

Test Alert! to Accompany the 2nd Edition LEM

8/16/07

series 9

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 9 License Exam Manual (LEM). This information is incorporated in the 2nd edition of the Kaplan Financial Series 9 LEM.

EXAMINATION AND STUDY OUTLINE

The rules of various stock and options exchanges state that broker/dealers may register an individual as a general securities sales supervisor if the individual's supervisory responsibilities in the investment banking and securities business are limited to the securities sales activities of a firm, including the training of sales and sales supervisory personnel and the maintenance of records of original entry and/or ledger accounts of the firm required to be maintained in branch offices by SEC recordkeeping rules.

The Series 9/10 examination tests a candidate's knowledge of securities industry rules and regulations and certain statutory provisions pertinent to the supervision of sales activities.

A general securities sales supervisor may not perform any of the following activities:

- Supervision of the origination and structuring of underwritings
- Supervision of market-making commitments (final approval of advertisements as these are defined in NASD Rules)
- Supervision of the custody of firm or customer funds and/or securities
- Supervision of overall compliance with financial responsibility rules for broker/dealers

Various Self-Regulatory Organizations

On October 14, 2005, NASD announced a revision to the Limited Principal—General Securities Sales Supervisor—Series 9/10 (see Series 10 *TestAlert!*). The changes began to appear in examinations late in 2005.

There are still 55 questions on the Series 9 exam, with 1½ hours to complete the test. Each question counts as one point, and each candidate must correctly answer 70% of the questions for a passing grade.

The Series 9/10 examination was reviewed by regulators of self-regulatory organizations that share the exam: the NYSE Arca, CBOE, AMEX, PHLX, PCX, and FINRA (NASD). As a result of the review and as discussed in greater detail below, FINRA (NASD) has revised the examination programs generally to reflect changes in relevant trading systems, as well as laws, rules, and regulations, with the goal of more accurately testing the duties and responsibilities of the individuals who are taking these examinations.

The Series 9 exam reflects contributions made to the exam by the various exchanges involved with options trading. Consequently, the study outline published by FINRA (NASD) emphasizes each exchange's individual rules and interpretations covering but not limited to the following:

- Definitions
- Account documentation
- Customer verification
- Delivery of disclosure document
- Minimum net equity requirements
- Special statement for uncovered writers
- Uncovered options transactions
- Supervision
- Options discretionary accounts
- Options programs
- Trading rotations
- Fast markets
- Positions and exercise limits
- Contract adjustments

The list of items from the newest study guide indicates that the test remains true to its purpose: evidencing a newly appointed sales principal as being at least minimally competent with supervising the day-to-day activity of options sales personnel.

Although each exchange's rules have differences and peculiarities, the questions found on the Series 9 test those points held in common with the other exchanges (i.e., how the rules pertaining to options enforced by the various SROs are put into practice in the day-to-day business of a general securities sales supervisor). The Series 9 test could be summed up as an application of best practices and rules common to all the exchanges.

Actual Application

The Series 9 candidate will be required to be familiar with the actual application and the results of activities such as exercise/assignment of options, including the following:

- The effect of exercise before ex-dividend date
- Customer notification of allocation method

- The mechanics and ramifications of the tendering of exercise notices for options
- Exercise by exception and same-day exercise
- Applicable time limitations
- The mechanics and effects of assignment, particularly on the ex-dividend date
- OCC assignment procedure and firm/market maker/customer assignment
- Firm procedures for allocating customer assignments (FIFO, random)
- Compliance with requirement for delivery and payment/settlement
- Priority-offered orders
- Time priority
- Off-floor accommodations
- The necessary reporting obligations, the mechanics, and effect of assignment, particularly on ex-dividend date
- Reverse splits
- Anti-money laundering

The Series 9 examination covers the areas of knowledge required for the aggressive supervision of sales activities.

FINRA (NASD) has repealed all the rules that have been replaced by SEC Regulation SHO. Accordingly, references to these rules from the Series 9 have been deleted.

As an experienced options professional, you will undoubtedly recognize many of the terms, concepts, and strategies listed below. Often the difference between the new test and the old is that a well-known rule is now being attributed to a stock or options exchange that was heretofore not credited in the official study outline:

- Withdrawal of approval of underlying securities
- Series of options open for trading
- Index options—broad-based index, narrow-based index, industry-based index, exercise style, expiration date, daily exercise, exercise assignment (European, American)
- NYSE Rules—American style index options, European style index options
- PHLX Rules—terms of option contracts
- Foreign currency options—contract sizes, expiration date, expiration style trading hours, expiration cycles
- PHLX Rules—foreign currency, foreign currency options series, block transactions in foreign currency

1. Reverse Collar

A reverse collar is established by a long call position accompanied by a short put position, where the long call expires with the short put and the strike price of the long call equals or exceeds the short put; each long call and short put position is hedged with 100 shares of the underlying security or other adjusted number of shares. Neither side of the long call, short put position can be in-the-money at the time that the position is established.

2. Regulation SHO

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

If an introducing firm places a short sale order through its clearing firm, it is the responsibility of the introducing firm, not the clearing firm, to determine that the security being shorted can be borrowed.

Closeout of Short Sales

Long sales not resulting in delivery must be closed out (i.e., bought in) after 10 business days from settlement. Short sales not resulting in delivery are covered by Regulation SHO. If a particular issue of stock has a significant number of shares that have been shorted and not delivered, it is termed a threshold security. If a market maker has failed to deliver in a threshold security open for 13 consecutive settlement days, Regulation SHO requires that the position be closed out by purchasing the securities. If the security is not on the threshold list, closeout is not required.

