

Series 66 Supplement and Errata
For NASAA Study Outline effective January 1, 2010
For use with RegEd Series 66 Study Guides purchased before January 2010

Effective January 1, 2010, the NASAA Study Outline for the Series 66 NASAA Investment Adviser Competency Examination will change to reflect changes in the securities industry.

NASAA has added information on several topics, mostly involving types of accounts, such as UGMA/UTMA and 529 Plan accounts, and investments. The most significant change is a shift in exam weighting: the test will move from a split of 80% legal and regulatory questions and 20% investments and strategies to a 50/50 split. In addition, the passing score increased from 71% to 75%

Series 66 Through 12/31/09			Series 66 As of 1/1/10		
Topic	Number of Questions	% of exam	Topic	Number of Questions	% of exam
Investment Analysis, Recommendations, and Strategies	20	20%	Economic Factors and Business Information	5	5%
			Investment Vehicle Characteristics	15	15%
			Client Investment Recommendations and Strategies	30	30%
Legal and Regulatory Guidelines, including Prohibition on Unethical Business Practices	80	80%	Laws, Regulations and Guidelines, including Prohibition on Unethical Business Practices	50	50%
Total	100	100%	Total	100	100%
<i>Needed to pass</i>	<i>71</i>	<i>71%</i>	<i>Needed to pass</i>	<i>75</i>	<i>75%</i>

RegEd has added the following material to our Study Guide which we believe will be valuable in helping students pass their exam.

General Information

Tax Updates for 2010

Each year, retirement plan contribution limits and some other dollar amounts related to taxation may be changed to reflect inflation. Due in large part to the weak economy in 2009, most of these limits remain unchanged for 2010. There is one change, to income thresholds for Roth IRAs, which will be discussed later.

	2008	2009/2010
Gift Tax Limit (to avoid gift tax)	\$12,000	\$13,000
Max 401k/403b/ 457 Contribution	\$15,500	\$16,500
401k/ 403b Catch Up Contributions	\$ 5,000	\$ 5,500
SEP- IRA Contributions	\$46,000	\$49,000
Keogh Contributions	\$46,000	\$49,000
Traditional IRA Contributions	\$ 5,000	\$ 5,000
Roth IRA Contributions	\$ 5,000	\$ 5,000
IRA Catch Up Contributions	\$ 1,000	\$ 1,000

FINRA

In July of 2007, NASD merged with the member regulation, enforcement and arbitration functions of the New York Stock Exchange to create a new regulatory body: the Financial Industry Regulatory Authority, or FINRA.

Please note that while NASD no longer technically exists, it is very likely that, at the present time, Series 65 test takers may continue to see reference to NASD and NASD rules in their exams. For purposes of the Series 66, it may be helpful to think of NASD and FINRA as being interchangeable.

Chapter 2:

UGMA/UTMA

Custodial accounts are usually set up under the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA). These acts are designed to protect the interests of the children. The account may be set up by the child's parents, grandparents or any other interested party. When the custodial accounts are established, the securities are registered under the name of the custodian for the benefit of the child and any gifts given to fund the account are irrevocable. The custodian is an adult who acts in a fiduciary capacity (protects the interests of the child). The custodian oversees the account and is responsible for all investment decisions.

Who's the Custodian?

The custodian is typically one of the parents of the child, but could be any adult. The donor could choose to designate either parent to be custodian on the account or they could ask another individual to act as custodian for their child. There is no requirement that a custodian be a blood relative of the child.

What Type of Investments

As fiduciaries, custodians are required to protect the interests of the child. Portfolios constructed for UGMA/UTMA accounts should not be overly aggressive. Most states operate under the Uniform Prudent Investors Act (UPIA) that establishes standards for fiduciaries. Under this act, the portfolio must be invested in a prudent and diversified manner. The account is looked at as a whole, as opposed to scrutinizing the individual investments. Under UGMA/UTMA, trading on margin (with borrowed funds) is prohibited, since it would put the child in debt.

Whose Money Is It?

Any assets in an UGMA/UTMA are the property of the child and any gifts given to the child are irrevocable. The custodian may remove funds from the account to pay any taxes due or for the benefit of the child. Although his name appears in the account title, the custodian is not a co-owner of the account. UGMA/UTMA accounts are not considered to be joint accounts.

