

Learning Objectives

An understanding of the material in this chapter should enable you to

1. Explain how investment planning relates to financial planning.
2. Explain life-cycle planning as an approach to financial planning.
3. Describe the players in the secondary securities market.
4. Describe the institutions that operate in the secondary securities market.
5. Describe fee components, types of orders, and short selling as they relate to secondary market transactions.
6. Explain the use of street name, the need for stock certificates, the types of accounts that are available, and the mechanics of bond trading.
7. Describe some of the more significant laws that affect the regulation of securities markets and advisors.
8. Explain the tax treatment of investments and investors.

A central element of financial planning involves advising on investments or even managing them. Therefore, as a financial advisor you need to be knowledgeable regarding investment choices, the expected rates of return and risk exposures associated with each investment choice, and the suitability of each investment category for a client. Each investment opportunity has advantages and disadvantages. Each client has a unique set of needs, goals, attitudes, and resources that influence the relative attractiveness and suitability of particular investments for that client. The goal of this book is to provide the requisite knowledge of what you as a financial advisor need to know to effectively advise your clients about investments.

This chapter begins by investigating what investment planning is all about. It then looks at how investment planning is impacted by a person's financial life cycle. Next is a review of the securities markets and their regulation. The chapter concludes with a discussion of the tax treatment of individual investors.

WHAT IS INVESTMENT PLANNING?

To properly explain what investment planning is, we must explain its relationship to financial planning. However, before we can adequately explain its relationship to financial planning, we must first explain what financial planning is.

The Planning Process

Financial planning can be defined conceptually as a process that a financial advisor uses to first determine a client's financial problems and/or goals, and then develop a plan to solve and/or achieve them.

The process is divided into six steps:

1. Establish and define the advisor-client relationship.
2. Determine goals and gather data.
3. Analyze and evaluate the data.
4. Develop and present a plan.
5. Implement the plan.
6. Monitor the plan.

comprehensive approach

multiple-purpose approach

single-purpose approach

Advisors who use this process in their practices find it both flexible and accommodating because it can be applied to the full range of a client's problems and/or goals using a *comprehensive approach* or it can be applied to a smaller subset of those problems and/or goals using a *multiple-purpose approach*. In fact, it can even be applied to a single client problem or goal using a *single-purpose approach*. It is not, however, the range of client problems and/or goals addressed that determine whether an advisor is engaged in financial planning. Rather, it is the advisor's use of the process to address the client's problems and/or goals that is the determining factor.

Advisors who primarily sell traditional financial products (such as insurance policies, stocks and bonds, and mutual funds) generally view the financial planning process as a selling/planning process that has eight steps—the six steps similar to those in the financial planning process preceded by two additional steps. These eight steps are

1. Identify the prospect.
2. Approach the prospect.

3. Meet the prospect.
4. Gather information and establish goals.
5. Analyze the information.
6. Develop and present the plan.
7. Implement the plan.
8. Service the plan.

Thus, the six-step financial planning process is an integral part of the eight-step selling/planning process. (See the table below for a comparison of the eight-step selling/planning process with the six-step financial planning process.)

Table 1-1 Comparing the Eight-Step Selling/Planning Process With the Six-Step Financial Planning Process			
Step	Selling/Planning Process	Financial Planning Process	Step
1	Identify the Prospect		
2	Approach the Prospect		
3	Meet the Prospect	Establish and Define the Advisor-Client Relationship	1
4	Gather Information and Establish Goals	Determine Goals and Gather Data	2
5	Analyze the Information	Analyze and Evaluate the Data	3
6	Develop and Present the Plan	Develop and Present a Plan	4
7	Implement the Plan	Implement the Plan	5
8	Service the Plan	Monitor the Plan	6

Although not all financial advisors sell traditional financial products, the financial plans they develop are themselves considered financial products that must be marketed and sold. Except for the few advisors who have prospects calling them for appointments, even fee-only advisors have to market and sell their financial planning expertise in developing plans. In other words, the eight-step selling/planning process reflects what the majority of financial advisors face: the necessity to market and prospect. In spite of this fact, however, the discussion of financial planning in this book will be based on the six-step process because the subject of prospecting, while extremely important to financial advisors, is beyond the scope of this book.

Investment planning is one of the six major planning areas that falls under the financial planning umbrella. These six major planning areas, along with a number of more specialized areas, make up financial planning. The six major areas are

- insurance planning and risk management
- employee benefits planning
- investment planning
- income tax planning
- retirement planning
- estate planning

Together, these six major areas form the nucleus around which comprehensive financial plans are developed. However, if for any reason one of these major planning areas does not apply to a particular client, the comprehensive plan developed for that client should spell out this fact. This indicates that the advisor did not overlook an important planning area, but that he or she investigated and found that it did not apply to the client at this time.

These six major planning areas are intertwined and thus affect each other. Planning done for one area typically impacts what can and should be done in another. This is why prioritizing the client's financial problems and/or goals is so important. Plan development begins by focusing on the problem or goal that is the first priority. The planning done for this problem or goal typically affects the planning that should be done for the second problem or goal. Similarly, the planning done for the first two problems and/or goals typically affects the planning that should be done for the third problem or goal, and so on.

The purpose of investment planning as a component of financial planning is to accumulate funds to facilitate goal achievement. Exactly how the client goes about accumulating funds—that is, what investments he or she makes to build the portfolio—is what investment planning is all about. Like financial planning, investment planning requires the use of a six-step process:

1. Establish and define the advisor-client relationship.
2. Set investment goals and gather client data.
3. Analyze the data.
4. Develop an investment plan and present it to the client for approval.
5. Select and make investments.
6. Monitor the portfolio.

This six-step process is in fact the financial planning process adapted to investment planning. This should not be all that surprising since investment planning is a major part of financial planning. Consequently, a financial advisor who uses the investment planning process to develop investment plans to guide his or her clients' investment activities is engaged in financial planning. (See the following table for a comparison of the financial planning process with the investment planning process.)

Because investment planning is a component of financial planning, it is difficult to separate it from financial planning. For this reason, we will use the broader terms "financial planning" and "the financial planning process" in many of our discussions, even though the title of the book is *Foundations of Investment Planning*. However, in those instances when the discussion focuses specifically on investment planning and the investment planning process (and it makes sense to do so), we will use these narrower terms. In still other situations, we will lump financial planning and investment planning together for emphasis (even though they are really one and the same process) and refer to "financial and investment planning" and "the financial and investment planning process."

Table 1-2 Comparing the Financial Planning Process With the Investment Planning Process

Step	Investment Planning Process	Financial Planning Process	Step
1	Establish and Define the Advisor-Client Relationship	Establish and Define the Advisor-Client Relationship	1
2	Set Investment Goals and Gather Client Data	Determine Goals and Gather Data	2
3	Analyze the Data	Analyze and Evaluate the Data	3
4	Develop an Investment Plan and Present It to the Client for Approval	Develop and Present a Plan	4
5	Select and Make Investments	Implement the Plan	5
6	Monitor the Portfolio	Monitor the Plan	6

Life-Cycle Planning

Financial Life Cycle

financial life cycle There are five distinct phases in an individual's *financial life cycle*. Starting at a relatively

young age (age 25 or younger), a career-minded person typically will pass through four phases en route to phase five, retirement. These five phases and their corresponding age ranges are as follows:

1. early career (age 25 or younger to age 35)
2. career development (age 35 to 50)
3. peak accumulation (age 50 to ages 58–62)
4. preretirement (3 to 6 years prior to planned retirement)
5. retirement (ages 62–66 and older)

Together these five phases span a person's entire financial life. Although some people will not experience all of the phases or will spend more or less time in any one, the vast majority of career-minded people will go through all five.

As previously indicated, the purpose of investment planning as a major component of financial planning is to accumulate funds. A young client in the early career phase typically has several accumulation goals. Some of these accumulation goals have short time horizons although most have fairly long time horizons. For example, the typical client who is in the early career phase has only been married for a few years and has young children. He or she probably has a short time horizon for accumulating a cash reserve or emergency fund to meet unexpected contingencies. His or her time horizon for accumulating a down payment on a home generally is longer, while the time horizon for accumulating funds for the children's college educations is longer still. However, this client probably has not given much thought to accumulating a retirement fund because of the numerous accumulation goals with shorter time horizons and higher priorities that he or she is facing.

The career development phase is often a time of career enhancement, upward mobility, and rapid growth in income. It usually includes some additional accumulation in the first few years for the children's college educations and has accumulation for retirement as a top priority throughout the period. For the most successful clients, this phase may be the time to begin general wealth building beyond basic accumulation goals, to fund extensive travel, or to plan for the vacation cottage.

As the typical client moves into the peak accumulation phase, he or she is headed toward maximum earnings and the greatest opportunity for wealth accumulation. This phase may include accumulating funds for special purposes, but it usually continues the accumulation for retirement as a top priority.

