under custody rules.

4. A — Custody: Fee deduction gives the adviser access to client funds and commonly triggers custody-related safeguards.

5. B — Discretion: Discretion is authority to decide investment action for the client, such as what to buy or sell and in what amount.

6. C — Trading authorization: The adviser is carrying out the client's decision; it is trading authorization, not discretion.

7. A — Discretion: Discretion should be documented. Many state rules require written authorization, with limited exceptions for temporary oral authority or time-and-price discretion.

8. B — Standard of care: Advisory recommendations must be based on the client profile and consistent with the adviser's fiduciary duties of care and loyalty.

9. B — Discretion supervision: Excessive trading, self-dealing, unauthorized transactions, and unsuitable recommendations are key concerns in discretionary accounts.

10. D — AML: AML programs focus on identity, source of funds, suspicious activity, and patterns that may indicate illicit finance.

11. D — AML: Broker-dealers have established AML program obligations. Advisers should understand AML concepts and coordinate with custodians and firms as required.

12. A — Standard of care: A recommendation must be reasonable for the client based on the client profile; ignoring suitability and fiduciary factors is improper.

13. D — Custody: Serving as trustee or in a comparable capacity can provide legal ownership of or access to client assets, creating custody.

14. B — Discretion vs authorization: Discretion involves investment decision-making authority; trading authorization can be limited to executing client instructions.

15. A — Custody exception: Checks made payable to third parties and forwarded promptly are generally not treated the same as adviser possession of client funds.

16. C — AML: AML focuses on identity verification, suspicious activity, source of funds, sanctions screening, and escalation/reporting obligations.

Lesson 71: Custody: Definition and Obligations

Learning Objectives

- Define **custody** in practical terms for Series 65 questions.
- Distinguish **custody** from **discretion**, **advice**, and **trading authorization**.
- Identify core custody obligations involving **qualified custodians**, **client notices**, **statements**, **surprise examinations**, and **pooled investment vehicles**.
- Apply common NASAA-style minimum net worth and bonding concepts for state-registered advisers.

71.1 Custody Definition

Custody generally means that an investment adviser directly or indirectly holds client funds or securities, has authority to obtain possession of them, or has a legal or control relationship that gives the adviser access to client assets.

- Possession: the adviser physically holds client cash, checks, or securities.
- Authority: the adviser can withdraw, transfer, or otherwise obtain client assets.
- Legal control: the adviser or a related person acts as trustee, general partner, managing member, or similar controller of client assets.

Example: Custody Exists
• A client gives the adviser authority to deduct advisory fees directly from the client's brokerage account.
• An adviser serving as trustee of a client trust can direct distributions from the trust.
• A private fund adviser acting through a general partner controls the fund's assets.

71.2 What Usually Does Not Create Custody

- Recommending securities or asset allocations without access to client assets.
- Receiving duplicate account statements or trade confirmations.
- Having discretionary trading authority that is limited to buying and selling securities in the client's account.
- Receiving an accidental check made payable to a third party or custodian and promptly returning or forwarding it under applicable rules.

Example: Discretion Without Custody
• A client authorizes the adviser to decide which ETFs to buy and sell in the client's brokerage account.
• The adviser can place trades but cannot withdraw funds, transfer assets to third parties, or deduct fees.
• This is discretion, not custody, although discretion can trigger separate state financial requirements.

71.3 Qualified Custodian Requirement

When an adviser has custody, client assets generally must be maintained with a qualified custodian. Qualified custodians commonly include banks, broker-dealers, futures commission merchants, and other permitted institutions. The main exam point is that client funds and securities should not be informally held by the adviser.

- The account should be in the client's name or clearly maintained for client benefit.
- The adviser should provide required custodial information when an account is opened or changed.
- Clients should receive account statements directly from the qualified custodian at least quarterly.

71.4 Client Notices and Account Statements

Custody rules are designed to create independent records that clients can use to detect unauthorized activity. Statements from the qualified custodian are especially important because they come from the institution holding the assets, not merely from the adviser.

- The client should receive notice of the qualified custodian's name, address, and how assets are maintained.
- The qualified custodian should send account statements directly to the client at least quarterly.
- If the adviser also sends its own reports, clients should compare adviser reports with custodian statements.

71.5 Annual Surprise Examination

Advisers with custody may be required to undergo an annual surprise examination by an independent public accountant. The purpose is to verify client assets and identify discrepancies. Exceptions may apply, including limited custody from fee deduction and certain audited pooled investment vehicle arrangements.

Example: Surprise Exam Concept
An adviser has broad authority to withdraw client funds to third-party accounts. Because this is more than limited fee deduction, a surprise examination may be required. The accountant's work helps verify that client assets exist and are properly accounted for.

71.6 Fee Deduction as Limited Custody

Direct deduction of advisory fees is custody because the adviser can obtain money from the account. However, many rules treat fee deduction as a limited custody situation when safeguards are present.

- The fee amount should be properly calculated under the advisory contract.
- The custodian statement should show the deduction to the client.
- The adviser should maintain records supporting the fee calculation.

- Fee deduction should not be confused with full authority to move client funds anywhere.

71.7 Standing Letters of Authorization and Transfers

Authority to transfer client money is custody-sensitive. A standing letter of authorization may allow an adviser to move funds according to client instructions. Exam questions usually turn on whether the adviser can move money to the adviser, to third parties, or only among the client's own accounts.

- Third-party transfer authority generally creates custody concerns.
- First-party transfers between accounts with identical client ownership may be treated differently if properly limited and documented.
- Custodian controls, written client instructions, and confirmation procedures are important safeguards.

71.8 Pooled Investment Vehicles

A private fund or pooled investment vehicle often creates custody issues because the adviser or a related person may control the pool's assets. For example, a general partner of a limited partnership fund typically controls fund assets on behalf of investors.

- Annual audited financial statements distributed to investors can satisfy or reduce certain custody obligations.
- The audit should be performed by an independent public accountant under applicable standards.
- The exam point is that private fund control can create custody even without holding individual client brokerage accounts.

71.9 Bond and Minimum Net Worth Requirements

For state-registered investment advisers, custody and discretion often trigger minimum financial requirements. Exact rules vary by state, but the following NASAA-style thresholds are commonly tested on the Series 65.

Adviser authority or arrangement	Common exam threshold	Why it matters
Custody of client funds or securities	$35,000 minimum net worth	Custody creates direct access or control risk.
Discretionary authority, no custody	$10,000 minimum net worth	Discretion gives trading control but not withdrawal authority.

Adviser authority or arrangement	Common exam threshold	Why it matters
Prepayment over $500 per client, six or more months in advance	Positive net worth	The adviser has collected money before services are performed.
State bonding requirement	Varies by state; may be in addition to or substitute for part of net worth	A surety bond provides a financial backstop if the adviser fails to meet obligations.

If an adviser falls below a required minimum, the adviser generally must notify the state securities Administrator promptly and may need to file a financial condition report. The Administrator may condition, restrict, suspend, or revoke registration if the deficiency is not corrected.

Calculated/Applied Example: Which Threshold Applies?
• Adviser A can choose trades but cannot withdraw money: discretion without custody, commonly $10,000 minimum net worth.
• Adviser B can deduct advisory fees directly: custody exists; limited-custody safeguards may apply, and state financial requirements should be checked.
• Adviser C holds client funds or can transfer them to third parties: custody, commonly $35,000 minimum net worth and possible bonding requirements.

71.10 Distinguishing Custody, Discretion, and Trading Authorization

Concept	Core power	Custody?	Example
Advice	Recommend what client may do	No	Suggest a 60/40 allocation.
Trading authorization	Place orders with client permission	Not by itself	Client signs a limited trading authorization.
Discretion	Decide trades without asking each time	Not by itself	Adviser reallocates among approved ETFs.

Concept	Core power	Custody?	Example
Custody	Hold, withdraw, transfer, or control assets	Yes	Adviser can deduct fees or move funds.

71.11 Recommendation and Advice Standard of Care

Custody obligations sit on top of the adviser's fiduciary duty. The adviser and IAR must act in the client's best interest when giving investment advice and must consider the client's financial situation, objectives, risk tolerance, time horizon, liquidity needs, tax status, and other relevant facts.

71.12 Anti-Money Laundering Context

Broker-dealers have formal AML program duties. Investment advisers should also understand AML red flags, especially when they have custody or fund-transfer authority. Suspicious patterns include unexplained third-party wires, rapid movement of funds in and out of accounts, refusal to provide identifying information, or transactions inconsistent with the client profile.

Common Exam Traps

- Do not assume every adviser with discretion has custody.
- Do not assume using a qualified custodian eliminates all custody obligations.
- Do not ignore limited custody created by direct fee deduction.
- Do not confuse receipt of duplicate statements with possession or control of client assets.
- Do not treat state bonding and net worth rules as identical in every state; know the common Series 65 thresholds and that state rules vary.

Key Takeaways

- Custody is about access to or control over client assets.
- Core safeguards include qualified custodians, client notices, direct account statements, audits, and surprise examinations where required.
- Custody and discretion can trigger minimum net worth or bonding requirements for state-registered advisers.
- Series 65 questions usually turn on the exact power the adviser has over the account.

Practice Questions

1. Which situation most clearly gives an investment adviser custody of client assets?

A. The adviser recommends that the client buy a mutual fund.
B. The adviser gives a general market outlook in a client newsletter.
C. The adviser receives duplicate trade confirmations from the custodian.
D. The adviser can withdraw advisory fees directly from the client account.

2. A state-registered adviser has custody of client funds or securities. Under a common NASAA-style exam framework, which minimum financial requirement is most likely to apply?

A. A minimum net worth of $100,000 for every adviser, regardless of custody.
B. A minimum net worth of $2,000, because the adviser is state registered.
C. A minimum net worth of $35,000, or a permitted surety bond substitute where state rules allow it.
D. No net worth or bonding requirement if the adviser uses a qualified custodian.

3. Which statement best describes a qualified custodian?

A. A bank, broker-dealer, futures commission merchant, or similar permitted institution that holds client assets.
B. Any investment adviser representative who passed the Series 65 exam.
C. Only a state securities Administrator.
D. Any person who introduces a client to an investment adviser.

4. An adviser has discretionary authority to trade client accounts but cannot withdraw funds, transfer securities, or deduct fees. What is the best characterization?

A. The adviser has custody because all discretion is custody.
B. The adviser is automatically exempt from all state financial requirements.
C. The adviser has discretion, but not custody, if the authority is limited to placing trades.
D. The adviser is acting as a broker-dealer agent.

5. Which arrangement usually creates custody because of a legal role or control position?

A. The adviser explains the difference between stocks and bonds.
B. The adviser prepares an asset allocation proposal the client may accept or reject.
C. The adviser receives a copy of the client's monthly custodian statement.
D. The adviser acts as trustee for the client trust and can direct distributions.

