PASS THE SIE™

A PLAIN ENGLISH EXPLANATION TO HELP YOU PASS
THE SECURITIES INDUSTRY ESSENTIALS EXAM

EXAMZONE, INC.

PASS THE SIE™ - A PLAIN ENGLISH EXPLANATION TO HELP YOU PASS THE SECURITIES INDUSTRY ESSENTIALS EXAM

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How to Use This Book

We're happy you chose Examzone to help you pass the Securities Industry Essentials (SIE) Exam. Our ***Pass the SIE™*** Exam Manual (this textbook) is written in Plain English so you can learn concepts and assimilate the material quickly and easily. We hope you take advantage of our full ***Pass The SIE Success Program™*** (sold separately*), complete with test prep materials for each step of the learning process.

All of the Learning Components of the ***Pass The SIE Success Program™*** are sold separately and can be found at http://www.examzone.com/passthesie and include:

- Pass the SIE™ Exam Manual (this textbook)
- Pass the SIE™ Online Practice Question Bank
- Pass the SIE™ Online Training Videos
- Pass the SIE™ Streaming Audio Lessons
- Pass the SIE™ Digital Study Plan

Our research has shown that students who follow the entire ***Pass The SIE Success Program™*** have considerably higher pass rates than those who use only one or two of the Learning Components. Our Success Program integrates each of the Learning Components on a chapter-by-chapter basis. The sequence starts with each textbook exam manual chapter, followed by the requisite Review Exercise and Review Quiz and finally finishes with the streaming video and audio lessons for that chapter. You can see this sequence outlined at www.examzone.com/studyplan by signing up for the ***free*** Pass The SIE Success Program™ Digital Study Plan.

Additionally, our Pass the SIE™ Online Practice Question Bank are designed to test your readiness for the Securities Industry Essentials (SIE) Exam. We recommend you take the final practice exam at least two weeks prior to your scheduled test date. If you score an 80% or above, we think you're ready to take the Securities Industry Essentials (SIE) Exam.

All of the Success Program materials mentioned above are available for purchase at http://www.examzone.com/passthesie. Email us at support@examzone.com or call us toll free at 1-855-EXAM-CARE – 1 (855) 392-6227 with any questions.

Please visit www.examzone.com/studyplan to sign up for your free personalized Pass the SIE™ Digital Study Plan which will help guide you and track your progress ensuring your success in passing the SIE.

Thanks for studying with Examzone, and good luck!

* Pass the SIE™ Learning Components and Pass the SIE Success Program Online Only Bundle™ are sold separately at http://www.examzone.com/passthesie. ***The Pass The SIE Success Program Online Only Bundle™*** includes 6 Month subscription access to the Pass the SIE™ Online Practice Question Bank, Pass the SIE™ Online Training Videos, Pass the SIE™ Streaming Audio Lessons and may be purchased for an additional subscription fee.

Introduction To the Securities Industry Essentials (SIE) Exam

What is the Securities Industry Essentials (SIE) Exam?

The Securities Industry Essentials Exam is an exciting, new development from the industry regulator known as FINRA. Historically, those who wanted to become securities agents had to be hired by a broker-dealer before taking a license exam. Now, with the implementation of the Securities Industry Essentials (SIE) Exam, those interested in entering the industry can take a securities license exam on their own. Then, after being hired by a member firm, these individuals will take a top-off exam, such as the Series 6 or Series 7, to complete their FINRA licensing requirements.

The results of the SIE are good for four years. Therefore, an individual can take the exam long before he chooses his career path and begins his job search in the financial services industry. Those who have passed the Securities Industry Essentials (SIE) Exam are presumed to have an advantage over other candidates, as they have shown initiative and already cleared one hurdle in the process of getting a candidate registered with FINRA and the state securities regulators.

Why Do I Need to Pass the SIE?

