

Test Alert! to Accompany the 1st Edition LEM

8/20/07

series **4**

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.

Be sure to visit Kaplan Financial's Website at www.kaplanfinancial.com for the latest updates to this *Test Alert!*

As always, we strive to provide you with the most current test preparation information. If you have any questions about this or any other Kaplan Financial study material, please call AnswerPhoneSM at 1-800-621-9621, ext. 3598, between the hours of 8 am and 6 pm CT, Monday through Friday.

KAPLAN FINANCIAL

FINRA: THE SECURITIES INDUSTRY'S NEW REGULATOR

On July 26, 2007, the SEC approved the consolidation of NASD and NYSE regulation into a single self-regulatory organization (SRO) known as the Financial Industry Regulatory Authority, or FINRA. The purpose of this regulator consolidation was to

- eliminate duplicate regulation by NASD and NYSE; and
- strengthen the competitiveness of US markets.

Securities Licensing Exams are now known as FINRA exams. Exam questions may include reference to the FINRA organization when speaking of the industry's self-regulator. However, you will continue to see exam questions refer to either NASD or NYSE, particularly when specific rules are referenced. It is expected this will continue until all the individual rules of NASD and NYSE have been combined at the end of 2008.

Please note that your study materials have been updated to reflect FINRA as the industry's SRO. Individual rules are still referred to as NASD or NYSE rules as appropriate.

The information below has been updated since the 1st edition of the Kaplan Financial Series 4 License Exam Manual. This information is incorporated in the 2nd edition of the Kaplan Financial Series 4 License Exam Manual.

EXAMINATION AND STUDY OUTLINE

On October 14, 2005, NASD announced the first major revision to the Series 4 exam in over 17 years. The newly revised Series 4 exam reflects for the first time contributions made by the various stock and options exchanges involved with options trading. Although each exchange's rules have differences and peculiarities, the questions found on the new Series 4 exam largely deal with the best practices and rules common to all participating exchanges. These changes are found in a study outline that is available on the FINRA Website (www.finra.org). The changes began to appear in the examination late in 2005.

A passing score of 70% (88 correctly answered questions out of 125) completed in three hours satisfies the qualification requirements of the CBOE, FINRA (NASD), NYSE Arca, Pacific Exchange, ISE, and Philadelphia Stock Exchange.

The Series 4 exam was designed by industry professionals with experience in the management of a broker/dealer's day-to-day options and securities futures activities to accurately test a candidate's knowledge of the applicable rules used in supervising options brokers and options accounts.

The Series 4 exam is organized much like the earlier test. There are three general areas of supervision with a slightly revised weighting:

- Options investment strategies—34 questions
- Supervision of sales activities and trading practices—75 questions
- Supervision of employees, business conduct, and recordkeeping and reporting requirements—16 questions

Updates Made to the Series 4 License Exam Manual, 2nd edition

Below you will find a number of the enhancements made to the Series 4 License Exam Manual, 2nd Edition. It is a sample of the key areas of new or renewed emphasis. Experienced options professionals may recognize many of the terms, concepts, and strategies listed below. Furthermore, many of test items from the newest study guide suggest that many familiar topics are still being tested. Furthermore, for those familiar with the General Securities Principal Examination (Series 24), there appears to be a new emphasis on the type of question found in that exam. Rather than concentrating on options strategies and calculations (although these topics are still tested), those responsible for the creation of the exam seem to be focusing on rules and principles of supervision. In addition, new products have been introduced to the exam along with changes to existing rules and trading practices. For instance, since early 2006, characteristics of VIX options have been tested; automatic exercise has been reduced to \$.05 for both institutions and retail customer accounts; and FCOs trade from 7:30 am to 2:30 pm.