6. A client gives an adviser the ability to move money only between the client's own accounts at the same custodian, with no ability to send funds to the adviser or a third party. Which is the best exam answer?

A. It automatically eliminates all recordkeeping obligations.
B. It may avoid custody treatment if properly limited, documented, and controlled under applicable guidance.
C. It is always treated the same as taking physical possession of client securities.
D. It makes the custodian an investment adviser representative.

7. Which obligation is most directly designed to help clients detect unauthorized withdrawals or transactions?

A. A finder's introduction of the client to the adviser.
B. Quarterly account statements sent directly by the qualified custodian.
C. Annual renewal of the adviser's business card.
D. The adviser's use of a marketing slogan.

8. An adviser requires prepayment of more than $500 in advisory fees six or more months in advance. What requirement is commonly tested for state-registered advisers?

A. The adviser must maintain a positive net worth, and some states may impose additional filing or balance sheet requirements.
B. The fee automatically makes the client account a margin account.
C. The adviser is never required to disclose the fee arrangement.
D. The fee converts the client into a broker-dealer.

Answer Key and Explanations

1. D — Authority to deduct advisory fees from a client account is custody because the adviser can obtain client funds from the account. It is often a limited form of custody, but it is still custody.

2. C — Custody increases regulatory concern because the adviser has access to client assets. Many state/NASAA-style rules test $35,000 as the custody threshold, with state-specific bonding alternatives.

3. A — Client assets generally should be held by a qualified custodian such as a bank or broker-dealer, not informally by the adviser.

4. C — Discretion to select trades is different from custody. Discretion may trigger its own minimum net worth requirement, commonly $10,000 under NASAA-style exam rules, but it is not custody by itself.

5. D — Acting as trustee, general partner, managing member, or in another legal-control role may give the adviser access to or control over client assets and therefore custody.

6. B — Standing letters of authorization and transfer authority are custody-sensitive. Proper limits, documentation, and custodian controls may affect whether custody treatment applies.

7. B — Direct statements from the qualified custodian help clients compare activity and detect unauthorized withdrawals or trading.

8. A — Prepaid fees create client risk because the adviser holds money for future services. A positive net worth requirement is commonly tested; exact filing obligations vary by state.

Lesson 72: Conflicts of Interest, Impermissible Activities, and Ethics Issues

Learning Objectives

- Identify common **conflicts of interest** and explain why **disclosure** alone may not cure prohibited conduct.
- Distinguish **permissible activities** from **impermissible activities** involving **client accounts**, **client information**, **personal trading**, **political contributions**, and **outside business activity**.
- Apply **fiduciary principles** to **client recommendations**, **trading practices**, **confidentiality**, and **vulnerable adult protection**.
- Recognize exam fact patterns involving **loans**, **sharing in profits and losses**, **insider trading**, **selling away**, **market manipulation**, and **excessive trading**.

Exam Anchor: The Fiduciary Lens

A Series 65 question often asks whether a fact pattern is merely a conflict, a conflict that must be disclosed, or conduct that is prohibited even if the client agrees. The exam answer usually turns on whether the adviser or representative placed the client's interests first, obtained required approvals, avoided misleading statements, and maintained required records.

A practical way to analyze these questions is to ask four questions: Does the activity create a conflict? Was the conflict fully and fairly disclosed? Was client consent and firm approval required? Is the activity prohibited regardless of disclosure or consent?

Quick Guide to the Covered Issues

Issue	Core Rule	Typical Red Flag	Exam Example
Loans to or from customers	Generally prohibited unless a narrow exception and required approvals apply.	Representative asks a client for a personal loan.	A client offers to lend money to an agent after a strong performance year.
Sharing profits/losses	Generally prohibited; limited exceptions require proper authorization and proportionate sharing.	Agent agrees to reimburse client losses.	"I will cover half your losses if this trade fails."

Issue	Core Rule	Typical Red Flag	Exam Example
Confidentiality	Client information must be protected and used only for authorized business, legal, or compliance purposes.	Discussing client holdings with another client.	Using client portfolio data as a marketing story without consent.
Insider trading	Trading or tipping on material nonpublic information is prohibited.	Tip from executive friend.	Buying shares before a confidential merger announcement.
Selling away	Private securities transactions outside the firm require prior notice and, when compensation is involved, firm approval.	Unapproved private placement sold to clients.	Agent sells a friend's startup shares to customers away from the firm.
Personal trading / outside accounts	Access persons and associated persons must follow code-of-ethics and outside-account requirements.	Unreported brokerage account.	IAR trades personally before placing client trades.
Political contributions	Pay-to-play rules can restrict compensation from government clients after certain contributions.	Contribution to official controlling pension selection.	Adviser seeks a city pension mandate after a covered contribution.
Vulnerable adults	Firms should escalate suspected exploitation and may place temporary holds when permitted.	Caregiver demands liquidation.	Elderly client suddenly wires money to a new "helper."

72.1 Loans to and From Customers

Definition: A loan to or from a customer occurs when a representative borrows money from a client or lends money to a client outside the ordinary client-service relationship.

General rule: The safest Series 65 rule is that borrowing from or lending to customers is generally prohibited unless a narrow regulatory exception applies and the firm has given any required approval.

Why it matters: Loans create pressure, impaired judgment, dependence, and possible exploitation. They can also become disguised compensation or a way to avoid firm supervision.

Example: An IAR with personal credit-card debt asks an elderly client for a $20,000 loan. Even if the client likes the IAR and agrees, this creates a serious conflict and is generally impermissible without a valid exception and required approvals.

72.2 Sharing in Profits and Losses in a Customer Account

Definition: Sharing means the representative participates in the economic gain or loss of a customer account, either directly or indirectly.

General rule: A representative may not guarantee a customer against loss or share in account profits and losses unless a permitted exception applies, required written approvals are obtained, and the sharing is proportionate to the representative's actual financial contribution.

Why it matters: Sharing can encourage excessive risk taking. A loss guarantee is especially problematic because it makes the recommendation misleading and distorts the client's understanding of risk.

Example: An agent tells a client, "Buy this stock and I will personally reimburse your loss if it goes down." This is an impermissible guarantee against loss.

72.3 Client Confidentiality

Definition: Client confidentiality means nonpublic information about the client, the client's account, holdings, transactions, tax circumstances, goals, or identity is protected from unauthorized disclosure.

General rule: Client information should be used only for proper business, legal, regulatory, compliance, or client-authorized purposes.

Why it matters: Confidentiality is part of fiduciary conduct. Unauthorized sharing of client information can create identity theft risk, privacy violations, and loss of trust.

Example: An adviser may discuss a client's account with the firm's compliance department, but should not tell another client, "My largest client just sold all of her technology stocks."

72.4 Insider Trading

Definition: Insider trading involves trading, recommending, or tipping others while in possession of material nonpublic information. Information is material if a reasonable investor would consider it important; it is nonpublic if it has not been broadly disseminated.

General rule: An adviser, IAR, agent, or client cannot lawfully profit by trading on material nonpublic information or tipping others so they can trade.

Why it matters: Insider trading undermines market integrity and creates unfair informational advantages. It may lead to civil, criminal, regulatory, and firm disciplinary consequences.

Example: A client who is a corporate officer tells an IAR that the company will announce an acquisition tomorrow. The IAR may not buy the stock personally, recommend it to other clients, or tell a friend to buy it.

72.5 Selling Away

Definition: Selling away is participation in a securities transaction outside the regular course or scope of the representative's employment with the firm.

General rule: Private securities transactions must be disclosed to the firm before participation. When selling compensation is involved, the firm generally must approve the activity and supervise it as firm business.

Why it matters: Selling away bypasses firm supervision, due diligence, books and records, and client protections.

Example: A broker-dealer agent sells units in a local real estate partnership to customers without telling the firm because the sponsor pays a finder's fee. This is classic selling away.

72.6 Market Manipulation

Definition: Market manipulation is conduct designed to create a false or misleading appearance of market activity, price movement, supply, or demand.

Common forms: Examples include wash trades, matched orders, pump-and-dump campaigns, spreading false rumors, marking the close, spoofing, and coordinated trading designed to move the market.

Why it matters: Manipulation harms price discovery and misleads investors. It is an antifraud issue, not merely a disclosure issue.

Example: A trader posts misleading social media claims about a thinly traded stock while secretly selling shares into the buying pressure created by the posts.

72.7 Personal Securities Transactions

Definition: Personal securities transactions are trades for the benefit of the adviser, IAR, access person, or related account rather than a client account.

General rule: Personal trading must not disadvantage clients. Firms use codes of ethics, restricted lists, pre-clearance, trade review, and reporting to prevent front-running, conflicts, and misuse of client information.

Why it matters: An adviser's personnel may know client trades before they occur. Personal trading before client trading can harm clients and create an appearance of unfair dealing.

Example: An access person buys a thinly traded stock for a personal account shortly before the firm buys the same stock for multiple client accounts. This raises front-running and allocation concerns.

72.8 Outside Securities Accounts

Definition: An **outside securities account** is a brokerage or financial account away from the employing firm in which the representative has beneficial interest and securities transactions can be effected.

General rule: Associated persons generally must obtain prior written consent from the employer firm and notify the executing firm of their association. The employer may request duplicate confirmations and statements.

Why it matters: Outside accounts can hide conflicts, unapproved trading, front-running, or trades that should be reviewed under the firm's supervisory system.

Example: An agent opens a personal brokerage account at another firm without written employer consent. Even if no customer is harmed, the account violates supervisory and outside-account controls.

72.9 Initial Holdings and Quarterly Reports

Definition: Holdings and transaction reports are personal trading reports required from access persons under an investment adviser's code of ethics.

Initial holdings: An access person must submit an **initial holdings report** no later than 10 days after becoming an access person, with information current as of a date no more than 45 days before becoming an access person.

Quarterly transactions: Quarterly transaction reports are due no later than 30 days after the end of each calendar quarter, unless an exception applies, such as duplicate statements already received by the firm.

Example: A new portfolio analyst becomes an access person on June 1. The initial holdings report is due by June 11, and the information cannot be stale by more than 45 days.

72.10 Political Contributions

Definition: Political contribution rules, often called pay-to-play rules, seek to prevent advisers from winning government advisory business by contributing to officials who can influence adviser selection.

General rule: Certain contributions by an adviser or covered associate can trigger a two-year timeout on receiving compensation from the affected government client. Rules also restrict soliciting or coordinating contributions and certain third-party solicitation arrangements.

Exam focus: Look for a contribution to an official who can influence a public pension, 529 plan, 403(b), 457 plan, or other government investment mandate.

Example: A covered associate contributes above the permitted threshold to a city treasurer who helps select the city pension plan's adviser. The adviser may face a compensation timeout for that government client.