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 contract. 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 relating to 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

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 the 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 suspicious activity report (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 relating to 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 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.

5. 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 associated with an investment banking transaction

6. 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 only applies 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 REITs and 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, direct participation program securities, or both.

TAKE NOTE

This exemption only applies 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. A prohibition of investment banking personnel from supervising or controlling research analysts and from influencing analysts' compensation
 - B. Generally bar investment banking personnel from discussing current research reports
 - C. Preclude firms from granting bonuses to analyst compensation
 - D. Analysts must participate in a road show to clarify and answer questions

7. VIX Options

Volatility market index (VIX) 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.

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 while accepting the remainder. The account transfer must be completed within three business days after validation.

Quick Quiz 2

1. The following statements are true EXCEPT
 - A. VIX options are a European-style contract
 - B. VIX option value is based on real-time quotes 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 provides an up-to-the-minute market estimate of expected volatility

2. The margin requirement for purchasing a VIX option is
 - A. the premium
 - B. the premium + 20% of the current market value
 - C. the premium + 15% of the current market value
 - D. the premium + 4% of the current market value

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 immediately forward the signed ACAT to the carrying firm.
 - 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.

Quick Quiz 3

- Which of the following statements regarding market makers on the floor of the Chicago Board Options Exchange is TRUE?
 - Market makers are necessary for a liquid trading market.
 - Market makers are not allowed to represent public investors and traders.
 - Market makers trade their own capital.
 - All of the above.
- Which of the following statements regarding floor brokers of the CBOE is TRUE?
 - A floor broker trades for himself.
 - A floor broker trades for public investors and his chief concern is obtaining the best possible price for his customers.
 - A floor broker may trade for his own account from time to time.
 - All of the above.
- Individuals responsible for providing liquidity to the options market are known as
 - designated reporting members
 - brokers
 - market makers
 - floor brokers
- An order to buy or sell options at the best available price is a
 - market order
 - limit order
 - stop order
 - fill-or-kill order
- A specialized market maker who is responsible for maintaining fair and orderly markets on the CBOE is a
 - DPM
 - market maker
 - floor broker
 - floor governor
- An order to buy or sell options at a certain price is a
 - market order
 - order
 - stop order
 - not-held order
- Market makers are required to input three parameters into the AutoQuote system, the Exchange's option pricing system. They include all of the following EXCEPT
 - dividends
 - volatility
 - interest rates
 - inflation rates
- Under present CBOE rules, any public customer is entitled to a fill of at least how many contracts on any posted market?
 - 1
 - 2
 - 5
 - 20
- A portfolio manager placed an order with your firm for 25 million shares of ARC common to hedge 250,000 (maximum permitted) calls written on the stock. The total number of calls within the same class eligible to be written by this customer would be
 - 250,000
 - 500,000
 - 25,000,000
 - unlimited
- Which of the following would be permitted if an investor sold 250,000 (position limit) put contracts of a single series?
 - 250,000 long calls of the same series
 - 250,000 short puts of the same class
 - 250,000 long puts of the same class
 - 25,000,000 short calls of the same series

Answers and Rationales

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 on 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 and from influencing their compensation.

Quick Quiz 2

1. **C.** The volatility is calculated using a 30-day period.
2. **C.** The margin requirement for the purchase of a VIX option with 9 months or less to maturity is 100% of the premium, exactly the same as a standardized equity option.
3. **A.** The firm is required to promptly send the ACAT to the carrying firm.

Quick Quiz 3

1. **D.** Market makers trade differently than investors. They often do not care whether stock prices rise or fall. They earn money by making tiny profits on each trade and are therefore interested in trading as many options as possible. Market makers are necessary for a liquid trading market. It is unusual for an order to buy a fixed number of options at a certain price and an order to sell those same options to arrive simultaneously. Because market makers are not allowed to represent public investors and traders, they trade their own capital.
2. **B.** One of the floor broker's responsibilities and duties is acting as an agent for the investor. He must have the customer's best interest in mind at all times. Floor brokers cannot trade

for themselves because of the potential for conflict of interest.

3. **C.** Market makers are responsible for providing liquidity to the market.
4. **A.** A market order may be filled at the best price currently available.
5. **A.** A DPM is a floor trader responsible for maintaining a two-sided market for a specific product on the Chicago Board Options Exchange and is the trading firm designated by the exchange to ensure a fair and orderly market. They can perform the roles of the market maker and/or the floor broker, if conditions warrant. All equity options listed on the CBOE have a DPM.
6. **B.** A limit order placed by a customer can be executed only at that price or better.
7. **D.** The CBOE's option pricing system is Auto Quote. Using a version of the Black-Scholes model, it continuously calculates prices on the options traded on the exchange. The system is set to track movements in the underlying stock and price the options accordingly. The market makers are required to input 3 parameters into the system: dividends, interest rates, and volatility. There are a few options quoted by voice market.
8. **D.** If a retail client places an order for 20 contracts or fewer and it is a market or marketable-limit order, he is considered eligible for RAES.
9. **B.** The customer's position was neutral to the market and need not be included in determining position limits. The 250,000 contracts written against the shares of ARC may be matched with an additional nonexempt 250,000, for a total of 500,000 contracts.
10. **C.** Long puts are on opposite sides of the market and would not be added to the investor's short-put position in determining the position limit.

Updates Made to the 2nd Edition LEM Since Publication

There are no new changes at this time.

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

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