The preretirement phase often involves winding down both the career and income potential, and restructuring the portfolio to reduce risk and enhance income. Throughout this phase, the advisor should be actively involved in keeping the client's financial plan on target to meet all remaining accumulation goals, including the now top priority of accumulating for retirement.

The final phase in the client's financial life cycle is retirement. If the advisor has periodically reviewed and revised the client's financial plan and its corresponding portfolio, the client should have sufficient income to enjoy retirement. A financial plan and portfolio that are developed for a relatively young client need to be reviewed and revised/restructured periodically as the client ages and passes through the phases of his or her financial life cycle. As time marches on and life's circumstances change, some of the client's longer term accumulation goals may need adjusting. Restructuring the portfolio to accommodate these goals is critical if the financial plan is to be successful.

SECURITIES MARKETS

primary market

When corporations want to acquire cash, they issue new securities. Corporations' sales of newly created securities to investors are referred to as the *primary*

secondary market

market. Investment bankers are the people who handle the sale of new securities, and the process is referred to as underwriting the offering. It is the *secondary market*, however, that most people think about when the stock market is mentioned. This market encompasses all transactions that take place on exchanges and over the counter where securities are bought and sold subsequent to their original issuance and sale. It is the structure of this secondary market that we investigate next. This requires us to examine the players, the institutions, and the transactions that make up this market. We then consider some trading issues, including whether to hold securities in street name, the type of account to hold, and bond trading. Next, we review some of the more critical laws that affect financial service firms and the securities markets today. Finally, we conclude the chapter by discussing the tax treatment of individual investors.

Players in the Market

It takes a variety of people and institutions to make the secondary securities market work. In this section, we will consider the key people in this market. In the next two sections, we will look at the institutions and transactions in the market.

Brokers, Dealers, and Brokerage Firms

The term broker/dealer is a term used to describe a financial advisor or a company that is licensed to buy investment products for or sell them to clients. A broker or a broker/dealer acting only as a broker buys and sells securities on behalf of clients. Brokers implement their clients' trading instructions and act as their clients' agent. A dealer, in contrast, trades for his or her own account and makes markets by advertising a willingness to buy and sell. To be in the securities business, an advisor or a company must be a broker/dealer, or an advisor must be affiliated with a broker/dealer as a registered representative. Clients refer to both the financial advisor who handles their accounts and to the firm employing the advisor as their broker.

Series 7 To be a registered representative, an advisor must be licensed in his or her state to sell securities and must have passed an exam known as *Series 7* that is administered by the Financial Industry Regulatory Authority (FINRA, formerly NASD).² This license qualifies the broker to solicit, purchase, and/or sell all securities products, including corporate securities, municipal securities, options, direct participation programs, investment company products, and variable contracts. Some states also require a broker to pass the *Series 63* exam, which tests his or her knowledge of state securities law. Advisors who wish to sell only open-end mutual funds, initial offerings of closed-end investment companies, and variable contracts must pass the *Series 6* exam. However, before any advisors can sell variable contracts, they must also obtain the appropriate state insurance licenses.

Gramm-Leach-Bliley Act As the financial services industry has become more product integrated in recent years, many brokerage firms have added such product lines as CDs, life insurance, portfolio management plans, and financial planning. In fact, many of the traditional brokerage firms have urged or required their brokers to obtain a financial planning designation, such as the ChFC. As brokerage firms have expanded into these new areas, other types of financial services firms have expanded into their areas. Although the lines between brokerage firms and other financial services firms, particularly commercial banks and

2. FINRA, the largest nongovernmental regulator for all securities firms doing business in the United States, was created in July 2007 through the consolidation of the National Association of Securities Dealers (NASD) and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange (NYSE). As of December 31, 2008, FINRA oversaw nearly 4900 brokerage firms, about 172,000 branch offices, and approximately 665,000 registered securities representatives. For more information, see www.finra.org/web/group/corporate.

insurance companies, have been eroding for years, the erosion accelerated with the passage of the *Gramm-Leach-Bliley Act* in 1999 that repealed the Glass-Steagall Act (the Banking Act of 1933). The Glass-Steagall Act prohibited investment banks from operating commercial banks and vice versa. Indeed, some nonfinancial firms have entered the field, mainly through acquisitions.

The brokerage industry can generally be dichotomized as full-service firms and discount firms. Although few firms are at either extreme, the general distinction is that in full-service brokerage firms, a specific individual handles each account. The emphasis is on personalized service, including such things as investment research advice. Full-service brokers will contact their clients to suggest trades. In discount firms, accounts are with the firm. Clients simply place an order with the firm rather than with a specific broker. A discount broker never calls a client to initiate a trade. Accounts at discount firms are for investors who want to manage their own accounts and seek to minimize the cost of maintaining their accounts.

Floor Brokers

Floor brokers are employees of firms who are members of an exchange and execute trades on the exchange floor on behalf of their firm's clients. Floor brokers receive orders from their firm and execute only those orders. Thus, they are different from floor traders, who can buy and sell for their own account. When a client places an order with his or her brokerage firm, it is transmitted to a floor broker or a floor trader for execution on the trading floor.

Designated Market Makers

Designated Market Makers (DMMs)

The stock exchanges (described in the next section) base their trading on Designated Market Makers (DMMs). The Designated Market Maker (DMM) is charged with making a market in a particular security. DMMs are the only participants in any market who have true accountability for maintaining a fair and orderly market and perform the duties previously assumed by market specialists. Among other important tasks, DMMs combine both a physical auction managed by the DMMs and a completely automated auction that includes quotes from other DMMs and other market participants. The DMMs have the obligation to maintain an orderly market in their stocks and to quote at the national best bid (or offer) a specified percentage of the time. They also facilitate price discovery throughout the day as well as at the open, close, and in periods of significant imbalances.

Registered Competitive Market Makers (RCMMs)

floor traders Individuals called registered competitive market makers (RCMMs) or *floor traders* serve a role as a backup specialist.³ RCMMs own exchange seats and trade for their own account. However, they also have "a specific Exchange-imposed obligation to enhance the quality of NYSE markets by injecting their own or their firms' capital into difficult market-making situations. At the request of an Exchange official, an RCMM must make a bid or offer that narrows an existing quote spread or improves its depth. An RCMM may also be asked to assist a commission broker or floor broker in executing a customer's otherwise nonexecutable order. The failure of an RCMM to enter into trading upon request can result in a financial penalty, suspension, or even loss of the use of one's membership.

Institutions in the Market

Any two people can get together and trade a stock or any other investment, just as they can trade a used car. The one catch with regard to trading securities directly is that the issuer of the security must be notified of the change in ownership. The stronger and more effective the institutional structure for trading securities is, the stronger the economy of that country. Economies that depend on direct trading are extremely weak. The United States has the strongest and deepest set of trading institutions of any country in the world.

The Stock Exchanges

seat **New York Stock Exchange.** In terms of the market value of trades, and the market value of companies listed on an exchange, the dominant trading institution for many years has been the New York Stock Exchange (NYSE). Historically, only members could transact business on the exchange, and only listed securities could be traded. A membership was referred to as a *seat*, and there were 1,366 seats for most of the history of the exchange.

After 212 years as an independent trading organization, the NYSE entered into a merger agreement with the Archipelago Exchange on April 20, 2005. The combined entity is known as the NYSE Group, Inc., and is a publicly held company. To date, it does not appear that the merger has affected the way that business is handled on the NYSE itself.

3. The RCMM title is used at the NYSE. The Amex uses the title of *registered trader or market maker* for essentially the same function.

As of October 31, 2009, the NYSE had 3,995 listed companies with a market value of approximately \$15 trillion. Of these, 453 were non-U.S.-based companies, whose market value was about \$7.1 trillion.⁴ The number of securities listed on the NYSE is well over 3,000, because many companies list not only their common stock on the exchange but their preferred stock, warrants, and rights as well. To be listed on the exchange, a company must apply, pay initial and any annual listing fees, and meet certain initial and continuing listing market value and accounting value requirements.

curb exchange **American Stock Exchange.** For many years, the next-largest exchange has been the American Stock Exchange (Amex). The Amex started out as a group of traders who met on a particular street to trade securities. After World War II, the group opted to become more formal and move indoors. Because of its early trading location, the Amex carries the nickname the *curb exchange*, which refers to a street curb.

Traditionally, the Amex has been the exchange for firms too small to be listed on the NYSE. Currently there are about 1,000 stocks listed on the Amex. The Amex is one of the largest exchanges for the trading of options, and it also provides bond trading.

dual listing **The Regional Exchanges.** The NYSE and Amex are national exchanges in that their listings are national, and even international, in nature. There are five other exchanges around the country that are known as regional exchanges. A regional exchange has substantially lower listing requirements than the Amex, and it specializes primarily in companies located in that region. In addition, some of the regional exchanges accept NYSE-listed companies for *dual listing*, meaning that the company is traded on both exchanges.