72.11 Excessive Trading

Definition: Excessive trading occurs when trading volume, frequency, or cost is inconsistent with the client's objectives and best interests.

General rule: Trading should serve a legitimate client purpose. High turnover used primarily to generate commissions, fees, or other compensation is unethical and may be churning when control and intent are present.

Why it matters: Excessive trading can erode returns through costs and taxes, increase risk, and signal that the representative is prioritizing compensation over the client.

Example: A retired income client has 70 trades in a quarter with no change in investment objective and high transaction costs. The pattern suggests excessive trading.

72.12 Exploitation of Vulnerable Adults

Definition: A vulnerable or specified adult generally includes an older adult, such as a person age 65 or older, or an adult whom the firm reasonably believes cannot protect personal interests due to mental or physical impairment.

General rule: Firms should escalate suspected exploitation, use trusted contacts appropriately, document concerns, and may place temporary holds where permitted by law or rule.

Why it matters: Financial professionals are often in a position to notice suspicious withdrawals, new caregivers, isolation, coercion, cognitive decline, or sudden changes in behavior.

Example: A caregiver pressures an 82-year-old client to liquidate a conservative portfolio and wire the proceeds to the caregiver's account. The firm should escalate and consider available protective steps.

72.13 Other Prohibited Activities

Examples: Other prohibited activities include unauthorized trading, misrepresenting registration status, guaranteeing performance, commingling client funds, misusing custody, cherry-picking allocations, failing to disclose material conflicts, falsifying records, and using misleading advertising.

General rule: The common thread is deception, conflict concealment, unauthorized control, misuse of client property, or placing the representative's interest ahead of the client.

Exam focus: The correct answer often uses words such as disclose, obtain written authorization, get firm approval, supervise, maintain records, or refrain from the activity entirely.

Example: An IAR allocates profitable trades to personal accounts and losing trades to client accounts. This is an allocation abuse and a serious fiduciary violation.

Decision Framework for Exam Questions

1. Step 1: Identify the client harm or potential harm. Look for conflicts, unauthorized action, misuse of information, or compensation incentives.
2. Step 2: Decide whether disclosure and consent are enough. Some conduct is still prohibited even if the client agrees.
3. Step 3: Look for required firm approval, written client authorization, supervisory review, and records.
4. Step 4: Choose the answer that protects the client, escalates the issue, or stops the impermissible activity.

References and Further Reading

- SEC Investment Adviser Codes of Ethics, Advisers Act Rule 204A-1.
- SEC Political Contributions by Certain Investment Advisers, Advisers Act Rule 206(4)-5.
- FINRA Rule 2150, Improper Use of Customers' Securities or Funds; Prohibition Against Guarantees and Sharing in Accounts.
- FINRA Rule 3210, Accounts at Other Broker-Dealers and Financial Institutions.
- FINRA Rule 3280, Private Securities Transactions of an Associated Person.
- FINRA Rule 2165, Financial Exploitation of Specified Adults.
- FINRA Regulatory Notice 24-12, amendments to borrowing from or lending to customers rule.

Specific Compliance Rules to Remember

Sharing in Profits and Losses in a Customer Account

Under FINRA Rule 2150, a member or associated person generally may share in the profits or losses of a customer account only when the associated person obtains prior written authorization from the employing member, the member or associated person obtains prior written authorization from the customer, and the sharing is in direct proportion to the financial contributions made to the account. The direct-proportion requirement does not apply to qualifying immediate-family accounts. Separate rules apply to performance-based advisory compensation.

Political Contributions and Pay-to-Play

For investment adviser pay-to-play purposes, a covered associate may generally contribute up to $350 per election to an official or candidate for whom the covered associate is entitled to vote, or up to $150 per election when the covered associate is not entitled to vote, without triggering the de minimis contribution issue. Contributions above the permitted exception can trigger a two-year restriction on receiving compensation for advisory services to the affected

government entity. The rule focuses on covered associates; an IAR is not automatically a covered associate solely because of the IAR title.

Churning

Churning is excessive trading in a customer account when the activity is inconsistent with the customer's objectives and circumstances and is driven by the desire to generate commissions or other transaction-based compensation. High turnover alone is a warning sign, but the analysis considers the account as a whole.

Regulatory References

- FINRA Rule 2150 — Improper Use of Customers' Securities or Funds; Prohibition Against Guarantees and Sharing in Accounts.
- SEC Investment Advisers Act Rule 206(4)-5 — Political Contributions by Certain Investment Advisers (**Pay-to-Play Rule**).

Practice Questions

1. An investment adviser representative asks a long-time elderly client for a personal loan to cover medical bills. The client agrees and says the loan is not related to the advisory relationship. What is the best conclusion?

A. The arrangement raises a serious conflict and is generally prohibited unless a narrow exception and required approvals apply.
B. The arrangement is acceptable if disclosed on the next quarterly account statement.
C. The arrangement is generally acceptable if the loan is interest-free.
D. The arrangement is generally acceptable because the client consented.

2. An agent tells a customer, "If this option trade loses money, I will personally cover your loss." Which statement is most accurate?

A. The statement is permitted if the agent receives no extra compensation.
B. The statement is an improper guarantee against loss.
C. The statement is permitted if the agent documents it in writing.
D. The statement is permitted if the customer is wealthy.

3. An access person becomes subject to an adviser's code of ethics on March 1. By when must the access person submit an initial holdings report?

A. By the next annual compliance meeting.
B. Within 30 days after the end of the quarter.
C. No later than 10 days after becoming an access person.
D. By the end of the calendar quarter.

4. A representative sells interests in a private real estate partnership to firm customers and receives a finder's fee, but does not notify the firm. What is the main issue?

A. A qualified domestic relations order
B. Market manipulation
C. A permitted outside account
D. Selling away

5. A client who works for a public company tells an IAR about a confidential merger that will be announced tomorrow. What should the IAR do?

A. Tell the information to all clients so it becomes fair.
B. Buy only for clients and not personally.
C. Use the information only in discretionary accounts.
D. Not trade, recommend, or tip based on the information.

6. A broker-dealer agent opens an outside brokerage account in which securities transactions can be made and the agent has beneficial interest. What is generally required before opening the account?

A. Only verbal notice to the branch receptionist.
B. A client signature on the account form.
C. Prior written consent from the employer member and notice to the executing firm.
D. No action if the account is small.

7. Which fact pattern most clearly suggests market manipulation?

A. A client places a limit order below the current market price.
B. A client requests a copy of Form ADV.
C. An adviser reallocates a client portfolio after a documented change in risk tolerance.
D. A trader posts false rumors about a thinly traded stock while selling into the price increase.

8. A portfolio manager buys a thinly traded stock personally shortly before placing large client orders in the same security. What is the primary concern?

A. A municipal bond tax issue.
B. Front-running or misuse of client trading information.
C. A required minimum distribution error.
D. A tenancy-in-common issue.

9. Which person would generally fit the protected “specified adult” concept under senior exploitation rules?

A. A natural person age 65 or older.
B. Any customer with a margin account.
C. Only customers with more than $1 million in assets.
D. Only customers who have signed a discretionary agreement.

10. An adviser seeks a public pension advisory contract after a covered associate makes a political contribution above the permitted threshold to an official who can influence the adviser selection. What is the likely regulatory concern?

A. The contribution eliminates the adviser’s fiduciary duty.
B. Pay-to-play restrictions may apply.
C. The public pension must register as a security.
D. The contribution automatically converts the adviser into a broker-dealer.

11. Which statement best describes excessive trading?

A. Trading volume, frequency, or cost is inconsistent with the client's objectives and best interests.
B. Trading frequently is always prohibited.
C. Trading is excessive only if the client loses money.
D. Trading is excessive only in a cash account.

12. An adviser wants to use details from a famous client's portfolio in a marketing presentation. The client has not approved the disclosure. What is the best answer?

A. Required because performance examples must identify the client.
B. Permitted if the portfolio performed well.
C. The adviser should not disclose nonpublic client information without proper authorization.
D. Permitted because famous clients have less privacy.

13. Which activity is most likely permitted without creating a selling-away issue?

A. Soliciting customers to buy a friend's startup shares outside the firm.
B. Receiving a finder's fee to sell a private placement away from the firm without notice.
C. Purchasing mutual fund shares for a personal account that is properly disclosed under the firm's outside-account policy.
D. Selling unapproved promissory notes to clients from a home office.

14. A firm suspects that a caregiver is pressuring an older client to liquidate securities and transfer the money. What is the best first response?

A. Escalate internally, document the concern, consider contacting the trusted contact, and evaluate whether a temporary hold or report is permitted.
B. Charge an additional fee for the extra work.
C. Immediately buy more aggressive investments for the client.
D. Ignore the issue because the caregiver says the client consented.

15. Which phrase is the best summary of fiduciary conduct in conflict situations?

A. Assume firm approval is unnecessary if the client is wealthy.
B. Put the client's interest first, disclose material conflicts, obtain required consent and approvals, and avoid prohibited conduct.
C. Rely on verbal consent for all conflicts.
D. Use disclosure only after the client complains.

16. A representative allocates profitable trades to personal accounts and unprofitable trades to client accounts. What is the best characterization?

A. Ordinary tactical asset allocation.
B. A required part of best execution.
C. A permissible form of dollar-cost averaging.
D. An allocation abuse and fiduciary violation.

Answer Key and Explanations

1. A — Loans to or from clients create conflicts and possible exploitation. Consent alone usually does not cure the problem.

2. B — Guaranteeing a customer against loss misrepresents risk and is prohibited.

3. C — Initial holdings reports are due no later than 10 days after the person becomes an access person.

4. D — Selling securities away from the firm without required notice and approval is selling away.

5. D — Material nonpublic information cannot be used for trading, recommendations, or tipping.

6. C — Outside securities accounts generally require prior written employer consent and notice to the other firm.

7. D — False rumors designed to move the price while trading in the stock are classic manipulation.

8. B — Personal trading ahead of client orders creates front-running and fiduciary concerns.

9. A — A specified adult generally includes a natural person age 65 or older.

10. B — Pay-to-play rules address contributions tied to government advisory business.

11. A — Excessive trading is evaluated in context, including objectives, costs, turnover, and client interest.

12. C — Client confidentiality prohibits unauthorized disclosure of nonpublic client information.

13. C — Properly disclosed personal investing is not the same as selling securities away from the firm to customers.

14. A — The firm should escalate, document, and use available protective procedures.

15. B — Fiduciary conduct requires client-first behavior, disclosure, consent/approval where required, and avoidance of prohibited conduct.

