

# Test Alert!

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series **3**

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

Below is information regarding changes in rules and regulations that have been approved since the Dearborn Financial Series 3, 11th edition was published. This information is incorporated in the 1st edition of the Kaplan Financial License Exam Manual.

1. **Significant Sales Practice Problems in Employment History** NFA

Rule 2-9 is one of the National Futures Association (NFA) rules designed to prevent abusive sales practices. It gives the members the responsibility for diligently supervising its employees' sales practices.

Member firms identified as having a sales force that has received questionable training in sales practices are required to meet certain criteria established by the board and adopt specific supervisory procedures designed to prevent abusive sales practices. Subsection (b) covers all activities regulated by NFA, including the off-exchange retail Foreign Exchange (forex) activities of members subject to NFA Compliance Rule 2-36.

The employment history of a member's sales force is relevant in identifying firms with potential sales practice problems. Member firms in this situation must have stringent supervision procedures in place to ensure that its associated persons' improper training does not corrupt their sales efforts.

The NFA has determined that a member will be required to adopt the special supervisory procedures over its sales practice activities if:

- for firms with fewer than five associated persons, two or more of them have been employed by one or more disciplined firms (firms or member firms that have been disciplined by NFA or the Commodities Futures Trading Commission (CFTC) or by any securities industry self-regulatory organization or the Securities and Exchange Commission (SEC) for sales practice fraud or matters involving security futures products);
- for firms with at least five but fewer than 10 associated persons, 40% or more of its associated persons have been employed by one or more disciplined firms;
- for firms with at least 10 but fewer than 20 associated persons, four or more of its associated persons have been employed by one or more disciplined firms; or
- for firms with at least 20 associated persons, 20% or more of its associated persons have been employed by one or more disciplined firms.

A disciplined firm is a firm that meets the following criteria.

1. The firm has been formally charged by either the CFTC or NFA with deceptive telemarketing practices or promotional material.
2. Those charges have been resolved.
3. The firm has been permanently barred from the industry as a result of those charges.

**Tape Recording Phone Calls** Member firms meeting the criteria will be required to tape record all telephone conversations between their associated persons and both existing and potential customers, including existing and potential retail forex customers of members subject to NFA Compliance Rule 2-36. Tape recording these conversations is the best way to monitor the activities of associated persons and provides the members with complete and immediate feedback on each associated person's method of soliciting customers.

Members required to tape record conversations must do so for two years and must retain the tapes for five years. The tapes must be readily accessible during the first two of the five years.

For two years, member firms meeting the criteria will be required to file all promotional material, as defined in NFA Compliance Rule 2-29, with NFA at least 10 days prior to its first use.

Members required to adopt enhancement procedures may seek a waiver of the enhanced supervisory requirement upon showing that the member's current supervisory procedures provide effective supervision over its employees, including enabling the member to identify potential problem areas before customer abuse occurs.

If a member meets the criteria and trades security futures products, the member firm must also show that the member's supervisory procedures ensure compliance with all applicable securities laws and regulations.

Some of the factors that the three-member waiver committee may consider in evaluating a waiver request include the:

- total number of associated persons sponsored by the member;
- number of branch offices and guaranteed introducing brokers (GIBs) operated by the member;
- experience and background of the member's supervisory personnel;
- number of the member's associated persons who had received training from firms which have been closed for fraud, the length of time those associated persons worked for those firms, and the amount of time that has elapsed since those associated persons worked for the disciplined firms;
- results of any previous NFA examinations; and
- cost effectiveness of the taping requirement in light of the firm's net worth, operating income, and related telemarketing expenses.

2. **Trading Ahead of Customer Orders** Rule 2-26 and Rule 2-4 require futures commission merchants (FCMs) and introducing brokers (IBs) to establish and enforce internal rules that prohibit employees from trading

ahead of customer orders that are executable at or near the market price. Trading ahead is not prohibited outright, but knowingly trading ahead of customer orders in any commodity violates the rules.