To sell securities for compensation, individuals are required to pass either a Series 6 or Series 7 license exam. The Series 6 license allows the individual to sell packaged products such as mutual funds and variable annuities for compensation, while the Series 7 license allows the individual to sell these products plus common stock, bonds, options, and other securities. For years, candidates have taken either the 100-question Series 6 Exam or the 250-question Series 7 Exam, depending on the securities sold to customers.

With the implementation of the SIE, candidates will now take the 75-question Securities Industry Essentials (SIE) Exam, typically, while in college. Then, after being hired by a broker-dealer, the individual will be required to pass either the Series 6 or Series 7 top-off exam, down to 50 questions for the Series 6 and just 125 for the Series 7 exam going forward.

So, if you pass the Securities Industry Essentials (SIE) Exam and then get hired by a firm to sell only packaged products, you will complete your license exam requirements by passing the Series 6, and then passing the state-law exam called the Series 63. If you will sell these products as well as the securities mentioned above, you will take the Series 7 plus the Series 63.

What Are the Basic Facts About the SIE Exam?

- The Exam is 75 questions
- All questions are multiple choice
- Candidates are allowed 105 minutes to complete the exam
- The passing score is 70%
- Exam results are good for four years from the date of passing the test
- Passing the exam does <u>not</u> qualify the individual to work within the industry by itself!
- To become licensed to work as an agent the individual must also:
    - Secure employment at a broker-dealer
    - Pass the appropriate top-off exam
    - Pass the state-securities-law exam, the Series 63
    - Register through FINRA with a U4 submitted by the broker-dealer

What Are the Prerequisites?

There are no prerequisites for the Securities Industry Essentials (SIE) Exam. Historically, there were no prerequisites for the Series 6 or Series 7 Exam. Now, the SIE is the prerequisite for both tests.

While a college degree may be required by a broker-dealer advertising for a position or as a general hiring policy, it is not a regulatory requirement. To take the SIE, the Series 6, or the Series 7, the candidate is not required to have a college degree.

What Information Is Covered on the SIE?

As its name suggests, the Securities Industry Essentials (SIE) Exam covers the essential information related to the securities industry. While this information was covered in both the Series 6 and Series 7 exams, FINRA has decided to separate the essential information covered in the new Securities Industry Essentials (SIE) Exam from the more detailed and job-specific information covered in the top-off exams taken after the individual has been hired and sponsored by a member broker-dealer.

As FINRA explained when introducing the exam to the industry, "the SIE assesses basic product knowledge; the structure and function of the securities industry markets, regulatory agencies and their functions; and regulated and prohibited practices."

The same FINRA notice explains that the four main topic areas of the exam are as follows:

The first topic area, "Knowledge of Capital Markets," focuses on topics such as types of markets and offerings, broker-dealers and depositories, and economic cycles. The second, "Understanding Products and Their Risks," covers securities products at a high level as well as associated investment risks. The third, "Understanding Trading, Customer Accounts and Prohibited Activities," focuses on accounts, orders, settlement and prohibited activities. The final section, "Overview of the Regulatory Framework," encompasses topics such as SROs, registration requirements and specified conduct rules.

How Is This Exam Manual Organized?

This book follows the Securities Industry Essentials (SIE) Exam Outline provided by FINRA. There are four sections of the FINRA outline, which is why this book, also, has four chapters.

Chapter 1 covers primary offerings of securities, such as IPOs or initial public offerings. Regulatory entities and market participants are explored. Finally, we look in some detail at basic economic factors affecting securities investments, including inflation, interest rates, and the business cycle.

The largest chapter, Chapter 2, is called "Understanding Products and Their Risks." Here, we explore insurance and securities products in detail, following with a detailed examination of investment risks related to various approaches.

Chapter 3 looks at customer accounts, trading securities, communications of a broker-dealer, suitability, and certain prohibited activities of agents and others in the industry.

The last chapter, Chapter 4, focuses on the regulation of the securities industry. Here, we explore FINRA membership, registration requirements, employee conduct, disciplinary hearings, and arbitration.