16. D — Cherry-picking or allocation abuse violates fiduciary obligations and fair dealing.

Lesson 73: Cybersecurity, Privacy, and Data Protection

Learning Objectives

- Define **cybersecurity**, **privacy**, **data protection**, **nonpublic personal information**, and **customer records**.
- Identify why cybersecurity is a **fiduciary** and **compliance issue** for investment advisers and representatives.
- Distinguish **privacy disclosures** from **cybersecurity controls** and from **data-retention practices**.
- Apply practical safeguards to **client records**, **email**, **websites**, **vendors**, **mobile devices**, and **remote work**.
- Recognize exam scenarios involving **unauthorized disclosure**, **phishing**, **ransomware**, **identity theft**, and **incident response**.

Core Concepts

Concept	Plain-English Meaning	Series 65 Example
Cybersecurity	Controls used to protect electronic systems, accounts, networks, devices, and data from unauthorized access, misuse, disruption, or theft.	An adviser requires multifactor authentication before an IAR can access client account files remotely.
Privacy	Rules about how client personal and financial information may be collected, shared, disclosed, and used.	A firm gives clients a privacy notice explaining when information may be shared with affiliates or service providers.
Data protection	The broader process of safeguarding information throughout its life cycle: collection, access, storage, transmission, retention, and disposal.	A firm encrypts archived client files and securely destroys records no longer required to be retained.
Nonpublic personal information (NPI)	Personally identifiable financial information that is not publicly available, and lists or groupings derived from that information.	A client's Social Security number, date of birth, bank account details, income, net worth, and account holdings.

Concept	Plain-English Meaning	Series 65 Example
Customer records and information	Records containing client or customer information held by the adviser, broker-dealer, custodian, vendor, or affiliate.	Client onboarding forms, risk questionnaires, account statements, tax forms, and beneficiary information.

73.1 Why This Is a Fiduciary Issue

Investment advisers owe fiduciary duties of care and loyalty. Protecting client information is part of acting with care, because sensitive client information can be used to steal assets, commit identity theft, pressure vulnerable clients, or execute fraudulent transfers. An IAR does not need to be a technology expert, but must follow firm policies, recognize red flags, protect client confidentiality, and escalate incidents promptly.

- Duty of care: use reasonable procedures to protect client information and prevent unauthorized access.
- Duty of loyalty: do not misuse client information for personal benefit or disclose it without authorization.
- Supervision: firms must train supervised persons and enforce cybersecurity and privacy policies.
- Recordkeeping: firms must preserve required books and records while protecting them from improper access or alteration.

73.2 Regulatory Framework for Exam Purposes

Source	Main Point	Exam Takeaway
SEC Regulation S-P	Covered SEC-regulated firms must provide privacy notices and adopt written policies and procedures to safeguard customer records and information. 2024 amendments add incident-response and customer-notification requirements for covered institutions.	Know that privacy notices and safeguard procedures are required; a breach of sensitive customer information requires prompt response and, generally, customer notice.

Source	Main Point	Exam Takeaway
Gramm-Leach-Bliley Act (GLBA)	Federal privacy framework for financial institutions that protects nonpublic personal information.	Client financial information is not ordinary business data; it receives special protection.
FTC Safeguards Rule	Applies to certain non-bank financial institutions under FTC jurisdiction and requires a written information security program with administrative, technical, and physical safeguards.	Some state-registered advisers and financial firms may be covered by FTC safeguards rather than only SEC rules.
FINRA / broker-dealer rules	Broker-dealers must protect customer information, supervise associated persons, and maintain identity-theft prevention programs when applicable.	IARs should recognize similar privacy and cybersecurity expectations in the brokerage context.
State securities law and administrator authority	State regulators may examine records, require books and records, investigate misconduct, and sanction unethical practices.	A state administrator may treat poor handling of client information as a compliance and ethics issue.

73.3 Key Obligations and Practical Controls

Obligation	What It Requires	Example
Written policies and procedures	Firms should have written procedures for access, confidentiality, retention, disposal, vendors, email, mobile devices, remote access, and incident response.	The firm policy says client account documents may not be stored on a personal laptop.

Obligation	What It Requires	Example
Access controls	Limit information access to authorized persons with a business need.	A receptionist cannot view client portfolio holdings unless that access is required for assigned duties.
Authentication	Use strong passwords and, where appropriate, multifactor authentication.	An IAR must approve a login from an authenticator app before accessing client files.
Encryption and secure transmission	Protect sensitive data at rest and in transit.	Tax forms sent by email are placed in an encrypted portal instead of as unprotected attachments.
Training and supervision	Personnel must be trained to recognize phishing, social engineering, spoofed instructions, and reporting obligations.	An assistant escalates a suspicious wire-transfer email rather than acting on it.
Vendor oversight	Service providers with access to client data must have appropriate safeguards and contractual obligations.	A portfolio-reporting vendor must protect client files and report relevant incidents.
Incident response	Detect, contain, investigate, document, notify appropriate parties, and recover from unauthorized access or use.	The firm disables a compromised account, contacts compliance, documents the event, and determines whether client notice is required.
Secure disposal	Dispose of consumer and client information in a way that prevents reconstruction or unauthorized use.	Paper files are shredded; obsolete hard drives are wiped or destroyed.

73.4 Privacy Notices and Client Disclosures

- Initial privacy notice: generally provided when a client relationship is established; explains information-sharing practices.
- Annual privacy notice: required in many cases, though exceptions may apply when policies have not changed and the firm shares information only in ways that do not trigger opt-out rights.
- Opt-out rights: clients may have rights to limit certain sharing of nonpublic personal information with nonaffiliated third parties.
- Privacy notice does not replace cybersecurity controls. A client disclosure explains practices; it does not secure the data by itself.
- Misleading privacy statements can create a separate compliance problem. Do not promise security practices the firm does not actually follow.

73.5 Common Risks and Red Flags

Risk	Red Flag	Proper Response
Phishing	An email appears to come from the custodian but asks the IAR to enter credentials through an unfamiliar link.	Do not click the link. Report to compliance or information security.
Business email compromise	A client's email requests a wire to a new bank account and says the client is unavailable by phone.	Verify through a trusted phone number already on file.
Ransomware	A workstation displays a message demanding payment to unlock files.	Disconnect if instructed by policy, notify the response team, and preserve evidence.
Lost device	A laptop or phone used for work is lost in public.	Report immediately so the firm can lock, wipe, or monitor access.
Vendor breach	A third-party reporting platform announces unauthorized access to stored client files.	Follow vendor-incident procedures, assess impacted clients, and determine notice obligations.

Risk	Red Flag	Proper Response
Insider misuse	An employee accesses celebrity or family-member account files without a business reason.	Treat as unauthorized access and escalate.

73.6 Email, Websites, Social Media, and Digital Messaging

- Use firm-approved channels for client communications and recordkeeping.
- Avoid sending account numbers, Social Security numbers, tax records, beneficiary information, or passwords through unencrypted email.
- Do not use personal email, personal text messages, or unapproved messaging apps for securities business unless the firm has approved and retained those communications.
- Website forms should collect only necessary information and should use secure transmission when sensitive information is submitted.
- Social media posts and direct messages can create advertising, recordkeeping, and privacy issues; they should follow firm policy.

73.7 Client Confidentiality

Client confidentiality means that an IAR should not disclose client information unless the client authorizes disclosure, the disclosure is necessary to provide services through an approved service provider, or disclosure is required or permitted by law or regulation. Confidentiality applies to conversations, paper files, digital files, and casual communications.

Scenario	Proper Analysis
A client's adult child asks for the parent's account balance.	Do not disclose unless the client has authorized the child, a legal document gives authority, or firm/legal review confirms permission.
A CPA asks for tax documents for the client.	Confirm client authorization and use an approved secure delivery method.
An employee discusses a client's financial problems in a public elevator.	Improper disclosure, even if no document was handed over.
A regulator requests records during an examination.	Escalate internally and provide records through the firm's compliance process.

73.8 Incident Response: What Should Happen After a Problem?

1. Identify: Recognize the event: unusual login, missing device, suspicious transfer request, malware alert, vendor notice, or data sent to the wrong person.
2. Escalate: Notify compliance, supervision, information security, or the designated incident-response contact. Do not hide or delay reporting.
3. Contain: Limit further harm by changing credentials, disabling access, quarantining systems, or stopping a transaction.
4. Investigate: Determine what information was involved, which clients were affected, whether assets were at risk, and whether vendor or custodian data was involved.
5. Notify and document: Provide required notices where applicable, document the response, preserve evidence, and update policies if needed.
6. Recover and improve: Restore systems, train personnel, remediate weaknesses, and test controls.

Exam Decision Framework

Question to Ask	Likely Exam Answer
Is client information nonpublic, personal, financial, or account-related?	Treat it as protected information.
Is the person requesting information authorized?	Verify authorization before disclosure.
Is the communication channel approved and retained?	Use firm-approved methods, especially for securities business and sensitive records.
Is a suspicious instruction urgent, secret, or inconsistent with client behavior?	Independently verify before acting.
Was client data accessed, used, or disclosed without authorization?	Escalate under the firm incident-response policy.
Does the firm use an outside vendor with client data?	Perform due diligence and require appropriate safeguards.

References and Further Reading

- SEC, Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Customer Information, including 2024 amendments.
- FTC, Safeguards Rule, 16 C.F.R. Part 314.
- FINRA, Customer Information Protection and cybersecurity guidance for member firms.

- Gramm-Leach-Bliley Act privacy and safeguards framework.

Practice Questions

1. An IAR receives an email that appears to be from a client requesting an immediate wire to a new overseas bank account. The client says they cannot speak by phone. What is the best next step?

A. Ask the custodian to decide whether the request is legitimate.
B. Verify the request through a trusted contact method already on file.
C. Reply to the same email and ask the client to confirm.
D. Send the wire because the request came from the client's email address.

2. Which statement best describes the difference between privacy and cybersecurity?

A. Privacy concerns how information is collected, shared, and used; cybersecurity protects systems and data from unauthorized access or misuse.
B. Cybersecurity rules apply only after an account has been hacked.
C. Privacy only applies to paper records; cybersecurity only applies to electronic records.
D. Privacy is optional if cybersecurity controls are strong.

3. A firm allows employees to download client files onto personal laptops without encryption or access controls. The main problem is that:

A. Personal devices are permitted if the employee is registered.
B. Client information is not protected unless the client has a margin account.
C. The practice creates data-protection and supervisory risk.
D. The risk exists only if a client complains.

4. A client's adult child asks an IAR to disclose the client's account balance. The IAR should:

A. Provide the balance if the child is a likely beneficiary.
B. Provide the balance if the child knows the client's date of birth.
C. Decline unless the client has authorized disclosure or legal authority exists.
D. Provide the balance because family members are not third parties.

5. Which item is most likely to be nonpublic personal information?

A. A company's ticker symbol.
B. A client's Social Security number and account holdings.
C. The name of a public mutual fund.
D. The closing price of a listed stock.