The newest edition of the Series 4 License Exam Manual (LEM) attempts to conform to what is universally agreed to be a more supervisory slant to the test. You will find the following topics, which are new to the LEM or enhanced:

- Regular way versus Regulation T delivery
- NASD 5% markup policy
- Enhanced recordkeeping requirements—three-year, five-year, six-year, and lifetime
- Code of Procedure (e.g., fines for a minor rule violation)
- Regulation SHO
- SIPC
- AML rules; Currency Transaction Reports, suspicious activity reports, and so forth; designation of compliance professional
- Regulation SP
- Securities Information Center (SIC)
- Regulation FD (Fair Disclosure)
- TCPA of 1991
- Gift limits and how the limit does not apply to employees
- Rules regarding options trading in qualified retirement plans
- Rule 144
- Form RE-3 and NYSE Rule 351
- Rule 2711
- Market maker regulation—prohibitions against adjusting inventory in anticipation of research
- Regulation M
- Arbitration
- ITSFE Act of 1988
- CROP or SROP discretion of approval

- Exercise assignment procedures
- Customer identification procedures (CIPs)
- Firm and regulatory elements—continuing education
- Rule 2790
- Electronic signatures for ACAT transfers

In addition, you will be pleased to see that we have:

- updated coordinated Student Notebooks to reflect these latest items for classroom delivery;
- updated Print Practice Finals to more accurately reflect content presented in the LEM and actual test;
- updated the Enrichment Exam with the latest exam feedback; and
- updated the Mastery Exams.

1. Regulation SHO

Regulation SHO also mandates a locate requirement with regard to short sales. Before entering a short sale order, members are required to locate the security to be assured that delivery can be made on settlement date. The locate requirement applies to short sales in all equity securities.

2. Securities Investor Protection Corporation (SIPC)

The Securities Investor Protection Corporation (SIPC), created under the Securities Investor Protection Act of 1970, is a nonprofit membership organization. SIPC members pay assessments into a general insurance fund that is used to meet customer claims in the event of a broker/dealer bankruptcy.

TEST TOPIC ALERT

- All broker/dealers registered with the SEC must be SIPC members except:
- banks that deal exclusively in municipal securities;
 - firms that deal exclusively in US government securities; and
 - firms that deal exclusively in redeemable investment company securities.

Protection of Customers

If the SEC or any SRO finds indications that a broker/dealer is in financial difficulty (usually this will entail net capital violations), SIPC will be notified immediately. If SIPC determines that the member has failed or is in imminent danger of failing, it may petition a federal court to take action by appointing a trustee to liquidate the firm and protect its customers. A customer can be broadly defined as anyone who has cash or securities in the possession of a broker/dealer.

The court, upon receipt of SIPC's petition, will issue a protective decree if the broker/dealer is, in fact, insolvent and will then promptly appoint a trustee for the liquidation of the broker/dealer's business.

Once a trustee has been appointed, the member firm is prohibited from engaging in business as a broker/dealer. It also is prohibited from attempting to conceal assets, file false statements, or alter securities records to defraud the trustee or SIPC.

Customer Account Coverage

The basic coverage under SIPC is up to \$500,000 per separate customer, not per separate account. Of that total, SIPC covers no more than \$100,000 in unrecovered cash.

3. Anti-Money Laundering Programs

NASD Rule 3011 requires member firms to develop, implement, and monitor anti-money laundering programs designed to achieve compliance with the Bank Secrecy Act and related regulations. Specifically, the rules would require member firms to:

- establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions that raise a suspicion of money laundering;
- establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act;
- designate to FINRA (NASD) an individual or individuals responsible for implementing and monitoring the day-to-day operations and internal controls of the program;
- provide ongoing training for appropriate personnel; and
- provide for independent testing for compliance.

Firms are required to designate and identify to FINRA (NASD) the compliance officer charged with oversight of the firm's anti-money laundering program. The firm must provide name, title, mailing address, email address, telephone number, and facsimile number of this contact. If there is a change in the designation, the firm must provide prompt notification to FINRA (NASD/NYSE).

TAKE NOTE

NASD Rule 3011 requires that a member of the firm's senior management approve the firm's anti-money laundering program and that the program be reviewed at least annually.