After each chapter, you will take a chapter review exercise, and then a chapter review quiz. At the end of the four chapters, you will find two full-length practice exams, 75 questions each. A detailed glossary follows the practice exams. Finally, an index of frequently used terms is found at the end of the manual.

How Should I Approach Exam Questions?

Some exam questions will be straight forward. Many, however, will be challenging based on the way they are presented. No matter what the structure of the question, the best way to avoid the trap is to read the question carefully. Make sure you didn't skip a word or insert a word.

Now, look at the four answer choices. Your job is to eliminate three of them. And, you can do it in any order.

What you do not want to do is rush through the question looking for familiar phrases and grabbing the first answer that looks decent.

That is a trap. Some questions present a false pattern and try to exploit it. Some questions are extra-wordy. Some use negative words—except, least likely, avoid—to confuse the test taker. And, all candidates have strengths and weaknesses, making some topics harder than others even when the questions are basic.

Do not expect to know the answer just from reading the question. The answer is always one of the four choices given. Again, your job is to eliminate the other three answers based on what you've learned through the book, training videos, and/or practice questions.

Where Can I Get More Information, Including How to Sign Up for the Exam?

FINRA provides information on the SIE and other license exams at http://www.finra.org/industry/qualification-exams.

At the time of this writing, Prometric is the sole provider of testing services for FINRA. The Prometric website is at https://www.prometric.com/en-us/Pages/home.aspx.

CHAPTER 1: Knowledge of Capital Markets

(12 of 75 questions on the Securities Industry Essentials Exam)

Regulatory Entities, Agencies and Market Participants

Let's start by discussing the principal participants in the securities industry.

Regulatory Entities and Agencies

Securities and Exchange Commission

Securities are defined generally as financial instruments of some value that can be traded among investors. Examples include stocks, bonds, and mutual funds.

The **Securities and Exchange Commission** is the securities regulator for the federal government. The **SEC** was created by Congress in 1934 to protect investors and foster efficient and trustworthy securities markets. The SEC website at www.sec.gov declares:

> The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC strives to promote a market environment that is worthy of the public's trust.

We will look at the "capital formation" referred to up ahead in some detail. For now, know that without public trust, companies such as Facebook and Starbucks would not be able to raise funds and expand, as few investors would be willing to purchase their stocks or bonds.

The SEC explains their organization this way:

> The Securities and Exchange Commission has five Commissioners who are appointed by the President of the United States with the advice and consent of the Senate. To ensure that the Commission remains non-partisan, no more than three Commissioners may belong to the same political party. The President also designates one of the Commissioners as Chairman, the SEC's top executive.

The securities markets are regulated under the federal securities Acts of the United States Congress. The Securities and Exchange Commission (SEC) also makes and updates rules under these securities laws.

Securities Act of 1933

The **Securities Act of 1933** aims to ensure that investors have the material information they need before buying stocks and bonds issued on the **primary market** and that this information be accurate and not misleading. The primary market is the term used for issuing securities to investors for the first time.

As the SEC explains:

> Often referred to as the "truth in securities" law, the Securities Act of 1933 has two basic objectives:
>
> • require that investors receive financial and other significant information concerning securities being offered for public sale; and
>
> • prohibit deceit, misrepresentations, and other fraud in the sale of securities.

The Securities Act of 1933 focuses solely on the offering of securities to public investors for the first time, requiring issuers to register an offering of securities with the SEC before the issuer is allowed to offer or sell their securities to the public. An **issuer** is any individual or entity issuing a stock, bond, or other security to investors. Facebook, for example, is the issuer of Facebook common stock.

Because of the Securities Act of 1933, an investor must be provided with a disclosure document that details everything he might need to know about the company issuing the security. This document is usually called a **prospectus,** but is sometimes called an **offering circular** or a **private placement memorandum,** depending on the type of offering.