6. A vendor that stores client reporting data reports unauthorized access to its system. The adviser should first:

A. Delete the vendor contract to limit liability.
B. Follow the firm's vendor incident-response procedure and determine what client information was affected.
C. Tell IARs to avoid discussing the incident with compliance.
D. Wait until the vendor completes all investigations before documenting anything.

7. Which practice best supports secure disposal of client records?

A. Shredding paper files and securely wiping or destroying electronic media when disposal is permitted.
B. Deleting files from a shared drive without confirming backups or copies.
C. Throwing old forms into regular trash after the retention period ends.
D. Keeping all records forever regardless of sensitivity.

8. An IAR posts a screenshot of a client portfolio on social media with the client's name cropped out, but account numbers and holdings are visible. This is:

A. Acceptable if the post receives no comments.
B. Only a problem if the client is famous.
C. Improper because sensitive account information is disclosed.
D. Acceptable because the name is cropped out.

9. Which control is designed to reduce the risk that a stolen password alone gives access to client records?

A. Annual privacy notice.
B. A performance disclaimer.
C. A longer marketing brochure.
D. Multifactor authentication.

10. A privacy notice primarily tells clients:

A. How the firm collects, shares, and protects nonpublic personal information.
B. How the adviser votes proxies.
C. Which securities the adviser recommends.
D. Whether the adviser guarantees performance.

11. An assistant accidentally emails a client tax document to the wrong client. What should happen next?

A. Ask the recipient to delete it and do nothing else.
B. Post a general notice on social media.
C. Ignore it if the recipient promises not to open it.
D. Escalate promptly under the firm's incident-response policy.

12. Which statement is most accurate about an IAR's cybersecurity responsibilities?

A. Client information can be sent through any channel if the client is wealthy and sophisticated.
B. Cybersecurity rules apply only to broker-dealers, not advisers.
C. Only the IT department has cybersecurity responsibilities.
D. The IAR should follow firm policies, protect client information, and report suspected incidents promptly.

Answer Key and Explanations

1. B — Urgent requests to new payment instructions are classic red flags. The IAR should verify through a trusted phone number or other firm-approved method already on file.

2. A — Privacy focuses on use and disclosure of information. Cybersecurity focuses on protecting systems and information from unauthorized access, misuse, theft, or disruption.

3. C — Sensitive client data should be protected through approved devices, access controls, encryption, and firm supervision.

4. C — Family status alone does not authorize disclosure of client information.

5. B — NPI includes personally identifiable financial information such as SSNs, financial holdings, account information, income, net worth, and related identifiers.

6. B — Vendor incidents can affect client information. The adviser should escalate, document, investigate impact, and determine any notice obligations.

7. A — Secure disposal means preventing unauthorized reconstruction or use of client information.

8. C — Removing a name does not make the disclosure safe when identifying account details or sensitive information remain visible.

9. D — Multifactor authentication requires an additional authentication factor beyond the password.

10. A — Privacy notices explain information-sharing practices and client rights relating to nonpublic personal information.

11. D — Misdirected sensitive information is a potential unauthorized disclosure and should be escalated and documented.

12. D — IARs are not expected to be IT experts, but they must follow firm policies, protect confidentiality, and escalate red flags.

Lesson 74: Business Continuity, Disaster Recovery, and Succession Planning

Learning Objectives

- Define a **business continuity plan** and explain why it matters to clients.
- Distinguish **business continuity**, **disaster recovery**, and **succession planning**.
- Identify **core plan elements**, including **record backup**, **alternate communications**, **office relocation**, **vendor/custodian coordination**, and **assignment of duties**.
- Apply continuity concepts to Series 65-style scenarios involving adviser interruption, unavailable personnel, and client access to funds and records.

74.1 Business Continuity Plan

A **business continuity plan (BCP)** is a written plan that explains how an adviser or broker-dealer will continue or restore critical operations during an emergency or significant business disruption. The plan should be tailored to the firm's size, services, personnel, locations, technology, vendors, and client relationships.

Why It Matters

- Clients may need to contact the firm, obtain account information, or access funds and securities during a disruption.
- The firm may need alternate procedures for communications, records, reporting, client service, and supervisory review.
- A plan reduces client harm when personnel, offices, systems, vendors, or custodians are unavailable.
- For broker-dealers, FINRA Rule 4370 specifically requires written BCP procedures and customer disclosure. For investment advisers, state rules and fiduciary principles commonly require or support written business continuity and succession planning.

Core Elements of a Strong BCP

Element	Purpose	Example
Protection, backup, and recovery of books and records	Keeps required records available after disruption.	Client agreements, contact lists, trading authorizations, billing records, and portfolio reports are backed up in a secure cloud repository and periodically tested.

Element	Purpose	Example
Alternate communications	Allows contact with clients, employees, regulators, vendors, custodians, and service providers.	If office email fails, the firm uses a secure backup email system, emergency phone tree, and website notice.
Office relocation or remote work plan	Allows work to continue if the principal office is unavailable.	After a fire, staff use a pre-approved remote work procedure and an alternate mailing address.
Critical systems and vendors	Identifies systems and third parties needed for client service.	The plan lists the custodian, portfolio-management platform, CRM, cybersecurity vendor, and billing system, with contact and backup procedures.
Regulatory communications and reporting	Preserves required communications with regulators.	The CCO knows how to contact state regulators or FINRA and how to continue required filings.
Client access to funds and securities	Reduces the risk that clients are trapped by the firm's disruption.	Clients receive instructions for contacting the custodian directly if the adviser cannot be reached.

Example:
A tornado destroys the adviser's office. A workable BCP identifies how employees will work remotely, how client records are recovered, how clients are notified, how the custodian is contacted, and who is responsible for critical functions.

74.2 Disaster Recovery

Disaster recovery is the operational and technology-focused part of continuity planning. It focuses on restoring systems, records, facilities, communications, and essential workflows after a disruptive event.

Common Disaster Recovery Controls

- Maintain secure, redundant backups of electronic records and essential paper records.
- Test whether backups can actually be restored within a reasonable recovery period.
- Identify mission-critical systems, such as trading platforms, portfolio-management software, client portals, email, phones, CRM, billing, compliance archives, and custodial access.
- Maintain alternate communication methods in case primary phone, internet, or email systems fail.
- Document responsible employees, vendor contacts, passwords/access procedures, and escalation steps in a secure but accessible location.
- Plan for cybersecurity incidents, ransomware, data breach response, and safe restoration from clean backups.

Disruption	Disaster Recovery Response
Ransomware locks the firm's local files.	Disconnect affected systems, notify responsible personnel, restore from clean backups, preserve records, and follow the incident-response and client-notification procedures.
Office internet and phones fail.	Use backup mobile hotspot, alternate phone number, secure messaging, website status notice, and custodian direct-contact instructions.
Cloud portfolio system is down.	Use vendor status procedures, backup reports, custodian data, and manual client-service procedures until the system is restored.
Principal office is inaccessible.	Activate remote work or alternate-location plan; retrieve records from off-site or cloud backup; communicate with clients and regulators as needed.

74.3 Succession Planning

Succession planning addresses how client service will continue if key personnel die, resign, become incapacitated, or are otherwise unavailable. It also considers how the firm might transition, wind down, or transfer client service in an orderly way.

Key Succession Planning Questions

- Who has authority to access client records, contact custodians, and communicate with clients if the principal adviser is unavailable?
- Who is the qualified responsible person assigned to critical duties?
- Where are client agreements, passwords, emergency contacts, trading-authority documents, and vendor contracts stored?
- How will the firm handle pending trades, client service requests, billing, regulatory filings, and record preservation?
- Will clients be referred to another adviser, assigned to remaining personnel, or given instructions to work directly with the custodian?
- How will the plan protect client confidentiality while allowing authorized continuity personnel to act?

Example:
A one-person adviser suffers a medical emergency. A succession plan names a qualified responsible person, gives that person secure access to the client contact list and custodian information, explains how clients will be notified, and identifies how records will be preserved and client requests will be handled.

Comparing the Three Concepts

Concept	Primary Question	Common Series 65 Clue
Business continuity plan	How will the firm continue serving clients during a disruption?	Emergency, significant business disruption, alternate communication, vendors, client access, records, regulatory reporting.
Disaster recovery	How will systems, data, facilities, and operations be restored?	Ransomware, server failure, lost data, office destruction, backup recovery, system restoration.
Succession planning	Who will act if key people are unavailable or the firm must transition?	Death, incapacity, founder unavailable, one-person firm, assignment of duties, qualified responsible person.

Exam Decision Framework

1. Identify the disruption: Is the issue a natural disaster, cyber event, office closure, vendor outage, death, or incapacity?
2. Ask who or what is unavailable: systems, records, employees, vendors, custodians, office space, or the principal adviser.
3. Select the plan feature that directly solves the problem: backup/recovery, alternate communications, office relocation, vendor coordination, client access, regulatory reporting, or assignment of duties.
4. Prefer the answer that reduces client harm and preserves access to records, funds, securities, and advice.
5. Do not assume that a custodian or third-party vendor eliminates the adviser's need for a plan. Reliance on third parties should be addressed in the plan.

Common Exam Traps

- A BCP is broader than a computer backup plan.
- Disaster recovery is part of continuity planning, but continuity also includes people, facilities, vendors, clients, and regulators.
- Succession planning is not estate planning for the adviser's personal assets. It is about continuity of client service and firm operations.
- A small firm still needs a plan tailored to its size and business model.
- A plan should be tested and updated; an outdated plan may fail when needed.

Practice Questions

1. A sole-owner investment adviser keeps client files on a local computer and becomes unavailable after a medical emergency. Which plan element best addresses both continuity and succession concerns?

A. A written social media policy
B. A new fee schedule delivered to clients
C. A written statement that the custodian will handle all client questions
D. A written procedure for record backup and assignment of duties to a qualified responsible person

2. Which item is most directly part of disaster recovery?

A. Determining whether the firm should use active or passive management
B. Calculating the client's time-weighted return
C. Restoring client records and critical systems after a ransomware attack
D. Selecting a new benchmark for client accounts

3. A firm's founder is the only person who knows how to access advisory agreements, client contact lists, and custodian portals. What is the primary risk?