Currency Receipt

The Bank Secrecy Act requires broker/dealers to report, on Form 104, any currency received in the amount of more than \$10,000 on a single day. Though paying for purchased securities with currency is not prohibited, many firms do not permit this. Failure to report can result in fines of up to \$500,000, 10 years in prison, or both. Records associated with Form 104 must be retained for five years.

Form 104 must be filed within 15 days of receipt of the currency. This rule is part of the regulatory effort to deal with money laundering. The two federal agencies empowered to deal with this abuse are the Federal Reserve and the Department of the Treasury.

Suspicious Activity Reports (SARs)

The USA PATRIOT Act requires firms to report to Financial Crimes Enforcement Network (FinCEN) when there is an event, transaction, or series of events or transactions that appear to be questionable. The act requires firms to report to FinCEN any transaction that alone or in aggregate involves at least \$5,000 in funds or other assets if the firm suspects that it falls within one of the following four classes.

- The transaction involves funds derived from illegal activity.
- The transaction is designed to evade the requirements of the Bank Secrecy Act.
- The transaction appears to serve no business or lawful purpose.
- The transaction involves the use of the firm to facilitate criminal activity.

Example A pattern of cash deposits over time, none of which individually would require a Form 104 filing, could trigger a SAR filing.

TAKE NOTE

Structuring refers to handling currency transactions in a way designed to avoid reporting requirements.

Firms must file a SAR within 30 days of becoming aware of the suspicious transaction(s). Copies of each SAR filing and the related documentation must be retained for five years from the date of the filing. The act also requires that the filing of a SAR remain confidential. The person involved in the transaction that is the subject of the report must not be notified. If subpoenaed, the firm must refuse to provide the information and must notify FinCEN of the request unless the disclosure is required by FinCEN, the SEC, an SRO, or other law enforcement authority.

In addition, the USA PATRIOT Act requires firms to make and retain records associated with wire transfers of \$3,000 or more. Information to be collected includes the name and address of both sender and recipient, the amount of the transfer, the name of the recipient's financial institution, and the account number of the recipient.

Stages of Money Laundering

Placement, *layering*, and *integration* are terms used to describe the three stages through which dirty money is laundered. In the placement stage, currency enters the financial system. When illicit monies are deposited at a financial institution, **placement** has occurred. To conceal their activities, money launderers must either violate the reporting requirements of the Bank Secrecy Act and the USA PATRIOT Act or circumvent the traditional financial system entirely (e.g., the purchase of money orders from money service bureaus). **Layering** describes an activity intended to obscure the trail left by the dirty money. During the layering stage, a launderer may conduct a series of transactions to build layers between the funds and their illicit source. For example, a series of wire transfers constitutes layering. During the final stage of the laundering process, illicit funds are integrated with monies from legitimate sources as they enter the mainstream economy.

Red Flags

There are particular signs of suspicious activity that may suggest money laundering. If a red flag is detected, additional diligence is required. Examples of red flags include the following.

- A customer engages in transactions that lack business sense or apparent investment strategy or are inconsistent with the customer's goals.
- A customer attempts to make frequent or large deposits of currency, insists on dealing only in cash equivalents, or asks for an exemption from the firm's policies relating to the deposit of cash or cash equivalents.
- For no apparent reason, a customer has multiple accounts under a single name or multiple names, with a large number of interaccount or third-party transfers.

- A customer has a large number of wire transfers to unrelated third parties inconsistent with the customer's business.
- A customer exhibits a lack of concern regarding risks, commissions, or other transaction costs.

4. Regulation SP

In 2000, the SEC adopted Regulation SP from the privacy rules promulgated under the Gramm-Leach-Bliley Act. The privacy provisions of the law state that each financial institution (e.g., a broker/dealer) has a responsibility "to respect the privacy of its customers and to protect the security and confidentiality of those customers' non-public personal information." The rules require that broker/dealers establish standards with respect to technical, administrative, and physical safeguards to:

- ensure the security and confidentiality of customer records and information;
- protect against any threats or hazards to the security or integrity of records; and
- protect against unauthorized access to or use of records or information that could result in substantial harm or inconvenience to any customer.