One of the largest regional exchanges is the Chicago Stock Exchange (CSE). It currently lists over 4,000 stocks, which includes stocks dually listed with the NYSE, the Amex, or the NASDAQ as well as its own exclusive listings. A major regional exchange is the National Stock Exchange (formerly the Cincinnati Stock Exchange) that is now strictly an electronic exchange without formal trading floors.

4. See "Listed Companies" at www.nyse.com, as of October 31, 2009.

NASDAQ and the Over-the-Counter Market**over-the-counter
(OTC)**

The *over-the-counter (OTC)* market is any trading done by a dealer. Almost any dealer can decide to make a market in any stock in which he or she thinks there is a profit to be made from such trading. Dealers profit from the bid-ask spread. There are over 35,000 securities in this market. The main problem with this system is the lack of public information. Since OTC stocks are not traded publicly, it is “buyer beware” on fees and other conditions controlling the trade.

The National Association of Security Dealers Automated Quotation (NASDAQ) system was formally organized in 1971 as the world’s first electronic market in order to provide price quotations from the OTC market. This NASDAQ market is divided into two sectors: the NASDAQ National Market System (which includes about 3,000 companies) and the NASDAQ SmallCap Market (which includes about 850 companies). This market is the largest U.S. electronic market and on average trades more shares daily than any other U.S. market.⁵

The OTC market remains the primary one for bond trading. Commercial paper, large CDs, municipal bonds, and other money market instruments trade primarily in similar OTC markets. Unlike the exchanges with specialists, the OTC market is a dealer market. More than one dealer may make a market in a particular security. Thus, when a broker is executing a trade in the OTC market, he or she is obligated to find the best price among the various dealers. The broker may attempt to negotiate a better price with a dealer, or a broker may end up acting as a dealer for the trade. In this last situation, the broker is obligated to provide a price that is as good or better than he or she could have obtained externally for the client.

The Third and Fourth Markets

Most trading and virtually all trades involving individual clients take place on an exchange or in the traditional OTC market for unlisted issues. Institutional investors, on the other hand, make significant use of two other markets. OTC trading of listed stocks constitutes what is called the third market. The fourth market is an informal arrangement for direct trading between institutions. Both the third and fourth markets involve off-exchange trading of what are usually large blocks of exchange-traded stock. The third and fourth markets provide institutions with a less costly way of trading.

5. See "Overview" at www.finra.com, October 31, 2009.

Transactions in the Market

Transaction Fee Components

There are three components to the transaction fees a client pays when trading. One is explicit, and the other two are implicit. They are:

- commissions (explicit)
- bid-ask spread (implicit)
- price concession (implicit)

Commissions. When a group of brokers got together in New York City in 1792 to formalize the origin of the NYSE with the so-called Buttonwood Agreement,⁶ they included a rate-fixing clause. Later, the NYSE prohibited exchange-member firms from trading listed securities off the exchange. This restriction stayed in place until the late 1960s when the NYSE began to make special exceptions to the fixed-rate schedule. Finally, the SEC mandated the fixed-commission schedule be abolished on May 1, 1975 (known in the industry as May Day), and that each brokerage firm would be free to set its own schedule. The full-service firms have the higher commission rates, but they will gladly negotiate with their largest customers. The discount brokerage firms can have some incredibly inexpensive rates, especially those that emphasize Internet service. Because it is always explicitly stated and easily understood, the commission will be the one component of trading costs on which most investors focus. This could be a mistake.

Bid-Ask Spreads. To make a market in securities, OTC dealers and stock exchange specialists quote both a bid price at which they will buy and an ask price at which they will sell. For example, a dealer in TAC Stock might give quotes of 20 bid and 20¼ asked. This means the dealer is willing to buy stock from an investor for \$20 per share and sell it to the investor for \$20.25 per share. What makes a dealer happy is if someone places an order to sell to the dealer 100 shares of the stock at \$20 per share, and then a few seconds later someone else places an order to buy 100 shares of the stock at \$20.25 per share. In this case, the dealer will make a profit of \$.25 per share, or \$25 on the 100 shares. This is known as the bid-asked spread, and it is the dealer's sole source of income. The bid-asked spread is a necessary component for effectively functioning markets.

6. The agreement was named for the buttonwood tree where the brokers met.

Spreads tend to represent a smaller percentage of the price for higher-priced and more actively traded stocks. Listed stocks generally have lower bid-ask spreads than those traded over-the-counter. In the OTC market, the number of dealers making a market in a particular stock is a function of the expected volume in the stock. The more volume there is, the more dealers there are, and the smaller the bid-asked spread. Conversely, the smaller the volume, the fewer dealers and the larger the bid-asked spread. The purchase of an obscure, thinly traded stock in the OTC market can involve a substantial transaction fee in the form of the bid-ask spread.

Price Concessions. Price concessions may occur on large trades. Although dealers and specialists stand ready to provide a bid-ask quote to anyone at anytime, this quote is only for a limited number of shares. Thus, suppose an investor wants to sell 10,000 shares, and the specialist's quote is good only for the first 1,000 shares. When a specialist is asked for his quotes, he or she does not know which way the broker wants to trade (that is, buy or sell). However, when the broker sells 1,000 shares the first time, then the specialist knows the broker is likely looking to sell a large amount of additional shares. Sooner or later, the specialist will start lowering his bid-ask prices as his inventory grows beyond the desired number of shares. This adjustment in the bid-ask spread as larger orders are processed is the price concession.

Types of Orders

market order

Market and Limit Orders. There are only two types of orders that almost all investors use: the market order and the limit order. A *market order* means an immediate execution at the best available price. If a specialist is quoting a stock at 23 bid and 23.25 ask, a market order to buy would generally result in a purchase at 23.25 and a market order to sell in a sale at 23. Naturally, if the order is placed on an exchange, one always hopes that a matching order arrives on the trading floor at the same time and the floor brokers can make the trade at a price within the bid-ask range.

limit order

trading station (post)

A *limit order* to buy sets the maximum price the investor is willing to pay, and a limit order to sell sets the lowest price an investor will accept. A good way to remember this is to think of a limit order as an order that sets a limit on how much the customer is willing to pay. A market order ensures a transaction, but the price is uncertain. A limit order ensures a good price, but only if the trade takes place. When an order is received, a floor broker takes this order

to the section of the exchange floor where this stock is traded (*trading station*, or *post*) and attempts to execute it. In the case of a limit order, if the order cannot be quickly executed, the representative will turn the order over to the specialist for that stock. The order will then be put on the specialist's book for later execution, if possible.

It is important to remember that there may be more than one limit order placed at a particular price. Suppose that several times during the last week a stock's price has bounced between \$23 and \$24. Several investors interested in buying this stock might all come to the same conclusion that a limit order to buy at \$23 might make sense. When this happens, limit orders are placed in a queue. In this case, there may be so many orders at this price, that even if a few other investors are willing to sell at \$23, it is possible that not all the orders in the queue will be executed. This would be particularly true if some sort of news developed that meant that no one was willing to sell at any price less than \$23.50. It can be quite frustrating to have placed a limit order, see that trading has taken place at that price, and then learn one's own limit order is still in the queue (albeit the order has moved up in the line).

A Planning Pitfall

Suppose a stock is trading at 23.40 bid and 23.65 ask. An investor notes that the stock has traded as high as 24.00 in recent days, and so places a limit order to sell at 24. If in fact the stock rises to 24 in the next few days, the investor will make an additional \$60 profit for each 100 shares owned. However, if the stock were to drop to \$20 over the next few days, the investor would receive \$340 less per hundred shares than he or she would have received with a market order.

Everyone feels like a market genius as long as his or her limit orders are eventually executed and they save a little something on the purchase price or make some extra profit on the sale price. However, the first time the limit order causes the investor to miss a bigger profit or take a bigger loss, that may be the last limit order the person uses.

Time Limit on Orders. Because market orders require immediate execution, specifying how long to keep trying to fill the order is not necessary. Limit orders, in contrast, may be entered either as good til canceled (GTC) orders or as executable for a specified period. An order can be placed to remain on the books till the end of that trading day (day order), till the end of that trading week (week order), till the end of that month (month order), or for some other period (good through date). These orders are canceled automatically at the close of the designated trading period. Fill-or-kill orders must be either executed immediately or canceled.

Period for Which an Order Is Executable
<ul style="list-style-type: none"> • GTC order: executable until filled or canceled • Day order: executable only during the day the order is placed • Fill-or-kill order: canceled if not immediately executed

Short Selling

short selling

Most of the time, investing involves buying a security, hoping that the price goes up, and then selling it. This is referred to as taking a long position, or going long. Being long in XYZ stock means one owns XYZ stock. It is possible to reverse this sequence of events, that is, sell a security one does not own, hope the price goes down, and then buy the security back at a lower price. This is known as *short selling* or selling short, and it is a perfectly legal practice. The short seller borrows the shares from his or her broker and sells them at the current market price. The short seller's broker borrows the shares from someone else's account. The short seller then owes the brokerage firm (actually, the lender) the shorted shares. Being short in XYZ stock means one has borrowed and sold the stock, and has an obligation to return it in the future.