Tax Issues

Tax information for the account is reported to the IRS under the minor's social security number. Payment of any taxes due is the responsibility of the child. At whose tax rate (marginal bracket) are these taxes payable? This is a harder question. The U.S. tax code includes provisions referred to as "kiddie tax" rules.

“Kiddie tax” rules apply to children under the age of 19. There is an exception whereby a student enrolled in college on a fulltime basis would be subject to these rules until age 24. Under the kiddie tax, the first \$950 of earnings each year is tax-free and the next \$950 is taxed at the child’s tax rate. Any additional income is taxed at the parents’ rate. Once the minor reaches age 19, all taxable income is assessed their tax rate.

Age of Majority

When the child reaches the age of majority (legal adulthood), the custodial account is closed. The legal age is determined by the state in which the child resides. All securities will be reregistered in the name of the beneficiary (former child) and transferred to a new account. Some states allow, in UTMA accounts specifically, the custodian to specify a different date for transferring assets; the custodian can use any date from age of majority up to as late as age 25.

Saving For Education

A primary concern of many investors is saving for the education of their children or grandchildren. Congress, aware of the hardships, has created tax incentives to encourage saving. We will talk about two separate vehicles. The first is a type of IRA and the second is a state sponsored qualified tuition program limited plan. The second, called Section 529 plans, may allow substantially larger contributions.

Education IRAs (Coverdell Education Savings Accounts)

For the tax year 2009, investors may contribute up to \$2,000 per year to help fund a child’s education. Contributions may be made up to the child’s 18th birthday and are always made on an after-tax (nondeductible) basis.

Earnings on Coverdell Education Savings Accounts are not subject to taxation provided the distribution is taken prior to age 30 and is used for qualified elementary, secondary, or higher education expenses. Although these accounts are often funded by parents or grandparents, there is no requirement that contributions be made by a blood relative of the child.

Sometimes the child decides not to pursue qualified education. In other cases, the account assets are not needed because schooling is being funded through other means, such as a scholarship. In these cases, account balances may be transferred to another relative without tax consequences.

Some individuals are unable to fund Coverdell Education Savings Accounts due to income limits. The ability to contribute phases out for individuals with AGI of \$95,000 and when the individual has AGI of

\$110,000, they can no longer contribute into a Coverdell IRA. For joint filers with AGI of \$190,000, the ability to contribute to a Coverdell IRA begins to phase out and once the AGI is \$220,000 they can no longer contribute.

Section 529 Plans

Education is very expensive. Under Section 529 of the tax code, Congress has authorized the creation of state sponsored qualified tuition programs.

Contributions to these qualified plans are considered gifts under the federal tax code and eligibility for participation is not subject to income limitations. Section 529 plans often allow for much larger contributions when compared with Education IRAs. For example, some state plans are structured to permit an individual to gift up to \$65,000 in a given year without triggering federal tax liability. (The lump sum is viewed as five annual \$13,000 gifts made in one calendar year.)

Contribution limits and investment choices vary from plan to plan. Some plans offer a fixed, aged-based asset allocation, while others give investors investment choices and the ability to periodically adjust the portfolio.

Although not required to do so, many investors select their home state plan to capture additional state tax advantages. Whether in-state or out-of-state, investment income from all plans is free from federal taxation as long as it is used for qualified education expenses. As is the case with Education IRAs, plan assets may be transferred from one relative to another without tax consequences.

In most states, if a withdrawal is taken out of a 529 plan and is not used for higher education, the donor will pay a 10% penalty on the withdrawal plus ordinary income on any earnings. However, there are some withdrawals for reasons other than for higher education that would allow the donor to remove the funds without the 10% penalty. They include, if the beneficiary:

- receives a scholarship
- is disabled and can not attend a college/university
- is deceased

Chapter 3

Correlation

If securities have a positive correlation, they tend to move in the same direction. Securities with a negative correlation tend to move in opposite directions. Correlations can range from -1 to +1. A correlation of +1.0 means the stocks move in perfect unison. Any positive number below +1.0 means the stocks move in the same direction, but the movement is less closely related. Negative correlation means the stocks tend to move in opposite directions. A 0 correlation indicates that there is no relationship between the price movements of one security and another.

