

Test Alert!

to Accompany the 3rd Edition LEM

9/23/08

series **66**

The information included in this release, in addition to your other Kaplan Financial Education 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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Introduction

The information in this TestAlert! is intended to update Kaplan Financial Education's Series 66 License Exam Manual, 3rd Edition, to match the newly published 4th 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.

Changes to the LEM

Note Almost all references to NASD have been replaced with FINRA.

Page 6 Change the wording in the description of commercial paper to the following:

Any commercial paper that has a maturity at the time of issuance of no more than nine months (270 days), with the stipulation that the proceeds are to be used by the issuer to increase working capital and not for the purchase of fixed assets; there is no minimum denomination or rating requirement similar to that found in the Uniform Securities Act.

Page 13 Add the following text after the sentence “The term accredited investor applies only to private placements”:

The net worth requirement has not changed since the introduction of this rule in 1982, but, particularly due to increased real estate values, many seniors meet this definition. There is a current SEC proposal to raise the limits, but in the meanwhile a favorite phrase of the regulators is, “eligibility does not equal suitability.” Therefore, just because one meets the financial requirements of an accredited investor does not mean that suitability standards are ignored.

Page 34 Replace the final bullet dealing with contractual plans (which are now obsolete) with the following:

- Shares purchased through automatic reinvestment of dividends and capital gains distributions. Although no tax benefit accrues, the investor is able to enjoy compounding without expense.

Page 34 Add the following Test Topic Alert before Quick Quiz 1.10:

TEST TOPIC ALERT

This rule may appear on your exam in a question asking if an investment adviser is permitted to reduce his fees because of commissions earned on the sale of mutual funds. Although negotiated commissions are allowable on other securities, because mutual funds are a continuous new issue sold based upon a stated offering price in the prospectus, reducing fees in this instance would be a prohibited practice.

Pages 37-40 Change the following information in the Unit Test 1 questions:

12. II. Change “bribery” to “a financial matter”

20. B. Change “NASD” to “FINRA”

Page 39 Replace Question 23 with the following:

23. It would be most correct to state that, as defined in the Securities Exchange Act of 1934, a securities information processor
- A. clears trades made on regulated stock exchanges
 - B. distributes information on trades or quotations for nonexempt securities
 - C. processes information provided by the SEC
 - D. secures the information necessary to process a trade

Pages 41-42 Change the following information in the answer key:

12. II. Change “bribery” to “a financial matter”; replace “not allowed” with “a cause for disqualification”
20. Change “NASD” to “FINRA”

Page 41 Replace the answer to Question 23 with the following:

23. **B** Securities information processors (SIPs) are regulated under the Securities Exchange Act of 1934. They include any person engaged in the business of collecting, processing, or preparing for distribution or publication information dealing with transactions in, or quotations for, any nonexempt security; or distributing or publishing (whether by means of a ticker tape, a communications network, a terminal display device, or otherwise), on a current and continuing basis, information with respect to such transactions or quotations.

Page 52 The snowbird exemption applies to all securities professionals, not just broker/dealers.

Page 53 Insert the following before the Test Topic Alert at the top of the page:

Another example that has recently been addressed by NASAA is broker/dealers and investment advisers using the Internet. A firm’s Website, considered advertising, can be seen everywhere. Does that mean the firm has a place of business in the state? Without getting too technical, there are several requirements to insure that the person is not deemed to be in the state.

- The communication clearly states that the person may only do business in this state if properly registered or exempt from registration.
- Any follow-up with prospects can only be made in compliance with state registration requirements.
- The site may only make available general information, not specific advice or recommendations.

Page 54 The Take Note at the top of page should read:

TAKE NOTE

In addition, at the time of registration of a broker/dealer, any partner, officer, or director of the broker/dealer who is active in the broker/dealer’s securities business, is automatically registered as an agent of the broker/dealer.

Page 56 Add the following first paragraph under “Exclusions from Definition of Agent for Administrative Personnel”:

In fact, if the broker/dealer they work for wishes to pay their employees, including this group, a year-end bonus based on company profits (not related to any individual’s sales efforts), it would be allowable.

Page 61 Add this Test Topic Alert to the end of the page:

TEST TOPIC ALERT

Please note that, unlike FINRA (NASD) registration requirements, fingerprints do not have to be submitted.

