

TestAlert!

to Accompany the 2nd Edition LEM

2/29/08

series **66**

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 rationale.

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KAPLAN FINANCIAL

Changes to the 2nd Edition LEM

Changes to the LEM are as follows:

- Updated material to reflect the decision on March 30, 2007, by the US Court of Appeals for the District of Columbia overturning the Merrill Lynch Rule
- Expanded coverage on NASAA's bonding and net worth requirements
- Updated material 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
- Added coverage of inherited IRAs
- Updated retirement plans for 2007 limits
- Added a Take Note related to future allowability of 401(k) rollovers into Roth IRAs
- Expanded coverage of trusts
- Added coverage on TIPS
- Made extensive additions to the Glossary of Terms
- Added coverage of joint accounts

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

Page 9 After the three 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 the following sentence:

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

Page 33 Replace the TEST TOPIC ALERT with this one:

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 69 Replace the TAKE NOTE with this one:

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.

Quick Quiz 1

A federal covered security would include a common stock listed for trading in any of the following markets EXCEPT

- A. the American Stock Exchange
- B. the OTC Bulletin Board
- C. Nasdaq Global Select Market
- D. New York Stock Exchange

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

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:

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:

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 2

A non-federal 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 10 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 194 Add the following two TAKE NOTE items before the example:

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 an inherited IRA, with minimum distributions taken under the rules that apply to beneficiaries. It is possible that this will be tested on your exam.

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 for 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 203 Sentence should end: "...and vesting procedure no less frequently than annually."

- Communication. The retirement plan must be in writing, and employees must be kept informed of plan benefits, availability, account status, and vesting procedure no less frequently than annually.

Page 223 Add after Individual Accounts TAKE NOTE:

Joint Accounts

A **joint account** is owned by two or more adults, and each is allowed some form of control over the account.

In addition to the new account form, a **joint account agreement** must be signed, and the account must be designated as either tenants in common (TIC) or joint tenants with right of survivorship (JTWROS). Account forms for joint accounts require the signatures of all owners. Joint account agreements provide that any or all tenants may transact business in the accounts. Checks must be made payable to the names in which the account is registered and must be endorsed for deposit by all tenants, although mail need be sent only to a single address. To be in **good delivery form**, securities sold from a joint account must be signed by all tenants.

Tenants in Common (TIC)

TIC ownership provides that a deceased tenant's fractional interest in the account is retained by that tenant's estate and is not passed to the surviving tenant(s). Ownership of a TIC account may be divided unequally.

At the death of an account owner, that person's proportionate share of the cash and securities in the account is distributed according to the instructions in the decedent's will. If one account owner dies or is declared incompetent, all pending transactions and outstanding orders must be canceled immediately.

Example If a TIC agreement provides for 60% ownership interest by one owner and 40% ownership interest by the other, that fraction of the account would pass into the deceased owner's estate if he died. The TIC agreement may be used by more than two individuals.

Joint Tenants with Right of Survivorship (JTWROS)

JTWROS ownership stipulates that a deceased tenant's interest in the account passes to the surviving tenant(s). Regardless of contributions, each JTWROS account owner has an equal and undivided interest in the cash and securities in the account. Upon the death or declaration of incompetency of any or all of the account owners, account ownership passes to the survivor(s); a right of succession occurs and the other party becomes sole owner of the account.

Transfer-on-Death Accounts (TOD)

Using a transfer-on-death (TOD) account is the simplest way to keep assets held in brokerage accounts from becoming subject to probate upon a client's death. However, the TOD account does not avoid estate taxes if applicable. TOD accounts are available for most types of paper assets, such as savings and checking accounts in banks and credit unions, certificates of deposit, stocks, bonds, and other securities.

The owner, while alive, is the only person with rights to the property. Upon the owner's death, the property is immediately transferred to the named beneficiaries, usually without added cost. The owner has the right to change beneficiaries at any time.

A cautionary note regarding TOD accounts: the client's will does not control who inherits the assets, so without proper coordination, it could be very difficult to predict who would receive what share of the estate. The only types of accounts that may be opened with a TOD designation are individual accounts and JTWROS accounts.