The customer whose stock is borrowed is just as secure as a bank depositor whose funds are loaned out by the bank. If the lender wishes to sell the loaned stock, the brokerage firm simply borrows replacement shares from another customer or brokerage firm. If a loan of additional shares cannot be made to return the shares to the original lender, then the short seller must buy the shares in the open market and return those shares.

The short seller hopes the price will fall far enough so that when the stock is repurchased, he or she will make a profit after covering trading costs. This gain would be reduced somewhat by commissions on the short sale and the covering (repurchase) transaction. Furthermore, while there is no specific time horizon on short positions, the short seller must pay any dividends accruing on the borrowed stock.

EXAMPLE
<p>Shorting 100 shares at \$50 and then repurchasing them (covering the short position) at \$35 produces a gross profit of \$1,500 ($100 \times [\\$50 - \\$35]$) minus commissions and accrued dividends. However, should the stock price increase to \$65, the seller would show a loss of \$1,500 ($\\$100 \times [\\$50 - \\$65]$) plus commissions and accrued dividends.</p>

One limit to short selling is the brokerage firm's ability to borrow stock to facilitate the short sale. For widely held stocks, this need to find shares to sell short is generally not much of a problem. Sometimes, however, the interest in selling a less widely held stock short is so great relative to the shares available to short that brokerage firms run out of available shares. This situation is particularly likely for small companies in which only a few people hold the shares and/or none of the brokerage firm's other customers hold these shares in their accounts. Simply put, it may not be physically possible to short certain stocks. Similarly, an investor who shorts a stock may be required by his or her brokerage firm to close the position if the firm finds that it can no longer borrow the shares needed to maintain the short position.

A Planning Pitfall

If a client goes long on a particular stock, the most he or she can lose is 100 percent of his or her investment. If a client shorts a particular stock, he or she may lose many times that amount. Suppose a client shorts 1,000 shares of Obscure Research Labs at \$50 per share, and overnight the company announces it has found a cure for cancer. The price of the stock could easily open at \$500 or more per share. The client might well be forced into bankruptcy to cover the repurchase and return of these shares!

Trading Issues

Street Name

street name Most investors leave their holdings in their account with their broker. These securities are referred to as being in *street name*. This is because the name of the brokerage firm is the only name of which the company issuing them is aware. Thus, if a client owns 10,000 shares of Citibank and the stock is in street name, then Citibank is completely unaware that the client owns this stock. Despite the use of street name, it is the investor who legally retains beneficial ownership. Street-name registration offers secure storage. Remember, accounts at most firms are covered by the SIPC for up to \$500,000. In addition, most brokerage firms supplement the SIPC coverage by purchasing additional insurance to protect their customers.

Street name also allows securities to be traded without new certificates having to be issued, and it relieves investors from having to deliver their certificates to their brokers when they sell securities. Since June 1995, all trades must be settled within 3 trading days. Therefore, in the case of the sale

of securities not held in street name, investors must either deliver them to the broker before the sale, or get them to the broker immediately upon sale.

Furthermore, an investor who holds a diversified portfolio of securities and who changes his or her address needs to file only one change of address notice with the brokerage firm, rather than notifying all the companies separately. In addition, investors receive only one Form 1099 from their brokerage firm, rather than separate ones for each stock owned. This can be a tremendous convenience when it is time to file one's tax returns.

Advantages of Street-Name Registration

- Secure storage
- Lets securities be traded without new certificates being issued or investors having to deliver certificates to the broker in a timely manner
- Allows customers who move to file only one change of address
- Single Form 1099

Stock Certificates

In this day of computerized accounting and electronic transfers, using stock certificates to prove ownership is similar to a cash-only payment system. Stock certificates must be issued whenever a stock is ordered out. Virtually all financial institutions and most individuals leave their holdings in street name. As such, appropriately safeguarded bookkeeping entries have largely eliminated the need for stock certificates. The National Securities Clearing Corporation (NSCC) minimizes stock certificate reissues. It records all members' transactions, verifies the consistency of their accounts, and reports net positions daily. NSCC members settle within the clearinghouse rather than between individual brokerage firms. Moreover, the Depository Trust Company (DTC) immobilizes many certificates by holding member firms' securities. Securities traded between members can be handled internally by simply debiting one account and crediting another.

Types of Accounts

discretionary account

Discretionary and Wrap Accounts. In a *discretionary account*, the investor appoints a broker or financial advisor to buy or sell on his or her behalf without prior consent.

These accounts may also be known as controlled accounts or managed accounts. There are generally two rationales for opening a discretionary

account. One is that, although the investor continues to be the primary decision maker, he or she does not want to miss an attractive trading opportunity if the broker cannot reach the investor in a timely manner. The other rationale for a discretionary account is that the investor wants his or her broker to act as the portfolio manager and to make the trades that he or she deems appropriate for the account. An alternative to a discretionary account is the limited discretionary account, in which the investor gives the broker or advisor the authority to make only certain types of trades without prior consent. Discretionary accounts can be of any size.

wrap account Similar to a discretionary account is the *wrap account*. Some firms also refer to this as a separate account or managed account, although this latter term could simply mean a discretionary account. In wrap accounts, a single annual fee known as a wrap fee is paid. This covers all commissions as well as any other expenses incidental to the account. In discretionary accounts, the only income to the broker is the commission from each trade. Wrap accounts can be solicited, whereas discretionary accounts are opened as a matter of convenience to clients. There is always a minimum size to open a wrap account; many firms require assets of at least \$100,000.

churning Discretionary accounts create an obvious potential for conflict of interest on the part of the broker in that he or she may make some trades for the primary purpose of enhancing his or her commission income rather than for the benefit of the client, a practice known as *churning*. In a wrap account, churning would be counterproductive because the fee for the account is fixed and independent of the amount of trading activity.

It is tempting to compare wrap accounts to mutual funds. The wrap fee usually appears to be much larger than the management fees paid on a mutual fund. Nonetheless, there may be some advantages to a wrap account. These include:

- customization. The portfolio can be tailored to an individual's specific needs. Clients may choose not to hold a particular company or industry for personal, ethical, or economic reasons.
- tax efficiency. Optimal tax treatment can be achieved.
- simple fee structure. The single wrap fee makes the cost of the account clear, unlike the complex and sometimes hidden nature of fees in a mutual fund.

cash account

Cash, Margin, and Option Accounts. When one opens an account, an account number is assigned. The account is also classified as to what activities the investor is allowed to do. The most basic account is the *cash account*. This is sometimes referred to as a Type 1 account. To buy stock in a cash account, an investor must have sufficient cash already in the account to complete the purchase. Almost anyone can open a cash account, although some brokerage firms require a minimum opening deposit of something like \$10,000 to do so.

margin account

The next classification is a *margin account*, otherwise known as a Type 2 account. In a margin account, an investor can borrow money from the brokerage firm to purchase stocks. Brokerage firms are fussier about who is allowed to open a margin account. For example, they will frequently run credit checks on prospective clients, as well as require the customer to sign a separate margin account agreement. Anyone with a margin account must also have a cash account. The distinction between the accounts is transparent to the investor, as both accounts have the same account number, and thus are grouped together on the same monthly statement. Short sales can only occur in a margin account. Also, because any securities bought in a margin account serve as collateral for any money borrowed to buy the securities, all securities in a margin account must be left in street name. Another benefit of margin accounts is that one can also borrow money from the broker for other purposes, pledging the securities in the account as collateral. If an investor has both types of accounts, then it is usually the case that marginable stocks are bought in the margin account and nonmarginable securities are held in the cash account. The Fed sets the rules for which stocks are marginable and which are not. However, a brokerage firm may add its own restrictions regarding what is marginable.

option account

The third category of accounts is the *option account*, sometimes referred to as a Type 3 account. It is in this account where trades in puts and calls occur. An investor opening an option account must sign a statement indicating he or she fully understands the risks inherent in option trading.

Bond Trading

Most trading of bonds takes place in the over-the-counter (OTC) market. Bond quotations usually include the name of the company issuing the bond, along with the coupon rate and year of maturity, the current yield, volume,

closing price, and net change. An example of what corporate bond quotations might look like in a trade publication is shown on the following page.

The buyer of a bond normally pays an amount equal to the sum of three numbers: the price of the bond, accrued interest, and commission. The price quote shows the price of the bond only. The exchange where the bond is traded tracks the accrued interest. The accrued interest involves the buyer paying and the seller receiving monies to reflect the portion of interest that has already been earned but not yet paid.

