

Test Alert!

to Accompany the 7th Edition LEM

2/22/07

series **55**

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

Kaplan Financial Series 55, 1st Edition Update

Introduction

The information found in this *TestAlert!* is intended to update Kaplan Financial's *Series 55 License Exam Manual, 7th Edition* to match the newly published 1st Edition.

On July 14, 2006, NASD released a revised Series 55 Study Outline, which is effective as of August 15. The changes noted below were not unexpected, and some of these changes have already been integrated in the current (7th) edition of the *Kaplan Series 55 License Exam Manual*.

There are still 100 questions, and candidates still have 3 hours to complete the exam. A score of 70% or better is still required to receive a passing grade.

NASD has modified the number of questions in each section of the exam as follows:

Section	Prior No. of Questions	Revised No. of Questions
Nasdaq and OTC Markets	42	41
Nasdaq Display, Execution, and Trading Systems	15	17
Trade Reporting Requirements	16	19

Part I

New Exam Material Currently Covered in the 7th Edition

1. **SEC Rule 600** This rule, which is part of Regulation NMS (National Market System), deals with definitions. Regulation NMS was designed to bring trading and reporting uniformity to the various securities markets in the United States. This rule defines various concepts, including limit orders, marketable limit orders, directed orders, nondirected orders, SROs, and the like. These terms are dealt with throughout the license exam manual (LEM).
2. **SEC Rule 602** This rule, which is part of Regulation NMS, deals with the quotation responsibilities of market makers, ECNs, and exchange specialists. These responsibilities, such as the obligation to execute orders against its quotes, are covered on pages 51–53 of the LEM.
3. **SEC Rule 604** This rule, which is part of Regulation NMS, is the limit order display rule and is covered on page 69 of the LEM.
4. **SEC Rule 605** This rule, which is part of Regulation NMS, deals with the disclosure of order execution information and is covered on page 21 of the LEM. This rule was originally designated as SEC 11Ac1-5.
5. **SEC Rule 606** This rule, which is part of Regulation NMS, deals with the disclosure of order routing information and is covered on page 21 of the LEM. This rule was originally designated as SEC 11Ac1-6.
6. **NASD Rule 4704** This rule deals with the regulations surrounding Nasdaq's opening cross and is covered on page 86 of the LEM.
7. **NASD Rule 4707** This rule deals with the entry of attributable quotes/orders, nonattributable quotes/orders, reserve size, and the time stamping of quotes and orders. This material is covered on pages 81–83 of the LEM.
8. **NASD Rule 4709** This rule deals with the regulations surrounding Nasdaq's closing cross and is covered on page 85 of the LEM.
9. **SEC Rule 200** This rule is now a part of Regulation SHO. The rule defines a short sale and includes a requirement to mark sell tickets on all equity securities. They must be marked long, short, or short-exempt. This information can be found on page 62 of the LEM.
10. **SEC Rule 203** This rule, which also is a part of Regulation SHO, mandates a locate requirement before the short sale of any equity security. The rule also defines a threshold security. These issues can be found on pages 62 and 65 of the LEM, respectively.

11. **References to specific types of Nasdaq securities covered by Series 55** Material on the equity and equity equivalent securities eligible for a Nasdaq listing is covered throughout the LEM.

Part II

New Exam Material Not Covered in the 7th Edition

1. **SEC Rule 612** This rule, which is part of Regulation NMS, mandates minimum price increments for quotations. For stocks priced at \$1 per share or greater, the minimum price increment is \$.01. For stocks priced below \$1 per share, subpenny pricing, as small as \$.0001, is permitted.
2. **NASD Rule 2111: Trading ahead of customer market orders.** This rule prohibits a firm that holds a customer market order from trading for its own account at prices that would satisfy the customer market order, unless the firm immediately executes the customer order. This rule applies to both Nasdaq and exchange-listed securities. It does not apply to not-held orders or to odd-lot orders.
For example: The inside market for ABCD is 10.00-10.05, and Firm A accepts and holds a customer market order to buy 1,000 shares. If Firm A buys 1,000 shares of ABCD at 10.00 from Firm B (or from any other source), it is required to fill the customer's order at that price. Similarly, if Firm A bought shares for its own account below the inside bid, it would be required to fill the customer order at that same price.
This is comparable to the requirements of the limit order protection rule. If a market maker is holding a customer order to buy at 31.01 and, as principal, buys at 31.00, it must fill the customer order at 31.00, passing along to the customer any price improvement it received as principal.
3. **NASD Rule 3380** *Trade shredding* is a term used to describe the practice of splitting customer orders into multiple smaller orders (e.g., a 1,000-share order split into ten 100-share orders) in order to maximize payment for order flow from the market maker to which the orders are directed. In other words, the payment for order flow would be greater on ten 100-share orders than it would be for a single 1,000-share order. Trade shredding is a prohibited practice.
4. **NASD Rule 4701** Rule 4701 introduces a new concept: the total good-till-canceled (GTX) order. If a GTX order is entered into the Nasdaq Market Center and the order is not executed in whole or in part, the order or unexecuted portion will remain available for display between 7:30 am and 4:00 pm and for execution between 8:00 am and 4:00 pm. The order will remain open until canceled by the entering party or until 1 year after entry, whichever comes first.

