

Test Alert!
to Accompany the 2nd Edition LEM

3/7/08

series **65**

The information included in this release, in addition to your other Kaplan Financial materials, is designed to assist you in preparing for concepts that your exam may include. We urge you to read it carefully and take time to review the sample questions and rationales.

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KAPLAN FINANCIAL

Introduction

The information in this *TestAlert!* is intended to update Kaplan Financial's Series 65 License Exam Manual, 2nd Edition to match the newly published 3rd edition. In addition to Take Note callouts, which highlight special or unusual information and amplify important points, you will also see Quick Quizzes, which will help ensure that you understand and retain the material covered in that particular section. Quick Quizzes are a quick interactive review of what you just read. Answers to Quick Quizzes appear at the end of this *TestAlert!*.

Changes to the LEM:

- Material has been updated to reflect the decision on March 30, 2007 by the US Court of Appeals for the District of Columbia overturning the Merrill Lynch Rule
- Added limited registration requirements for Canadian broker/dealers and agents
- Expanded coverage on NASAA's bonding and net worth requirements
- Material has been updated to reflect the May 24, 2007 announcement by the SEC that Nasdaq Capital Market securities are now federal covered
- Expanded coverage on NASAA's recordkeeping requirements
- Amended the discussion of short sales to reflect the removal of the plus tick requirement
- Added coverage of inherited IRAs
- Updated retirement plans for 2007 limits
- Added a TAKE NOTE relating to future allowability of 401(k) rollovers into Roth IRAs
- Complete revision to Unit 10 expanding our coverage of economics and analysis
- Extensive additions to the Glossary of Terms

The following pages will address key issues that have been added to the material.

Page 9 After the 3 bullets, DELETE this entire statement:

The red herring prospectus does not contain such information as the final public offering price, the underwriter's spread, or the date of the due diligence meeting.

Replace it with:

Under no circumstances may a broker/dealer or one of its agents accept money or orders prior to the effective date.

Page 33 Replace the TEST TOPIC ALERT with this one:

TAKE NOTE

An **affiliated person** is defined as any person directly or indirectly owning, controlling, or holding with power to vote, 5% or more of the outstanding shares of the investment company. An affiliated person also includes any person directly or indirectly controlling, controlled by, or under common control with the investment company or any officer, director, partner, or employee of the investment company. However, while technically considered an affiliated person, no person is deemed to be an "interested person" for purposes of the maximum percentage of interested persons on the board solely by reason of his being a member of the fund's board of directors or an owner of its securities. A person is deemed to be a control person when owning or controlling more than 25% of the outstanding shares.

Page 59 Prior to Quick Quiz 2.3, add the following text:

Limited Registration of Canadian Broker/Dealers and Agents

Provided the limited registration requirements enumerated below are met, a broker/dealer domiciled in Canada that has no office in this state may effect transactions in securities with or for, or attempt to induce the purchase or sale of any security by:

- a person from Canada who is temporarily a resident in this state and who was already a client of the broker/dealer; or
- a person from Canada who is a resident in this state and whose transaction is in a self-directed tax advantaged retirement plan in Canada of which the person is the holder or contributor.

An agent who will be representing a Canadian broker/dealer who registers under these provisions may effect transactions in securities in this state on the same basis as permitted for the broker/dealer.

In order for the Canadian broker/dealer to register in this fashion, it must:

- file an application in the form required by the jurisdiction where it has its principal office in Canada;
- file a consent to service of process;
- provide evidence that it is registered in good standing in its home jurisdiction; and
- be a member of an SRO or stock exchange in Canada.

Requirements for agents are the same except that membership in an SRO or stock exchange is not relevant.

However, just as with domestic broker/dealers, if there is no place of business in the state, there are no registration requirements if the only securities transactions are with issuers, other broker/dealers, and institutional clients.

TAKE NOTE

Renewal applications for Canadian broker/dealers and agents who file for limited registration must be filed before December 1 each year.