EXAMPLE

A bond that is quoted at \$93 would initially cost the buyer \$930 in principal plus the accrued but unpaid interest (plus commission). If the bond has a 10 percent coupon paid semiannually and made its last coupon payment 3 months ago, unpaid interest would have accrued for 3 months; that is, because the bond pays interest every 6 months, and 3 months have elapsed, half of one coupon payment has accrued. This corresponds to an amount of \$25.

As with dividends on stock, interest is paid to the holder of the bond on the day of record. When the issuer makes the coupon payment, the new owner of record will receive the entire amount of interest for that period. Hence, in the above example, if the buyer is still holding the bond 3 months later, the buyer receives the full semiannual interest payment of \$50. Half of the \$50 is a reimbursement for the \$25 of accrued interest paid to the seller, and the other half is the interest actually earned by the buyer.

flat

Bonds trading for a net price that does not reflect any accrued interest are said to be trading *flat*. Typically, bonds that are in default or whose interest payments are considered uncertain trade flat. In bond quotations, bonds that trade flat have an "f" following their name.

Examples of Corporate Bond Quotations				
Bonds	Cur. <u>Yld.</u>	<u>Vol.</u>	Close	<u>NetChg.</u>
Att6s09	6.6	4	90½	-1/8
Hilton5s08	cv	130	82	-1
Polaroid111/2	f	489	14½	-½

- Bonds: The name of the company issuing the bond, the interest or coupon rate as a percentage of the face or par value (typically \$1,000), and the year in which the bond will be paid off (the "s" that sometimes appears between the interest rate and the year of maturity has no significance other than to separate the interest rate from the year of maturity when the interest rate does not include a fraction—read the explanatory notes given in the financial media for the meaning of other letters used)
- Cur. Yld.: The current yield, calculated by dividing the coupon amount by the current price. Flat bonds show no current yield, and convertible bonds have the letters "cv" listed here.
- Vol.: The actual number of bonds traded
- Close: The bond trading price of the day, which is stated as a percentage of par value
- Net Chg.: The difference between the closing price as listed in the Close column and the closing price from whatever day the bond previously traded, which is usually the previous trading day

Regulation of Markets and Advisors

Because securities markets are "clothed with the public interest," they are regulated. It is important that both financial advisors and their clients understand the nature and direction of this regulation. Let us consider some of the more significant laws and regulations that affect the investment process today.

Securities Act of 1933

The first significant modern legislation to protect investors was the Securities Act of 1933. This is often referred to as the "truth in securities" law. This act essentially prohibits deceit, misrepresentations, and other fraud in the sale of securities.

Banking Act of 1933

Although it does not directly involve the securities market, an equally important piece of legislation involved the creation of the Federal Deposit Insurance Corporation (FDIC) under the Banking Act of 1933. The initial amount of deposit coverage was quite low, but the coverage has been raised steadily over the years to where it now stands at \$100,000, a sum that vastly exceeds what most people have on deposit as a cash reserve or emergency fund to meet unexpected contingencies.

Securities Exchange Act of 1934

self-regulatory organizations

insider trading

The next major legislation quickly followed the first. It was the Securities Exchange Act of 1934. This law created the SEC and charged it to oversee the provisions of the 1933 Act. It also empowered 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 securities self-regulatory organizations. The various stock exchanges, such as the NYSE and Amex, are *self-regulatory organizations*, as is the FINRA (formerly the NASD). The 1934 Act also requires publicly traded firms to file periodic financial statements with the SEC (Forms 10K and 10Q)⁷, the exchanges where they are traded, and their stockholders (annual reports). In addition, trading by insiders (that is, persons with access to key information before it is announced to the public) must be reported to the SEC because *insider trading* is prohibited by the 1934 Act.

Maloney Act of 1938

The Maloney Act, which amends the Securities Exchange Act of 1934, gives the SEC the power to delegate securities industry regulation of broker/dealers and the OTC market to securities trade and professional associations that register with the SEC. To date, only one association has ever registered under this act, namely the NASD (now the FINRA). Its regulatory responsibilities include registration and testing of securities professionals and review of their advertising and sales literature.

Insurance advisors who sell variable products are considered registered representatives of the insurer's broker/dealer and are required to be both

7. Form 10K is filed annually. As it contains basically the same information as the annual report, some firms take their annual report to the shareholders, attach a few pages with additional required information, and make that their 10K report. The 10Q report is the quarterly report. It provides unaudited financial results for each of the firm's first three fiscal quarters.

cognizant of and compliant with the FINRA rules. In addition, they must also sit for qualification tests to demonstrate professional competence before selling variable products.

The reach of the FINRA, however, does not stop with testing; it goes far beyond into the everyday sales practices used by insurance advisors. Sales literature, advertising, and most public-oriented written communications are subject to FINRA regulatory review. Even home office employees involved in the sale and distribution of variable products are subject to FINRA rules and registration.

Investment Company Act of 1940

This act requires that investment companies disclose their financial condition and investment policies to investors when stock is initially sold and, subsequently, on a regular basis. It is because of this act that anyone buying a mutual fund must receive a prospectus at the time of purchase and on a regular basis thereafter.

Investment Advisors Act of 1940

The Investment Advisors Act of 1940 is perhaps the most important legislation in terms of its regulatory impact on financial advisors. The act seeks to protect the public from harmful and fraudulent conduct of persons who are paid to advise others on buying and/or selling securities. It was aimed at two categories of advisors: those who publish market reports or newsletters for paying subscribers that contain recommendations concerning securities, and those who advise individual clients about securities. A major purpose of the law was, and still is, to reveal conflicts of interests that may cause the advisor to make recommendations more in his or her own interest than in the client's interest.

The act sets out a scheme of federal regulation for investment advisors. The key question for financial planning advisors posed by the act is whether or not they are considered investment advisors. If they are, they are required to register with the SEC.

**registered
representative
(RR)**

Who Is Subject to the Investment Advisors Act? To sell securities products and work as a financial planning advisor, you need to register with a governmental regulator. There are three basic ways to become registered:

**investment
advisor
representative
(IAR)**

- *registered representative (RR)*. When you work for a broker/dealer, your supervisor, manager, or employer will tell you what licenses, exams, and registration you need to be able to sell the services and products the broker/dealer offers. The broker/dealer will instruct you on what forms, agreements, and records to keep, and what payouts, commissions, or salary you will receive. You will be a registered representative under your broker/dealer's FINRA registration. (See the earlier discussion under **Brokers, Dealers, and Brokerage Firms**.) If you change your broker/dealer, you will need to transfer your registration to your new broker/dealer.
- *investment advisor representative (IAR)*. If you join an independent firm, you will register as an IAR of the independent advisory firm. Again, your supervisor will tell you how and where to register.
- *registered investment advisor (RIA)* Registration as an investment advisor is discussed below.

**registered
investment
advisor (RIA)**

The SEC takes the position that the Investment Advisors Act of 1940 governs the regulation of financial planning advisors. The act defines an investment advisor as any person who, for compensation, engages in the business of advising others as to the value of securities or the advisability of acquiring or disposing of securities. Any person who falls within the act's definition (unless expressly excluded from the definition or exempted from the registration requirements) and who makes use of the mails or any instrumentality of interstate commerce is required to register with the SEC pursuant to the act.

The Supreme Court defined what constitutes a security in the 1946 landmark case *SEC v. T.W. Howey Co.* In that case, the Court ruled,

The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.

Under this test, virtually every investment that a financial planning advisor might recommend for his or her clients would appear to qualify as a security. The term security has been interpreted to include not only marketable securities traded on an organized exchange (such as the New York Stock Exchange) but also such instruments as limited partnerships, mutual funds, certificates of deposit, commercial paper, variable annuities, and variable

life insurance. However, merely dealing with a security does not, by itself, make someone an investment advisor. Note that as 2009 draws to a close Congress is considering sweeping legislation that may change the securities regulatory landscape considerably.

Three Tests. In the 1980s, the SEC issued three tests to determine whether or not individuals must register as an investment advisor. If all three tests are answered in the affirmative, registration is required. If any of the tests is answered in the negative, there is no need to become a registered investment advisor. The SEC's three tests are as follows:

- security advice test—the individual or entity must give advice or analysis concerning securities. The advice need not relate to specific securities but may focus on the advisability of investing in securities in general. The SEC has determined that a person who deals with securities in general or who advises as to the advantages and disadvantages of investing in securities vis-à-vis other financial vehicles (for example, life insurance) meets this test. Virtually any person who presents himself or herself as a financial planning advisor will render advice concerning securities.
- security business test—the individual or entity must be engaged in the business of advising others regarding securities. Providing advice with some regularity, even when it is not the person's primary business activity, is an important factor in subjecting the person to the act. A person is deemed to be "in the business" if he or she does any of the following:
 - holds himself or herself out as an investment advisor
 - receives separate or additional compensation that is a clearly definable charge for providing advice about securities
 - provides specific investment advice in other than isolated instances
- compensation test—the individual or entity must be in receipt of compensation. The compensation can be in any form and from any source. Even though a person does not charge a separate fee for advice concerning a security, if he or she receives some form of advisory fee, a fee relating to total services rendered, a commission, or some combination thereof in connection with this advice, he or she meets the compensation test.