A. A violation of the short-sale rule
B. Key-person dependency that could harm clients if the founder dies or becomes unavailable
C. Improper use of a market maker
D. Excess trading

4. Which statement best describes a business continuity plan?

A. It is limited to cybersecurity controls and does not address employees or vendors
B. It is a written plan designed to keep the firm serving clients during an emergency or significant business disruption
C. It is only required after a disaster occurs
D. It is the same thing as a performance report

5. Which example best shows a client-focused continuity procedure?

A. The adviser maintains an alternate method for contacting clients if the office phones and email are unavailable
B. The adviser keeps marketing brochures in the lobby
C. The adviser knows the office alarm code
D. The adviser changes benchmarks quarterly

6. A small adviser relies on a third-party custodian and cloud document provider. What should the adviser's BCP do?

A. Address the adviser's reliance on those service providers and how disruptions would be handled
B. Avoid naming service providers in the plan
C. Ignore third parties because the adviser does not control them
D. State that all responsibilities are transferred to the custodian

7. Which event most clearly triggers review or update of a BCP?

A. A client asks about an IRA rollover
B. The firm changes its office location and adds remote employees
C. The firm sends a birthday card to a client
D. A mutual fund pays a dividend

8. Which statement about succession planning is most accurate?

A. It is primarily a tax-planning device
B. It replaces the need for recordkeeping
C. It is only needed for large broker-dealers
D. It plans for the death, incapacity, or unavailability of key personnel and the possible transition of client service

9. Which answer best distinguishes business continuity from disaster recovery?

A. Business continuity is used only by issuers
B. They are unrelated concepts
C. Business continuity is the broader plan for maintaining client service; disaster recovery is the technical and operational recovery of systems and records
D. Disaster recovery applies only to paper documents; business continuity applies only to computer systems

10. Which topic would least likely be the core of a BCP?

A. A sales contest for IARs
B. Office relocation after loss of the principal place of business
C. Alternate client communications
D. Data backup and recovery

11. A state-registered adviser has a written BCP but has not identified who will contact the custodian if the principal dies. What is the weakness?

A. The firm has created an impermissible performance guarantee
B. The plan has too much focus on clients
C. The firm must stop using a custodian
D. The plan lacks a succession procedure assigning duties to a qualified responsible person

12. Which client harm is a BCP designed to reduce?

A. A client invests in a diversified portfolio
B. A client chooses a conservative allocation
C. A client cannot reach the adviser, access records, or receive account service during a disruption
D. A client receives a properly disclosed fee invoice

Answer Key and Explanations

1. D — The key issues are access to records and continuity if key personnel are unavailable. Backup/recovery and assignment of duties are core BCP/succession planning elements.

2. C — Disaster recovery is the operational recovery portion of the continuity plan. It focuses on systems, data, records, facilities, and communications after a disruptive event.

3. B — Succession planning should reduce key-person risk by assigning duties, documenting access procedures, and identifying qualified responsible persons.

4. B — A BCP is a written set of procedures for continuing or restoring critical operations during disruptions. It should address clients, personnel, vendors, records, facilities, and regulators.

5. A — Alternate communications are a central BCP element. The goal is to reduce client harm and keep clients informed during a disruption.

6. A — A BCP should address critical vendors, custodians, and service providers. Reliance on another entity does not eliminate the adviser's need to plan.

7. B — A material change in operations, structure, business, or location should trigger a review and update of the continuity plan.

8. D — Succession planning is intended to prevent client harm when key personnel cannot perform their duties and to support an orderly transition.

9. C — Business continuity is broader. Disaster recovery is a subset focused on restoring systems, data, facilities, and operations.

10. A — Sales contests are not a core continuity procedure. BCPs focus on operations, client protection, records, communications, vendors, and regulatory obligations.

11. D — Succession planning should identify who can act if key personnel die or become unavailable, including communicating with custodians and clients.

12. C — The BCP is designed to minimize service disruption and client harm, including communication failures, inaccessible records, and interrupted access to account service.

Glossary

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529 plan. A tax-advantaged education savings program sponsored by a state or eligible educational institution under Section 529 of the Internal Revenue Code.

A

Accredited investor. An investor that meets specified financial, professional, or institutional criteria under securities law and therefore may participate in certain private offerings.

Agent. An individual who represents a broker-dealer or, in certain circumstances, an issuer in effecting or attempting to effect securities transactions.

Alpha. Return above or below what would be expected for the level of risk taken, commonly measured relative to CAPM or a benchmark.

Alternative minimum tax (AMT). A parallel tax system that may affect some private activity bond interest.

Annuity. A series of equal payments made at regular intervals.

Annuity due. An annuity with payments made at the beginning of each period.

Anti-money laundering (AML). Policies and controls designed to prevent, detect, and report the use of financial systems for money laundering, terrorist financing, and related illicit activity.

Appreciation. A rise in the value of a currency relative to another currency.

Asset-backed security. Security backed by a pool of loans or receivables.

Audited financial statements. Financial statements examined by an independent auditor, who expresses an opinion on whether they are fairly presented under the applicable accounting framework. An audit provides reasonable, not absolute, assurance.

Automatic stabilizers. Tax and spending mechanisms that change with the business cycle without a new vote, such as progressive income taxes or unemployment benefits.

B

Balance sheet. A point-in-time report showing assets, liabilities, and shareholders' equity.

Basis point. One one-hundredth of one percentage point; 100 basis points equals 1.00%.

Basis risk. The risk that a hedge does not move exactly opposite the exposure being hedged.

Behavioral finance. The study of how psychology affects financial decision-making.

Best execution. The obligation to use reasonable diligence to seek the most favorable terms reasonably available for a client or customer transaction, considering more than just explicit commission cost.

Beta. A measure of an investment's sensitivity to broad market movements. A beta above 1.0 implies greater market volatility than the market; a beta below 1.0 implies less.

Bid-ask spread. The difference between the highest price a buyer is willing to pay (bid) and the lowest price a seller is willing to accept (ask or offer).

Bond insurance. Credit enhancement in which an insurer promises scheduled principal and interest if the issuer defaults.

Book value. Accounting value of assets minus liabilities.

Book value per share. Common shareholders' equity divided by common shares outstanding.

Broker-dealer. A person or firm in the business of effecting securities transactions for others as a broker or buying and selling securities for its own account as a dealer.

Business continuity plan (BCP). A documented plan for maintaining or restoring critical business functions during and after a significant disruption.

Business cycle. Recurring expansion and contraction in broad economic activity.

C

C corporation. A corporation taxed separately from its shareholders.

Call option. An option giving the buyer the right to buy the underlying asset at the strike price.

Call risk. Risk that a bond is redeemed early, often when rates have fallen.

Capital Asset Pricing Model (CAPM). A model relating an asset's expected return to the risk-free rate, its beta, and the market risk premium.

Capital call. A demand by a private fund for investors to contribute a portion of their committed capital.

Capital controls. Government restrictions on the movement of money into or out of a country.

Capital market line (CML). The line showing risk-return combinations created by mixing the risk-free asset with the market or tangency portfolio under the assumptions of capital market theory.

Carried interest. A performance-based share of profits paid to the fund sponsor or manager, commonly associated with private equity and venture capital.

Cash flow. Money coming in and going out over a period; it shows savings capacity and liquidity pressure.

Churning. Excessive trading in a customer account, considering the account's objectives and circumstances, primarily to generate commissions or other transaction-based compensation.

Closed-end fund. A fund with a generally fixed number of shares that trade in the secondary market.

Coincident indicator. A data series that tends to move with the overall economy.

Commission. Transaction-based compensation commonly charged when a broker acts as agent for a customer trade.

Commodity. A basic good or raw material that is interchangeable with other goods of the same type, such as crude oil, wheat, copper, or gold.

Compounding. Earning returns on both the original principal and previously earned returns.

Conflict of interest. A circumstance in which an adviser's, representative's, or firm's interests could influence advice, recommendations, execution, or other conduct involving a client.

Consumer Price Index (CPI). A price index measuring changes in the cost of a basket of consumer goods and services.

Contraction. A period when economic activity declines; a recession is a broad, significant contraction lasting more than a few months.

Contractionary policy. Policy intended to slow economic activity or reduce inflationary pressure.

Core CPI. CPI excluding food and energy prices, often used to assess underlying inflation trends.

Cost basis. The amount used to calculate taxable gain or loss when an investment is sold.

Counterparty risk. The risk that the other party to a contract will fail to perform.

Coverdell Education Savings Account (ESA). A tax-advantaged account used for qualified education expenses, subject to contribution, income, and distribution rules.

Covered call. A call option sold against stock already owned by the investor.

Credit enhancement. Structural support designed to reduce loss risk for certain investors.

Credit risk. Risk that a borrower or issuer fails to meet promised payment obligations.

Credit spread. The additional yield above a benchmark Treasury that investors require for credit risk.

Cryptocurrency. A digital asset commonly designed to be transferred electronically, sometimes used as a medium of exchange or store of value.

Currency risk. The risk that exchange-rate changes will reduce the investor's return after converting back into the investor's home currency.

Currency valuation. Whether a currency is strengthening, weakening, overvalued, or undervalued relative to another currency or a basket of currencies.

Current yield. A bond's annual coupon interest divided by its current market price.

Custody. Holding client funds or securities, directly or indirectly, or having authority or legal control that permits possession or withdrawal of client assets.

Cybersecurity. The protection of systems, networks, devices, accounts, and data from unauthorized access, attack, disruption, theft, or misuse.

D

Debt restructuring. A renegotiation of debt terms, often involving maturity extensions, reduced interest payments, or reduced principal.

Defined benefit plan. A qualified retirement plan promising a specified retirement benefit, typically based on a formula involving compensation and service.

Defined contribution plan. A retirement plan in which contributions are allocated to individual accounts and the eventual benefit depends on contributions and investment performance.

Deflation. A sustained decrease in the general price level.

Depreciation. A decline in the value of a currency relative to another currency.

Derivative. A contract whose value is based on an underlying asset, index, rate, or commodity.

Digital asset. A digital representation of value recorded on a cryptographically secured distributed ledger or similar technology.

Disaster recovery. The technical and operational process of restoring systems, data, communications, facilities, and other resources after a disruption.

Discount. A closed-end fund market price below NAV.

Discounting. Finding what a future cash flow is worth today.

Discretion. Authority to decide securities, amounts, or timing for trades in a client account without obtaining specific client approval for each transaction, subject to the scope of the authorization.

Discretionary policy. Policy that requires active legislative, executive, or central bank action.

Disinflation. A decrease in the rate of inflation.

Diversification. The practice of spreading investments to reduce exposure to any single issuer, sector, or risk factor.

Dollar-cost averaging. Investing a fixed dollar amount at regular intervals regardless of market price, causing more shares to be bought when prices are lower and fewer when prices are higher.

Dollar-weighted return. A performance measure that reflects both investment performance and the timing and size of investor cash flows; it is equivalent to an internal rate of return on the account cash flows.

Donor-advised fund. A charitable giving account maintained by a sponsoring public charity in which a donor makes an irrevocable contribution and retains advisory privileges over future grants and investments.

Duty of care. The fiduciary obligation to provide advice based on a reasonable understanding of the client, seek best execution where applicable, and provide monitoring consistent with the agreed relationship.

Duty of loyalty. The fiduciary obligation not to place the adviser's interests ahead of the client's and to make full and fair disclosure of material conflicts so the client can provide informed consent where appropriate.

E

Earnings per share (EPS). The portion of company earnings attributable to each common share.

Efficient frontier. The set of portfolios offering the highest expected return for each level of risk, or the lowest risk for each expected return.