Efficient Markets Hypothesis (EMH)

The efficient markets theory is one that relies on the various levels of information available to investors. One important assumption of the efficient market hypothesis is that new information regarding securities comes to the market in a random fashion and that security prices adjust to or reflect all new information available in the market.

The theory actually takes three forms: (1) Weak-form Efficient Market Hypothesis; (2) Semi-strong form Efficient Market Hypothesis; and (3) Strong-form Efficient market Hypothesis.

Weak-form Efficient Hypothesis

The weak-form of the EMH assumes that current security prices fully reflect all security market information, including the historical sequence of prices, rates of return, trading volume data, and other market-generated information, such as old-lot transactions, block trades, and transactions by exchange specialists. Because it assumes that current market already reflect all past returns and any other security market information, this hypothesis implies that past rates of returns and other historical market data should have no relationship with future rates of return. Therefore, this hypothesis contends that you should gain little from using any trading rule that decides whether to buy or sell a security based on past rates of return or any other past market data.

Semi-strong Form Efficiency Market Hypothesis

The semi-strong-form of the EMH suggests that the current security prices fully incorporate all publicly available information. Public information includes not only past prices, but also data reported in a company's financial statements (annual reports, income statements, filings for the Security and Exchange Commission, etc.), earnings and dividend announcements, announced merger plans, the financial situation of company's competitors, expectations regarding macroeconomic factors (such as inflation,), etc. In fact, the public information does not even have to be of a strictly financial nature. For example, for the analysis of pharmaceutical companies, the relevant public information may include the current (published) state of research in pain-relieving drugs.

The assumption behind semi-strong market efficiency is still that one should not be able to profit using something that “everybody else knows” (the information is public). Nevertheless, this assumption is far stronger than that of weak-form efficiency. Semi -strong efficiency of markets requires the existence of market analysts who are not only financial economists able to comprehend implications of vast financial information, but one should not be surprised that investment companies analyzing many of the high -tech industries have started employing experts from many non-financial areas (such as medical doctors, pharmacists, biochemists, etc.) in order to be able to assess viability of projects undertaken by high -tech companies.

Arguably, acquisition of such skills must take a lot of time and effort. In addition, the “public” information may be relatively difficult to gather and costly to process. It may not be sufficient to gain the information from, say, major newspapers and company-produced publications. One may have to follow wire reports, professional publications and databases, local papers, research journals etc. in order to gather all information necessary to effectively analyze securities.

Strong-form Efficient Market Hypothesis

The strong-form of the EMH contends that stock prices fully reflect all information from from public and private sources. The means that no group of investors has monopolistic access to information relevant to the formation of prices. Therefore, this hypothesis contends that no group of investors should be able to consistently derive above-average risk-adjusted rates of return. The strong-form of the EMH encompasses both the weak-form and the semistrong-form of the EMH. Further, the strong form of the EMH extends the assumption of efficient markets, in which prices adjust rapidly to the release of new public information, to assume perfect markets, in which all information is cost free and available to everyone at the same time.

Implications of the Efficient Market Hypothesis

Most academic studies indicate that the stock market is highly efficient, and consequently, investors gain from active management strategies. Attempts to beat the market are not likely to be successful and can reduce returns as a result of transaction costs.

The EMH implies that although investors should follow a passive investment strategy, returns can be optimized through diversification and asset allocation, and by minimization of investment costs and taxes. In addition, the portfolio manager must choose a portfolio that is geared toward the time horizon and risk profile of the investor. The appropriate mixture of securities may vary according to the age, goals, tax bracket, employment, and risk aversion of the investor.

Chapter 4

This chapter should now be titled "Investment Vehicle Characteristics, Life Insurance and Retirement Plans. This section will include information on specific investment and insurance products which have been added to the exam.

Life insurance

There are several different forms of life insurance which offer different features, guarantees and benefits. The four basic types are term life, whole life, universal life and variable life.

Term Life Insurance

Term policies cover the policy holder during the term of the policy. Term insurance has no investment component. Term insurance generally has a steady monthly premium. Annual-renewable term may be purchased year-by-year without the need to requalify through evidence of good health each year. The monthly premiums are lower than those for whole-life policies. The premiums levels are related to the age of the policy holder: the older the policy holder at the beginning of the term the higher the premium. Term insurance can be purchased for relatively short periods and go as long as 30 years.