Members must take care not to trade ahead of customer orders. A member will not be held accountable for trading ahead of customer orders that originate in a different branch office or for proprietary orders that originate in a trading department that does not have access to customer order information.

3. **Email** Members must supervise the use of futures-related email by employees as they supervise other forms of correspondence. Email supervision procedures must be in writing and identify by title or position the person responsible for conducting the review.

Firms may wish to consider whether the following procedures would be appropriate as well:

- Specify how and with what frequency emails will be reviewed and how that review will be documented
- Categorize what type of email will be pre-reviewed or post-reviewed

Firms dealing with individual, relatively unsophisticated retail customers might consider using a larger sample or even reviewing all the routine email. A firm may wish to conduct a comprehensive review of employees' and agents' email if they have a disciplinary history involving problems with customers or came from a firm that has been disciplined for fraud.

4. **High-Pressure Sales** Rule 2-29 prohibits the use of high-pressure sales practices, but itself does not define high-pressure sales practices. However, there have been a significant number of NFA enforcement cases prosecuted under the rule which illustrate the types of practices that have been found to constitute high-pressure sales practices.

A common characteristic of many high-pressure sales is the undue sense of urgency the associated person conveys to the customer. The associated person is asking the customer to act now and think later.

Abuses include:

- rushing customers through the account opening forms and glossing over the risk disclosure in haste to open the account;
- actively attempting to dissuade unsophisticated customers from seeking further advice on their investment decision from friends, relatives, and other financial advisers;
- threatening or intimidating customers;
- a pattern of telephone calls that are unusual in their timing or frequency (i.e., barraging customers with calls late at night or early in the morning); and
- shouting at customers, using profane language, or otherwise attempting to bully the customer into opening an account.

### 5. **Trading Based on Material, Nonpublic Information (CFTC/SEC)**

CFTC regulations and NFA and exchange rules do not generally prohibit trading futures based on material, nonpublic information; SEC rules do. However, NFA Rule 2-37(a) prohibits members registered with the SEC as broker/dealers and representatives from violating regulations regarding trading on material, nonpublic information in connection with security futures products. Insider trading and other forms of trading based on material, nonpublic information that violate SEC rules would also be a violation of NFA Rule 2-37.

Members may not purposefully establish, increase, decrease, or liquidate a position in any security futures product in anticipation of the issuance of a research report regarding the underlying security or a derivative based primarily on the underlying security (including the security futures product itself).

Members should isolate specific information within research departments of the firm using firewalls to prevent the trading department from acting on the advance knowledge of research reports. Firms that do not create firewalls must demonstrate that the position was not changed in anticipation of the issuance of a research report.

### 6. **Glossary** The glossary of terms was significantly enhanced.

Below is information regarding changes in rules and regulations that have been approved since the Kaplan Financial Series 3, 1st edition was published. These changes will be incorporated in the next edition of the Kaplan Financial License Exam Manual.

### Establishing AML Programs

The USA PATRIOT Act amended the Bank Secrecy Act (BSA) to require that financial institutions establish AML programs. FCMs, CPOs, and CTAs are now included in the definition of financial institutions in the BSA. IBs are considered to be “brokers or dealers in commodities” within the financial institution definition.

An AML program must be in writing and must include:

- the development of internal policies, procedures, and controls;
- the designation of a compliance officer;
- an ongoing employee training program; and
- an independent audit function to test programs.

### Discretionary Accounts

An associate of a commodities member firm may not exercise discretion over a customer’s commodity futures account unless the representative has been continuously registered and worked in that capacity for at least two years. This requirement does not apply for those registered as a CTA.

### Glossary Addition

Dual trading means the execution of customer orders by a floor broker during the same trading session in which the floor broker executes any trade in the same contract market or registered derivatives transaction execution facility for:

1. the account of such floor broker;
2. an account for which such floor broker has trading discretion; or
3. an account controlled by a person with whom such floor broker has a relationship through membership in a broker association. Dual trades are not permitted with security futures.

