CHAPTER 1

Definition of Terms

INTRODUCTION

In order to successfully complete the Series 65 exam, it is important to have an in-depth understanding of the terms used within the securities industry—specifically within the framework of the Uniform Securities Act (USA). The terms used by the USA, also known as The Act, may have broader meanings than we are accustomed to in everyday usage.

SECURITY

A security is anything that can be exchanged for value that involves a risk to the holder. A security also represents an investment in an entity managed by a third party. The Supreme Court used the Howey test to determine a security. The Howey test states that a security must meet the following four characteristics:

1. It must be an investment of money.
2. It must involve a common enterprise.
3. It must give the investor an expectation of a profit.
4. It must entail the management of a third party.

The following are examples of securities:

- Stocks
- Bonds
- Notes

- Debentures
- Evidence of indebtedness
- Transferable shares
- Warrants, rights, or options for securities

Oftentimes when you see the term *certificate*, you have a security that is a:

- Certificate of interest in a profit sharing or partnership agreement.
- Preorganization certificate.
- Collateral trust certificate.
- Voting trust certificate.
- Certificate of interest in oil or a gas mining title.
- Certificate of deposit for a security, such as an American depositary receipt (ADR) or an American depositary share (ADS).

The term *variable* will also identify a security, as in:

- Variable annuity
- Variable life insurance
- Variable contract

The phrase *interest in* is another key to identifying a security on the Series 66 exam. All of the following are securities:

Interest in:

- Farmland and animals.
- Whiskey warehouse receipts.
- Commodity options (not futures).
- Insurance company separate accounts.
- Real estate condominiums or cooperatives.
- Merchandise marketing programs, franchises, or schemes.
- Multilevel distributorships, such as Amway.

The term *option* is also a good way to identify a security, such as:

- Stock option
- Index option

- Futures option
- Commodity futures option

The following are not considered securities:

- Real estate
- Retirement plans, such as IRAs and 401(k)s
- Bank accounts
- Collectibles
- Precious metals
- Fixed annuities/fixed contracts
- Whole and term life policies
- Antiques
- Futures contracts (commodities)
- Trade confirmations
- Prospectuses

The term *future*, as it appears alone, is an indication that a security is not involved. If the question is asking about a commodity future option, however, then a security is involved. Also, the term *fixed* is a good indication that a security is not involved.

PERSON

The term *person*, as it is used in the USA, refers to any entity that may enter into a legally binding contract. Any entity that can enter into a legally binding contract may transact business in the securities markets. Agreeing to buy or sell a security represents a legally binding contract. For the Series 66, a person is any of the following:

- Natural person
- Corporation
- Trust
- Government organization
- Partnership

- Joint stock company
- Sole proprietor
- Association
- Unincorporated organization

A nonperson is an individual or entity that may not enter into a legally binding contract and therefore may not transact business in the securities market. A nonperson is:

- A minor
- Someone deemed to be legally incompetent
- A deceased individual

BROKER DEALER

A broker dealer is a person or a firm that maintains a place of business and affects transactions in the securities markets for its own account or for the account of others. A broker dealer must be registered in its home state as well as in the states of its individual clients.

A broker dealer is *not*:

- An agent.
- A bank.
- A savings and loan.
- A person with no place of business in the state, who deals exclusively with financial institutions or issuers.

A person who conducts business with existing clients who do not reside in the state and are in state for less than 30 days.

AGENT

An agent or registered representative may only be an individual (natural person) who represents the issuer or a broker dealer in the purchase and sale or the attempted purchase and sale of securities with the public. Agents are required to register in their home state, their state of employment, and the state of residence of their customers.

Agents are *not* required to register if:

- They represent the issuer or a broker dealer in an underwriting transaction.
- They represent a bank or a savings and loan in the issuance of securities.

Agents who represent exempt issuers are not required to register. Examples of exempt issuers are:

- U.S. government.
- State and municipal governments.
- Canadian federal and municipal governments.
- Commercial paper with maturities of less than 270 days, sold in denominations exceeding $50,000.
- Investment contracts associated with employee pension plans, profit sharing, stock purchases, or savings plans.
- Foreign national governments recognized by the United States.