Quick Quiz 1

1. An order entry firm receives a customer market order to buy 1,000 shares of WXYZ. The firm directs the order to a market maker with which the firm has a payment for order flow arrangement. The order is placed as ten 100-share orders. This is a prohibited practice known as
 - A. interpositioning
 - B. trade shredding
 - C. nonattribution
 - D. piggybacking
2. Under SEC rules, subpenny pricing is permitted for which of the following?
 - A. A Nasdaq stock trading at \$2.75 per share
 - B. A non-Nasdaq stock trading at \$2.00 per share
 - C. A Bulletin Board stock trading at \$1.75 per share
 - D. Any stock trading below \$1.00 per share
3. The inside market for ABCD is 20.00-20.03. A firm accepts and holds a customer market order to buy 1,000 shares. If the firm buys 1,000 shares of ABCD as principal from a market maker at 20.00, it would be required to fill the customer order at
 - A. 20.00
 - B. 20.01
 - C. 20.02
 - D. 20.03
4. A GTX order, if not executed in whole or in part, will remain open until canceled by the entering party or until
 - A. 30 days after entry, whichever comes first
 - B. 90 days after entry, whichever comes first
 - C. 180 days after entry, whichever comes first
 - D. 1 year after entry, whichever comes first

5. **NASD Rule 4706** NASD has amended this rule to allow ITS/CAES market makers to enter orders in increments of fewer than 100 shares. These orders must be entered into the Nasdaq Market Center, not into the Intermarket Trading System (ITS), which continues to require orders to be in round lot multiples.
6. **NASD Rule 4710** This rule amendment allows SuperMontage to automatically match any nondirected buy and sell quotes/orders entered by an order entry firm against the quotes/orders of that same firm on the other side of the market if such a quote/order on the other side is at the inside price. This rule effectively prevents locked or crossed markets in the Nasdaq Market Center.
7. **NASD Rule 4714** In the event an order becomes nonmarketable while it is in the execution queue (e.g., a marketable limit order where the market has moved away), the order must be included in the Nasdaq Market Center book in accordance with the time priority established by the time stamp attached to it when it was initially submitted. Once an order is placed on the book, it cannot be routed outside the Nasdaq Market Center unless otherwise instructed by Nasdaq.
8. **NASD Rule 4715** This rule deals with the adjustment of open orders/quotes as the result of cash dividends, stock dividends, or stock splits. For cash dividends, only open orders/quotes entered below the market, such as buy limits, are adjusted. Orders entered above the market, such as sell limits, are not adjusted.
 For example: ABCD declares a cash dividend of \$.25 per share. On the morning of the ex-date, the price of open orders to buy will be reduced by \$.25 per share. If a cash dividend includes a fraction, it is rounded up for ex-date reduction purposes. A cash dividend of \$.065 cents per share results in an ex-date reduction to the price of a buy limit order of \$.07. If an order to buy is marked DNR (do not reduce), no adjustment is made to the price of the order.
 For stock dividends and stock splits, all orders on the book are adjusted.
 For Example: ABCD declares a 20% stock dividend. On the morning of the ex-date, an order to buy 100 shares of the stock at 60.00 will be adjusted to an order to buy 120 shares at 50.00. Note that the customer still has an order to buy \$6,000 worth of stock. Stock splits are adjusted in the same way. On the morning of the ex-date for a 3-for-2 split, an order to buy 100 shares at 60.00 becomes an order to buy 150 shares at 40.00.
 For reverse splits, all open orders are canceled. Odd-lot orders that result from partial execution rather than order entry are canceled rather than adjusted.
9. **NASD Rule 4719: Anonymity** The identity of a member submitting a nonattributable quote/order seeking pretrade anonymity will remain anonymous until execution, at which time the member's name will be revealed to the contra party. This is the basic rule surrounding the placement of orders/quotes using the SIZE MPID. This rule has been enhanced to provide full anonymity. If a member submits a nonattributable quote/order seeking full anonymity, any execution will be processed anonymously. The transaction reports will indicate the details of the transaction but will not reveal the identity of the contra party.
10. **IPO process** Under new rules, Nasdaq will automatically use the issuer's public offering price as the first bid at the start of trading. The lead underwriter is expected to notify Nasdaq as to what that price will be by 6:45 pm on the evening before trading will begin. In the event the IPO price is not communicated to Nasdaq by 6:45 pm, the security will open via the current process. In this event, firms can

begin entering orders at 7:30 am on the day IPO trading is set to begin. These orders will be displayed at the beginning of the quote-only period and will become active at the time of the IPO trading release.