**A contract market** (also known as a designated contract market or DCM) is a board of trade or exchange designated by the CFTC to trade futures or options under the CEA. A contract market can allow both institutional and

retail participants and, provided that each contract is not readily susceptible to manipulation, can list for trading futures contracts on any commodity. A derivatives transaction execution facility (DTEF) is subject to fewer regulatory requirements than a contract market. To qualify as a DTEF, an exchange can only trade certain commodities and excludes retail participants (retail participants may trade on DTEFs through futures commission merchants with adjusted net capital of \$20 million or more, or a registered CTA that directs trading for accounts containing total assets of at least \$25 million).

## PART III

### New Sample Questions

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1. An FCM registered with the SEC and the CFTC to conduct business in securities futures products must conform to
  - A. specific CFTC rules banning trading on inside, nonpublic information
  - B. specific SEC rules banning trading on inside, nonpublic information
  - C. SEC net capital rules for FCMs
  - D. none of the SEC rules
2. A member required to adopt the special supervisory procedures over its sales practice activities must tape record conversations for
  - A. 2 years
  - B. 3 years
  - C. 5 years
  - D. 10 years
3. Which of the following statements may be considered an acceptable sales approach under the rules governing commodity futures contracts?
  - A. "Timing is everything. Now is the time to sell. It will be too late tomorrow."
  - B. "I am a fully licensed broker and there's no need for further advice."
  - C. "Your potential losses can be eliminated if you place a sell stop order."
  - D. "It's possible you may sustain a total loss of your investment."
4. All of the following are acceptable practices under CFTC/NFA rules EXCEPT
  - A. requiring membership in the NFA for commodity trading advisors who decide on trades or place orders for customers
  - B. requiring CPOs to distribute an account statement of income (loss) monthly if net assets are more than \$500,000
  - C. permitting IBs to accept customer funds in the name of the FCM if they have written authorization from the FCM
  - D. trading ahead of customer orders to get a better price for the firm
5. A US automobile manufacturer plans to sell a large number of heavy duty trucks to a Canadian oil company in 6 months for a price of \$15 million Canadian. The US manufacturer is nervous that the Canadian dollar will fall in value between now and then. The Canadian dollar is currently selling for \$.8200, and the 6-month futures are priced at \$.8130. The US manufacturer puts on the proper hedge and then offsets (closes the hedge) when the Canadian dollar spot market is \$.8175 and the Canadian dollar futures market is \$.8135 (contract size is \$100,000 Canadian). Which of the following represents the profit or loss?
  - A. Loss of \$22,500
  - B. Loss of \$45,000
  - C. Gain of \$22,500
  - D. Gain of \$45,000

## PART IV

### Answers & Rationales

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1. **B** The CFTC itself has no such rules; however, if the firm is registered with the SEC, it must comply with SEC rules regarding insider trading. Failure to abide by SEC rules when dually registered is a violation of the CFTC rule.
2. **A** Members required to tape record conversations must do so for 2 years and must retain the tapes for 5 years. The tapes must be readily accessible during the first 2 of the 5 years.
3. **D** Customers may sustain total losses in connection with investing in futures. The other statements are either false or not in keeping with high standards of commercial honor.
4. **D** Members must avoid trading ahead of customer orders. However, a member may not be held accountable for trading ahead of customer orders that originate in a different branch office or for proprietary orders that originate in a trading department that does not have access to information regarding customer orders.
5. **B** Solve this using the four-column technique:
  1. Enter the type of hedge: short hedge.
  2. We have the initial values: cash of \$.8200 and futures of \$.8130. Enter numbers.
  3. We have the final values: cash of \$.8175 and futures of \$.8135. Enter numbers.
  4. We know the basis has weakened (.0070 to .0040).
  5. In a short hedge, a weakening basis is a loss.
  6.  $-\$.0030 \times 15,000,000 = \text{loss of } 45,000$

Cash	Futures	=	Basis	
.8200	.8130	=	+.0070	short hedge
.8175	.8135	=	+.0040	weakened
			.0030	loss

To submit comments or suggestions, please send an email to [errata@kaplan.com](mailto:errata@kaplan.com).

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