Page 69 Replace the TAKE NOTE with this one:

TAKE NOTE

Effective July 3, 2006, Nasdaq renamed the Nasdaq National Market as the Nasdaq Global Market. In addition, they created an even higher tier known as the Nasdaq Global Select Market. On May 24, 2007, the SEC added Nasdaq Capital Market securities to the list of federal covered securities. The effect of these changes is that any security included any Nasdaq listing is considered to be federal covered.

Page 70 Replace the TAKE NOTE at the top of the page with:

TAKE NOTE

States can require the registration of the securities of public offerings by nonbank, nongovernment issuers whose issues are traded in uncovered marketplaces such as the *Pink Sheets* or the OTC Bulletin Board. Notwithstanding the preemptive provisions of the NSMIA, state securities Administrators may require certain issuers whose securities are not traded on SEC-registered exchanges or the Nasdaq Stock Market to file copies of those documents filed with the SEC for notice purposes.

QUICK QUIZ 2.6

3. A federal covered security would include a common stock listed for trading in any of the following markets EXCEPT
- the American Stock Exchange
 - the OTC-Bulletin Board
 - the Nasdaq Global Select Market
 - the New York Stock Exchange

Page 71 Just prior to Coordination, add:

TEST TOPIC ALERT

Prior to the initial offer of any federal covered security in this state, the Administrator, by rule or order, may require the filing of all documents that are part of a federal registration statement filed with the US Securities and Exchange Commission under the Securities Act of 1933, together with a consent to service of process signed by the issuer.

Page 74 Add a new sentence at the end of the Take Note.

TAKE NOTE

A promissory note (commercial paper), draft, bill of exchange, or banker's acceptance that matures within nine months is issued in denominations of at least \$50,000 and receives one of the three highest ratings by a nationally recognized rating agency is exempt from registration requirements. Please note that this is the only case where a security's rating is part of the registration or exemption under the Uniform Securities Act.

Page 75 Add a new sentence at the end of this bullet.

- Bankruptcy, guardian, or conservator transactions. Transactions by an executor, administrator, sheriff, or trustee in bankruptcy are exempt transactions. Please note that a Custodian under UTMA or UGMA is not included in this list

Page 129 Replace the 2nd TAKE NOTE on the page with this one:

TAKE NOTE

In 2005, the SEC issued Rule 202(a)(11)-1 to the Investment Advisers Act of 1940. This rule (known in the industry as the Merrill Lynch Rule) modified the broker/dealer exclusion from the definition of investment adviser. On March 30, 2007, the US Court of Appeals for the District of Columbia Circuit overturned the rule so it is unlikely that there will be questions dealing with it on your exam.

Basically, special compensation is no longer the sole criterion of whether a broker/dealer is acting as an adviser. Any broker/dealer maintaining discretionary accounts is deemed to be acting as an adviser and, unless otherwise exempt, would have to register. In almost any case, a broker/dealer providing comprehensive financial planning service will be deemed an investment adviser.

Page 138 Replace the TAKE NOTE at the top of the page with this one:

TAKE NOTE

Because the USA is only a template, some states have higher net worth or bonding requirements. The exam may want you to know that if an IA meets the net worth or surety bonding requirements of the state where its principal office is located, that is sufficient in any other state in which it may be registered.

Page 145 Add this Test Topic Alert following the first paragraph on the page

TAKE NOTE

Because the Uniform Securities Act is only a template, some states have more stringent recordkeeping requirements than others. The exam will want you to know that as long as the investment adviser complies with the requirements of the state in which its principal office is located, it will not have to meet the requirements of any other state.

QUICK QUIZ 3.9

2. A nonfederal covered investment adviser whose principal office is located in State A is also registered in States B and C. The IA maintains custody of client funds and securities. Which of the following statements are CORRECT?
- I. The IA must meet the net worth requirements of State A regardless of the requirements of State B or State C.
 - II. The IA must meet the highest net worth requirements of States A, B, or C.
 - III. The IA must keep records in accordance with the requirements of State A, regardless of the requirements of State B or State C.
 - IV. The IA must keep records in accordance with the requirements of each state in which it is registered.
- A. I and III
 - B. I and IV
 - C. II and III
 - D. II and IV

Page 154 Add this “bullet” just ahead of Quick Quiz 3.12

- Any material legal action against the adviser must be disclosed to existing clients promptly. If the action occurred within the past 20 years, it must be disclosed to prospective clients not less than 48 hours before entering into the contract, or no later than the time of entering into such contract if the client has the right to terminate the contract without penalty within five business days.