TEST TOPIC ALERT Tenants in common can own unequal interests in the account, unlike joint tenants with right of survivorship, who always share equally.

TIC: interest can be unequal.

JTWROS: all parties must have equal interests.

Checks or distributions must be made payable in the account name and endorsed by all parties.

Quick Quiz 3

- A joint account that provides for the direct passage of account assets upon the death of one of the owners is registered
- A. joint tenants in common
 - B. joint tenants with right of survivorship
 - C. with a power of attorney
 - D. in the name of the donor

Quick Quiz 4

- One of the major attractions of opening a TOD account is that
- A. estate taxes are reduced
 - B. income taxes are reduced
 - C. probate costs are eliminated
 - D. transfer fees are waived

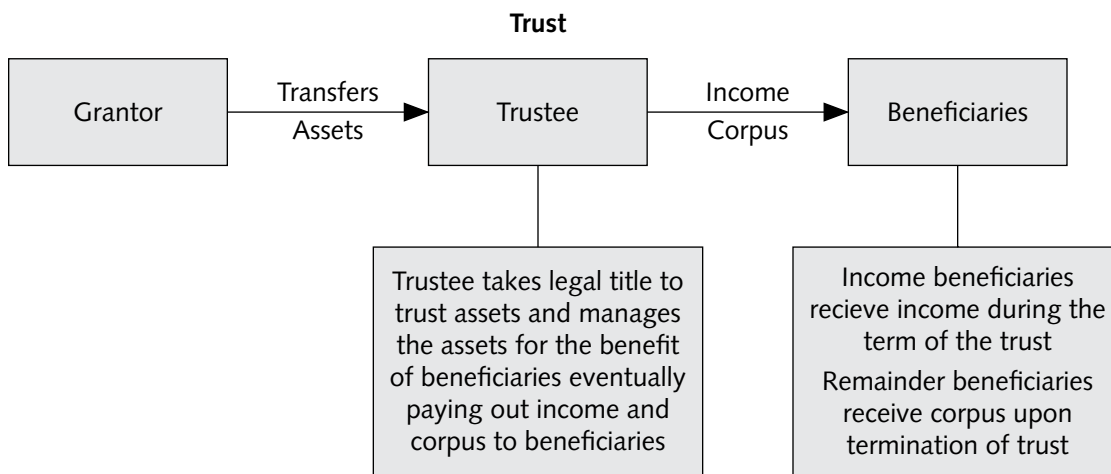
Page 224 Add **the following text to the paragraph Beneficiary:**

Usually, the grantor **has created two types of beneficiaries:** the income beneficiary **and the remainder beneficiary.** The **remainder** beneficiary, sometimes called **the remainderman**, receives the trust corpus upon termination of the trust. These beneficiaries may be the same person.

Quick Quiz 5

- Mr. Jones places ownership of his home into a trust with the stipulation that should he predecease his wife, she will be able to live in it until her passing. Upon Mrs. Jones's death, ownership of the home will pass to their daughter Barbara. Under trust law, Barbara would be known as
- A. the beneficiary
 - B. the conditional beneficiary
 - C. the grantor
 - D. the remainderman

Page 224 Following **the example, insert this chart:**



Page 225 Replace **Living Versus Testamentary Trusts** with the following text:

Living Trust

A **living trust**, also known as an **inter vivos trust**, is established during the maker's lifetime. In general, the settlor transfers property into the trust and either appoints himself or someone else to act as trustee. During the maker's lifetime, he has complete control over the assets and manages them for the benefit of the beneficiaries (he may be one of them). A successor trustee is always named and upon the death of the maker (or becoming legally incapacitated), the successor trustee takes over. The main advantage of a living trust is the avoidance of probate (but not estate taxes).

Testamentary Trust

In its simplest form, a testamentary trust is any trust that comes into being on death through a will. Depending on instructions in the will, the terms of the trust can provide for the payment of income or principal or both to the beneficiaries. The interests of all beneficiaries can either be stated in the will or allocation decisions can be left to the trustee.