The Gramm-Leach-Bliley Act requires that a broker/dealer make certain disclosures and information to customers such as:

- at the time of establishing the customer relationship, information about its privacy policies and practices and a description of the conditions under which the institution may disclose nonpublic personal information about consumers to nonaffiliated third parties; and
- a method for consumers to prevent the broker/dealer from disclosing that information to certain nonaffiliated third parties by permitting them to opt out.

5. Regulation FD

Regulation Fair Disclosure (Regulation FD) was adopted by the SEC in 2000. It is aimed at curbing selective disclosure of material nonpublic information by issuers to analysts and institutional investors. Regulation FD requires that when an issuer discloses material information, it does so publicly to provide a level playing field.

Regulation FD also addressed the intentional and unintentional disclosure of material, nonpublic information. Whenever an issuer (or anyone acting on its behalf) discloses material, nonpublic information to any person outside the issuer, the issuer must simultaneously make public disclosure of that same information if the disclosure is intentional. In the case of unintentional disclosure, the issuer must promptly (before the start of the next trading day) make public disclosure.

Regulation FD permits issuers to make public disclosure by filing or furnishing a Form 8-K (the current report with the SEC) or by disseminating information through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, nonexclusionary distribution of the information to the public. Public conference calls, press releases, and Webcasts are allowable forms of public disclosure.

6. Research Analyst Conflicts of Interest (NASD Rule 2711 and NYSE Rule 472)

NASD Rule 2711 is intended to improve the objectivity of research reports and provide investors with more useful and reliable information when making investment decisions. Members must take steps to ensure that all research reports reflect an analyst's honest view and that any recommendation is not influenced by conflicts of interest, such as investment banking business with the issuer.

If a member issues a report or a research analyst renders an opinion that is inconsistent with the analyst's actual views regarding a subject company, NASD considers that action to constitute a fraudulent act and conduct inconsistent with just and equitable principles of trade.

Contact Between Research Analysts and Investment Banking Personnel

To prevent conflicts of interest between the delivery of research and activities of the firm's investment banking department, the rules require the following:

- Prohibit investment banking personnel from supervising or controlling research analysts and from influencing analysts' compensation
- Generally bar investment banking personnel from discussing research reports with analysts before issuance—investment bankers cannot approve research reports
- Preclude firms from tying analyst compensation to specific investment banking transactions
- Preclude analysts from becoming involved in any effort to solicit investment banking business from existing or prospective clients
- Prohibit analysts from participating in a road show relating to an investment banking transaction

7. Restrictions on Sales of Initial Equity Public Offerings (NASD Rule 2790)

NASD Rule 2790 replaces the Free-Riding and Withholding Rule, known as the Hot Issue Rule. The new rule is designed to protect the integrity of the public offering process by ensuring that:

- members make a bona fide public offering of securities at the public offering price;
- members do not withhold securities in a public offering for their own benefit, or use such securities to reward persons who are in a position to direct future business to the member; and
- industry insiders, such as members and their associated persons, do not take advantage of their insider status to gain access to new issues for their own benefit at the expense of public customers.

Rule 2790 applies only to a new issue, which is defined as any initial public offering of equity securities. The rule does not apply to additional issue offerings, debt securities, restricted or exempt securities, convertible securities, preferred stock, investment company securities, or ADRs that have a preexisting market outside the United States. Also excluded are real estate investment trusts (REITs) and direct participation programs (DPPs). Essentially, the rule applies to IPOs of common stock.