Whole Life Insurance

Whole life policies are permanent insurance that combines life coverage with an investment fund. Whole life policies pay a stated, fixed amount upon the death of the policy holder. Part of the premium paid during the lifetime of the policy holder goes toward building cash value from investments made by the insurance company. Cash value builds tax-deferred each year that the policy is in force. Policy holders can borrow against the cash accumulation fund free of income tax. The amount of premiums policy holders pay generally do not change throughout the life of the policy.

Universal Life Insurance

Universal life combines term insurance with a money market-type investment that pays a market rate of return. To get a higher return, these policies generally do not guarantee a rate. These policies offer the ability to make flexible premium payments by using the cash value to reduce or skip premium payments.

Variable Life Insurance and Variable Universal Life Insurance

Variable life allows policyholders who are seeking higher rates of return to have all or part of the premiums they pay invested in securities in a separate account. The cash value and death benefit on the

policy will vary based on the performance of the securities in this separate account, although there is normally a minimum guaranteed death benefit. Since the policyholder will make decisions about the investments in the account through the use of subaccounts (similar to selecting mutual funds), the policyholder takes investment risk in this type of policy. Salespersons selling variable life products are generally required to hold both a state insurance license and a securities license (Series 6 or Series 7).

Annuities: Variable, Fixed, and Equity Indexed

Variable Annuities

A variable annuity is a contract between the policy holder and an insurance company, under which the insurer agrees to make periodic payments to the policy holder beginning either immediately or at some future date. The policy holder purchases a variable annuity contract by making either a single purchase payment or a series of purchase payments. A variable annuity offers many investment options. The value of the policy holder's investment will vary depending on the performance of the investment options chosen. The investment options available are generally mutual funds that invest in stocks, bonds, money market instruments, or some combination of the three.

Variable annuities differ from directly investing in mutual funds in three important ways:

First, they can insure that the policy holder receives periodic payments for the rest of owner's life as detailed in the policy.

Second, variable annuities have a death benefit. If the policy holder dies before the the insurance company has started making payments , the beneficiary is guaranteed to receive a specified amount.

Third, variable annuities are tax-deferred. The policy holder pays no taxes on the income and investment gains from the annuity until withdraw of funds. In addition, the owner may also transfer money from one investment option to another within a variable annuity without paying tax at the time of the transfer. When money is withdrawn from a variable annuity, however, the policy holder will be taxed on the earnings at ordinary income tax rates rather than lower capital gains rates. In general, the benefits of tax deferral will outweigh the costs of a variable annuity only if held as a long-term investment to meet retirement and other long-range investment goals.

Fixed Annuities

Fixed annuities or single premium annuities, require one payment made at the purchase of the contract. They have a stated fixed interest rate. Deferred fixed annuities generally earn substantially more than other money market instruments because of compounding and tax deferral. Annuities can be purchased

for the short, medium and long term. The longer the term, the higher the interest rate paid on the annuity. Like other insurance, fixed annuities contain a death benefit provision.

The IRS imposes a penalty of 10% if the policy holder withdraws income from an annuity prior to the age of 59.5. In addition, annuities are taxed as ordinary income when the income is received, not as a capital gain. Contracts have penalty charges upon early withdrawal of funds and may not guarantee the same interest rate for the entire period. In general fixed annuities are suitable for investors and retiree who are risk averse or conservative. There are three general types of fixed annuities: immediate, deferred, and CD type. An immediate annuity provides payments immediately after the accumulation phase. In the case of the fixed deferred annuity, the insurance company reinvests the interest earned and pays at the end of the term in one lump sum or in a stream of payments as designated in the policy. CD annuities guarantee a fixed interest payment but also provide the tax advantage of a regular annuity.

Equity Indexed Annuities

An equity-indexed annuity (EIA) is an annuity that earns interest linked to a stock or other equity index. One of the most commonly used indices is the Standard & Poor's 500 Composite Stock Price Index (the S&P 500). EIAs provide market-driven investments with potentially attractive returns, plus a guaranteed minimum return. As a result, policy holders get less upside potential as well as less downside risk.