Although the beneficiaries of the trust have an interest in it, the trustee is the legal owner of the property held in the trust and has the authority to control the management of the assets. As a fiduciary, among the trustee's obligations is making decisions about the investment of the trust assets.

The testamentary trust does not reduce the grantor's income or estate tax exposure. Furthermore, assets that pass to a testamentary trust do not avoid probate, because the validity of the will's instructions to pass property to the trust must be substantiated in probate court.

Page 249 Before the **TAKE NOTE** at the top of the page, add the following text:

Estate taxes are due no later than nine months after the date of death. The Internal Revenue Code gives the executor the right to elect to value all of the property included in the gross estate as of the date, which is six months after the decedent's death if that would result in a lower tax. In any event, unless an extension is obtained, taxes are still due nine months after death.

Page 249 Add this paragraph to **Gift Tax**:

When a gift is made between spouses, the rule is somewhat different. Generally, there is an unlimited exclusion for these gifts. However, there are limits if your spouse is not a citizen of the United States. For 2007, a spouse may gift up to \$125,000 to a noncitizen spouse. The number won't be tested as it changes each year, but the concept might be on your exam.

Page 266 Add this **TEST TOPIC ALERT** after the **TAKE NOTE**, but before **Standard Deviation**:

Other than those managers who attempt to mimic a specific index, most portfolios are constructed with a portion of the assets devoted to those with a negative correlation to the overall holdings. Because positions with a negative correlation move in an opposite direction, during a market selloff, that portion of the portfolio will tend to rise, offsetting some of the loss of market value.

Page 267 Replace the paragraph Beta Versus Standard Deviation with the following text:

Beta is a volatility measure of a security, compared with the overall market; it is a measure of systematic risk. Standard deviation is a volatility measure of a security, compared with its expected performance. It includes both systematic and nonsystematic risk, making it a measurement of the total risk inherent in investing in that particular security.

Page 270 Add this paragraph to Business Risk:

This risk is sometimes referred to as a *nonsystematic risk* because it is a risk found in that specific investment, not the market as a whole. You will need to know that nonsystematic risk can be diversified away—that is, a well diversified portfolio will protect an investor from a financial calamity in one stock or industry.

Add this paragraph to Market Risk:

You will need to know that systematic risk cannot be diversified away because it is a risk inherent in the market as a whole; diversification does not help.

Quick Quiz 6

Diversification in a portfolio may help to reduce

- I. business risk
 - II. market risk
 - III. nonsystematic risk
 - IV. systematic risk
- A. I and III
 - B. I and IV
 - C. II and III
 - D. II and IV

Page 271 Replace Inflation Risk with the following text:**INFLATION RISK**

Inflation reduces the buying power of a dollar. That is why it is frequently referred to as purchasing power risk. A modest amount of inflation is inherent in a healthy, growing economy, but uncontrolled inflation causes uncertainty among individual investors as well as corporate managers attempting to evaluate potential returns from projects. One of the investments that may be used that offers inflation protection is a Treasury issue known as TIPS.

Treasury Inflation Protection Securities (TIPS)

A relatively new type of Treasury issues, **Treasury Inflation Protection Securities (TIPS)**, helps protect investors against purchasing power risk. These notes are issued with a fixed interest rate, but the principal amount is adjusted semiannually by an amount equal to the change in the Consumer Price Index (CPI), the standard measurement of inflation.

The interest payment the investor receives every six months is equal to the fixed interest amount times the newly adjusted principal. During times of inflation, the interest payments increase, whereas during times of deflation, the interest payments fall. These notes are sold at lower interest rates than conventional fixed-rate Treasury notes because of their adjustable nature.

Like other Treasury notes, TIPS are exempt from state and local income taxes on the interest income generated, but are subject to federal taxation. However, in any year when the principal is adjusted for inflation, that increase is considered reportable income for that year even though the increase will not be received until the note matures.

TEST TOPIC ALERT The Series 66 exam may ask questions similar to the following.