Page 66 After the example on the bottom of page 66, add this Test Topic Alert:

TEST TOPIC ALERT

When investors purchase shares of an open-end investment company (mutual fund), that is always an issuer transaction because the fund is continuously offering new shares. However, when the investment company sells shares out of its portfolio, that is a nonissuer transaction in the secondary markets.

Page 82 In the bullet referring to the Nasdaq National Market (NNM), replace both references with Global (NGM) to reflect the name change by Nasdaq.

Page 84 Add the following to Using Inside Information:

However, the use of a broker/dealer or investment adviser’s internally generated research report prior to public release is not considered use of inside information.

Page 87 Add this sentence to Sharing in Customer Accounts

Unlike agents, investment advisers and their representatives are never permitted to share in the profits or losses in their client’s accounts.

Page 87 The Market Manipulation section should have front running replaced with wash sales as follows:

Securities legislation is designed to uphold the integrity of markets and transactions in securities. However, market integrity is violated when transactions misrepresent actual securities prices or market activity. The most common forms of market manipulation are matched purchases and its first cousin, wash sales.

Matched purchases occur when market participants agree to buy and sell securities among themselves to create the appearance of activity or trading in a security. Increased volume in a security can induce unsuspecting investors to purchase the security, thereby bidding up the price. As the price rises, those who initiated the matched purchases sell their securities at a profit.

A **wash sale** is an attempt to manipulate a security’s price by creating an apparent interest in the security that really does not exist. This is done when an investor buys through one brokerage account while simultaneously selling through another. No real change in ownership has occurred, but, to the marketplace, it appears that volume is increasing.

Page 88 Add the following bullet points at the top of the page:

- Accepting anything other than an indication of interest prior to the effective date of a security in registration
- Failing to know your customer’s goals, objectives, and financial capabilities
- Withholding shares of an IPO by the underwriter for the purpose of personal gain
- Offering “free lunch” seminars, especially for seniors, without explaining that the primary purpose of the seminar is to make sales, not educate

Page 97 Add the following after the Case Study:

Frequently, before a final determination of proceedings under the act, the Administrator will act summarily to suspend a registration. However, no formal order may be issued without the Administrator:

- giving appropriate prior notice to the affected persons;
- granting an opportunity for a hearing; and
- providing findings of fact and conclusions of law.

Page 98 Add the following before the first Take Note:

TEST TOPIC ALERT

Because of a lack of uniformity in state criminal laws, a person can be convicted of a misdemeanor in one state and then move to a state where that same crime is a felony. If the person were to then apply for registration, the Administrator must consider the crime under the statutes of the state where it occurred, not his own.

Page 101 Add the following Test Topic Alert before Criminal Penalties:

TEST TOPIC ALERT

The USA provides that every cause of action under this statute survives the death of any person who might have been a plaintiff or defendant. Therefore, any bond required must provide that suit may be brought for the specified two-year period even though the person who is bonded dies before the expiration of that period.

Pages 103–110 Change the following information in Unit Test 2:

4. B. Change to “an individual who represents an issuer of a security exempt from the act”
5. III. Replace “various” with “registered”
8. IV. Should read: An individual who is paid a commission to sell nonnegotiable certificates of deposit for ABC National Bank.
24. III. Delete “front running” and replaced with “wash sales”
26. III. Add “instead of exercising them”

40. Replace “an asset management” with “a wrap fee” and add the word “client’s” before “portfolio”

Choice D – replace “in advance” with “no later than completion”

Pages 111–116 Change the following information in the answers:

- 3. Add “or supervise those that do”
- 4. Third sentence should read: “The law excludes those individuals from the definition of an agent who represent an issuer in exempt transactions, selling exempt securities, and transactions with issuers’ employees when no commission is paid.”
- 8. Change the last sentence to read: “to sell these certificates”
- 16. Change “brokers” to “broker/dealers”
- 19. Delete sentence relating to oil, gas, and mining
- 24. Replace the first sentence with: “Wash sales, the practice of attempting to create the appearance of trading activity by entering offsetting buy and sell orders, is a form of market manipulation.”
- 40. Change to: “Any action that results in a transaction in which the firm or an affiliate acts in either a principal or agency capacity requires, prior to completion of the trade, written disclosure of that fact to the client and approval of the client.
- 44. Add “without a prior hearing”