ISSUER

An issuer is any person that issues or simply proposes to issue a security. Issuers include:

- Corporations
- U.S. government and agencies
- State and local governments

In an issuer or primary transaction, the issuer receives the proceeds from the sale.

NONISSUER

A nonissuer is anyone who does not issue or propose to issue a security. All secondary-market transactions that take place on an exchange or in the over-the-counter (OTC) market are nonissuer transactions, and the selling security holder receives the proceeds from the sale.

INVESTMENT ADVISER

An investment adviser is any person who is actively involved in and receives a fee for any of the following:

- Issuing research reports or analysis.
- Publishing a market letter based on market developments or conditions.
- Advising clients as to the advisability of the purchase or sale of a security.
- Providing investment advisory services as a complement to their services and claiming to provide such services for a fee.
- Presenting him- or herself as an investment adviser, also known as the shingle rule.
- Providing advice about selecting portfolio managers or asset allocation.
- Nationally recognized statistical ratings organizations such as Moody's.
- Serving as a pension consultant.

PENSION CONSULTANTS

A pension consultant is anyone who advises employees on how to fund their employee benefit plans. A person would also be considered to be a pension consultant if he or she advises employees on the selection of asset managers or investment advisers for the plan.

An investment adviser is *not*:

- A bank or savings and loan.
- A broker dealer.
- An agent.
- A lawyer, accountant, teacher, engineer (LATE) whose services are incidental to his or her business and who do not receive a specific fee for such services.
- Any person exempted by the administrator or SEC.
- Individuals who only provide advice relating to government securities.
- Publishers of newspapers and magazines.
- Securities information processors.

FORM ADV

An investment adviser will begin the formal registration process by filing Form ADV, which provides detailed information regarding the investment adviser. Form ADV has four parts: 1A, 1B, 2A, and 2B.

ADV Part 1A includes general information about the investment adviser, including:

- The principal office address.
- Type of organization, such as corporation or partnership.
- How the adviser will conduct business.
- If the firm engages in other activities, such as that of a broker dealer.
- Biographical data on the officers, directors, or partners.
- Disciplinary history of the officers, directors, partners, and the firm.
- Location of books and records if other than the principal office.
- If the adviser has custody of customer assets.
- If the adviser has dictionary authority over customer assets.

ADV Part 1B is filed with the state securities administrator for advisers registered at the state level. Advisers who are federally registered do not file ADV Part 1B.

Form ADV Part 2A will disclose information relating to clients. ADV Part 2A includes:

- How and when fees are charged.
- The types of securities the adviser does business in.
- How recommendations are made.
- The type of clients the adviser has.
- The qualifications of officers and directors.

Form ADV Part 2B provides information relating to individuals who:

- Provide investment advice and who have direct contact with advisory clients.
- Have discretion over client assets regardless of whether the individual has contact with clients.

INVESTMENT ADVISER REPRESENTATIVE

An investment adviser representative is a person who is under the control of the investment adviser and includes:

- Officers and directors
- Partners
- Solicitors
- Supervisors

Clerical employees are not considered investment advisory representatives and are not required to register.

SOLICITOR

A solicitor is any person who for compensation actively seeks new business for an investment adviser. A solicitor can also include professionals who refer clients to the investment adviser for a fee. All solicitors must be registered as investment adviser representatives.

INSTITUTIONAL INVESTOR

An institutional investor is a person or firm that trades securities for his or her own account or for the accounts of others. Institutional investors are generally limited to large financial companies. Because of their size and sophistication, fewer protective laws cover institutional investors. It is important to note that there is no minimum size for an institutional account. Institutional investors include:

- Broker dealers
- Investment advisers
- Investment companies
- Insurance companies
- Banks
- Trusts
- Savings and loans
- Government agencies
- Employment benefit plans with more than $1,000,000 in assets

ACCREDITED INVESTOR

An accredited investor is an individual who meets one or more of the following criteria:

- Has a net worth of $1,000,000, excluding the primary residence,

  or
- Earns $200,000 per year or more for the last two years and has the expectation of earning the same in the current year,

  or
- Is part of a couple earning $300,000 per year or more.