An equity-indexed annuity may properly be considered a fixed annuity. Policy holders earn a return on their money while deferring the taxes on gains. Fixed annuities also offer specified annual company-guaranteed returns. Variable annuities, on the other hand, let you decide where to allocate your funds in any number of mutual funds and, therefore, perhaps offer better returns, but at a higher risk. Equity-indexed annuities are different from other fixed annuities in the way they credit interest to the annuity's value. Most fixed annuities credit interest calculated at a rate set in the contract. EIAs credit interest using a formula based on changes in the index to which the annuity is linked. The formula decides how the additional interest, if any, is calculated and credited. How much excess interest the policy holder gets and when they receive it depends on the features of the particular annuity.

Equity-indexed annuities, like other fixed annuities, pay a minimum interest rate. The rate that will be applied will not be less than this minimum guaranteed rate even if the index-linked interest rate is lower. The value of EIA will not drop below a guaranteed minimum. For example, many single premium annuity contracts guarantee the minimum value will never be less than 90 percent (100 percent in some contracts) of the premium paid, plus at least 3% in annual interest (less any partial withdrawals). The insurance company will adjust the value of the annuity at the end of each term to reflect any index increases. EIAs have surrender charges which are assessed in the early years of the contract. Withdrawals of earnings are taxable as ordinary income and, if made prior to age 59½ are subject to a

10% federal penalty tax. EIAs contain mortality and expense charges, cost-of-insurance charges, and administrative fees.

Derivatives

Rather than being collections of other securities like packaged products, the value of a derivative is related to the value of another security, usually through some type of exchange privilege. We will look at three main types of derivatives for the Series 66: rights, warrants and options.

Rights

Using an example, Skinnee Minnie Enterprises Inc. currently has 35 million shares outstanding and is considering selling more stock.

One way the company may accomplish this goal would be to offer existing shareholders a chance to buy the new issue before going to outside investors. Skinnee Minnie may issue a security called a preemptive right (usually simply referred to as rights) that gives existing shareholders the opportunity to buy more shares for a very limited time period (often only days). To encourage investors to participate, rights usually allow current owners to purchase the stock at a discount to its current market price.

Existing shareholders have several choices. They may let the rights expire, use them to purchase additional stock (called “exercise”) or sell the rights to another investor. If a shareholder does not exercise his rights, he will own a smaller percentage of the company. His ownership stake will have been diluted.

Warrants

Warrants, like rights, allow the holder to buy shares of stock at a predetermined price. The “strike” price is usually set above the current market value of the stock. Warrants are long-term securities that may not expire for many years. Some of these securities, called perpetual warrants, never expire! Like rights, warrants often trade in the marketplace independently of the underlying stock.

Why are warrants issued? Rights, as you remember, are used to encourage current shareholders to buy more stock. Warrants, on the other hand, are typically used as a bonus or “sweetener” to buyers of the corporation’s bonds. Warrants provide these income investors with a potential way to participate in the growth of the company. The benefit to the issuer is that potential purchasers of the company’s debt may be willing to accept less interest if a warrant is included as part of the package.

One thing to keep in mind is that the exercise of a right or warrant will give additional capital to the company when the shares are paid for. Conversion of the preferred will not affect the firm’s

capital base since no money changes hands.

Options

Another type of security that you may encounter on the Series 66 Exam is called an option. Although many people panic when they hear this term, options are not really all that difficult to understand. The easiest way to begin the discussion is to think of an option as a legal contract that gives one party (the buyer) certain rights and the other party (the seller or writer) certain obligations. The rights and obligations we are alluding to involve the purchase or sale of a specific stock, at a predetermined price, the "strike price," for a specific time period. For our discussion we will assume that each contract involves 100 shares of the specified stock. Keep in mind, though, that options are available on other assets as well, including indexes, currencies, and debt instruments. Option premiums are always expressed on a per share basis. To get the dollar cost of a contract, multiply by 100.

Premium of \$3 = contract cost of \$300

Premium of \$4 = contract cost of \$400

Premium of \$3.50 = contract cost of \$350

Premium of \$7.25 = contract cost of \$725

Call Options

The first type of contract we will discuss is the call option. At the beginning of the contract the buyer (contract owner) pays the seller (contract writer) a specific sum of money called a premium. In return for this premium the seller (writer) of the contract promises to deliver 100 shares of the underlying stock at the strike price if asked. The call buyer has the right to buy stock at this locked in price and the call writer is obligated to deliver stock at this locked in price

Put Options

The next type of contract we will look at is called the put option. At the onset of this contract, the buyer once again pays the seller a premium in return for a promise. The writer of the contract promises to buy 100 shares of the underlying stock at the strike price if asked. The put buyer has the right to sell stock at this locked in "strike price" and the put writer is obligated to buy stock if asked to do so by the option owner.