Page 117 Delete “effecting transactions” in the answer to Question 2 of Quick Quiz 2.3:

Page 131 Delete the Take Note relating to the Merrill Lynch rule and replace with the following:

TAKE NOTE

For purposes of incidental, look at this example. The Maryland Securities Act sets that, “[a] lawyer, certified public accountant, engineer, or teacher whose performance of investment advisory services is solely incidental to the practice of the profession will be excluded from the definition of investment adviser. However the performance of such services is not solely incidental unless: 1) the investment advisory services rendered are connected with and reasonably related to the other professional services rendered; 2) the fee charged for the investment advisory services is based on the same factors as those used to determine the fee for other professional services, and 3) the lawyer, certified public accountant, engineer, or teacher does not hold out as an investment adviser.”

Page 131 Add the following before the Case Study:

TEST TOPIC ALERT

Because these exemptions all apply when the investment adviser does not have an office in the state, it is relevant to understand that an investment adviser or one of its representatives who advertises to the public, in any way, the availability of meeting with prospective clients in a hotel, seminar, or any other location in the state is considered to have an office in the state. However, an investment adviser representative who contacts clients in the state and notifies them that he will be passing through the state and will be available to meet with them in his hotel room is not considered to have an office in the state because the announcement is being made only to existing clients and not to the public.

Page 134 Add the following Take Note before Schedule I:

TAKE NOTE

Although there are no minimum educational requirements, the ADV Part II requires disclosure of the formal education after high school of each principal executive officer of the investment adviser or each person with similar status or performing similar functions as well as each member of the investment committee or group that determines general investment advice to be given to clients.

Page 145 Add the following sentence to the first bullet on the Brochure rule:

Part II contains information about the IA's management and advisory personnel, style of investing, fees, etc. It does not include information found in Part I such as the legal form of the entity, states in which registered, and number of employees.

Page 150 Add the following before the Take Note:

TEST TOPIC ALERT

Most investment advisers do not take custody and, therefore, are unable to accept direct delivery of customer securities or funds except under the limited conditions described in this section. However, broker/dealers are not constrained by this rule; they are only required to provide receipts anytime they accept customer assets.

Page 159 In Quick Quiz 3.14, question 1, choice III, delete the words "of the same asset class."

Page 162 Add the following Test Topic Alert before the Take Note:

TEST TOPIC ALERT

There are two additional points related to performance based compensation that you must know. First, the adviser must use net performance, that is, consider both gains and losses. Second, as with so many other rules, the Administrator has the power to authorize this type of fee even when the stated conditions are not met.

Page 165 Add the following after this bullet in the middle of the page referring to CPA:

- Recommending the same security to clients without regard to individual suitability; this is sometimes referred to as blanket recommendations
- Relying on oral discretionary authority for transactions in a customer's account beyond the first 10 business days after the date of the initial transaction

Pages 172–177 Change the following in Unit Test 3:

7. Replace “act” with “Investment Advisers Act of 1940”
8. Replace “act” with “Investment Advisers Act of 1940”
13. III. Replace “registered” with “doing business”
23. Change the Act of 1940 to the Investment Advisers Act of 1940

Pages 178–180 Change the following in the answers:

9. Delete the last sentence
18. Replace the rationale with: “Both state and federal law require that records be kept easily accessible for a period of no less than five years. What might have tricked you here is that these laws require that the records be kept in the principal office of the IA for the first two years.”
33. Change “either party” to “both parties”

Unit 3 Change the following information in the Quick Quizzes:

- 3.5 Add a new first sentence: “ABC Advisers is a federal covered IA.”
- 3.11 Question 2: Remove the statement “with the exception stated above”
- 3.14 Question 1: Remove the words “of the same asset class”
- 3.12 Delete the end of the rationale beginning with the word “Nothing”
- 3.14 Delete the words “of the same type of asset,” and change “cover” to “covering”

Page 189 Insert this Take Note after the first heading:

TAKE NOTE

Although individual retirement arrangements is the technical IRS term (not tested), because everyone refers to these as individual retirement accounts (IRAs), we're going to use the common phrase to avoid confusion.