Page 193/224

Change option III to read as follows:

2. Among the benefits of owning common stock are
 - I. it has historically been a hedge against inflation
 - II. voting rights
 - III. that as owners, they have access to corporate earnings prior to the general public
 - IV. dividends

Change rationale to: One does not have access to insider information solely due to becoming a shareholder. Even if one did receive material nonpublic information, such as prior access to earnings, no benefit may be received from that information. All of the other choices....

2. **B.** One does not have access to insider information solely due to becoming a shareholder. Even if one did receive material nonpublic information, such as prior access to earnings, no benefit may be received from that information. All of the other choices are among the reasons to purchase common stock.

Page 223 Question #15 – Key should say:

15. **A.** CMOs generally carry AAA or AA ratings and thus have little credit risk.

Instead of:

15. **A.** A bond that is callable has a provision that the issuer, at its option, may redeem that bond at a specified price known as the *call or redemption price*.

Page 224 Change Quick Quiz 4.2 # 4 from B to A

4. **A.**

Page 253 Follow the third bullet (limited liability) with:

The exam will probably give more attention to the disadvantages which include:

Liquidity Risk. The greatest disadvantage is lack of liquidity. Because the secondary market for DPPs is limited, investors who want to sell their interests frequently cannot locate buyers.

Legislative Risk. When Congress changes tax laws, new rules can cause substantial damage to LPs, who may be locked into illiquid investments that lose previously assumed tax advantages.

Risk of Audit. Statistics from the IRS indicate that reporting ownership of a DPP results in a significantly higher percentage of returns selected for audit.

Page 282 Update for Plus Tick rule elimination

Replace the following:

Sometimes limit orders are not executed even if a limit price is met. Two possible explanations for this are stock ahead and plus tick situations.

with this text:

Sometimes limit orders are not executed even if the price limit is met. The most common explanation for this is that orders were placed on the specialist's book prior to yours. This is known as stock ahead.

Delete this entire bullet:

- **Plus (up) tick.** Limit orders to sell short may be executed only on plus ticks or zero-plus ticks. Thus, even if a trade occurs on the NYSE at the limit order price, a limit order to sell short might not be executed because a plus tick did not occur.

Page 283 Plus Tick Rule: delete this entire entry*Exchange Short Sale Rules*

SEC and exchange plus tick rules operate to block a short seller from flooding orders into a declining market to drive a stock's price lower. An order to sell a listed security short may be executed on either a plus tick or a zero-plus tick. A plus tick is a price higher than the last different price—for instance, from 30 to 30.04.

A zero-plus tick occurs when the last trade for the security was made at the same price as the trade before, but that trade was higher than the previous trade.

EXAMPLE

A trade at 30.04, after a trade at 30 is a plus tick; if the next trade is also at 30.04, it is a zero-plus tick.

Page 285 Plus Tick Rule

Delete this question.

5. Which of the following statements regarding the short sale rule is TRUE?
- A. A security cannot be sold short in the OTC market because the bid price is always lower than the offering price.
 - B. A short sale can take place if the previous sale of the security was a downtick.
 - C. A short sale cannot take place in the OTC market if the spread has widened from the last previous sale.
 - D. A short sale on a listed security can take place on a plus tick or a zero-plus tick.

Page 286 Plus Tick Rule

Delete this rationale.

5. **D.** A short sale on a listed security can take place on a plus tick or a zero-plus tick. A plus tick is a price higher than the last different price, and a zero-plus tick occurs when the trade for the security was made at the same price as the trade before, but is higher than the last different priced trade.

Page 296 Add the following two TAKE NOTE items prior to the example

TAKE NOTE

Rollovers by nonspouse beneficiaries of certain retirement plan distributions.