The SEC requires issuers to provide information, but they do not determine the information is accurate or complete. They could not do that, since only the issuer knows the story of its operations. To avoid confusion as to whether the federal government endorses the offer or the issuer, there must be a prominent SEC legend on the disclosure document, such as the following:

> Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus. Any representation to the contrary is a criminal offense.

We will look at securities exchanges and trading facilities up ahead. For now, know that if the issue of stock is authorized for listing on NYSE, NASDAQ, or other major securities exchanges, the issuer only registers with the SEC. But, if the issue will not trade on those exchanges, the stock also must be registered with the states where it will be offered and sold. This state-level registration could be referred to as **blue sky-ing** the issue because "Blue Sky Law" is a synonym for state securities law.

Securities trading on the OTC Bulletin Board—discussed up ahead—are required to register with both the SEC and state regulators if offering securities in more than one state, for example. And, some offers are registered only with the state regulators.

When the issuer is finally given the **effective date** (release date) by the SEC, sales from the underwriters to the investors are finalized, and the issuer receives the capital it is seeking.

Securities Exchange Act of 1934

As the SEC explains on their website:

> With this Act, Congress created the Securities and Exchange Commission. The Act empowers the SEC with broad authority over all aspects of the securities industry. This includes the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation's securities self-regulatory organizations (SROs). The various securities exchanges, such as the New York Stock Exchange, the NASDAQ Stock Market, and the Chicago Board of Options are SROs. The Financial Industry Regulatory Authority (FINRA) is also an SRO.
>
> The Act also identifies and prohibits certain types of conduct in the markets and provides the Commission with disciplinary powers over regulated entities and persons associated with them.
>
> The Act also empowers the SEC to require periodic reporting of information by companies with publicly traded securities.

The Securities Exchange Act of 1934 gave the SEC broad powers over the securities markets. The Act requires companies such as Starbucks and Facebook to file quarterly and annual reports with the SEC. There are reports filed when the officers and members of the board sell their shares of the company's stock. Mergers and acquisitions must be announced through various filings, as well.

SROs

The above passage mentions **SROs,** or **Self-Regulatory Organizations.** A self-regulatory organization is an organization that regulates its own members, enforcing its rules along with SEC rules and securities laws. Broker-dealers belong to one or more SROs such as FINRA, NASDAQ, and NYSE. These SROs register with the SEC under the Securities Exchange Act of 1934 and, in turn, regulate their member firms.

State Securities Regulators

The SEC is the securities regulator for the federal government. In addition, each state has a securities department that protects investors. Some call the department the "Bureau of Securities," some the "Securities Commissioner," but, whatever it is called, each state has an administrative office that regulates offers of securities and the professionals in the brokerage and advisory businesses.

Each state has its own securities law designed to protect investors. While there are differences among the state laws, there are far more similarities. That is because the securities laws in each state typically follow the model legislation for state securities law called the **Uniform Securities Act**. The Uniform Securities Act announces its purpose as:

> Relating to securities; prohibiting fraudulent practices in relation thereto; requiring the registration of broker-dealers, agents, investment advisers, and securities; and making uniform the law with reference thereto.

The state securities regulators want the securities laws uniform from state to state, and they want to protect investors by requiring persons in the securities industry and offerings of securities to be registered. The states end up tweaking things, but, overall, the state securities laws look pretty much the same.

The Uniform Securities Act calls the official in charge of securities regulation the [**Administrator**] and puts the term in brackets, encouraging each state to insert the appropriate title. Often the Secretary of State is the Administrator, with a specific "Division" or "Department of Securities" enforcing the state's securities act. Therefore, we often apply for a driver's license and register our vehicles with the same administrative office with which we apply for a license as a securities agent or IAR.