Page 200 Add the following Test Topic Alert after Contributions:

TEST TOPIC ALERT

Only earnings from self-employment count toward determining the maximum that may be contributed. For example, if a corporate employee had a part-time consulting job, only that income, not the corporate salary, could be included in the computation.

Page 307 Change Quick Quiz 4.3 to the following:

The maximum annual employer contribution to a 403(b) for the 2008 plan is

- A. \$9,500
- B. \$15,500
- C. \$25,000
- D. \$46,000

Page 209 Replace the first paragraph with the following:

Although it is 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 211 Add the following paragraphs after the first paragraph on 401(k) Plans:

There are maximum limits, and the amount withdrawn is not eligible for a rollover and, therefore, is taxable as ordinary income and possibly the 10% penalty. It differs from a 401(k) loan, which is not taxable as long as the repayment requirements of the IRS are met.

Somewhat different from the hardship withdrawal is the ability to borrow from the 401(k). This has the advantage of not being treated as a distribution so there is no tax. However, if certain IRS rules are not followed, it will be considered a premature distribution and taxed as such. The IRS maximum loan amount is the participant's vested share or \$50,000, whichever is the smaller. Other than if used for a home mortgage, the loan must be paid back on a regular schedule (usually through payroll deduction) in a period not to exceed 60 months.

Page 218 Change Question 10, choice D, to the following:

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- D. A former corporate employee who decides to become self-employed may not rollover any distributions from a qualified corporate plan into a rollover IRA if he has created a Keogh Plan.

Page 220 For Question 10 answer, replace the first sentence of the rationale with the following:

Rollovers are permitted into an IRA regardless of any plans maintained.

Page 226 Add the following Test Topic Alert after the existing alert:

TEST TOPIC ALERT

The exam will require you to know that there are only two signatures necessary on a new account form—that of the registered representative (agent) introducing the account, and of the principal accepting it, but not of the client. Although many firms do ask for a client's signature, that is the "real" world and not the "test" world.

Page 233 Add the following Test Topic Alert before Client Personal Profile:

TEST TOPIC ALERT

You may be asked about tax documents for each of different forms of business organizations. Sole proprietors file their business information on a Schedule C. Members of LLCs and shareholders in S corporations receive a Form K-1 and C corporations report their income on a Form 1120.

Page 238 Under Asset and Income Shifting, the kiddie tax now applies to all children under age 19 and full-time students under age 23:

Page 265 Add the following sentence to the end of Holding Period Return (HPR):

It is essentially the same as total return, but, whereas total return is usually computed on an annual basis, holding period return can be for any period.

Page 268 Add the following after the Example of Internal Rate of Return (IRR):

Dividend Models

Some analysts believe you can determine the value of a stock based upon current or anticipated dividends. The models work best with a company whose dividends are paid with regularity, so they are more popular with larger, well established organizations than small cap stocks. Two methods used are the dividend discount model and the dividend growth model

Dividend Discount Model

This model says that the value of a stock should be equal to the present value of all future dividends. There are several methods to use, such as assuming constant or variable dividends, but the concept is still the same. What does the investor expect to receive in the future and then discount that to the present value? You will not have to know the formula, but it is basically the annual dividend divided by the required rate of return. For example, if a stock pays a \$1.20 dividend and the required rate of return in the marketplace is 6%, the stock should be worth \$20 ($1.20/.06$)

Dividend Growth Model

This model assumes that the amount of the annual dividend will grow at a constant rate. Because projections of future growth can be hazy at best, this model is best used in conjunction with other forecasting tools. You will not have to know the formula, but it is basically the current dividend multiplied by $(1 + \text{the dividend growth})$ and then divided by the required rate of return. For example, if a stock pays a \$1.20 dividend that expected to grow at a 3% rate each year, with a required rate of return of 6%, the stock should be worth \$41.20. This is significantly higher than a stock whose dividends are expected to remain constant.

Page 274 Add the following Test Topic Alert after Business Risk:

TEST TOPIC ALERT

Business risk is highest for investors whose portfolios contain stock in only one issuer or in lower rated bonds.

Page 277 Add the following before Quick Quiz 6.2:

Reinvestment Risk

A variation of interest rate risk is reinvestment risk. There is reinvestment risk as to interest and reinvestment risk as to principal.