Why Do People Use Options?

There are literally hundreds of different options strategies that may be employed by market professionals. Luckily for us, the Series 66 Exam simply wants you to understand some of the general uses of options. Most options trading strategies are designed for one of the following reasons:

- Speculation
- Protection (hedging)
- Income generation

The only specific strategy you may encounter on the Series 66 Exam is a strategy referred to as covered call writing. The mechanics are not important. Simply recognize that this is an income producing strategy that may be employed by mutual fund managers to increase the yield on their portfolio.

Bulls and Bears

Bullish investors want stocks to go up . Bearish investors want stock prices to fall. As mentioned previously some people use options to speculate on the direction of stock prices. Call buyers want stocks to go up since they can buy the stock at the guaranteed “locked in” strike price no matter what the market value . Put buyers are bearish since their options become more valuable as the stock goes lower and lower.

As you can see from the chart below, the contract writers are always cheering in the opposite direction as the contract buyers.

Bullish	Bearish
Call buyers	Call sellers (writers)
Put sellers (writers)	Put buyers

Futures and Forward Contracts

Futures

Futures, or futures contracts, are standardized contracts to buy or sell a specified commodity of standardized quality at a certain date in the future, at a market determined price (the futures price). The

123 contracts are traded on a futures exchange. The price is determined by supply and demand among competing buy and sell orders on the exchange at the time of the purchase or sale of the contract.

The underlying asset to a futures contract need not be a traditional commodities such as cattle or corn but may be currencies, securities or financial instruments (e.g., stock indexes and interest rates). The future date is called the delivery date or final settlement date. The official price of the futures contract at the end of a day's trading session on the exchange is called the settlement price for that day of business on the exchange.

A futures contract gives the holder the obligation to make or take delivery under the terms of the contract, whereas an option grants the buyer the right, but not the obligation, to establish a position previously held by the seller of the option. In other words, the owner of an options contract may exercise the contract, but both parties of a "futures contract" must fulfill the contract on the settlement date. The seller delivers the underlying asset to the buyer, or, if it is a cash-settled futures contract, then cash is transferred from the futures trader who sustained a loss to the one who made a profit. To exit the commitment prior to the settlement date, the holder of a futures position has to offset his/her position by either selling a long position or buying back (covering) a short position, effectively closing out the futures position and its contract obligations.

Futures are exchange traded derivatives. The exchange's clearinghouse acts as counterparty on all contracts, sets margin requirements, and crucially also provides a mechanism for settlement.

Forward Contracts

A forward contract is much like a futures contract because both types of contracts cover the delivery and payment for a specific commodity at a specific future date at a specific price. Unlike futures contracts, which have fixed terms, such as delivery date and quantity, forward contracts are not traded on regulate exchanges. Forward contracts are individually negotiated contracts traded over the counter between the counterparties. The price specified in the forward contract may be higher or lower than the actual market price at the time of delivery, known as the spot price. The purpose of a forward contract is to lock in a price for the underlying commodity or product thereby eliminated market risk.

457 Plans

457 Plans are deferred compensation plans for governmental employees and employees of non-church controlled organizations. Only eligible employers can establish a 457 plan. A 457 plan allows their employees to defer compensation on a pre-tax basis though payroll deduction. Through a 457 plan, holders defer federal and sometimes state taxes until the assets are withdrawn. An eligible 457 plan includes limits on the amounts deferred. Annual contribution to a 457 plan cannot exceed the lesser of

100% of the employees compensation or \$16,500 for tax years 2009 and 2010. distributions are made when the employee reaches the age of 70, is severed from employment, or has a financial need due to an unforeseeable emergency. Participants in a 457 plan may rollover distributions into an IRA or another 457 plan without incurring income tax on the amount rolled over

Chapter 7

Federal Covered Securities

The definition of federal covered securities now includes Nasdaq Capital Market securities. Previously, only Nasdaq Global and Global Select securities were federally covered.