The Federal Reserve

As the **Federal Reserve** explains at their website www.federalreserve.gov:

The Federal Reserve System is the central bank of the United States. It performs five general functions to promote the effective operation of the U.S. economy and, more generally, the public interest. The Federal Reserve:

1. conducts the nation's monetary policy to promote maximum employment, stable prices, and moderate long-term interest rates in the U.S. economy

2. promotes the stability of the financial system and seeks to minimize and contain systemic risks through active monitoring and engagement in the U.S. and abroad

3. promotes the safety and soundness of individual financial institutions and monitors their impact on the financial system as a whole

4. fosters payment and settlement system safety and efficiency through services to the banking industry and the U.S. government that facilitate U.S.-dollar transactions and payments

5. promotes consumer protection and community development through consumer-focused supervision and examination, research and analysis of emerging consumer issues and trends, community economic development activities, and the administration of consumer laws and regulations

As the website explains, "The Federal Reserve conducts the nation's monetary policy by managing the level of short-term interest rates and influencing the overall availability and cost of credit in the economy. Monetary policy directly affects short-term interest rates; it indirectly affects longer-term interest rates, currency exchange rates, and prices of equities and other assets and thus wealth. Through these channels, monetary policy influences household spending, business investment, production, employment, and inflation in the United States."

Up ahead, we will look at interest rates, yields, and monetary policy in detail.

Department of the Treasury/IRS

In the first presidential administration, under George Washington, there were only three members of the cabinet: Secretary of State, Secretary of War, and Secretary of the Treasury. Alexander Hamilton was Secretary of the Treasury, which oversees taxation and financing the federal government by issuing Treasury securities (T-Notes, T-Bonds, for example). They also protect the integrity of the financial system.

As their website explains:

> The U.S. Department of the Treasury's mission is to maintain a strong economy and create economic and job opportunities by promoting the conditions that enable economic growth and stability at home and abroad, strengthen national security by combating threats and protecting the integrity of the financial system, and manage the U.S. Government's finances and resources effectively.

Broker-dealers are required to file suspicious activity reports with the United States Treasury's **FinCEN** or **Financial Crimes Enforcement Network.** We will explore such reports and the types of activity that would cause a firm to file them in another section.

When filing your federal income taxes, you may notice the forms you fill out are from the **Internal Revenue Service (IRS)**, while any taxes owed are payable to the United States Treasury. The IRS explains on its website that, "The IRS is a bureau of the Department of the Treasury and one of the world's most efficient tax administrators. In fiscal year 2015, the IRS collected almost $3.3 trillion in revenue and processed almost 240 million tax returns."

The mission of the IRS is to, "Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all. This mission statement describes our role and the public's expectation about how we should perform that role:

- In the United States, the Congress passes tax laws and requires taxpayers to comply.
- The taxpayer's role is to understand and meet his or her tax obligations.
- The IRS role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share."

SIPC, FDIC

The **Federal Deposit Insurance Corporation (FDIC)** is an independent agency created by Congress to maintain stability and public confidence in the nation's financial system by:

- Insuring deposits.
- Examining and supervising financial institutions for safety and soundness and consumer protection.
- Making large and complex financial institutions resolvable. and
- Managing receiverships.

Money deposited in an **FDIC**-insured bank is not at risk or subject to loss of value. Even if the bank fails, the Federal Deposit Insurance Corporation (FDIC) puts a healthy bank in charge, the bank changes names, and in a few days customer accounts are restored.

On the other hand, money invested in stocks, bonds, and mutual funds is at risk. Unlike a bank product, which cannot lose value, all securities are subject to fluctuations and even total losses. A $200,000 savings account cannot drop to $150,000 unless withdrawals are made. On the other hand, even the safest securities are subject to large losses.

Investors with accounts at broker-dealers have no guarantee the $200,000 they invest will not drop to $150,000, $50,000, or even zero. While nothing protects securities investors against bad investments, broker-dealers who have control of customer securities and funds belong to **SIPC** or the **Securities Investor Protection Corporation.** SIPC is an industry-funded insurance company protecting broker-dealer customers against missing assets should their broker-dealer go bankrupt.