Under this three-pronged definitional test, all of the elements must be present in order to require an individual to register as an investment advisor. Given

the broad scope of each of the definitional elements, those advisors engaged in financial planning activities are highly likely to be included in the act's definition of an investment advisor.

It is important to remember that the purpose of the SEC in devising the three tests is to protect clients from fraud and other abusive situations. The SEC does not guarantee the competence or investment abilities of any individuals who register under the act; it merely seeks to provide a mechanism for discouraging unethical behavior, principally via full disclosure to clients.

Avoiding Registration as an RIA for Insurance Advisors. Many insurance advisors involved in the sale of variable products will find it difficult not to answer the compensation test in an affirmative manner. Therefore, the second test (security business) becomes the key issue. If you do not wish to be an RIA, do not present yourself as a full-fledged financial planning advisor to the public. Exercise caution when developing a name for your business. Get approval for any business name from your insurance company or broker/dealer.

Also, take a look at your state's law. Some states, such as Maryland and Washington, have very strict criteria as to what constitutes being a financial planning advisor. For instance, using such designations as Chartered Financial Consultant (ChFC) can be enough to trigger registration. Insurance advisors who wish to avoid registration should also keep four other factors in mind:

- Make it clear to your clients that you are a financial advisor who is selling insurance. Do not try to hide the identity of the product. Trying to recast an insurance policy as a mutual fund is one example not only of a violation of ethics, but also of a legal matter that indicates the need for compliance with SEC registration requirements.
- Up-front fees may be a tempting source of income, but if you want to avoid registration, do not charge clients for your professional advice.
- Base your income on regular commissions. Again, to avoid registration, do not charge advisory fees.
- Follow your company guidelines. If your company is affiliated with a broker/dealer, in all likelihood it has specified methods of operating the business in a manner that can avoid the necessity of registering as an investment advisor. Ignoring these guidelines is an invitation to becoming an RIA.

RIA: Weighing the Responsibilities, Advantages, and Disadvantages.

An individual who becomes an RIA assumes a series of responsibilities. For some individuals, the advantages offered by RIA status outweigh any potential disadvantages. For others, these responsibilities outweigh the advantages of being an RIA.

Whether or not you choose to register as an investment advisor depends in part on the type of practice you wish to develop and the guidelines drafted by your company. Some companies discourage their advisors from being RIAs because of the potential for added legal liability that the company and the advisor share. Other companies leave registration up to the discretion of their individual advisors.

Summarized below are some of the advantages and disadvantages you may wish to take into consideration before deciding whether or not to conduct your practice as an RIA.

Advantages. If you are an RIA, you have the ability to charge fees for your professional advice and planning services. For those who wish to move away from a dependence on commissions, this can be a substantial reason to become an RIA.

Registering as an investment advisor also affords you far greater latitude in how you advertise and promote your practice. Your cards and letterhead can indicate that you are engaged in providing investment advice. As an RIA, you can indicate that you develop financial planning programs and investment achievement strategies for clients. You can expand your practice in investment planning and asset management, and you can move into markets calling for a wider array of product and service needs.

Disadvantages. To register as an investment advisor, you must pay application fees. Although these are not onerous, they are a factor to be considered.

Being an RIA also involves substantial paperwork. As an RIA, you must maintain meticulous records regarding the advice you give to clients, and you must also comply with regulatory reporting requirements. Perhaps the greatest disincentive to being an RIA is the potential for substantial legal liability. You are clearly inviting clients to rely on your expertise and investment advice. If your expertise is limited or your investment advice imprudent, you are likely to find yourself named in a lawsuit. In addition,

an RIA is legally held to a higher professional standard than that normally applied to an individual who is engaged solely in the sale of insurance.

Securities Investor Protection Act of 1970

Securities Investor Protection Corporation (SIPC)

As part of the Securities Investor Protection Act of 1970, Congress set up the *Securities Investor Protection Corporation (SIPC)*. It is patterned after the Federal Deposit Insurance Corporation (FDIC), with the objective of protecting customer property. The SIPC is a nonprofit, nongovernmental, membership corporation funded by member broker/dealers, although it does have the privilege of borrowing from the SEC if its own funds are inadequate to meet its obligations.

Virtually all broker/dealers registered with the SEC are SIPC members; those few that are not must disclose this fact to their customers. SIPC's power to protect customers of former SIPC members ends 180 days after the member loses SEC registration. The SEC normally does not terminate a broker/dealer's registration if it knows that the broker/dealer owes securities or cash to customers. Customers can therefore better protect themselves and assist the SEC by reporting a broker's failure to return cash and/or securities promptly.

Customers are insured by the SIPC for up to \$500,000, not more than \$100,000 of which may be in cash. Note that the \$100,000 protection for cash applies only to cash that is left on deposit incidental to transactions. Cash in a brokerage account for the purpose of earning interest is not covered by the SIPC.

Although \$500,000 is adequate coverage for most customers, many brokerage firms purchase additional insurance coverage for their customers. Coverage of \$2,000,000 or more per account is not unusual. For clients with large holdings of financial assets, a financial advisor should make sure the assets are with a brokerage firm with adequate insurance coverage.

Gramm-Leach-Bliley Act of 1999

As noted earlier, this act repeals the last vestiges of the Glass-Steagall Act of 1933. It modifies portions of the Bank Holding Company Act to allow affiliations between banks and insurance underwriters. While preserving the authority of states to regulate insurance, the act prohibits state actions that have the effect of preventing bank-affiliated firms from selling insurance on an equal basis with other insurance advisors.

Sarbanes-Oxley Act of 2002

This act mandates a number of reforms to enhance corporate responsibility and financial disclosures and to combat corporate and accounting fraud.

For example:

- it requires CEOs and CFOs to personally certify their firms' financial condition as a fair representation, and subjects these officers to personal penalties for misrepresentation
- it limited auditors from providing other services to their clients, so that the auditing process is not biased by the prospect of consulting fees

TAX TREATMENT OF INDIVIDUAL INVESTORS

Investors are able to retain only the after-tax component of their returns. The after-tax return of an investment is similar to a worker's take-home pay. It is the part of the return available to the investor after various governments take their cut. Because not all types of investment income are taxed equivalently, tax considerations are an important factor in deciding which investments to purchase. The tax treatment of an investment is particularly relevant for investors in high tax brackets. To understand how investment income is taxed, we need to examine our tax system's basic makeup.

taxable income

The individual federal tax return on Form 1040 has a relatively complex structure. First, income from wages, salaries, and most other sources (including investment income) is added to compute total income. (Certain items of income, such as municipal bond interest, are excluded because they are tax free at the federal level.) Total income is then reduced by certain deductions, such as alimony paid by the taxpayer, to arrive at adjusted gross income (AGI). AGI is then reduced by personal exemptions and either itemized deductions or the standard deduction. The result of this series of calculations is called *taxable income*. This sum is the amount on which tax liability is based. The actual tax liability incurred depends on both the individual investor's taxable income and filing status (married filing jointly, unmarried head of household, unmarried or single, and married filing separately).

Itemizing deductions is advantageous to the taxpayer if allowable deductions exceed the standard deduction. Deductions are allowed for charitable contributions, certain employee business expenses (above a threshold), some types of interest payments, unreimbursed medical expenses (above a

threshold), casualty losses (above a threshold), and most types of property taxes, as well as state and local income taxes or state and local general sales taxes (but not both types of taxes).

effective marginal tax rate It should be noted that at higher income levels a taxpayer's *effective marginal tax rate* may be higher than his or her statutory *marginal tax rate*. This can happen as a result of the phaseout rules that reduce the taxpayer's itemized deductions and personal and/or dependency exemption amounts as his or her adjusted gross income increases. The effective marginal rate for an upper-income taxpayer depends on the level of his or her adjusted gross income, the amount of his or her itemized deductions, and the number of personal and/or dependency exemptions that he or she can claim. The calculation of the effective marginal rate for an upper-income taxpayer is beyond the scope of this discussion.

Taxation of Extra Income

effective tax rate Additions to total income almost always increase taxable income. Moreover, except when a taxpayer is in the lowest tax bracket, extra taxable income is taxed at a marginal tax rate that is higher than the *effective tax rate* (that is, taxes paid divided by taxable income) because of the progressive structure of the federal income tax system. A taxpayer in the lowest tax bracket has an effective tax rate that is equal to his or her marginal tax rate. Under current law, the six basic federal income tax rates are 10, 15, 25, 28, 33, and 35 percent.