11. **Reporting canceled trades** Under an amendment to the transaction reporting rules, the cancellation of any trade previously submitted must be made by the party responsible for submitting the original trade report. For trades executed through a Nasdaq system that automatically reports trades to ACT, the party that would have been responsible for reporting the trade, had the system not been in place, must make the cancellation report. The time frame for reporting canceled trades is as follows.
 - For trades executed during normal hours and canceled before 5:13:30, the cancellation report must be made within 90 seconds of the time the trade is canceled.
 - For trades executed during normal hours and canceled after 5:13:30 but before 5:15, the member responsible must use its best efforts to report the cancellation not later than 5:15. If the member is unable to do so, it must report the cancellation by 6:30 pm on the following business day.
 - For trades executed during normal hours and canceled after 5:15, the cancellation report must be made by 6:30 pm on the following business day.

12. **ACT reporting modifiers** The modifier **.W** is now being used to report stop-stock trades to ACT. A stop-stock transaction is any trade that is the result of an order in which a member and another party agree that the order will be executed at a stop-stock price or better. This is comparable to an exchange specialist stopping stock for a floor broker. The ACT report will include the time at which the parties agreed to the stop-stock price, not the actual time the trade was executed.

The modifier **.ST** is now being used for late reports of trades in the pre-open and after-hours trading sessions. Unlike the rules governing the **.SLD** modifier, members will not be required to append the **.ST** modifier to late reports of pre-open and after-hours trades. Nasdaq will automatically compare the time of the report to the time of execution (now required on all trade reports) and append the modifier as appropriate.

13. **Naming conventions** Nasdaq National Market stocks are now called Global Market stocks, whereas SmallCap stocks are now referred to as Capital Market stocks. Furthermore, there is a special tier of Global Market stocks called Global Select. The listing requirements for Global Select are somewhat comparable to those of the NYSE. The rules that were applicable to National Market and SmallCap stocks are now applicable to the Global Market and Capital Market stocks, respectively.

Quick Quiz 2

1. A trade executed during normal hours is canceled at 4:20 pm. Under Nasdaq rules, the cancellation must be reported
 - A. within 90 seconds
 - B. by 5:15 pm on the day of execution
 - C. by 6:30 pm on the day of execution
 - D. before market opening on the following business day
2. ABCD declares a 1-for-2 reverse stock split. On the morning of the ex-date, which of the following describes how limit orders on the book are handled?
 - A. Buy limits are adjusted to reflect the split.
 - B. Sell limits are adjusted to reflect the split.
 - C. Both buy and sell limits are adjusted to reflect the split.
 - D. Both buy and sell limits are canceled.
3. Under Nasdaq rules, the lead underwriter for an IPO must notify Nasdaq as to what the public offering price will be
 - A. as soon as it is determined
 - B. no later than 6:45 pm on the day before trading will begin
 - C. at or before 7:30 am on the day trading will begin
 - D. at or before 9:28 am on the day trading will begin
4. A trade between two market makers executed at 8:40 during the pre-opening session is reported to ACT at 8:50. Nasdaq will append which of the following modifiers to the trade report?
 - A. .SLD
 - B. .PRP
 - C. .ST
 - D. .W

Part III

Items Deleted from the Official Series 55 Study Outline

1. **SEC Rule 11Ac1-1** This rule dealing with dissemination of quotations is no longer being tested. It can be found on page 14 of the LEM.
2. **SEC Rule 11Ac1-4** This rule dealing with the display of customer limit orders has been renamed Rule 604 and is still being tested. The former rule designation has been deleted.
3. **SEC Rule 11Ac1-5** This rule dealing with the disclosure of order execution information has been renamed Rule 605 and is still being tested. The former rule designation has been deleted.
4. **SEC Rule 11Ac1-6** This rule dealing with the disclosure of order routing information has been renamed Rule 606 and is still being tested. The former rule designation has been deleted.
5. **SEC Rule 10b-10** This rule dealing with confirmations has been deleted from Series 55 and can be found on page 11 of the LEM.
7. **NASD Rule 3360** This rule, which has been deleted from the Series 55, deals with short interest reporting and can be found on page 66 of the LEM.

Quick Quiz Answers

QUICK QUIZ 1

1. **B.** *Trade shredding* describes the splitting of customer orders into multiple smaller orders to maximize payment for order flow.
2. **D.** The minimum increment for stocks trading at \$1 per share or greater is \$.01. Subpenny pricing is only permitted for stocks trading below \$1 per share.
3. **A.** A firm cannot trade ahead of a customer market or a customer limit order. Therefore, the firm must fill the order at 20.00.
4. **D.** GTX orders (total good-till-canceled orders), if unexecuted, will remain open until canceled by the entering party or until 1 year after entry, whichever comes first.

QUICK QUIZ 2

1. **A.** Trades executed during normal market hours and canceled before 5:13:30 pm must be reported within 90 seconds of the time the trade is canceled.
2. **D.** With reverse splits, all open orders are canceled as of the ex-date.
3. **B.** Nasdaq uses the issuer's public offering price as the first bid at the start of trading. The lead underwriter is expected to notify Nasdaq as to what that price will be by 6:45 pm on the day before trading will begin.
4. **C.** For late reports of trades in the pre-open and after-hours trading sessions, the modifier **.ST** will be appended to the report by Nasdaq.

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

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