SIPC petitions a court to appoint a trustee over the failed firm. Customer accounts are valued as of the day the trustee is appointed and protected up to $500,000 in total, of which only $250,000 of un-invested cash is covered. Cash builds up when customers make deposits of funds or sales of securities, and when securities pay interest or dividends to the investor. If the cash balance is greater than $250,000—or if the total account value is over $500,000—for the excess amounts the customer becomes a general creditor of the bankrupt broker-dealer.

A customer could have several accounts with the same broker-dealer, and each account is treated separately. For example, if an individual has an individual account, an IRA account, and a joint account with his wife, those are three separate accounts, all covered up to the maximum.

A cash account and a margin account would not be two separate accounts, however. When a cash account is turned into a margin account, the account number does not change. Margin is just the approval to trade on credit, and we explore such accounts in more detail in another section.

The most important thing for investors to understand is that FDIC and SIPC are not similar. No security is backed by FDIC, with a guaranteed value. And, SIPC only covers customer accounts against broker-dealer bankruptcy or "failure," not market loss. If an investor deposits $300,000 and quickly loses it trading options, there is no protection from such folly.

SIPC protects customers whose broker-dealer could end up losing control of their assets due to insolvency. It was created by the **Securities Investor Protection Act** of 1970.

Market Participants

Investors

Saving and investing are not the same. In a savings account, the only risk is that the interest earned will not keep pace with rising consumer prices, called a loss of purchasing power. When we invest, on the other hand, we take the risk of losing money.

Some investors buy real estate. Many invest in securities, such as stocks, bonds, and mutual funds. Some securities are riskier than others, but all securities put the investor's money, or "capital," at risk.

We will explore securities and their risks in another section. For now, let's look at three types of securities investors: **retail, accredited,** and **institutional**.

A retail investor is a term used for investors whose accounts are worth anywhere from a few thousand dollars to several hundred thousand dollars. Retail investors are protected more than the other two types due to a general lack of sophistication and a lack of funds they can afford to put at risk.

Accredited investors, on the other hand, are allowed to take on more risk than retail investors. An accredited investor includes an individual or married couple with a net worth—excluding the value or equity of their primary residence—of $1 million, or an annual income of $200,000 for an individual, $300,000 for a married couple.

Accredited investors also include institutional investors. An institutional investor is what it sounds like. It is not a human being. Rather, it is a bank, for example, or an insurance company, or a mutual fund. Institutions are, also, not bound by all the restrictions that retail investors are.

The following institutional investors are also accredited investors:

- banks, savings & loans, etc.
- insurance companies
- investment companies
- business development companies
- employee benefit plans meeting minimum assets or being run by professional fiduciaries
- charitable organizations with $5 million or more total assets
- trusts with $5 million or more total assets directed by a sophisticated investor
- any entity in which all equity owners are accredited investors

And, if a company is offering securities, the following are also accredited investors:

- directors, executive officers, or general partners of the issuer of the securities

Investment Advisers and Broker-Dealers

Many investors know the importance of investing but have no idea how to do it. Fortunately, there are **investment advisers** who manage client accounts for a percentage of the account balance. An investment adviser is a financial services firm or individual whose compensation is based on giving investment advice concerning securities and/or providing portfolio management services.

The adviser might manage client accounts in exchange for 1% of assets. Under that arrangement if the client puts $1 million under the adviser's management, 1% works out to $10,000 a year to the adviser, more as the account value increases or the client adds funds to the account.

That is different from how a securities **agent** working for a **broker-dealer** is compensated. A securities agent is a financial-services professional whose compensation is based on executing securities transactions. A securities agent/salesperson gets paid for generating activity. The agent earns a commission when the customer buys a stock and a commission when he sells the stock, regardless of whether the customer makes or loses money on the trades.

But an investment adviser acting as a portfolio manager typically charges a percentage of the assets in the account. The client's $1 million account balance pays the adviser $10,000 a year if they bill 1% of