An individual's taxable income results from adding investment income to other forms of income (after subtracting appropriate deductions). Thus we can view investment income as the last increment of taxable income. If the investment income had not been received, taxable income would have been less by that amount. Taxes would then be reduced by the amount of the investment income not received multiplied by the tax rate on that increment of income. The last increment of income is always taxed at the marginal tax rate. Therefore, the marginal tax rate is the relevant rate to use in assessing most investment decisions.

Different tax brackets apply to the various filing statuses. For example, single filers reach the higher tax brackets at lower levels of income than joint filers do. Although Congress may change the tax rates from time to time, each

investor's marginal rate (whatever its current level) remains the relevant rate for most investment decisions.

Tax laws are discussed in the sections that follow. While tax laws are frequently revised, most revisions are relatively minor, although some result in substantial changes. The possibility of tax law changes increases both the complexity and the desirability of financial planning, especially its tax planning and investment planning components. Serious investors need to stay abreast of the current tax laws. They may well want to change their investment strategies and adjust their portfolios in light of actual and/or anticipated tax law changes.

Taxation of Investment Income

Whether, and if so how, the income from an investment is taxed can have a major impact on the net return that the investor receives. Accordingly, effective tax planning is an important aspect of investment planning. The form of investment income determines how it is taxed.

Interest income on savings accounts, corporate bonds, and U.S. government obligations (as well as most obligations issued by federal and government-sponsored agencies) is taxed as ordinary income (that is, like wages and salaries), whereas the interest income on state and local (municipal) government obligations is (with a few exceptions) untaxed at the federal level. Capital gain on the sale of municipal obligations, however, is subject to capital gains taxation. After any relevant expenses are deducted, rents, royalties, and most dividends are also taxed as ordinary income.

qualified dividends

However, even though *qualified dividends* are classified as ordinary income (as opposed to capital gains), they are nonetheless eligible for the same lower tax rates that apply to long-term capital gain income. If the regular tax rate that would apply is 25 percent or higher, both qualified dividends and long-term capital gains are subject to a 15 percent rate. If the regular tax rate that would apply is lower than 25 percent, both qualified dividends and long-term capital gains are subject to a 0 percent rate (after the 2007 tax year).

In order for dividends to qualify for the 0 percent or 15 percent maximum rate, they must meet all of the following requirements:

ex-dividend date

- The dividends must have been paid by a U.S. corporation or a qualified foreign

corporation. This includes dividends paid directly to taxpayers by corporations as well as those passed through by mutual funds.

- The dividends are not a type of nonqualified dividend.
- Taxpayers receiving the dividends must have held the stock for more than 60 days during the 121-day period that begins 60 days before the *ex-dividend date*. Preferred stock is subject to a longer holding period.

capital distributions

Dividends not covered by current profits are considered *capital distributions*. These distributions are not taxed when received but do affect the taxable capital gains or losses on such assets when they are sold. Capital gains and losses are subject to special tax treatment.

Capital Gains and Losses

Capital gains basis

Capital gains and losses arise whenever capital assets (essentially, any assets that are held for investment purposes, such as stocks or bonds) are bought and sold for different amounts. Normally, the taxable gain equals the sale price (minus commissions) minus the purchase price (plus commissions). Any capital distributions must, however, be subtracted from the purchase price to determine the *basis*. The basis is the sum that is subtracted from the sale price to produce the taxable gain.

EXAMPLE

Suppose 100 shares of the BDC Company are purchased for \$25 per share and sold for \$35 per share. The taxable gain (ignoring commissions) would normally be \$1,000 ($\$3,500 - \$2,500$). Prior capital distribution dividends of \$500 would, however, reduce the basis from \$2,500 to \$2,000. Such distributions would have the effect of increasing the taxable gain to \$1,500 ($\$3,500 - \$2,000$).

realized gains recognized gains

Capital gains or losses are subject to rather complicated tax treatment. The basic rule is that short-term gains (gains on assets sold after being held 1 year or less) are taxed as ordinary income, whereas long-term gains (gains on assets sold after being held for more than 1 year) are generally subject to a maximum tax rate of 0 percent or 15 percent that depends on the taxpayer's tax bracket. Unrealized gains (appreciation on assets that have not yet been sold) are

not subject to tax. Gains only become taxable if and when they are realized. *Realized gains* are the economic gains that a taxpayer obtains from the sale (or exchange) of an asset. As a general rule, any gains realized on the sale (or exchange) of an asset must also be recognized. And realized gains only become *recognized gains* when they are included in the taxpayer's gross income for federal income tax purposes.

Taxes are applied to the net gain or loss. Thus, a taxpayer who has some capital losses may deduct the amount lost on some transactions from any gains or other transactions to arrive at the net gain or loss. A separate net figure is computed for both short- and long-term gains or losses.

If both short- and long-term gains are positive, the taxpayer is taxed at his or her ordinary income tax rate on the short-term gains and at the 0 percent or 15 percent maximum rate on the long-term gains. If, however, either short- or long-term transactions result in a net loss figure, that amount is netted against the opposite gain. If the net gain is short term, it is taxed as ordinary income, and if it is long term, the 0 percent or 15 percent maximum applies.

If the overall net number shows a loss or if there are only short-term and long-term losses, the taxpayer may use the loss to offset ordinary income. Generally, up to \$3,000 of capital losses may be deducted from ordinary income (married filing separately taxpayers are limited to \$1,500) in any 1 year. If the net capital loss is greater than \$3,000, the excess may be carried forward and used to offset capital gains and/or ordinary income in subsequent years.

The Alternative Minimum Tax

Individuals with large amounts of tax-sheltered income (accelerated depreciation, and so on) or high itemized deductions may be subject to the alternative minimum tax (AMT). To determine whether the AMT applies, tax liability is first computed in the regular way. Then all of the includible tax-sheltered items are added back to adjusted gross income and certain allowable deductions are subtracted to obtain the income subject to the AMT. The individual's tax liabilities computed for the two different ways (regular and AMT) are then compared. The higher of the two tax figures is the one that must be paid. When an individual pays taxes based on the AMT, his or her marginal tax rate becomes the AMT tax rate.

State and Local Taxes

Investment income may also be subject to state and local taxation. U.S. Treasury obligations (as well as most obligations issued by federal and government-sponsored agencies), however, may be exempt from state and local taxation. Moreover, state and local obligations typically are not taxed within the state that issued them. In contrast, those obligations issued by other jurisdictions typically are fully taxed in the owner's own state and local residence jurisdiction.

Implications of Investment Tax Treatment

Those whose incomes put them in high tax brackets will find tax-sheltered investments particularly attractive. Stated another way, a given tax-free yield is worth more to people in higher tax brackets. Note that state taxes, exemption and deduction phaseouts, and the AMT have the effect of raising the tax rates of higher-income investors.

Since investors are able to retain only the after-tax portion of their investment returns, they tend to focus on the portion of the return they get to keep. This means that for two otherwise similar investments with the same before-tax return, investors would prefer the one with the higher after-tax return. For example, a tax-free payment stream of \$100 per month is worth more than an otherwise equivalent payment of \$100 per month that is taxable. Indeed, for an investor in the highest (35 percent) tax bracket, a \$100-per-month tax-free income stream is worth more than a \$150-per-month taxable income stream. Accordingly, asset prices generally reflect the way their returns are taxed. If other characteristics, such as risk, are the same, a tax-free or tax-sheltered payment stream will be priced higher than a payment stream of equal size that is fully taxable. Pricing investments in this way produces a trade-off. Investments that offer a tax-free or tax-sheltered return are priced to offer a lower before-tax return than otherwise equivalent investments whose returns are fully taxed. Thus, for example, the before-tax yields of tax-free bonds are generally well below otherwise equivalent taxable bond returns. A lower tax-free return may or may not be more attractive than a higher taxable return for a particular investor. Which investment offers the highest after-tax return depends on both the level of the two pre-tax returns and on the investor's tax bracket.

The market-determined trade-off between fully taxed and tax-deferred income reflects the average tax impact on the relevant investors. Different investors, however, face different tax rates. Some investors (for example,

nonprofit charities and college endowment funds) do not incur taxes on their investment income, while others pay taxes at various marginal rates (10, 15, 25, 28, 33, and 35 percent). A fully taxable return of 10 percent might be equivalent to an after-tax return of 9 percent, 8.5 percent, 7.5 percent, 7.2 percent, 6.7 percent, or 6.5 percent, depending on the investor's tax bracket. State and local income tax rates further complicate the after-tax cash flow comparisons, as does the AMT and the phaseout of exemptions for higher-income taxpayers. Thus, the after-tax return on a given investment depends, among other things, on the particular investor's tax bracket.