Effective January 1, 2007, the Pension Protection Act of 2006 amends the Internal Revenue Code of 1986 to allow nonspouse beneficiaries to roll over qualified retirement plan distributions to an inherited traditional IRA. Using the term rollover may be confusing because these distributions must be made via direct trustee-to-trustee transfer, and any checks made out to the beneficiary are not eligible for rollover. The IRA must be set up as inherited IRA, with minimum distributions taken under the rules that apply to beneficiaries. It is possible that this will be tested on your exam.

TAKE NOTE

Direct rollovers from retirement plans to Roth IRAs.

Effective January 1, 2008, the Pension Protection Act of 2006 amends the Internal Revenue Code of 1986 to allow rollovers from qualified retirement plans directly to Roth IRAs, providing the client meets the requirements from converting a traditional IRA to a Roth IRA. The two main requirements are that the client must report the amount converted as income in the year of the conversion (or rollover) and have modified adjusted gross income of less than \$100,000 not counting the amount converted. We do not expect this to be tested until the middle of 2008.

Page 311 Should say:

Investment Policy Statement

While not specifically mandated under ERISA, it is strongly suggested that each employee benefit plan have an investment policy statement, preferably in writing, that serves as a guideline for the plan's fiduciary regarding funding and investment management decisions. Investment policy statements address the specific needs of the plan.

Page 388-91 Add this example after Gross Domestic Product (GDP)

EXAMPLE

A US-based firm assembles electronic equipment using parts imported from Singapore. Its income statement looks like this:

Sales	\$60,000,000
Expenses	46,000,000
Wages	30,000,000
Parts	16,000,000
Net Income	14,000,000

What is this firm's contribution to the US GDP?

- A. \$14 million
- B. \$30 million
- C. \$44 million
- D. \$60 million

Answer: C. The question is how we measure this firm's contribution to US output. The straightforward answer is \$60 million, the total value of its sales. But if we think about this a minute, we realize that \$16million of this was produced somewhere else, so it shouldn't be counted as part of the firm's or the US's output. A better answer is \$44 million, the amount of value the firm has added to the imported parts.

Answers to Quick Quizzes

Quick Quiz 2.6

3. **B** Stocks traded on the OTC-Bulletin Board are not considered federal covered securities.

Quick Quiz 3.9

2. **A** Under the Uniform Securities Act, a state registered investment adviser is required to meet the net worth and recordkeeping requirements of the state in which its principal office is located regardless of the requirements of any other state where it is also registered.

Errata

Page 34

Quick Quiz 1.10 – choice client’s orders should be clients’ orders

Page 80

The last bullet under withdrawal should be: the issue is subject to a court injunction

Page 84

Failure to State Material Facts – 2nd sentence should say:
...that could have an impact on the price of the security

Page 87

Analysis should read:
Analysis: Mr. Thompson has engaged in a prohibited practice because securities professionals may not borrow from customers who are not in the business of lending money.

Page 92

- “on a merger” should be “or a merger”
- class vote by stockholders, pursuant to the certificate of incorporation or the applicable corporation statute, or a merger, consolidation, reclassification of securities, or sale of corporate assets in consideration of the issuance of securities of another corporation; or

Page 104

Question #8
ABCD should be I, II, III and IV. EFGH should be ABCD

Page 133

Replace the italicized words with “as it is now excluded from”
Analysis: As a partnership in the business of managing money for individual clients, Charles & Goode falls within the definition of an investment adviser and must so register with the Illinois securities Administrator until it manages \$25 million or more in assets. However, with the addition of new clients as of the current year, Charles & Goode will be exempt from registration with Illinois, *although it still falls within* the definition of an investment adviser. Charles & Goode is now a federal covered adviser that must register with the SEC because it has crossed the threshold of \$30 million of assets under management.

Page 136

TEST TOPIC ALERT

Under the Investment Advisers Act of 1940 as well as NASAA’s Model Rule, any person that directly or indirectly has the right to vote more than 25% of the voting securities, or *is entitled more than 25%* of the profits, of an investment adviser is presumed to control that investment adviser.

Page 176 Question 8 – Key should be A, not C. Add the following to the rationale:

8. **A.** One of the criteria for using the term investment counsel is that the adviser's primary business is providing investment advice. It is always prohibited to make an untrue statement, whether the fact is material or not, and one can never imply government approval of one's abilities.