QUALIFIED PURCHASER

A qualified purchaser must meet strict minimum financial requirements. Securities sold to qualified purchasers are not required to register in the state where the qualified purchaser resides. A qualified purchaser is:

- An individual with at least $5,000,000 in investments.
- A family-owned business with at least $5,000,000 in investments.
- A trust sponsored by qualified purchasers.

PRIVATE INVESTMENT COMPANY

A private investment company is an unregistered investment company or hedge fund that raises funds through the sale of securities to qualified purchasers for any business purpose.

OFFER/OFFER TO SELL/OFFER TO BUY

An offer is any attempt to solicit the purchase or sale of a security for value. An offer is considered to have been made in the state where the offer originated, as well as in the state where it is received or directed. An offer will not be considered to have been made if it was received through a television or radio broadcast originating outside the state. Additionally, an offer will not be considered to have been made if received by a newspaper or magazine published out of the state or by a magazine published in a state that has two-thirds of its paid circulation outside of the state.

SALE/SELL

To sell a security, its ownership must be conveyed for value. A sale is considered to have been made at the time of the contract (trade). A sale of a security that has warrants or a right attached is also considered a sale of the attached security. A sale of any security that is convertible or exercisable into another security is considered to include a sale of the security for which the security is convertible or exercisable. A gift of assessable stock is also considered a sale. Assessable stock is stock that may require the holder to make additional payments as a term of ownership. A sale does not include a dividend or the pledge of a security for a collateral loan.

GUARANTEE/GUARANTEED

The term *guarantee* means that another party, other than the issuer of the security, has guaranteed the payment of principal, interest, or dividends. Only three parties may guarantee something:

- U.S. government
- Insurance company
- Parent company (it may guarantee obligations of a subsidiary)

CONTUMACY

Contumacy is the willful display of contempt for the administrator's order. An act of contumacy may result in the agent's or firm's registration being revoked or other disciplinary action.

FEDERALLY COVERED EXEMPTION

A federally covered exemption provides for a full exemption from state registration for federally covered investment advisers and federally covered securities.

A federally covered investment adviser is one who meets the requirements for assets under management and is registered with the Securities and Exchange Commission (SEC).

A federally covered security is any of the following:

- A security listed on a centralized U.S. stock exchange or on the Nasdaq.
- An investment company security issued under the Investment Company Act of 1940.
- Securities sold to qualified purchasers.

OPTION CONTRACTS

An option is a contract between two parties that determines the time and price at which a stock may be bought or sold. The two parties to the contract are the buyer and the seller. The buyer of the option pays money, known as the option's premium, to the seller. For this premium, the buyer obtains a right to buy or sell the stock, depending on what type of option is involved in the transaction. Because the seller has received the premium from the buyer, the seller now has an obligation to perform under that contract. Depending on the option involved, the seller may have an obligation to buy or sell the stock.

CALL OPTIONS

A call option gives the buyer the right to buy, or to call, the stock from the option seller at a specific price for a certain period of time. The sale of a call option obligates the seller to deliver or sell that stock to the buyer at that specific price for a certain period of time.

PUT OPTIONS

A put option gives the buyer the right to sell or to "put" the stock to the seller at a specific price for a certain period of time. The sale of a put option obligates the seller to buy the stock from the buyer at that specific price for a certain period of time.

FUTURES AND FORWARDS

Futures, like options, are a two-party contract. Many futures contracts are an agreement for the delivery of a specific amount of a commodity at a specific place and time. Futures were first traded for commodities such as wheat and gold, and over the years they have expanded to include financial futures, such as on Treasury securities, and, most recently, single stock futures. The specific terms and conditions of the contracts are standardized and set by the exchanges on which they trade. The contract amount, delivery date, and type of settlement vary between the different futures contracts. Most investors will use futures as a hedge or to speculate on the value of the underlying commodity or instrument. Forwards are privately negotiated contracts for the purchase and sale of a commodity or financial instrument. Forwards are often used in the currency markets by corporations and banks doing business internationally. If a corporation knows that it needs to make a payment for a purchase in foreign currency three months from now, the corporation can arrange to purchase the currency from a bank the day before the payment is due. The big drawback with forwards is that there is no secondary market for the contracts.