Table 1-3 Tax Treatment of Various Types of Investment Income	
Types of Investment Income	Tax Treatment
Capital distributions on stock Interest on state and local (municipal) bonds	Not subject to federal income tax
Unrealized capital gains	Tax deferred until realized
Nonqualified dividends and interest income (other than municipal bond interest) Rents, royalties and any other investment income payments Short-term capital gains and short-term capital gain distributions (net of capital losses) Payments from deferred income plans, 401(k) plans, and IRAs	Taxed at ordinary income tax rates
Long-term capital gains and long-term capital gain distributions Qualified dividends	Maximum tax rate of 0% or 15% depending on tax bracket

Suppose tax-free bonds offer a 7.2 percent yield, while otherwise similar taxable bonds offer 10 percent. An investor in the 28 percent tax bracket would earn the same net return on either investment ($.72 \times 10\% = 7.2\%$). Investors in higher brackets will retain more from the tax-free investment, whereas those in lower brackets will receive a higher after-tax return from the taxable investment. Thus tax-sheltered investments will normally offer those in very high tax brackets relatively higher net returns, while those in below-average tax brackets will find fully taxed investments more attractive.

In general, the following formula converts a tax-exempt yield to an equivalent taxable yield:

$$\text{Equivalent fully taxable yield} = \text{Tax-exempt yield} \div (1 - \text{MTR})$$

where MTR is the investor's marginal tax rate

A second formula converts a fully taxable yield to an equivalent tax-exempt yield:

$$\text{Equivalent tax-exempt yield} = \text{Fully taxable yield} \times (1 - \text{MTR})$$

To use these formulas, the tax-exempt yield or the fully taxable yield must be expressed as a percentage, while the marginal tax rate must be expressed as a decimal.

CHAPTER SUMMARY

Investment planning is one of the six major planning areas that falls under the financial planning umbrella. As a component of financial planning, the role of investment planning is to accumulate funds to facilitate goal achievement. Exactly how the client goes about accumulating funds is what investment planning is all about. Investment planning requires the use of a six-step process that is nothing more than the six-step financial planning process adapted to investment planning. The six steps of this process are (1) establish and define the advisor-client relationship, (2) set investment goals and gather client data, (3) analyze the data, (4) develop an investment policy statement and present it to the client for approval, (5) select and make investments, and (6) monitor the portfolio.

There are five distinct phases in an individual's financial life cycle. These phases are (1) early career, (2) career development, (3) peak accumulation, (4) preretirement, and (5) retirement. Together these five phases span a person's entire financial life.

The secondary market is what most people think about when the stock market is mentioned. The players in this market include brokers, dealers, brokerage firms, floor brokers, specialists, and floor traders. The major institutions that make up the secondary market include the stock exchanges, the NASDAQ system, and the OTC market. The transactions in the secondary market involve various fees and orders. Also important to trading in the

secondary market are the types of accounts that investors can establish with their brokers and whether they should leave their holdings in street name. Because securities markets are "clothed with the public interest," they are regulated. Both financial advisors and their clients need to understand exactly how this regulation affects the investment process.

Because not all types of investment income are taxed equivalently, tax considerations are an important factor in deciding which investments to purchase. Accordingly, effective tax planning is an important aspect of investment planning. The form of investment income determines how it is taxed.

Interest income on savings accounts, corporate bonds, and U.S. government obligations (as well as most obligations issued by federal and government-sponsored agencies) is taxed as ordinary income (that is, like wages and salaries), whereas the interest income on state and local (municipal) government obligations is (with a few exceptions) untaxed at the federal level. Capital gain on the sale of municipal obligations, however, is subject to capital gains taxation. After any relevant expenses are deducted, rents, royalties, and most dividends are also taxed as ordinary income. However, even though qualified dividends are classified as ordinary income (as opposed to capital gains), they are nonetheless eligible for the same lower rates that apply to long-term capital gain income. Capital gains and losses arise whenever capital assets (such as stocks and bonds held for investment purposes) are bought and sold for different amounts.

CHAPTER REVIEW

Key Terms and Concepts are explained in the Glossary. Answers to the Review Questions and Self-Test Questions are found in the back of the book in the Answers to Questions section.

Key Terms and Concepts

comprehensive approach	cash account
multiple-purpose approach	margin account
single-purpose approach	option account
Financial Life Cycle	flat
primary market	self-regulatory organizations
secondary market	insider trading
Series 7	registered representative (RR)
Series 6	investment advisor representative (IAR)
Gramm-Leach-Bliley Act	registered investment advisor (RIA)
Designated Market Makers (DMMs)	Securities Investor Protection Corporation (SIPC)
floor traders	taxable income
seat	effective marginal tax rate
curb exchange	marginal tax rate
dual listing	effective tax rate
over-the-counter (OTC)	qualified dividends
market order	ex-dividend date
limit order	capital distributions
trading station (post)	Capital gains
short selling	basis
street name	realized gains
discretionary account	recognized gains
wrap account	
churning	

Review Questions

1. Describe the financial planning process.
2. What determines whether a financial advisor is engaged in financial planning?
3. Distinguish the selling/planning process from the financial planning process.
4. Identify the six major planning areas that fall under the financial planning umbrella.
5. Explain the role of investment planning as a component of financial planning.
6. What is the relationship of the investment planning process to the financial planning process?

7. Identify the five phases in an individual's financial life cycle.
8. Distinguish the primary market from the secondary market.
9. Distinguish a broker from a dealer.
10. What are the five essential functions performed by a specialist?
11. What is the NASDAQ market?
12. Distinguish the third market from the fourth market.
13. Briefly describe the principal types of buy and sell orders.
14. Explain what is meant by selling short.
15. Describe the advantages of street name registration.
16. What is the significance of the Maloney Act?
17. Briefly describe the three tests that determine whether a financial advisor must register with the SEC as an investment advisor.
18. What are the six basic federal income tax rates for individual taxpayers?
19. Describe the requirements for dividends to qualify for the 0 percent or 15 percent maximum tax rate.
20. What is the holding period for gains on assets sold to be considered long-term gains?

Self-Test Questions

Instructions: Read the chapter first, then answer the following questions to test your knowledge. There are 10 questions; circle the correct answer, then check your answers with the answer key in the back of the book.

21. The practice by a broker of making some trades for the primary purpose of enhancing his or her commission income rather than benefiting clients is known as
 - (A) short selling
 - (B) insider trading
 - (C) churning
 - (D) dual listing
22. In which of the following life-cycle stages is the client usually headed toward maximum earnings and greatest opportunity for wealth accumulation?
 - (A) career development
 - (B) peak accumulation
 - (C) preretirement
 - (D) retirement

23. Which of the following individuals own stock exchange seats and trade on the exchange floor for their own accounts?
- (A) specialists
 - (B) floor brokers
 - (C) dealers
 - (D) floor traders
24. Which of the following legislation requires that anyone buying a mutual fund receive a prospectus at the time of purchase?
- (A) Investment Company Act of 1940
 - (B) Investment Advisors Act of 1940
 - (C) Securities Investor Protection Act of 1970
 - (D) Gramm-Leach-Bliley Act of 1999
25. Which of the following statements concerning the taxation of state and local (municipal) obligations at the federal level is (are) correct?
- I. Interest income from municipal obligations is taxed as ordinary income.
 - II. Capital gain on the sale of municipal obligations is not subject to capital gains taxation.
- (A) I only
 - (B) II only
 - (C) Both I and II
 - (D) Neither I nor II
26. Which of the following statements concerning itemizing deductions is (are) correct?
- I. It is advantageous if allowable deductions exceed the standard deduction.
 - II. Deductions are allowed for some types of interest payments and most types of property taxes.
- (A) I only
 - (B) II only
 - (C) Both I and II
 - (D) Neither I nor II

27. Which of the following statements concerning capital gains and losses is (are) correct?
- I. Basis is the sum that is subtracted from the sale price to produce the taxable gain.
 - II. Generally, up to \$10,000 of net losses may be deducted from ordinary income in any 1 year.
- (A) I only
 - (B) II only
 - (C) Both I and II
 - (D) Neither I nor II

READ THE FOLLOWING DIRECTIONS BEFORE CONTINUING

The questions below differ from the preceding questions in that they all contain the word EXCEPT. So you understand fully the basis used in selecting each answer, be sure to read each question carefully.

28. All the following are types of accounts that an investor may open with a brokerage firm EXCEPT
- (A) a margin account
 - (B) a discretionary account
 - (C) a floor account
 - (D) a wrap account
29. All the following statements concerning the federal taxation of investment income are correct: EXCEPT
- (A) Interest income on savings accounts, corporate bonds, and U.S. government obligations is taxed as ordinary income.
 - (B) Interest income on state and local (municipal) government obligations generally is untaxed at the federal level.
 - (C) Qualified dividends are eligible for the same lower tax rates that apply to long-term capital gains.
 - (D) Short-term capital gains are subject to a maximum tax rate of 5 percent or 15 percent depending on overall income.

30. Corporate bond quotations usually include all the following EXCEPT
- (A) the bond's issuing company
 - (B) the bond's investment rating
 - (C) the bond's year of maturity
 - (D) the bond's coupon rate