One receiving a periodic cash flow from an investment, such as interest on a debt security, may be unable to reinvest the income at the same rate as the security itself is paying. For example, if one purchased a bond with a 10% coupon and several years later comparable securities were only paying 7%, the investor would not be able to compound the investment at the original rate. Zero coupon bonds avoid this risk because there is nothing to reinvest.

This risk also occurs at maturity. If your fixed income client had been enjoying a 10% return on the above bond, when it matured, he was only able to reinvest the principal in a 7% security.

Currency or Exchange Rate Risk

Purchasers of foreign securities, whether through direct ownership or ADRs, face the uncertainty that the value of either that foreign currency or our domestic currency will fluctuate. As of the date of this publication, the past few years has seen the Euro increase greatly against the dollar. As a result, investors in stocks domiciled in those countries using the Euro have seen their investment grow, in many instances solely due to the exchange rate of the Euro.

Page 278 Add the following bullet under Benchmark Portfolios:

- International Stocks—EAFE

Page 280 Add the following index after NASDAQ Composite Index:

EAFE

The EAFE, sometimes referred to as the MSCI EAFE (it was developed by Morgan Stanley Capital International), is an index of foreign stocks. The index is market capitalization weighted. The EAFE acronym stands for Europe, Australasia, and Far East.

The index includes a selection of stocks from 21 developed countries outside of the US and Canada. The index has been calculated since the end of 1969, making it the oldest truly international stock index. It is probably the most common benchmark for foreign stock funds.

Page 280 Add the following to the Efficient Market Hypothesis section:

Eugene F. Fama, coined the term in a 1965 Financial Analysts Journal article titled “Random Walks in Stock Market Prices”:

In an efficient market, competition among the many intelligent participants leads to a situation where, at any point in time, actual prices of individual securities already reflect the effects of information based both on events that have already occurred and on events which, as of now, the market expects to take place in the future. In other words, in an efficient market at any point in time the actual price of a security will be a good estimate of its intrinsic value.

Page 280 Replace the first paragraph under Modern Portfolio Theory with the following:

Modern portfolio theory is an approach that attempts to quantify and control portfolio risk. It differs from traditional securities analysis in that it emphasizes determining the relationship between risk and reward in the total portfolio rather than analyzing specific securities. This is derived from the **capital asset pricing model (CAPM)**, which states that the pricing of a stock must take into account two types of risk: systematic and nonsystematic.

Page 281 Add the following before the HotSheets:

Optimal Portfolio

An optimal portfolio is one that returns the highest rate of return consistent with the amount of risk an investor is willing to take. In other words, an optimal portfolio is the portfolio that makes the best trade-off between risk and reward for a given investor's investment profile.

Errata

Note Throughout the LEM, beginning with the Table of Contents on page iii, references to the Securities Acts Amendments of 1975 should be changed to Securities Amendments Act of 1975.

Page 23 Market Manipulation—Churning is listed in this group in such a fashion that it might be thought that it is considered a form of market manipulation. It is not. It is, however, a prohibited practice. The other three items on the list are forms of market manipulation.

Page 42 Delete the last sentence of the rationale to Question 17. We have not yet given you the short list of items that are not securities. That comes in the next Unit.

Page 111 In the third sentence in Question 4, the word “selling” is missing and should be inserted after the comma and before “exempt.”

Page 185 The second line of Question 2 in Quick Quiz 3.17 should say “derives an economic benefit” rather than “derives and economic benefit.”

Page 195 In the listing of ineligible investments, there is a comma that does not belong between bond funds and UITs. The statement is meant to refer to municipal bond mutual funds and municipal bond UITs.

Page 233 The Take Note should say: “*Distributions* from LLCs and S corporations are taxed only once because there is no taxation at the corporate level.”

Page 242 The example on the bottom of the page should say the following:

ABC would be attractive to investors because its intrinsic value is higher than its market value.

Page 267 Delete the Risk Adjusted Return entry and example. Risk Adjusted Return is measured by the Sharpe Ratio and has nothing to do with beta.

Page 269 Change Item 8 in Quick Quiz 6.1 to say: “Determined by dividing the difference between a security’s actual return and the risk-free rate by its standard deviation.”

Page 299 “Spousal account” should be “spousal IRA.”

Page 302 The second item on the left column under Miscellaneous should be change, not charge.

Page 354 “Front running” is not a form of market manipulation. Replace with “capping.”



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