SECONDARY MARKET ORDERS

Investors who do not purchase their stocks and bonds directly from the issuer must purchase them from another investor. Investor-to-investor transactions are known as secondary market transactions. In a secondary market transaction, the selling security owner receives the proceeds from the sale. Secondary market transactions may take place on a centralized exchange or in the OTC market known as Nasdaq. Although both facilitate the trading of securities, they operate in a very different manner. We will begin by looking at the types of orders that an investor may enter and the reasons for entering the various types of orders. Investors can enter various types of orders to buy or sell securities. Some orders guarantee that the investor's order will be executed immediately. Other types of orders may state a specific price or condition under which the investor wants an order to be executed. All orders are considered day orders unless otherwise specified. All day orders will be canceled at the end of the trading day if they are not executed. An investor may also specify that an order remain active until canceled. This type of order is known as good til cancel, or GTC.

MARKET ORDERS

A market order will guarantee that the investor's order is executed as soon as the order is presented to the market. A market order to either buy or sell guarantees the execution but not the price at which the order will be executed. When a market order is presented for execution, the market for the security may be very different from the market that was displayed when the order was entered. As a result, the investor does not know the exact price at which the order will be executed.

BUY LIMIT ORDERS

A buy limit order sets the maximum price that the investor will pay for the security. The order may never be executed at a price higher than the investor's limit price. Although a buy limit order guarantees that the investor will not pay over a certain price, it does not guarantee that the order will be executed. If the stock continues to trade higher away from the investor's limit price, the investor will not purchase the stock and may miss a chance to realize a profit.

SELL LIMIT ORDERS

A sell limit order sets the minimum price that the investor will accept for the security. The order may never be executed at a price lower than the investor's limit price. Although a sell limit order guarantees that the investor will not receive less than a certain price, it does not guarantee that the order will be executed. If the stock continues to trade lower away from the investor's limit price, the investor will not sell the stock and may miss a chance to realize a profit or may realize a loss as a result.

FOCUSPOINT

Remember that even if investors see the stock trading at their limit price it does not mean that their order was executed, because there may have been stock ahead of them at that limit price.

STOP ORDERS/STOP LOSS ORDERS

A stop order or stop loss order can be used by investors to limit or guard against a loss or to protect a profit. A stop order will be placed away from the market in case the stock starts to move against the investor. A stop order is not a “live” order; it has to be elected. A stop order is elected and becomes a live order when the stock trades at or through the stop price. The stop price is also known as the trigger price. Once the stock has traded at or though the stop price, the order becomes a market order to either buy or sell the stock, depending on the type of order that was placed.

BUY STOP ORDERS

A buy stop order is placed above the market and is used to protect against a loss or to protect a profit on a short sale of stock. A buy stop order could also be used by a technical analyst to get long the stock after the stock breaks through resistance.

EXAMPLE An investor has sold 100 shares of ABC short at $40 per share. ABC has declined to $30 per share. The investor is concerned that if ABC goes past $32 it may return to $40. To protect his profit, the investor enters an order to buy 100 ABC at 32 stop. If ABC trades at or through $32, the order will become a market order to buy 100 shares, and the investor will cover the short at the next available price.

SELL STOP ORDERS

A sell stop order is placed below the market and is used to protect against a loss or to protect a profit on the purchase of a stock. A sell stop order could also be used by a technical analyst to get short the stock after the stock breaks through support.

CHAPTER 1

Pretest

DEFINITION OF TERMS

1. Which of the following is not considered to be a person under the Uniform Securities Act (USA)?
   - **a.** A joint stock company
   - **b.** A trust
   - **c.** A 17-year-old honor student
   - **d.** A government agency

2. Which of the following is NOT considered a sale of a security?
   - **a.** A gift of assessable stock
   - **b.** A contract to convey ownership for value
   - **c.** A pledge of securities as collateral for a margin loan
   - **d.** A bonus of securities

3. The minimum financial requirement for an individual to be considered a qualified purchaser is:
   - **a.** $1,000,000.
   - **b.** $2,500,000.
   - **c.** $5,000,000 individually or $10,000,000 jointly with a spouse.
   - **d.** $5,000,000 individually or jointly with a spouse.