Restricted Persons

Rule 2790 prohibits member firms from selling a new issue to any account in which restricted persons are beneficial owners. Restricted persons are defined as:

- FINRA (NASD) members;
- employees of FINRA (NASD) members;
- finders and fiduciaries acting on behalf of the managing underwriter, including attorneys, accountants, and financial consultants;

- portfolio managers, including any person who has the authority to buy or sell securities for a bank, savings and loan association, insurance company, investment adviser or collective investment partnership, investment corporation, venture capital funds, or any other vehicle engaged primarily in the purchase or sale of securities; and
- any person owning 10% or more of a member firm.

Any immediate family member of any person above is also restricted. Immediate family includes parents, in-laws, spouses, siblings, children, or any other individual to whom the person provides material support.

EXAMPLE

Aunts, uncles, and grandparents are not considered immediate family. If, however, one of these individuals lives in the same household as a restricted person, that individual is a restricted person.

There is an exemption granted to employees of a limited business broker/dealer, which is defined as a firm engaged solely in the purchase and sale of investment company/variable contract securities, DPP securities, or both.

TAKE NOTE

This exemption applies only to employees of a limited business firm, not the firm itself.

De Minimis Rule

If the beneficial interests of restricted persons do not exceed 10% of an account, the account may purchase a new equity issue. Restricted persons will be able to have an interest in an account that purchases new equity issues as long as no more than 10% of the account's beneficial owners are restricted persons.

QUICK QUIZ 1

1. The Bank Secrecy Act requires that Form 104 must be filed for currency transactions exceeding
 - A. \$2,000
 - B. \$3,000
 - C. \$5,000
 - D. \$10,000
2. Rule 2790 generally prohibits or restricts member firms from selling a new issue to all of the following EXCEPT
 - A. finders
 - B. employees of NASD members
 - C. aunts and uncles
 - D. any person owning 10% or more of a member firm
3. To prevent conflicts of interest between the delivery of research and activities of the firm's investment banking department, NYSE Rule 472 requires which of the following?
 - A. Investment banking personnel may not supervise or control research analysts or influence analysts' compensation.
 - B. Investment banking personnel generally may not discuss current research reports.
 - C. Firms may not grant bonuses to analyst compensation.
 - D. Analysts must participate in a road show to clarify and answer questions.

8. Account Transfers (ACAT Form)

To transfer a customer's account from one broker/dealer to another, the customer submits transfer instructions on an ACAT form to the new broker/dealer. If any of the assets in the account cannot be transferred (e.g., because they are proprietary products or available only through a business relationship with a third party), the customer must give directions as to whether they should be liquidated, retained for the customer by the original broker/dealer, or transferred directly to the customer. The transfer instructions are then sent to the firm currently carrying the account.

The firm has three business days to validate or to take exception to the transfer instructions. The firm may take exception to the transfer instructions if it has no record of the account, the instructions are not valid, or the account contains no transferable assets. The firm may not take exception solely because of a dispute about the value of the cash or securities in the account.

Transfer instructions are validated when the delivering firm returns them to the receiving firm, with an attachment detailing the customer's securities positions, securities held in street name, cash balances, and outstanding Regulation T calls. The account at the delivering firm is then frozen, except for options expiring within seven business days.

The receiving firm reviews the attachment and may reject the account in its entirety if the firm's minimum account size requirements or credit policies are not met. For instance, if the customer's credit and debit balances do not meet house margin requirements, the new firm may not reject only the portion of the account that is not in compliance with credit policies and accept the remainder. The account transfer must be completed within three business days after validation.

9. Securities Information Center (SIC)

SEC Rule 17f-1

SEC Rule 17f-1 designated the Securities Information Center (SIC) as the central reporting institution for keeping records of lost, counterfeit, missing, or stolen securities.

Reporting Requirements

Upon discovery of the loss of a security, if no criminal action is suspected, a member has two business days to locate the security. If it is still missing on the third day, the loss must be reported to the SIC and the transfer agent. If securities are missing and criminal action is suspected, a member has one business day to report the loss to the SIC and the transfer agent. In addition, the FBI must be notified promptly. If the securities are later recovered, the parties that were originally notified must be advised of the recovery within one business day.