Page 356 Replace the italicized \$40,000 with \$400,000

TAKE NOTE

Geraldine invested \$25,000 in an S corporation, along with nine other investors who invested the same amount. Within a year, the corporation needed additional candy-making equipment, so Geraldine lent \$10,000 to the business from her own funds. Her basis is now \$35,000. If the corporation experiences a *\$400,000* loss, Geraldine's portion is \$40,000. However, she may deduct only \$35,000 of the loss because that is the amount of her basis.

Page 374

The correct number for the AGE is \$2,450,000 making the taxable estate \$450,000.

Unit 7

All Quick Quizzes in this section were mislabeled as 4.1, 4.2, etc., rather than 7.1, 7.2, etc. Please note that these quizzes should all reflect the correct unit number, 7.

D&P Errata

QID 41454 Key should be A

QID 29003 Key should be D

QID 50816 Revised wording

When referring to a federal covered investment adviser, all of the following are supervised persons EXCEPT

- A. an investment adviser representative
 - B. an investment adviser solicitor
 - C. the receptionist who works for the investment adviser and analyzes client financial profiles
 - D. the chief analyst
- B** All individuals working for an investment adviser who provide investment advice or management are considered supervised persons. Whether analyzing securities or customer profiles, one would be a supervised employee. Solicitors are not employees of the adviser and, therefore, under the Investment Advisers Act of 1940, the adviser is only required to make a bona fide effort to determine that the solicitor complies with the solicitor agreement. Please be careful because this is not so under the USA. That act considers solicitors supervised persons, whether employed by the adviser or not, and requires IAR registration.

QID 50004 Key should be B

QID 39408 Key should be D, (II and IV)

QID 37166 Revised choice B

An agent and a customer enter into a written agreement to share in the profits and losses of an account on a 50/50 basis. If the client invests \$6,000 and the agent invests \$4,000, this practice is

- A. a violation unless approved by a principal
 - B. a violation because the customer must receive 60% and the agent 40% of the profits or losses generated by the account
 - C. a violation unless the practice is approved by the state Administrator
 - D. permitted
- B** Sharing profits and losses in a customer's account is permitted if the profit and losses are shared in proportion to the amount invested. Since the client invested 60%, the client must receive 60% of the gains and losses. A 50/50 split would not be allowed in this case because provisions of the act cannot be waived by virtue of an agreement by the client and the agent, or by the approval of a principal of the firm.

QID 42465 Revised answer choices

Which of the following statements describes the powers of the Administrator over the issuance of orders?

- I. A final order may be appealed in the appropriate court within 60 days of the order being issued.
 - II. Appeal of a final order will act as a stay of the order unless a court of competent jurisdiction rules to the contrary.
 - III. No final order may be issued without the opportunity for a hearing.
 - IV. Final orders must receive approval from the state legislature.
- A. I and III
 - B. I and IV
 - C. II and III
 - D. II and IV
- A** Any final order of the Administrator may be appealed within 60 days of the order. The appeal does not act as a stay of the order. Only a court of competent jurisdiction may issue a stay of the order. Because the final order is similar to passing sentence, an opportunity for a hearing must be granted. The Administrator's orders are not related to the state legislature.

QID 50891 Key should be B

QID 39207 Key should be D

QID 50862 Question should say:

As defined in the Uniform Securities Act (USA), which of the following parties is not considered a person?

QID: B03_09180 Question should be worded as follows:

The term *churning* means

- I. switching a client's account from an income fund to a growth fund
 - II. excessively trading securities in the account of a client primarily for the purpose of generating commissions for the agent
 - III. trading unsuitable securities in a client's account
 - IV. a bond swap in a customer's account for tax benefits
- A. I and II
 - B. I and III
 - C. II only
 - D. II and IV
- C** *Churning* is conducting excessive transactions in a customer's account for the purpose of generating commissions and is prohibited.

To submit comments or suggestions, please send an email to errata@kaplan.com.

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www.kaplanfinancial.com
30 S. Wacker Drive, Ste. 2500, Chicago, IL 60606
800-824-8742