4. As it pertains to the USA, which of the following are considered institutional investors?

I. A bank
II. An insurance company
III. An employee benefit plan with $800,000 in assets
IV. A trust

a. I and II
b. I and IV
c. I, II, and IV
d. I, II, III, and IV

5. All of the following are considered securities, EXCEPT:

a. whiskey warehouse receipts.
b. a trust indenture.
c. a commodity future option.
d. interest in a marketing scheme.

6. A parent gives 1,500 shares of assessable stock to his child. Under the USA this is:

a. subject to approval of the state securities administrator.
b. considered an offer of securities.
c. subject to a transfer tax.
d. considered a sale of securities.

7. Which of the following is considered an investment adviser?

a. The publisher of a market report based on market internals
b. A publisher of a financial newspaper
c. An accountant
d. A person paid a commission for executing a securities transaction

8. Which of the following is considered a qualified purchaser?

a. An individual with $1,000,000 in investments held jointly with a spouse and with an annual income of $375,000
b. A publicly held company with at least $5,000,000 in net assets
c. A pension plan with $2,000,000 in assets
d. A family-owned business with at least $5,000,000 in assets

9. XYZ common stock trades on a U.S. stock exchange. XYZ common stock is an example of a(n):

a. blue-chip security.
b. federally covered security.
c. exempt security.
d. security of an exempt issuer.

10. A security is represented by an interest in which of the following?

I. Farmland or animals
II. A cooperative
III. A marketing scheme
IV. A multilevel distributorship

a. None of these
b. I and II
c. I, II, and III
d. I, II, III, and IV

11. Under the USA, which of the following is an investment adviser?

I. XYZ Advisers, Inc.
II. Mr. Jones, the owner of XYZ Advisers, Inc.
III. The publisher of a market letter based on economic trends
IV. A partner for XYZ who solicits new clients for XYZ advisers

a. I only
b. I and III
c. I, II, and IV
d. I, II, III, and IV

12. Which of the following is NOT one of the Howey test criteria for determining whether an investment is a security?

a. Third-party management
b. Investment of money
c. A common enterprise
d. The promise of a profit

13. A broker is a(n):
    a. registered representative.
    b. duly licensed agent.
    c. issuer of collateralized securities.
    d. person who executes transactions for the accounts of others.

14. An offer of securities is considered to have been made in which of the following circumstances?
    a. A sales presentation for a fixed annuity
    b. Delivering a market report
    c. Mailing a form letter
    d. Delivering a prospectus

15. The Uniform Securities Act defines an issuer as which of the following?
    a. A broker dealer
    b. A bank
    c. A corporation proposing the sale of common shares
    d. A savings and loan

16. Which of the following individuals is considered to be an agent?
    a. An individual represents a bank as the issuer of securities
    b. An individual represents a corporate issuer in the sale of large-denomination commercial paper
    c. An individual represents a Canadian province
    d. An individual represents an out-of-state broker dealer selling securities to residents

17. Which of the following is NOT a broker dealer?

I. A firm with no office in the state that transacts business only with existing customers who do not reside within the state.

II. A firm with no office in the state that transacts business only with broker dealers in state.

III. A firm with an office in state that only transacts business with other broker dealers.

IV. A firm with no office in the state that only transacts business with wealthy clients in state.

a. I and II

b. II and IV

c. I, II, and IV

d. I, II, III, and IV

18. Which of the following is NOT a federally covered security?

a. A security issued by an investment company

b. A security issued by a unit investment trust (UIT)

c. Exchange-listed common shares

d. A security listed on the Nasdaq OTC BB

19. A guarantee may be issued by which of the following?

I. An insurance company

II. The U.S. government

III. A parent company

IV. An investment adviser

a. I and IV

b. I and III

c. I, II, and III

d. I, II, III, and IV

20. An offer to sell has been made:

a. when stock has been pledged as collateral for a loan at the bank.

b. when a gift of securities to a charity results in tax credit for the donor.

c. when a representative calls a client and recommends a security.

d. when an account is transferred to the surviving party under joint tenants with rights of survivorship.