Efficient Market Hypothesis. The hypothesis that security prices reflect available information, making consistent risk-adjusted outperformance difficult.

Efficient Market Hypothesis (EMH). The hypothesis that security prices reflect information with varying degrees of completeness depending on the weak, semi-strong, or strong form.

ESG criteria. Environmental, social, and governance considerations used to include, exclude, or evaluate investments.

Estate. The property and obligations of a deceased person, managed by an executor or personal representative.

Eurobond. A bond issued outside the country whose currency is used.

Exchange rate. The price of one currency expressed in terms of another currency.

Exempt reporting adviser. An adviser exempt from full SEC registration that is nevertheless required to make certain reports on Form ADV, commonly because it advises only venture capital funds or private funds below specified thresholds.

Expansion. A period when economic activity is increasing.

Expansionary policy. Policy intended to stimulate economic activity, usually by increasing demand, lowering borrowing costs, or both.

Expiration date. The date on which an option or futures contract expires.

Extension risk. Risk that principal is returned later than expected.

F

Fama-French five-factor model. An asset-pricing model that adds profitability and investment factors to the market, size, and value factors.

Fama-French three-factor model. An asset-pricing model that extends market risk with size and value factors.

Federal covered adviser. An investment adviser registered with the SEC or otherwise covered by federal law so that states generally use notice filing rather than state adviser registration.

Federal funds rate. The overnight rate at which depository institutions lend reserve balances to one another; it is the Fed's primary short-term policy rate target.

Fiduciary. A person or organization required to act in another party's best interest.

Fiduciary duty. The obligation of an investment adviser to act in the client's best interest and satisfy duties of care and loyalty within the scope of the advisory relationship.

Financial goal. A desired financial outcome, such as retirement income, education funding, wealth accumulation, home purchase, or capital preservation.

Financial reports. Company documents that summarize financial performance, financial position, cash flows, and disclosures.

Financial risk. Risk arising from leverage, liquidity pressure, or financial weakness.

Finder. A person whose limited role is to introduce potential investors and issuers or other deal parties. Activity beyond introductions can trigger broker-dealer or other registration issues.

Fiscal policy. Government decisions about taxation, spending, transfer payments, deficits, and borrowing.

Flat yield curve. A curve where short-term and long-term yields are similar.

Foreign corporate debt. Debt issued by a corporation organized outside the United States.

Foreign-issued bond. A debt security issued by a non-U.S. government or corporation.

Form 10-K. The annual report filed with the SEC by public companies.

Form 10-Q. The quarterly report filed with the SEC by public companies.

Form 8-K. A current report filed with the SEC to disclose important events.

Form ADV. The uniform form used by investment advisers to register with the SEC or states and to disclose information about the advisory business, ownership, conflicts, fees, and disciplinary history.

Form U4. The Uniform Application for Securities Industry Registration or Transfer used for individuals such as investment adviser representatives and broker-dealer agents.

Form U5. The Uniform Termination Notice for Securities Industry Registration used to report the end of an individual's registration with a firm and required related information.

Forward pricing. Pricing fund orders at the next calculated NAV after the order is received.

Foundation or charity. An organization that invests assets to support a charitable, religious, educational, or similar mission.

Front-running. Trading for a personal or proprietary account ahead of a known client order or other transaction in order to benefit from the expected market impact.

Full faith and credit. The backing of the U.S. government for Treasury obligations.

Future value (FV). The amount an investment may grow to at a future date.

Futures contract. A standardized contract obligating parties to buy or sell an asset or settle the price difference in the future.

G

General obligation bond. Muni backed by the issuer's full faith and credit and taxing power.

General partnership. A business association in which partners usually share management, profits, losses, and personal liability.

Geopolitical risk. Risk that political instability, war, sanctions, elections, policy changes, or international conflict will affect markets.

Global factors. Economic, financial, political, and currency forces outside a single domestic market that can affect investment returns.

Global minimum variance portfolio. The portfolio on the feasible set with the lowest possible variance or standard deviation.

Gross Domestic Product (GDP). The market value of final goods and services produced within a country during a period.

H

Hard-currency debt. Debt issued in a major external currency, such as the U.S. dollar or euro, rather than the issuer's local currency.

Headline CPI. CPI including food and energy prices.

Health Savings Account (HSA). A tax-advantaged account available to eligible individuals covered by a qualifying high-deductible health plan, with tax benefits for contributions, growth, and qualified medical distributions.

Hedged foreign investment. An international investment that uses currency hedges to reduce or offset currency exposure.

High-frequency trading. Automated trading that uses high-speed systems and algorithms to submit, modify, and cancel large numbers of orders over very short time intervals.

Holding period return. The total return earned over the period an investment is held, including income and price change relative to beginning value.

Home-currency return. The return experienced by the investor after translating the local-currency return into the investor's own currency.

I

Income statement. A period-of-time report showing revenues, expenses, gains, losses, and net income.

Income-related monthly adjustment amount (IRMAA). An income-based surcharge added to Medicare Part B and Part D premiums for beneficiaries whose modified adjusted gross income exceeds specified thresholds.

Inflation. A sustained increase in the general price level of goods and services.

Inflation risk. The risk that inflation will erode an investment's purchasing power.

Initial holdings report. A code-of-ethics report in which an access person discloses required securities holdings shortly after becoming subject to the reporting requirement.

Interest rate. The cost of borrowing money or the return earned for lending money.

Interest rate / required return (r). The rate used to compound money forward or discount future cash flows back to today.

Interest rate risk. Risk that changes in market interest rates will affect security prices, especially bonds.

Inverse strategy. An investment approach designed to move in the opposite direction of a specified benchmark, often through derivatives or inverse funds.

Inverted yield curve. A downward-sloping curve where short-term yields are higher than long-term yields.

Investment adviser. A person or firm that, for compensation, is in the business of providing advice about securities, subject to applicable exclusions and exemptions.

Investment adviser representative (IAR). An individual who represents an investment adviser and performs advisory, solicitation, supervisory, or other functions that require registration under applicable state law.

Investment contract. A securities-law concept often analyzed under Howey: investment of money, common enterprise, and expectation of profits from the efforts of others.

Investment objective. The primary result the client wants from the portfolio, commonly income, growth, preservation, liquidity, or a combination.

Investment policy statement. A written statement of objectives, constraints, roles, and portfolio guidelines for an account.

Investment policy statement (IPS). A written statement describing an investment portfolio's objectives, constraints, risk parameters, asset-allocation guidelines, and governance or monitoring procedures.

Issuer. A legal entity that issues or proposes to issue a security, such as a corporation, government, partnership, or other organization.

Issuer agent. An individual who represents an issuer in effecting or attempting to effect transactions in the issuer's securities, subject to exclusions and registration rules.

Issuer-specific risk. Risk tied to one particular company, bond issuer, or security.

J

J-curve. A private equity return pattern in which early returns may be negative before later gains emerge.

Joint tenants with right of survivorship (JTWROS). A form of joint ownership in which each owner has an undivided interest and a deceased owner's interest generally passes automatically to the surviving joint owner or owners.

L

Labor force participation rate. The percentage of the working-age population that is employed or actively seeking work.

Lagging indicator. A data series that tends to move after the economy has already changed direction.

Leading indicator. A data series that tends to move before the overall economy.

Legal/regulatory risk. Risk from lawsuits, enforcement actions, or regulatory changes.

Leverage. The use of a smaller amount of capital to control a larger economic exposure.

Limited partnership. A partnership with at least one general partner and one or more limited partners.

Liquidity need. The need to have cash or near-cash assets available for expected or unexpected uses.

Liquidity risk. Risk that a bond cannot be sold quickly at a fair price.

LLC. A limited liability company; a flexible business entity that separates the business from its owners.

Local-currency debt. Debt denominated in the issuer's local currency.

Local-currency return. The return earned in the currency of the country where the investment is denominated.

Lockup. A period during which investors cannot redeem or withdraw capital.

Loss aversion. The tendency to feel the pain of losses more strongly than the satisfaction of similar gains.

M

Margin. Collateral required to support certain derivative positions.

Markdown. The amount deducted from the prevailing market price when a dealer buys a security from a customer as principal.

Market manipulation. Intentional conduct designed to deceive investors or artificially affect market price, volume, supply, or demand.

Market risk premium. The extra return investors expect for taking market risk instead of holding the risk-free asset.

Marking the close. Manipulative trading near the end of a trading session intended to influence a security's closing price.

Markup. The amount added to a dealer's cost or prevailing market price when the dealer sells a security to a customer as principal.

Matched orders. Coordinated buy and sell orders of substantially the same size, price, and time that are intended to create a false appearance of market activity.

Modern Portfolio Theory (MPT). A framework for constructing portfolios by considering expected return, variance, covariance, and diversification to identify efficient risk-return combinations.

Monetary policy. Central bank actions and communications that influence short-term interest rates, credit conditions, money, and overall financial conditions.

Municipal bond. Debt issued by a state or local government or public authority.

Mutual fund. A pooled investment company that invests money from many investors in a portfolio of securities.

N

Natural person. An individual human client, either acting alone or jointly with another person.

Net asset value (NAV). Fund assets minus liabilities divided by shares outstanding.

Net worth. Assets minus liabilities.

NFT. A non-fungible token representing a unique or non-interchangeable digital item, right, or collectible.

Nominal GDP. GDP measured in current dollars without removing inflation.

Nominal rate. The stated interest rate before adjusting for inflation.

Nominal return. The stated investment return before adjusting for inflation.

Nonfarm payrolls. A monthly measure of jobs added or lost, excluding farm workers and selected other categories.

Nonpublic personal information (NPI). Personally identifiable financial information about a consumer that is not publicly available and is protected by privacy and safeguarding requirements.

Normal yield curve. An upward-sloping curve where longer maturities generally have higher yields than shorter maturities.

Notice filing. A state filing made by a federal covered adviser, typically involving Form ADV information, consent to service of process, and state fees; it is not state registration of the adviser.

Number of periods (n). The number of compounding or discounting periods.

O

Open market operations. Purchases or sales of securities by the Federal Reserve to support its policy rate target and liquidity conditions.

Open-end fund. A fund that continuously offers and redeems shares at NAV.

Outside securities account. A brokerage or securities account maintained away from the person's employing firm and subject to applicable notice, consent, and monitoring requirements.

Overconfidence. The tendency to overestimate knowledge, forecasting ability, or control over outcomes.

P

P/B ratio. Market price per share divided by book value per share.

P/E ratio. Market price per share divided by earnings per share.

Pay-to-play rule. Rules restricting investment adviser political contributions and solicitation activity that could improperly influence the award of government advisory business.

Payable on death (POD). A beneficiary designation commonly used for bank accounts that transfers the account to a named beneficiary at the owner's death, outside probate when valid.