1. A customer wishes to buy a security providing periodic interest payments, safety of principal, and protection from purchasing power risk. The customer should purchase
 - A. TIPS
 - B. TIGRS
 - C. COMs
 - D. STRIPS

A. TIPS offer inflation protection and safety of principal because they are backed by the US government.
2. A client has TIPS with a coupon rate of 4.5%. The inflation rate has been 7% for the last year. What is the inflation-adjusted return?
 - A. -2.5%
 - B. 4.5%
 - C. 7.0%
 - D. 11.5%

B. Treasury Inflation Protection Securities (TIPS) adjust the principal value every 6 months to account for the inflation rate. Therefore, the real rate of return will always be the coupon.

Page 273 Add the following Test Topic Alert after Benchmark Portfolios:

You may be presented with a question where the IA has designed a custom portfolio for a client that does not correspond to a conveniently available benchmark. In that case, you measure the portfolio's performance against suitable alternatives that match the portfolio's objectives and risks.

Answers to Quick Quizzes

1. **B.** Stocks traded on the OTC Bulletin Board are not considered federal covered securities.
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.
3. **B.** Joint tenants with right of survivorship (JTWRROS) is a form of joint tenancy that provides for direct passage of account assets to the survivor(s) upon the death of one of the tenants.
4. **C.** Among the benefits of using a TOD registration on an account is that upon the death of the account owner, assets in the account pass to the designated beneficiaries without going through probate.
5. **D.** The remainderman is the person who receives the remaining corpus of a trust.
6. **A.** Diversification has the effect of reducing risks that are specific to a company or industry rather than the economy as a whole.

Errata

Page 34: Quick Quiz 1.10: *Client's orders* should be *clients' orders*.

Page 80: Last bullet under withdrawal should be: the issue is subject to a court injunction.

Page 84: Failure to State Material Facts: second sentence should say:

...that could have an impact on the price of the security.

Page 87: Text should say:

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: Text should read *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: The text should read:

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 because it is now excluded from 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: In the Test Topic Alert, the highlighted text below should read: is entitled to more than.

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, is entitled to 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 text 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 or not the fact is material, and one can never imply government approval of one's abilities.

Page 229: In the top line of the page, it should be a \$400,000 loss, not a \$40,000 loss.

Page 249: The correct number for the AGE is \$2,450,000.

Page 281: Unit 6: Even though there are rationales shown for Quick Quizzes 6.1 through 6.4, the only quizzes that belong in this Unit are 6.5, 6.6, and 6.7.

Drill & Practice Errata

QID 41454: Key should be A.

QID 29003: Key should be D.

QID 50816: Question should be revised as follows:

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 required only to make a bona fide effort to determine that the solicitor complies with the solicitor agreement. Be careful; this is not the case under the USA. The USA considers solicitors supervised persons, whether or not they are employed by the adviser, and requires IAR registration.

QID 50004: Key should be B.

QID 39408: Key should be D (II and IV).

QID 37166: Choice B and the rationale should be revised as follows:

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. Because 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: The answer choices should be revised as follows:

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

- I. A final order may be appealed in the appropriate court within 60 days of order issue.
 - 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. Final orders 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 read: 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.

3rd Edition Errata

42238

66_2827 Fraudulent and Prohibited Business Practices of Investment Advisers/Reps

Which of the following practices are prohibited?

- I. An investment advisory firm organized as a partnership failed to inform its clients of the departure of a partner with a very small interest in the partnership.
 - II. An investment advisory firm charges an annual fee equal to 2% of the first \$250,000 in assets under management, 1% of the next \$500,000, and .5% for everything in excess of \$750,000.
 - III. Without client consent, the majority stockholder of a registered investment adviser pledges his stock as collateral for a loan taken out by the firm to expand its services.
 - IV. An investment adviser engages in an agency cross transaction.
 - A. I and II
 - B. I and III
 - C. I and IV
 - D. III and IV
- B.** Any change in the ownership of an investment advisory firm organized as a partnership, no matter how small, requires notification to all clients within a reasonable amount of time. If the firm is structured as a corporation, the pledging of a controlling interest in the company's stock is viewed as an assignment of the contracts. This may not occur without the approval of the clients. Agency cross transactions, where the adviser represents both sides of the trade, are permitted as long as the adviser makes the proper written disclosures and does not make the buy/sell recommendations to both parties.

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

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