Every member is required to make an inquiry to the SIC regarding certain securities coming into its possession as to whether the security has been reported missing, lost, counterfeit, or stolen.

Exceptions are made to this inquiry rule if the security is:

- received directly from the issuer;
- received from another reporting institution (e.g., member firm);
- received from an existing customer of the firm and registered in the customer's name, or was previously sold to that customer as verified by the member's records; or
- part of a transaction valued at \$10,000 or less.

However, any member may inquire at any time as to the validity of any security delivered into the firm. In essence, the rule requires inquiry only if securities are received from a new customer in registered or bearer form or from an existing customer in bearer form in which the record of the purchase is not available.

TAKE NOTE

If securities are discovered missing as the result of a quarterly securities count, the member has 10 business days to report it to the SIC.

10. VIX Options

VIX or Volatility Market Index options are broad-based, European-style contracts provided by the CBOE. The value of a contract is derived from the S&P 500 Index option (SPX). Also known as the fear gauge, VIX options are designed to reflect investors' views of expected stock market volatility over the next 30 days.

VIX options trade like most broad-based index options from 8:30 am to 4:15 pm ET. They do not open until the S&P 500 opening rotation is complete.

Currently, they have no position limit, but that is subject to change, and members that maintain an end-of-day position greater than 100,000 contracts in VIX for its proprietary account or the account of a customer must report and describe any hedging position to the CBOE's Department of Regulation. The strike price interval for these contracts is 2½ points with premium fractions. Each point equals \$100 and settles in cash.

VIX options expire on the Wednesday that is 30 days before the third Friday of the calendar month immediately following the expiring month. The exercise-settlement value is determined by a special opening quotation (SOQ).

The cash amount of settlement is the difference between the exercise settlement value and the exercise price of the option, multiplied by \$100.

QUICK QUIZ

1. All of the following statements are true EXCEPT
 - A. VIX options are a European-style contract
 - B. VIX option value is based on real-time S&P 500 Index option quotes
 - C. VIX options measure the anticipated S&P 500 Index option price volatility of the upcoming 60 days
 - D. VIX options provide an up-to-the-minute market estimate of expected volatility
2. The firm has received \$12,000 of nonexempt securities from a registered broker/dealer. Which of the following statements is true?
 - A. The firm must inquire to the SIC as to the status of nonexempt securities.
 - B. The firm must apply for a new CUSIP number(s) for the securities if one is unavailable.
 - C. The firm is under no requirement to inquire about the status of the securities received.
 - D. The firm must inquire about the status of all securities presented for delivery.
3. A new customer to the WRJ firm (a broker/dealer) signs an ACAT form and mails it to the registered representative. Which of the following statements is true?
 - A. The new firm must forward the signed ACAT to the carrying firm immediately.
 - B. The representative must return the ACAT for a notarized signature.
 - C. The new firm has 3 days to validate the customer's account.
 - D. The new firm may expect delivery of the securities within 4 days of receipt of the ACAT.

Answers to Quick Quizzes

Quick Quiz 1

1. **D.** The BSA requires broker/dealers to report on Form 104 currency received in the amount of more than \$10,000 in a single day.
2. **C.** Aunts and uncles are specifically excluded from the meaning of restricted persons under Rule 2790.
3. **A.** Investment banking personnel may not supervise or control research analysts or influence their compensation .

Quick Quiz 2

1. **C.** The volatility is calculated using a 30-day period.
2. **C.** Because the securities arrived from a registered broker/dealer, an inquiry of the SIC is not required.
3. **A.** The firm is required to promptly send the ACAT to the carrying firm.

Updates Made to the License Exam Manual, 2nd Edition, Since Publication

Below is information regarding changes in rules and regulations that have been approved since the Kaplan Financial Series 4 License Exam Manual, 2nd edition, was published. These changes will be incorporated in the next edition of the License Exam Manual.

Effective September 7, 2007, NASDAQ members are now required to increase the frequency of short interest reporting from monthly to twice a month.

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

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