Payment (PMT). A recurring cash flow, such as a mortgage payment, bond coupon, or retirement contribution.

Payment for order flow. Compensation or another economic benefit received by a broker-dealer for routing customer orders to a particular market center or liquidity provider.

Peak. The high point of activity before a downturn begins.

Pension. Employer-provided retirement benefit, often paid as a lifetime income stream or sometimes offered as a lump sum.

Per stirpes. A beneficiary distribution method under which a deceased beneficiary's share passes down that beneficiary's family branch to descendants.

Performance-based fee. Advisory compensation based on investment performance, generally permitted only when applicable regulatory conditions and client eligibility requirements are satisfied.

Personal securities transaction. A securities transaction in which an access person has a direct or indirect beneficial interest, subject to the firm's code-of-ethics and reporting requirements.

Policy lag. The delay between recognizing an economic problem, implementing a policy response, and seeing the economic effect.

Political contribution. A contribution to an official, candidate, political party, or related political organization that can create pay-to-play compliance obligations for advisers and covered associates.

Pre-clearance. A compliance requirement that certain transactions or activities receive approval before they occur, commonly used for employee securities trades and political contributions.

Precious metal. A commodity metal valued for scarcity, durability, industrial use, or monetary/investment demand. Common examples include gold, silver, platinum, and palladium.

Premium. A closed-end fund market price above NAV.

Prepayment risk. Risk that principal is returned earlier than expected.

Present value (PV). The value today of a future cash flow or series of cash flows.

Private fund. A pooled investment vehicle offered privately rather than broadly to the public through a registered public offering.

Prohibited transaction. A transaction involving a retirement plan or IRA that is barred because of conflicts, self-dealing, misuse of plan assets, or dealings with disqualified persons, subject to exemptions.

Protective put. A put option purchased to help protect an existing long position from downside risk.

Purchasing power. The amount of goods and services money can buy.

Put option. An option giving the buyer the right to sell the underlying asset at the strike price.

Q

Qualified client. A client meeting Investment Advisers Act standards that permit an adviser to charge performance-based compensation; current dollar thresholds are adjusted periodically.

Qualified custodian. A regulated financial institution permitted to hold client funds or securities under custody rules, such as certain banks, registered broker-dealers, and other qualifying institutions.

Qualified default investment alternative (QDIA). A retirement-plan investment that can receive certain fiduciary protections when participant assets are invested by default and applicable requirements are satisfied.

Qualified domestic relations order (QDRO). A domestic-relations order that meets federal requirements and assigns some or all of a qualified retirement plan participant's benefits to an alternate payee.

Qualified opinion. An audit opinion with an exception or limitation; the auditor has a specific reservation.

Qualified purchaser. A higher private-fund eligibility category based largely on investment assets, commonly associated with Section 3(c)(7) private funds.

Quarterly transaction report. A periodic code-of-ethics report identifying required personal securities transactions during the quarter, subject to applicable exceptions.

Questionnaire. A structured tool used to collect client data and document preferences, constraints, and risk profile.

R

Real GDP. GDP adjusted for inflation; used to evaluate actual output growth.

Real rate. The inflation-adjusted rate; approximately nominal rate minus inflation rate.

Real return. The return after adjusting for inflation.

Recency bias. The tendency to overemphasize recent events when making investment decisions.

Redemption. Selling shares back to the fund, common with open-end mutual funds.

Regulation S-P. The SEC privacy rule governing notices, safeguarding of customer information, and related requirements for covered financial institutions.

Religious criteria. Faith-based investment screens or objectives, such as avoiding certain industries or favoring specific stewardship principles.

Required minimum distribution (RMD). A minimum amount that must generally be distributed each year from specified retirement accounts after the account owner reaches the applicable starting age, subject to current law.

Restricted list. A compliance list of securities in which employee or proprietary trading is prohibited or limited because the firm may possess material nonpublic information or face another conflict.

Revenue bond. Muni backed by a specific revenue source rather than broad taxing power.

Risk capacity. The client's financial ability to absorb loss without jeopardizing required goals or obligations.

Risk need. The amount of risk that may be necessary to pursue a stated return or goal.

Risk tolerance. The client's willingness to accept volatility and potential loss.

Risk-adjusted return. Return evaluated relative to the amount or type of risk taken, using measures such as the Sharpe ratio, alpha, or other risk-adjusted comparisons.

Risk-free rate. A benchmark rate often represented by U.S. Treasury securities of a comparable maturity.

Roll yield. The gain or loss created when a futures-based strategy replaces an expiring contract with a later-dated contract.

Roth IRA. An individual retirement account funded with after-tax dollars in which qualified distributions are generally tax-free and original owners are generally not subject to lifetime RMDs.

S

S corporation. A corporation that generally passes income, deductions, and credits through to shareholders and is subject to eligibility restrictions.

Sector risk. Risk from concentration in a particular industry or sector.

Sector rotation. Shifting portfolio exposure among economic sectors in response to expected changes in the business cycle, valuations, or other market conditions.

Securitization. Process of pooling financial assets and issuing securities backed by their cash flows.

Selling away. A registered person's participation in a securities transaction outside the regular scope of the employing broker-dealer without the required notice and approval.

Semi-strong-form efficiency. The form of EMH stating that current prices reflect all publicly available information.

SEP IRA. A simplified employee pension arrangement funded by employer contributions to employees' IRAs, commonly used by self-employed individuals and small businesses.

SIMPLE IRA. A retirement arrangement for eligible small employers that permits employee salary-reduction contributions and requires specified employer contributions.

Social Security. Government retirement, survivor, or disability benefit that may provide a base layer of retirement income.

Soft dollars. Research or brokerage products and services obtained with client commissions under conditions that must be consistent with applicable law and the adviser's fiduciary obligations.

Sole proprietorship. A business owned by one person that is not legally separate from the owner.

Solo 401(k). A 401(k) plan designed for an owner-only business with no eligible non-spouse employees, allowing the owner to contribute in employee and employer capacities subject to limits.

Sovereign debt. Debt issued by a national government.

Sovereign default. A failure by a national government to make promised payments on its debt.

Sovereign risk. The risk that a government issuer defaults, restructures, or takes actions that hurt investors.

Spoofing. Placing orders with the intent to cancel them before execution in order to create a false impression of supply, demand, or market depth.

Spot price. The current market price for immediate purchase or sale of a commodity.

Stablecoin. A digital asset designed to maintain value relative to a reference asset, such as the U.S. dollar.

State securities Administrator. The state official or agency charged with administering and enforcing the state securities law.

Statement of cash flows. A period-of-time report explaining cash from operating, investing, and financing activities.

Strategic asset allocation. A long-term target mix of asset classes designed to match a client's objectives, risk tolerance, and constraints.

Strike price. The price at which the option may be exercised.

Strong U.S. dollar. A dollar that buys more foreign currency or foreign goods than before.

Strong-form efficiency. The theoretical form of EMH stating that prices reflect all public and private information.

Succession planning. Planning for the orderly continuation, transfer, or wind-down of an advisory business when an owner or key person dies, becomes disabled, retires, or otherwise becomes unavailable.

Systematic risk. Market-wide or broad economic risk that cannot be eliminated through diversification.

T

Tactical asset allocation. Temporary deviations from a strategic target allocation based on shorter-term market views or valuation judgments.

Tax-deferred account. An account in which taxes are generally delayed until withdrawal, such as a traditional IRA or 401(k).

Tax-equivalent yield. The taxable yield needed to equal a tax-exempt yield after taxes.

Tax-free account. An account in which qualified withdrawals are generally not taxable, such as a Roth IRA.

Tenancy by the entirety (TBE). A form of ownership available in some states to married couples, generally including survivorship rights and special creditor protections under state law.

Tenants in common (TIC). A form of co-ownership in which each owner has a divisible interest that generally passes through the owner's estate rather than automatically to the other co-owners.

Time horizon. The length of time until invested assets are expected to be used for a goal.

Time-weighted return. A performance measure that geometrically links subperiod returns and minimizes the effect of external cash-flow timing.

TIPS. Treasury Inflation-Protected Securities; principal adjusts with CPI.

Trade deficit. A situation in which a country imports more goods and services than it exports.

Trading authorization. Client permission allowing another person to place trades in the account within the authority granted. Trading authority is distinct from authority to withdraw or transfer client assets.

Traditional IRA. An individual retirement account in which eligible contributions may be deductible and distributions of pretax amounts and earnings are generally taxable.

Tranche. Class of securities within a securitization with a particular priority and risk profile.

Transfer on death (TOD). A beneficiary registration that transfers specified securities or other eligible property to a named beneficiary at the owner's death, outside probate when valid.

Treasury bill. Short-term Treasury security usually sold at a discount and redeemed at face value.

Treasury bond. Long-term Treasury security that pays periodic interest.

Treasury note. Intermediate-term Treasury security that pays periodic interest.

Trough. The low point before recovery begins.

Trust. A legal arrangement in which a trustee holds or manages property for one or more beneficiaries according to the trust terms.

U

Unaudited financial statements. Financial statements that have not been subjected to a full independent audit. They may still be prepared using recognized accounting standards, but they do not carry an audit opinion.

Unemployment rate. The percentage of the labor force that is unemployed and actively seeking work.

Unhedged foreign investment. An international investment where the investor remains exposed to currency movements.

Uniform Gifts to Minors Act (UGMA). A state-law framework allowing certain financial assets to be transferred irrevocably to a custodian for a minor; many states now use the broader UTMA framework.

Uniform Transfers to Minors Act (UTMA). A state-law framework allowing irrevocable transfers of property to a custodian for the benefit of a minor until the custodianship ends under state law.

Unqualified opinion. A clean audit opinion indicating the financial statements are fairly presented in accordance with the applicable accounting framework.

Unsystematic risk. Issuer-specific or security-specific risk that can usually be reduced through diversification.

V

Valuation multiple. A ratio that compares market price with a financial measure such as earnings or book value.

Vulnerable adult. An adult who may be at increased risk of financial exploitation because of age, disability, cognitive impairment, dependency, or similar circumstances, as defined under applicable law.

W

Warrant. A company-issued right to buy the company's stock at a specified price.

Wash trade. A transaction or series of transactions that creates the appearance of trading activity without a genuine change in beneficial ownership, often used as a form of market manipulation. It is different from the tax wash-sale rule.

Weak U.S. dollar. A dollar that buys less foreign currency or foreign goods than before.

Weak-form efficiency. The form of EMH stating that current prices reflect past market prices, returns, and trading-volume information.

Will. A legal document directing the disposition of probate property and addressing other estate matters at death; it generally does not override valid beneficiary designations, survivorship ownership, or trust ownership.

Y

Yankee bond. A U.S.-dollar bond issued in the United States by a foreign issuer.

Yield curve. A graph of interest rates by maturity for bonds of similar credit quality, often Treasury securities.